Balance of Payment

When a payment is received from a foreign country, it is a credit transaction while a payment to a foreign country is a debit transaction. The principal items shown on the credit side are exports of goods and services, unrequited or transfer receipts in the form of gift etc. from foreigners, borrowings from abroad, foreign direct investment and official sale of reserve assets including gold to foreign countries and international agencies.

The principal items on the debit side include imports of goods and services, transfer payments to foreigners, tending to foreign countries, investments by residents in foreign countries and official purchase of reserve assets or gold from foreign countries and internal agencies.

The credit and debit items are shown vertically in the BOP account of a country. Horizontally, they are divided into three categories, i.e.

(a) The current account,
(b) The capital account, and
(c) The official settlements account or official reserve assets account.

(a) **The Current Account:** It includes all international trade transactions of goods and services, international service transactions (i.e. tourism, transportation and royalty fees), and international unilateral transfers (i.e. gifts and foreign aid).

(b) **The Capital Account:** Financial transactions consisting of direct investment and purchases of interest-bearing financial instruments, non-interest bearing demand deposits and gold comprise the capital account.

(c) **The Official Reserve Assets Account:** Official reserve transactions consist of movements of international reserves by governments and official agencies to accommodate imbalances arising from the current and capital accounts.

In other words, it measures the change in nation's liquid and non-liquid liabilities to foreign official holders and the change in a nation's official reserve assets during the year. The official reserve assets of a country include its gold stock, holdings of its convertible foreign currencies and SDRs and its net position in the IMF.

BOP Account Chart:

Credit **(Receipts)** – Debit **(Payments)** = Balance **[Deficit (–) , Surplus (+)]**

(i) Deficit if Debit > Credit

(ii) Surplus if Debit < Credit

1. CURRENT ACCOUNT:

(a) Merchandise:

- Exports (+) (i.e. added)
- Imports (–) (i.e. deducted)

(b) Services:

- Services rendered (+)
- Services received (–)

(c) Transfer Payments:

- Transfer payments received (+)
- Transfer payments rendered (–)

(d) Current Account Balance

2. CAPITAL ACCOUNT:

(a) Financial Transactions:

- Borrowing from foreign countries (+)
- Lending to foreign countries (–)
- Direct investment by foreign countries (+)
- Direct investment to foreign countries (–)

(b) Capital Account Balance

3. OFFICIAL ACCOUNT:

(a) Reserves:

- Increase in foreign official assets in the country (+)
- Decrease in official reserves of gold and foreign currency (i.e. official reserve assets) (–)

(b) Official Account Balance

Pakistan's balance of payment for the financial years 2002 to 2009 are as follows:

BALANCE OF PAYMENTS

Items	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
1. Trade Balance	-294	-444	-1,208	-4,352	-8,259	-9,495	-14,820	-12,492
Exports (f.o.b)	9,140	10,889	12,396	14,401	16,388	17,119	20,207	18,918
Imports (f.o.b)	9,434	11,333	13,604	18,753	24,647	26,614	35,027	31,410
2. Services (Net)	-2,617	-2,128	-3,594	-5,841	-7,304	-7,968	-10,530	-7,922
Receipts	2,027	2,967	2,894	3,837	4,718	5,239	5,422	5,183
Payments	-4,644	-5,095	-6,488	-9,678	-12,022	-13,207	-15,952	-13,105
Shipment	-809	-951	-1,253	-1,713	-2,203	-2,337	-3,087	-2,740
Investment Income	-2,430	-2,381	-2,394	-2,823	-3,451	-4,522	-5,536	-5,281
Others	-1,405	-1,763	-2,841	-5,142	-6,368	-6,348	-7,329	-5,084
3. Private Unrequired								
Transfers (net)	4,249	5,737	6,116	8,440	9,914	10,102	11,048	11,019
(Workers Remittances)	2,389	4,237	3,871	4,168	4,600	5,494	6,451	7,811
4. Current Account Balance	1,338	3,165	1,314	-1,753	-5,649	-7,361	-14,302	-9,395
5. Long-term Capital (net)	1,280	1,035	-201	2,562	6,016	10,006	8,427	6,448
Private Capital (net)	-177	225	691	1,221	4,153	7,826	6,187	3,805
Official Capital (net) @	1,457	810	-892	1,341	1,863	2,180	2,240	2,643
6. Basic Balance	2,618	4,200	1,113	809	367	2,645	-5,875	-2,947
7. Errors and Omissions (net) *	961	909	-137	-854	36	527	-676	310
8. Balance Requiring Official Financing	3,579	5,109	976	-45	403	3,172	-6,551	-2,637
9. Official Assistance & Debt Relief	-925	-520	-95	472	470	1,051	679	-611
Medium and Short-								
Term Capital	-334	-180	-317	147	-193	-83	559	-151
Other Short-Term Assets/								
Liabilities FEBC, DBC								
FEBC, Euro & Special								
US $ Bonds (Net), GDR(OG)	-591	-340	222	335	663	1,134	120	-460
10 Exceptional Financing	138	620	-55	-55	-55	100	0	0
11. Change in Reserves								
(- ve = increase)	-2,792	-5,209	-826	-372	-818	-4,323	5,872	3,249

