**10. International Economics**

**(Trade, Finance, Balance of Payment and Exchange Rate)**

**International Trade**

**International trade** is the exchange of capital, goods, and services across international borders or territories.

International trade is also a branch of economics, which, together with international finance, forms the larger branch called international economics.

The following are noted models of international trade:

* Adam Smith's model
* Ricardian model
* Heckscher–Ohlin model
* New Trade Theory
* Gravity model
* Contemporary theories
* Neo-Ricardian trade theory
* Ricardo-Sraffa trade theory

**Adam Smith's model: Absolute Advantage**

Adam Smith displays trade taking place on the basis of countries exercising absolute advantage over one another. In economics, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce more number of a good product or service than competitors, using the same amount of resources. Adam Smith first described the principle of absolute advantage in the context of international trade, using labor as the only input. Since absolute advantage is determined by a simple comparison of labor productiveness, it is possible for a party to have no absolute advantage in anything; in that case, according to the theory of absolute advantage, no trade will occur with the other party. Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation’s import and instead stated that all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage. Smith also stated that the wealth of nations depends upon the goods and services available to their citizens, rather than their GOLD reserves.

**Ricardian Model: Comparative Cost Advantage**

David Ricardo developed the classical theory of comparative advantage in 1817 to explain why countries engage in international trade even when one country's workers are more efficient at producing every single good than workers in other countries. He demonstrated that if two countries capable of producing two commodities engage in the [free market,](https://en.wikipedia.org/wiki/Free_market) then each country will increase its overall consumption by exporting the good for which it has a comparative advantage while importing the other good, provided that there exist differences in [labor productivity](https://en.wikipedia.org/wiki/Labor_productivity) between both countries. Widely regarded as one of the most powerful yet counterintuitive insights in economics, Ricardo's theory implies that comparative advantage rather than [absolute advantage](https://en.wikipedia.org/wiki/Absolute_advantage) is responsible for much of international trade.

**Ricardo's example**

In a famous example, Ricardo considers a world economy consisting of two countries, Portugal and England, which produce two goods of identical quality. In Portugal, the a priori more efficient country, it is possible to produce wine and cloth with less labor than it would take to produce the same quantities in England. However, the relative costs of producing those two goods differ between the countries.

|  |  |  |
| --- | --- | --- |
| **Hours of work necessary to produce one unit** | | |
| Country | Cloth | Wine |
| England | 100 | 120 |
| Portugal | 90 | 80 |

In this illustration, England could commit 100 hours of labor to produce one unit of cloth, or produce units of wine. Meanwhile, in comparison, Portugal could commit 90 hours of labor to produce one unit of cloth, or produce 9/8 units of wine. So, Portugal possesses an absolute advantage in producing cloth due to fewer labor hours, and England has acomparative advantage due to lower opportunity cost.

In the absence of trade, England requires 220 hours of work to both produce and consume one unit each of cloth and wine while Portugal requires 170 hours of work to produce and consume the same quantities. If each country specializes in the good for which it has a comparative advantage, then the global production of both goods increases, for England can spend 220 labor hours to produce 2.2 units of cloth while Portugal can spend 170 hours to produce 2.125 units of wine. Moreover, if both countries specialize in the above manner and England trades a unit of its cloth for 5/6 to 9/8 units of Portugal's wine, then both countries can consume at least a unit each of cloth and wine, with 0 to 0.2 units of cloth and 0 to 0.125 units of wine remaining in each respective country to be consumed or exported. Consequently, both England and Portugal can consume more wine and cloth under free trade than in autarky. **Modern theories**

Since 1817, economists have attempted to generalize the Ricardian model and derive the principle of comparative advantage in broader settings, most notably in the neoclassical specific *factors* Ricardo-Viner and *factor proportions* Heckscher–Ohlin models. Subsequent developments in the new trade theory, motivated in part by the empirical shortcomings of the H– O model and its inability to explain intra-industry trade, have provided an explanation for aspects of trade that are not accounted for by comparative advantage. Nonetheless, economists like Alan Deardorff,Avinash Dixit, Gottfried Haberler, and Victor D. Norman have responded with weaker generalizations of the principle of comparative advantage, in which countries will only *tend* to export goods for which they have a comparative advantage.

