Module 4
Macroeconomic Concepts

The Circular Flow of Income

The circular flow of income and expenditure refers to the process whereby the national income and expenditure of an economy flow in a circular manner continuously through time. The various components of national income and expenditure such as saving, investment, taxation, government expenditure, exports, imports, etc. The following are the 3 models:

1. Circular Flow in a Two Sector Economy
2. Circular Flow in a Three- Sector Economy
3. Circular Flow in a Four- Sector Economy

Circular Flow in a Two Sector Economy

We begin with a simple hypothetical economy where there are only two sectors, the household and business. The household sector owns all the factors of production, that is, land, labour and capital. This sector receives income by selling the services of these factors to the business sector.

The business sector consists of producers who produce products and sell them to the household sector or consumers. Thus the household sector buys the output of products of the business sector. The circular flow of income and expenditure in such an economy is shown in Figure 1 where the product market is shown in the upper portion and the factor market in the lower portion.

$$Y = C + I$$

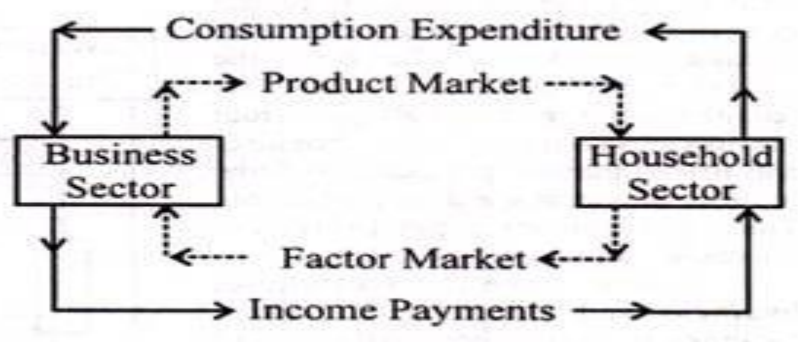

Fig. 1.

In the product market, the household sector purchases goods and services from the business sector while in the factor market the household sector receives income from the former for providing services. Thus the household sector purchases all goods and services provided by the business sector and makes payments to the latter in lieu of these.

Circular Flow with Saving and Investment (Banking Sector) Added

Figure 2 shows how the circular flow of income and expenditure is altered by the inclusion of saving and investment.

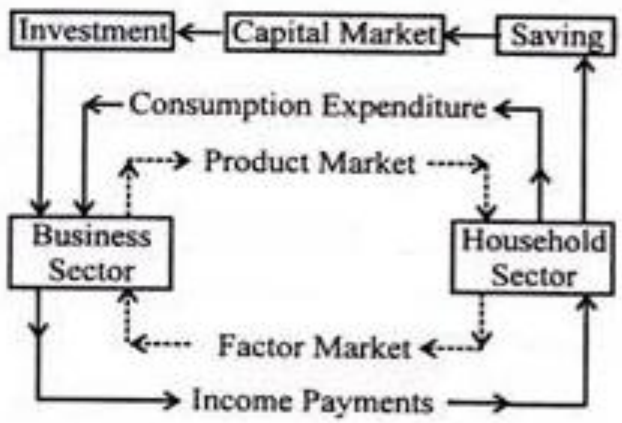

Fig. 2.

Three- Sector Model

We add the government sector so as to make it a three-sector closed model of circular flow of income and expenditure. For this, we add taxation and government purchases (or expenditure) in our presentation.

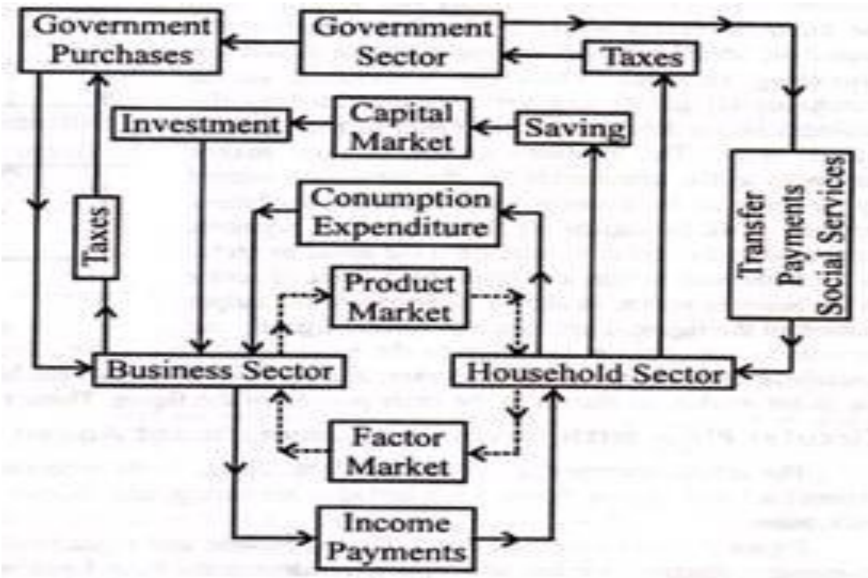

Fig. 3.