@ : Includes Official Unrequited Transfers (P) : Provisional Source : State Bank of Pakistan

* : Includes Private Short-term Capital

Difference between BOT and BOP:

Balance of trade refers only to the merchandise balance or balance on *'visible transactions'* alone. Visible items refer to the commodity exports and imports entering the balance of trade. They are visible because they are recorded at the customs barriers of the country.

On the other hand, the balance of payments refers to the sum of both the balance on *'visible transactions'* as well as *'invisible items'*. It also includes capital and financial accounts. Invisible items refer to the imports and exports of services. Such services may be of various kinds for which payments have to be made or received, for example, transport charges, shipping freight, passenger fares, harbour and canal dues, commercial services (fees and commissions), financial services (brokers' fees) and services connected with the tourist traffic and payment of interest on external debt. As against the commodity or merchandise transactions, which are visible, these services are called invisible items of the balance of payments as they are not recorded at the customs barriers.

Balance of Payment Equilibrium:

Equilibrium is that state of balance of payment over the relevant time period which makes it possible to sustain an open economy without severe unemployment on a continuing basis.

In BOP equilibrium, we have to make certain assumptions for the simplicity of our analysis. These assumptions are:

(a) A given supply curve,
(b) No change in price expectations,
(c) Internal capital flows depend on the level of the interest rate at home and abroad,
(d) No accumulation of real capital.

It is evident that the balance of payments depends on both the level of domestic economic activity and the level of domestic interest rate.

FE curve is the set of all transactions of income and interest rate levels for which the overall payments balance is in equilibrium, i.e. neither in surplus nor in deficit (as shown in the following figure).

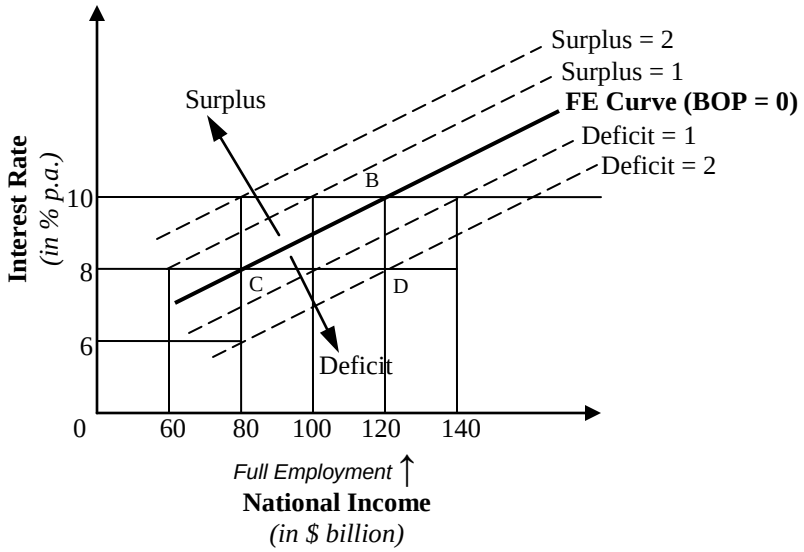

Figure 1 – Equilibrium of Balance of Payment

In the above figure, FE curve showing equilibrium in BOP. All the points above FE curve show surpluses in BOP and all the points below FE show deficits. B is the target point of policy at which the nation has achieved both internal balance (full employment without excessive inflation) and external balance.

