2.8 ANSWERS TO CHECK YOUR PROGRESS

A 4 i) True; ii) False; iii) True; iv) True; v) False.

B 5 i) True; ii) False; iii) True; iv) True; v) False.

2.9 TERMINAL QUESTIONS

1. Critically examine Ricardian Theory of Trade.
2. Describe The Heckscher—Ohlin—Samuelson Theorem.
3. "In the neoclassical model free trade not only equalises the relative commodity price in the two countries but also equalises the relative wage rate". Discuss.
4. Explain the Rybczynski Theory of trade with suitable diagram.
5. Explain the modern theory of trade.
6. Distinguish between
   i) Absolute advantage & comparative advantage
   ii) Classical theory and Neo-classical theory.
7. Write notes on:
   i) Terms of Trade
   ii) Free trade and gains from trade
   iii) Factor price equalisation theorem.

UNIT 3 BALANCE OF PAYMENTS

Structure

3.0 OBJECTIVES

After studying this unit, you should be able to:

- analyse the significance of balance of payments as a major variable of business environment
- describe the concept of balance of payments
- explain the accounting mechanism of balance of payment
- distiguish between the current account, the capital account and official reserves account
- describe the links among these accounts
- analyse the nature, causes and consequences of disequilibrium in balance of payment
- explain various measures of dealing with the disequilibrium in balance of payment.

3.1 INTRODUCTION

Following the emergence of global competition, managers have started taking interest in the changing international scenario. To understand the dynamics of changing environment, they require a thorough knowledge of the macro economic environment - particularly the financial and real linkages between the domestic and global economies. How these linkages affect business viability is of almost interest to them. These linkages are measured and relevant statistics compiled and presented for analysis in balance of payments. In India, Reserve Bank of India compiles the data and brings out quarterly statements regularly.

Balance of payments statistics affect the exchange markets and are therefore, of concern to every one concerned with foreign exchange. Developments in foreign exchange markets may necessitate entailing changes in the relevant policies. The continuous deficits of BOP is an important indicator in credit rating of countries. Market may interpret the data as evidence the country may have difficulties in servicing its debts. Therefore, corporate managers must monitor balance of payments data on a regular basis, not only of their country but also of their trading partners. BOP situation is a key element in macroeconomic environment which is a major concern for the companies. In this Unit, you will learn the concept of the balance of payment, the accounting procedures, the components and the disequilibrium in the balance of payment. You will also be acquainted with the factors affecting the balance of payment and the methods to correct the disequilibrium.

3.2 DEFINITION

Balance of payment is an accounting record of the transactions between the residents of one country and the residents of the rest of the world over a given period of time. Transactions in which domestic residents either purchase assets (goods and services) from abroad or reduce foreign liabilities are considered uses (out flow) of funds because payments abroad must be made. Similarly, transactions in which domestic residents either sell assets to foreign residents or increase their liabilities to foreigners are sources (inflows) of funds because payments from abroad are received. Thus, in a way, it resembles a company's sources and uses of funds statement.

3.3 UNDERLYING PRINCIPLES AND CONCEPTUAL FRAMEWORK

The balance of payment is part of a larger system of social accounts recording the economic activity of an economy and its various sections. The social accounts relate to economic transactions not only within the domestic economy but also between the domestic economy and the rest of the world.

Balance of payment is concerned with economic transactions. Five basic types of economic transactions may be distinguished. They are:

a) Purchases and sales of goods and services against financial items i.e. the interchange of goods and services against claims and monetary gold;

b) Barter, i.e. the interchange of goods and services against other goods and services;

c) The interchange of financial items against other financial items e.g. sale of securities for money, or the repayment of commercial debts in money;

d) The provisions or acquisition of goods and services without requital, e.g. grants in aid;

e) The provision or acquisition of financial items without requital, e.g. in payment of taxes or as a gift.

The social accounts have common rules of credit and debit for recording economic transactions. Credit entries are made for the provision of goods and services or of financial items, whether they are sold, bartered, or furnished without requital. Debit entries are made for acquisition of goods and services or of financial items, whether these items are purchased, obtained by barter, or acquired without requital. For the first three types of transactions, the rules immediately result in equal credit and debit entries. For the remaining types, a credit entry for goods and services or financial items is matched by a debit entry for an unrequited transfer, and vice versa.

