Balance of Payment Disequilibrium

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Abstract: *The balance of payment of a country summarises all the transactions that have taken place between its residence and foreigners in a given period of time, usually a year. The research was undertaken to provide an insight over BOP disequilibrium in Indian economy for the period from 2006 to 2011. BOP cannot remain in equilibrium always. Disequilibrium is inevitable resulting in surplus or deficit balance of payment. But Initiating corrective mechanisms will help us to minimize the extent of disequilibrium.*

Keywords: Balance of payment disequilibrium, current account, capital account, double entry system, deficit, surplus, export, import, credit, and debit.

Introduction

In the realm of international finance, one of the most heavily used data sources is an accounting statement known as the Balance of Payment, which records the economic transactions between the residents and government of a particular country and the residents and the governments of the rest of the world, during a given period of time. BOP comprises of current account, capital account and financial account services, income and current transfers. In the capital account, transactions of capital transfers, capital acquisition and non-produced non-financial assets like buildings and patents are included, while in the financial account, transactions relating to financial assets and liabilities like portfolio investments and foreign exchange reserves are included.

Certain forces determine the volume of these transactions, how they are brought into balance, what problems arise when they fail to balance and what policies are available to deal with these problems are some of the issues to be dealt with.

Balance of Payment Accounting

The BOP conforms to the principle of double entry book keeping. This means that every international transaction should produce debit and credit entries of equal magnitude. It is important to mention here that BOP is neither an income statement nor a balance sheet. It is a sources and uses of funds statement that reflects changes in assets, liabilities and net worth during a specified period of time. Decrease in assets and increases in liabilities or net worth represent credits or sources of funds. Increase in asset and decreases in liabilities or net worth represent debits or uses of funds. In accordance with the principle of double entry book keeping, sources and uses should always match.

The basic convention applied in constructing the balance of payments is the double-entry accounting system. Every transaction is represented by two entries with equal values but opposite signs, a debit (−) and a credit (+). By convention, certain items are recorded as debits and others as credits, as follows:

- Exports of goods and services Credit (+)

- Imports of goods and services Debit (−)
- Increase in financial liabilities Credit (+)
- Increase in financial assets Debit (−)
- Decrease in liabilities Debit (−)
- Decrease in assets Credit (+)

Background

In particular, a country's own balance of payments is important to investors, multinational companies, business managers, consumers and government officials because it affects the value of its currency, its policy towards foreign investments and also influences important macroeconomic variables like gross national product, interest rates, price levels, employment scenario and exchange rate. The monetary and fiscal policy of a country also takes into account the BOP position of a country. International managers may be interested in a foreign country's balance of payment for predicting the country's overall ability regarding exports, imports, the payment of foreign debts and dividend remittance. Country experiencing severe balance of payment deficit is not likely to import as much as it would in a surplus situation. Persistent and continuing deficit in a country's BOP may signal future problems over payment of dividends and interest fees or other cash disbursements to foreign investors. Also the balance of payment is an important indicator of the likely pressure on a country's foreign exchange rate and the resultant foreign exchange gains or losses which firms trading with that country are likely to face.

Research methodology

Type of Research

For the purpose of the study descriptive type of research has been used.

Statement of the Problem

India's Balance of payment on its current account has been negative from past many years. The scenario still continues to prevail leading to balance of payment disequilibrium. But the BOP statements are balanced every year by introducing an item called 'Errors & Omissions'. The present study is focused on throwing light to various aspects of Balance of payment disequilibrium.

Research Objectives

- To analyze the major components and sub-components of BOP statement that brings about disequilibrium
- To enumerate the causes for disequilibrium in the Indian economy.
- To enumerate the long term consequences of current account deficit in Indian economy
- To measure the level of correlation between current account and capital account

Method of Data Collection

Secondary data: Study relies on secondary sources namely Articles, Journals, Newspapers, etc.

Data Analysis Tool

- To analyze the trend of various components of BOP, trend analysis has been used.

Scope of the Study

- Scope of the study extended to the field of framing fiscal policy.
- Current account convertibility
- Capital account convertibility and its implication on economic development of a country
- Currency valuation and exchange rate movements.

Limitation of the study

- Extensive study on balance of payment disequilibrium.
- Study relies on secondary sources.
- Only the data from 2006 to 2011 is used for the study.

Analysis and interpretation

Various components of BOP statement and their balances have been observed and the respective trend movements for the period of study have been analyzed and interpreted.

Table 1: Current Account Balance

Years	Current Account
2005-06	-43737
2006-07	-44383
2007-08	-63479
2008-09	-127631
2009-10	-180626
2010-11	-202532

Source: http://www.rbi.org.in

In Table 1 we can see that the current account deficit in India is increasing year by year showing a downward trend. If we analyse further we can infer that the merchandise and invisibles being the major constituents of the current account, it is the merchandise deficit i.e. more imports that contributes majorly to current account deficit.

