International Business
Prof. J. K. Nayak
Department of Management Studies
Indian Institute of Technology, Roorkee

Lecture - 28
BOP, Capital Account, Financial Account, Numericals, Reserve Account, SDR

Welcome friends to our course of International Business. So, in the last class; we had started with the balance of payment, which is our 5th unit. And we just had started understanding what is balance of payment and how it is connected with the; you know the condition economic, condition of any country right.

So, as we said the balance of payment is nothing, but it is the balance sheet of a nation right; so which is made by the RBI or the Central Bank in India right.

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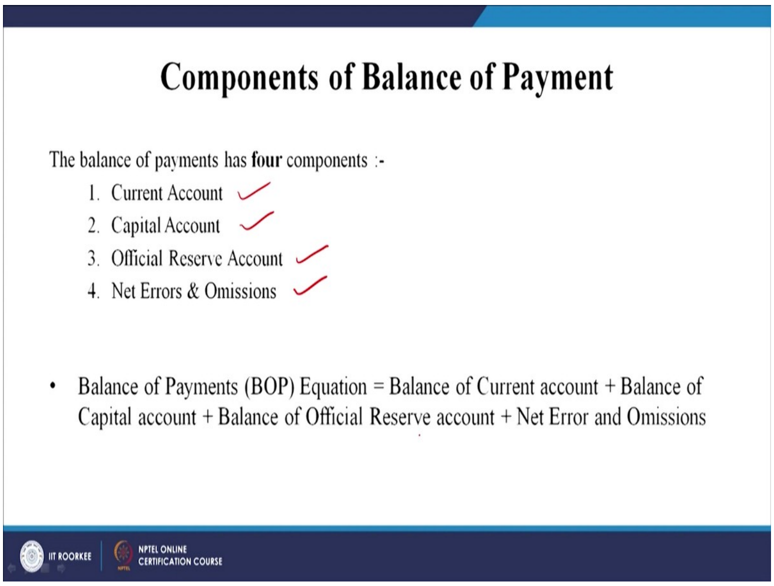

So, the balance of payment has four components; we discussed, the first component which we had covered is the current account and then we have capital account, the official reserve account, the net errors and omissions ok. And the balance of payment equation looks something like this; so it is the balance of the current account plus balance of the capital account plus balance of the official reserve account plus net error and omissions.

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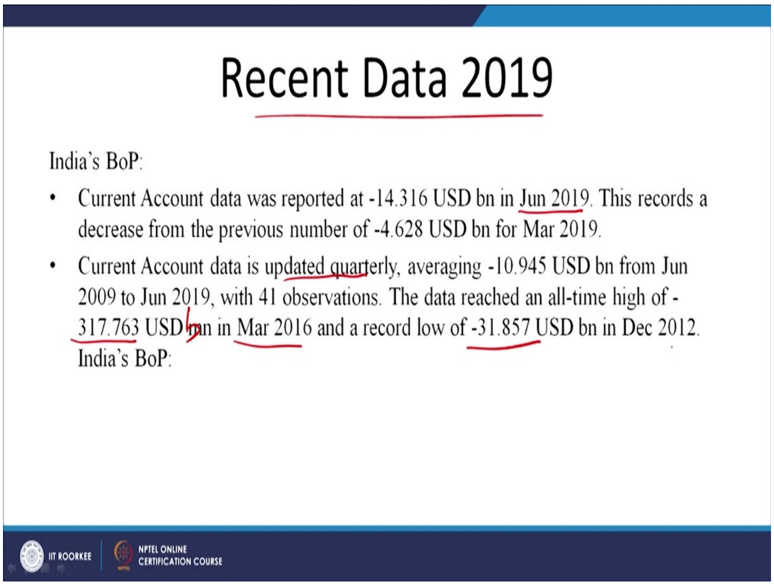

So, as of a recent data; you can see of 2019, India's BOP at the moment is the current account data was reported at minus 14.316 USD billion in June 2019. So, this records are decrease from the previous number of minus 4.628 USD billion for March 2019.

So, in this quarter; it has further decreased by another around close to 10 billion US dollars right. The current account data is updated quarterly averaging; as you can see here, averaging minus 10.945 USD billion from June 2009 to June 2019 with 41 observations. The data reached an all time high of 317.763 USD; million USD in March 2016. So, this is not million, it is billion actually and record low of this much in December 2012 right.

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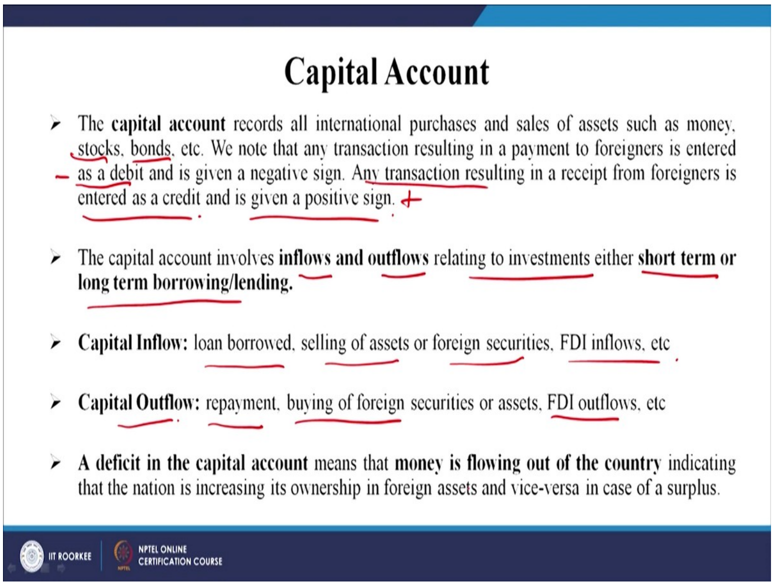

Now, after the current account; we move into the capital account. So, the capital account records; all international purchase and sales of assets such as money, stocks, bonds etcetera right. So, the government for example, initiates bonds right to generate money from the market right. For example, at this moment; the government is trying to generate bonds through the REC for the power sector and other things.

