INTERNATIONAL FINANCIAL MANAGEMENT

Dr. R. Amuthan

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This book is intended for all students of MBA (Finance) of various Universities and Management Institutes and the same can be used for CA, CMA and ACS courses. The objective of the book are to provide the student with a conceptual framework of financial decisions taken with regard to International Trade Finance. The purpose is to make students familiar with the unique economic fundamentals and financial factors, which challenge the financial manager in the international context. The book covers the entire syllabus as approved by UGC on the subject of International Trade Finance, with increasing prospects on Export and Import sectors through hedging, Derivative Instruments and International Trade Logistics assume significance. This book could be the perfect guide for the beginners who wish to invest in Export and Import segment. Besides, this book is presented in simple language and mathematical terms, easily understandable to the average students.

This has the advantage of harmonizing the finance function with the International Trade on the one hand and integrating with international finance on the other. At the cost of repetition, each chapter is made self-contained and related to other chapters. But this is an added advantage to students who get a recap of some of the points of significance. The material is kept as brief as possible, yet with a comprehensive coverage of all the modules as approved by various universities and autonomous institutions and in accordance with their syllabus.

This text book could be the perfect guide to the new beginners who want to know about International Trade and International Finance.

Author
I like to express my heartfelt gratitude and countless thanks to Mrs. N. Parvathy, Managing Trustee, Excel Group of Institutions, Komarapalayam for her support to complete this book.

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INTERNATIONAL TRADE MEANING AND BENEFITS

Meaning and Definition of International Trade

Trade means buying and selling of commodities/articles for valuable consideration. For example, shopkeeper sells the goods after receiving the money value of goods. The payment may be either in currency or by exchange of another goods or item. Trade may be within the country and outside the country.

International Trade or Foreign Trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

All countries need goods and services to satisfy wants of their people. Production of goods and services requires resources. Every country has only limited resources. No country can produce all the goods and services that it requires. It has to buy from other countries what it cannot produce or can produce less than its requirements. Similarly, it sells to other countries the goods which it has in surplus quantities. India too, buys from and sells to other countries various types of goods and services.

According to Wasserman and Halman, “International trade consists of transaction between residents of different countries”.

According to Anatol Marad, “International trade is a trade between nations”.

International trade is in principle not different from domestic trade as the motivation and the behavior of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with differences among countries such as language, the legal system or culture. International trade consists of ‘export trade’ and ‘import trade’. Export involves sale of goods and services to other countries. Import consists of purchases from other countries.

International trade is quickly becoming one of the hottest industries around the world, but it is not a new industry by any means. Importing and exporting is big business not only in the developed nations, but all over the world as well. Today’s EXIM trade is not only highly competitive but also dynamic. It is a vital part of development strategy and it can be an effective instrument of economic growth, employment generation and poverty alleviation.

Features of International Trade

The most salient features of international trade are as follows:

1. Immobility of Factors of Production: The main feature of international trade was the international immobility of factors of production. The belief that factors of production, labour and capital; if not land, although mobile within the country were immobile between countries led the classical economists to argue that the principles which determined the relative prices differed between the domestic (inter-regional) trade and foreign (international) trade.
Table 1.1: Features of International Trade

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2. **Independent Monetary Systems:** The second distinguishing factor of international trade is the existence of independent monetary systems in different countries giving rise to the need of exchanging one country’s currency unit for another at an agreed ratio. The purchase and sale of foreign currency is conducted in the foreign exchange market and the ratio at which different currencies are exchanged is known as the foreign exchange rate.

3. **Political Boundaries:** The third distinguishing factor of international trade arises from the fact that “the existence of political boundaries carries with it controls and regulations of international trade and payments, in the form of customs duties, quotas, exchange control, foreign trade monopolies, the more subtle measures of control referred to as “administrative protectionism” and so forth, which do not generally exist in the domestic trade area”.

4. **Greater Geographical Distances:** The fourth distinguishing factor of international trade lies in the existence of greater geographical distances and the consequent increases in the transport costs. The fact of distance which renders international exchange costly necessitates a special theory for the determination of international values. International trade, in most cases, involves the hauling of goods over longer distances involving land, air and sea routes through different countries necessitating the use of different modes of transport.

5. **Territorial Specialization:** International trade takes place basically due to geographical specialization. Every country specializes in the production of goods and services in which it has a specific advantage. For example, India has specific advantage in the production of jute and tea. Therefore, India exports these commodities to U.S. India imports computer processors from U.S. which U.S. can produce at lower cost than India.

6. **International Competition:** Producers from many countries complete with another to sell their products. Therefore, there is intense competition in international trade. Here the quality, design, packing, price, advertisement, etc., all play a significant role in deciding the winner in the market.

7. **Separation of Sellers from Buyers:** In international trade, sellers and buyers belong to different countries. They may have no chance of ever meeting one another. Therefore, they have to depend upon middlemen for transactions.

8. **Long Chain of Middlemen:** The procedure of international trade is very long and complex. It is very difficult for buyers and sellers to perform all the formalities themselves. They require the services of expert middlemen such as, indent houses, forwarding agents, clearing agents, foreign exchange banks, etc.
9. Different Currencies: A critical difference between inter-regional and international trade is the use of different currencies in foreign trade but a common currency in inter-regional trade. So, international trade is limited by the extent of liquidity of foreign exchange while there are no such restrictions in inter-regional trade.

10. Issue of Balance of Payments: The fact that balance of payments should balance the trade between any two countries in the long-run restricts the volume of demand for goods and services produced in the other nation. If the domestic country cannot export equivalent amount of exports, then there is a restriction on the amount of goods and services that it can import also. Such a restriction is absent for inter-regional trade.

11. Different National Policies: Countries may pursue various domestic policies with regard to trade, industry, commerce and so on. So, trade between regions will not be affecting such difference, while those differences matter in international trade. For example, non-tariff barriers regarding environment, child labour, etc., may create problems in the international market. Domestic environmental laws may allow the production process of certain commodities, while they may be rejected in the international market.

12. Difference in Constitutional Policy: The constitution mandates protection of inter-regional trade by preventing any provincial government from framing policies that obstruct trade between regions. On the other hand, there are constitutional provisions that enable the national government to frame policies that protect the domestic industries from external competition and thereby reduce free flow of international goods into domestic economy.

BASIS OF INTERNATIONAL TRADE

Basis of international trade are as follows:

1. Variations in Spatial Distribution of Natural Resources: The main basis of trade is inequalities in the distribution of natural resources bestowed by nature. Some countries possess rich natural resources while others are poor. Countries with a rich resource base are in a position to produce much more than their requirement. Therefore, this surplus goods are exchanged with other countries in which those countries are deficit.

Argentina has plenty of wheat, corn and dairy products which it exports to those countries which are short of it. India is a major producer of tea, mica and jute. It has surplus for others. Thus, it exports these items to other countries of the world where these are required. The United States cannot grow tea, coffee and jute.

As such, it imports these commodities. The Middle East countries are the largest oil producing and oil exporting countries in the world on account of large production and less consumption at home; they have enough surplus for export to other countries. It is, therefore, clear that richness in natural resources and their spatial distributional differences in the world form a basis of international trade.

2. Differences in Economic Development: There are variations in the stage of economic development which necessitate extensive transfer of commodities. For example, the U.K. which is in an advanced stage of economic development buys raw materials from Australia, South Africa,
Argentina, etc., where manufacturing industries related to these raw materials have not been developed. Later, the U.K. exports finished products made from these raw materials to these very countries.

3. Uneven Distribution of Population in the World: It is an important factor which determines the volume, character and direction of trade. If regions of small population produce more and have some rich mineral resources in comparison to large population size of countries of poor production and resources, they exchange services and labour in place of manufactured and other products with small population size countries.

Commercial grain farming regions produce extensive volumes of wheat but have sparse population at home. As such, they have large wheat surplus for export. Japan exports electronic computers, automobiles, ships, textiles, etc., on account of and mass scale production and little demands of such goods in the country due to less population.

4. Transportation Facilities: Transportation affects international trade tremendously. Transportation may be the use of seas, lakes, rivers, rail roads, etc. With the development of the modes of transportation, international trade has undergone great changes in volume and direction.