Types of BOP Equilibrium:

There are two types of BOP equilibrium, i.e., *static equilibrium* and *dynamic equilibrium*:

(a) Static Equilibrium: The distinction between static and dynamic equilibrium depends upon the time period. In static equilibrium, exports equal imports including exports and imports of services as well as goods and the other items on the BOPs – short term capital, long term capital and monetary gold are on balance, zero. Not only should the BOPs be in equilibrium, but also national money incomes should be in equilibrium vis-à-vis money incomes abroad. The foreign exchange rate must also be in equilibrium.

(b) Dynamic Equilibrium: The condition of dynamic equilibrium for short periods of time is that exports and imports differ by the amount of short-term capital movements and gold (net) and there are no large destabilising short-term capital movements.

The condition for dynamic equilibrium in the long run is that exports and imports differ by the amount of long term autonomous capital movements made in a normal direction, i.e. from the low-interest rate country to those with high rates. When the BOP of a country is in equilibrium, the demand for domestic currency is equal to its supply. The demand and supply situation is thus neither favourable nor unfavourable. If the BOP moves against a country, adjustments must be made by encouraging exports of goods, services or other forms of exports or by discouraging imports of all kinds. No country can have a permanently

unfavourable BOP, though it is possible – and is quite common for some countries – to have a permanently unfavourable balance of trade. Total liabilities and total assets of nations, as of individuals, must balance in the long-run.

Types and Causes of BOP Disequilibrium:

There are three main types of BOP Disequilibrium which are discussed below:

(a) Cyclical disequilibrium,
(b) Secular disequilibrium, and
(c) Structural Disequilibrium.

(a) Cyclical Disequilibrium: Cyclical disequilibrium occurs because of two reasons. First, two countries may be passing through different paths of business cycle. Second, the countries may be following the same path but the income elasticities of demand or price elasticities of demand are different. If prices rise in prosperity and decline in depression, a country with a price elasticity for imports greater than unity will experience a tendency for decline in the value of imports in prosperity; while those for which import price elasticity is less than one will experience a tendency for increase. These tendencies may be overshadowed by the effects of income changes, of course. Conversely, as prices decline in depression, the elastic demand will bring about an increase in imports, the inelastic demand a decrease.

(b) Secular Disequilibrium: The secular or long-run disequilibrium in BOP occur because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. The current account follows a varying pattern from one state to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports.

Disequilibrium arises owing to lack of sufficient funds available to finance the import surplus, or the import surplus is not covered by available capital from abroad. Then comes a stage when domestic savings tend to exceed domestic investment and exports outrun imports. Disequilibrium may result, because the long-term capital outflow falls short of the surplus savings or because surplus savings exceed the amount of investment opportunities abroad. At a still later stage, domestic savings tend to equal domestic investment and long term capital movements are on balance, zero.

(c) Structural Disequilibrium: Structural disequilibrium can be further bifurcated into:

(i) Structural Disequilibrium at Goods Level: Structural disequilibrium at goods level occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium, or when a change occurs in the basic circumstances under which income is earned or spent abroad, in both cases without the requisite parallel changes

elsewhere in the economy. Suppose the demand for Pakistani handicrafts falls off. The resources engaged in the production of these handicrafts must shift to some other line or the country must restrict imports, otherwise the country will experience a structural disequilibrium.

A deficit arising from a structural change can be filled by increased production or decreased expenditure, which in turn affect international transactions in increased exports or decreased imports. Actually it is not so easy, because the resources are relatively immobile and expenditure not readily compressible. Disinflation or depreciation may be called for to correct a serious disequilibrium.