We note that any transaction resulting in a payment to the foreigners is entered as a debit and is given a negative sign right. Any transaction resulting in a receipt from foreigners is entered as a credit and is given a positive sign. So, this is plus because money is coming in and this is minus because money is going out. The capital account involves inflows and outflows relating to the investment either short term or long term borrowing; so basically it involves the inflows and outflows; from a short term or a long term perspective.

So, there are different implications; if it is a short term borrowing, the interest rates would be different; if is a long term borrowing, it would be different; so and it has an impact also differently. Largely, you know for long term investments, the long term borrowings are favoured right and; and because they are for a long period of time right.

So, and very rarely general; it is all both of them are important short term versus long term, but generally any for large investments long term borrowings are favoured ok.

Capital inflow; the loan borrowed selling of assets or foreign securities, FDI inflows etcetera right; so, this is through how the inflow happens.

The capital outflow happens through repayment, buying of foreign securities or assets, FDI outflows right. A deficit in the capital account means that money is flowing out of the country; indicating that the nation is increasing its ownership in foreign assets; that means, when we say FDI investment outside. Suppose, India somebody, some of the companies are you know trying to put up a plant in let us say Africa; so that is an FDI being done in the African nation right. So, there it is a case of the money going outside. So, increase ownership in foreign assets and vice versa in case of a surplus ok.

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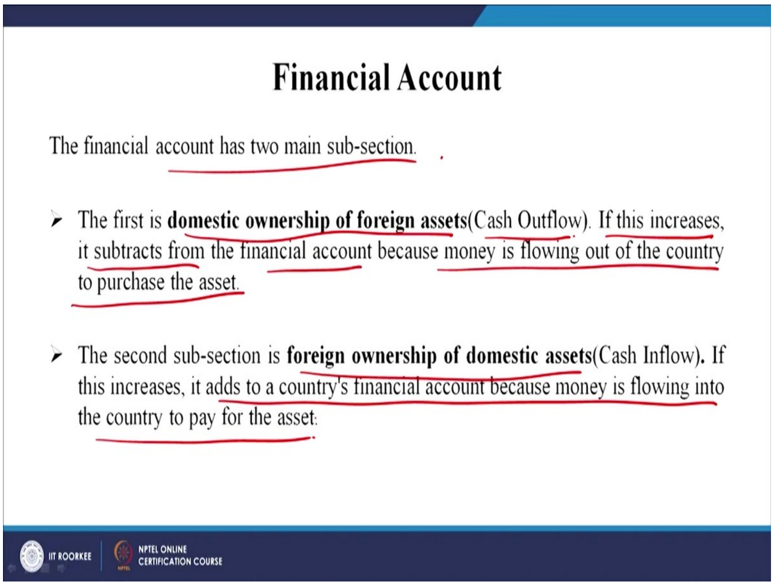

Now, financial account has two main subsection; the first is domestic ownership of foreign assets which is cash outflow. If this increases, it subtracts from the financial account because money is flowing out of the country to purchase the assets.

As I said, if you want to put up a plant in Africa; so to purchase that asset, money is flowing out of the country. The second section is the foreign ownership of domestic assets which is the cash inflow. If this increases, it adds to a country’s financial account because money is flowing into the country to pay for the asset. So, for example, if a Ford motor started a plant in Chennai. Now, that is an FDI investment in India right; so money has come in, so there is a cash inflow ok.

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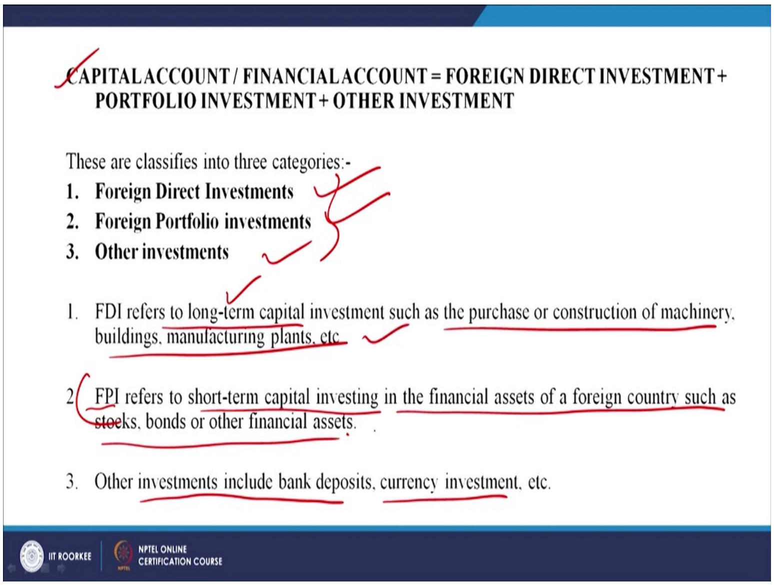

So, cash; capital account or financial account is equal to foreign direct investment plus portfolio investment plus other investments ok. These are classified into three categories; so this account capital or financial account is classified into three categories, so and these are the summation of these three right.

So, FDI, FPI and other investments; FDI refers to as we have done in the, you know some other classes also lectures but, still let me remind ah; go through it. FDI refers to long term capital investment such as the purchase or construction of machinery, buildings, manufacturing plants etcetera. So, as the example of FDI; for example, when any company as I said, Ford coming to India; for example, Volkswagen starting its own plant, Samsung starting its own; you know in plant in Gurgaon.

So, all these are cases or you know examples of FDI investment in India. So, the assets are being made in India; so there is a money in flow right. On the other hand, FPI refers to short term capital investing. Now, these are generally long term right for a maybe 20 years, 50 years, 30 years, you know and these are short them; maybe for a year, 2, 3; in the financial assets of a foreign country such as stocks bonds or financial assets.

