UNIT - III

Balance of Payments:

Meaning: The balance of payments of a country is a systematic record of all its economic transactions with the outside world in a given year. The balance of payments is merely a way of listing receipts and payments in international transactions for a country.

Structure (or) components of Balance of Payments

Credits (+) Receipts	Rs.	Debits (payments)	Rs
		I. Current Account	
Exports		Imports	
a) Goods	----	Goods	----
b) Services	----	payments	----
c) Transfer payments	----	Transfer payments	----
		II. Capital Account	
a) Borrowings money	----	Lending to foreign countries	----
b) FDI by foreign countries	----	FDI in foreign countries	----
		III. Official Settlement A/c	
a) Increase in foreign official Holdings	----	official Reserve of Gold and foreign currencies	----
		Errors and ommissions.	

Disequilibrium in Balance of Payments.

Disequilibrium may be either deficit (or) Surplus. If autonomous Credit receipts exceed autonomous debit payments, there is a Surplus Balance of Payments.

If autonomous debit payments exceeds autonomous Credit receipts, there is a deficit Balance of Payment and the disequilibrium is said to be unfavourable (or) adverse Balance of payments.

Causes of Disequilibrium:

1. Temporary change (or) disequilibrium
2. Fundamental disequibrium
3. Structural changes - Technological changes
4. change in Exchange Rate.
5. cyclical fluctuations
6. change in National Income.
7. price changes.
8. Stage of Economic Development
9. Capital movements
10. Political conditions.

Measures to correct deficit balance of payments

Any disequilibrium (deficit (or) surplus) in the balance of payments when it persists continuously is certainly undesirable because of its disastrous effects on the countries economy orderly world trade.

I. Monetary measures:

a) Deflation
(b) Exchange Depreciation
(c) Devaluation and
(d) Exchange control.

II. Non-monetary measures:

(a) Tariffs - import duties
(b) Import Quotas
(c) Export promotion policy and programmes.
(d). Import substitution policy and programmes.

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Importance of Balance of Payments:

The followings are the importance of Balance of payments

① It examines the transaction of all the export and import of goods and services for a given period.

② It helps the government to analyse the potential of a particular industry export growth and formulate policy to support that growth.

③ It gives the government a broad perspective on a different range of import and export tariff.

④ If the economy urges support in the mode of import, the government plan according to the BoP and direct the cash flow and technology to the unfavourable sector of the economy.

5. The Balance of payment also indicates the government to detect the state of economy, and plan expansion, Monetary and fiscal policy establish.

Balance Of Trade V.s. Balance of Payments

I) Balance of payments:

(i) Visible exports which relate to the goods exported for which the country receives payments

(ii) Invisible exports which refers to the services rendered by one country to other countries.

(iii) Transfer receipts in the form of gifts received from foreigners

(iv) Borrowings from abroad and investments by foreigners.

(v) The official sale of reserve assets including gold to foreign countries and International institutions.

II) Balance of Trade:

(i) The difference between the value of goods and services exported and imported.

(ii) Balance of Trade refers to only the value of imports and exports of goods i.e, visible items only.

(iii) The Balance of Trade is the one of the segment of Balance of payments.

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Foreign Exchange Rate:

Meaning: The foreign exchange rate (or) exchange rate is the rate at which one currency exchanged for another. It is the price of one currency interms of another currency.

Determination of Equilibrium Exchange Rate:

The equilibrium exchange rate is the rate at which the ~~rate~~ demand for foreign exchange equal to supply of foriegn Exchange.

Demand for Foreign Exchange:

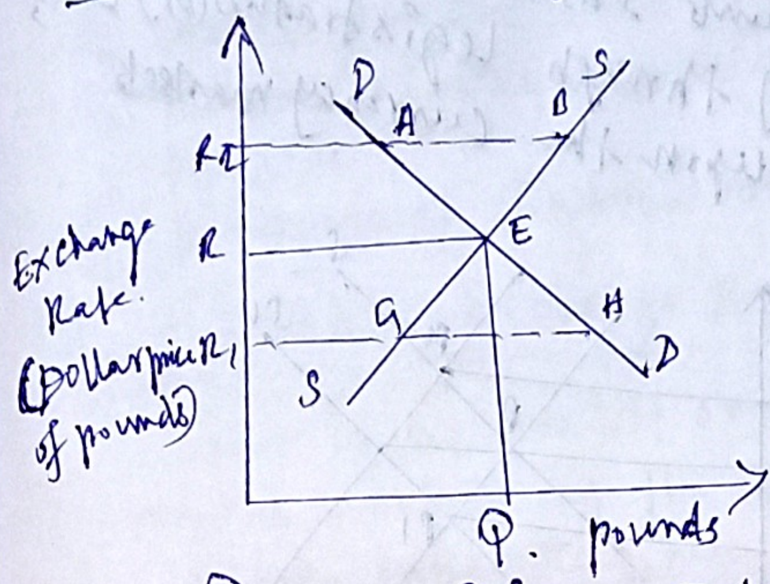
The demand for foreign exchange is a derived demand from pounds. It arises from the ~~US~~ import of British goods and services into the US and from capital movements from the US to Britain.

Supply of Foriegn Exchange:

The supply of foreign exchange in our case is the supply of pounds. It arises from the US exports of goods

and Services and from capital movements from the US to Britain

Equilibrium Exchange Rate:

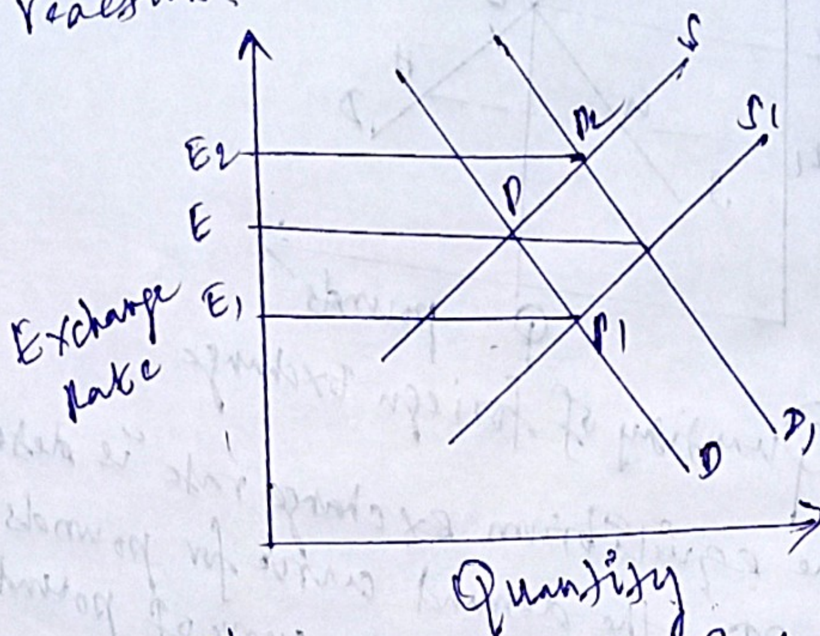


Quantity of foriegn Exchange

The equilibrium exchange rate is determined where DD, the demand curve for pounds intersect SS, the supply curve of pounds. They cut each point at E. The equilibrium rate is OR and OQ of foreign exchange is demanded and supplied. The followings are the different types of exchange rate adjustment policies with the establishment of the IMF.

① Fixed Exchange Rates (or) Pegged Exchange Rate.

Government Intervention (or) Monetary Authority through Legistration (or) Law, depends upon the currency market reaction.



The determine the Exchange rate 'E' which the authority maintains

Case for Fixed Exchange Rates:

