8. Open Economy - Balance of Payments

Q:1 Explain Open Economy?

(A) **Open Economy :-** "An Open economy is one which has better Trading and financial Relationships with Other economies". In open economies, goods, Labour and Capital move easily from one country to other.

"Close Economy has no international economic Relations."

Here GDP = C + I + G

But in open Economy—

GDP = C + I + G + (X - M)

GNP = C + I + G + (X - M) + (R - P)

Balance of payment is the Outcome of an open economy. Due to international borrowing or Lending economy's BOP is in Disequilibrium. i.e BOP surplus or BOP Deficit.

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Q:2 Explain the Concept of Balance of Payments and major division in BOP statement.?

OR Distinguish between Current account and Capitalaccount?

(A) **Balance of Payment (BOP) :-** "The Balance of Payment (BOP) of a Country is a systematic account of all economic transactions between a country and the rest of the world during a year".

Balance of Payment is the difference between all the receipts from Foreign Countries and all the Payments to Foreign Countries.

(B) Meaning :- According to Charles Kindle Berger :-

"The BOP of a Country is a systematic Record of all economic transactions between a Country and the rest of the world during a given Period of time."

According to IMF Publication :-

"The Balance of Payments is a Statistical statement For a given Period which shows-

i) Transactions of goods and sewices, income between the economy and the rest of the world.

ii) Changes in Country's Claims and Liabilities to the rest of world."

(C) Structure of the Balance of Payments :-

Balance of Payment is a Systematic Record is maintained in a Standard Double-Entry Book-keeping method.

The Payments Received from Foreign Countries is enter on Credit Side and Payment given to other Countries is enter on Debit side.

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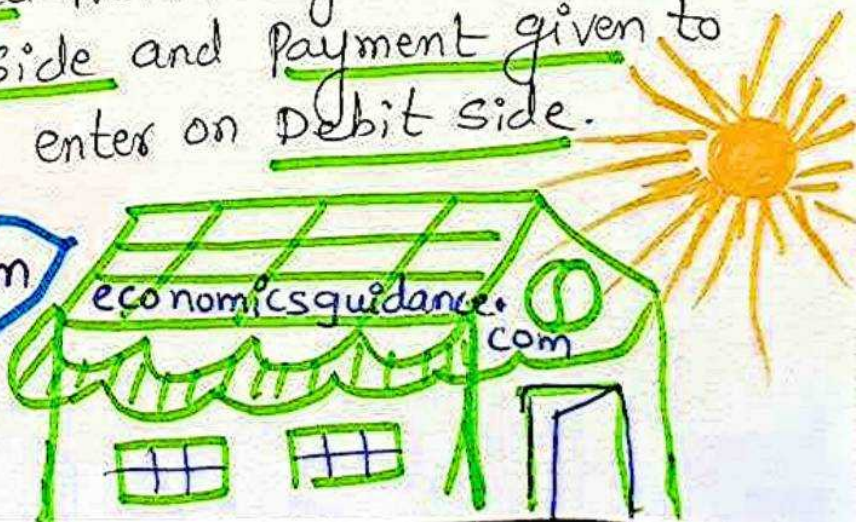

BALANCE OF PAYMENTS Account

Receipts (Credit)	Payments (Debits)
1. Export of Goods	1. Import of Goods
	Trade Account Balance
2. Export of Services	2. Import of Services
3. Interest, Profit and Dividend Received	3. Interest, Profit and Dividend Paid
4. Unilateral Receipts	4. Unilateral Payments
5.	Current Account Balance (1 to 4)
6. Foreign Investment	6. Investment in Abroad
7. Short-term Borrowings	7. Short-term Lending
8. Medium and Long-term Borrowings	8. Medium and Long-term Lending.
9.	Capital Account Balance (6 to 8)
10. Statistical Discrepency (Errors and Omissions)	
11. Overall balance = Current A/c + Capital A/c + Statistical Discrepency = 5 + 9 + 10	
12 Change in reserves (-)	12) Change in reserves (+)
BOP: Total Receipts	= Total Payments

1. Trade Account Balance (BOT)

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"Trade Account balance is the difference between Export and Import OF Visible or Tangible goods"

If the Exports are more than Imports - X > M, there will be Trade Surplus.

If the Imports are more than Exports - M > X, there will be Trade Deficit.

Generally Developing Countries like - India have Deficit trade balance.

The members of Organisation of Petroleum Exporting Countries - OPEC are in a better position on Trade Account balance because demand OF Petroleum, Oil and Lubricants is always increasing.