Now, if you look at; for example, the stock market; our Indian stock market is largely affected because of this foreign; you know portfolio investment; investors. Now, what they are doing? They are putting in the money; in the market and as per the fluctuation, they would try to make their profits right. The third is the other investments include bank deposits, currency investment etcetera ok. So, all these three together; make up the capital account right; so this is the long, this is the short term.

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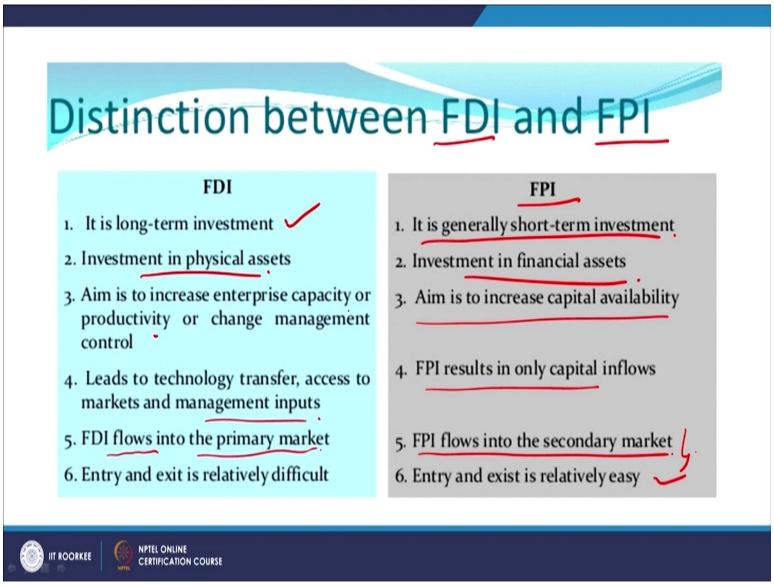

Now, what are the difference? Let us understand, for some people; they might not be very clear with between the difference between FDI and FPI. So, as I said; FDI is a long term investment in let us say in assets right. FPI is a short term investment in; maybe the stock market or you can see for example, financial assets right; bonds, stocks etcetera right.

Investment is in physical assets, investment is in financial assets; so this one has to be very clear right. The aim is to increase enterprise capacity or productivity or change management control. So, what is the aim of FDI? To increase the capacity or productivity; so Ford wants to, let us say Nike wants to produce its shoes in India. So, they set up and capacity building right so that, they can produce more right and at a cheaper cost.

Here the aim is to increase capital availability; so what these company, what is the foreign portfolio investor doing? He is investing in the companies and he is trying to make capital available to the; you know owners of the company so that they can utilize it better and increase their profitability.

FDI leads to technology transfer, access to markets and management inputs; this is what happens. When a FDI comes in the local; there is a technology transfer, the gain and access to new markets for the; you know company who is putting up his own plant India for example, and it gets a local knowledge; management inputs.

FPI results only in capital inflows; the only thing that FPI does is, it helps in giving the money or the capital and it you know wants that this money should be used productively by the company owners and this should increase the product; the profitability of the company and so that; they can also take advantage of it ok.

FDI inflows into the primary market; so setting up a plant, constructing a factory, machinery all these, FPI flows into the secondary market which we say basically like the stock market right. So, we are; the FPI flows into the secondary market means they invest in the stocks of the companies or maybe you know some products right, some financial products.

Entry and exit is little bit difficult because to set up a plant, it is difficult and even to wind up; it is also not so easy. But, here it is relatively much easier because it is in in terms of capital money; so, which you can easily sell off and go back or you can pump in more money right. So, the market also sentiments fluctuate with the inflow of money. So, as more foreign; you know investors come in, the market sees it is like a very productive sign, positive sign and the sentiment of the market improves.

But, if the foreign players are taking up their money, the retail investors think there is some kind of danger and they would like also to you know come out of the market. So, this also affects the investors invest, you know sentiments to a very large extent.

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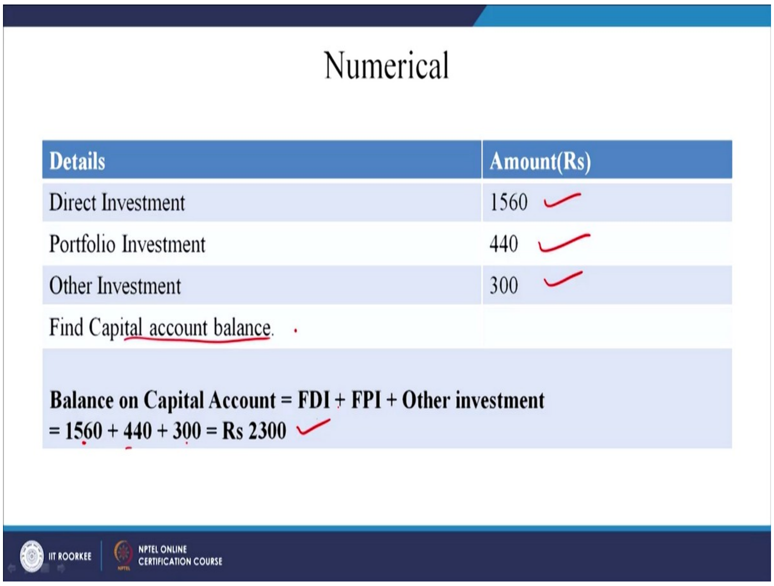

Now, let us take a case; now this is the direct investment right, this is some portfolio investment right, other investments in; let us say in some currency or something. What is the capital account balance? So, the capital account balance is very simple. So, 1560 + 440 + 300, that is 2300 right. So, this is the capital account or the financial account ok.