$$Y = C + I + G$$

Four Sector Model

The actual economy is an open one where foreign trade plays an important role. Exports are an injection or inflows into the economy.

$$Y = C + I + G + (X - M)$$

Y = Total Income

C = Consumption

I = Investment

G = Government Expenses

X = Exports

M = Imports

(X – M) = Net Exports

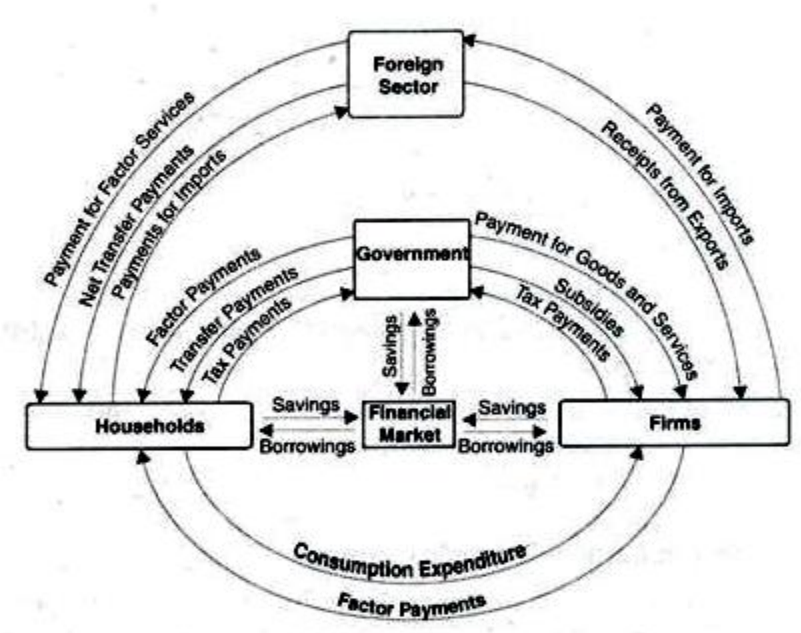

Fig. 1.7

Stock and Flow

- Stock is a quantity measurable at a particular point of time. E.g. total wealth of a person.
- Flow is a quantity measured over a period of time E.g. annual salary of an individual.

Stock	**Flow**
Point of time	Over a period of time
No time dimension	Involves time dimension
Static Concept	Dynamic Concept

Final Goods and Intermediate Goods

Intermediate goods are referred to as those goods that are used by businesses in producing goods or services. These goods are also known as producer goods.

Final goods are referred to as those goods which do not require further processing. These goods are also known as consumer goods and are produced for the purpose of direct consumption by the end consumer.

Intermediate goods are used for producing final goods or consumer goods or it can be said that they act as inputs in other goods and constitute the final goods as an ingredient.

National Income (NI)

- NI is defined as the money value of the total goods and services produced in a country during a financial year. It is the total income of nation
- In India, it is central statistical organization (CSO) who is responsible for national income accounting

Gross Domestic Product (GDP)

- It is the market value of all final goods and services produced in an economy during a financial year

Gross National Product (GNP)

- It is the market value of all final goods and services produced in an economy during a financial year plus net factor income from abroad (NFIA)

GDP = GNP – NFIA

GNP = GDP + NFIA

National domestic product (NDP)

- It is the market value of all final goods and services produced in an economy during a financial year after deducting depreciation (consumption of fixed capital)
- Deprecation refers to the fall in value of capital due to wear and tear

NDP = GNP – Deprecation

Market price & Factor cost

- Market price is the price paid by the buyer of a commodity in the market
- Factor cost is the cost paid by the producer to the factor of production for their contribution in the production of commodity
  - **MP = Cost of production + Indirect taxes – Subsidies**
  - **FC = Cost of production - Indirect taxes + Subsidies**

Personal Income (PI)

- It is the sum of all income actually received by an individual from different sources in a country during financial year

Disposable income (DPI)

DPI = Personal income – Direct taxes

Percapita Income (PCI)

It is the per person average national income

PCI = NI / Population

METHODS FOR ESTIMATING NATIONAL INCOME

3 METHODS

1. Output method / Production method
2. Income method
3. Expenditure method

Output method / Production method

- It is also known as value added method.

