

Economic Environment and Business Strategy
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Week- 06
Lecture- 27

Understanding an open economy

Welcome to this session on the economic environment and business strategy. Today, we shift our focus to a critical dimension of macroeconomics: the external sector of the economy. In an increasingly globalized world, no country operates in isolation. Trade flows, capital movements, and exchange rate dynamics shape the environment in which businesses make strategic decisions. For firms operating in or engaging with global markets, understanding these external forces is not optional; it is essential. In this session, our focus will be on the balance of payments, a comprehensive accounting framework that captures all economic transactions between a country and the rest of the world.

The BOP is not just a statistical tool; it offers deep insights into a nation's trade patterns, capital flows, and economic growth. More specifically, in this session, we will examine how these components are structured and what drives imbalances in the balance of payments. By the end of this lecture, you will be equipped to interpret key external-sector indicators and connect them to the strategic challenges and opportunities faced by businesses operating in India and beyond. So, let us begin by understanding the structure and logic of the balance of payments.

To begin with, how a country is related to the rest of the world is reflected in trade in goods and services. One component of this trade is exports. That means some of a country's production is exported to foreign countries, and that the demand for domestically produced goods and services is increased. As we saw in the previous session, when discussing the circular flow, we identified exports as an injection into the System, which is the export.

The other component is imports; imports are goods that are consumed or invested in at home but produced abroad, and we receive them by importing from abroad. We have also identified this as a leakage from the circular flow of income. As I have mentioned, a country is connected to the rest of the world through trade in goods and services, as we have already seen in exports and imports. Another way in which a country is related to the rest of the world is through the financial route. That means portfolio managers shop the world for the most attractive yields; that is, as international investors shift their assets around the world, they link asset markets here and abroad, which would affect their income, exchange rates, and the ability of monetary policy to affect interest rates.

In short, Indian residents, for instance, can hold assets in India and/or assets in foreign countries. These are the two routes through which a country connects to the rest of the world. These links have been documented in the balance of payments record. The balance of payments is an official record of the transactions of a country's residents with the rest of the world.

There are two main accounts. One is called the current account. It records all trade, including trade in goods and services, as well as transfer payments. In short, the current account is often referred to as the balance of trade account, or BOT account. The second is called the capital and finance account, but we often refer to it as the capital account, which also includes a finance account.

It records the purchases and sales of assets, such as stocks, bonds, and land, by foreigners in India and by Indians abroad. These are the two main components. To understand this balance of payments, there is an intuitive rule for determining credits and debits. Regarding credit transactions in the balance of payments account, these transactions give rise to conceptual inflows or sources of foreign exchange.

When foreign residents purchase goods, services, and assets from domestic residents, these transactions are recorded as credits because they result in the generation of foreign exchange. In addition to exports, these purchases also represent a form of capital inflow, even when foreigners lend to our country, which should be accounted for accordingly. However, they are recorded on the credit side mainly because they are a source of foreign exchange. Then, coming to the debit transaction, it gives rise to conceptual outflows or uses of foreign exchange. Primarily, this involves the purchase of goods and services.

These imports of goods and services, plus assets held by domestic residents from foreign residents, are debits because they cause an outflow of foreign exchange. As you can see here, the export should primarily be related to goods and services. Similarly, this input should primarily relate to the goods and services part. Assets will later relate to the financial flow, capital inflow, or capital outflow. Moving further, a key principle in the balance of payments account is that the external accounts must balance.

That means the central point of any international payment is straightforward. Individuals and firms must pay for goods and services they purchase overseas. If a person spends more than their income, the deficit must be financed by selling or borrowing abroad. Similarly, if a country runs a deficit in its current account, the deficit must be financed by selling assets or borrowing abroad. In short, selling or borrowing implies that the country is running a capital account surplus.

Any current account deficit is necessarily offset by an equal and opposite capital inflow. That means, suppose a country has, for example, a 1 billion current account deficit; we will use a simple example where there is a 1 billion current account deficit. For example,

the current account deficit is \$ 1 billion. That means exports here are less than imports by 1 billion. That means, in layman's terms, we are exporting less than we are importing. That means we are importing more than we can give back. By 1 billion, in this example, we have a shortage, specifically a deficit of 1 billion. That means we are importing 1 billion more than our exports. That means, how do we pay for this? Because when we import goods and services, we must make a payment.

That means the rule here is what I have written at the beginning. Individuals and firms must pay for goods and services they purchase overseas. They must pay. That means they need to pay this 1 billion to cover the excess 1 billion; either they need to sell their assets, such as gold or other assets abroad, or they should borrow from abroad. Then, only either this or a mix of both can finance this 1 billion.