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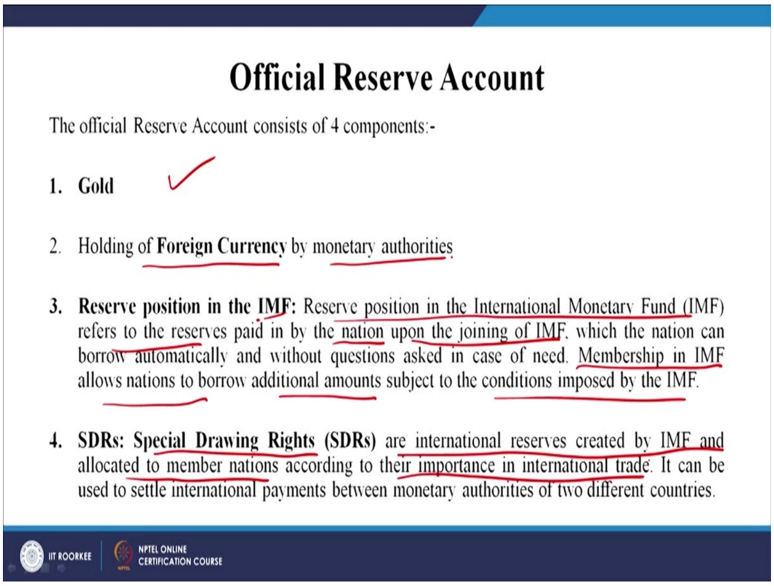

Now, what is the official reserve account? The official reserve account consists of four components; gold, holding of foreign currency by the authorities, reserve position in the

IMF and SDRs. Now, gold we all know; so the you know gold is a; is kept as a reserve account right.

Then, holding a foreign currency; so how much of foreign currency do we have? For example, India has ah; today the foreign reserve that we say is around; the latest, if to my knowledge around close to 500 billion right; 400, 500 billion. So, so how much foreign currency are you holding so that affects your trade because you can you know, the money can; if in case of emergency or something, you can use that money to buy something, import something or do something right.

Reserve position in the IMF; now reserve position in the IMF refers to the reserves paid in by the nation; while joining the IMF right which the nation can borrow automatically without question ah; in case of need; that means, when you join the IMF, you put in some kind of a payment; you make some keep some money. Now, during time of emergency when the country needs it; it can borrow money from the IMF right.

So, the membership in IMF allows nations to borrow additional amounts; subject to the conditions imposed by the IMF. So, there is an x amount and tomorrow you want x plus more; you can borrow it, but there are certain conditions put by the IMF. The fourth reserve account is the SDR; a Special Drawing Rights.

Now, these are international reserves created by the IMF and allocated to the member nations, according to their importance in the international trade. It is not same for everybody, it depends on what is your international; your reputation of the country right or you are standing in trade. It can be used to settle international payments between monetary authorities of two different countries right.

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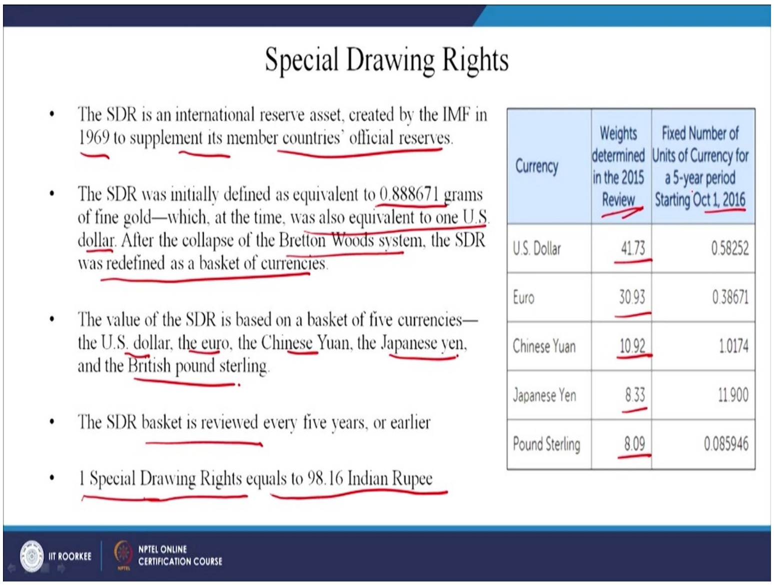

So, let us see this; now I have brought one. So, the SDR is an international reserve asset created by the IMF in 1969, to supplement its member countries official reserves. So, the member countries who have become a member of the IMF; in case there is an emergency, it is like a; you know, it is like a corporation. So, if somebody wants money; if he is a member, he can take; take gets, get the money without any problem right.

The SDR was initially defined as equivalent to 0.888671 grams of fine gold, which at that time; in 1969 was also equivalent to 1 US dollar. But after the collapse of the Bretton Woods system; the SDR was redefined as a basket of currencies and gold was not kept as a measure right. So, what are the currencies? The five currencies are the US dollar, the euro, the Chinese Yuan, the Japanese yen and the sterling; British sterling right.

The SDR basket is reviewed every five years or earlier; in depending on the condition. So, then the current situation; today, as of today; the one special drawing right equals to 98.16 Indian Rupee, as defined by the IMF right. So, this will vary according; this number 98.16; it could be different for other countries, the member countries depending on the standing of the country in the international trade.

Now, this is an example which I have brought; you can see now US dollar, euro, Chinese Yuan Yen and sterling. So, the weights determined in the 2015 review is, what are the weights? As you have a weight for; for example, in the stock market also you have BSE, NSE which is made on different weights right. So, different; so the weights determined in the 2015 review is the US dollar 41.73, Euro 30.93, Chinese; 10.92, Japanese 8.33, sterling is 8.09.

The fixed number of units of currency for a 5 year period; starting for, from October 1, 2016 is all this; right. So, this is how the SDR is designed.