As stated earlier, balance of payments is concerned with economic transactions between the residents of the reporting country and the residents of the rest of the world. To acquire an indepth understanding, it is necessary to clarify the concept of residents. This term is certainly not identical with the term "citizen" though there is normally a substantial overlap. As regards individuals, 'residents' means those individuals whose general centre of interest can be said to rest in the given economy. They consume goods and services, participate in the productive process or otherwise carry out economic activity within the territory of the country on other than a temporary basis. Members of diplomatic and

consular staffs and official missions, members of armed forces stationed abroad, and citizens undergoing medical treatment or studying abroad are considered residents of their own rather than of the country where they are staying. The extent to which other citizens living abroad are treated as residents (travellers) or foreigners (emigrants) depends upon a number of factors such as permanence of their living and the extent to which they shift their general "centre of interest". As regards non-individuals a set of conventions have been evolved. For example, governments and non profit bodies servicing resident individuals are residents of the respective countries. For enterprises, rules are somewhat complex particularly those concerning unit of corporate branches of foreign multinationals. According to IMF rules, these are considered to be residents of countries where they operate, though they are not a separate legal entity from the parent located abroad. International organizations like the UN, the World Bank, the IMF are not considered to be residents of any national economy even though their offices may be located within the territories of any number of countries.

3.4 BALANCE OF PAYMENT ACCOUNTING

The balance of payment is a standard double entry accounting record and as such subject to all the rules of double entry book-keeping viz. for every transaction two entries must be made. One credit (+) and one debit (-) and leaving aside errors and omissions, the total of credits must exactly match the total of debits i.e. the balance of payments must always balance.

Simple accounting rules followed in BOP are the following :

a) All transactions which lead to an immediate or prospective payment from the rest of the world to the country should be recorded as credit. Hence, all payments received for export of goods and services as also loans received abroad or inward foreign investment—whether direct or portfolio would be credit items.

b) Conversely, all transactions which result in an actual or prospective payment from the country to the rest of the world should be recorded as debits.

c) A transaction which results in an increase in demand for foreign exchange is to be recorded as debit entry while a transaction which results in an increase in the supply of foreign exchange is a credit entry.

3.5 COMPONENTS OF THE BALANCE OF PAYMENTS

The balance of payments is a collection of accounts conventionally grouped into three main categories with subdivisions in each.

Three main categories are:

a) **The Current Account :** Under this are included imports and exports of goods and services and unilateral transfers, which reflect government and private gifts and grants.

b) **The Capital Account :** Under this are grouped transactions leading to changes in foreign financial assets and liabilities of the country.

c) **The Reserve Account :** In principle, this is not different from the capital account in as much as it relates to financial assets and liabilities. However, in this category, only reserve assets are included. These are the assets which the central bank of the country uses to settle the deficits and surpluses that arises in the other two categories.

Check Your Progress A

1. What is Balance of Payment?

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2. Enumerate two basic types of economic transactions.

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3. What do you mean by residents?

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4. Distinguish between Current Account and Capital Account of Balance of Payment.

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3.5.1 The Current Account

Look at Table 1, where the structure of the current account in India's BOP statement has been shown. Let us briefly discuss each of the above heads and subheads.

I) **Merchandise:** Merchandise exports valued on F.O.B.. (Free on board) basis, on private and government account are the credit entries data for these items. They are calculated from the various documents exporters fill and submit to designated authorities.

Imports valued at C.I.F. (Cost, Insurance and Freight) are the debit entries. The difference between the totals of credits and debits appears in the 'Net' column. This is the balance on Merchandise Trade Account, a deficit, if negative and a surplus if positive.

II) **Non-Monetary Gold Movements:** Gold is both a commodity and a financial asset. It is treated as a financial assets when it is held by the monetary authority. "Monetisation" of gold refers to the transaction when the monetary authority acquires gold, from residents and non residents to add to reserves. This get recorded as a debit entry in reserve account and the off setting credit entry is made in the non monetary gold account. Conversely, when the monetary authority acquires gold demonetisation, reserve account shows a credit and the non monetary

gold movement account shows a debit. Gold imported (or exported) by other agencies form a part of the merchandise trade account.