2. Current Account Balance (1 to 4)

"Current Account balance is the difference between the receipts and Payments on account OF Current Account which includes Trading OF goods and Services"

The Current A/c include →

1. **Services :-** Current A/c include international trade Services like - Transport, Banking insurance, tourism, Education, Entertainment etc. This Service Sector plays an important role in the growth OF a Country.

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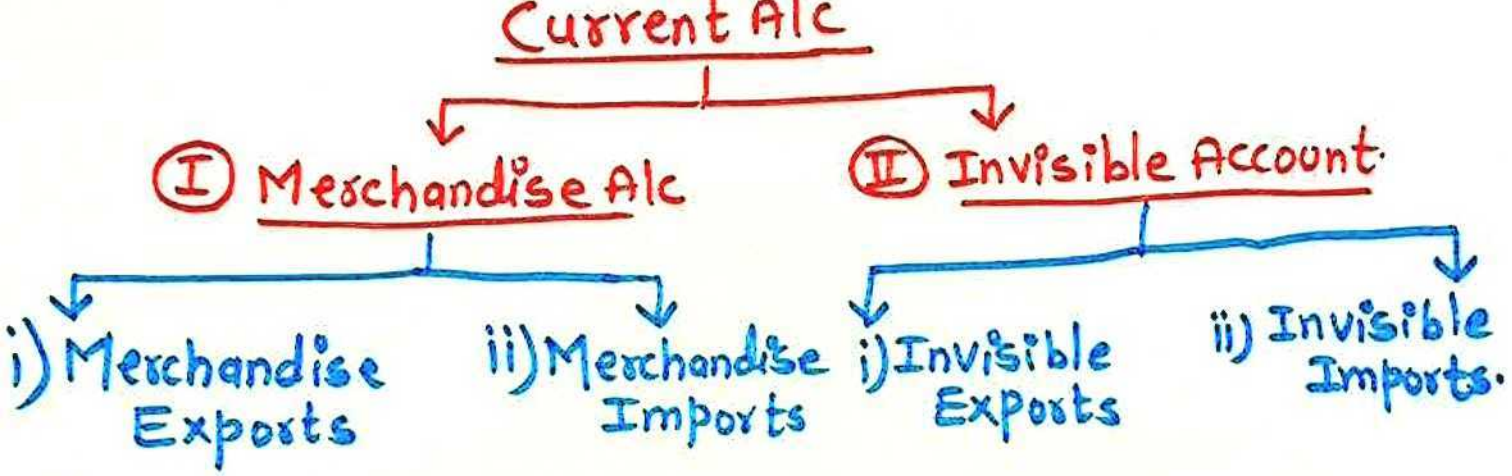
2. **Investment Income :-** When a Country invest in Abroad or invest in Foreign stock Market, It will receive - interest, Profit and Dividend.

Similarly, a developing countries has to pay interest, Profit and dividend on Borrowed Foreign Capital.

3. **Unilateral Flow :-** Countries give or receive donations, grants, gifts and other such Payments. These Payments and Receipts are given on the basis OF Political and humanitarian ground.



i) The Merchandise Exports means sale of goods to Foreign Countries which generate Monetary claims on Foreigners.

ii) The Merchandise Imports means Purchase of goods From Foreign Countries which generate Foreign claims on Domestic Country.

iii) The Invisible Exports means Sale of Services Such as banking, insurance, transport, shipping etc to Foreign Countries.

iv) The Invisible Imports means Purchase of Services from Abroad. Here Home Country make Payments to Foreign Country.

(3) Capital Account Balance :- "It is difference between receipts and Payments on account of Capital account."

a) Foreign Investment :-

i) It include FDI mostly taken by multinational Corporations.

ii) Portfolio investment i.e Purchase of financial assets for short-term and Long-term.

b) Short-term Borrowings :- These borrowings

are mostly for the Period of 5 years or Less. To reduce the deficit in Current A/c Countries borrow funds from commercial banks for short-Period.

c) Medium Term and Long-Term Borrowings :-

Countries borrow Medium term and Long-term funds from government of other Countries or International Financial Institutions Like- IMF, World Bank etc.

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Types of Capital A/c

i) Private capital A/c ii) OFFICIAL Capital A/c

i) The Private Capital A/c shows capital balance held by Commercial banks, Corporates etc.

ii) The Official (Government) Capital A/c shows capital Assets and Liabilities of government Organisations.

(4) Statistical Discrepency (Errors and Omissions)

The Double Entry book-Keeping Principle Says that every Credit has a debit, then only Balance of Payment will be Properly balanced.

But in Reality, BOP may not balance due to errors and omissions. Errors may be due to statistical differences and omissions. Sometimes, Few transactions may not recorded properly.