Steps

1. Production units divides into different sectors like agriculture , industry , services sectors
2. Estimating the net value added by each sector
3. Summing it up to get the value of the domestic product (GDP)
4. Add NFIA with the domestic product > NI

Income Method

- Using this method , NI is obtained by adding up all the income of all individuals and business enterprises in the economy
- Income earned in the form of Rent (Land) , Wage (Labour) , Interest (Capital) , Profit (Organization)

NI = Rent + Wage + Interest + Profit

Steps

- Production units divides into different sectors like agriculture , industry , services sectors

- Estimating factor income (Rent , Wage , Interest , Profit)
- Calculate NFIA

Domestic Factor Income + NFIA = NI

Expenditure Method

- It is also known as consumption – saving method
- This method considers the computation of NI by adding up all the expenditure made on goods and services during a given year

Types of Expenditures

1. Consumption expenditure (C) by households
2. Investment expenditure (I) by firms
3. Government expenditure (G)
4. Net Exports (X – M)

NI = C + I + G +(X – M)

Difficulties in the estimation of NI

- Income generated from the process of production for self- consumption
- All transfer payments
- Illegal income like smuggling , Black money etc.,
- Value of second hand goods
- Service of house-wives
- Lack of statistical data
- Problem of double counting
- Illiteracy
- Non- availability of data

- Lack of accountability

3 sectors of the economy

- **Primary Sector**: This sector deals with the extraction and harvesting of natural resources such as agriculture and mining.
- **Secondary Sector**: This sector comprises construction, manufacturing, and processing.
- **Tertiary Sector**: Retailers, entertainment, and financial companies make up this sector

INFLATION

- It is the persistent increase in general price level or persistent decline in the real income of the people
- It means as the price rises, the value of money declines

Definition

Coulborn "Too much money chasing too few goods"

Inflation occurs due to an imbalance in demand and supply of money

Types of Inflation

1. Demand pull inflation: It happens when an increase in aggregate demand in the absence of an increase in aggregate supply or a relatively less increase in aggregate supply.
2. Cost push inflation: It is the result of increase in cost of production. As the cost of production increases, the supply decreases and the prices go up.
3. Creeping inflation > 0 – 3 %
4. Walking inflation > 3 – 10 %
5. Galloping inflation > More than 10%
6. Hyper inflation > More than 50%

Causes of Inflation

- Causes of inflation has been classified into two: Demand side factors and Supply side factors

Demand side Factors

- Increase in money supply
- Increase in disposable income
- Increase in consumer spending
- Black money
- Increase in exports
- Cheap monetary policy
- **Supply side factors**
- Shortage in factors of production
- Industrial dispute
- Natural calamities
- Artificial scarcity (Hoarding)
- International factors

Methods to control Inflation

Monetary measures

- Bank Rate: The bank rate policy is used as an important instrument to control inflation. The Bank rate, also called as the Central Bank rediscount rate is the rate at which the central bank buys or redsicounts the eligible bills of exchange and other commercial papers presented by commercial banks to build their reserves.
- Open market operations: The open market operations are characterized by the sale and purchase of government securities and bonds by the central bank. The central bank buys and sells the government securities and bonds to the public through commercial banks. The government securities are sold via commercial banks such that a certain amount of bank deposits is transferred to the central bank. As a result, the credit creation capacity of the commercial banks reduces. Thus, the flow of money from the banks to the public also gets reduced.

- Variable reserve ratio: The variable reserve ratio, also called as the Cash Reserve Ratio (CRR) is a certain proportion of total demand and time deposits that the commercial banks are required to maintain in the form of cash reserves with the central bank.
- The cash reserve ratio is often determined and imposed by the central bank with a view to controlling the money supply. When the central bank raises the CRR, the lending capacity of the commercial banks reduces due to which the flow of money from the banks to the public also decreases. Thus, it helps in controlling the rise in the price to the extent it is caused by the bank credit to the public.

Fiscal Measures

- Reduction of unnecessary expenditure: A cut in the public expenditure reduces not only the government's demand for goods and services but also private consumption expenditure. Therefore, the excess demand decreases more than a given cut in the public expenditure.
- Increase taxes: Taxation of income reduces the disposable income. As consumer demand is a function of disposable income, consumer demand decreases due to taxation. Thus, a well-designed taxation policy reduces aggregate demand and thereby brings the inflation under control.
- Increase savings: Promote savings so as to decrease the money supply in the public.

Other measures

- Increase output: Increase production in the economy
- Price control: Government has to intervene in the market to control process.
- More imports: Increased imports will reduce the money supply in the economy.
- Control black money: government has to take polices to control lack money in the economy.

Business financing

Business finance refers to funds availed by business owners to meet their needs that may include commencing a business, obtaining top-up funds to finance business operations, obtaining finance to purchase capital assets for the business, or to deal with a sudden cash crunch faced by the business.

