For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

4. INTERNATIONAL TRADE:

International Trade is frequently explained by the fact that countries have different endowments of factors of production. It plays an important role in the economy of a country. It enhances the living standards of the inhabitants through imports of luxury items and other valuable goods. International trade is necessary to achieve the gains that international specialization makes possible. With trade, each individual region or nation is able to concentrate on producing goods and services that it produces efficiently while trading to obtain goods and services that it does not produce efficiently. In other words, more of the goods, in which production is specialized, are produced and traded. The concept of "Gains from Trade" can be studied through Absolute cost Advantage and Comparative cost Advantage.

ABSOLUTE COST ADVANTAGE:

According to Adam Smith, a country is said to have an absolute advantage in the production of a commodity when it can produce it more cheaply than the other country. In other words, absolute advantage states that a country produces more of a commodity than the other country. In such a situation, the total production of both countries can be increased if each specializes in the commodity in which it has an absolute advantage. Consider the following example where 2 countries, US and UK, produce 2 commodities, wheat and cloth, with one unit of resources.

	Wheat	Cloth
US	10	6
UK	5	10
	15	16

From the above table, US can produce 10 wheat or 6 cloth, while UK can produce 5 wheat or 10 cloth. Hence, US has an absolute advantage in producing wheat, while UK has an absolute advantage in producing cloth.

Thus, according to Adam Smith, each country will specialize in the commodity in which it has an absolute advantage and then trade. If these 2 countries specialize completely, then US will concentrate on wheat by reallocating one unit of resources out of cloth into wheat and UK will specialize in cloth by moving one unit of resources out of wheat into cloth. The situation after specialization can be shown as follows

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

After specialization:

	Wheat	Cloth
US	20	0
UK	0	20
	20	20

Hence, it can be noted that the total world output of both wheat and cloth increases when each country produces more of the good in which it has an absolute advantage. This represents a gain of 5 wheat and 4 cloth, that is, more wheat and more cloth for the same use of resources.

COMPARATIVE COST ADVANTAGE:

However, if a country has an absolute advantage in the production of both commodities vis-a-vis another country, trade will cease to exist according to Adam Smith statement. It was left to Ricardo to show the fallacy in Smith's argument. Ricardo maintained that gains from specialization can still take place even when a country has an absolute advantage in the production of each and every commodity. He, thus, argued that it is comparative advantage which determines trade and not absolute advantage. Hence, he stated that a country is going to specialize in the production of a commodity in which it has a comparative advantage and then trade to benefit from gains from trade. The theory of comparative advantage is calculated in terms of opportunity cost. In other words, a country is said to have a comparative advantage over another country in producing a commodity when the opportunity cost of production in that country is lower. Consider the following example.

Mega Lecture

	Food	Clothing
US	100	100
UK	200	100

Suppose that US and UK use all their resources efficiently to produce food and cloth, US produces 100 tonnes of food or 100 metres of cloth, while UK produces 200 tonnes of food or 100 metres of cloth. It is, therefore, apparent that UK has an absolute advantage in the production of food and equally efficient in the production of cloth.

If the 2 countries do not trade, they must produce both food and clothing for themselves, dividing their resources equally between the 2 commodities. The production possibilities can be stated as follows:

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

Pre-trade:

	Food	Clothing
US	50	50
UK	100	50
	150	100

Although UK has an absolute advantage over US in the production of food and equally efficient in cloth, trade can still exist between the 2 countries. It is possible to see that if each country concentrates on the commodities in which it has a comparative advantage, total output could be increased. As stated, the comparative advantage is calculated in terms of opportunity cost. Hence, the opportunity cost of producing 100 tonnes of food in US is 100 metres of cloth, which follows that the opportunity cost of producing 1 tonne of food is 1 metre of clothing in US. Whereas in UK the opportunity cost of producing 200 tonnes of food is 100 metres of cloth. In this case, the opportunity cost of producing 1 tonne of food is 0.5 metres of cloth in UK.

This follows that UK is said to have a comparative advantage in the production of food since the opportunity cost of producing food in UK is lower than in US. On the other hand, US has a comparative advantage in clothing. Indeed, a country is going to specialize in the production of that good in which it has a comparative advantage. Besides, gains from trade are possible only if the opportunity cost is different. Thus, it is advantageous for US to specialize in clothing and trade this for other commodities. Similarly, UK is better off specializing in producing food and trading it for clothing. If each country specializes completely in the commodity in which it has a comparative advantage, the situation could be shown as follows.

Pre-trade but after specialisation:

	Food	Clothing
US	0	100
UK	200	0
	200	100

It can be deduced that the world output increases for food with cloth production remaining the same after specialization.

If trading is opened up between the 2 countries, it is important to know the mutually beneficial exchange rate ratio which is calculated as follows: In US, 100 tonnes of food cost 100 metres of clothing.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

This implies that 1 tonne of food costs 1 metre of clothing. On the other hand, in UK 1 tonne of food cost 0.5 metre of clothing. Thus, to show the gains from trade, any ratio which lay between the 2 domestic ratios could be beneficial to both countries.

