Impacts Foreign Assets and Liabilities of a Country – An Empirical View

***Jagadeesha Aladakatti. Assistant Professor of Commerce, S R M P P Govt First Grade College, Huvinahadagali.**

Abstract

This paper attempts to study how **the current, capital,** Theorists believe that holding reserves in currencies which is not immediately connected to its own is best policy. As of April 2016 China holds the largest foreign exchange reserves $3520.4 billion. The holding of forex is used to back the one's domestic currency. Countries who wish to have fixed exchange rate uses forex reserves as a tool of monetary policy. Central institution has ability to exert some control over exchange rates by retaining the option to shove reserves from another currency in to the market. In the field of international trade and commerce, these two terms – current account and capital accounts – are widely used. Both of them relate to trade and business dealings of a nation with others. Wondering how does a Capital Account work? Let's consider the following. While capital account deals with the change in ownership of a country's assets, the current account reflects the change in a country's net income. These two accounts – capital and current – together form the balance of payments or BoP of a country. When we refer to balance of payments, this refers to the record of all commercial transactions between a country along with the rest of the world. The country, in this context, includes the government, private entities and citizens. Both the capital account and current account can have deficit or surplus situations. A surplus capital account means that money is flowing into the country, but these inflows reflect changes in the ownership of national assets by way of sale or borrowing.

Key words: ***Current** , **capital accounts** , **payments**, India, Foreign exchange.*

Introduction

The surplus account will not be against any goods or services supplied by a domestic entity to a foreign entity that can qualify as income or payment of a fee against delivery of some service. Capital Account Deficit with Example For example, an Indian corporate entity acquires a large European steel producer in a deal involving payment of billions of Euros. The transaction may turn the capital account into a deficit situation as the total outflow in the capital account may exceed total inflows because of the size of the deal. It will create a deficit situation in the capital account, but the deal will result in an Indian entity acquiring ownership right of a foreign asset.

The major differences between capital account and current account are as follows −

Capital Account

- These are accounts related to capital investments and expenditures of a country to another.
- It measures inflow and outflow of capital in economy.
- It evaluates country net investment position.
- Impacts foreign assets and liabilities of a country.
- Deals with source and utilisation of capital.

Current Account

- These are accounts related to trade of goods and services of a country.
- It measures inflow and outflow of goods and services in the economy.
- Merchandise trade, services, income receipts and unilateral transfers are key components.
- It evaluates trade surplus/trade deficit of a country.
- Impacts on net income and output of a country.
- Deals with receipts and disbursements in cash and non-capital items.

Objective:

This paper intends to explore and analyze how **current and capital** account are interlinked on forex transaction. Also, how buy or sell **foreign exchange** for any current account transaction, measures the inflow and outflow of goods, services, investment incomes and transfer payments.

Inflow of money (foreign receipts)

The foreign receipts include the inflows from external earnings and external borrowings.

- **Source of earnings:** It includes the merchandise exports, services exports, private transfers and remittances, Gifts and Aids from foreign sources, money earned from interest, dividends, and royalties etc.

- **Source of borrowings:** the borrowings include Foreign Direct Investments (FDI), foreign portfolio investments (FPI), external commercial borrowings, NRI deposits, loans taken by the government from external sources etc.

Outflow of money (foreign payments)

- **Spendings:** it includes spending on merchandise imports, service imports, remittances sent to their home countries by foreign nationals, gifts, and grants given to foreign countries, interest, dividends and royalties etc paid to the foreign countries etc.
- **Lendings:** it includes Foreign Direct Investment made by Indian companies in foreign countries, Foreign Portfolio Investment made by the Indian citizens, short term deposits made by Indian residents in foreign countries, the loans given by the Indian government to the foreign governments etc.

Components of the B**alance of payments (B**OP)

The components of the balance of payment are:

- **Current account:** It includes the financial transactions dealing with the export and import of goods, services, unilateral transfers, investment income etc.
- **Capital account:** It includes the financial transactions dealing with assets such as foreign direct investment, foreign portfolio investment, foreign loans etc.
- **Official reserve transactions:**It conducted by the central bank in case of the BOP deficit or BOP surplus.
- **Errors and omissions:** It is the element of BOP (other than the current account and the capital account) which refers to the balancing items reflecting the inability to record all the international financial transactions.

Autonomous and accommodating transactions

All the transactions under the current account and the capital account are known as autonomous transactions. This is because these transactions are done solely on the basis of profit motives without taking into consideration the status of the Balance of payments. Autonomous transactions are also known as above the line elements in the Balance of payments.

The accommodating transactions depend upon the status of the Balance of payments. These transactions are determined by the consequences of the autonomous transactions on the BOP. The accommodating transactions are also known as below the line elements in the Balance of payments. The official reserve transactions are an example of accommodating transactions.

Current Account transactions

It includes all the transactions for exports and imports of goods, services, unilateral transfers and investment income etc. The receipts from the exports of goods, services, investment income, and unilateral transfers are shown as positive items or credit in the current account. Whereas the payments made for the import of goods, services, investment income sent abroad and unilateral payments are shown as negative items or debit in the current account. The balance on current account refers to the net value of these credits and debits.

When the net value of these transactions is negative, then it leads to the current account deficit (CAD). While if the net value of all these transactions is positive then it is known as current account surplus. The current account shows the income generated from the foreign sources.

Components of the current account

The major components of the current account are as follows:

- **Merchandise transactions or the visible trade (export and import of goods):** the major part of foreign trade transaction include the export and import of a country. Payments made for the import of goods from other countries are shown as a negative side or debit items, and the receipts from the export of goods to other countries are shown as positive items. The balance of these exports and imports is called as the balance of trade or the merchandise trade balance. If the imports are more than exports, it will lead to trade deficit; while if the exports are more than imports, it will lead to a trade surplus. India has experienced consistent trade deficits except for the two years in the 1970s.