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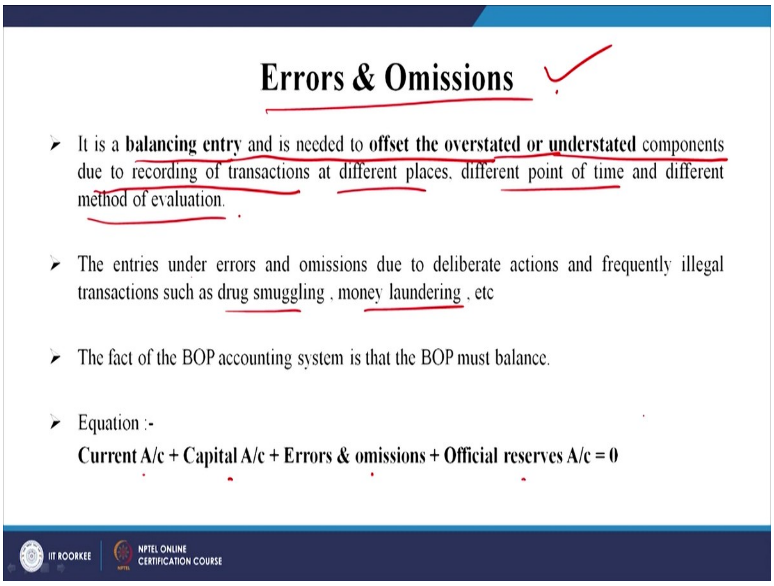

The last is the errors and omissions; it is a balancing entry, now this is the interesting part. So, as we said the; like the balance of payment is like a balance sheet; made by the RBI right or any Central Bank.

So, in order to balance right; so we said balance of trade might be favourable unfavourable, but this has to be necessarily balanced ok. It is a balancing entry and is needed to offset the overstated or understated components ok. Due to recording of transactions at different places, different point of time and different methods of evaluation.

The entries under errors and omissions, due to deliberate actions and frequently illegal transactions such as drugs smuggling, money laundering etcetera. The fact of the BOP; balance of payment accounting system is that the BOP must balance; so that is why this comes handy in making that adjustment. So, as we said current account plus capital account plus errors and omissions plus official reserves is all equal to 0.

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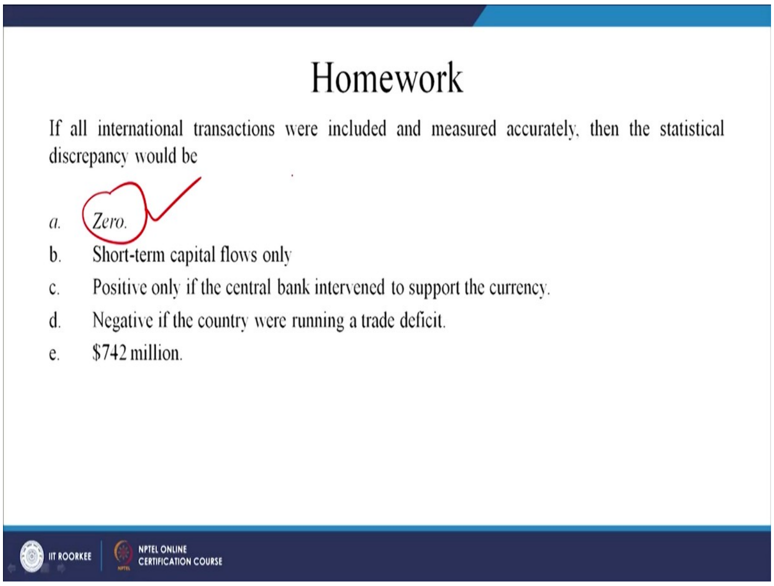

Now, let us take this question; if all international transactions were included and measured accurately, then the statistical discrepancy would be a; zero, short term capital flows only, positive only, negative or 742 million; so the answer is zero right; so, because we say it has to be balanced ok.

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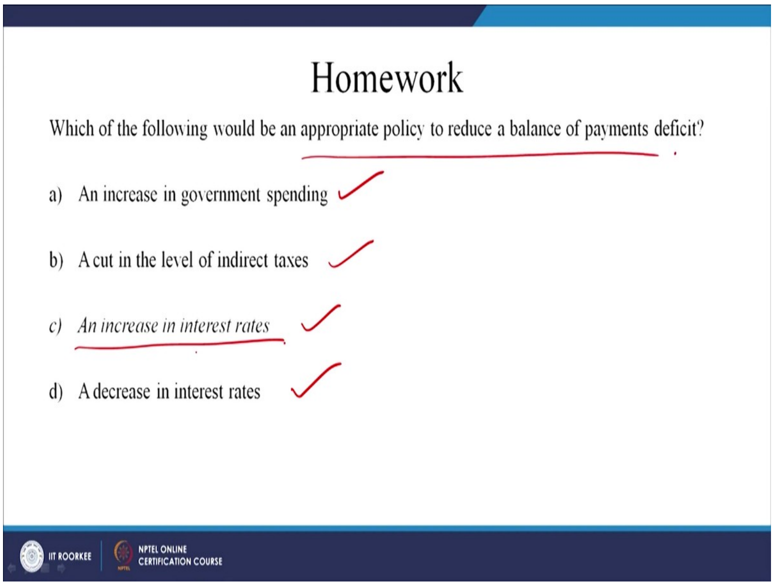

Which of the following would be an appropriate policy to reduce a balance of payments deficit? An increase in the government spending, a cut in the level of indirect taxes, an increase in interest rates or a decrease in interest rate; what should be done?

Think about it, the answer is an increase in interest rate, but why it is an increase in interest rate? What happens, when there is an interest rate increase right? So, thus; the savers gain more, but the ones who are using it for some purpose, for them the money flow would be restricted right. So, to reduce the balance of payment deficit, the government tries to increase the interest rates.