Table 3.1: Structure of Current Account in India's Balance of Payments Statement.

A.	Current Account	Credits	Debits	Net
I	Merchandise			
	1. Private			
	2. Government			
II	Non-monetary Gold Movements			
III.	Invisibles			
	1. Travel			
	2. Transportation			
	3. Insurance			
	4. Investment Income			
	5. Government, not included elsewhere			
	6. Miscellaneous			
	7. Transfer payments			
	(i) Official			
	(ii) Private.			

III) **Invisibles:** Credits under 'invisibles' consist of services rendered by residents to non residents, income earned by residents on their ownership of foreign financial assets (interest, dividends etc.), income earned from the use, by non residents, of non-financial assets such as patents and copy rights owned by residents and the offset entries to the cash and in kind gifts received by residents from non-resident. Debits consist of same items with the roles of residents and non-residents reversed. A few examples may be cited as follows.

- Receipts in foreign exchange, reported by authorised dealers in foreign exchange, remitted to them by organisers of foreign tourist parties located abroad for meeting hotel and other local expenses of the tourists. This will be a credit under "travel".
- Freight charges paid to non resident airlines or shipping companies directly will appear as debits under transportation.
- Premiums on all kinds of insurance and re-insurance provided by Indian insurance companies to non-resident clients is a credit entry under "insurance".
- Profits remitted by the foreign branch of an Indian company to the parent company represent a receipt of 'direct investment income', to be recorded as a credit entry under 'investment income'. Interest paid by an Indian company on its borrowings abroad will appear as a debit.
- Funds received from a foreign government for the maintenance of their embassy, consulates etc. in India will constitute a credit entry under 'Government not included elsewhere'.
- Foreign exchange earnings of Indian consultancy firms for professional services rendered to non residents will be recorded as a credit entry under 'miscellaneous'. Similarly, professional services provided to residents by non resident companies will appear as debit entry.
- Revenue contributions made by the Government of India to international institutions or non resident entities abroad will be recorded as a debit entry under 'official transfer'. Simply, cash remittances for family maintenance received from Indian nationals working abroad will be a credit entry under private transfers. Look at Table 3.2 which gives you an idea about India's balance of payments:

Table 3.2: India's Balance of Payments

(*In US $ Million*)

	1998-99	1997-98	1996-97	1991-92
Current Account				
Exports, *f.o.b.*	34,298	35,680	34,133	18,266
Imports, *c.i.f.*	47,544	51,187	48,948	21,064
Trade balance	-13,246	-15,507	-14,815	-2,798
Invisibles, *net*	9,208	10,007	10,196	1,620
Of which:				
Investment income	-3,544	-3,521	-3,307	-3,830
Private transfers	10,280	11,830	12,367	3,783
Official transfers	307	379	410	460
Current Account Balance	-4,038	-5,500	-4,619	-1,178
Capital Account				
External assistance, net	820	907	1,109	3,037
Of which:				
Disbursements	2,726	2,885	3,056	4,366
Amortisation	-1,906	-1,978	-1,947	-1,329
Commercial borrowings, *net*	4,362	3,999	2,848	1,456
Of which:				
Disbursements	7,226	7,371	7,571	3,133
Amortisation	-2,864	-3,373	-4,723	-1,677
Short term credit, *net*	-748	-97	838	-515
NRI deposits, *net*	1,742	1,125	3,350	290
Foreign investments	2,412	5,390	6,153	139
Rupee debt service	-802	-767	-727	-1,240
Other capital, *net*	779	-714	-1,565	801
Total capital account	8,565	9,844	12,006	3,968
Overall balance	4,222	4,511	6,793	2,790
IMF, *Net*	-393	-619	-975	786
Reserves and monetary gold	-3,829	-3,893	-5,818	-3,576

Source: Statistical Outline of India, 1999-2000.

The net balance between the credit and debit entries under the heads merchandise, non-monetary gold movements taken together is the Current Account Balance. The net balance is taken as deficit, if negative (debits exceed credits), a surplus, if positive (credits exceed debits).

3.5.2 The Capital Account

You have learnt the Current Account of India's balance of payment. Let us now learn the Capital Account.

