**UNIT – 2**

**Foreign Trade & Economic growth**

 Foreign trade enlarges the market for a country’s output. Exports may lead to increase in national output and may become an engine of growth. Expansion of a country’s foreign trade may energise an otherwise stagnant economy and may lead it onto the path of economic growth and prosperity.

Due to Increased foreign demand may lead to large production and economies of scale with lower unit costs. Increased exports may also lead to greater utilisation of existing capacities and thus reduce costs, which may lead to a further increase in exports.

Expanding exports may provide the great employment opportunities. The possibilities of increasing exports may also reveal the underlying investment in a particular country and thus assist in its economic growth.

**The foreign trade contributes to economic growth are as follows:**

Foreign trade generates pressure for dynamic change through

(a) Competitive pressure from imports

(b) Pressure of competing export markets

(c) A better allocation of resources;

1. The primary function of foreign trade is to explore means of procuring imports of capital goods, without which no process of development can start;
2. Trade provides for flow of technology, which allows for increases in productivity, and also result in short-term multiplier effect;
3. Foreign trade increases most workers’ welfare. It does so at least in four ways:

(a) Larger exports translate into higher wages

(b) Because workers are also consumers, trade brings them immediate gains through products of imports

(c) It enables workers to become more productive as the goods they produce increase in value

(d) Trade increases technology transfers from industrial to developing countries resulting in demand for more skilled labour in the recipient countries.

1. Exports allow fuller utilisation of capacity resulting in achievement of economies of scale, separates production pattern from domestic demand, increases familiarity with absorption of new technologies;
2. Increased openness to trade has been strongly associated with reduction in poverty in most developing countries. As the historian Arnold Toynbee said ‘civilisation’ has been spread though ‘mimesis’, i.e. emulation or simply copying.
3. In short, trade promotes growth enhancing economic welfare by stimulating more efficient utilisation of factor endowments of different regions and by enabling people to obtain goods from efficient sources of supply.

**Balance of Trade**

**Balance of Trade (BOT)** is the difference in the value of all exports and imports of a particular nation over a period of time. A positive or favorable trade balance occurs when exports exceed imports. A negative or unfavorable balance occurs when the opposite happens. Simply put, if a country exports more than what it imports, for a given period of time, it has a positive BOT.

BOT is most often the largest component of a country’s current account or Balance of Payment (BOP) and is a crucial reflection of a country’s business scenario. Moreover, the BOP data also highlights key inferences from the past performances, which help create better strategies for future. The components contributing heavily to exports/imports can be readily identified and improved upon.

Let’s take a look at an example.

**Example**

Country X exports $1 billion of goods and services for the financial year 2015-2016, while in the same period it imported $1.5 billion of goods. Thus, this country has an unfavorable balance because it imports more than it exports. This is typically considered unfavorable because it shows how little the country produces and how dependent it is on foreign countries.

Country X is a reputed player in the rubber products industry, owing to the climate that accentuates rubber cultivation. It also has a majority share in its export portfolio.

The political and business leaders focus heavily on the same and ensure more and more rubber exports in coming years. However, this has led to jeopardized attention to food grains cultivation, which was observed from the high import value in the balance of trade figures of the particular year.

As such, it becomes imperative to the policy makers that it’s good to focus largely on the main profit centers, but not at the cost of the very basic necessities being left untouched. This can result in costlier imports. Moreover, the BOT data also reflects how effectively a nation has been using its key factors of production in the past and clearly depicts the outlook a nation is heading forth with.

**Balance of Trade:** BOT means the discrepancy between a countries’s exported goods and services and its imported goods and services.

# Balance of Payments

The balance of payments (henceforth BOP) is a consolidated account of the receipts and payments from and to other countries arising out of all economic transactions during the course of a year.

In the words of C. P. Kindleberger : **“The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting and the residents of the foreign countries during a given period of time.”** Here by ‘**residents**’ we mean individuals, firms and government.

By all economic transactions we mean individuals, firms and government. By all economic transactions we mean transactions of both visible goods (merchandise) and invisible goods (services), assets, gifts, etc. In other words, the BOP shows how money is spent abroad (i.e., payments) and how money is received domestically (i.e., receipts).