Sources of Capital

- Internal self – finance: An important source is the saving of the unit itself.
- Public Deposits: I t is mostly short – term finance. People keep their money as deposit with these companies for a period of 6 months a year, two years or so. Depositors receive a fixed interest. This money is used by companies to meet their expenses.
- Loans from Bank: Commercial banks also provide funds for meeting short- term needs for working capital.
- Indigenous Bankers: These banks charge heavy rate of interest.
- Development finance institutions: It caters the financial needs of large and small industries.

Bonds and Shares

A bond is a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental). Bonds are used by companies, municipalities, states, and sovereign governments to finance projects and operations. Owners of bonds are debtholders, or creditors, of the issuer. Bond details include the end date when the principal of the loan is due to be paid to the bond owner and usually include the terms for variable or fixed interest payments made by the borrower. A bond is referred to as a fixed-income instrument since bonds traditionally paid a fixed interest rate (coupon) to debtholders.

How Bonds Work

When companies or other entities need to raise money to finance new projects, maintain ongoing operations, or refinance existing debts, they may issue bonds directly to investors. The borrower (issuer) issues a bond that includes the terms of the loan, interest payments that will be made, and the time at which the loaned funds (bond principal) must be paid back (maturity date). The interest payment (the coupon) is part of the return that bondholders earn for loaning their funds to the issuer. The interest rate that determines the payment is called the coupon rate.

Shares

A share represents a unit of equity ownership in a company. Shareholders are entitled to any profits that the company may earn in the form of dividends. They are also the bearers of any losses that the company may face. In simple words, if you are a shareholder of a company, you hold a percentage of ownership of the issuing company in proportion to the shares you have bought. Shares are perpetual investment and they do not have specific maturity period.

Bonds	Shares
The investor lends money to the company	The investor owns part of the company
Risk is low	High risk
Issued by Govt. Institutions, Financial institutions etc.,	Issued by Corporate enterprises
Bond holders get interest, as a fixed payment	Shareholders get dividend
Return is certain	Return is uncertain
Maturity period is fixed	No maturity period

Money Market and Capital Market

A financial market is a place where buyers and seller come together to trade in financial assets such as bonds, stocks, derivatives, currencies and commodities. The main objective of a financial market is to fix prices for global trade, increase capital and transfer risk and liquidity.

Thought the financial market has various components; the two most important components are the money market and capital market. In the money market, only short-term liquid financial instruments are exchanged. Whereas, in the capital market, only long term securities are dealt with.

Capital Market plays a significant role in the growth of a country's economy as it provides a platform for mobilising the funds. Similarly, the money market holds a range of operational characteristics.

The Money Market

The money market is a good place for individuals, banks, other companies, and governments to park cash for a short period of time, usually one year or less. It exists so that businesses and governments that need cash to operate can get it quickly at a reasonable cost, and so that businesses that have more cash than they need can put it to use. The money market is less risky than the capital market while the capital market is potentially more rewarding.

Capital Market

A kind of financial market where the company or government securities are generated and patronised with the intention of establishing long-term finance to coincide the capital necessary is called Capital Market. The capital market is a type of financial market where financial products like stocks, bonds, debentures are traded for a long duration of time. They serve the purpose of long-term financing and long-term capital requirement.

In this market, the buyers use funds for longer-term investment. The nature of the capital market is risky markets. Therefore, it is not used for short-term funds investment. Most of the investors obtain the capital markets to preserve for education or retirement.

Features of Money Market

1. It is fund-term market funds.
2. It's maturity period up to one year.
3. It trades with assets that can be transformed into cash easily.
4. All the transactions take place through phone, email, text, etc.
5. Broker not required for the transaction
6. The components of a money market are the Commercial Banks, Non-banking financial companies and Central Bank, etc.

Features of Capital Market

1. Unites entrepreneurial borrowers and savers
2. Deals with long-term investments.
3. Agents are required.
4. It is controlled by government rules and regulations.
5. Deals in both commercial and non-commercial securities.
6. Foreign Investors.

Capital Market	Money Market
Long-term securities are traded in capital markets	Short-term securities are traded in money markets
Capital markets are well organized	Money markets are not that organized
Instruments in money markets are a low risk	Capital markets are the comparatively high risk
Capital markets generally give higher returns	Money markets give a low return on investments

Stock Market

Stock markets are venues where buyers and sellers meet to exchange equity shares of public corporations. The stock market refers to public markets that exist for issuing, buying, and selling stocks that trade on a stock exchange or over-the-counter.

Stock markets are vital components of a free-market economy because they enable democratized access to trading and exchange of capital for investors of all kinds.

