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# BALANCE OF TRADE AND BALANCE OF PAYMENTS

## 28.1 INTRODUCTION

Foreign trade refers to a country's trade with other countries. It consists of exports and imports. A country receives payments from other countries for its exports and makes payments to other countries for its imports. The difference between total receipts on account of exports of goods and total payments on account of imports of goods is called **Balance of Trade**. However, these receipts and payments are not necessarily in a country's own currency. Besides, receipts and payments on account of trade of goods, some other receipts and payments also take place between countries. In this lesson, you will study the meaning and importance of balance of trade, balance on current account and balance of payments.

## 28.2 OBJECTIVES

After going through this lesson, you will be able to:

- explain the meaning of balance of trade and balance on account of invisibles;
- explain the meaning of current account and capital account;
- distinguish between current account and capital account of the balance of payments account;
- explain the meaning and implications of deficit in current account;
- distinguish between autonomous and accommodating transactions of capital account;
- explain what is meant by 'balance of payments always balances'.

## 28.3 MEANING OF BALANCE OF TRADE

Trade account of the balance of payments includes exports and imports of goods in a year. The difference between the value of exports of goods and value of imports of goods is called **balance of trade**. For example, if the value of exports of goods is Rs.10,000 in a year and the value of imports in the same year is Rs.6,000, then the balance of trade is (+) Rs. 4,000. It is a surplus balance of trade as exports are greater than imports. In other words, the receipts on account of exports of goods are greater than the payments on account of imports of goods. Similarly, if the value of exports in a year is Rs. 8,000 and the value of imports in the same year is Rs. 10,000, there is a deficit in the balance of trade as receipts from exports are less than the payments on account of imports. This deficit is equal to Rs.2,000.

The important point to note here is that trade account includes exports and imports of goods only. No other items are included in it. Exports and imports of goods are also called **transactions of visible items or merchandise**. Therefore balance of trade is also called **balance on visibles**..

Since Independence, India has generally been having a deficit balance of trade. This is because during this period our imports have been continuously rising at a faster rate than growth of exports. Growth in imports has been caused by many factors such as growing population, increasing consumption requirements, need for imports of capital goods for development of the economy etc. India's exports too have grown but their rate of growth has been lower than that of imports. Reasons for slow growth of exports are many, the important ones being , low quality and high cost of our goods which makes them uncompetitive in the world market and our increasing domestic requirements which leaves lesser surplus for exports. Table 28.1 shows the balance of trade position of India since 1980-81.

**Table 28.1**

**(Rs. Crores)**

| Year | Value of Exports | Value of Imports | Balance of Trade |
|---|---|---|---|
| 1980-81 | 6,576 | 12,544 | - 5,967 |
| 1989-90 | 22,229 | 40,642 | - 12,413 |
| 1990-91 | 33,153 | 50,086 | - 16,934 |
| 1991-92 | 44,923 | 51,418 | - 6,495 |
| 1992-93 | 54,762 | 68,863 | - 14,101 |
| 1993-94 | 71,146 | 78,630 | - 7,484 |

## 28.4 BALANCE ON ACCOUNT OF INVISIBLES

Services are a part of invisibles. These include shipping, banking, insurance and consultancy services, foreign travel, investment income, transfer payments etc. Let us discuss these items one by one.

**(1) Services - banking, insurance, shipping etc.**

These services like banking, insurance, shipping and consultancy services etc. are provided by one country to other countries. When a country gets such services from other countries, it is called **import of services** for which payments in foreign currencies are made. When a country provides these services to other countries it is called **exports of services** for which it gets payments in foreign currencies.

**(ii) Foreign travel**

Tourism is another source of receipts and payments of foreign currencies. When foreign tourists visit a country, it results in receipts of foreign currencies which they spend during their stay. Similarly, when people of a country visit other countries, they require foreign currencies for their spending in those countries. This results in an outflow of foreign currencies.

**(iii) Investment income**

A country may receive interest on loans given to other countries. It may also receive dividends on investments made by its people in other countries. These receipts are also in foreign currencies. Similarly payments of interest and dividends on loans and investments by people of other countries results in outflow of foreign currencies.

**(iv) Transfer payments**

People of a country may receive gifts etc. from their friends and relatives living abroad. These are called **'unilateral transfers'**. Similarly people of a country may be sending gifts to their relatives and friends. Thus such transfer payments also result in inflow and outflow of foreign currencies.

The difference between total receipts and total payments of foreign currencies on account of invisibles is called **balance on account of invisibles**. If the receipts on account of invisibles are greater than payments on account of invisibles then there will be a surplus balance on invisibles. On the other hand if the foreign exchange receipts on account of invisibles are less than foreign exchange payments on this account , then there will be a deficit balance on invisibles. Table 28.2 shows the receipts, payments and net balance on account of invisibles for India since 1980-81.