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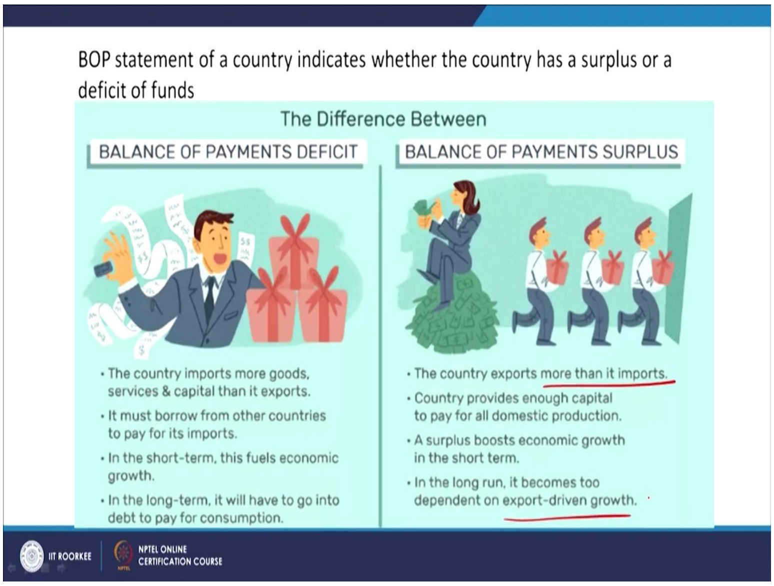

The BOP statement of a country indicates whether the country has a surplus or a deficit of funds; we have seen that; so we have discussed on this also. So, balance of payments deficit, balance of payments surplus. So, now this person is not very happy and here the people are very happy; as if it seems like the right. Now, let us look at the deficit; the country imports more goods services and capital than it exports, you are importing more.

It must borrow from other countries to pay for its imports; it does not have the money; so it has to, it must borrow. In the short term, this fuels the economic growth; in the short term the economic growth happens, but in the long term; it will have to go into debt, to pay for the consumption.

So, this is what happens when there is a balance of payment deficit, but when there is a balance of payment surplus. The country exports more than it imports; the country provides enough capital to pay for all the domestic production; thus the country has enough capital right.

A surplus boosts economic growth in the short term. So, if there is a surplus; economic growth would happen right. In the long run becomes too dependent on export driven growth; so that is not also very good; so there has to be a balance. In the long run, it becomes too dependent on export driven. So, today China for example, is a highly export driven growth economy right.

So, if something wrong would happen to the; on the export side; as currently the US, China; you know; a cold war is going on right. So, this economic crisis that can happen can have a devastating effect on the Chinese economy because they are heavily and heavily dependent on the export; exports right.

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Particulars	Amount(Rs) in cr.
Merchandise exports	100
Merchandise imports	125
Tourism exports	90
Insurance imports	80
Income receipts from abroad	110
Interest payments to foreigners	150
Increase in Domestic Ownership of Foreign Assets	160
Increase in Foreign Ownership of Domestic Assets	200

Assuming that unilateral transfer equal zero, find the merchandise trade balance, net exports of services, the current account balance and the capital account balance.

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So, let us take this example; let us take a case. So, these are some of the particulars and these are the amounts right in crores. So, merchandise export; 100, merchandise imports; 125, tourism exports; 90, insurance imports; 80, income received from abroad; 110, interest payment to foreigners; 150, increase in domestic ownership of foreign assets 160, increase in ownership; foreign ownership domestic asset 200.

Assuming that unilateral transfer equals zero right, find the merchandise trade balance, net exports of services, the current account balance and the capital account balance. I would; I would request you to, before I move into the next slide to show you the answer; kindly try it on your own and whatever you have understood till now, you try to solve this you know problem and come up with the answers for the same right; for these. Try to do it and then automatically, I will take you over ok.

So, let us move to the solution right and you can check whether you have done the same or not.

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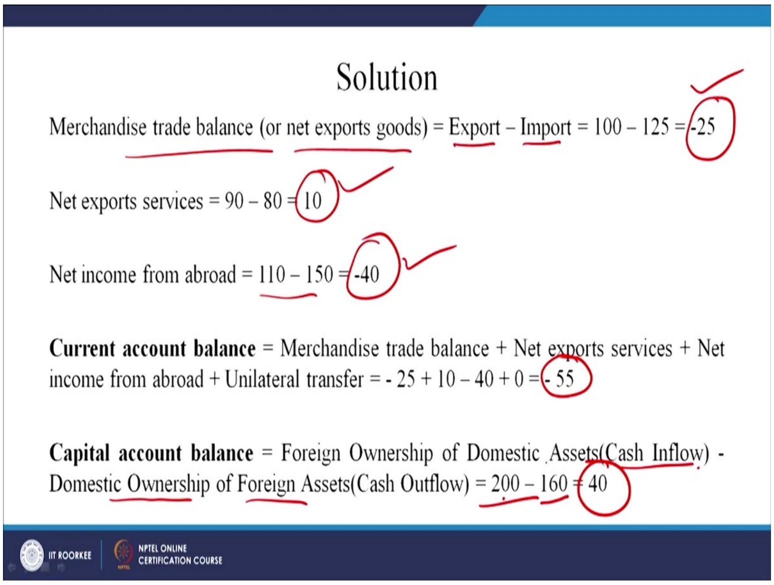

So, merchandise trade balance or net export goods is equal to export minus import. So, which is how much? 100 and this is 125; so exports was 100, imports was 125, so you imported more; so that is minus 25 ok.

Net export services; so let us see, how much it is? 90 minus 80; so, tourism exports, insurance imports right; so 90 minus 80; 10 right. Net income from abroad, so income receipts, 110, payments; 150 right; so this is minus 40. So, the current account balance is equal to merchandise trade balance plus net export services plus net income from abroad right plus unilateral transfers right. So, we said it is 0 right, so that means, it is minus 55. So, the current account balance of; at this moment is minus 55 crores right.