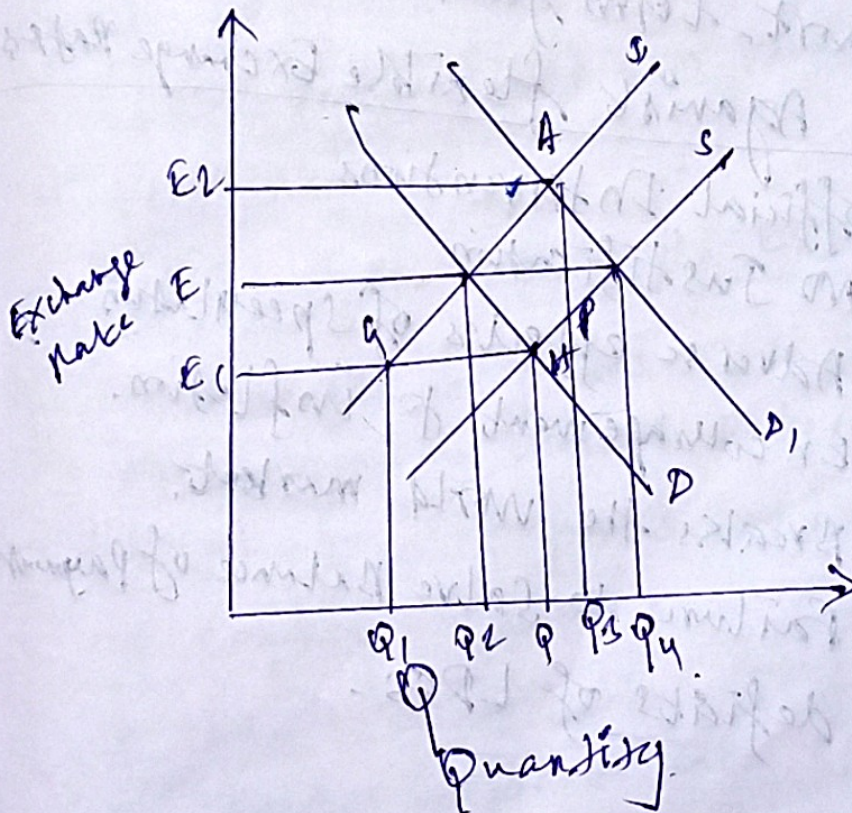
① Based on common currency
② Encourage Long term capital flows
③ No fear of currency fluctuations
④ No adverse effect of Speculation
⑤ Best for Small countries,
⑥ promote money and capital markets.

Case Against Fixed Exchange Rates.

1. Sacrifice of objectives
2. Unexpected Disturbances
3. Heavy Burden.
4. Balance of payments disequilibrium persists
5. Problems of International Liquidity

II. Flexible Exchange Rates:

There is no control over Government currency market by the Govt. in the Exchange Rate Regime.



Where D and S are the demand and supply curves of pounds which intersect at point P and the equilibrium exchange rate E is determined.

Case for flexible Exchange Rates

1. Simple operation
2. Autonomy of Economic Policies
3. Disequilibrium of BOPs automatically Corrected.
4. Removes problem of international liquidity.
5. No need of Borrowing and Lending short-term funds.

Case Against flexible Exchange Rates

1. Official Interventions
2. No Justification
3. Adverse effects of Speculation.
4. Encouragement to inflation.
5. Breaks the world market.
6. Failure to solve Balance of Payments deficits of LDCs.

III. Floating Exchange Rates

(a) Managed floating (or) Dirty floating

Govt. intervention in flexible Exchange Rate system.

(b) Clean Floating: not at all the Government intervention through out the time period in the currency market.

(c). Adjuestable Peg system (or) Adjustable Fixed Exchange Rate.

Deficit (or) Surplus in the Balance of payments in which exchange rate is devalued (or) over valued (or) Revalued.

Causes of changes in the Exchange Rate.

1. changes in Prices
2. changes in Interest Rates
3. change in Exports and Imports.
4. capital movements
5. Influence of Banks.
6. changes in Bank Rate.

7. Influence of Speculation.
8. Stock Exchange influences
9. Structural influences.
10. political conditions
11. policies of Exchange control and protection.
12. Type of Economy.

Theories of foreign Exchange Rate

There are three theories of the determination of foreign exchange Rate.

1. The mint parity Theory
2. The purchasing power parity Theory.
3. The Balance of payments Theory

We discuss these theories one by one.