**Table 28.2**

**(Rs. Crores)**

| Year | Invisible Receipts | Invisible Payments | Net Invisibles |
|---|---|---|---|
| 1980 -81 | 5,669 | 1,580 | 4,311 |
| 1989 -90 | 12,484 | 11,459 | 1,025 |
| 1990 -91 | 13,394 | 13,829 | - 435 |
| 1991 -92 | 23,449 | 19,191 | 4,258 |
| 1992 -93 | 23,901 | 22,564 | 1,337 |
| 1993 -94 | 30,262 | 26,413 | 3,849 |

As the table 28.2 shows , India's position with regard to invisibles has not been as bad in case of visibles i.e. balance of trade. On the invisible account , receipts have been greater than the payments (except 1990-91) giving a positive net balance or surplus balance on invisibles. In our receipts of foreign exchange from invisibles have been more than our payments on invisibles.

## POINTS TO REMEMBER

- Balance of trade is calculated on the basis of exports and imports of goods only.
- If the value of exports of goods is greater than the value of imports of goods, the balance of trade shows a surplus. If the value of exports of goods is less than the value of imports of goods, the balance of trade shows a deficit.
- The balance of trade of our country has always been in deficit because our imports of goods have increased at a faster rate than the exports of goods.
- Different types of services like foreign tourism, investment income, transfer payments, etc. all called 'invisibles' items. The difference between receipts from invisibles and payments of invisibles is called 'invisible balance'. The invisible balance of India has been better as compared to the balance of trade.

## INTEXT QUESTIONS 28.1

Fill in the following blanks :

(i) The difference between the value of export of goods and the value of import of goods is called ____________. (balance of trade, deficit, profit)

(ii) The difference between the value of export of invisibles and the value of import of invisibles is called ____________. (invisible balance, surplus, deficit)

(iii) Ever since Independence, India has been generally having ____________ on balance of trade account and ____________ on balance on invisibles account. (deficit, surplus)

## 28.5 CURRENT ACCOUNT OF BALANCE OF PAYMENTS ACCOUNT

Trade account and invisibles account together constitute the current account. In other words, by adding the balance of trade and balance on invisibles we get the balance on current account.

So current account of balance of payments account records all transactions relating to sale and purchase of all visible items as well as all transactions relating to invisible items. India's current account of balance of payments account is given in table 28.3. It can be seen from the table that whereas India's balance of trade has always been negative, its balance on invisibles account has been positive for most of the years. The balance on current account has been arrived at by adding the trade balance and net invisibles.

**Table 28.3**

**(Rs. Crores)**

| Year | Trade Balance | Net Invisible | Current Account Balance |
|---|---|---|---|
| (1) | (2) | (3) | (2) + (3) |
| 1980 - 81 | - 5,967 | 4,311 | - 1,657 |
| 1989 - 90 | -12,413 | 1,025 | - 11,388 |
| 1990 - 91 | -16,934 | - 435 | - 17,369 |
| 1991 - 92 | - 6,493 | 4,258 | - 2,237 |
| 1992 - 93 | -14,101 | 1,337 | - 12,764 |
| 1993 - 94 | - 7,484 | 3,849 | - 3,636 |

It is clear from the table 28.3 that when there was a surplus on invisibles account the current account deficit had been less than the deficit on balance of trade. This is because a part of the trade deficit has been set off by the surplus on invisibles account. This table also shows that for all the years the balance on current account has shown a deficit.

A deficit on current account means that India's receipt of foreign currencies on account of trade and invisibles has been less than its payments. However, this deficit is to be covered. How this deficit is covered would be clear to you after going through the next section of this lesson in which the capital account of the balance of payments is discussed.

## POINTS TO REMEMBER

- The current account includes both trade account and invisible account. So, the sum of trade balance and invisible balance is called balance on current account.
- India has always been facing deficit in the current account. During most of the years deficit on current account has been less than the deficit on trade account. It is because of surplus in the invisible account during all the years.

## INTEXT QUESTIONS 28.2

Fill in the following blanks :

(i) By adding together balance of trade and balance on invisibles, we get __________. (balance on current account, balance of payments)

(ii) For last many years, India has __________ on its current account balance. (surplus, deficit)

(iii) Current account deficit means that a country has purchased __________ of goods and services from other countries than what it has sold to them. (more, less)

## 28.6 CAPITAL ACCOUNT OF BALANCE OF PAYMENTS ACCOUNT

The capital account shows all the inflows and outflows of capital . These flows of capital may be in the form of borrowings from and lending to abroad and receipts and payments of capital on account of sales and purchases of shares and securities to other countries or from other countries.

The items included in the capital account can be categorised as

(i) autonomous capital transactions and

(ii) accommodating capital transactions.