Assuming the mutually beneficial exchange rate ratio is 1 food: 0.75 clothing, this implies that for each tonne of food exported, UK imports 0.75 units of clothing. Suppose UK then exports 66 tonnes of food, it will be able to exchange its exports for 50 metres of clothing. The situation after specialization and trade can be shown as follows:

Post-trade:

	Food	Clothing
US	66	50
UK	134	50
	200	100

It follows that compared to the pre-trade situation both countries are consuming extra tonnes of food and no less cloth.

Thus, it can be seen that as a result of specialization and trade both countries are better off. Besides, the total world production has risen.

ASSUMPTIONS / LIMITATIONS OF COMPARATIVE ADVANTAGE:

However, the theory of comparative cost advantage lies under several assumptions which, in real life, cannot be held. These assumptions have been criticised on several grounds.

1. No transport cost:

First and foremost, the theory assumes that there are no transport costs. Had there been high transport costs in moving products from one country to another, this would offset the benefits from trade. For instance, country X might have advantages in the production of some goods but the high transport costs may mean that country Y still does not buy the product. Thus, it is assumed that there should not be any transport costs. But in real world, such an assumption cannot be held.

2. Constant cost condition:

Moreover, it is assumed that production is carried out under constant cost conditions such that when higher production is to take place due to specialization, cost does not rise and there exists no extra costs. However, constant conditions may not always be encountered. Different cost conditions such as increasing and decreasing costs may be encountered.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

3. Tastes and preferences are held constant:

Furthermore, if specialization takes place, there must be as well high demand in the economy for certain goods. If demand changes, which so often happens, then production patterns are disturbed and specialization cannot be undertaken. Thus, to illustrate gains from trade, tastes and preferences are held constant.

4. No barriers to trade:

Besides, the assumption that there is no protection of domestic industries does not reflect the reality. For a variety of reasons, countries do protect their industries through customs duties and other trade barriers. Free trade, unless based on strict bilateral and multilateral agreements, is hardly undertaken.

5. International immobility of factors of production:

In addition, it is held that labour especially is immobile so that production must be carried out in specialized form in the countries having a comparative advantage.

6. Foreign exchange problems:

Besides, foreign trade involves exchanging currencies. But the value of currencies tends to fluctuate.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

PROTECTIONISM & FREE TRADE:

Protectionism is a policy of protecting home industries from foreign competition by imposition of trade barriers on foreign goods and services. This is because individual governments in the countries are more concerned with achieving national objectives and improving the welfare of their local people rather than maximizing world output or increasing the welfare of the world. Many arguments are advanced in favour of protectionism.

1. First and foremost, trade barriers are imposed **to protect infant industry**. An infant industry is a new industry that a country has embarked on. In fact, these infant industries have potential advantages to reap large economies of scale. But at early stage they are unable to compete with established industries in the world. Thus, protection will enable countries, particularly the developing countries, to use their resources more efficiently in the development of these infant industries which have a chance to grow. Once they become large enough, they will be able to produce as cheaply as the foreign rivals. However, it is argued that once protection is given, it is very difficult to withdraw it because infant industries will want protection even when they are fully grown.

2. Moreover, the imposition of protectionism to keep out cheap foreign imports will maintain or raise **the level of employment** and living standard of the people. This argument is based on the fact that imports may aggravate domestic unemployment and in the wake of foreign competition, local companies may be put out of business, causing massive unemployment. Thus, protection could be a way of alleviating this problem since it allows a country time to reallocate factors of production in a more efficient manner.

3. Furthermore, protectionist measures are used to protect local industries against unfair trade practices, such as **dumping**. Dumping is often used as a marketing strategy to put local producers out of business by foreign monopolists. The latter, by using high profits at home, usually sell the goods in foreign markets at a price lower than the home market. Thus, it is quite legitimate and necessary for a country to protect its industries from this type of unfair competition.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

4. All the more, protection is necessary **to correct a persistent deficit in the balance of payments**. A balance of payment shows the international receipts and payments of a country over a period of one year. A persistent deficit in balance of payments shows that the country is not doing well economically. It is losing gold and foreign exchange. Measures must be taken to correct the deficit and to bring the BOP back to equilibrium. One of the methods advocated is trade protection.

5. Besides, countries impose trade barriers **to raise revenue**. In fact, customs duties are one of the sources of government revenue. However, the effect of customs duties will depend upon the elasticity of demand for imports. If the demand is inelastic, the tax will indeed make money for the government but will also add to domestic inflation. Where demand is elastic, the government could increase its revenue by cutting the rate of custom duties.

6. Last but not the least, protection must **be given to key industries**. It is important for a country to develop these strategic industries so that it does not have to depend on other countries in the event of a crisis which disrupts trade. For instance, protection must be given so as to encourage the development of defence industries.

FORMS OF BARRIERS TO TRADE:

1. Customs duties:

Customs duties, which are classified as indirect taxes, will have the effect of shifting the supply curves of the imported goods to the left. In other words, customs duties make the imported products more costly and hence, reduce imports.