(ii) **Structural Disequilibrium at Factors Level:** Structural disequilibrium at the factor level results from factor prices which fall to reflect accurately factor endowments, i.e., when factor prices are out of line with factor endowments, distort the structure of production from the allocation of resources which appropriate factor prices would have indicated. If, for instance, the price of labour is too high, it will be used more sparingly and the country will import goods with a higher labour content. This will lead to unemployment, upsetting the balance in the economy.

General Measures to Correct BOP Disequilibrium:

To correct the different types of disequilibrium in BOP the following general measures are used:

(a) Exchange depreciation (price effect) or devaluation (by government),
(b) Deflate the currency,
(c) Tariffs,
(d) Import quotas, and
(e) Export duties.

(a) **Exchange Depreciation (Price Effect) or Devaluation (by Government):** Exchange depreciation means a reduction in the value of a currency in terms of gold or other currencies under *'free market'* conditions and coming about through a decline in the demand for that currency in relation to the supply. This is usually applied to *'floating exchange rates'*. The purpose of this method is to depreciate the external exchange value of the home currency, thus cheapening the domestic goods for the foreigner. Whereas, under *'fixed-parity system'* or *'fixed exchange rate'*, the reduction of currency value in against the gold or other currencies is official and not market based. This official reduction of exchange rate is called *'devaluation'*. The purpose of both *'depreciation'* and *'devaluation'* is to cheapen the domestic goods and boost up the exports. But the governments regarded devaluation as a means of correcting a balance of payments deficit only as a measure of last resort. They predominantly relied on deflation of the home

market and international borrowing. Devaluation or depreciation of the exchange rate can correct a balance of payment deficit because it lowers the price of exports in terms of foreign currencies and raises the price of imports on the home market. This does not necessarily succeed in its purpose. The immediate effect is similar to an unfavourable change in the TOT. For the resources devoted to the production of exports, less foreign exchange is earned with which to pay for imports. If the level of imports remained the same, more output would have to be diverted to exports and away from home consumption and investment simply to maintain the status quo. Devaluation or depreciation could lead to a loss of real income without any benefit to the balance of payments.

Pakistan has always faced negative BOT except for three years, i.e. 1947-48, 1950-51 and 1972-73. The newly born Pakistan had a quite high exports and a handsome balance of trade (US $ 42 million). With the Korean War boom in 1950-51, once again Pakistan gained a surplus in BOT (US $ 53 million). However, the reason for 1972-73's positive BOT ($ 20 million) was the massive currency devaluation in 1972 when the rupee was devalued from Rs. 4.76 to 2.3 times higher level of Rs. 11 per US dollar. The exports increased significantly and the share of exports in GDP rose to 14.9%.

(b) **Deflate the Currency:** According to this method, the currency is deflated. As the currency contracts, prices will fall, which will stimulate exports and check imports. But the method of deflation is also full of dangers. If prices are forced down while costs, which are proverbially rigid (especially as regards wages in countries where trade unions are well organised), do not follow suit, the country may face a serious depression and unemployment. Correcting the balance of payments, therefore, once a disequilibrium has arisen is not an easy matter.

(c) **Tariffs:** Tariff is a tax levied on imports. It is synonymous with import duties or custom duties. Tariffs are used for two different purposes; for revenue and for protection. *'Revenue Tariffs'* are a source of government revenue and *'Protective Tariffs'* are meant to maintain and encourage those branches of home industry protected by the duties.

Tariff duties are of four types:

(i) **Ad Valorem Tariff:** It is levied as a percentage of the total value of the imported commodity.
(ii) **Specific Duties:** These are levied per unit of the imported commodity.
(iii) **Compound Duties:** These are a mixture of above two.
(iv) **Sliding Scale Duties:** These vary with the prices of commodities imported.

(d) **Import Quotas:** As a protective device, import quotas are alternative to tariffs. Under an import quota, fixed amount of a commodity in volume or value is

allowed to be imported into the country during a specified period of time. The major objectives of import quotas are:

(i) to avoid foreign competition,
(ii) to provide greater administrative flexibility,
(iii) to solve the problem of BOP and BOT.