The capital account records the changes in the levels of international financial assets and liabilities. The various classifications within the capital account are private, banking and official. Distinction is also made between short term and long term capital flows, loans with

original maturity of more than one year are classified as long term flows. Long term foreign investment measures all capital investments made between countries, including both direct foreign investment and purchases of securities with maturities exceeding one year. Short term foreign investment measures flows of funds invested in securities with maturities of less than one year. Because of the short maturity, investors of such securities will often maintain their funds in a given country for only a short time, causing short term investment flows to be quite volatile over time.

Table 3.3: The Capital Account in India's Balance of Payments

B. Capital Account	Credits	Debits	Net
I. Private			
1. Long Term			
2. Short Term			
II. Banking			
III. Official			
1. Loans			
2. Amortisations			
3. Miscellaneous			
Total Capital Account (I+II+III)			

Private Capital Flows

These flows consist of several type of transactions. Among them are: long term loans received by individuals and companies (other than banking institutions), investment by foreigners in the joint stock companies in India, repayment of long term loans by non-resident, obtained from residents, repatriation of Indian investments abroad, deposits in non-resident (external) rupee accounts and in foreign currency non-resident accounts. Capital outflows (debit entries) comprise investments by residents in shares and other financial assets abroad, repayment of foreign loans by residents, repatriation of foreign investments in India, long term loans made to non-residents and so forth.

Short term capital flows on private account consists of short term borrowings and investments.

Banking

Capital movements in banking sector covers changes in foreign assets and liabilities of commercial banks, whether privately owned or government owned and cooperative banks. Assets consist of balances held by banks with their foreign branches or correspondent banks abroad, and rupee assets representing loans granted by Indian banks to branches of foreign banks in India and correspondent banks. Liabilities consist of Indian banks' debit balances in their foreign accounts and credit balances held by non resident banks and few other institutions with banks in India. Any increase in assets (or decrease in liabilities) will be a debit entry while a decrease in assets (or increase in liability) a credit.

Official Capital Flows: This category covers transactions affecting foreign financial assets and liabilities of the government of India and the Reserve Bank of India, excluding transactions relating to official reserve assets. Government of India's purchase and repurchase from the IMF are shown in a separate account. Loans received by the Government of India from foreign governments and international institutions are treated as credit entries and amortisation or repayment of such loans as debit.

Look at Table 3.2 which shows India's balance of payments on Current Account and Capital Account in recent years.

3.5.3 The Other Accounts

The remaining accounts in India's BOP are set out in Table 3.4.

Table 3.4: IMF, SDR and Reserve Accounts

		Credits	Debits	Net
C	IMF Account			
D	SDR Account			
E	Reserves and Monetary Gold			

The IMF account contains, as mentioned above, purchases (credits) and repurchases from the IMF. SDRs (Special Drawing Rights) are a reserve asset created by the IMF and allocated to member countries from time to time. Subject to IMF regulations, SDRs can be used to settle international payments between monetary authorities of member countries. An allocation is a credit and the utilisation is a debit. The reserves and Monetary Gold account increases (debits) and decreases (credits) in reserve assets. Reserve assets consist of RBI holdings of gold and foreign exchange (in the form of balances with foreign central banks and investments in foreign governments securities) and Government's holdings of SDRs.

Check Your Progress B

1. What do you mean by monetisation of gold?

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2. What is invisibles?

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3. What do you mean by Capital Account of BOP?

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4. What is official capital flows?

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5. State whether following statements are **True** or **False**.

   i) Balance of payments statistics affect the exchange markets.

   ii) Freight charges paid to non resident airlines or shipping companies directly will appear as credit under transportation.

   iii) Cash remittances for family maintenance received from Indian nationals working abroad will be a debit entry under private transfer.

   iv) Short term foreign investment measures flows of funds invested in securities with maturities of less than one year.

   v) Special drawing rights can be used to settle international payments between monetary authorities of member countries.

3.6 DEFICIT AND SURPLUS IN BALANCE OF PAYMENTS

You have learnt that BOP accounting is based on the principles of double entry book-keeping, meaning thereby that for every credit entry, there is a debit entry. Thus, a BOP account always balances. The difference between aggregate debit and credits is called balance. In case, debits exceed credit, balance is negative or deficit, when the credits exceed debits, the balance is positive or surplus. Obviously, the term, deficits or surplus cannot then refer to the entire BOP but sub set of accounts included in BOP.