Thus, a BOP account records all payments and receipts arising out of all economic transactions. All payments are regarded as debits (i.e., outflow of money) and are recorded in the accounts with a negative sign and all receipts are regarded as credits (i.e., inflow or money) and are recorded-in the accounts with a positive sign. The International Monetary Fund defines BOP as a **“statistical statement that subsequently summarises, for a specific time period, the economic transactions of an economy with the rest of the world.”**

### ****Components of BOP Accounts****

#### ****(A) The Current Account****

The current account of BOP includes all transaction arising from trade in currently produced goods and services, from income accruing to capital by one country and invested in another and from unilateral transfers— both private and official. The current account is usually divided in three sub-divisions.

The first of these is called visible account or merchandise account or trade in goods account. This account records imports and exports of physical goods. The balance of visible exports and visible imports is called balance of visible trade or balance of merchandise trade

The second part of the account is called the invisibles account since it records all exports and imports of services. The balance of these transactions is called the balance of invisible trade. As these transactions are not recorded—in the customs office—unlike merchandise trade we call them invisible items.

It includes freights and fares of ships and planes, insurance and banking charges, foreign tours and education abroad, expenditures on foreign embassies, tran­sactions out of interest and dividends on foreigners’ investment and so on. Items 2(a) and 2(b) comprise services balance or balance of invisible trade in table 6.1.

The difference between merchandise trade and invisible trade (i.e., items 1 and 2) is known as the balance of trade.

There is another flow in the current account that consists of two items [3(a) and 3(b)]. Investment income consists of interest, profit and dividends on bonus and credits. Interest earned by a US resident from the TELCO share is one kind of investment income that represents a debit item here.

There may be a similar money inflow (i.e., credit item). Unrequited transfers include grants, gifts, pension, etc. These items are such that no reverse flow occurs. Or these are the items against which no quid pro quo is demanded. Residents of a country received these cost-free. Thus, unilateral transfers are one-way transactions. In other words, these items do not involve give and take unlike other items in the BOP account.

Thus the first three items of the BOP account are included in the current account. The current account is said to be favourable (or unfavourable) if receipts exceed (fall short of) payments.

#### ****(B) The Capital Account****

The capital account shows transactions relating to the international movement of ownership of financial assets. It refers to cross-border movements in foreign assets like shares, property or direct acquisitions of companies’ bank loans, government securities, etc. In other words, capital account records export and import of capital from and to foreign countries.

The capital account is divided into two main subdivisions: short term and the long term move­ments of capital. A short term capital is one which matures in one year or less, such as bank accounts.

Long term capital is one whose maturity period is longer than a year, such as long term bonds or physical capital. Long term capital account is, again, of two categories: direct investment and portfolio investment. Direct investment refers to expenditure on fixed capital formation, while portfolio investment refers to the acquisition of financial assets like bonds, shares, etc. India’s investment (e.g., if an Indian acquires a new Coca- Cola plant in the USA) abroad represents an outflow of money. Similarly, if a foreigner acquires a new factory in India it will represent an inflow of funds.

Thus, through acquisition or sale and purchase of assets, capital movements take place. Investors then acquire controlling interests over the asset. Remember that exports and imports of equipment do not appear in the capital account. On the other hand, portfolio investment refers to changes in the holding of shares and bonds. Such investment is portfolio capital and the ownership of paper assets like shares does not ensure legal control over the firms.

[In this connection, the concepts of capital exports and capital imports require little elabo­ration. Suppose, a US company purchases a firm operating in India. This sort of foreign investment is called capital import rather than capital export. India acquires foreign currency after selling the firm to a US company. As a result, India acquires purchasing power abroad. That is why this transaction is included in the credit side of India’s BOP accounts. In the same way, if India invests in a foreign country,, it is a payment and will be recorded on the debit side. This is called capital export. Thus, India earns foreign currency by exporting goods and services and by importing capital. Similarly, India releases foreign currency by importing visible and invisibles and exporting capital.]

#### ****(C) Statistical Discrepancy Errors and Omi­ssions****

The sum of A and B (Table 6.1) is called the basic balance. Since BOP always balances in theory, all debits must be offset by all credits, and vice versa. In practice, it rarely happens—parti­cularly because statistics are incomplete as well as imperfect. That is why errors and omissions are considered so that the BOP accounts are kept in balance (Item C).

#### ****(D) The Official Reserve Account****

The total of A, B, C, and D comprise the overall balance. The category of official reserve account covers the net amount of transactions by governments. This account covers purchases and sales of reserve assets (such as gold, convertible foreign exchange and special drawing rights) by the central monetary authority.