Import quotas are of the following five types:

(i) Tariff quota,
(ii) Unilateral quota,
(iii) Mixing quota,
(iv) Bilateral quota, and
(v) Import licensing.

(e) **Export Duties:** When world prices are higher than domestic prices, there is an incentive to export. In such a situation, a government may levy export duties. Export duties are used to prevent exports. The reason may be that exported commodities are required domestically.

Causes of Disequilibrium in BOP with Reference to Pakistan:

Following are the main causes of disequilibrium in BOP with reference to Pakistan:

(a) **Revenue oriented tariffs:** The import and export tariffs of Pakistan are by and large revenue oriented. The balance of payment reasons are no doubt taken into account in the determination of import and export duties. However, there are numerous anomalies in these tariffs. There are cases where the raw materials for a finished article are taxed at such a high rate that it is cheaper to import the finished articles rather than import the raw materials and produce the finished articles locally. In cases like this, there can be no possibility for producing such articles for export.

The import and export tariffs need a thorough revision from the point of view of minimising the tax element in the cost of production. The approach should be to tax consumption but not production.

(b) **Adverse terms of trade:** The TOT has a tendency to move against us. This is because of this fact that prices of our exports decreasing the world market while the prices of our imports are constantly rising. The prices of our exports fall because we export raw materials and semi-manufactured goods which cannot be stored for a long time. Our cotton and leather are facing the competition of artificial and synthetic fibre from China, Malaysia, Korea, etc. On the other hand, the prices of our import commodities are rising because they are finished and final products and can be disposed in the market very quickly. In such state of affairs, our international receipts go on falling while our payments go on increasing. Accordingly, the deficit is sure to occur.

(c) **Import substitution policy of Pakistan:** The emphasis of Pakistan's industrial policy has been more on import substitution than on export promotion. The position of domestic industries results in higher prices for the consumer. But what is worse is that industries having a sheltered domestic market tend to become inefficient, because, in the absence of foreign competition, there is no incentive to reduce their production costs. The export industries, on the other hand, have to be very efficient in order to be able to compete in the world market, for they don't have the luxury of a sheltered market at home, in which they can thrive at the cost of the consumer. Besides, some of the export industries are much more labour intensive than the import substitution industries.

(d) **Export of primary commodities:** The main factor for the disturbing export performances is the adverse trend in the terms of trade. But the vulnerability to the TOT shock is the result of heavy dependence of the country's export earnings on primary commodities like cotton, rice, and semi-manufactured goods, which are subject to frequent price fluctuations in the world market. To import stability to the country's export trade, it has been suggested times and again that the export of manufactured goods, for example, textiles, automobiles, heavy engineering goods, etc., should be increased.

(e) **Capital account problem:** The deficit in Current Account of BOP may be washed out by a surplus in capital account. But this is not the case with Pakistan. We have to face the following problems relating to capital account:

(i) The foreign official loans are specific and tied in nature and are attached with political interference and heavy rates of interest.

(ii) A lot of amount is spent on repayment of loans and debt servicing.

(iii) The private investors are still hesitant in making investment in our country because of several reasons, like political instability, lack of proper infra-structure, lack of energy generation plants, involvement of official procedures, and the element of stubbornness in the country.

(f) **Trade restrictions of developed countries:** The trade barriers raised by developed countries against the import of manufactures especially on agricultural products by the developing countries is one of the important factors preventing greater production and export by some industries in Pakistan, particularly the cotton textile industry. The dismantling of these barriers through negotiations can go a long way in increasing Pakistan's exports of manufactured goods.

(g) **Inflation:** Inflationary conditions are a serious obstacle to the promotion of exports. Inflation results in a rise in the domestic cost of production so that the goods produced cannot compete in the world market, if the rate of exchange is not suitably adjusted. So the control of inflation is essential for keeping Pakistani

goods competitive and for promoting exports. It has not been possible to control inflation in Pakistan even in recent years.