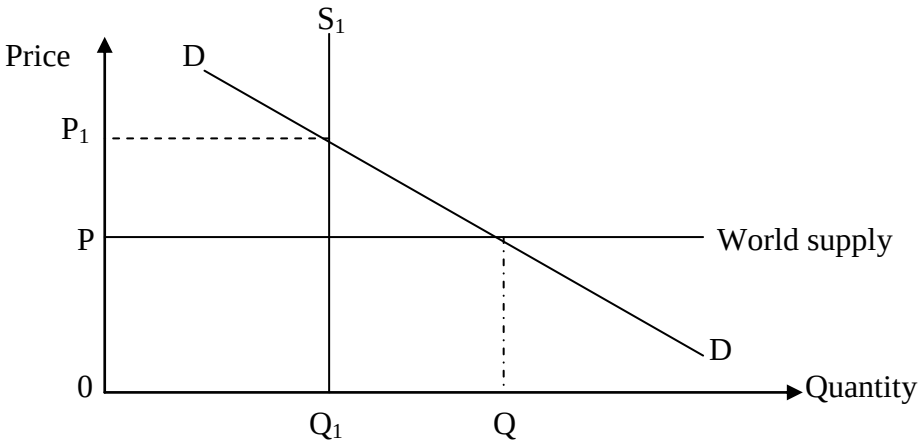
2. Quotas:

Quotas place a physical limit to the amount of imported goods which are allowed to enter a country. In other words, the importing country sets a maximum of the quantity of some commodity that may be imported each year. Quotas bring in no revenue to the government. The effect of quota is shown as follows:

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

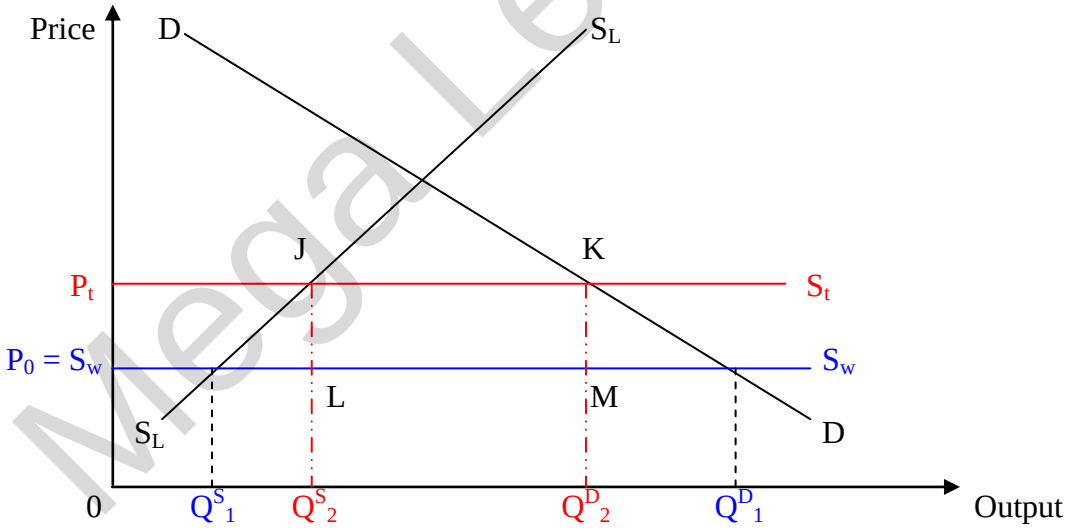
For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com



The government sets an import quota of Q_1. This makes the supply curve perfectly inelastic at Q_1 and raises price to P_1.

3. Tariffs:

A tariff represents a special duty which is levied on imported goods. A tariff may not be raised from every imported item, it is usually specific. Its effect is to raise the price of imports.



Initially, the world free price is $0P_0$ corresponding to the world supply curve S_w. Local supply is S_LS_L and demand DD. At the initial price $0P_0$, local producers could sell only $0Q^S_1$ and local consumers would consume $0Q^D_1$. Thus, $Q^D_1 - Q^S_1$ represents initial imports. If the government introduces a tariff, whereby price rises to $0P_t$ corresponding to new world supply S_t, local production rises to $0Q^S_2$ and demand contracts to $0Q^D_2$. Thus, new imported quantity is $0Q^D_2 - 0Q^S_2$. Clearly, imports have fallen.

Evaluation: [+] (1) Reduce imports

(2) Expanding local production.

(3) Revenue to the government given by the area JKLM

[-] (1) Reduce consumers' surplus by the shaded area.

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

4. Exchange control:

The government may restrict the amount of foreign currencies in circulation within the country to prevent local citizens from purchasing foreign goods in excess. The central bank may take the necessary steps to control the sale of foreign currencies in commercial banks to importers. In addition, the central bank may allow only the priority sectors to purchase these currencies to make productive imports, for example, the purchase of up-to-date technology.

5. Subsidies:

A country may decide to subsidise certain industries as a means of protecting them from the competition of lower-priced foreign goods. The subsidy will reduce the price of domestic product and hence make it more difficult for the foreign producer to sell a similar product in the home market.