In both Ricardian and H–O models, the comparative advantage concept is formulated for 2 country, 2 commodity case. It can easily be extended to the 2 country, many commodity case or many country, 2 commodity case. But in the case with many countries (more than 3 countries) and many commodities (more than 3 commodities), the notion of comparative advantage requires a substantially more complex formulation.

**Heckscher–Ohlin model:**

The Heckscher–Ohlin model (H–O model) is a general equilibrium mathematical model of international trade, developed by Eli Heckscher and Bertil Ohlin at the Stockholm School of Economics. It builds on David Ricardo's theory of comparative advantage by predicting patterns of commerce and production based on the factor endowments of a trading region. The model essentially says that countries will export products that use their abundant and cheap factor(s) of production and import products that use the countries' scarce factor(s).

Relative endowments of the factors of production (land, labor, and capital) determine a country's comparative advantage. Countries have comparative advantages in those goods for which the required factors of production are relatively abundant locally. This is because the profitability of goods is determined by input costs. Goods that require inputs that are locally abundant will be cheaper to produce than those goods that require inputs that are locally scarce.

For example, a country where capital and land are abundant but labor is scarce will have comparative advantage in goods that require lots of capital and land, but little labor—grains. If capital and land are abundant, their prices will be low. As they are the main factors used in the production of grain, the price of grain will also be low—and thus attractive for both local consumption and export. Labor-intensive goods on the other hand will be very expensive to produce since labor is scarce and its price is high. Therefore, the country is better off importing those goods.

The Ricardian model of comparative advantage has trade ultimately motivated by differences in labour productivity using different "technologies". Heckscher and Ohlin did not require production technology to vary between countries, so (in the interests of simplicity) the "H–O model has identical production technology everywhere". Ricardo considered a single factor of production (labour) and would not have been able to produce comparative advantage without technological differences between countries (all nations would become autarkic at various stages of growth, with no reason to trade with each other). The H–O model removed technology variations but introduced variable capital endowments, recreating endogenously the inter-country variation of labour productivity that Ricardo had imposed exogenously. With international variations in the capital endowment like infrastructure and goods requiring different factor "proportions", Ricardo's comparative advantage emerges as a profit-maximizing solution of capitalist's choices from within the model's equations. The decision that capital owners are faced with is between investments in differing production technologies; the H–O model assumes capital is privately held.

**Assumptions:** The original, 2×2×2 model was derived with restrictive assumptions:

Both countries have identical production technology;

Production output is assumed to exhibit constant returns to scale;

The technologies used to produce the two commodities differ;

Factor mobility within countries;

Factor immobility between countries; Commodity prices are the same everywhere; Perfect internal competition.

**Heckscher–Ohlin theorem:**

The exports of a capital-abundant country will be from capital-intensive industries, and labourabundant countries will import such goods, exporting labour-intensive goods in return. Competitive pressures within the H–O model produce this prediction fairly straightforwardly.

Conveniently, this is an easily testable hypothesis.

**Rybczynski theorem:**

When the amount of one factor of production increases, the production of the good which uses that particular factor of production intensively increases relative to the increase in the factor of production, as the H–O model assumes perfect competition where price is equal to the costs of factors of production. This theorem is useful in explaining the effects of IMMIGRATION emigration, and foreign capital investment. However, Rybczynski suggests that a fixed quantity of the two factors of production are required. This could be expanded to consider factor substitution, in which case the increase in production would be more than proportional.