Capital account balance; what happens? Is equal to foreign ownership of the domestic assets which is cash inflow minus; the domestic ownership of foreign assets; so money has gone out; cash outflow. So, which is; let us say, you see increase in foreign ownership of domestic asset is 200; this is money come in because foreign ownership of domestic assets. So, foreign ownership as money has come in, here money has gone out right.

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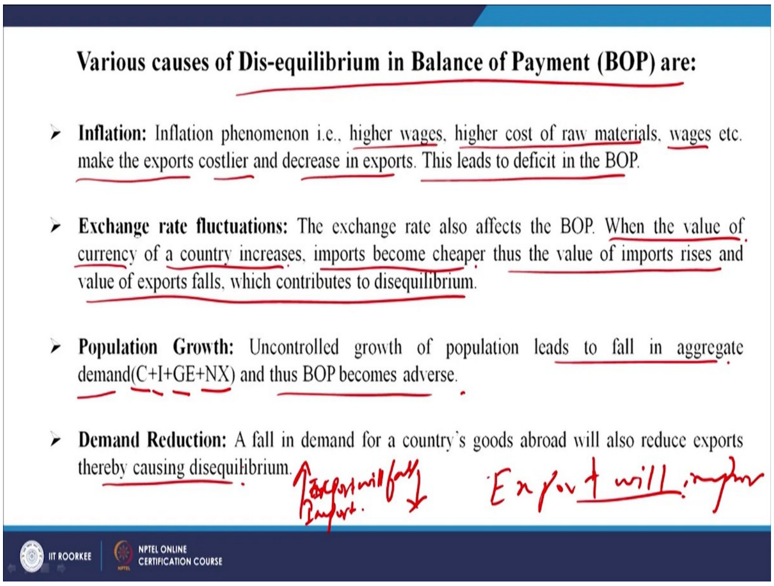

So, this is yes. So, if you look at it; cash inflow is 200 and cash outflow is 160; so the result is 40; so, I hope you have been able to do it with me right.

Now, various causes of disequilibrium in the balance of payment; now, what, why there is a disequilibrium in the balance of payment, how it affects and what happens? Few factors affect the balance of payment right, they create a disequilibrium. The first one being the inflation; now, as we all understand; what is inflation? Inflation is the rise in price of the basic goods and services right.

So, inflation phenomena that is higher wages, higher cost of raw material, wages etcetera makes the exports costlier and decrease in exports. This leads to a deficient in the BOP; the balance of payment right. So, when the cost of; cost of goods are increasing, the wages are increasing; so automatically the cost of production will also increase. So, now, you; that will lead to a decrease in the exports right; so that makes making because it becomes costlier right, so that leads to a deficit.

Then another point is the exchange rate fluctuations, the exchange rate also affects the BOP. Now, what is it? Now, how does the exchange rate affects the BOP? When the value of currency of a country increases, imports become cheaper; now let us understand this. In fact, many countries have adopted; this as a strategy, in order to increase their exports; one being Japan, the other being China which comes to my mind very easily right.

Now, what happens here is; here is that when the currency of a country; you know, when the value of the currency of a country increases, imports become cheaper; thus the value of imports rises and the value of exports falls which contributes to disequilibrium. You see for example, when currency devaluation happens; so the you know; the foreign, the dollar with the same amount of dollar, now you can buy more.

So, because you can buy more; so exports increase right, when the currency is devaluating, export will improve right; export will improve; export will improve. But, when the currency is appreciating; suppose in comparison to the dollar; let us say, the same amount of dollars; they can buy less; so export will fall, export will fall. But import will have a positive effect; it will have a positive effect on the import.

Here, on the other side; when the, it was devaluating or the currency was depreciating, the export was growing, but the imports were becoming costlier in this condition; so exchange rate fluctuation has a very large impact. Population growth, uncontrolled growth of population leads to fall in the aggregate demand.

Now, what is aggregate demand, we have seen; is aggregate demand is the consumption plus investment plus; plus government expenditure plus; plus net exports right. So, this is the export minus import basically and thus BOP becomes adverse. So, when there is a uncontrolled population growth; there is a fall in the actual or its sometimes called actual demand also aggregated demand or actual demand. So, this false right; so and thus the BOP becomes negative or adverse.

Demand reduction, a fall in demand; for a country’s goods abroad will also reduce exports, thereby causing disequilibrium. Now, for example, you see with westernization; many of the local products or the designs that were made by the, you know local industries went out of ah; you know demand. And the products the; the foreign products from other countries like Italy in for example, in you know certain products; from different countries purses, perfume and all; they were heavily in demand.

So, because of this what happened? Because of the change in style, tradition; you know habits of people, the; there has been a, they can be fall in the demand for the local goods and a rise in the goods of the foreign companies. So, this also can lead to a disequilibrium of the BOP.

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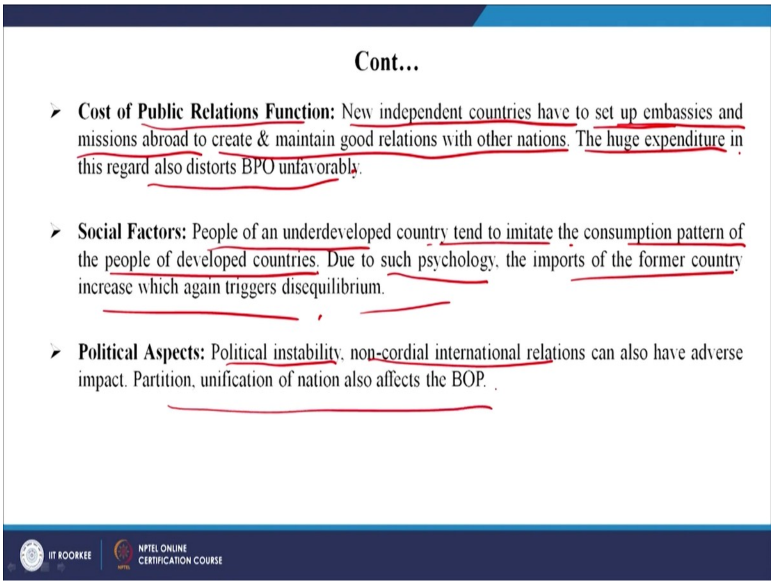

The next point is the cost of public relations function; now what it says? New, independent countries have to be set up, have to set up embassies and missions abroad to create and maintain good relationship with other nation. This is a huge expenditure and this also distorts the; distorts the BOP unfavourably.