5. Nature, Choice and Fashion: Every country has a different pattern of nature, choice and fashion. The American and European women like to wear woollen clothes whereas the Japanese women like to wear silken clothes. At some places, there is a demand for woollen clothes while at others there is a demand for silken clothes. Some people like wearing leather jackets.

The Indian women prefer coloured sarees and bangles. The rice is considered to be a high class dietary item in Thailand, Vietnam, etc. Wheat is the main food crop in Pakistan, Afghanistan, Saudi Arabia, etc. Thus, in order to meet different demands of people of different countries, foreign trade system is helpful and is the only answer.

6. Scientific Progress: It has increased international trade. There has been great progress in transport and communication system due to scientific and technological development. A person can get information about the products and price, etc., off places with the help of telephone, television, fax, etc.

The raw materials and manufactured goods are transported by rail, ships and trucks to distant places. Thus, science and technology have revolutionised international trade. Development of means of transportation and introduction of refrigeration in the ships and rail wagons has facilitated transportation of perishable commodities even too far off markets.

7. War and Peace: For trade, it is imperative that the goods must reach their destination in a secure way. In war days, it becomes difficult to transport commodities safely because the enemy planes and warships try to destroy the merchant ships. This inhibits international trade. Peace is ideal for the growth of international trade, whereas war or insecurity hampers or discourages international trade.

8. Trade Policy: Every country keeps on changing its trade policy. For example, India grants loans to many African countries with the condition that they will have to purchase industrial goods from India. Japan gives loans worth crore of rupees to India with the condition that India shall supply coal or iron ore or mica to Japan. India’s trade policy is pro-Russia. Thus, government policies matter a lot in the development of international trade.
9. Political Contacts and Trade Alliances: Political affiliations play an important role in trade alliances. For example, CIS carries on trade due to its friendly relations with communist countries. The Islamic countries have given special concessions to the friendly Islamic countries in matters of trade. In Europe, the Benelux countries do not charge taxes on the import and export of goods belonging to their trade allies – Belgium, Luxembourg, Netherlands, etc.

REASONS FOR GOING INTERNATIONAL

There are many factors, which motivate or drive firms to go international, are considered as the major drivers/motives of international trade and may be broadly divided into following groups:

**Fig. 1.1**

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1. **Pull Factors**: The pull factors, most of which are proactive reasons, are those forces of attraction, which pull the business to the foreign market. In other words, companies are motivated to internationalize because of the attractiveness of the foreign market. Such attractiveness includes, broadly, the relative profitability and growth prospects. The followings are important Pull Factors:

(i) **Growth**: Firms enter international markets when the domestic market potential saturates and they are forced to explore alternative marketing opportunities overseas. However, in the context of Indian market, given the size of the Indian market, enormous opportunities for most of the practices exist in the domestic market itself. Therefore, growth is the motive of only a few select companies to internationalize.

(ii) **Profitability**: The price differences among markets also serve as an important incentive to internationalize. An important incentive for international business is the profit advantage. International business could be more profitable than the domestic. There are cases of companies which earned more than 100 per cent of the total from foreign markets (in which case the domestic operation, obviously, resulted in loss). Even when international business is less profitable than the domestic, it could increase the total profit.

(iii) **Achieving Economies of Scale**: Large-scale production capacities necessitate domestic firms to dispose of their goods in international markets once the domestic markets become
saturated. One of the basic reasons behind the internationalisation of Great Britain during the Industrial Revolution was domestic market saturation. Large volumes of production to meet international markets will give scale of economies in production. Nations encourage and industries build large facilities.

(iv) **Risk Spread:** A company operating in domestic markets is highly vulnerable to economic upheavals in the home market. Overseas markets provide an opportunity to reduce their dependence on one market and spread the market risks.

(v) **Access to Imported Inputs:** The national trade policies provide for import of inputs used for export production, which are otherwise restricted. Besides, there are a number of incentive schemes which provide duty exemption or remission on import of inputs for export production, such as advance licensing, duty drawback, duty exemption, export promotion, capital goods scheme. It helps the companies in accessing imported inputs and technical know-how to upgrade their operations and increase their competitiveness.

(vi) **Economic Integration and Free Markets:** The growth of liberalisation is opening free markets. There is movement in goods and services from country to country. Companies look for growth opportunities in free markets. For example, German chemical companies going international from Germany. Local consumption in Germany is too small.

(vii) **Emergence of WTO:** A number of friendly and neighbouring countries enter into trade agreements to develop trade. The World Trade Organisation (WTO) replaced GATT (General Agreement on Tariffs and Trade) in 1994. WTO has 159 members and helps to develop multilateral trade.

(viii) **Unifying Effect and Peace:** Two-way business help development activities and economic growth. Business develops long lasting relationships of trust and a feel good factor. All this lead to peace.

2. **Push Factors:** The push factors refer to the compulsions of the domestic market, like saturation of the market, which prompt companies to internationalise. Most of the push factors are reactive reasons. The followings are important push factors:

(i) **Uniqueness of Product or Service:** The products with unique attributes are unlikely to meet any competition in the overseas markets and enjoy enormous opportunities in international markets. For example, herbal and medicinal plants, handicrafts, value-added BPO services, and software development at competitive prices provide Indian firms an edge over other countries and smoothen their entry into international markets.

(ii) **Marketing Opportunities Due to Life Cycles:** Each market shows a different stage of life cycle for different products, which varies widely across country markets. When a product or service gets saturated in the domestic or an international market, a firm may make use of such challenges and convert them into marketing opportunities by operating into international markets. Strategies to launch new products in the existing markets or identify new markets for existing products may be adopted.

(iii) **Spreading R&D Costs:** By way of spreading the potential market size, a firm recovers quickly the costs incurred on research and development. It is especially true for products involving higher costs of R&D, where use of price skimming strategies necessitate faster
recovery of costs incurred, such as software, microprocessors, pharmaceutical products, etc. International markets facilitate speedy recovery of such costs because of the large market size and also due to larger coverage of the right market segments in international markets.

(iv) **Resource Utilisation:** New industries are developed where resources are readily and abundantly available. This reduces considerable transport costs of raw materials. This is especially true in case of mineral based industries. For example, raw steel capacities now being built in Orissa.

(v) **Competition and Costs:** Competition may become a driving force behind internationalisation. The economic liberalisation, ushered in India since 1991, which has increased competition from foreign firms as well as from those within the country, have, however, significantly changed the scene. Many Indian companies are now systematically planning to go international in a big way. Many companies also take an offensive international competitive strategy by way of counter-competition. The strategy of counter-competition is to penetrate the home market of the potential foreign competitor so as to diminish its competitive strength and to protect the domestic market share from foreign penetration.

(vi) **Quality Improvement:** Larger markets and improved margins help large investments in quality improvements. These include better equipment training and adopting quality systems. Quality improvement gives larger markets again and again the cycle continues. For example, Caterpillar earth-moving equipment manufacture.

(vii) **Government Policies and Regulations:** Government policies and regulations may also motivate internationalisation. There are both positive and negative factors which could cause internationalisation. Many governments offer a number of incentives and other positive support to domestic companies to export and to invest in foreign countries. Similarly, several countries give a lot of importance to import development and foreign investment.

**BENEFITS OF INTERNATIONAL TRADE**

The benefits of international trade are as follows:

1. **Greater Variety of Goods Available for Consumption:** Foreign trade brings in different varieties of a particular product from different destinations. This gives consumers a wider array of choices which will not only improve their quality of life but as a whole it will help the country grow.

2. **Efficient Allocation and Better Utilisation of Resources:** Efficient allocation and better utilisation of resources since countries tend to produce goods in which they have a comparative advantage. When countries produce through comparative advantage, wasteful duplication of resources is prevented. It helps save the environment from harmful gases being leaked into the atmosphere and also provides countries with a better marketing power.

3. **Promotes Efficiency in Production:** Foreign trade promotes efficiency in production as countries will try to adopt better methods of production to keep costs down in order to remain competitive. Countries that can produce a product at the lowest possible cost will be able to gain larger
share in the market. Therefore an incentive to produce efficiently arises. This will help to increase the standards of the product and consumers will have a good quality product to consume.