Functions of Stock Market

- Fair Dealing in Securities Transactions: the stock exchange needs to ensure that all interested market participants have instant access to data for all buy and sell orders, thereby helping in the fair and transparent pricing of securities.
- Pricing of securities: Stock markets need to support an efficient mechanism for price discovery, which refers to the act of deciding the proper price of a security and is usually performed by assessing market supply and demand and other factors associated with the transactions.
- Investor Protection: Along with wealthy and institutional investors, a very large number of small investors are also served by the stock market for their small amount of investments.
- Safety of transaction: the membership of a stock market is well-regulated and its dealings are well defined according to the existing legal framework.
- Contributes to economic growth: A well functioning stock market helps in the economic growth of the nation.

Demat Account

A Demat Account or Dematerialised Account provides the facility of holding shares and securities in an electronic format. During online trading, shares are bought and held in a Demat Account, thus, facilitating easy trade for the users. A Demat Account holds all the investments an individual makes in shares, government securities, exchange-traded funds, bonds and mutual funds in one place.

Demat is the abbreviation for "Dematerialization", which means to convert physical shares and securities into electronic form. Demat Accounts are required to hold shares in electronic form instead of paper form. Demat Accounts keep the shares safe, thereby preventing loss of shares or risks related to forgery. It is an easy method to trade securities quickly. A Demat account and a trading account are necessary to carry out the trading of shares in the stock market.

Trading Account

A trading account is an investment account for transacting in securities. We can buy or sell assets frequently through your trading account. Trading account acts as an investment account to holds your securities and other holdings. A trading account is used to buy or sell equity shares in a stock market.

Sensex

The Sensex was launched on Jan. 1, 1986. It is an investable index used to track the performance of India's 30 largest and most financially sound companies. These companies are listed on the BSE (previously known as the Bombay Stock Exchange) and represent some of the biggest and most important sectors of the Indian economy. The term 'Sensex' is a blend of words 'Sensitive' and 'Index' and was coined by stock market expert Deepak Mohini. The Sensex reflects the movements in the Indian stock market. It is considered the benchmark index of the Indian stock market. It is the oldest index in India and provides time series data from 1979, BSE, which was previously known as Bombay Stock Exchange.

NIFTY

The Nifty meaning is a derivation from the mix of two words, i.e. "National Stock Exchange" and "fifty". It is an abbreviation of the National Stock Exchange Fifty. It is a collection of top performing 50 equity stocks that are actively trading in the index. However, 51 stocks are currently trading on Nifty. Hence, Nifty is also known as Nifty50 or CNX Nifty. Nifty is a popular stock index. The National Stock Exchange of India introduced it. This index was founded in 1992 and started trading in 1994. It is owned and managed by India Index Service & Products Limited (IISL).

Module – 5

International Trade

International Trade

International trade is the exchange of goods and services between countries.

Trading globally gives consumers and countries the opportunity to be exposed to goods and services not available in their own countries or more expensive domestically. International trade is an exchange involving a good or service conducted between at least two different countries. The exchanges can be imports or exports. An import refers to a good or service brought into the domestic country. An export refers to a good or service sold to a foreign country.

Advantages and Disadvantages of International Trade

Advantages of International Trade:

(i) Optimal use of natural resources:

International trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited.

(ii) Availability of all types of goods:

It enables a country to obtain goods which it cannot produce or which it is not producing due to higher costs, by importing from other countries at lower costs.

(iii) Specialisation:

Foreign trade leads to specialisation and encourages production of different goods in different countries. Goods can be produced at a comparatively low cost due to advantages of division of labour.

(iv) Advantages of large-scale production:

Due to international trade, goods are produced not only for home consumption but for export to other countries also. Nations of the world can dispose of goods which they have in surplus in the international markets. This leads to production at large scale and the advantages of large scale production can be obtained by all the countries of the world.

(v) Stability in prices:

International trade irons out wild fluctuations in prices. It equalizes the prices of goods throughout the world (ignoring cost of transportation, etc.)

(vi) Exchange of technical know-how and establishment of new industries:

Underdeveloped countries can establish and develop new industries with the machinery, equipment and technical know-how imported from developed countries. This helps in the development of these countries and the economy of the world at large.

(vii) Increase in efficiency:

Due to international competition, the producers in a country attempt to produce better quality goods and at the minimum possible cost. This increases the efficiency and benefits to the consumers all over the world.

(viii) Development of the means of transport and communication:

International trade requires the best means of transport and communication. For the advantages of international trade, development in the means of transport and communication is also made possible.

(ix) International co-operation and understanding:

The people of different countries come in contact with each other. Commercial intercourse amongst nations of the world encourages exchange of ideas and culture. It creates cooperation, understanding, and cordial relations amongst various nations.

(x) Ability to face natural calamities:

Natural calamities such as drought, floods, famine, earthquake etc., affect the production of a country adversely. Deficiency in the supply of goods at the time of such natural calamities can be met by imports from other countries.