That means that if there is a \$1 billion shortage, there is a \$1 billion deficit in the current account. That means that if there is a \$1 billion deficit in the current account, we need a \$1 billion surplus in the capital account. That means the money we are receiving from abroad is from the sale of assets, such as gold, or from borrowing abroad. The current account plus the capital account equals zero. That means, as I mentioned earlier, minus \$ 1 billion, which must be paid either by buying or selling assets or by borrowing. That means here, plus 1 billion, when we are borrowing. That means it will be credited in the balance of payments; this is what I meant in the previous slide. That means the debit and credit part, so this is when we borrow from abroad or sell our assets abroad, and that money will be credited to the balance of payments account. Now, let us proceed to examine the current account and capital account individually. Therefore, we follow the definition outlined in the international standard.

First, the trade balance. A trade balance occurs when the value of exports equals the value of imports. In this case, the value of goods and services that Indian residents export is less than the value of those they import. Therefore, we can say that there is a balance of trade; neither a deficit nor a surplus exists, which means it is equal. So, when a balance of trade deficit means our imports are greater than our exports, a balance of surplus means our exports are greater than our imports. So, the second component is mainly the primary income balance, which means here in the trade balance, I primarily refer to the export and import of goods and services, and here the primary income balance mainly refers to the income from abroad, specifically the net income that Indian residents earn from factory income abroad. Abroad, they pay less than they do for working in the rest of the world.

That means, in terms of wages and from financial market investments, you will get interest income and dividends. So, prime net income from abroad refers to the amount Indians earn from abroad minus the amount foreigners earn in our domestic territory. So, that is recorded as the primary income balance. There is also a secondary income balance. Secondary income balances are not due to any productive activity; for example, foreign

aid remittances provide grants. It consists of two parts. One is the income that Indian residents earn, which is less than what they pay to the rest of the world in taxes to the government. That mainly means tax payments and refunds. And then, coming in second, is the current transfers. These are the transactions between Indian residents and the rest of the world in which one party provides something to be consumed by another party without receiving anything in return. For example, emergency food aid or any grant or gift to meet natural calamities or any other emergency, or that is just a current transfer not given for any productive services; and then moving to the second component, that is the capital account.

The capital account primarily consists of capital transfers, where one party transfers ownership of an asset to another without receiving anything in return, similar to current transfers, which I mentioned on the previous slide. Here, the capital transfer is also not for a specific purpose, meaning that someone is receiving this money without providing anything in return. This includes conditional grants for specific capital projects, such as a foreign aid project to build roads and other infrastructure, as well as debt forgiveness. Another component is the transfer of non-financial, non-produced assets.

These are primarily intangible assets, including brand names, copyrights, and the right to use land or water for mining or fishing purposes. This category includes transfers of non-financial, non-produced assets. Another major component is the financial account. It records changes in ownership of the country's assets or liabilities with the rest of the world. Briefly, let us delve into the components of the financial account. It involves a change of ownership of the country's assets or liabilities with the rest of the world.

The main component of the financial account is direct investment. Direct investment refers to financial transactions involving long-term capital investment in a business. For example, the purchase of machinery, buildings, or factories. We refer to it as direct investment, or foreign direct investment. That means, shortly, you might have heard of FDI.

FDI stands for Foreign Direct Investment, and it is recorded in the financial account under the "Direct Investment" heading. Then we have portfolio investment. Portfolio investment refers to the practice of foreign entities purchasing equity or debt instruments in India, rather than directly investing in the country. They may invest in the stock market, buy an IPO (initial public offering), purchase from the secondary market, or buy government-issued or corporate-issued bonds. So, they are investing in India, but they are not directly coming here, setting up factories, or directly engaged in production.

This means that the other component of portfolio investment, instead of directly engaging in capital investment, involves buying equity or debt instruments in a business. In short, unlike direct investment, portfolio investment occurs when the investor has no

influence over the business's operations. Then we have the third component, called a financial derivative. That is the purchase and sale of a financial derivative. So, they will be investing in the options market or the spot market.

They will primarily invest in the derivative market. That means financial contracts between two parties, where the value is derived from another financial instrument, such as a bond, share, or market index. Additionally, there are reserve assets, which are mainly held by the central bank. This refers to the purchases or sales of other reserve assets held by the central bank, which, in India's case, is the Reserve Bank of India. These reserves are assets controlled by the Reserve Bank to meet policy objectives, such as intervention in the foreign exchange market, and to assist the Indian government in fulfilling its commitments to the IMF.

Reserve assets, to repeat, are transactions conducted mainly by the Reserve Bank of India. The primary objective is to intervene in the foreign exchange market to stabilize and influence the exchange rate, thereby supporting the Indian government in meeting its commitments to the International Monetary Fund (IMF). The last component is other investments, which encompass transactions that do not fit into any of the other categories. For example, trade credit occurs when an importer purchases goods from overseas and doesn't pay for them until they are received. Another example is currency and deposits, where money is deposited in or withdrawn from banks across borders, or banknotes or coins are transferred between countries. To summarize, I mentioned the components of the balance of payments under current account transactions.

It primarily includes purchases of goods and services, exports and imports, income payments, interest and dividend receipts and payments, as well as transfer payments between countries, such as gifts or aid. The other component is the capital account, which includes capital or financial account transactions. This primarily refers to capital outflow when residents invest in foreign assets, and capital flight occurs when a large amount of money leaves a country quickly. There is also capital inflow, which occurs when foreigners invest in domestic assets. Additionally, there are official reserve account transactions. These are mainly conducted by the central bank, as I already mentioned.