![Benefits of International Trade](image)

4. **More Employment**: More employment could be generated as the market for the countries’ goods widens through trade. International trade helps generate more employment through the establishment of newer industries to cater to the demands of various countries. This will help countries to bring down their unemployment rates.

5. **Consumption at Cheaper Cost**: Foreign trade enables a country to consume things which either cannot be produced within its borders or production may cost very high. Therefore, it becomes cheaper to import from other countries through foreign trade.

6. **Reduces Trade Fluctuations**: By making the size of the market large with large supplies and extensive demand international trade reduces trade fluctuations. The prices of goods tend to remain more stable.

7. **Utilisation of Surplus Produce**: Foreign trade enables different countries to sell their surplus products to other countries and earn foreign exchange.

8. **Fosters Peace and Goodwill**: Foreign trade fosters peace, goodwill, and mutual understanding among nations. Economic interdependence of countries often leads to close cultural relationship and thus avoid war between them.

**LIMITATIONS OF INTERNATIONAL TRADE**

International trade does not always amount to blessings. It has certain limitations also, such as:

1. **Rapid Depletion of Exhaustible Natural Resources**: It could lead to a more rapid depletion of exhaustible natural resources. As countries begin to increase up their production levels, natural resources tend to get depleted with the time and it could pose a dangerous threat to the future generation.

2. **Import of Harmful Goods**: Foreign trade may lead to import of harmful goods like cigarettes, drugs, etc., which may harm the health of the residents of the country. For example, the people of China suffered greatly through opium imports.
3. **It may Exhaust Resources:** Foreign trade leads to intensive cultivation of land. Thus, it has the operations of law of diminishing returns in agricultural countries. It also makes a nation poor by giving too much burden over the resources.

4. **Overspecialisation:** Overspecialisation may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.

5. **Danger of Starvation:** A country might depend for its food mainly on foreign countries. In times of war, there is a serious danger of starvation for such countries.

6. **One Country Gains at the Expense of Other:** One of the serious drawbacks of foreign trade is that one country may gain at the expense of other due to certain accidental advantages. **For example,** the Industrial revolution is Great Britain ruined Indian handicrafts during the nineteenth century.

7. **May Lead to War:** Foreign trade may lead to war different countries compete with each other in finding out new markets and sources of raw material for their industries and frequently come into clash, this was one of the causes of First and Second World War.

8. **Language Diversity:** Each country has its own language. As foreign trade involves trade between two or more countries, there is diversity of languages. This difference in language creates problem in foreign trade.

### **DIFFERENCE BETWEEN INTERNATIONAL TRADE AND DOMESTIC TRADE**

The following table describes the clear difference between the international trade and domestic trade.

<table>
<thead>
<tr>
<th>Basis of Difference</th>
<th>International Trade</th>
<th>Domestic Trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope</td>
<td>Scope of international trade is quite wide. It includes merchandise exports, trade in services, licensing and franchising as well as foreign investments.</td>
<td>Domestic trade pertains to a limited territory. Though the firm has many business establishments in different locations, all the trading activities are inside a single boundary.</td>
</tr>
<tr>
<td>Benefits</td>
<td>International trade benefits both the nations and firms.</td>
<td>Domestic trade has lesser benefits when compared to international trade.</td>
</tr>
<tr>
<td>Market Fluctuations</td>
<td>Firms conducting trade internationally can withstand these situations and huge losses as their operations are widespread. Though they face losses in one area, they may get profits in other areas. This provides for stabilising during seasonal market fluctuations.</td>
<td>Firms carrying business locally have to face this situation which results in low profits and in some cases losses too.</td>
</tr>
<tr>
<td>Political Relations</td>
<td>Foreign trade improves the political relations among the nations which give rise to cross-national cooperation and agreements.</td>
<td>Does not improve political relations globally, and subsequently does not give rise to cross-national cooperation and agreements.</td>
</tr>
</tbody>
</table>
Purvey (Deals in) | Globally operating firms need to follow complicated customs procedures and trade barriers like tariff, etc. | Providing goods and services as a business within a territory is much easier than doing the same globally. Restrictions such as custom procedures do not bother domestic entities.
---|---|---
Sharing of Technology | Foreign trade provides for sharing of the latest technology that is innovated in various firms across the globe. | Does not provide for sharing of technology, only adopts the technology.
Trade Restrictions | Will have to face restrictions in trade practices, licenses and government rules. | In few cases, restrictions exist due to area development, forest, land, etc.
Distance | Long distances and hence more transaction time. | Short distances. Quick business is possible.
Modes of Entry | A firm desirous of entering into international business has several options available to it. These range from exporting/importing to contract manufacturing abroad, licensing and franchising, joint ventures and setting up wholly owned subsidiaries abroad. | Firms going for domestic trade does have the options but not too many as in international business.
Location | MNCs take advantage of location economies wherever cheaper resources available. | No such advantage, once plant is built, it cannot be easily shifted.
Cost Advantage | High volumes cost advantage. | Cost advantage by automation, new methods, etc.
MNCs | MNCs have perfected principles, procedures and practices at international level. MNCs take advantage of location economies wherever cheaper resources available. | No such experience or exposure. Once plant is built, it cannot be easily shifted.

**DIFFERENCE BETWEEN INTERNATIONAL FINANCIAL MANAGEMENT AND DOMESTIC FINANCIAL MANAGEMENT**

1. International Finance is different from domestic financial management in many aspects and most significant of them is foreign currency exposure. This is dealing with Income and Expenditure transactions in different political, cultural, legal, economical and taxation environment.

2. Domestic Financial Management aims at minimizing the cost of capital while raising funds and try optimizing the returns from investments to create wealth for shareholders.

3. Foreign Exchange risk is an additional risk which a finance manager is required to mitigate with implementable strategies. In the Domestic Finance Management, there is no Foreign Exchange risk as the money dealings are completely in domestic currency only.
4. International Financial Management has to take into account Foreign Currency Exposure on account of receiving income from foreign customers and importing Plant and Machinery from abroad. In the case of Domestic Financial Management, there is no such exposure on account of all buying and selling taking place only inside the country.

5. In International Financial Management, we use derivatives instrument to hedge the risk. But in the case of domestic financial management, we do not use derivatives because there is less risk.

6. Under International Finance, the manager has to deal with different tax structure and different country legal laws. Whereas in Domestic Financial Management, the finance manager have to deal with domestic country legal laws and tax structure.

7. In International Finance domain, the finance manager has to work in Macro Business Environment of different countries but in Domestic Financial Management, the manager has to be aware of local macro business environment of single country.

**SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT**

1. Like any finance function, international finance, the finance function of a multinational firm has two functions namely, treasury and control. The treasurer is responsible for financial planning analysis, fund acquisition, investment financing, cash management, investment decision and risk management. On the other hand, controller deals with the functions related to external reporting, tax planning and management, management information system, financial and management accounting, budget planning and control, accounts receivables, etc.

2. For maximizing the returns from investment and to minimize the cost of finance, the firms has to take portfolio decision based on analytical skills required for this purpose. Since the firm has to raise funds from different financial markets of the world, which needs to actively exploit market imperfections and the firm’s superior forecasting ability to generate purely financial gains. The complex nature of managing international finance is due to the fact that a wide variety of financial instruments, products, funding options and investment vehicles are available for both reactive and proactive management of corporate finance.

3. Multinational finance is multidisciplinary in nature, while an understanding of economic theories and principles is necessary to estimate and model financial decisions, financial accounting and management accounting help in decision making in financial management at multinational level. Because of changing nature of environment at international level, the knowledge of latest changes in FOREX rates, volatility in capital market, interest rate fluctuations, macro level charges, micro level economic indicators, savings, consumption pattern, interest preference, investment behavior of investors, export and import trends, competition, banking sector performance, inflationary trends, demand and supply conditions, etc. is required by the practitioners of international financial management.
DISTINGUISHED NATURE OF INTERNATIONAL FINANCIAL MANAGEMENT

International Finance is a distinct field of study and certain features set it apart from other fields. The important distinguishing features of international finance from domestic financial management are discussed below:

1. Foreign exchange risk is an understanding of foreign exchange risk which is essential for managers and investors in the modern-day environment of unforeseen changes in foreign exchange rates. In a domestic economy, this risk is generally ignored because a single national currency serves as the main medium of exchange within a country. When different national currencies are exchanged for each other, there is a definite risk of volatility in foreign exchange rates.

