Chapter 9: Foreign Trade

GSEB Class 12 Economics — Complete Board Exam Notes

INTRODUCTION

The geographical boundaries of our country like all countries is determined. There are legal restrictions and sometimes prohibitions on crossing geographical boundaries of a country. Yet we have Korean refrigerators, Japanese TVs in our homes, German cars on our roads, American tractors in our farms, UK made shoes and garments in our malls. Bulk of the petrol and diesel comes from Gulf countries. Hence, the activity of exchanging goods, services, technology etc. by a country across the geographical boundary is called international trade.

9.1 MEANING OF DOMESTIC AND INTERNATIONAL (FOREIGN) TRADE

Trade means a commercial (business) activity which involves exchange of goods, services, resources, capital, technology, know-how, intellectual property etc. In other words, trade is an activity in which such goods are exchanged for earning profit.

Activity of trade which takes place within the geographical boundary of a nation is called **internal (domestic) trade** and trade activity taking place outside the geographical boundary of a country is called **International Trade (Foreign Trade)**.

9.2 REASONS FOR INTERNATIONAL TRADE

The main reasons for occurrence of trade stated in economics are:

(1) Difference in Factor Endowments in Various Countries:

Different countries are endowed with different factors of production in different proportions. Besides, all countries may not have all the factors necessary for production of all types of goods. Hence countries trade in resources, factors of production and technology to fulfil their requirements.

(2) Cost of Production:

Owing to differences in availability of factors of production and resources, the cost of production of goods and services is also different in different countries. Scarcity of factors leads to higher price of those factors — hence higher cost of production. When domestic cost of production is higher, it becomes cheaper and easier to import such goods and services from countries where they are produced cheaply.

(3) Technological Progress:

All countries do not achieve the same level of technological progress. Besides, some countries have expertise in some type of technology while others possess greater ability in another type. Hence every country does not possess equal efficiency in production of all types of goods — and hence trade in goods and services takes place between countries.

(4) Division of Labour and Specialization:

Labour productivity and dexterity in each country is different. Besides, entrepreneurial efficiency is also different. Countries specialize in the production of goods and services in which they are most efficient, while they import those goods and services which they cannot produce more efficiently.

9.3 FACTORS AFFECTING THE NATURE OF INTERNATIONAL TRADE

Nature of international trade means such special features and aspects of trade which gives it a unique identity from other activities. The nature of international trade is determined by the circumstances affecting trade, policies and laws governing trade. These are:

(1) Lesser Geographical and Occupational Mobility of Factors of Production:

Labour is less mobile in international trade owing to policy and social reasons. Certain type of huge capital is less mobile, while there are policy restrictions on mobility of some other types of capital. Entrepreneurs are less mobile for the same reasons as labourers. But in present times entrepreneurship has become more mobile. Land has no geographical mobility. Hence, owing to lower mobility, the size of international trade is restricted to some extent.

(2) Trade in Many Varieties of Goods:

Large varieties of goods and services are made available through international trade so as to satisfy the needs of populations with different standards of living and different lifestyles. The very success and prosperity of international trade depends upon 'variety'.

(3) More Challenging in Nature:

International trade is more challenging as the environment, language, culture, customs, preferences, habits, tastes of people in different countries are different. Traders have to overcome these barriers in order to trade.

(4) Requirement of Diplomatic Efforts:

For setting up and development of international trade, the efforts of traders alone are not enough. Government of every nation has to make diplomatic efforts, hold informal meetings and organize trade fairs etc. E.g., Gujarat state government organizes the 'Vibrant Gujarat Summit' in which representatives of governments and businesses of various countries participate.

(5) Knowledge and Forecasts Regarding the Value of Different Currencies:

Payments in international trade are made in internationally acceptable currencies. Every trading country has to convert its national currency into international currency. Proper information regarding value of various currencies and the changes in their values is essential. Hence traders have to hire experts who can guide in matters of exchange rates.

(6) Joint Effort of Nations and International Organizations:

International trade can develop only with joint efforts of governments of various countries of the world and international organizations like **World Trade Organization (WTO)**. Political systems of all countries must work towards making their policies more conducive for trade.