Disadvantages of International Trade:

(i) Impediment in the Development of Home Industries:

International trade has an adverse effect on the development of home industries. It poses a threat to the survival of infant industries at home. Due to foreign competition and unrestricted imports, the upcoming industries in the country may collapse.

(ii) Economic Dependence:

The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic exploitation. For instance, most of the underdeveloped countries in Africa and Asia have been exploited by European countries.

(iii) Political Dependence:

International trade often encourages subjugation and slavery. It impairs economic independence which endangers political dependence. For example, the Britishers came to India as traders and ultimately ruled over India for a very long time.

(iv) Mis-utilisation of Natural Resources:

Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise. This will cause economic downfall of the country in the long run.

(v) Import of Harmful Goods:

Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.

(vi) Storage of Goods:

Sometimes the essential commodities required in a country and in short supply are also exported to earn foreign exchange. This results in shortage of these goods at home and causes inflation. For example, India has been exporting sugar to earn foreign trade exchange; hence the exalting prices of sugar in the country.

(vii) Danger to International Peace:

International trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

(viii) World Wars:

International trade breeds rivalries amongst nations due to competition in the foreign markets. This may eventually lead to wars and disturb world peace.

(ix) Hardships in times of War:

International trade promotes lopsided development of a country as only those goods which have comparative cost advantage are produced in a country. During wars or when good relations do not prevail between nations, many hardships may follow.

Theories of International Trade

Absolute Advantage Theory

The concept of absolute advantage was developed by Adam Smith in The Wealth of Nations to show how countries can gain by specializing in producing and exporting the goods that they produce more efficiently than other countries, and importing goods other countries produce more efficiently.

Adam Smith's Theory of Absolute Advantage

The trade theory that first indicated importance of specialization in production and division of labor is based on the idea of theory of absolute advantage which is developed first by Adam Smith in his famous book The Wealth of Nations published in 1776. Later on David Ricardo in his book titled On the Principles of Political Economy published in 1819 extended it to incorporate theory of comparative advantage and showed that it is the basis why nations need to trade and why trade is mutually beneficial to countries.

Statement of Theory

Countries should specialize in producing the goods and services in which they have absolute advantage and engage in free trade with other countries to sell their goods. A country's resources would therefore be utilized in the best possible way—in the production of goods and services in which the country has a productivity advantage compared with other countries—and national wealth would be maximized.

To illustrate the idea of absolute advantage (AA) consider the following table which gives the labor hours required to produce one unit of C and W in our hypothetical countries A and B.

	A	B
Cheese	2	10
Wine	8	4

Country A has AA in production of C as it takes fewer hours to produce a unit of C in A than in Country B. Since it takes less hours in Country B to produce W, Country B has an AA in production of W. Adam Smith's theory: Countries should specialize in the production of goods in which they have an AA. So Country A will be better of it specializes in the production of C and Country B will be better off if it specializes in W. So they don't need to produce both goods at home.

Comparative advantage Theory: David Ricardo

The law of comparative advantage is popularly attributed to English political economist David Ricardo and his book “On the Principles of Political Economy and Taxation” written in 1817.

The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labour and specialisation in production. Each country specialises in the production of that commodity in which its comparative cost of production is the least. Therefore, when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high. This is basis of international trade, according to Ricardo.

Ricardo’s Theorem:

Ricardo stated a theorem that, other things being equal, a country tends to specialize in and export those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. Similarly, the country’s imports will be of goods having relatively less comparative cost advantage or greater disadvantage.

According to Ricardo even in the case of a country for which there is no absolute advantage for both the commodities, it can still gain from the international trade. In this situation, the country should specialize in the production and export of the commodity in which its absolute disadvantage is smaller and import the commodity in which the its absolute disadvantage is greater.

The Heckscher – Ohlin Theorem (H-O) or Factor Endowment Theory

The theory was originally developed y Eli Heckscher in 1919. Later in 1935 it was refined by Bertil Ohlin. Hence it is known as Heckscher – Ohlin Theorem.

Heckscher – Ohlin Theorem states that a country will produce and export that commodity whose production requires the intensive use of nation’s relatively abundant and cheap factor and import the commodity whose production requires the intense use of relatively scare and expensive factor. In other words, relatively labor abundant country will export the relatively labor-intensive commodity and import the relatively capital – intensive commodity.

Balance of Payments (BoP)

The balance of payments (BOP), also known as the balance of international payments, is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year. It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country.

The balance of payments summarises the economic transactions of an economy with the rest of the world. These transactions include exports and imports of goods, services and financial assets, along with transfer payments (like foreign aid).