2. The present International Monetary System set up is characterized by a mix of floating and managed exchange rate policies adopted by each nation keeping in view its interests. In fact, this variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policy makers.

3. At present, the exchange rates among some major currencies such as the U.S. dollar, British pound, Japanese yen and the euro fluctuate in a totally unpredictable manner. Exchange rates have fluctuated since the 1970s after the fixed exchange rates were abandoned. Exchange rate variation affects the profitability of firms and all firms must understand foreign exchange risks in order to anticipate increased competition from imports or to value increased opportunities for exports.

4. Political risk is yet another risk that firms may encounter in international finance is political risk. Political risk ranges from the risk of loss (or gain) from unforeseen government actions or other events of a political character such as acts of terrorism to outright expropriation of assets held by foreigners. MNCs must assess the political risk not only in countries where it is currently doing business but also where it expects to establish subsidiaries. The extreme form of political risk is when the sovereign country changes the ‘rules of the game’ and the affected parties have no alternatives open to them. For example, in 1992, Enron Development Corporation, a subsidiary of a Houston based energy company, signed a contract to build India’s largest power plant. Unfortunately, the project got cancelled in 1995 by the politicians in Maharashtra who argued that India did not require the power plant. The company had spent nearly $ 300 million on the project. The Enron episode highlights the problems involved in enforcing contracts in foreign countries. This, episode highlights the problems involved in enforcing contracts in foreign countries. Thus, political risk associated with international operations is generally greater than that associated with domestic operations and is generally more complicated.

5. Expanded opportunity sets – When firms go global, they also tend to benefit from expanded opportunities which are available now. They can raise funds in capital 7 markets where cost of capital is the lowest. In addition, firms can also gain from greater economies of scale when they operate on a global basis.

6. Market imperfection is the final feature of international finance that distinguishes it from domestic finance is that world markets today are highly imperfect. There are profound differences among nations’ laws, tax systems, business practices and general cultural environments. Imperfections in the world financial markets tend to restrict the extent to which investors can diversify their portfolio.
Though there are risks and costs in coping with these market imperfections, they also offer managers of international firms abundant opportunities.

**FOREIGN TRADE AND ECONOMIC GROWTH**

**Introduction**

International trade has exerted a profound influence on the economic growth of a country. It has been observed that with the opening up of the economy and liberalization of trade restrictions, the developing countries, especially India and China, have grown over the years.

The issues of international trade and economic growth have gained substantial importance with the introduction of trade liberalization policies in the developing nations across the world. International trade and its impact on economic growth crucially depend on globalization. As far as the impact of international trade on economic growth is concerned, the economists and policy makers of the developed and developing economies are divided into two separate groups.

One group of economists is of the view that international trade has brought about unfavorable changes in the economic and financial scenarios of the developing countries. According to them, the gains from trade have gone mostly to the developed nations of the world. Liberalization of trade policies, reduction of tariffs and globalization have adversely affected the industrial set-ups of the less developed and developing economies. As an aftermath of liberalization, majority of the infant industries in these nations have closed their operations. Many other industries that used to operate under government protection found it very difficult to compete with their global counterparts.

The other group of economists, which speaks in favour of globalization and international trade, come with a brighter view of the international trade and its impact on economic growth of the developing nations. According to them, developing countries, which have followed trade liberalization policies, have experienced all the favourable effects of globalization and international trade. China and India are regarded as the trend-setters in this case.

There is no denying that international trade is beneficial for the countries involved in trade, if practiced properly. International trade opens up the opportunities of global market to the entrepreneurs of the developing nations, International trade also makes the latest technology readily available to the businesses operating in these countries. It results in increased competition both in the domestic and global fronts. To compete with their global counterparts, the domestic entrepreneurs try to be more efficient and this in turn ensures efficient utilization of available resources. Open trade policies also bring in a host of related opportunities for the countries that are involved in international trade.

In conclusion, it can be said that international trade leads to economic growth provided the policy measures and economic infrastructure are accommodative enough to cope with the changes in social and financial scenario that result.

**Relationship between Foreign Trade and Economic Growth**

International trade and economic growth are two concepts that go together, because international trade contributes to the growth of a country’s economy in several ways. Some of these ways include
the effects of import and export, specialization, increased productivity and improved infrastructure. The export of goods to other countries can contribute to the growth of the exporting country by increasing the earnings of that country.

The national economies of some countries are even dependent on and sustained by their exports. For example, some oil-producing countries depend on the income from the export of crude oil and its derivatives to sustain their nations. Some of these countries actually plan their national budgets based on projections or calculations of expected income from the export of oil. Apart from crude oil, other countries also partially base their national budget on the income from items like agricultural products, precious stones and even technology. This represents one way in which international trade and economic growth are linked.

Apart from commodities, the international trade in labour is also an offshoot of globalisation. Immigrants take much-needed skills to countries in which these skills are needed. Most immigrants from less developed nations to countries of highly developed state send money to their country of origin contributing to its economic growth. They also help to increase the growth of the economies of the countries where they live by contributing to productivity. For example, migrant workers often work on farms where they supply labour to help prepare food items for sale locally and internationally. More skilled immigrants like engineers, doctors and nurses contribute to the growth of the economy of their chosen country.

Another factor establishing a link between international trade and economic growth is the increase in productivity. When there is a high demand for a product, the countries that produce such a product will automatically increase production in order to meet up with the demand for the product. This increase translates to more revenue and an improvement in the economy of the country.

A vibrant culture of international trade also contributes to the building of an infrastructural framework in order to sustain the trade. For example, the demand for groundnuts from a country may lead to the building of roads and an improved transportation system to support the production. If the groundnuts are cultivated in farms located in villages that previously had a poor network of roads, the government or other corporate interests might build better roads.

**Contribution of Foreign Trade in Economic Growth**

Foreign trade plays a vital role in the economic development of a country. Its importance can be judged from the following points:

1. **Specialisation in Production:** Foreign trade leads to specialisation in the production of those goods which a country can produce at lower cost. This situation improves the overall welfare of the people.
2. **Quality Goods at Lower Rates:** If a country cannot produce a specific commodity, then it can import that commodity at lower rates from international market in the presence of foreign trade.
3. **Flow of Capital Goods and Technical Know-how:** In the presence of foreign trade, flow of capital goods and technical know-how take place which increase the rate of economic growth and development of the country.
4. **Removal of Shortage of Goods:** Foreign trade is helpful for the removal of shortage of goods. If there is shortage of any commodity, then that commodity can be imported from the international market which will eliminate shortage of good.

5. **Industrial and Agricultural Development:** Foreign trade brings improvement in industrial and agricultural sectors of the economy. The necessary inputs of industrial and agricultural sector can be imported which will develop both the sectors of the economy.

6. **Discourage the Formation of Monopolies:** Foreign trade discourages the formation of local monopolies. The local producers cannot exploit the consumers because of fear of cheap imports. In the absence of imports, some local firms may create monopoly and charge very high prices.

7. **Quality Importance of Local Products:** The foreign competition helps to improve the quality of local products. If Pakistani Government allows cycles to be improved, then the quality of Pakistani cycles will definitely improve.

8. **Optimum Utilization of Resources:** International trade helps in the optimum utilization of resources. A country specializes in the production of those goods for which its resources are more suitable, and as a result, the resources are properly utilized.

9. **Price Stability:** Foreign trade helps in the price stability of a country. If the price level is very high of a commodity, then that commodity can be imported which will keep price in stable position.

10. **World Peace:** Foreign trade promotes peace in the entire world because in the presence of international trade, people of different countries come close together and they become interdependent.

11. **Increase in National Income:** In the presence of international trade, the resources are properly utilized which increases exports of the country and, as a result, per capita income and national income increases.

### CURRENT TRENDS IN INDIA

#### Economic Growth Trends in Indian Economy

There are the following major economic trends in India:

1. **Foreign Exchange Market:** The Indian rupee led a weekly loss in Asian currencies on increasing speculation that the U.S. will scale back monetary stimulus. The Indian rupee continued its freefall despite the central bank’s efforts to prop up the currency. The rupee hit another record low during the week by ending at 65.83 per U.S. dollar on 6 September 2013.