**(i) Autonomous capital transactions :**
Investments made by foreigners in a country result in inflow of capital (in foreign currencies). Similarly investments made by the people of a country in other countries result in outflow of capital (in foreign currencies). Such investment decisions are based on expectations about the profitability of investments. These flows are not as a result of the deficit or surplus on current account of the balance of payments of a country. So these are called **autonomous capital transactions.**

Thus due to the autonomous transactions on capital account, there may be a net inflow or outflow of foreign exchange in a country. This balance when added to the balance on current account shows the total deficit or surplus of balance of payments. This surplus or deficit results in accommodating capital transactions.

**(ii) Accommodating capital transactions :**
The transactions that take place due to the deficit or surplus in the balance of payments ( the sum of current account balance and balance of autonomous capital transactions ) are called **accommodating capital transactions.** If a country has a deficit in the balance of payments, it means the total receipts of foreign exchange falls short of the total payments that the country has to make ( in foreign exchange). This deficit is covered by assistance from foreign governments or international institutions such as International Monetary Fund. Such receipts of foreign exchange are accommodating receipts. However, if the deficit is not fully covered by such accommodation, then the balance of deficit will have to be covered by withdrawals from its stock of foreign exchange reserves. This would lead to a fall in foreign exchange reserves of the country. Similarly if a country's balance of payments shows a surplus then it may result in accommodating transactions in the form of external assistance or increase in its foreign exchange reserves or both.

## POINTS TO REMEMBER

- Capital account includes two types of transactions : (i) autonomous and (ii) accommodating.
- Autonomous transactions are undertaken for their own sake. These are not undertaken on account of deficit or surplus in the balance of payments.
- Accommodating transactions are those which are undertaken on account of deficit or surplus in the balance of payments.

## INTEXT QUESTIONS 28.3

Fill in the following blanks :

(i) The capital account of BOP's record all the inflows and outflows of ____________ (goods, capital)

(ii) The item in the capital account of BOP's can be divided into ____________ and ____________ transactions. (autonomous, accommodating, goods, services)

(iii) Autonomous capital flows are ____________ on the deficit or surplus on current account of BOP's. (dependent, independent)

(iv) That part of deficit on current account which is offset by arranging accommodating capital inflows represents the ____________ in the balance of payments. (deficit, surplus)

## 28.7 BALANCE OF PAYMENTS ACCOUNT

To understand the balance of payments account let us take India's balance of payments accounts for the years 1990-91 and 1993-94. Table 28.4 shows India's balance of payments position for the years 1990-91 and 1993-94.

**Table 28.4**

**Balance of Payments** **(Rs crores)**

| | | 1990-91 | 1993-94 |
|---|---|---|---|
| 1. | Imports | 50,086 | 78,630 |
| 2. | Exports | 33,153 | 71,146 |
| 3. | Trade Balance ( 2 - 1) | - 16,193 | - 7,484 |
| 4. | Net Invisibles | - 435 | 3,848 |
| 5. | Current Account (3 + 4) | - 17,368 | - 3,636 |
| 6. | Capital Account ( NET ) | 12,898 | 30,852 |
| 7. | Overall Balance (5 + 6 ) | - 4,470 | 27,216 |
| 8. | IMF Transactions ( NET ) | 2,177 | 587 |
| 9. | Increase ( - ) or Decrease (+ ) in foreign Exchange Reserves | 2,293 | - 27,803 |

It is clear from the table 28.4 that item 9, i.e., increase or decrease in foreign exchange reserves is the balancing item of the balance of payments.

Item 7 in the table shows that in 1990-91 there was an overall deficit of Rs. 4,470 crores in balance of payments. Actually there was a deficit of Rs 17,368 crores on current account shown as item 5 and there was a net inflow of capital of Rs 12,898 crores shown as item 6.

The sum of items 5 and 6 gives the overall position of balance of payments which is a deficit of Rs. 4,470 crores. A part of this deficit ( Rs. 2,177 ) was covered by drawings from International Monetary Fund. The uncovered deficit of Rs.2,293 crores as shown under item 9 resulted in a decrease in country's foreign exchange reserves. Thus the overall deficit was covered partly by drawings from International Monetary Fund and partly by the foreign exchange reserves of the country.

The balance of payments position in 1993 - 94 was different from the position in 1990- 91. There was a deficit of Rs. 3,636 crores on current account and a surplus of Rs. 30,852 crores on capital account. The surplus on capital account exceeds the deficit on current account and the overall balance of payments shows a surplus of Rs. 27,216 crores. During this year there was also a net inflow of Rs. 587 crores from I. M. F. Thus the net result was an increase in foreign exchange reserves of Rs. 27,803 crores.

However, in both the years there was a deficit on current account. A country's balance of payments position is assessed by its balance on current account. A country with adverse balance on current account always tries to take care of it through current account transactions. In other words, it will try to increase its exports and reduce its imports.