(7) Impact of Political and Social Ideologies:

The size and direction of international trade is greatly influenced by political and social events taking place in the world. Trade relations between nations get disturbed owing to world war; on the other hand if leaders promote trade, world trade increases.

(8) Vast Scale:

The scale of international trade is vast as it involves several countries, several varieties of goods, several rules, international organizations etc.

(9) Involves More Permissions and Taxes:

In order to carry out international trading activity, traders need several permissions and licenses from their respective countries. They have to clear procedures regarding tradable goods and quality of goods, custom procedures, international freight and transport procedures, quality tests for different countries etc.

(10) Involves Higher Degree of Competition:

Several countries of the world make attempts to produce and sell a variety of goods and services. Hence the degree of competition among sellers is very high. Similarly, the degree of competition among buyers is also very high. High quality standards have to be maintained, huge promotional expenses and sales costs have to be incurred.

9.4 DIFFERENCE BETWEEN DOMESTIC TRADE AND INTERNATIONAL TRADE

Point	Domestic Trade	International Trade
Scale	Smaller; within one country	Much larger; involves many countries, more rules, procedures
Currency/Payment	Only domestic currency; same banking system	Several currencies; exchange rates; letter of credit; international clearing
Language, Culture, Society	Common social, cultural, language setup	Very different; must be careful to avoid controversies or legal offence
Transport Cost	Lower; goods transported within the country	Much higher; goods transported across the country
Competition	Relatively lesser; fewer product varieties	Very high; international sellers and buyers compete
Consumer Satisfaction	Easier; consumer preferences are predictable	Harder; preferences very different in different countries
Administrative/Legal Systems	Known to traders; relatively less difficulty	Highly different; permits, licenses, taxes, quality standards of many countries

Table: Difference between Domestic Trade and International Trade (7 Points)

9.5 MAGNITUDE OF WORLD TRADE IN PRESENT TIMES

The World Trade Report, 2013 has stated some trends of world trade from the work of historian Agnus Maddison. Since the mid-1800s, the world's population has grown roughly six-fold, world output has grown 60-fold, and world trade has grown over 140-fold. Dramatic decreases in transport and communication costs have been the driving forces behind today's global trading system.

In the last 30 years, world merchandise and commercial services trade have increased by about 7% per year on average. Between 1980 and 2011, the share of developing economies in world trade increased from 34% to 47% and their share in world imports increased from 29% to 42%. The Asian countries are playing an increasing role in world trade. For a number of decades, world trade has grown on average nearly twice as fast as world production (World GDP growth).

Time Period	World Trade Growth
1950-1973	7.88%
1973-1985	3.65%
1985-1996	6.55%
1996-2000	6.89%
2000-2011	5.00%
2015-2016	2.8%

Table 9.1: Average Annual Growth of World Trade During Different Time Periods

9.6 INDIA'S SHARE IN GLOBAL TRADE

India's share in the world trade has remained low considering the size and growth of world trade. However, as a developing nation India plays an important role in determining direction of world trade. India's own exports have grown significantly and exports are rising significantly as a percentage of GDP. Share of India's total trade in world trade in **2014-15 was about 2.07%**.

Financial Year	Share in Global Merchandise Exports (%)	Rank
2005	0.9	29
2010	1.5	19
2012	1.6	19
2013	1.7	19
2014	1.7	19

Table 9.2: Share of India's exports in the world exports — Source: EXIM Bank

9.7 SIZE, COMPOSITION (NATURE) AND DIRECTION OF INDIA'S FOREIGN TRADE

9.7.1 Size of India's Foreign Trade (Table 9.3)

In simple terms, size of foreign trade means the total value and volume of merchandise imports and exports of a country. Every successive year if the payments made towards imports and revenues generated from exports rise, the percentage share of trade value rises in national income and the share of a country's trade in world trade rises.

Item	1991-92 (mn US$)	1998-99 (mn US$)	2014-15 (mn US$)
Merchandise Exports	17.9	33.2	310.5
Merchandise Imports	19.4	42.4	448.0
Balance of Trade	–1.5	–9.2	–137.5

Table 9.3: Size of India's Foreign Trade after 1991 — Source: Economic Survey of India, 2015-16

After 1991, India's exports increased significantly. Imports also increased as technology, petrol etc. by industries remained very high demand along with rising exports. Size has increased but balance of trade has remained in DEFICIT throughout.