Table 2: Merchandise Balance

Years	Merchandise
2005-2006	-229664
2006-2007	-279962
2007-2008	-367664
2008-2009	-547452
2009-2010	-560746
2010-2011	-595028

Source: http://www.rbi.org.in

The merchandise balance in table 2 is representing a negative trend year by year i.e. In India the imports are more than the exports. More goods are imported every year to satisfy domestic consumption. Increased demand for foreign goods also act as a major reason for the merchandise deficit

Table 3: Business Service Balance

Years	Business services
2005-2006	6928
2006-2007	-5762
2007-2008	961
2008-2009	14622
2009-2010	-31563
2010-2011	-17430

Source: http://www.rbi.org.in

The business services in table 3 are representing a negative trend over the years as more services are availed rather rendered that has resulted in deficit balances.

Table 4: Software Services Balance

Years	Software services
2005-2006	100803
2006-2007	131144
2007-2008	148526
2008-2009	200634
2009-2010	228169
2010-2011	258538

Source: http://www.rbi.org.in

In table 4 we can see that the software services have gained momentum over the years with increasing surplus balances we can infer that the trend remains to be positive.

Table 5: Financial Services Balance

Years	Financial services
2005-2006	1090
2006-2007	550
2007-2008	357
2008-2009	6856
2009-2010	-4211
2010-2011	-4419

Source: http://www.rbi.org.in

We find a negative trend with respect to financial services as the balance in table no 5 as it shows surplus to a minimum extent between 2005-2008. but later on deficit balance has started.

Table 6: Overall Services Balance

Years	Services
2005-2006	102611
2006-2007	133064
2007-2008	156244
2008-2009	248406
2009-2010	169843
2010-2011	217058

Source: http://www.rbi.org.in

With regard to services it is difficult to infer upward or downward trend. From the year 2005, we could witness increasing inflow of funds from services rendered but in the year 2009, there is a decrease in flow of funds accompanied by an increase in the succeeding year.

Table 7: Capital Account Balance

Years	Capital account
2005-2006	111965
2006-2007	203673
2007-2008	427926
2008-2009	26018
2009-2010	252132
2010-2011	273133

Source: http://www.rbi.org.in

In table 7 we can see that the capital account is following a positive upward trend with increasing inflow of funds. Among the constituents of capital account, it is the foreign investments that take lead in bringing capital account surplus through a contribution from foreign direct investments and portfolio investments.

Table 8: Foreign Investment Balance

Years	Foreign investment
2005-2006	68782
2006-2007	66791
2007-2008	174395
2008-2009	22685
2009-2010	243641
2010-2011	172154

Source: http://www.rbi.org.in

While analyzing table 8 we can see that the Foreign investments are not signifying any downward or upward trend. In the year 2009-2010, we can infer that inflow of funds due to foreign investments is higher than any other years for the period from 2005 to 2011.

From table no 9, we can infer that there was a steady increase in FDI surplus upto 2009-2010 but in 2010-2011 it has come down by Rs.56899 crs. There is more FDI inflow than outflow.

Table 9: Foreign Direct Investment Balance

Years	FDI
2005-2006	13425
2006-2007	34910
2007-2008	63776
2008-2009	87734
2009-2010	89675
2010-2011	32776

Source: http://www.rbi.org.in

Table 10: Portfolio Investment Balance

Years	Portfolio investment
2005-2006	55357
2006-2007	31881
2007-2008	110619
2008-2009	-65049
2009-2010	153966
2010-2011	139378

Source: http://www.rbi.org.in

We can infer that portfolio investments are not signifying any upward or downward trend. There is volatility in terms of inflow and outflow of funds over the years with larger surplus and a deficit in 2008-2009.

Table 11: Loans Balance

Years	Loans
2005-2006	34397
2006-2007	110434
2007-2008	163491
2008-2009	34800
2009-2010	61673
2010-2011	126993

Source: http://www.rbi.org.in

From table 11, we can infer that there is surplus flow of funds through loans. Inflow is more than outflow of funds. More loans have been procured by the country for developmental activities.

Table 12: Banking Capital Balance

Years	Banking capital
2005-2006	5795
2006-2007	8477
2007-2008	47155
2008-2009	-19205
2009-2010	9844
2010-2011	22025

Source: http://www.rbi.org.in

From table 12, we can infer that comparatively inflow is greater than outflow and there is surplus in every year except in 2008-2009 when there was deficit banking capital.

