Balance of Payments

Current Account Deficit (CAD) Financing

Learning Objectives

- ✓ To understand the concepts of BoP
- ✓ To analyse Financing of CAD

- *The Balance of Payments* (BoP) is a systematic record of all economic transactions between the residents of a given country and the residents of other countries- the rest of the world – carried out in a specific period of time, usually a year.
- Balance of payments account is used on the '*standard double entry system*' of bookkeeping. Thus every entry entered twice, once as a credit item and once as a debit item.

A transaction which increases the external purchasing power of a country is recorded as a credit entry. It represents a source of foreign exchange. Examples of such transactions are:

1. Export of goods or merchandise exports;
2. Export of services like travel, insurance, etc., or invisibles;
3. A capital inflow into the country, i.e. borrowing abroad;

A transaction which reduces the external purchasing power of the country is recorded as a debit entry. It represents the use of foreign exchange reserves. Such transactions are:

1. Merchandise imports and invisible imports;
2. A capital outflow or lending abroad;

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	Credit	Debit	Net
A. CURRENT ACCOUNT			
1. MERCHANDISE			
a. Exports			
b. Imports			
2. INVISIBLES (a+b+c)			
a. Services			
i. Travel			
ii. Transportation			
iii. Insurance			
iv. G.n.i.e			
v. Miscellaneous			
b. Transfers			
i. Official			
ii. Private			
c. Investment Income			
Total Current Account(1+2)			
B. CAPITAL ACCOUNT			
1. FOREIGN INVESTMENT (a+b)			
a. In India			
i. Direct			
ii. Portfolio			
b. Abroad			
2. LOANS (a+b+c)			

CURRENT ACCOUNT

The Current Account records the transactions in merchandise and invisibles with the rest of the world. Merchandise covers exports and imports of all movable goods, where the ownership of goods changes from residents to non-residents and vise versa.

The merchandise trade values exports on f.o.b (free on board) basis are shown as credit items and the imports valued on c.i.f (Cost Insurance and Freight) basis are the debit items. However, the IMF BoP manual provides guidelines for compilation of both BoP statistics prescribing the valuation of both exports and imports on f.o.b. basis.

The current account is a section in a country's balance of payments (BOP) that records its current transactions.

The account is divided into four sections: goods, services, income (such as salaries and investment income) and unilateral transfers (for example, workers' remittances).

The difference between the value of commodity exports and imports is known as the ***Balance of Trade***. If exports exceed imports, the balance of trade is said to be *favourable* and if imports exceed exports the balance of trade will be *unfavourable.*

- The commodity exports and imports entering the balance of trade are called *visible* items because they are recorded at the customs barriers of the country.
- The item *Invisibles* include travel, transportation, insurance, investment income and other miscellaneous items. The credit under the Invisibles comprises the value of services rendered by residents to non residents. Similarly remittances made by residents to non-residents are recorded as debits.

G.n.i.e. implies government not included elsewhere. A credit entry of G.n.i.e includes items like: funds received from a foreign government for the maintenance of their embassy, consulates, etc. in India.

Under the heading ‘miscellaneous)’, a payment to a foreign technical consultant for professional services rendered by him will appear as a debit item.

CURRENT ACCOUNT + -

1. Exports

1a. Goods

1b. Services (includes also income from tourism, insurance, banking, research, etc.)

1c. Income receipts (income generated by the services of our capital 'employed' abroad)

2. Imports

2a. Goods

2b. Services (includes also tourism spending, insurance, banking, research, etc.)

2c. Income payments (income generated by the services of foreign capital 'employed' in our country)

3**. Net unilateral transfers (foreign aid, money sent to the relatives abroad, scholarships for foreigners, etc.)**

4**. Balance on the current account = 1 + 2 + 3**

5. CAPITAL ACCOUNT

(NONRESERVE) FINANCIAL ACCOUNT

6. **Our holdings of assets abroad = purchases of foreign assets**, increase = (-), excluding official reserves, (assets of a

Foreign origin or location owned by the residents of **our** country.) Includes payments by foreigners for our exports.

6a. Direct investment transactions (long term)

6b. Portfolio investment transactions (short term)

7. **Foreigners' assets holdings in our country = sales of our assets to foreigners**, increase = (+), excluding official reserves,

(our assets owned by foreigners.) Includes our payments to foreigners for our imports.

7a. Direct investment transactions (long term)

7b. Portfolio investment transactions (short term)

8. **Balance on non-reserve financial account = 6 + 7**

9. Statistical discrepancy

10. Official settlements balance = 4 + 5 + 8 + 9

OFFICIAL RESERVE TRANSACTIONS

11. **Our official reserves abroad** (purchases of foreign assets), increase = (-)

12. **Our assets used as official reserves by other countries** (sales of our assets to foreign reserves holders), increase=(+)

13. Balance of official reserve transactions = 11 + 12

Current Account Deficit

A current account deficit occurs when a country has an excess of one or more of the four factors making up the account.

When a current transaction enters the account, it is recorded as a credit; when a value leaves the account, it is marked as a debit.

Basically, a current account deficit occurs when more money is being paid out than brought into a country.

What a Deficit Implies

When a current account is in deficit, it usually means that a country is investing more abroad than it is saving at home. Often, the logic dictating a country's investment decisions is that it takes money to make money.

In order to try and boost its gross domestic production (GDP) and future growth, a country may go into debt, taking on liabilities to other countries. It then becomes what is termed as a "net debtor" to the world.

However, a **problematic deficit** can result if a government has not planned out a sound economic policy and used its debts for consumption purposes, not future growth

A current account deficit implies that a country's economy is functioning on borrowed means. In other words, other countries are essentially financing the economy, and hence sustaining the deficit.

When determining the economic health of a nation, it is important to understand where the deficit stems from, how it's being financed and what possible solutions exist for its alleviation.

To do so, we need to look at not only the current account, but also the other two sections of the BOP, the **capital account and the financial account**.

The Capital and Financial Accounts

Foreign funds entering a country from the sale or purchase of **tangible assets - as opposed** to non-physical assets such as stocks or bonds - are recorded in the **capital account** of the BOP. (Again, money entering the account is noted as a credit, and money leaving the account is a debit.)

Financial transactions such as money leaving the country for investment abroad are recorded in the financial account. Together, these two accounts provide financing for a current account deficit.

Financing the Deficit

Public and Private Foreign Funds

Funding channeled into the capital and financial accounts (remember, these accounts finance the deficits in the current account) can come from both public (official) and private sources.

Governments, which account for official capital flows, often buy and sell foreign currencies. Credit from these sales is recorded in the financial account.

Private sources, whether institutions or individuals, may be receiving money from some sort of foreign direct investment (FDI) scheme, which appears as a debit in the income section of the current account but, when investment income is finally received, becomes a credit.

Balanced Financing

To avoid unnecessary extra risks associated with investing money abroad, the financing of the deficit should ideally rely on a combination of long-term and short-term funds rather than one or the other.

If, for example, a foreign capital market suddenly collapses, it can no longer provide another country with investment income.

The same would be true if a country borrows money and political differences cut the credit line.

However, by planning to receive recurrent investment income over the years, such as by means of an FDI project, a country could intelligently finance its current account deficit.