### ****Now, we can summarise the BOP data****

Current account balance + Capital account balance + Reserve balance = Balance of Payments

(X – M) + (CI – CO) + FOREX = BOP

**X** is exports,

**M** is imports,

**CI** is capital inflows,

**CO** is capital outflows,

**FOREX** is foreign exchange reserve balance.

### ****BOP Always Balances****

A nation’s BOP is a summary statement of all economic transactions between the residents of a country and the rest of the world during a given period of time. A BOP account is divided into current account and capital account. Former is made up of trade in goods (i.e., visible) and trade in services (i.e., invisibles) and unrequited transfers. Latter account is made up of transactions in financial assets. These two accounts comprise BOP

A BOP account is prepared according to the principle of double-entry book keeping. This accounting procedure gives rise to two entries— a debit and a corresponding credit. Any transaction giving rise to a receipt from the rest of the world is a credit item in the BOP account. Any transaction giving rise to a payment to the rest of the world is a debit item.

The left hand side of the BOP account shows the receipts of the country. Such receipts of external purchasing power arise from the commodity export, from the sale of invisible services, from the receipts of gift and grants from foreign govern­ments, international lending institutions and foreign individuals, from the borrowing of money from the foreigners or from repayment of loan by the foreigners.

The right hand side shows the payments made by the country on different items to the foreigners. It shows how the total of external purchasing power is used for acquiring imports of foreign goods and services as well as the purchase of foreign assets. This is the accounting procedure.

However, no country publishes BOP accounts in this format. Rather, by convention, the BOP figures are published in a single column with positive (credit) and negative (debit) signs. Since payments side of the account enumerates all the uses which are made up of the total foreign purchasing power acquired by this country in a given period, and since the receipts of the accounts enumerate all the sources from which foreign purchasing power is acquired by the same country in the same period, the two sides must balance. The entries in the account should, therefore, add up to zero.

In reality, why should they add up to zero? In practice, this is difficult to achieve where receipts equal payments. In reality, total receipts may diverge from total payments because of:

**(i)** The difficulty of collecting accurate trade information

**(ii)** The difference in the timing between the two sides of the balance

**(iii)** A change in the exchange rates, etc.

Because of such measurement problems, resource is made to ‘balancing item’ that intends to eliminate errors in measurement. The purpose of incorporating this item in the BOP account is to adjust the difference between the sums of the credit and the sums of the debit items in the BOP accounts so that they add up to zero by construc­tion. Hence the proposition ‘the BOP always balances’. It is a truism. It only suggests that the two sides of the accounts must always show the same total. It implies only an equality. In this book-keeping sense, BOP always balances.

Thus, by construction, BOP accounts do not matter. In fact, this is not so. The accounts have both economic and political implications. Mathe­matically, receipts equal payments but it need not balance in economic sense. This means that there cannot be disequilibrium in the BOP accounts.

A combined deficit in the current and capital accounts is the most unwanted macroeconomic goal of ,an economy. Again, a deficit in the current account is also undesirable. All these suggest that BOP is out of equilibrium. But can we know whether the BOP is in equilibrium or not? Tests are usually three in number:

**(i)** Movements in foreign exchange reserves including gold

**(ii)** Increase in borrowing from abroad

**(iii)** Movements in foreign exchange rates of the country’s currency in question.

Firstly, if foreign exchange reserves decline, a country’s BOP is considered to be in disequilibrium or in deficit. If foreign exchange reserves are allowed to deplete rapidly it may shatter the confidence of people over the domestic currency. This may ultimately lead to a run on the bank.

Secondly, to cover the deficit a country may borrow from abroad. Thus, such borrowing occurs when imports exceed exports. This involves payment of interest on borrowed funds at a high rate of interest.

Finally, the foreign exchange rate of a country’s currency may tumble when it suffers from BOP disequilibrium. A fall in the exchange rate of a currency is a sign of BOP disequilibrium.

Thus, the above (mechanical) equality between receipts and payments should not be interpreted to mean that a country never suffers from the BOP problems and the international economic transactions of a country are always in equilibrium.

### ****Implications of an Unbalance in the BOP****

Although a nation’s BOP always balances in the accounting sense, it need not balance in an economic sense.