Table 13: Errors And Omission Balance

Years	Errors & omissions
2005-2006	-2332
2006-2007	4344
2007-2008	5241
2008-2009	4498
2009-2010	-7269
2010-2011	-11152

Source: http://www.rbi.org.in

According to the requirement of balancing the BOP, errors and omissions have been introduced every year either as a negative value or positive value in order to balance the BOP. From table no 13, we can see that in the year 2010-2011there was huge difference between current and capital account with that of monetary movement resulting in introducing higher negative Errors and omission value.

Table 14: Monetary Movements Balance

Years	Monetary movements
2005-2006	-65896
2006-2007	163634
2007-2008	-369689
2008-2009	97115
2009-2010	-64237
2010-2011	-59449

Source: http://www.rbi.org.in

Monetary movement represents the change in reserves. From above table we cannot ascertain a particular trend as there is deficit and surplus balance alternatively.

Table 15: Correlation Between Current And Capital Account

Years	Current account	Capital account
2005-2006	-229664	111965
2006-2007	-279962	203673
2007-2008	-367664	427926
2008-2009	-547452	26018
2009-2010	-560746	252132
2010-2011	-595028	273133

Karl pearson's coefficient of correlation

Value obtained**:-0.047751637**

There is a highly negative correlation between current account and capital account. The balance of statement as a whole would fully balance without any surplus or deficit but in reality deficit or surplus is inevitable and this gives rise to negative correlation. Accordingly the deficit or surplus of current account can be set off against surplus or deficit of capital account. But a very high negative correlation signifies that any surplus received will have to be wholly transferred to finance the deficit alone and hinders any investment activities for the development of the nation.

Discussion and Findings

- Merchandise-There is an upward negative trend. The net cash inflow is reducing yearly.
- Invisibles: (including services, transfers, income)- upward positive trend.
- Current account: outflow more than inflow.
- Foreign direct investment increasing yearly with large inflow and relatively low outflow.
- Portfolio investment follows the same suit.
- Loans and Bank capital: Inflow more than outflow. The level of import has increased tremendously. we are becoming more dependent on imports
- Service industries booming rapidly like travel, transport and business services.
- The future foreign investment and its returns seem to be bright from Indian perspective.
- Increase in loans depicts higher investment activities.
- At no point debit will be equal to credit.
- There will be a surplus or deficit balance of payment.
- Deficit in current will be compensated by surplus in capital account and vice versa.
- Surplus capital account is due to future claims arising from capital account transaction which is not possible in current account.

Causes of disequilibrium in balance of payment statement

- Population Growth: Most countries experience an increase in the population and in some like India and China the population is not only large but increases at a faster rate. To meet their needs, imports become essential and the quantity of imports may increase as population increases.
- Development Programmes: Developing countries which have embarked upon planned development programmes require importing capital goods, some raw materials which are not available at home and highly skilled and specialized manpower. Since development is a continuous process, imports of these items continue for the long time landing these countries in a balance of payment deficit..
- Demonstration Effect: When the people in the less developed countries imitate the consumption pattern of the people in the developed countries, their import will increase. Their export may remain constant or decline causing disequilibrium in the balance of payments.
- Natural Factors: Natural calamities such as the failure of rains or the coming floods may easily cause disequilibrium in the balance of payments by adversely affecting agriculture and industrial production in the country. The exports may decline while the imports may go up causing a discrepancy in the country's balance of payments.
- Cyclical Fluctuation: Business fluctuations introduced by the operations of the trade cycles may also cause disequilibrium in the country's balance of payments. For example, if there occurs a business recession in foreign countries, it may easily cause a fall in the

exports and exchange earning of the country concerned, resulting in a disequilibrium in the balance of payment

- Inflation: An increase in income and price level owing to rapid economic development in developing countries, will increase imports and reduce exports causing a deficit in balance of payments.
- Flight of Capital: Due to speculative reasons, countries may lose foreign exchange or gold stocks People in developing countries may also shift their capital to developed countries to safeguard against political uncertainties. These capital movements adversely affect the balance of payments position.
- Globalisation: Due to globalisation there has been more liberal and open atmosphere for international movement of goods, services and capital. Competition has beer increased due to the globalisation of international economic relations. The emerging new global economic order has brought in certain problems for some countries which have resulted in the balance of payments disequilibrium.

Conclusion

The research was undertaken to provide an insight over BOP disequilibrium in Indian economy for the period from 2005 to 2011.BOP cannot remain in equilibrium always. Disequilibrium is inevitable resulting in surplus or deficit balance of payment. Initiating corrective mechanisms will help us to minimize the extent of disequilibrium. One of the prominent methods is to adopt price specie automated adjustment mechanism.

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