ARGUMENTS AGAINST PROTECTIONISM [FREE TRADE]:

However, on purely economic grounds, it is difficult to support most of the arguments for the restriction of international trade. Owing to protection, the extent of international specialization is reduced and so is the potential level of world output. The erection of trade barriers invites retaliation and increases the probability of a general reduction in world trade. Industries operating behind tariff walls are protected from foreign competition and this could lead to a lower level of efficiency. In fact, benefits from protectionism are mostly short term. In the long run, free trade brings more benefits to a country. Several economic conferences had been held with a view to reducing tariffs or eliminate other trade barriers, for instance, World Trade Organisations (WTO).

Free trade means a lack of obstacles such as tariffs and quotas. Free international trade and investment have been the engines of growth over the past decades. Tonnes of goods traded around the world have grown considerably, reflecting the lowering of tariff barriers. The benefits of free international trade have been shared. The countries that are getting poorer are those that are not open to world trade, notably many nations in Africa. On the other hand, China's opening to world trade has brought tremendous benefits to the country so much so that now China is enjoying a higher income per head. Hence, to some extent, free international trade in goods should be encouraged.

First and foremost, **free international trade promotes international specialisation and increases world output.** Owing to trade liberalisation, the world's factors of production will be employed more efficiently. This is based on the principles of comparative advantage. Countries that lower trade barriers concentrate their national energies in industries they are good at, where they have an international advantage. As a result, world output can be increased. With greater output and increased foreign sales, the national income of the country can be expected to be larger.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

Besides, **free trade implies competition**. Lowering import barriers makes industries even more efficient and competitive in world markets. Competition provides a powerful incentive to innovate. Not only are new goods and services being put onto the market, but firms are also competing to find production methods which cut costs and improve the quality and reliability of goods. This will enable the most efficient firms to expand at the expense of less efficient which will no longer enjoy protection. Free trade leads to "survival of the fittest".

Furthermore, free trade allows consumers the choice of what to buy from the whole world, and not just from what is produced domestically. Consumer welfare is thus increased because some consumers at least will prefer to buy foreign goods rather than domestic goods. In short, **free international trade in goods allows a greater choice of goods for consumers.**

Moreover, free international trade allows developing countries access to the heavily protected markets of the developed world, thus, helping to promote development. In other words, **free trade opens up the world as a potential market for the products of a country**. A wider market means greater demand, and thus, more production for the country. For instance, with the AGOA Treaty, the African countries are now allowed to enter the American market and they can trade freely. The increase in aggregate demand will raise the level of income and employment in the economy.

All the more, **free trade gives firms in developing countries access to improved capital inputs**, such as, machine tools and other sophisticated technology. These developing countries will, thus, be able to improve their productivity and achieve industrial development. There is evidence that some developing countries that erect barriers to imports have slower growth in incomes than those that are open to trade.

Mega Lecture

However, in reality, free trade may have harmful effects in some circumstances, and this may apply particularly to developing economies. "Fair trade and not Free trade" is the banner carried out protestors of anti-globalisation. Hence, free international trade in goods should not always be encouraged. First and foremost, unequal bargaining strength may prevent a fair sharing of the benefits. In fact, the benefits of free trade are mainly diverted to developed countries. These industrialised nations pressured some developing countries to open their markets to the products of the richer countries while at the same time imposing restrictions on developing countries' exports into rich country markets. Indeed, the case for free trade has to apply to all and not in one direction only.

Besides, trade liberalisation encourages dumping. Dumping is a process of selling goods in an overseas market at a price below the cost of production. The purpose of dumping might be to destroy existing competition in the overseas market or to prevent new firms in the overseas market from

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

becoming established. This unfair trading practice may undermine a country's industries. For instance, China's opening to world trade did not pleased countries in EU since China was trying to dump most of its products in European countries.

In addition, free trade prevents the growth of infant industries. These industries initially established on a small scale. Hence, in conditions of free trade, they will not survive the competition from fully developed large-scale producers who are enjoying economies of scale and are operating at much lower costs. As a result, these infant industries, which sometimes have a very crucial contribution in the economy of a country, will be forced to close down.

Moreover, trade liberalisation boost up imports. But as import penetration rises, domestic firms come under increasing pressure to maintain sales at very low prices. However, the less successful firms will have to lay off workers and some may close down completely. Hence, due to free trade, there may be high short-term costs in terms of unemployment and disruption. High import penetration may also cause countries, especially developing ones, to face a BOP deficit. A persistent deficit in BOP will eventually lead to overseas debt and a depreciation of the local currency.

Furthermore, countries, going towards trade liberalisation by abiding by the rules of WTO, will face a loss in government revenue. Lowering imports barriers, especially custom duties and tariffs, clearly implies less revenue for the government. Henceforth, the government will have to find out other sources of finance. This is very difficult for developing countries since the government will have to either raise internal tax, such as income tax or Value added tax, or recourse to borrowing.

From the above exposé, it can be argued that in today's world, a country's product must stand up to international competition if they are to survive. Globalisation is today the "talk of the town". Markets across the world are becoming more integrated, with developed and developing economies becoming much more economically dependent upon each other. Free international trade in goods should be encouraged since it brings benefits of higher standard of living, more employment and greater choice at lower cost. However, globalisation has not shared benefits equally and there may be a cause for a slow transition towards free trade.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

ECONOMIC INTEGRATION:

There have been many examples of groups of countries joining together for the purpose of stimulating trade between themselves and to obtain other benefits of economic cooperation. Economic integration between countries can take several forms:

1. Free trade areas: These consist of groups of countries which have abolished tariffs and quotas on trade between themselves. However, each of the member countries maintains its own independent and different restrictions on imports from non-member countries.