In the accounting sense, the balance of payments account always balances which means that the total credits and total debits of the balance of payments account are always equal. The sum of the balances on current account and autonomous capital transactions measures the deficit or the surplus. The sum of the accommodating capital transactions will just be equal to this deficit or surplus with reverse signs. In other words, if there is a deficit due to current account and autonomous capital account the same balance will appear as a plus sign in accommodating capital transactions. Look at table 28.4, the overall balance shown as item 7 shows a deficit of Rs 4, 470 crores for the year 1990-91. As it is a deficit there is a negative sign appearing in the table. Items 8 and 9 are accommodating capital transactions and their total is just equal to Rs 4,470 crores. Thus the overall deficit has been financed by the accommodating capital transactions. Hence the balance of payment account has balanced. Similarly for the year 1993-94, the sum of the balances on current account and autonomous capital transactions shows a surplus of Rs 27, 216 crores and has a plus sign. This is shown in the table as item 7. Items 8 and 9 are accommodating capital transactions and their total is Rs -27, 216 crores, which is just equal to the overall surplus balance.

It must now be clear to you that the sum of the debits and the sum of the credits (payments and receipts) of the balance of payments account will always be equal. The balancing factors are the accommodating capital transactions which includes external assistance, transactions with IMF, and increase/decrease in foreign exchange reserves.

You must have noted that all the figures shown in the tables of this lesson are in Rupees. You may wonder that we have all through been talking of inflows and outflows of foreign exchange and the figures for these flows are given in Rupees. Actually these figures are also available in US $, but for the sake of convenience we are taking the figures given in Rupees.

## POINTS TO REMEMBER

- Current account balance represents deficit or surplus in the balance of payments.
- This deficit or surplus is made by undertaking autonomous transactions.
- Balance of payments always balances because total receipts are always equal to payments. It is made possible by the accommodating transactions.

## INTEXT QUESTIONS 28.4

State whether the following statements are true or false :

(i) Balance of payment situation is known from the capital account.

(ii) The sum of current account and capital account shows total deficit and surplus.

(iii) Total payments and total receipts of balance of payments are always equal.

(iv) Accommodating transactions bring balance in the balance of payments account.

## WHAT YOU HAVE LEARNT

Trade account of BOP (Balance of Payment) shows the receipts from export of goods and payment for import of goods of a country. If the foreign exchange receipts are greater than foreign exchange payment, then a country is said to have a surplus on Trade account. Conversely, if the foreign exchange receipts are less than foreign exchange payments, then a country is said to have deficit on Trade account. Ever since Independence, India has been generally having deficit on Trade account because growth in imports have been faster than growth in exports.

Invisible items includes services such as shipping, banking, insurance, etc., tourist traffic, interest and dividends on foreign loans and investments and unilateral transfers such as gifts etc. The difference between the receipts and payments of foreign currency on account of invisibles is called balance on invisibles. If these receipts are greater than payments then a country is said to have a surplus balance of invisibles. If such payments exceed receipts, then there is a deficit on invisibles account. For India, except for few years, generally there has been surplus on invisibles account.

By adding together BOT (Balance of Trade) and balance on invisibles, we get balance on current account. India's balance on current account has always shown a deficit and over the years this deficit has been increasing.

The capital account of BOP's records all the inflows and outflows of capital. These capital flows can be in the form of borrowing and lending, purchase and sale of shares, securities etc. The items in capital account of BOP's can be categorised as autonomous and accommodating transactions. Those transactions which take place independent of deficit or surplus on current account of BOP are called autonomous transactions, while accommodating transactions are those which are motivated by deficit or surplus in current account of BOP's.

Balance on current account and balance of autonomous capital transactions taken together show the overall BOP's position of the country. Overall deficit or surplus results in accommodating capital transactions which remove the surplus or deficit and the balance of payments account balances.

## TERMINAL EXERCISE

1. What do you mean by BOT?

2. Distinguish BOT from balance on account of invisibles.

3. Distinguish between current account of BOP's and capital account of BOP's.
4. Distinguish between autonomous and accommodating transactions.
5. State the meaning of overall deficit in BOP's of any given country.

## ANSWERS

**Intext Question 28.1**

(i) balance of trade (ii) invisible balance (iii) deficit, surplus.

**Intext Question 28.2**

(i) balance on current account (ii) deficit (iii) more.

**Intext Question 28.3**

(i) capital (ii) autonomous, accommodating (iii) independent (iv) deficit.

**Intext Question 28.4**

(i) False (ii) True (iii) True (iv) True.

**Terminal Exercise**

1. Read Section 28.3
2. Read Section 28.3 & 28.4
3. Read Section 28.5 & 28.6
4. Read Section 28.6 (i) & (ii)
5. Read Section 28.7