2. **Exports:** Indian exports to Euro-zone, which constitute around 17% of the total exports, appear to be impacted due to the decreasing demand from Euro countries. In the first nine months of 2012-13, a 10%, contraction in exports has been observed when compared to that over a similar period in the previous year.
3. **Fiscal Environment:** The Government has found it difficult to contain expenditure despite proactive reforms to boost the slowing economy. The Government revised its fiscal consolidation roadmap in October 2012. As per the revised roadmap, the fiscal deficit of the central government will be reduced in a calibrated way from the targeted 5.3% of GDP in FY 2012-13 to 3.0% of GDP by FY 2016-17. The revision proved challenging as the actual fiscal deficit fared at 5.9%.

4. **Industrial Sector:** The industrial sector, usually more than one-fourth size of the total GDP, performed significantly below par this year with growth of mere 1% during the first half of 2016-17 as against 4.6% in first half of 2016-17. The under-performing manufacturing sector, particularly the capital goods industries, posed a real challenge for the country.

5. **Agricultural Sector:** In the agricultural sector, good winter crop sowing prospects are expected to overcome the negative effect of a deficient summer crop output. The yearly output is likely to be better than the 2.1% growth achieved in first half of 2013. Overall, the year is expected to close at a lower level compared to earlier years.

6. **Services Sector:** A larger concern exists on the services sector which has moderated during 2012. With “trade, hotels, transport, storage and communication” an important sub-sector in services performing the worst, various indicators of service sector activities such as cargo handling, civil aviation and railway freight, etc., suggest further weakening of growth. Additionally, the uncertain global outlook is likely to affect services exports adversely.

7. **Trade Deficit:** At the helm of worsening, CAD for the current year is the burgeoning trade deficit. During the period April to December 2012, both exports (U.S. $214 billion) and imports (U.S. $361 billion) declined. With a sharper drop in exports than imports, the trade deficit has surged to U.S. $147 billion in the first 9 months as against U.S. $137 billion of last year. Major decline in exports growth is an effect of sluggish global demand and an uncertain macro-economic environment.

8. **Balance of Payment:** These statistics show that capital inflows had improved in 2016-17 and in fact that capital inflows have financed the expanding CAD. While net FDI inflows moderated to U.S. $14.7 billion during April-November 2012 (as against U.S. $19.6 billion last year), net FOREX inflows have shown a significant uptrend reaching U.S. $11.2 billion in 2012.

9. **External Debt:** This has witnessed a steep rise in second quarter of 2016-17, reaching U.S. $365 billion from U.S. $345 billion at the start of the financial year.

10. **Inflation and Monetary Conditions:** For most of the period of 2016-17, the Wholesale Price Inflation (WPI) has remained around the mark of 7.5%. It reached as high as 8% in August 2012 and then revised down to 7.2% by December 2017, further moderating to 6.62% in January 2013. Inflation moderation has been faster than expected in the third quarter touching a three year low.

11. **Monetary Policy:** This monetary policy action is expected to result in consequent reduction in the interest rates. However, it remains to be seen if and how much a 25 basis point reduction will encourage banks in passing on a significant benefit to consumers.
Introduction

The balance of trade (or net exports, sometimes symbolised as NX) is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation’s imports and exports. A favourable balance of trade is known as a trade surplus and consists of exporting more than is imported; an unfavourable balance of trade is known as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and services balance.

The balance of trade forms part of the current account, which includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country’s net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position.

The trade balance is identical to the difference between a country’s output and its domestic demand (the difference between what goods a country produces and how many goods it buys from abroad; this does not include money spent on foreign stocks, nor does it factor the concept of importing goods to produce for the domestic market).

For a given country, trade balance comprises those products that a country trades on with other countries.

Measuring the balance of trade can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for all the world’s countries are added up, exports exceed imports by a few per cent; it appears the world is running a positive balance of trade with itself.

This cannot be true, because all transactions involve an equal credit or debit in the account of each nation. The discrepancy is widely believed to be explained by transactions intended to launder money or evade taxes, smuggling and other visibility problems. However, especially for developed countries, accuracy is likely.

According to Benham, “Balance of trade of a country is the relation over a period between the values of her exports and imports of physical goods”.

In other words, balance of trade account is an account which records the exports and imports of goods of a country during a given period and shows the difference between the total value of exports of goods and the total value of imports of goods during a given period. Balance of trade can be represented as under:

\[ B_g = E_g - M_g \]

where

- \( B_g \) = balance of trade
- \( E_g \) = value of exports of goods
- \( M_g \) = value of imports of goods
**Features of BOT**

The features of balance of trade are as follows:

1. **Balance of Trade** highlights the variation between the total exports and imports of a country for a given period of time.
2. It only shows the value of imports and exports and not the services. So, in this sense, it is a narrow concept.
3. **Favourable Balance of Trade** shows the country’s claim from other countries to the extent of difference between the total value of exports and imports of goods.
4. The country’s indebtedness is depicted by the unfavourable Balance of Trade.

**Types of BOT**

Balance of trade may be of three types as follows:

1. **Favourable Balance of Trade**: Balance of trade is said to be favourable when the total value of exports of goods of a country exceeds her total value of imports of goods (i.e., when $E_g > M_g$).
2. **Unfavourable (or Adverse) Balance of Trade**: Balance of trade is said to be unfavourable when the total value of imports of goods of a country exceeds her total value of exports of goods (i.e., when $E_g < M_g$).
3. **Equilibrium Balance of Trade**: Balance of trade is said to be in equilibrium when the total value of exports of goods of a country is equal to her total value of imports of goods (i.e., $E_g = M_g$).

**BOT Deficit**

It is the negative difference of the value of goods exported out of a country less the value of goods and services imported into the country. A balance of trade deficit is the official term for negative net exports that occurs when imports exceed exports. A balance of trade deficit is also termed an “unfavourable” balance of trade because it results in a net outflow of monetary payments from the domestic economy to the foreign sector, which tends to be bad for a country. The alternative is a balance of trade surplus in which exports exceed imports.

A balance of trade deficit exists for a country when the value of imports produced by the foreign sector and purchased by the domestic economy is greater than the value of exports produced by the domestic economy and purchased by the foreign sector. In other words, imports exceed exports and net exports are negative.

This is also commonly termed an unfavourable balance of trade because the excess of exports over imports creates a net outflow of monetary payments out of a country. This generates a decrease in aggregate income and associated measures, especially consumption, saving, investment, and tax revenue, which is rightfully considered to be “unfavourable” for the country.

A given country can have an “overall” balance of trade deficit in which imports from the foreign sector exceed exports to the foreign sector. One country can also said to have a balance of trade deficit...
with just one other country, in which imports from that country exceed exports to that country. For example, the United States might have an overall balance of trade surplus with the foreign sector, but a balance of trade deficit with China. An overall balance of trade deficit with the foreign sector does not necessarily mean a balance of trade deficit for every other country.

Causes of Balance of Trade Deficit

A negative balance of trade can have many causes like the following:

1. Not enough companies engage in exporting. For example, most big companies in the U.S. do not emphasize the extension of their exports. They prefer delocalizing their production by investing in emerging economies such as China. From there, the products produced at a by far lower cost are imported to the U.S. and Europe at a by far higher margin.

2. A second reason for a country’s negative balance of trade may be that its companies are not internationally competitive enough (because of high labour costs, lack of technology, high taxes, inadequate industrial structures, etc.).

3. Another reason may be an over-rating of the country’s currency, which makes its products and services too expensive to export, while imports from other countries are relatively low priced.

4. A government’s budget deficit may be an important factor leading to a negative balance of trade. For example, the U.S. government, unlike many European governments, supports its budget deficit by borrowing from other countries. This borrowing makes it possible to maintain consumption at high level, which results in a negative balance of trade (and in net imports of capital because of the higher returns of investments).

An international marketer interested in the economic outlook of a potential country market may analyse the country’s balance of trade and the government’s budget deficit as a percentage of GDP for both short-term and long-term effects.