Where value of exports exceeds imports, the situation is referred as trade surplus or surplus on trade account. Excess of imports over exports results in trade deficit on trade account.

The transactions appearing in a balance of payments can be classified in two categories, viz autonomous transactions and accommodating or financing transactions. Autonomous transactions take place on their own, in response to their felt needs and are independent of situation in the balance of payments. Accommodating or financing transactions refer to the flows which take place in response to surplus or deficit in the balance of payments. For example, a country may incur or raise its liabilities or reduce its assets in order to pay for the deficit. A deficit in balance of payment exists when payments for autonomous or self motivated transactions exceed receipts. In case, there is a deficit or surplus, there have to be some compensatory transactions to balance the imbalance.

Autonomous and financing transactions are also referred to as above the line and below the line respectively.

There are several concepts of 'balance' in balance of payments. These are:

1. **Trade Balance:** This is the balance on the merchandise trade account, i.e. item I in the current account.

2. **Balance on goods and services:** This is the balance between the export and imports of goods and services. It is the net balance on item I and sub-items 1-6 of item III taken together.

3. **Current Account balance:** This is the net balance on the entire current account items I+II+III. When it is negative we have a current account deficit, when positive, a current account surplus.

4. **Balance on current account and long term capital:** This is also called basic balance. This is supposed to indicate the long term trends in BOP.

While changes in reserve assets are accurately measured, recording of other items is subject to errors arising out of data inadequacies, discrepancies of valuation and timing, erroneous reporting etc. These are reconciled through a fictitious head of account called 'Errors and Omissions'.

3.7 BALANCE OF PAYMENT DISEQUILIBRIUM

A nation's balance of payment is said to be in equilibrium when it is neither drawing upon its international reserves to make excess payments nor accumulating such reserves as a result of its receipts. In other words, when a country is not able to pay for its imports of goods and services from its export earnings, on accumulating reserves year after year, a disequilibrium in balance of payments sets in. Policy initiatives are needed to restore equilibrium.

A disequilibrium in balance of payment may be short term or long term in nature. Short term disequilibrium, arises largely on account of cyclical factors. A crop failure leading to a sudden fall in export earnings may create a shortfall and consequently a disequilibrium.

Long term or structural disequilibrium arises on account of long term structural changes in the economy. Fall in demand of export products due to technological changes may bring about a decline in export proceeds. Decline in demand and prices for natural rubber on account of development of synthetics may be cited as an example. Such a situation can be remedied only by diversification of economy.

3.8 FACTORS AFFECTING BALANCE OF PAYMENTS

3.8.1 The Current Account

A country's current account balance can significantly affect its economy, therefore, it is important to identify the factors that influence it. The most important factors are:

i) Inflation

ii) National Income

iii) Government Restructures

iv) Exchange Rates.

Let us discuss them one by one.

Inflation: If a country's inflation rate increases relative to the countries with which it trades, its current account would be expected to decrease. Due to higher prices at home, consumers and corporations with in the country will most likely purchase more goods overseas (due to high local inflation), while the country's exports to other countries will decline.

National Income: If a country's national income rises by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

Government Restrictions: If a country's government imposes a tax on imported goods (often referred to as a tariff) the prices of foreign goods to consumers effectively increases. An increase in prices of imported goods relative to goods produced at home will discourage imports and is expected to increase the current account balance. In addition to tariffs, a government may reduce its imports by enforcing a quota, or a maximum limit on imports.

Exchange Rates: Each country's currency is valued in terms of other currencies through the use of exchange rates, so that currencies can be exchanged to facilitate international transactions. The values of most currencies can fluctuate over time because of market and government forces. If a country's current account balance decreases, other things being equal, goods exported by the country will become more expensive to the importing countries, if its currency strengthens, as a consequence, the demand for such goods will decline. For example, a refrigerator selling in the United State for $ 100 require a payment of Rs. 3500, if the dollar were worth Rs. 35/- Rs. 1 = $0.028). Yet, if the dollar were worth Rs. 40/- (Rs. 1 = $ 0.025), it would take Rs. 4000 to buy the refrigerator. which could discourage Indians to buy

it. However, according to J-curve theory, a country's trade deficit worsens just after its currency depreciates because price effects will dominate the effect on volume of imports in the short run. That is the higher costs of imports will more than offset the reduced volume of imports. Thus, the J curve theory states that a decline in the value of home currency should be followed by a temporary worsening in the trade deficit before its longer term improvement.