I. The Mint Parity Theory

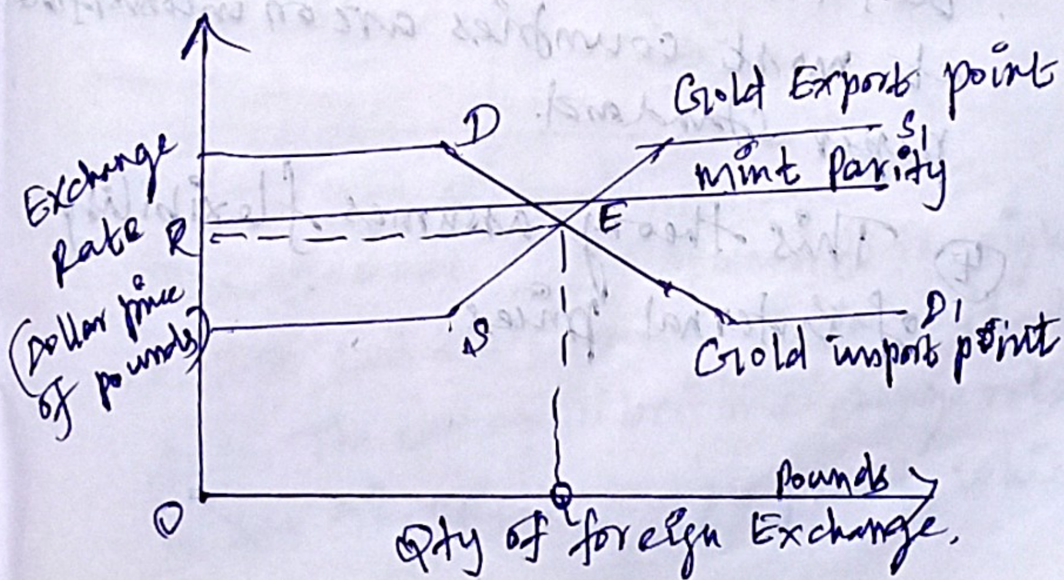
(Determination under Gold Standard)

The rate at which the standard money of the country was convertible into gold was called the mint price of gold.

Assumptions:

1. The price of gold is fixed by a country interms of its currency.
2. It buys and sell gold in any amount at that price.
3. Its supply of money consists of gold (or) paper currency which is backed by gold.
4. Its price level varies directly with its money supply.
5. There is movement of gold between countries.
6. Capital is mobile with in countries.
7. The adjustment mechanism is automatic.

Explanation:



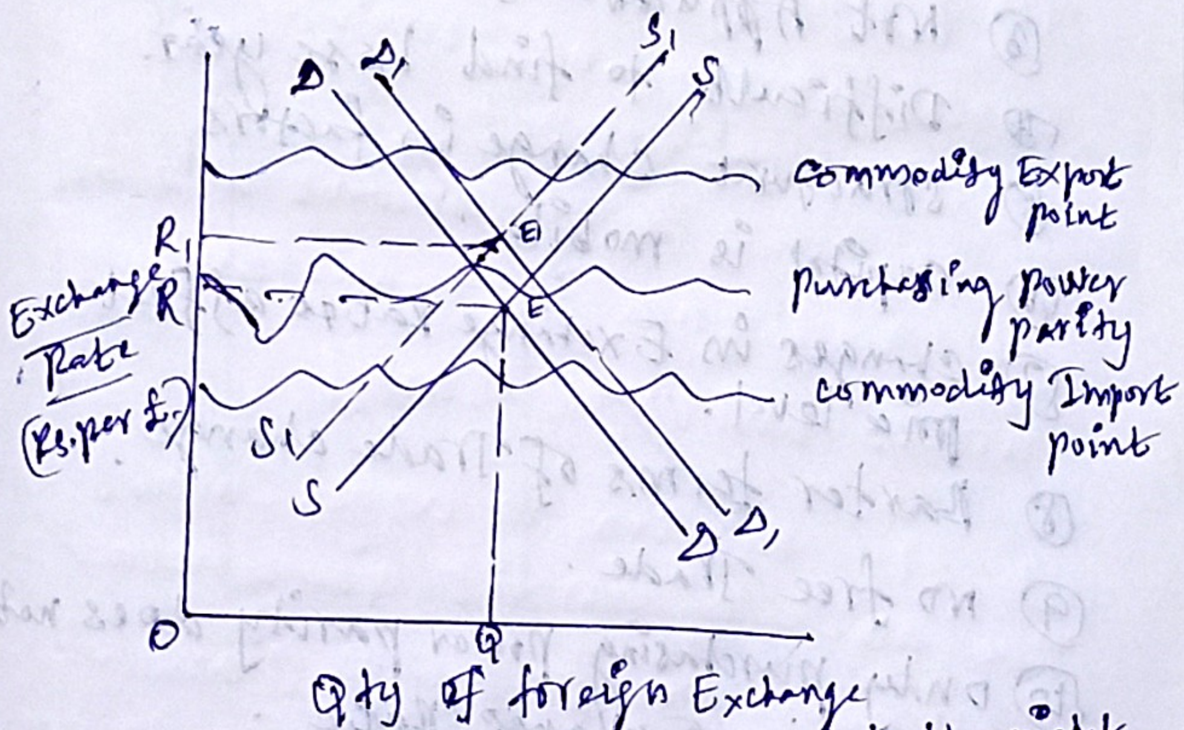
The determination of the exchange rate under the gold standard. The exchange rate OR is set up at point 'E' where the demand and supply curve DD_1 and SS_1 intersect. The Exchange Rate need not be at the mint parity. It can be any-where between the gold points depending on the shape of the demand and supply curves.