  Capital account transactions:

Capital account refers to the record of all the transactions of the capital inflows and capital outflows which affect a country's foreign assets and liabilities. It deals with all the international capital trade transactions between the residents of one nation with other. The capital account shows net the changes in the ownership of a country's assets and liabilities. For example, if an Indian citizen buys a property in a foreign country it will be shown as a debit in the capital account.

The capital account components include foreign investment such as FDI and FPI, immovable properties, intangible assets trade credits, borrowings from other countries, banking capital, changes in the foreign exchange reserve etc. The NRI deposits, Special Drawing Rights, funds held in foreign countries etc are also included in the capital account. The capital account is concerned with the claims and liabilities of financial nature regardless of the time period.

The capital account is used for financing deficits in the current account or absorbing any surplus of the current account. As the capital account deals with financial transfers, it does not have any direct impact on the output, income and the employment of the nation.

Components of capital account

- **Borrowing and lendings from foreign countries:** it includes the financial transactions related to borrowing money from foreign countries by the private sector companies or individuals, government etc. The receipts from abroad which include the repayment of loans from the foreign citizens etc are shown as a credit in the capital account. The financial transactions dealing with lending to abroad by the private sector companies, individuals and the government, and the repayment of loans taken from foreign countries is shown as a debit in the capital account.
- **Investments to and from the foreign countries:** the investments from the foreign countries in the Indian companies, government bonds, real estate etc in India are shown as a credit in the capital account as they lead to the inflow of foreign exchange. The investments made by the Indian residents in the stocks and shares of companies abroad, government bonds, real estate etc are shown as a debit in the capital account as they lead to the outflow of foreign exchange.
- **Foreign direct investment (FDI):** when the foreign residents buy Indian capital assets such as companies, industrial complexes, machines etc, it is shown as a credit to the capital account. The FDI investment made by Indians in the foreign countries is shown as a debit in the capital account.
- **Foreign portfolio investment (FPI):** when the foreign residents purchase stocks, government bonds, corporate securities etc, then these transactions are shown as a credit to the capital account. When the Indian residents purchase securities and bonds in foreign countries, it is shown as a debit in the capital account.
- **Changes in the Foreign Exchange Reserves:** the foreign exchange reserves are the financial assets held by the central bank (RBI for India) of the country. These reserves serve as financing item in the Balance of payments. Any withdrawal from the foreign exchange reserves is shown as credit, while any addition in the reserves is shown as a debit in the capital account. The changes in foreign exchange reserves is shown in the BOP account and not the actual foreign exchange reserves .

Balance on the capital account

The net value of all the credits and debits as mentioned above gives the balance on the capital account. When the credit items are more than the debit items, it leads to capital account surplus and indicates the net inflow of capital in the country. When the debit items are more than the credit items then it leads to a deficit in the capital account which indicates the net outflow of capital from the country.

Balance of payments (BOP) = Current account + Capital account =0

Current account deficit

Current account deficit refers to a situation when the value of goods and services imported by a country exceeds the value of goods and services exported by it. In other words, it simply means that a country imports more than what it exports.

This current account deficit is paid through surplus in the capital account i.e through surplus foreign investments or foreign loans or through the forex reserves. When foreign exchange reserves fall below the critical level, the country faces the balance of payment crisis.

Impact of current account deficit

- The impact of the current account deficit depends upon the manner in which this deficit is financed. If it is financed through loans and borrowings from foreign countries, it becomes unsustainable in the long run because large borrowings ultimately leads to high interest payments in the future.
- The financing of CAD through hot money such as foreign Institutional Investment (FII) is also risky as when the confidence of market falls, the hot money flows out quickly leading to rapid depreciation of currency as happened during the East Asian crisis.
- Running CAD means the claims of foreigners are increasing in the countries assets which could be redeemed by them at any point of time.
- However, the impact of CAD may not be necessarily negative as CAD during the period of inward investment through FDI can create jobs and growth in the economy. This improves the health of the country's economy and the country will be able to pay its debts back.
- The developing countries usually run CAD for buying capital goods, and later they export the consumer goods for repaying their debts.
- A moderate CAD of around 2% of GDP is stable for the economy and can be helpful in long run to improve its productivity.

Conclusion

The *current account balance* seems to be an abstruse economic concept. But in countries that are spending a lot more abroad than they are taking in, the current account is the point at which international economics collides with political reality. When countries run large deficits, businesses, trade unions, and parliamentarians are often quick to point accusing fingers at trading partners and make charges about unfair practices. Tension between the United States and China about which country is primarily responsible for the trade imbalance between the two has thrown the spotlight on the broader consequences for the international financial system when some countries run large and persistent current account deficits and others accumulate big surpluses. Current Account Transaction is a transaction other than a capital account transaction and includes:

a. Payment due in connection with foreign trade, other current business, services and short term banking and credit facilities in the ordinary course of business

b. Payments due as interest on loans and as net income from investments

c. Remittances for living expenses of parents, spouse and children residing abroad

d. Expenses in connection with foreign travel, education and medical care of parents, spouse and children.

The definition of current account transaction is inclusive and any expenditure which is not covered under capital account transaction will be current account transaction even if the transaction is not specified above.

All the current account transactions are free from restrictions, unless specifically restricted by Central Government as per section 6(4) of the Foreign Exchange Management Act, 1999 and Foreign Exchange Management (Current Account Transactions) Rules, 2000.

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