3.8.2 The Capital Account

As with the current flows, government policies affect the capital account as well. A country's government could, for example, impose a special tax on income account by local investors who invested in foreign markets. A tax would discourage people from sending their funds for investment in the foreign markets and could therefore, increase the country's capital account. Capital flows are also influenced by capital controls of various types. Interest rates also affect the capital flows. A hike in interest rates relative to other countries may affect capital inflows from abroad. Similarly, a reduction in domestic rates may induce people to invest abroad.

The anticipated exchange rate movements by investors in securities can affect the capital account. If a home currency is expected to strengthen, foreign investors may be willing to invest in the country's securities to benefit from the currency movement. Conversely, a country's capital account balance is expected to decrease, if its home currency is expected to weaken, other things being equal.

When attempting to assess why a country's capital account changed and how it will change in future, all factors must be considered simultaneously. A particular country may experience a reduction in capital account even when its interest rates are attractive, if the home currency is expected to depreciate.

3.9 METHODS OF CORRECTING DISEQUILIBRIUM

When such a situation of disequilibrium arises, the following measures are usually adopted.

i) Use of past reserves

ii) Borrowings from IMF

iii) Monetary and fiscal policy measures

iv) Exchange rate adjustments.

Let us learn them in detail.

Use of Past reserves: A country may make use of past reserves to finance the BOP deficit provided such reserves are available. Such reserves consist of gold, foreign currencies and fund related assets i.e. reserve position with the IMF and holdings of special drawing rights. In recent years, increase in quotas and additional allocations of SDRs and expanded private capital flows have contributed to an overall increase in national reserves of several countries.

Borrowing from IMF: Countries with disequilibrium in B.O.P. can make use of IMF facilities. These are:

1. Stand bye loans
2. Extended Fund Facilities (EFF)
3. Structure Adjustment Facilities (SAF)
4. Enlarged Structural Adjustment Facilities (ESAF)
5. Compensatory and Contingency Financing Facilities (CCFF)
6. Systemic Transformation Facilities (STF).

Monetary and fiscal policy measures: Monetary and fiscal policies are also important tools for influencing B.O.P. conditions. A change in money supply brought about either through fiscal or monetary policies can bring about the required change in the level of total demand, which includes demand for imported goods and services.

Exchange rate adjustments: Adjustments in exchange rate is an effective tool. A downward adjustment in exchange rate will make exports cheaper and imports dearer. In other words, as a result of such a policy, exports will be encouraged and imports will be discouraged and equilibrium will be restored.

All these methods, however, suffer from certain limitations. Hence, managing a state of disequilibrium in B.O.P. continues to be a major problem which every country faces. The major problem is that a policy initiative taken for the sake of achieving equilibrium in B.O.P. comes into conflict with other, rather more endearing objectives, such as, economic growth, employment and price stability. Reconciling such conflicts continues to worry policy makers.

Check Your Progress C

1. What is Balance of payment disequilibrium?

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2. What is Current Account Balance?

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3. Enumerate three factors affecting Balance of Payments.

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4. Enumerate three methods of correcting disequilibrium in Balance of Payments.

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5. Tick the right answer.

   i) The accounting statement that summarises all the economic transactions between the residents of the home country and the residents of all other countries is called the

   (a) Balance of trade
   (b) Current account balance
   (c) Balance of payment
   (d) All of the above.

   ii) The sale of Indian jewellery to a US Departmental store shows up.
   (a) A credit in India's official reserves
   (b) A credit on current account
   (c) A credit in both (a) and (b).
   (d) None of the above.

   iii) Capital movements in banking sector shows in
   (a) Merchandise account
   (b) Current account
   (c) Capital account
   (d) (a) and (c) above.

   iv) Suppose Air India buys 10 boeing 747 for $ 500 million in 1996, financed by a 5 years loan from the US Export and Import Bank. There is one year grace period on principal and interest payments. The net impact of the sale in India's balance of payments in 1996.
   (a) A $ 500 million increase in India's trade deficit.
   (b) A $ 500 million decrease in current account surplus
   (c) All of the above
   (d) None of the above.