**An unbalance in the BOP account has the following implications:**

**In the case of a deficit**

**(i)**Foreign exchange or foreign currency reserves decline,

**(ii)** Volume of international debt and its servicing mount up, and

**(iii)** The exchange rate experiences a downward pressure. It is, therefore, necessary to correct these imbalances.

### BOP Adjustment Measures:

**BOP adjustment measures are grouped into four:**

**(i)** Protectionist measures by imposing customs duties and other restrictions, quotas on imports, etc., aim at restricting the flow of imports,

**(ii)** Demand management policies—these include restrictionary monetary and fiscal policies to control aggregate demand [C + I + G + (X – M)],

**(iii)** Supply-side policies—these policies aim at increasing the nation’s output through greater productivity and other efficiency measures, and, finally,

**(iv)** exchange rate management policies— these policies may involve a fixed exchange rate, or a flexible exchange rate or a managed exchange rate system.

As a method of connecting disequilibrium in a nation’s BOP account, we attach importance here to exchange rate management policy only.

**Difference Between BOT and BOP**

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| **Basis for Comparison** | **Balance of Trade** |  | **Balance of Payment** |
| --- | --- | --- | --- |
| Meaning | Balance of Trade is a statement that captures the country's export and import of goods with the remaining world. |  | Balance of Payment is a statement that keeps track of all economic transactions done by the country with the remaining world. |
| Records | Transactions related to goods only. |  | Transactions related to both goods and services are recorded. |
| Capital Transfers | Are not included in the Balance of Trade. |  | Are included in Balance of Payment. |
| Which is better? | It gives a partial view of the country's economic status. |  | It gives a clear view of the economic position of the country. |
| Result | It can be Favorable, Unfavorable or balanced. |  | Both the receipts and payment sides tallies. |
| Component | It is a component of Current Accountof Balance of Payment. |  | Current Account and Capital Account. |

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**Foreign Trade forms**

Trade between two or more countries is called foreign trade or international trade. This involves the exchange of goods and services between the citizens of two countries. When citizens of one country exchange goods and services with the citizens of another country, it is called foreign trade.

**Classification of International Trade:**

**(a) Import Trade:**

It refers to purchase of goods from a foreign country. Countries import goods which are not produced by them either because of cost disadvantage or because of physical difficulties or even those goods which are not produced in sufficient quantities so as to meet their requirements.

**(b) Export Trade:**

It means the sale of goods to a foreign country. In this trade the goods are sent outside the country.

**(c) Entrepot Trade:**

When goods are imported from one country and are exported to another country, it is called entrepot trade. Here, the goods are imported not for consumption or sale in the country but for re- exporting to a third country. So importing of foreign goods for export purposes is known as entrepot trade.

**FOREIGN TRADE RESTRICTIONS**

**Tariffs and Non-Tariffs Barriers in International Trade**

Trade barriers are restrictions imposed on movement of goods between countries. Trade barriers are imposed not only on imports but also on exports. The trade barriers can be broadly divided into two broad groups: (a) Tariff Barriers, and (b) Non-tariff Barriers.

**TARIFF BARRIERS**

Tariff is a customs duty or a tax on products that move across borders. The most important of tariff barriers is the customs duty imposed by the importing country. A tax may also be imposed by the exporting country on its exports. However, governments rarely impose tariff on exports, because, countries want to sell as much as possible to other countries. The main important tariff barriers are as follows:

**(1) Specific Duty:**Specific duty is based on the physical characteristics of goods. When a fixed sum of money, keeping in view the weight or measurement of a commodity, is levied as tariff, it is known as specific duty.

For instance, a fixed sum of import duty may be levied on the import of every barrel of oil, irrespective of quality and value. It discourages cheap imports. Specific duties are easy to administer as they do not involve the problem of determining the value of imported goods. However, a specific duty cannot be levied on certain articles like works of art. For instance, a painting cannot be taxed on the basis of its weight and size.

**(2) Ad valorem Duty:**These duties are imposed “according to value.” When a fixed percent of value of a commodity is added as a tariff it is known as ad valorem duty. It ignores the consideration of weight, size or volume of commodity.

The imposition of ad valorem duty is more justified in case of those goods whose values cannot be determined on the basis of their physical and chemical characteristics, such as costly works of art, rare manuscripts, etc. In practice, this type of duty is mostly levied on majority of items.