Example:- An Indian working in Abroad Sent $ 50,000 to India and it is not recorded in BOP. Then BOP Should increase by $ 50,000 due to error of Omission

(5) OVer all Balance :-

OVer all balance means Sum total of Current A/c, Capital A/c and Statistical Discrepancie

OVer All Balance = Current A/c + Capital A/c + Statistical Discrepancies

IF the Total Payments are more than Total Receipts, the BOP Position is Deficit or Negative or Unfavourable.

IF the Total Receipts are more than Total Payments, the BOP Position is Surplus or Positive or Favourable.

(6) Foreign Exchange Reserves :-

Foreign Exchange Reserves in BOP A/c means the reserves held in the form of Currencies Like- Dollars, Euro, Pound Gold, Special Drawing Rights (SDR)

A Country having a Net Surplus in Current and Capital Account is combined and kept aside in the form of Foreign Exchange to settle international payments. Thus Foreign Exchange Reserves are used for adjusting Surplus or Deficit in BOP which is called Official Settlement.

(7) The Basic Balance :-

"The basic balance is the Sum of Current A/c and Capital A/c on both sides are equal"

Thus Basic balance is achieved when difference between Current A/c and Capital A/c is equal to zero.

A Surplus or Deficit Position can disturb the basic balance.

BOP balance can be Favourable or Unfavourable which Create problem of Disequilibrium

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(8) Equilibrium and Disequilibrium :-

The BOP always balances in accounting Sense.

" when Total Receipts of Country are equal to Total Payment of a Country, then BOP have Equilibrium Position"

Equilibrium = Total Receipts = Total Payments.

" when Total Receipts of a Country are more than Total Payment of Country, then it is Surplus BOP Position"

Surplus BOP = Total Receipts > Total Payments.

" when total Payments of a Country are more than total Receipts of a Country, then it is Deficit BOP Position."

Deficit BOP = Total Payments > Total Receipts.

Q:3 Short Note → **Balance of Payment Always Balances**

The balance of Payment always balances in a Accounting OR Technical Sense. BOP is a systematic Record of Receipts and Payments which is maintained in Double-Entry Book-Keeping method. Every Debit has a Credit IF there is any difference in Actual Receipts and Payments then there is need of Adjustment.

Example:- A Deficit in Current A/c is Adjusted in Capital A/c. [OR]

A Surplus or Deficit in Overall balance is Adjusted in Foreign Exchange Reserves. Such adjustments make BOP Position to balance level.

It means

BOP = Total Receipts = Total Payments.

Q:4 Select the Correct answer and rewrite the Statement :-

1. An open economy is one which — d = All the above
   a) Trade with other countries.
   b) Capital moves between the countries.
   c) Labour moves between the Countries.
   d) All the above.
2. Current Account includes — c - both (a) and (b)
   a) only merchandise trade b) only Trade in Services
   c) both (a) and (b)

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3. When Current account deficit is greater than Capital account Surplus, then over all balance is
b - negative

a) Positive b) negative c) Zero.

4. When Foreign Exchange Reserves are in Surplus it is shown with a b - minus (-) sign)

a) Plus(+) sign b) minus(-)sign c) neighther minus nor Plus sign

5. In a Closed economy, GDP is equal to C = C+I+G

a) C+I+G+(X-M) b) C+I+G+(X-M)+(R-P)

c) C+I+G

6) In a BOP statements Foreign Exchange reserves are equal to a - Overall balance.

a) Overall balance b) Current A/c balance

c) Capital A/c balance

7) Balance of accounts balances when b - Total Credits and Debits of all accounts balance.

a) Credits and debits in current account are equal.

b) Total credits and debits of all account balance.

c) Credits and debits in Capital account balance.

Q:5 State with Reasons whether Following Statements are True or False :-

1. Open economies are those where goods, Capital and Labour move between them.

Ans:- True. Reason :- Q:1

2. Unilateral Receipts and Payments are Part of Trade Account.

Reasons:-

Ans. False. Unilateral Receipts and Payments are known as Transfers. Countries Receive or give donations, grants, gifts and other such Payments on the basis of humanitarian or Political ground. These Payments are given to help the countries during emergencies or natural calamities.

3. A Surplus in OVerall balance is shown with a Plus(+) Sign in Reserve account.

Ans:- False. Reasons:- OVerall balance is the Sumtotal OF Current Alc, Capital Alc and statistical discrepancies.

OVerall Balance = Current Alc + Capital Alc + Statistical Discrepancies

IF the Sum of Current Alc, Capital Alc and Statistical discrepancies is Positive, the Overall balance is Surplus and it is shown with a minus(-) sign in Reserve Alc. We know that minus(-) indicate increase in Foreign Reserves and Plus(+) sign shows decline in foreign Reserves.

4. Balance OF Payments always balances.

Ans:- True Reasons:- Q:3

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