The Components of the Balance of Payments

There are three components of balance of payment viz current account, capital account, and financial account (The official reserve account). The total of the current account must balance with the total of capital and financial accounts in ideal situations.

Current Account

The current account is used to monitor the inflow and outflow of goods and services between countries. This account covers all the receipts and payments made with respect to raw materials and manufactured goods.

It also includes receipts from engineering, tourism, transportation, business services, stocks, and royalties from patents and copyrights. When all the goods and services are combined, together they make up to a country's Balance Of Trade (BOT).

Capital Account

All capital transactions between the countries are monitored through the capital account. Capital transactions include the purchase and sale of assets (non-financial) like land and properties.

The capital account also includes the flow of taxes, purchase and sale of fixed assets etc by migrants moving out/into a different country.

The deficit or surplus in the current account is managed through the finance from the capital account and vice versa. There are 3 major elements of a capital account:

- Loans and borrowings – It includes all types of loans from both the private and public sectors located in foreign countries.
- Investments – These are funds invested in the corporate stocks by non-residents.
- Foreign exchange reserves – Foreign exchange reserves held by the central bank of a country to monitor and control the exchange rate does impact the capital account.

The Official Reserve Account

The flow of funds from and to foreign countries through various investments in real estates, business ventures, foreign direct investments etc is monitored through the financial account.

Balance of Payments Deficit

Disequilibrium in the balance of payment means its condition of Surplus or deficit.

A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus,

BOP = CREDIT > DEBIT

A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus,

BOP = CREDIT < DEBIT

Causes of Disequilibrium/ Deficit in The Bop

- Cyclical fluctuations
- Short fall in the exports
- Economic Development
- Rapid increase in population
- Structural Changes
- Natural Calamites
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

a**) Monetary Policy**

The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.

b) Fiscal Policy

Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure,. It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

c) **Exchange Rate Depreciation**

By reducing the value of the domestic currency, government can correct the disequilibrium in the BoP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country

d) **Devaluation**

devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

e) Export Promotion

To control export promotions the country may adopt measures to stimulate exports like:

- Export duties may be reduced to boost exports.
- Cash assistance, subsidies can be given to exporters to increase exports.
- Goods meant for exports can be exempted from all types of taxes.

f) Import Substitutes

Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

Devaluation

The reduction of a currency´s value in relation to other currencies. Devaluation is a downward adjustment to a country’s value of money relative to a foreign currency or standard. Devaluation occurs when a country intentionally reduces the value of its currency relative to one or more foreign countries. Devaluation occurs when a government wishes to increase its balance of trade (exports minus imports) by decreasing the relative value of its currency.

Trade policy

Trade policy can be defined as goals, rules, standards, and regulations that are involved in the trade between countries. The major 2 policies that the countries follow with respect to international trade are

1. Free Trade
2. Protectionism

Free Trade

Free trade means free and unfettered trade between countries, unhindered by steep tariffs, and where goods can pass over borders unmolested by any restrictions. Free trade agreements are contracts between countries to allow access to their markets.

Advantages of Free Trade

1. **Increased economic growth**: Free trade will increase the production scale and division of labour which lead to economic growth.
2. **More dynamic business climate**: Without free trade agreements, countries often protected their domestic industries and businesses. This protection often made them stagnant and non-competitive on the global market. With the protection removed, they became motivated to become true global competitors.
3. **Foreign direct investment**: Investors will flock to the country. This adds capital to expand local industries and boost domestic businesses.
4. **Technology transfer**: Local companies also receive access to the latest technologies from their multinational partners.
5. **Expertise**: Global companies have more expertise than domestic companies to develop local resources.
6. **More choice of goods**: Free trade is good for consumers. It reduces prices by eliminating tariffs and increasing competition.
7. **Improves Quality**: Greater competition is also likely to improve quality and choice.

Disadvantages of Free Trade

1. **Threat to domestic industries**: Many emerging markets are traditional economies that rely on farming for most employment. These small family farms can't compete with subsidized agri-businesses in developed countries. As a result, they lose their farms and must look for work in the cities. This aggravates unemployment, crime, and poverty.
2. **Poor working conditions**: Multinational companies may outsource jobs to emerging market countries without adequate labor protections.

3. **Degradation of natural resources**: Emerging market countries often don’t have many environmental protections.
4. **Destruction of native cultures**: As development moves into isolated areas, indigenous cultures can be destroyed.

Protectionism

Trade protectionism is a policy stance that some countries adopt to protect their domestic industries from foreign competition. The policy may work in the short run to bolster domestic production and business, but in the long run, trade protectionism can make a country and its industries less competitive in international trade.

Trade protectionism is a measured and purposeful policy by a nation to control imports while promoting exports. It is done in an effort to promote the economy of the nation above all other economies.