Year	% Share of Trade in India's GDP (US $)
1981	12
1991	13.9
2001	19
2011	41.8
2014	38.3

Table 9.4: % Share of Trade in India's GDP — Source: World Trade Report, 2015

9.7.2 Composition (Nature) of India's Merchandise Imports and Exports:

In 1961, the share of food imports in India's total merchandise imports was 19.1% which declined to just **3.9% in 2014-15**. This shows India attained self-reliance in grains and other food items. In 1960-61, the share of capital intensive goods in India's merchandise imports was as high as 31.7% which declined to 9.8% in 2014-15.

The imports of new items in 1960-61 were only 2.2% of the total merchandise imports which increased to **46.5% in 2014-15**. With diversification in the development process, imports of new goods increased.

In a similar way, the nature of exports has also changed. The share of entire primary sector in India's merchandise exports in 1960-61 was 44.2% which reduced to as low as **12.3% in 2014-15** (tea/coffee exports declined from 19.3% to 0.2%, jute export declined from 21% to 0.2%). Against that the export of readymade garments increased from 0.1% in 1960-61 to **5.4% in 2014-15**. The share of all manufactured goods in total merchandise exports was 45.3% which increased to **66.7% in 2014-15**. Exports of petroleum products: 1.1% (1960-61) → **18.5% (2014-15)**.

9.7.3 Direction of India's Foreign Trade:

Direction of foreign trade means the trade relations of a nation with various countries of the world. In 1960-61, India's imports from England constituted 19% of total merchandise imports, which fell to less than 2% after 2007. Imports from USA: 29% in 1960-61 which fell to less than 8% after 2007. Our imports from OPEC increased as our imports of petroleum (crude oil) increased with increasing pace of industrialization. (**OPEC = Organization of Petroleum Exporting Countries**). Our imports from developing countries: 11.8% in 1960-61 increased to 32% in 2007-08 and further to **59% in 2014-15**. **From total merchandise exports, those to Asian countries were almost 50% in 2014-15**.

Region	% share in India's Merchandise Imports (2014-15)	% share in India's Merchandise Exports (2014-15)
Asia	59	50
Europe	16	18
North America	06	14
Africa	08	11
Latin American Countries	07	05
CIS and Baltic Regions	02	01
Others	02	01
Total	100	100

Tables 9.5 & 9.6: Direction of India's Foreign Trade 2014-15 — Source: EXIM Bank and Economic Survey 2015-16

9.8 CONCEPT OF BALANCE OF PAYMENTS

> ***"Balance of Payments is a systematic account of the value of transactions of a country with the rest of the world in goods and services, transfer payments and capital (assets)."***

"An accounting statement showing the value of imports and exports of **tangible (visible)** and **intangible (invisible)** goods during a year." Tangible/visible goods = goods with physical existence. Intangible/invisible goods = services. Balance of Payments has a **credit entry** and a **debit entry**. All receipts by the home country from foreigners are recorded in the credit entry and all payments by the home country to foreigners are recorded in the debit entry.

9.8.1 Types of Balance of Payments:

Balance of Payments can be (1) Balanced (2) Unbalanced. It is balanced when credit side = debit side. It is unbalanced when they are not equal.

- If payments > receipts (credit < debit) → **Deficit** in Balance of Payments.
- If receipts > payments (credit > debit) → **Surplus** in Balance of Payments.

■ **According to the double entry book keeping system, a balance of payments always balances. However, in reality there can be a deficit or a surplus in the balance of payments.**

9.8.2 Accounts of Balance of Payments:

Balance of Payments (BoP) has TWO accounts: (1) Current Account and (2) Capital Account

(1) Current Account:

This account records the credit and debit entries for:

- **(i) Trade in merchandise goods (tangible goods):** Receipts from exports → credit entry. Payments for imports → debit entry. The sum total on this section of current account is called the **balance of trade**. If payments for merchandise imports > receipts from merchandise exports → deficit in balance of trade. Vice versa = surplus on balance of trade.
- **(ii) Trade in invisibles or services:** The incomes from invisibles are recorded on credit side and payments on debit side. Combined balance of (i) and (ii) is called the **current account balance**.