2. Customs unions: These consist of groups of countries which allow free trade between member countries, but all members are obliged to operate a common external tariff on imports from non-member countries.

3. Common markets: These are customs unions which, in addition to free trade in goods and services, also allow the free movement of factors of production between member states.

4. Economic unions: These organizations include all features of a common market, but also require member states to adopt common policies on such matters as agriculture, transport and taxation.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

BALANCE OF PAYMENTS:

The balance of payments is a record of all economic transactions between the residents of the country and the rest of the world. It records transactions in goods and services as well as capital flows.

Any item that, from the home country's point of view, gives rise to a purchase of foreign currency or an outflow of domestic currency **[IMPORTS]** is recorded as a **DEBIT** item on the BOP. On the other hand, any item that gives rise to a sale of foreign currency or an inflow of domestic currency **[EXPORT]** is recorded as a **CREDIT** item.

The balance of payment is split into 3 main parts:

1. Current account
2. Capital account
3. financial account

Balance Of Payment	£	£
A. Current Account:		
1. Visible Trade :(Goods)		
Exports	200	
Less import	(150)	
Balance of Trade (Visible Trade Balance)		50
2. Invisible Trade: (Services)		
Exports	100	
Less imports	(125)	
Balance of invisible trade		(25)
Balance on current account (1 + 2)		25
B. Capital account:		
Net capital transfers	15	
Capital account balance		15
C. Financial account:		
Investment (direct and portfolio)		
(a) Net investment from abroad (capital inflow)	175	
(b) Net investment to abroad (capital outflow)	(145)	
Other financial flows (short-term)		
(a) Net deposits from abroad and borrowing from abroad	225	
(b) Net deposits to abroad and lending to overseas residents	(185)	

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

Reserves (drawing on + adding to -)	+35	
Financial account balance		105
Overall balance (A+B+C)		145
Net errors and omissions		(145)
		0

The balance of payments always balances, that is, it must be equated to Zero.

Current Account:

It is divided into 2 sections known as the balance of visible trade and the balance of invisible trade. The former section records only exports and imports of goods. The difference between the value of goods exported and imported is called the Balance of Trade. In fact, the balance of trade is only a part of the balance of payment. It is therefore possible to have a deficit on the balance of trade but a surplus on the balance of payment, or vice versa.

The invisible trade balance consists of all exports and imports of services, such as insurance, banking, tourist expenditure, transport. For instance, a British tourist coming to Mauritius will be recorded as an invisible export in the Mauritian BOP. On the other hand, if a Mauritian is going abroad as a tourist, this will be recorded as an invisible import.

The invisible section also records income flows into and out of the country and transfers of income such as flow of interest, profits and dividends. For example, dividends earned by a foreign resident from shares in a UK company would be an invisible imports for UK.

Capital Account:

The capital accounts records the flows of funds into the country and out of the country, associated with the acquisition or disposal of fixed asset or non-financial assets (for example; land purchased or sold by a foreign embassy, purchases and sales of patents, copyrights and trademarks), receipts of funds for capital projects.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

Financial Account:

This records the flows of money into and out of the country for the purposes of investment or as deposits in banks and other financial institutions. The financial account records

(a) *Investment, both direct and portfolio*: This account covers long term investment.

Direct investment: This involves the transfer of ownership of a country and foreign businesses, for example, the setting up of a branch of a UK company abroad and the expansion of a foreign-owned firm in the UK.

Portfolio investment: This is changes in the holding of paper assets, such as company shares, government bonds or securities, treasury bills. For instance, if a UK resident buys shares in a Spanish company, this will create an outflow of capital in the short-run for the UK. It is, therefore recorded on the debit side of the BOP in the financial account. However, in the long run, money will flow back into the country by way of interest, profits and dividends on current account as invisible exports.

(b) Other financial flows: This records short term capital investment, also called "hot money". These investments tend to move about in search of better interest rates or expectations of changes in the value of currencies. For example, if UK interest rate rises above the rates in other countries, there will be a large inflow of funds, and will be recorded on the credit side in the financial account.

(c) Flows to and from the reserves: Any countries hold reserves of gold and foreign currencies. From time to time the central bank will sell some of these reserves to purchase domestic currency on the FOREX market. Drawing on reserves represents a credit item in the BOP since it is an inflow to the BOP but an outflow from the reserves account. Conversely, building up reserves records as a debit item in the BOP since it represents an outflow from it but an inflow to the reserves account.

When all the components of the BOP are taken together, the balance of payments should exactly balance. So when added together, the current, capital and financial accounts balances should add up to zero. However, in practice, because of mistakes and failure to record all items, often due to time delay, there is always a discrepancy. To correct for this, **a net error and omissions item** is included in the accounts. The net errors and omissions figure is the amount which is required to bring the recorded BOP into balance.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

Balance of payments disequilibrium:

Disequilibrium in BOP exists when there is a tendency for outflows of trade and capital to be significantly greater or smaller than the corresponding inflows. In other words, there is a surplus or a deficit in BOP.