Advantages of Protectionism

1. **Infant Industry Argument**: If a country is trying to grow strong in a new industry, tariffs will protect it from foreign competitors. That gives the new industry’s companies time to develop their competitive advantages.
2. **Protect the Consumer**: One of the more recent phenomenon surrounding protectionism has been the development of protecting the consumer.
3. **National Security**: It is argued that should a nation become reliant on international imports, it also becomes defensively weak.
4. **More growth opportunities**: Protectionism provides local industries with growth opportunities until they can compete against more experienced firms in the international market
5. **Lower imports**: Protectionist policies help reduce import levels and allow the country to increase its trade balance.
6. **More jobs**: Higher employment rates result when domestic firms boost their workforce
7. **Higher GDP**: Protectionist policies tend to boost the economy’s GDP due to a rise in domestic production

Disadvantages of Protectionism

1. **Limited choices for consumers**: Consumers have access to fewer goods in the market as a result of limitations on foreign goods.
2. **Increase in prices (due to lack of competition):** Consumers will need to pay more without seeing any significant improvement in the product.
3. **Economic isolation**: It often leads to political and cultural isolation, which, in turn, leads to even more economic isolation.
4. **Stagnation of technological advancements**: As domestic producers don't need to worry about foreign competition, they have no incentive to innovate or spend resources on research and development (R&D) of new products.
5. **Less Choice:** By restricting international competition, there are fewer goods coming into the country. This means less choice for the average consumer.
6. **Economic Loss:** Protectionist policies impose an additional cost and loss on all parties. First of all, domestic consumers must pay a higher price for goods. At the same time, importers face a decline in demand, so international jobs are lost.

Tariff and Non-Tariff Barriers.

Tariff barriers are the tax or duty imposed on the goods which are traded to/from abroad. On the contrary, non-tariff barriers are the obstacles to international trade, other than tariffs. These are administrative measures implemented by the country's government to discourage goods brought in from foreign countries and promote domestically produced items.

Tariff Barriers

When two countries trade in the goods, a certain amount is charged as a fee by the country, in which goods are entered, so as to provide revenue to the government as well as raise the price of foreign goods, so that the domestic companies can easily compete with the foreign items. This fee is in the form of tax or duty, which is called a tariff barrier.

The amount of tax or duty charged as tariff is added to the cost of the import, which makes the foreign goods more expensive, whose price is ultimately borne by the consumer of the products. The tariff is paid to the customs authority of the country in which goods are sent. It includes:

- Export Duties
- Import Duties
- Transit Duties

- Specific Duties
- Ad-valorem Duties etc.,

Non-Tariff Barriers

Non-tariff barriers refer to non-tax measures used by the country's government to restrict imports from foreign countries. It covers those restrictions which lead to prohibition, formalities or conditions, making the import of goods difficult and decrease market opportunities for foreign items.

It can be in the form of laws, policies, practices, conditions, requirements, etc., which are specified by the government to restrict import. Hence it encompasses popular trade-distorting practices such as:

- Import quotas
- VERs, i.e. Voluntary Export Restraints
- Import licensing
- Technical and administrative regulations
- Price control
- Foreign exchange regulations etc.

Differences between Tariff and Non-Tariff Barriers

1. Tariff Barriers implies the tax or duty levied by the country's government on the import of goods from a foreign country so as to restrict imports, to a certain extent. On the contrary, non-tariff trade barriers are the policies and regulations, which are implemented by the country, with the aim of protecting and supporting domestic industries.

2. World Trade Organization (WTO) permitted the levy of tariff barriers to its member nations but at a reasonable rate only. Conversely, World Trade Organization (WTO) has put an end to the imposition of Import Quotas and Voluntary Export Restraints, i.e. non-tariff barriers.

3. Tariff barriers are simple to understand and levy, whereas non-tariff barriers are difficult to understand and involve more official.

4. Tariff barriers can take the form of taxes and duties, while non-tariff barriers are in the form of regulations, conditions, requirements, formalities, etc.

5. The imposition of tariff barriers results in the increase in government revenue. On the other hand, enactment of non-tariff barriers does not adds to government revenue.

6. Tariff barriers levied by the government increases the cost of the imported item. As against, non-tariff barriers include quantity restrictions, which affects the volume, as well as it also sometimes affects the price of the imported goods.

7. In the case of tariff barriers, as the government levies import duty, monopolistic groups can be controlled. In contrast, when non-tariff barriers are imposed monopolistic organization charges high prices through low output.

8. When tariff barriers are levied, the importers cannot make more profits, as the tax imposed will already make the product expensive, and to compete in the country's market, they need to keep the prices competitive. On the contrary, when non-tariff barriers are imposed, importers can make good profits, as it is a non-tax measure, which does not increase the price.