BALANCE OF PAYMENT (BOP)

Introduction

Balance of payment is a broader term and it includes balance of trade. It is more comprehensive than the balance of trade. Balance of trade refers to the merchandise account of exports and imports only.

Balance of payment refers to the net results that are drawn recording all the visible and invisible items that are imported and exported from the country. Balance of payment, such as, provides a comprehensive statement over the net results of foreign trade and gives a true picture as to where the country stands in the international trade. Balance of payment clearly exposes the economic viability, strength, and capability by correctly measuring its imports and exports, competency in goods and services as well as technical know-how. By services, we mean the services of shipping lines, insurance companies, banking concerns and others. Balance of payment also includes the foreign loan that is either provided by it or accepted from other country or countries.
According to Kindleberger, “Balance of payment is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time”.

In other words, the balance of payments is a comprehensive record of economic transactions of the residents of a country with the rest of the world during a given period of time. The aim is to present an account of all receipts and payments on account of goods exported any services rendered by resident of a country and goods imported, services received and capital transferred by residents of the country.

The balance of payments is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries. It is a measure of all transactions between domestic countries and international countries.

**Nature of Balance of Payment**

The nature of balance of payments is as follows:

1. **Systematic Record**: It is a systematic record of receipts and payments of a country with other countries.
2. **Fixed Period of Time**: It is a statement of an account pertaining to a given period of time, usually a year.
3. **Comprehensiveness**: It includes all the three items, i.e., visible, invisible and capital transfers. The balance of payments is a comprehensive record of economic transactions of the residents of a country with the rest of the world during a given period of time. The aim is to present an account of all receipts and payments on account of goods exported services rendered and capital by resident of a country and goods imported, services received and capital transferred by residents of the country.
4. **Double Entry System**: Receipts and payments are recorded on the basis of double entry system. The basic convention applied in constructing a balance of payments statement is that every recorded transaction is represented by two entries with equal values. One of these entries is designated a credit with a positive arithmetic sign; the other is designated a debit with a negative sign. In principle, the sum of all credit entries is identical to the sum of all debit entries, and the net balance of all entries in the statement is zero.
5. **Self-balanced**: From the point of view of accounting, double entry system keeps automatically debit and credit sides of the accounts in balance.
6. **Adjustment of Differences**: Whenever there are differences in actual total receipts and payments, need is felt for necessary adjustment.
7. **All Items – Government and Non-government**: Balance of payments includes receipts and payments of all items government and non-government.
Components of BOP

The accounting contents or components of balance of payments are:

<table>
<thead>
<tr>
<th>Components of BOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
</tr>
<tr>
<td>Capital Account</td>
</tr>
<tr>
<td>Official Reserve Account</td>
</tr>
<tr>
<td>Other Items in the Balance of Payments</td>
</tr>
</tbody>
</table>

Fig. 1.3

1. Current Account: Current account is typically divided into three sub-categories; the merchandise trade balance, the services balance and the balance on unilateral transfers. Entries in this account are “current” in value as they do not give rise to future claims. A surplus in the current account represents an inflow of funds while a deficit represents an outflow of funds. The capital account can be divided into three categories:

(i) Merchandise: Balance of merchandise trade refers to the balance between exports and imports of tangible goods such as automobiles, computers, machinery and so on. A favourable balance of merchandise trade (surplus) occurs when exports are greater in value than imports. An unfavourable balance of merchandise trade (deficit) occurs when imports exceed exports. Merchandise exports and imports are the largest single component of total international payments for most countries.

(ii) Invisibles: Services represent the second category of the current account. Services include interest payments, shipping and insurance fees, tourism, dividends and military expenditures. These trades in services are sometimes called invisible trade.

(iii) Unilateral Transfers: Unilateral transfers are gifts and grants by both private parties and governments. Private gifts and grants include personal gifts of all kinds and also relief organization shipments. For example, money sent by immigration workers to their families in their native country represents private transfer. Government transfers include money, goods and services sent as aid to other countries.

2. Capital Account: The capital account is an accounting measure of the total domestic currency value of financial transactions between domestic residents and the rest of the world over a period of time. This account consists of loans, investments, and other transfers of financial assets and the creation of liabilities. It includes financial transactions associated with international trade as well as flows associated with portfolio shifts involving the purchase of foreign stocks, bonds and bank deposits.

The capital account can be divided into three categories: direct investment, portfolio investment and other capital flows.

(i) Direct Investment: Direct investment occurs when the investor acquires equity such as purchases of stocks, the acquisition of entire firms, or the establishment of new subsidiaries. Foreign direct investment (FDI) generally takes place when firms tend to take advantage of various market imperfections. Firms also undertake foreign direct investments when the
expected returns from foreign investment exceed the cost of capital, allowing for foreign exchange and political risks. The expected returns from foreign profits can be higher than those from domestic projects due to lower material and labour costs, subsidised financing, investment tax allowances, exclusive access to local markets, etc.

(ii) **Portfolio Investment:** Portfolio investments represent sales and purchases of foreign financial assets such as stocks and bonds that do not involve a transfer of management control. A desire for return, safety and liquidity in investments is the same for international and domestic portfolio investors. International portfolio investments have specifically boomed in recent years due to investor’s desire to diversify risk globally. Investors generally feel that they can reduce risk more effectively if they diversify their portfolio holdings internationally rather than purely domestically. In addition, investors may also benefit from higher expected returns from some foreign markets.

(iii) **Capital Flows:** Capital flows represent the third category of capital account and represent claims with a maturity of less than one year. Such claims include bank deposits, short-term loans, short-term securities, money market investments and so forth. These investments are quite sensitive to both changes in relative interest rates between countries and the anticipated change in the exchange rate. For example, if the interest rates rise in India, with other variables remaining constant, India will experience capital inflows as investors who would like to deposit or invest in India take advantage of the higher interest rate. But if the higher interest rate is accompanied by an expected depreciation of the Indian rupee, capital inflows to India may not materialise.

3. **Official Reserve Account:** Official reserves are government owned assets. The official reserve account represents only purchases and sales by the central bank of the country (for example, The Reserve Bank of India). The changes in official reserves are necessary to account for the deficit or surplus in the balance of payments. For example, if a country has a BOP deficit, the central bank will have to either run down its official reserve assets such as gold, foreign exchange and SDRs or borrow fresh from foreign central banks. However, if a country has a BOP surplus, its central bank will either acquire additional reserve assets from foreigners or retire some of its foreign debts.

4. **Other Items in the Balance of Payments:** The remaining items that can not be categorised in to the preceding categories constitute the other items in the balance of payments.

(i) **Errors and Omissions:** These take into account the difficulty of accurately recording all the wide variety of transactions that take place in the accounting period. They may arise due to the presence of sampling of transactions rather than recording each individual transaction (e.g., instead of recording each of a thousand exports of lemons, they may multiply an average lemon export figure by thousand), due to dishonesty, i.e., businessmen under reporting sales abroad to avoid taxes, or when smuggling occurs, etc.

(ii) **Official Reserve Transactions:** All transactions except those in this category may be termed as autonomous transactions. They are so-called because they are entered into with some independent motive, i.e., not with a view to bring their consequences on the balance of payments or on the exchange rate. In contrast to this, official reserve transactions are carried out by the government and the central banks in pursuit of some international economic policy objective; while keeping an eye on the effect of such transactions on the
BOP and the exchange rate. As a result, such transactions are not autonomous. The first of these items is the change in the domestic country’s official reserve assets. These reserves of a country are held in the form of foreign currency or foreign currency securities, gold and Special Drawing Rights (SDR) with the IMF. SDR allows a country to avail of foreign exchange in proportion to the quantum of the country’s deposit of its currency with the IMF under the SDR scheme. The changes in the country’s reserves must reflect the net value of all other items in the BOP. Reduction in these assets will be used to finance expenditures abroad. Reductions appear as a credit item in the BOP (because their sale causes foreign exchange inflow into the country). An increase in these reserves will appear as a debit because of purchasing assets.