   v) Purchase of US Treasury bonds by Unit Trust of India shows up.
   (a) A credit on capital account
   (b) A debit on capital account
   (c) A debit on the current account
   (d) A credit in official reserves account.

   vi) Purchase of US dollar from International Monetary Fund will be
   (a) A credit on official reserves account
   (b) A credit on capital account
   (c) A debit on official reserves account.
   (d) A credit in current account.

   vii) Which of the following items will not be included in balance of payments Capital Account.
   (a) Purchase of shares by a US Pension Fund
   (b) Purchases of US Treasury bonds by a US fund
   (c) A foreign company liquidating its investments and repatriating the proceeds
   (d) Dividends received by an Indian company on its overseas investment.

   viii) Which of the following will adversely affect the B.O.P.
   (a) A rise in interest rate
   (b) A rise in taxes

(c) A rise in capital inflows

(d) A rise in inflation rate.

ix) In order to reduce its current account deficit, the Government of India must do which of the following?

(a) Reduce the Union budget deficit

(b) Encourage foreign investments in India

(c) Bring down the rate of interest

(d) Only a & b

(e) a, b and c.

x) A stronger rupee will help India.

(a) To reduce its current account deficit

(b) To attract more foreign investments in India

(c) Erode India's competitiveness and adversely affect its exports.

(d) None of the above.

6. State whether the following statements are **True** or **False**.

i) Transactions arising from international business cause money flows from one country to another. The balance of payments represents a measure of international money flows.

ii) The recording of transactions in B.O.P. statement is done by double entry book-keeping.

iii) Unilateral transfer of funds by residents of one country to residents of another are excluded in B.O.P. accounting.

iv) US tourists who spend money in London will affect only US balance of payments and not UK's.

v) If a country's inflation rate increases relative to the countries with which it trades, its current account would be expected to increase, other things being equal.

vi) If a country's national income increases by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal.

vii) A strong local currency is expected to reduce the currency account balance if the traded goods are price elastic.

viii) If a country's home currency is expected to strengthen, foreign investous may become reluctant to invest in country's securities.

ix) A surplus in home country's budget can adversely affect its current account balance.

x) A rise in home country's interest rates adversely affect the capital inflows.

3.10 LET US SUM UP

Following emergence of global competition and consequently increased flows of goods, services and capital, an understanding of balance of payment statistics is very essential for understanding changes in international macro environment.

Balance of payment is an accounting record of the transactions between the residents of one country and the residents of the rest of world over a given period of time. It is a standard double entry accounting record and as such subject to all the rules of double entry book-keeping. All transactions which lead to an immediate or prospective payment from the rest

of the world to the country should be recorded as a credit entry. Conversely all transactions which result in an actual or prospective payment from the country to the rest of the world are debits.

The Balance of payment is a collection of accounts conveniently grouped into three main categories. These are: Current account, Capital account and the Reserves Account. Under Current Account, imports and exports of goods and services and unilateral transfers of funds are included. In the Capital Account, capital transactions leading to changes in the assets and liabilities of the country are included. The Reserve Account is concerned with the assets held by the central bank of the country which are used to settle the deficits and surpluses that arises on the other two categories.

Where the exports of merchandise exceeds its imports, the situation is referred to as trade surplus or surplus on trade account. Excess of imports over exports results in trade deficit or deficit on trade account. When exports and imports of services and transfers are added to the trade balance, result in balance is referred to as balance on current account. When credits exceed debits, it is called a current account surplus. Conversely, an excess of debits over credits results in a deficit on current account. The capital account records the changes in the levels of international financial assets and liabilities. Therefore, the overall balance is adjusted against movements in reserves assets.

A nation's balance of payments accounts is said to be in disequilibrium when it is neither drawing upon its international reserves to make excess payments nor accumulating such reserves as a result of its receipts. It can be classified as a short term or cyclical disequilibrium and a long term or secular on structural disequilibrium. Cyclical disequilibrium arises on account of cyclical factors and can be corrected by short term measures. Structural disequilibrium arises on account of long term structural changes and can be corrected only by initiating changes in economic structure such as diversification of economy.