Criticisms:

1. The international gold standard does not exist.
2. The theory is based on the assumption of free buying and selling of gold.
3. The theory fails to explain the determination of exchange rates at most countries are on inconvertible paper standard.
4. This theory assumes flexibility of internal prices.

II. The Purchasing Power Parity Theory (PPP)

It developed by Gustav Cassel in 1920 to determine the exchange rate between countries on inconvertable paper currencies. The theory states that equilibrium exchange rate between inconvertable paper currencies is determined by the equality of the relative change in relative prices in the two countries. The rate of exchange between two countries is determined by their relative price levels.



The DD curve shifts upward to the right to D_1D_1 and the SS curve to the left to S_1S_1. The new equilibrium exchange rate is set at OR_1 rupees per pound, which

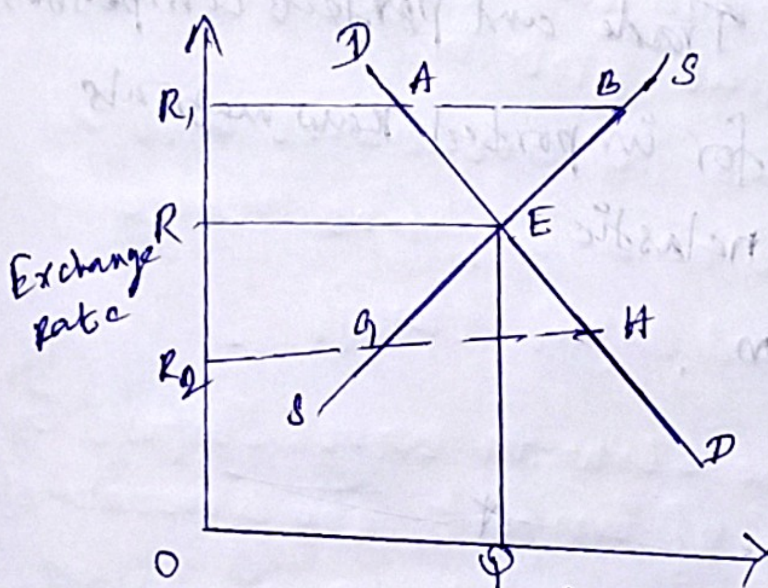
- represents the new purchasing power parity. The PPP curve shows that with relative change in the price level, the exchange rate tends to fluctuate along this curve above (or) below the normal exchange rate.

Criticisms:

1. Defects in calculating price level
2. Comparison of General price level a difficult problem.
3. Not Applicable to capital Account
4. Difficult to find base year.
5. structural change in factors
6. capital is mobile.
7. changes in Exchange Rates affect price level.
8. Barter terms of Trade change.
9. No free Trade.
10. only purchasing power parity does not determine Exchange Rate.
11. Neglect of elasticities of Reciprocal demand.

III. The Balance of Payments Theory:

The demand for foreign exchange arises from the debit side of the balance of payments. The supply of foreign exchange arises from the credit side of the balance of payments. Any change in the conditions of demand (or) supply refects itself in a change in the exchange rate and the ruling rate the balance of payments balances from day to day moment



Qty of foreign Exchange

The two curves i.e, dd and ss curves intersect at point 'E' where OR equilibrium exchange rate is determined. ~~Any chans~~

Any exchange rate above (or) below or will means disequilibrium in the balance of payments. Ultimately, the equilibrium exchange rate OR will be restored where demand and supply of foreign exchange equals at point "E".

<u>Criticisms:</u>

1. Balance of payments independent of Exchange Rate.
2. Neglects the role of price level
3. No free Trade and perfect competition.
4. Demand for imported Raw matirials not Inelastic.
5. Truism.