(2) Capital Account:

This account records receipts and payments from transactions on assets such as money assets like bonds, shares, gold, capital loans, etc. and other forms of fixed capital. The total of current account and capital account is called the balance of payments.

9.8.3 Factors Influencing Balance of Payments:

Factors influencing balance of payments means those factors which affect imports, exports, movement of capital, movement of factors of production, investment, lending etc. in a nation. Deficit or surplus in the balance of payments can arise owing to such factors:

- Exchange rate
- Prices of tradable goods in home country and in foreign countries
- Variety and quality of tradable goods
- Inevitable imports
- Level of economic development of the country
- Legal restrictions on trade
- Trade supporting facilities and infrastructures like transport, communication etc.

Table 9.7 — Hypothetical Example of Balance of Payments:

Credit Items (Receipts)	Amount (■ crores)	Debit Items (Payments)	Amount (■ crores)	Balance
Merchandise Exports	200	Merchandise Imports	300	
Trade Balance				–100
Services exported	100	Services imported	200	
Investment income earned	100	Investment money paid	200	
Unilateral receipts	200	Unilateral payments	100	
Sub Total (Current A/c)	600		800	–200
Long term borrowing	200	Long term lending	80	
Short term borrowing	100	Short term lending	60	
Sale of Gold	100	Purchase of Gold	50	
Sub Total (Capital A/c)	400	Errors & Omissions	+200	

Credit Items (Receipts)	Amount (■ crores)	Debit Items (Payments)	Amount (■ crores)	Balance
Capital Account Balance				+200
Total Receipts	1,000	Total Payments	1,000	
Balance of Payments				0

Table 9.7: Hypothetical Example of Balance of Payments (■ in crores)

9.9 CONCEPT OF EXCHANGE RATE

When an Indian tourist visits a foreign country she/he may not be able to purchase goods there in Indian Rupees. They need currency of that country. Such conversion of currency is done at a specific rate at a specific time which is known as the **exchange rate**. Exchange rate is the price of a foreign currency in terms of domestic currency. In other words, it is the units of home currency required to buy one unit of a foreign currency.

> ***"The rate at which the currency of one country can be converted into currency of another country is called exchange rate."***
>
> ***"Exchange rate is the price of a foreign currency in terms of domestic currency."***

Example: Exchange rate of US $1 = ■60 implies that in order to buy $1, a price of ■60 must be paid.

A rise in the exchange rate for India means that the value of Indian currency has declined in the international market. For now, more Indian ■ will have to be paid to buy one unit of a foreign currency. If US $1 = ■60 initially, and exchange rate rises, then US $1 = ■65. On the other hand, when exchange rate falls for India, the value of Indian ■ rises.

If the exchange rate rises for India and value of ■ falls, the demand for imports by India tends to decline and India's exports tend to rise. If the exchange rate falls for India and value of ■ rises, imports tend to rise and exports tend to fall.

EXERCISE — MCQs (Ch9)

(1) What happens owing to trade?

Options: (a) Mobility of factors of production declines (b) Number of industries declines (c) Production process slows down (d) Diversification in production occurs

✓ Answer: (d) Diversification in production occurs — trade leads to specialization and diversification.

(2) In today's time which factor of production is the most mobile in international trade?

Options: (a) Capital (b) Labour (c) Entrepreneurship (d) Land

✓ Answer: (c) Entrepreneurship — in present times entrepreneurship has become more mobile.

(3) Which significant change has occurred in India's foreign trade after 2005?

Options: (a) Size increased and rank risen (b) Size increased but rank fallen (c) BoP has continuously recorded deficit (d) Traditional exports share increased

✓ Answer: (a) The size of trade has increased and India's rank in world trade has risen.

(4) Which countries can be included in India's traditional trade partners?

Options: (a) England and Russia (b) Japan and China (c) Countries of Central Asia (d) Australia

✓ Answer: (a) England and Russia — India had large trade with England and Russia after independence.

(5) What is balance of trade?