Causes of Balance of payments deficit:

A deficit in BOP occurs when export earnings fail to cover imports expenditure. Indeed, it is generally the developing countries which are faced with a recurrent BOP deficit since they rely much on imported production techniques, know-how and raw materials to develop their economies. A deficit in BOP can be caused by various factors.

1. Relaxed import controls:

A deficit, especially in current account, may occur because the government has not taken the appropriate measures to curb imports. Policies might have been relaxed, for example, low custom duties and no imposition of quota.

2. High domestic inflation:

If the rate of inflation in the country exceeds world's inflation, then local consumers would refrain from purchasing locally manufactured goods. Instead they will shift to foreign substitutes since the latter becomes cheaper. As a result, imports will rise. On the other hand, foreigners will demand less of the country's products as exports become less competitive. As such, exports will fall.

3. The economic situation within the country:

If the country is experiencing an economic boom with rising output and consumption, it is expected that its imports will rise since imports depend on the level of national income.

4. Level of foreign income:

The exports function of a country depends on foreign national income. If the world economy experiences a depression, this will reduce foreign national income. As a result, the country's exports will be likely to fall, leading to current account deficit.

5. Low Interest rate:

If a country's rate of interest falls below the rate in other countries, it becomes less competitive for savers and other depositors to invest in the country. Hence, more local residents would be likely to deposit their money abroad and fewer people abroad would deposit their money in the country. As a result, "hot" money flows out to earn high interest elsewhere.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

6. Capital flows:

If during the year, the country has been investing far more than what the foreigners have been investing in local industries, it is clear that the capital account balance will be unfavourable.

Hence, the overall deficit in the BOP would occur if the unfavourable capital account offsets any surplus or reinforces any deficit in the current account.

Consequences of Balance of payments disequilibrium:

One of the macro-economic objectives of every government is to achieve a satisfactory balance of payment position. But generally, countries prefer to have a surplus in their BOP rather than a deficit. A balance of payment deficit is a matter of great concern since it shows that the country is not doing well in all of its trade in goods and services and in capital flows. Indeed, a deficit in BOP causes drastic effects in the economy. The perils of the deficit can be discussed as follows:

First and foremost, a deficit in BOP leads to a shortfall in foreign currencies. The government will therefore have to borrow money from abroad, or draw on its foreign currency reserves to make the shortfall. This is a problem because, if it goes too long, overseas debt will rise along with the interest that must be paid. As result, reserves will begin to run low.

Moreover, if the government does nothing to correct the BOP deficit, then the exchange rate must fall. A falling exchange rate is a problem because it pushes up the price of imports and may fuel inflation.

Furthermore, if a country experiences BOP deficit, it means that its exporting firms are in perils and that the country is investing far more abroad than attracting foreign direct investment. As a result, the level of employment in the economy will be very low. If the situation continues, the exporting firms will have to close down, and consequently, thousands of jobs will be in jeopardy.

However, an excess surplus in BOP also presents some problems. It is generally argued that while one economy is in surplus, others must be in deficit. A persistent surplus may, therefore, embarrass one's trading partners and force them to place restrictions on imports which are to the detrimental of world trade. (Feedback effect)

Besides, both Keynesian and monetarist analysis of a BOP surplus point to possible inflationary consequences. According to Keynesian analysis, demand pull inflation will be caused if the economy is at full employment since a surplus is an injection into the economy. Monetarists argue that a surplus increases money supply. (Inflationary pressures)

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

All the more, a country running a considerable BOP surplus is, in fact, keeping down the standard of living of its citizens. This is because the reserves of foreign currency built up by the surplus could be turned into goods and services for the population. Besides, the local people do not enjoy a wide variety of goods and services since the domestically manufactured goods are being exported.

Policies designed to correct Balance of payments deficit:

The correct measures to remedy a deficit will depend upon its cause. A short term deficit might be dealt with by running down the reserves or by borrowing. Another short term measure might be to raise interest rates to encourage the inflow of money.

However, a persistent BOP deficit will be cured by implementing other measures, and these are

(i) Expenditure reducing policies (demand-management policies).

(ii) Expenditure-switching policies.

Expenditure-reducing policies are measures which aim to rectify the deficit by cutting expenditure. Hence, if a country is facing a persistent BOP deficit, a contractionary fiscal and monetary policy such as reductions in money supply, cuts in government expenditure, and increases in taxes would be appropriate. This measure would reduce aggregate demand (deflation), including the demand for imports, and may at the same time reduce inflationary pressure and so make exports more competitive in world markets. However, such policies may conflict with the domestic objectives of full employment and economic growth. In particular, if a country has both a deficit and high unemployment, a demand reducing policy designed to correct the BOP will tend to worsen the rate of unemployment.

Expenditure-switching policies refer to the measures designed to switch expenditure from imports to domestically produced goods. Hence, the government could impose import controls such as customs duties, quota, tariffs, exchange control and devaluation or depreciation.