**(3) Combined or Compound Duty:**It is a combination of the specific duty and ad valorem duty on a single product. For instance, there can be a combined duty when 10% of value (ad valorem) and Re 1/- on every meter of cloth is charged as duty. Thus, in this case, both duties are charged together.

**(4) Sliding Scale Duty:**The import duties which vary with the prices of commodities are called sliding scale duties. Historically, these duties are confined to agricultural products, as their prices frequently vary, mostly due to natural factors. These are also called as seasonal duties.

**(5) Countervailing Duty:**It is imposed on certain imports where products are subsidised by exporting governments. As a result of government subsidy, imports become more cheaper than domestic goods. To nullify the effect of subsidy, this duty is imposed in addition to normal duties.

**(6) Revenue Tariff:**A tariff which is designed to provide revenue to the home government is called revenue tariff. Generally, a tariff is imposed with a view of earning revenue by imposing duty on consumer goods, particularly, on luxury goods whose demand from the rich is inelastic.

**(7) Anti-dumping Duty:**At times, exporters attempt to capture foreign markets by selling goods at rock-bottom prices, such practice is called dumping. As a result of dumping, domestic industries find it difficult to compete with imported goods. To offset anti-dumping effects, duties are levied in addition to normal duties.

**(8) Protective Tariff:**In order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports. Normally, a very high duty is imposed, so as to either discourage imports or to make the imports more expensive as that of domestic products.

**Note:** Tariffs can be also levied on the basis of international relations. This includes single column duty, double column duty and triple column duty.

**NON-TARIFF BARRIERS**

A non tariff barrier is any barrier other than a tariff, that raises an obstacle to free flow of goods in overseas markets. Non-tariff barriers, do not affect the price of the imported goods, but only the quantity of imports. Some of the important non-tariff barriers are as follows:

**(1) Quota System:**Under this system, a country may fix in advance, the limit of import quantity of a commodity that would be permitted for import from various countries during a given period. The quota system can be divided into the following categories:

(a) Tariff/Customs Quota    (b) Unilateral Quota

(c) Bilateral Quota               (d) Multilateral Quota

* **Tariff/Customs Quota:**Certain specified quantity of imports is allowed at duty free or at a reduced rate of import duty. Additional imports beyond the specified quantity are permitted only at increased rate of duty. A tariff quota, therefore, combines the features of a tariff and an import quota.
* **Unilateral Quota:**The total import quantity is fixed without prior consultations with the exporting countries.
* **Bilateral Quota:**In this case, quotas are fixed after negotiations between the quota fixing importing country and the exporting country.
* **Multilateral Quota:**A group of countries can come together and fix quotas for exports as well as imports for each country.

**(2) Product Standards:**Most developed countries impose product standards for imported items. If the imported items do not conform to established standards, the imports are not allowed. For instance, the pharmaceutical products must conform to pharmacopoeia standards.

**(3) Domestic Content Requirements:**Governments impose domestic content requirements to boost domestic production. For instance, in the US bailout package (to bailout General Motors and other organisations), the US Govt. introduced ‘Buy American Clause’ which means the US firms that receive bailout package must purchase domestic content rather than import from elsewhere.

**(4) Product Labelling:**Certain nations insist on specific labeling of the products. For instance, the European Union insists on product labeling in major languages spoken in EU. Such formalities create problems for exporters.

**(5) Packaging Requirements:**Certain nations insist on particular type of packaging materials. For instance, EU insists on recyclable packing materials, otherwise, the imported goods may be rejected.

**(6) Consular Formalities:**A number of importing countries demand that the shipping documents should include consular invoice certified by their consulate stationed in the exporting country.

**(7) State Trading:**In some countries like India, certain items are imported or exported only through canalising agencies like MMTC. Individual importers or exporters are not allowed to import or export canalised items directly on their own.

**(8) Preferential Arrangements:**Some nations form trading groups for preferential arrangements in respect of trade amongst themselves. Imports from member countries are given preferences, whereas, those from other countries are subject to various tariffs and other regulations.

**(9) Foreign Exchange Regulations:**The importer has to ensure that adequate foreign exchange is available for import of goods by obtaining a clearance from exchange control authorities prior to the concluding of contract with the supplier.

**(10) Other Non-Tariff Barriers:**There are a number of other non – tariff barriers such as health and safety regulations, technical formalities, environmental regulations, embargoes, etc.