Options: (a) Balance of current account (b) Balance of capital account (c) Balance of merchandise (visible) trade (d) Balance of service (invisible) trade

✓ Answer: (c) Balance of merchandise (visible) trade — balance of trade refers to sum total of value of merchandise imports and merchandise exports.

(6) A balance of payments has how many accounts?

Options: (a) 1 (b) 2 (c) 3 (d) 4

✓ Answer: (b) 2 — Current account and Capital account.

Key One-Line Answers

(1) What is meant by international trade?

International trade is the activity of exchanging goods, services, resources, capital, technology, know-how, intellectual property etc. by a country across its geographical boundary with other countries, for earning profit.

(2) What is meant by size of international trade?

Size of foreign trade means the total value and volume of merchandise imports and exports of a country. India's total trade in world trade in 2014-15 was about 2.07%.

(3) What is meant by direction of international trade?

Direction of foreign trade means the trade relations of a nation with various countries in different regions of the world. E.g., in 2014-15, Asian countries had 50% of India's merchandise exports.

(4) What is meant by exchange rate?

Exchange rate is the rate at which the currency of one country can be converted into currency of another country, or the price of a foreign currency in terms of domestic currency. E.g., US $1 = ■60.

(5) Difference between balance of trade and balance of payments:

• Balance of Trade = Sum total of value of MERCHANDISE (visible/tangible) imports and exports only.

• Balance of Payments = Broader — accounting statement showing value of imports and exports of BOTH tangible (visible) AND intangible (invisible) goods and services during a year.

• BoP includes Current Account (trade in goods + services) AND Capital Account (transactions on assets like bonds, shares, gold, capital loans) = TOTAL BoP.

■ BOARD EXAM QUICK REVISION — CHAPTER 9: FOREIGN TRADE

1. Foreign Trade = International Trade = Trade activity taking place outside the geographical boundary of a country.

2. Domestic Trade = Trade within the geographical boundary of a nation.

3. 4 REASONS FOR INTERNATIONAL TRADE: (1) Difference in Factor Endowments (2) Cost of Production (3) Technological Progress (4) Division of Labour and Specialization.

4. WTO = World Trade Organization — the international organization for promoting and regulating international trade.

5. Vibrant Gujarat Summit = example of diplomatic effort to promote international trade in Gujarat.

6. India's share in world trade (2014-15) = 2.07% | India's rank in global merchandise exports = 19th (from 29th in 2005).

7. Size of India's Foreign Trade (2014-15): Exports = $310.5 bn | Imports = $448.0 bn | Balance of Trade = –$137.5 bn (DEFICIT).

8. Trade as % of India's GDP: 1981 = 12% → 2011 = 41.8% → 2014 = 38.3%.

9. Nature/Composition of Exports: Primary sector exports 44.2% (1960-61) → 12.3% (2014-15). Manufactured goods 45.3% → 66.7%. Petroleum products 1.1% → 18.5%.

10. Direction of India's imports: From developing countries 11.8% (1960-61) → 59% (2014-15). Imports from England fell from 19% to <2%.

11. Direction of India's exports: To Asian countries = 50% (2014-15). To OPEC increased due to petroleum exports.

12. BALANCE OF TRADE = Merchandise (visible/tangible) exports minus imports. India has had consistent DEFICIT.

13. BALANCE OF PAYMENTS = Current Account + Capital Account. Current A/c = trade in goods (merchandise) + trade in invisibles (services). Capital A/c = assets (bonds, shares, gold, capital loans). BOP always balances in double-entry.

14. OPEC = Organization of Petroleum Exporting Countries — India imports petroleum from OPEC countries.

15. Exchange Rate = Price of foreign currency in terms of domestic currency. E.g., $1 = ■60. Rise in ER → ■ value falls → imports fall, exports rise. Fall in ER → ■ value rises → imports rise, exports fall.

16. Developmental Imports = Imports of capital, technology by developing country to boost development (machines, know-how). Maintenance Imports = spare parts, petrol, intermediate goods to sustain ongoing industrialization.

17. Traditional Exports = Tea, coffee, jute etc. (declining). Non-traditional = readymade garments (0.1% → 5.4%), petroleum products (1.1% → 18.5%), manufactured goods.

Notes prepared from GSEB Class 12 Economics Textbook — Complete Board Exam Coverage.