<table>
<thead>
<tr>
<th>(A)</th>
<th>(B)</th>
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<tbody>
<tr>
<td><strong>(A) Current Account</strong></td>
<td><strong>Credit</strong></td>
</tr>
<tr>
<td><strong>1. Merchandise</strong></td>
<td></td>
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<tr>
<td>(i) Exports (on f.o.b. basis)</td>
<td></td>
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<tr>
<td>(ii) Imports (on c.i.f. basis)</td>
<td></td>
</tr>
<tr>
<td><strong>2. Invisibles (i + ii + iii)</strong></td>
<td></td>
</tr>
<tr>
<td>(i) Services</td>
<td></td>
</tr>
<tr>
<td>(a) Travel</td>
<td></td>
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<td>(b) Transportation</td>
<td></td>
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<td>(c) Insurance</td>
<td></td>
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<tr>
<td>(d) Miscellaneous</td>
<td></td>
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<tr>
<td>(ii) Transfers</td>
<td></td>
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<tr>
<td>(a) Official</td>
<td></td>
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<tr>
<td>(b) Private</td>
<td></td>
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<tr>
<td>(iii) Investment Income Total Current Account (1 + 2)</td>
<td></td>
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</tbody>
</table>

| **(B) Capital Account^** | | | |
| **1. Foreign Investment (i + ii)** | | | |
| (i) In India | | | |
| (a) Direct | | | |
| (b) Portfolio | | | |
| (ii) Abroad | | | |
| **2. Loans (i + ii + iii)** | | | |
| (i) External Assistance | | | |
| (a) By India | | | |
| (b) To India | | | |
(ii) Commercial Borrowings (MT and LT)
   (a) By India
   (b) To India
(iii) Short-term
   (a) To India
3. Banking Capital (i + ii)
   (i) Commercial Banks
      (a) Assets
      (b) Liabilities
      (c) Non-resident Deposits
   (ii) Others
4. Rupee Debt Service
5. Other Capital Total Capital Account (1 + 2 + 3 + 4 + 5)
(C) Errors and Omissions
(D) Overall Balance (A + B + C)
(E) Monetary Movements (i + ii)
1. I.M.F.
2. Foreign Exchange Reserves (Increase -/Decrease +)

Since the balance of payments statement is drawn up in terms of debits and credits based on a system of double-entry book-keeping, if all entries are made correctly, the total debits must equal total credits.

This is because two aspects (debits and credits) of each transaction recorded are equal in amount and appear on the opposite sides of the balance of payments account. In the accounting sense, balance of payments of a country must always balance.

In other words, debit or payment side of the balance of payments accounts of a country represents the total of all the uses made out of the total foreign exchange acquired by a country during the given period, while the credit or the receipt side represents the sources from which this foreign exchange was acquired by this country in the same period. The sides as such necessarily balance.

**FACTORS AFFECTING BALANCE OF PAYMENT (BOP)**

Following factors affect the balance of payments of the country.

1. **Cost of Production:** The cost of production (land, labour, capital, taxes, incentives, etc.) in the exporting economy or those in the importing economy
2. **Demand and Supply:** The demand and supply trend defines the cost of domestic products to be sold in the international market.
3. **Cost and Availability:** The cost and availability of raw materials, intermediate goods and other inputs.
4. **Exchange Rate Movements:** For nations with low exchange rate values, balance of trade tends to remain unfavourable.

5. **Domestic Business:** Sound, domestic policies are required to boost production and international trade. Some countries like the U.S. provide subsidies to local manufacturers for exported goods and services.

6. **Trade Agreements:** Bilateral agreements govern international trade and define the products and their prices in the global context.

7. **External Pressures:** Many countries export items that face heavy competition in international market. This results in market segmentation and low pricing. Countries that are mostly oil exporters or IT hubs tend to generate favourable trade balance due to less competition in the international market. External pressures also work in the form of trade bans. These bans are enforced by either individual countries or international organisations such as the WTO or IMF.

8. **Price:** Prices of goods manufactured at home (influenced by the responsiveness of supply).

### Importance of BOP

BOP data may be important for any of the following reasons:

1. **Forecasting:** The BOP helps forecast a country’s market potential, especially in the short run. A country experiencing a serious BOP deficit is not likely to import as much as it would if it were running a surplus.

2. **Indicator of Pressure:** The BOP is an important indicator of pressure on a country’s foreign exchange rate, and thus on the potential of a firm trading with or investing in that country to experience foreign exchange gains or losses. Changes in the BOP may presage the impositions (or removal) of foreign exchange controls.

3. **Signal of Imposition:** Changes in a country’s BOP may also signal the imposition (or removal) of controls over payment of dividends and interest, license fees, royalty fees, or other cash disbursements to foreign firms or investors.

4. **Judging the Stability:** Judging the stability of a floating exchange rate system is easier with BOP as the record of exchanges that take place between nations help to track the accumulation of currencies in the hands of those individuals more willing to hold on to...
them and judging the stability of a fixed exchange rate system is also easier with the same record of international exchange. These exchanges again show the extent to which a currency is accumulating in foreign hands, raising questions about the ease of defending the fixed exchange rate in a future crisis.

**Disequilibrium in BOP r**

The balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is equivalent to the supply of it. The balance of payments is in disequilibrium when there is either a surplus or a deficit in the balance of payments. When there is a deficit in the balance of payments, the demand for foreign exchange exceeds the demand for it.

Though the credit and debit are balanced in the balance of payment account, it may not remain balanced always. Very often, debit exceeds credit or the credit exceeds debit causing an imbalance in the balance of payment account. Such an imbalance is called the disequilibrium. Disequilibrium may take place either in the form of deficit or in the form of surplus.

Disequilibrium of deficit arises when the receipts from the foreigners fall below our payment to foreigners. It arises when the effective demand for foreign exchange of the country exceeds its supply at a given rate of exchange. This is called an ‘unfavourable balance’.

Disequilibrium of surplus arises when the receipts of the country exceed its payments. Such a situation arises when the effective demand for foreign exchange is less than its supply. Such a surplus disequilibrium is termed as ‘favourable balance’.

**Causes of Disequilibrium in Balance of Payments (BOP)**

Various causes of disequilibrium in the balance of payments or adverse balance of payments are as follows:

1. **Development Schemes:** The main reason for adverse balance of payments in the developing countries is the huge investment in development schemes in these countries. The propensity to import of the developing countries increases for want of capital for industrialization. The exports, on the other hand, may not increase because these countries are traditionally primary producing countries. Moreover, the volume of exports may fall because newly created domestic industries may need them. All this leads to structural changes in the balance of payment resulting in structural disequilibrium.

2. **Price-Cost Structure:** Changes in price-cost structure of export industries affect the volume of exports and create disequilibrium in the balance of payments. Increase in prices due to higher wages, higher cost of raw materials, etc. reduces exports and makes the balance of payments unfavourable.

3. **Changes in Foreign Exchange Rates:** Changes in the rate of exchange is another cause of disequilibrium in the balance of payments. An increase in the external value of money makes imports cheaper and exports dearer; thus, imports increase and exports fall and balance of payments become unfavourable. Similarly, a reduction in the external value of money leads to a reduction in imports and an increase in exports.

4. **Fall in Export Demand:** There has been a considerable decline in the export demand for the primary goods of the underdeveloped countries as a result of the large increase in the domestic
production of foodstuffs, raw materials and substitutes in the rich countries. Similarly, the advanced countries also find a fall in their export demand because of loss of colonial markets. However, the deficit in the balance of payment due to the fall in export demand is more persistent in the underdeveloped countries than in the advanced countries.

5. Demonstration Effect: According to Nurkse, the people in the less developed countries tend to follow the consumption patterns of the developed countries. As a result of this demonstration effect, the imports of the less developed countries will increase and create disequilibrium in the balance of payments.

6. International Borrowing and Lending: International borrowing and lending is another reason for the disequilibrium in the balance of payments. The borrowing country tends to have unfavourable balance of payments, while the lending country tends to have favourable balance of payments.

7. Cyclical Fluctuations: Cyclical fluctuations cause cyclical disequilibrium in the balance of payments. During depression, the incomes of the people in foreign countries fall. As a result, the exports of these countries tend to decline which, in turn, produces disequilibrium in the home country's balance of payment.

8. Newly Independent Countries: The newly independent countries, in order to develop international relations, incur huge amounts of expenditure on the establishment of embassies, missions, etc. in other countries. This adversely affects the balance of payments position.