(h) **Ever-increasing demand for imports:** Our socio-economic set-up is import and ultra import biased. People have craze to purchase imported goods. Accordingly, the demand for imported vehicles, consumer durables, electronics, etc. is increasing day by day. Moreover, the increased population, urbanisation and demonstration effect has necessitated the increase in demand for imported goods.

(i) **Political instability:** The development of the economy depends on the political circumstances of that country. Pakistan has been chronically suffered from different political shocks since her independence. Our exports and BOP are the clear reflection of these political instabilities. For example, during 1988-89, exports were affected by the political uncertainty and disturbances during the greater part of the year. The events starting from the dissolution of National Assembly on 29th May 1988 made a deep imprint on the psychology of business communities.

Measures to Correct Disequilibrium in BOP:

The following steps should be taken in order to remove the deficit or disequilibrium in balance of payment of Pakistan:

(a) **Exports:** The enhancing of exports will result in increasing the supply of foreign exchange in the country. In order to promote exports following steps should be taken:

(i) The ***proportion of manufactured goods be increased*** and that of primary and semi-manufactured goods be decreased.

(ii) In addition to manufactured exports, the ***non-traditional exports*** like food processing, dairy farming, vegetables and fruit canning, and dry fruits be promoted.

(iii) More and more delegates be sent abroad so that new markets could be explored. The ***export exhibitions and fairs*** be arranged in the big trading centres of the world. The establishment of Expo Centres in Karachi and Lahore is a good step. Such expo centres should also be established in Rawalpindi-Islamabad, Faisalabad, Peshawar and the future city of Gwadar.

(iv) The ***quality and cost of the export goods be improved***. Management philosophies like Continuous Improvement, TQM, Kaizen, and 3Es be adopted.

(v) The exporters be provided with ***compensatory and concessionary finance*** along with rebates, tax holidays and bonuses, etc. Export processing zones be increased and expanded in all the major cities.

(b) **Imports:** Our imports need proper check. Imports of only those goods should be allowed duty-free that are used in the production of export goods. Following steps should be taken:

(i) The ***imports of luxurious items should be restricted***. The Government can impose heavy tariffs on foreign goods or even ban the imports of certain foreign goods that are deteriorating the BOP situation.

(ii) The ***imports of capital goods and engineering goods should be allowed***, which are necessary for the economic development. Moreover, the Government should also allow the imports of those goods duty-free that are used in the production of export goods.

(c) **Increase in Invisible Receipts and Decrease in Invisible Payments:** The efforts be made to reduce the invisible expenditures. In this respect, the expenditures faced in respect of foreign embassies and foreign tours be decreased. The facilities of higher education regarding science and technology, medicine and surgery, business and economics, performing arts, etc. be provided for foreign students, especially from India, Afghanistan, Iran, Sri Lanka, Saudi Arabia, Bangladesh, independent Muslim states of Russia and UAE. In this way we can earn a lot of foreign exchange and remove the deficit in balance of payment. Moreover, the domestic airlines, shipping services, locomotives, recreational places including resorts, historical places, shopping places, etc should be made attractive for foreign tourists. Most of the countries are earning through their tourism and cultural sector, for example, Sri Lanka, Maldives, Malaysia, Indonesia, Singapore, Thailand, UAE, Egypt, Turkey, etc.

(d) **Industrialisation and engineering:** Reduction of BOP depends on our rapid industrial production and the quality of our products. We need to fully utilise the existing capacity of our industries, and to promote the process of industrialisation and development of engineering sector. The Government can establish more technical and engineering institutes and allow foreign faculties. The Government can also reduce sales tax or even allow tax exemptions on production and sale of machineries and heavy engineering goods including electric generators.

(e) **Explore new vistas:** The disequilibrium in BOP can also be corrected by exploring new vistas and diverting the resources to the production and sale of such new exportable goods and services. For example, the Government can find handsome export earnings in the new fields of genetic engineering, IT, anti-terrorism technology, computer gaming (like in South Korea), computer-based surgery, or even in the field of fashion designing, art and culture including sports.