Then social factors, people of an underdeveloped country tend to imitate the consumption pattern of the people of developed countries; so, due to such psychology, the imports of the foreign country increases which again triggers disequilibrium.

Now, interestingly this has happened largely with India also, but on the other side if you see what happened to Japan; Japan’s automobile sector saw a serious growth and huge of; improve in our foot for you know in their business just because when the currency devalued, Japanese cars were becoming cheaper to the US owners and as a result of it; there was a huge demand right.

But when it comes to comes true consumption you know; basic goods for example, style, luxury goods and all; so the when Indian economy was growing, there was a demand for those luxury goods and kind of style oriented goods. And the young generation which had a larger earning or you know purchasing power, they wanted to go for the; foreign goods instead of the India's, Indian localized goods.

So, as a result of it this also lead; led to a disequilibrium ok. Finally, political aspects; so political instability, non cordial international relations can also have very adverse impact. So, partition, unification of nation; all these can have a very significant effect on the BOP.

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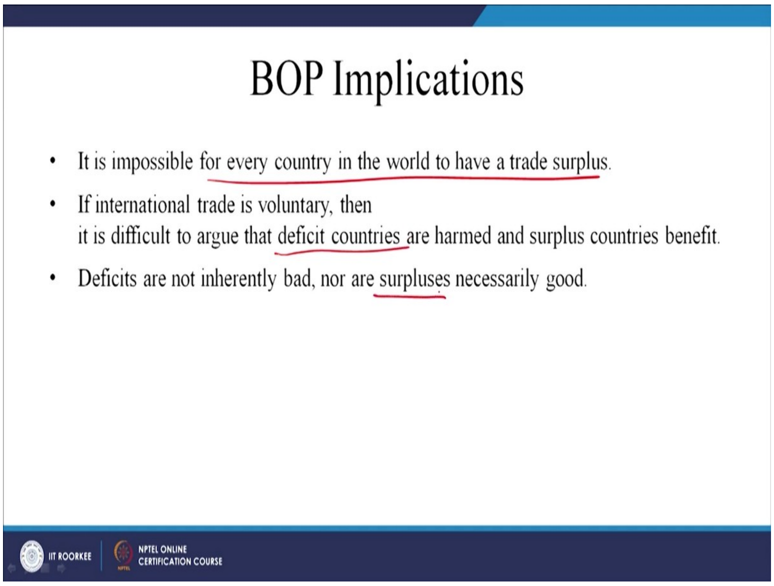

Now, let us look at the implication; so what, how; what is its effect? It is possible for every country in the world to have a trade surplus right, if international trade is voluntary; then it is difficult to argue that deficit countries are harmed and surplus countries benefit.

Deficits are not inherently bad nor are surpluses necessarily good; one has to understand that the balance of payment, from the balance of payment that sometimes the argument is that deficit countries are in a bad situation and the surpluses are in a positive or a good situation, but it is not necessarily true right.

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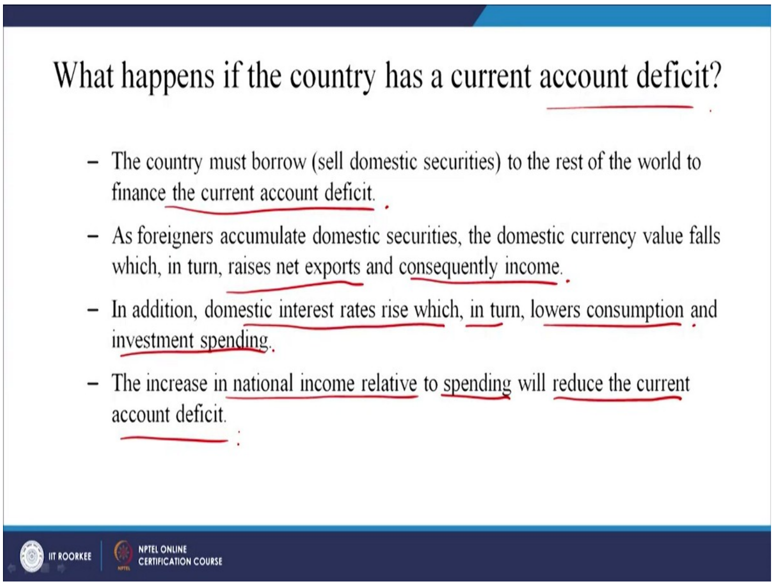

What happens if the country has a current account deficit? The country must borrow right to the rest of the world, to finance the current account deficit.

As foreigners accumulate domestic securities; the domestic currency value falls which in turn raises net exports which I just explained and consequently the income; so, which Japan and China had done very largely. In addition, domestic interest rates rise which in turn lowers the consumption and investment spending; so this has vicious effect on the economic. The increase in national income, related to spending will reduce the current account deficit right.

So, this is what happens. So, I hope you have understood from this lecture of today that what balance of payment is, what are its implications and how it affects any economy? So, all these things we discussed today; I think when you again go back to the lecture and listen to it, you will have more questions maybe more clarity will also come. So, in case you have questions; you can always ask me later on.

Thank you very much.