9. Population Explosion: Another important reason for adverse balance of payments in the poor countries is population explosion. Rapid growth of population in countries like India increases imports and decreases the capacity to export.

10. Natural Factors: Natural calamities, such as droughts, floods, etc., adversely affect the production in the country. As a result, the exports fall, the imports increase and the country experiences deficit in its balance.

Types of Disequilibrium in the BOP

The following are the main types of disequilibrium in the balance of payments:

<table>
<thead>
<tr>
<th>Table 1.4: Types of Disequilibrium</th>
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<tbody>
<tr>
<td>Structural Disequilibrium</td>
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<tr>
<td>Monetary Disequilibrium</td>
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<tr>
<td>Short-run Disequilibrium</td>
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</tbody>
</table>

1. Structural Disequilibrium: It takes place due to structural changes in the economy affecting demand and supply relations in commodity and factor market. Structural disequilibrium in balance of payments persists for relatively longer periods; as it is not easy to remove structural imbalance in the economy. Structural disequilibrium is caused by changes in technology, tastes and attitude towards foreign investment, political disturbances, strikes, lockouts, etc. which affect the supply of exports thereby causing structural disequilibrium.
Structural disequilibrium can be further bifurcated into:

(i) **Structural Disequilibrium at Goods Level:** It occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium, or when a change occurs in the basic circumstances under which income is earned or spent abroad, in both cases without the requisite parallel changes elsewhere in the economy. Suppose the demand for Pakistani handicrafts falls off. The resources engaged in the production of these handicrafts must shift to some other line or the country must restrict imports, otherwise the country will experience a structural disequilibrium.

A deficit arising from a structural change can be filled by increased production or decreased expenditure, which in turn affect international transactions in increased exports or decreased imports. Actually it is not so easy, because the resources are relatively immobile and expenditure not readily compressible. Disinflation or depreciation may be called for to correct a serious disequilibrium.

(ii) **Structural Disequilibrium at Factors Level:** It results from factor prices which fall to reflect accurately factor endowments, i.e., when factor prices are out of line with factor endowments, distort the structure of production from the allocation of resources which appropriate factor prices would have indicated. If for example, the price of labour is too high, it will be used more sparingly and the country will import goods with a higher labour content. This will lead to unemployment, upsetting the balance in the economy.

Some of the important causes of structural disequilibrium are as follows:

(a) If the foreign demand for a country’s products decline due to the discovery of cheaper substitutes abroad, then the country’s export will decline causing a deficit.

(b) If the supply position of a country is affected due factors like crop failure, shortage of raw-materials, strikes, and political instability, etc., then there would be the deficit in the balance of payments.

(c) A shift in demand due to the changes in tastes, fashions, and income, etc., would increase or decrease the demand for imported goods causing a disequilibrium in the balance of payments.

(d) Changes in the rate of international capital movements may also cause structural disequilibrium.

(e) A war also results in structural changes which may affect not only goods but also factor of production causing disequilibrium in balance of payments.

2. **Cyclical Disequilibrium:** When disequilibrium is caused due to the changes in trade cycles, it is termed as cyclical disequilibrium. Cyclical disequilibrium occurs because of two reasons which are as follows:

(i) Two countries may be passing through different paths of business cycle. It is possible that different phases of trade cycles like depression, prosperity, boom, and recession, etc., may disturb terms of trade and cause disequilibrium in balance of payments. For example, during boom period, imports may increase considerably due to increase in-demand for imported goods. During recession and depression, imports may be reduced due to fall in demand on account of reduced income. During recession exports may increase due to fall in price. During boom period, a country may face deficit in
its BOP position on account increase in imports. However, during recession its export may increase, and as such BOP position may show surplus.

(ii) The countries may be following the same path but the income elasticities of demand or price elasticities of demand are different, i.e., the importing countries may face cyclical changes. For example, there may be recession in the importing countries, which in turn would reduce demand for imports. Therefore, the demand for exports will decline and the exporting country may face a trade deficit, which in turn may affect BOP positions.

In short, cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables. When prices rise during prosperity and fall during a depression, a country which has a highly elastic demand for imports experiences a decline in the value of imports and if it continues its exports further, it will show a surplus in the balance of payments.

3. Monetary Disequilibrium: It takes place on account of inflation or deflation. Due to inflation, the prices of the products in the domestic market rises, and therefore, export items will become expensive. Such a situation may affect the BOP equilibrium. Inflation also results in to increase in money income with the people, which in turn may increase demand for imported goods. As a result imports may turn BOP position in disequilibrium.

It arises due to deficient or excess nominal demand for goods and securities and the resulting accumulation or de accumulation of money.

4. Technological Disequilibrium: It is caused by various technological changes involve inventions or innovations of new goods or new technique of production. These technological changes affect the demand for factors and goods.

A technological change will give comparative advantage to the innovating country leading to the increase in exports or a decline in imports. This will create disequilibrium in the balance of payments.

5. Short-Run Disequilibrium: A short-run disequilibrium in a country’s balance of payments will be a temporary one, lasting for a short period, which may occur once in a while. When a country borrows or lends internationally, it will have a short-run disequilibrium in its balance of payments, as these loans are usually for a short period or even if they are for a long duration, they are repayable later on; hence the position will be automatically corrected and poses no serious problem. As such a disequilibrium arising from international lending and borrowing activities is perfectly justified. However, a short-run disequilibrium may also emerge if a country’s imports exceed its exports in a given year. This will be a temporary one if it occurs once in a way, because later on, the country will be in a position to correct it easily by creating the required credit surplus by exporting more to offset the deficit. But even this type of disequilibrium in the balance of payments is riot justified, because it may pave the way for a long-term disequilibrium. When such disequilibrium (arising from imports exceeding exports or even vice versa) occurs year after year over a long period, it becomes chronic and may seriously affect the country’s economy and its international economic relations. A persistent deficit will tend to deplete its foreign exchange reserves and the country may not be able to raise any more loans from foreigners.
Disequilibrium caused on a temporary basis for a short period, say one year is called short-run disequilibrium. Such disequilibrium does not pose a serious threat as it can be overcome within a short run. Such disequilibrium may be caused due to international borrowing and lending. When a country goes for borrowing or lending it leads to short-run disequilibrium. Such disequilibrium is justified as they do not pose a serious threat.

Short-run disequilibrium may also be caused when a country’s imports exceeds exports in a particular year. Such disequilibrium is not justified as it has the potentiality to develop in to a crisis in time. The Economic crisis in India in 1990-91 is nothing but the development of short-run disequilibrium. If the short-run disequilibrium is persistent and occurs repeatedly; it may pave the way for long-run disequilibrium.

6. Secular or Long-Run Disequilibrium: It prevails for a long period of time, i.e., when the disequilibrium is persistent and long-run oriented, it is called long-run disequilibrium. The IMF terms such disequilibrium as “Fundamental Disequilibrium”.

Long-run or fundamental disequilibrium refers to a persistent deficit or a surplus in the balance of payments of a country. It is also known as secular disequilibrium.

The secular or long-run disequilibrium in BOP occur because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. The current account follows a varying pattern from one state to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports.

Disequilibrium arises owing to lack of sufficient funds available to finance the import surplus, or the import surplus is not covered by available capital from abroad.

When there is a continuous increase in the stock of gold and foreign exchange reserves. There is a persistent surplus and vice versa. Permanent changes in the conditions of demand and supply of exports and imports cause fundamental disequilibrium. A permanent deficit or surplus may make a country debtor or creditor causing a fundamental disequilibrium.

Then comes a stage when domestic savings tend to exceed domestic investment and exports outrun imports.

Disequilibrium may result, because the long-term capital outflow falls short of the surplus savings or because surplus savings exceed the amount of investment opportunities abroad. At a still later stage, domestic savings tend to equal domestic investment and long-term capital movements are on balance zero. A developing country in its initial stages may import large amount of capital and hence its imports would exceed exports. When this becomes chronic, there emerges a secular deficit in its balance of payments. Deep rooted dynamic changes like capital formation, innovations, technological advancements, and growth of population, etc., also contribute to fundamental disequilibrium. When there is a series of short-run disequilibrium in a country’s balance of payments, ultimately it would lead to fundamental disequilibrium.