- Customs duties
- Quota
- Tariffs
- Exchange control
- Devaluation or depreciation, depending upon the exchange rate system
    - Must satisfy the Marshall- Lerner condition
    - J-curve.

However, if the government adopts protective measures such as import controls, it may conflict with a nation's treaty obligations such as WTO. Besides, protective measures invite retaliation.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

TERMS OF TRADE:

Terms of trade represent the quantity of imported goods that can be obtained per unit of goods exported. They are measured by the ratio of the price of exports to the price of imports. A rise in the price of imports, with the price of exports unchanged, indicates a fall in terms of trade. It will now take more exports to buy the same quantity of imports. Similarly, a rise in the price of exports, with the price of imports unchanged, indicates a rise in terms of trade. It will now take fewer exports to buy the same quantity of imports. Hence, terms of trade are calculated as follows:

$$\text{Terms of trade} = \frac{\text{index of export prices}}{\text{index of import prices}} * 100$$

The base terms of trade is always equated to 100, meaning that prices of exports are equivalent to prices of imports.

A rise in the index is referred to as a favourable change in a country's terms of trade. A favourable change means that more can be imported per unit of goods exported than previously, leading to an increase in the country's real standard of living. For example, if in 2004 TOT = 102 and in 2005 TOT = 106, it is said that TOT have improved and remained favourable. However, if 2002 TOT = 106 and 2003 TOT = 104, TOT have deteriorated but still remained favourable. (As long as TOT exceed 100).

A decrease in the index of the terms of trade, called an unfavourable change, means that the country can import less in return for any given amount of exports or, equivalently, it must export more to pay for any given amount of imports. For example, TOT = 98 in 2002 and keep falling below 100, it means that TOT are worsening severely.

Improvement in TOT

(i) export prices rise, import prices unchanged.

(ii) import prices fall, export prices unchanged.

(iii) export prices rise faster than import prices.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

FACTORS INFLUENCING TERMS OF TRADE:

A country's terms of trade may change due to changes in prices of exports and /or prices of imports. Changes in these prices are, however, caused by several factors.

1. Demand conditions for exports and imports

If demand for export rises faster than demand for import, it is sure that terms of trade will improve. This is because of the significant rise in export prices than import prices. On the other hand, a fall in demand for export seriously affects terms of trade of a country.

2. Supply conditions of export and imports:

Besides, supply conditions influence terms of trade to a large extent. Conditions of supply on international market for goods are never constant. They are sensible to changes in technology, competition and movement in exchange rates. Once they fluctuate, they affect both prices of exports and imports. For instance, when the OPEC restricted their output of oil in the 1970s, they were able to drive up the price of oil. This turned the terms of trade in their favour.

3. World economic situation:

Demand conditions are especially affected by the world economy. If a depression is experienced abroad, demand for exports is likely to fall, causing a fall in export prices. The terms of trade will, thus, be unfavourable. On the other hand, if an economic boom is experienced abroad, prices of exports may rise due to a rise in the demand for export. As a result, terms of trade will be favourable.

4. Internal economic situation:

The demand conditions for foreign goods are affected by the level of economic activity within the country. While an economic boom within a country enhances demand for imports, an economic depression discourages foreign demand for imports. Thus, an economic boom witnessed by a country causes an unfavourable terms of trade, while an economic depression leads to a favourable terms of trade.

5. Rate of inflation:

Inflation has a tendency to increase export prices and encourage more imports which may be cheaper. Thus, inflation improves a country's terms of trade. However, the improvement further depends on foreign rate of inflation. If domestic rate of inflation exceeds foreign rate of inflation, terms of trade may improve, otherwise if the latter's rate exceeds domestic rate, terms of trade will worsen.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

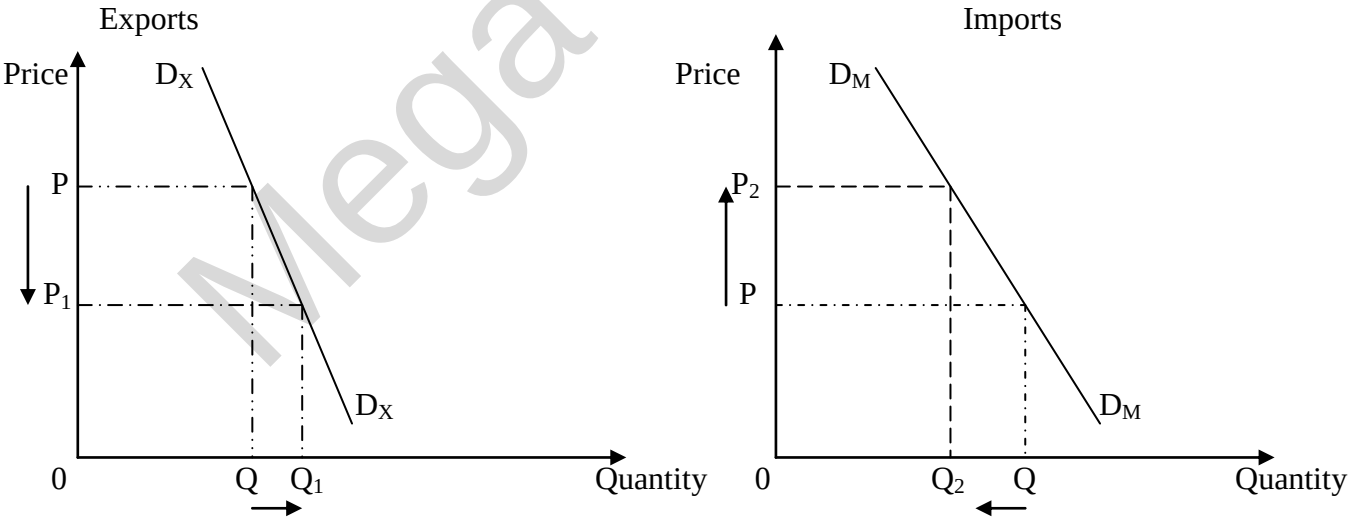
6. Changes in the exchange rate:

Devaluation or depreciation lowers export prices and raises import prices. Thus, if a country's currency depreciates or if the government devalues its currency against another currency, the country's terms of trade will be unfavourable. On the other hand, an appreciation or revaluation causes export prices to rise and import prices to fall, thereby improving the terms of trade.

RELATIONSHIP BETWEEN BALANCE OF TRADE AND TERMS OF TRADE:

As such there exists no direct relationship between terms of trade and balance of trade. An improvement in terms of trade may not necessarily imply an improvement in balance of trade, and a worsening in terms of trade may not necessarily imply a worsening in balance of trade. In fact, the relationship between terms of trade and balance of trade depends on the price elasticities of demand for exports and imports.

A direct relationship between terms of trade and balance of trade exists if and only if the price elasticities of demand for exports and imports are inelastic. For instance, an improvement in terms of trade leads to an improvement in balance of trade, and similarly, a worsening in a country's terms of trade will cause a worsening of its balance of trade, provided the price elasticities of demand for exports and imports are inelastic. This can be illustrated diagrammatically as follows:



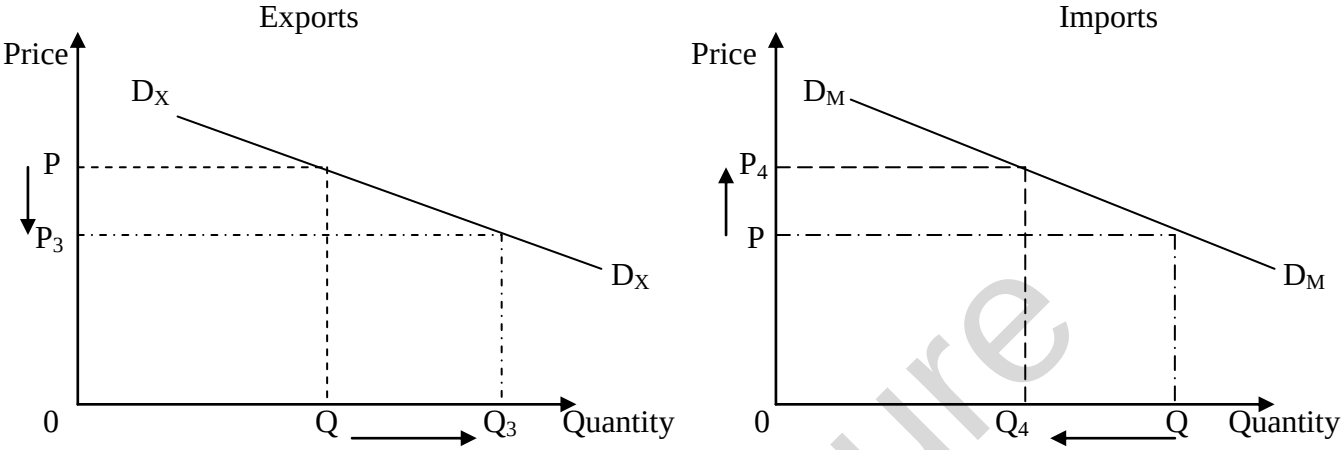
The diagrams show a worsening in a country's terms of trade caused by a fall in export price from 0P to $0P_1$ or a rise in import price from 0P to $0P_2$. But due to the inelastic demand for export and import, balance of trade is also unfavourable. This is because of the marginal increase in quantity demanded for export from 0Q to $0Q_1$ given the great percentage fall in its price or because of the marginal decrease in quantity demanded for import from 0Q to $0Q_2$ given the great percentage rise in its price.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123

For Live Classes, Recorded Lectures, Notes & Past Papers visit:
www.megalecture.com

However, a worsening in a country's terms of trade can also cause an improvement of its balance of trade if demand for exports and imports are elastic. In other words, there also exists an indirect relationship between terms of trade and balance of trade.



Terms of trade worsen due to a fall in export price from 0P to $0P_3$ or a rise in import price from 0P to $0P_4$. However, balance of trade improves since the slight fall in the price of export leads to a more than proportionate increase in quantity demanded for export from 0Q to $0Q_3$, and the slight increase in import price causes a more than proportionate decrease in quantity demanded for import from 0Q to $0Q_4$.

Mega Lecture

https://www.youtube.com/c/MegaLecture
+92 336 7801123