Inflation, national income, government restrictions and exchange rates affect the balance of payments on current account. If a country's inflation rate increases relative to the countries with which it trades, the current account will be adversly affected. If the national income of a country rises relative to its trading partners, other things being equal, its current account will decrease. Similarly import restrictions will reduce the demand for imports and the current account balance will increase. A rise in the value of domestic currency in term of other currencies, will increase the export prices, adversely affect the exports and consequenty a decline in current account balance. Reserve situation arises in case of depreciation of domestic currency. A disequilibrium in balance of payments can be corrected either by making use of national reserves, making use of IMF facilities, use of appropriate monetory and fiscal policies and exchange rate mechanism.

3.11 KEY WORDS

Balance of Payments — Statement of inflow and outflow payments for a particular country.

Balance of Trade — Difference between the value of merchandise exports and imports.

Balance on goods and services — Balance on trade, plus the net amount of payment of interest and dividends to foreign investors and from investment, as well as receipts and payments resulting from international tourism and other transactions.

Current Account — Broad measure of a country's international trade in goods and services.

Capital Account — Account reflecting changes in country in ownership of long term and short term financial assets.

International Monetary Fund (IMF) — Agency established in 1944 to promote and facilitate international trade and financing.

J Curve effect — Theory that says a country's trade deficit will initially worsen after its currency depreciates because higher prices on foreign imports will more than offset the reduced volume of imports in the short run.

Tariff — Tax imposed by a government on imported goods.

Official reserves — Holdings of gold and foreign currencies by official monetary institutions.

Special Drawings Rights (SDR) — A new form of international reserve assets, created by the IMF in 1967, whose value is based on a portfolio of widely used currencies.

3.12 ANSWERS TO CHECK YOUR PROGRESS

B 5 i) True; ii) False; iii) False; iv) True; v) True.

C 5 i) (c) ii) (b) iii) (c) iv) (a) v) (b) vi) (a) vii) (d) viii) (d) ix) (d) x) (c)

6 i) False ii) True iii) False iv) False v) False vi) True vii) False viii) False ix) False x) False

3.13 TERMINAL QUESTIONS

1. What do you mean by the Balance of Payment Accounting? Describe various components of the Current Account.
2. Distinguish between the current account and the capital account. Describe the components of the capital account.
3. What is balance of payment? Explain the factors affecting the balance of payments.
4. How disequilibrium occurs in the balance of payment? Describe the methods of correcting the disequilibrium.
5. Select a country and undertake an analysis of that country's balance of payments for 5 to 7 years. The analysis must include examinations (presentation of statistical data with discussion) of the trade balance, current account balance, basic balance and over all balance.
6. Discuss the trend in India's balance of payments since 1991. How can you explain the trend ?

UNIT 4 INSTRUMENTS OF TRADE POLICY

Structure

4.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the partial equilibrium theory of trade
- describe various non-tariff barriers to trade
- discuss the impact of quota and tariff
- explain the exchange control mechanism
- describe the method of balance of payment adjustments
- explain the flexible and fixed exchange rates system

4.1 INTRODUCTION

You have learnt the theories related to patterns of trade among countries in Unit 2. You have also seen that for all countries free trade is better than autarky. Even though free trade is better than a complete absence of trade, is free trade better than restricted trade, i.e., trade restricted by import tariff, import quotas or exchange controls? It turns out that the answer depends mainly on whether the country is large or small. The countries that tend to restrict trade by charging an import tariff (a tax on imported goods) are said to follow a protectionist trade policy. A tariff is a price based policy to restrict trade because it changes the price of import paid by the importer. But there are other ways to restrict trade and some of these are non-price based policies. For instance an import quota will restrict the quantity of import. These non-price based policies are known as non-tariff barriers to trade. In this unit, you will learn the partial equilibrium theory of trade and various non-tariff barriers to restrict trade. You will be further acquainted with the impact of quota and tariff, exchange control, balance of payment adjustments and the exchange rates system.

4.2 A PARTIAL EQUILIBRIUM THEORY OF TRADE

Even though the markets are generally inter-related sometimes it is useful to focus on one market provided its links with other markets are not very strong. Then a partial equilibrium theory of trade is just an extension of what you have learnt in microeconomics. Suppose.