This reflects changes in the official international reserves. The reserves primarily comprise gold, special drawing rights with the IMF, the IMF's reserve position, and other claims. Note that the official reserves are accumulated, meaning they include not only what is received in the current period but also what has been accumulated over time. Let us now explore the structure of the balance of payments. As I already know, it has a current account and a capital and financial account.

Within the balance of payments record, the current account is divided into several components. The first is the trade balance, which is the difference between exports of

goods and imports of goods. The second is the services balance, which is the difference between exports of services and imports of services. Then comes the income balance, which is primary, as I already mentioned in the previous slide; it is the net compensation of employees and investment income. The fourth is net unilateral transfers, which are primarily represented by the secondary income balance. You can see that item 1, 2, 3, and 4 are collectively referred to as the current account.

Then, moving to the capital and financial accounts, the capital account, which we have already discussed, and the financial account will be classified into three categories: FDI, which is foreign direct investment; the second is portfolio investment; and the third is other investments, such as loans, amortization, and financing. Then there are some errors and omissions known as statistical discrepancies. These are also part of the financial accounts. In total, the balance of payments, as it is structured in the record, is that the current account plus the capital account, as you know, A plus B plus C, all these together will constitute the balance of payments. In short, when we summarize this, we should arrive at a value of 0 because the current account plus the capital account will be equal to 0.

I'm showing you an illustrative example of the balance of payments account. Virtual transactions are reported on the credit side, and they have been recorded on the debit side. So, you can see, for example, here on the credit side, these are straightforward. You can see that these are export transactions. The export of goods and services generates proceeds from exports, which include goods and services; similarly, income from foreign investments is also included.

You can see that these are all credits in the balance of payments account. Then you can see the unilateral receipts we receive from abroad, and similarly, the foreign borrowing we undertake from abroad. Although it involves borrowing, which means we owe them, in the balance of payments, since it represents a capital inflow, we record it in the credit section. That means if you are borrowing from abroad on the capital account, it will show a surplus. Then, even short-term borrowing also becomes a part of credit.

Similarly, if you are selling gold and other assets, these will all be recorded as credits. That means this item, which you can see clearly, refers to items 6, 7, and 8. Items 6 and 7 are clearly borrowings, but on the balance of payments account, they will be reported as credits. Similarly, if you are selling assets, such as gold or any assets we have abroad, like buildings or factories, selling those also becomes part of our credit. Coming to the debit, you can see that these are all imports; for imports, we report everything on the debit side.

And what about unilateral payment? Suppose the Indian government gives aid, foreign aid, to African countries and nearby South Asian countries. Then, what are we going to do if we are giving aid, for example? The government is simply giving money to nearby

and neighboring countries, but then that will be reported as a debit in our account. We are paying money, but they, in fact, owe us. However, in the balance of payments, it will be reported as minus; in fact, it is a debit in our account. Additionally, there are long-term loans and short-term loans to foreign countries and corporations, which will be debited from our account. Similarly, if you are purchasing gold or assets of foreign entities, that also becomes a debit because we are paying for it from our foreign exchange reserves, and similarly, errors and omissions will become positive. This also applies; for example, these errors and omissions become a debit in the account.

This is how the balance of payments account is structured. I am showing you how the balance of payments is recorded in India's official records. Please review the Economic Survey and the Statistical Appendix, as these documents clearly outline the information. You can see each item that starts with 'import' or 'export'. These include the trade balance, its calculation, the invisibles, the current account balance, and the capital account balance. So, you go one by one, and then it will provide you with more detailed information about the balance of payments components.

When you submit, you will gain valuable insight into the components of the balance of payments and how they evolve over time. I strongly recommend that you review the economic survey's statistical appendix. In the previous slide, I mentioned the invisible account. Let us have a quick discussion of what is meant by an invisible account. It is part of the current account and typically comprises the service account, as well as the gifts and charities accounts.

It includes banking and insurance charges, with restaurants as the main component of tourist expenditure, along with transport charges, gifts, and charitable donations. Thus, the IMF includes the following items as invisible transactions. These include international transactions of goods, including warehousing, while in transit, and other transit expenses, as well as travel for business, education, health, international conventions, or pleasure, insurance premiums, and payments of claims, as well as investment income, including interest, rents, dividends, and profit. Miscellaneous services, including advertising, commissions, film rentals, pensions, patent fees, donations, migrant remittances, legacies, contractual amortization, and depreciation of direct investments.

All these components between countries, including the transactions denoted by the invisible account in this context. In this lecture, we discussed what is meant by the balance of payments. In that context, we discussed current accounts and capital accounts. We then listed each component that falls under the current account and capital account. We also demonstrated that the current account and capital account must balance according to the balance of payments transaction.

Thank you for watching this session. I look forward to seeing you at the next one. Thank you.