**Stolper–Samuelson theorem:**

Relative changes in output goods prices will drive the relative prices of the factors used to produce them. If the world price of capital-intensive goods increases, it will increase the relative rental rate as well as decrease the relative wage rate (the return on capital as against the return to labor). Also if the price of labor-intensive goods increases, it will increase the relative wage rate as well as decrease the relative rental rate.

**Factor–price equalization theorem:**

Free and competitive trade will make factor prices converge along with traded goods prices. The

FPE theorem is the most significant conclusion of the H–O model, but it is also the theorem which has found the least agreement with the economic evidence. Neither the rental return to capital, nor the wage rates seem to consistently converge between trading partners at different levels of development.

**Leontief paradox:**

In 1954 an econometric test by Wassily W. Leontief of the H–O model found that the United States, despite having a relative abundance of capital, tended to export labor-intensive goods and import capital-intensive goods. This problem became known as the Leontief paradox. Alternative trade models and various explanations for the paradox have emerged as a result of the paradox. One such trade model, the Linder hypothesis, suggests that goods are traded based on similar demand rather than differences in supply side factors (i.e., H–O's factor endowments).

**The Vanek formula:**

Various attempts in the 1960s and 1970s to "solve" the Leontief paradox and save the Heckscher–Ohlin Theory failed. From the 1980s a new series of statistical tests had been tried. The new tests depended on the Vanek's formula.[[3]](https://en.wikipedia.org/wiki/Heckscher%E2%80%93Ohlin_model#cite_note-3) It takes a simple form Fc = Vc - ScV

Where Fc is the net trade of factor service vector for country, Vc the factor endowment vector for country, and  the country's share of the world consumption and V the world total endowment vector of factors. For many countries and many factors, it is possible to estimate the left hand sides and right hand sides independently. To put it another way, the left hand side tells the direction of factor service trade. Thus it is possible to ask how this system of equations holds. The results obtained by Bowen, Leamer and Sveiskaus (1987) was disastrous.[[4]](https://en.wikipedia.org/wiki/Heckscher%E2%80%93Ohlin_model#cite_note-4) They examined the cases of 12 factors and 27 countries for the year 1967. They found that the both sides of the equations had the same sign only for 61% of 324 cases. For the year 1983, the result was more disastrous. Both sides had the same sign only for 148 cases out of 297 cases (or the rate of correct predictions was 49.8%). The results of Bowen, Leamer, and Sveiskaus (1987) mean that the Hecksher–Ohlin–Vanek (HOV) theory has no predictive power concerning the direction of trade.

**Gravity model of trade:**

The gravity model of international trade predicts bilateral trade flows based on the economic sizes of two nations, and the distance between them.

**Ricardo–Sraffa trade theory:**

Ricardian theory is now extended in a general form which includes not only labor but also inputs of materials and intermediate goods. In this sense, it is much more general and plausible than the Heckscher–Ohlin model and escapes the logical problems such as capital as endowments, which is in reality produced goods. As the theory permits different production processes to coexist in an industry of a country, the Ricardo–Sraffa theory can give a theoretical bases for the New Trade Theory.

**International Finance**

**International finance** (also referred to as **international monetary economics** or **international macroeconomics**) is the branch of financial economics broadly concerned with monetary and macroeconomic interrelations between two or more countries. International finance examines the dynamics of the global financial system, international monetary systems, balance of payments, exchange rates, foreign direct investment, and how these topics relate to international trade. Sometimes referred to as multinational finance, international finance is additionally concerned with matters of international financial management. Investors and multinational corporations must assess and manage international risks.

**International financing may take one of the following forms:**

· Bilateral arrangements

· Third country financing arrangements

· Multilateral arrangements

· Combined or multiparty arrangements (Other types of financing are available but may be considered as a variation of one of the above categories).

**Sources of Finance for Development:**

* International Institutions
* International Finance Facility
* Foreign Direct Investment
* Aid
* Tax measure

**International Institutions:**

**The International Monetary Fund (IMF):**

The International Monetary Fund (IMF) Set up in 1944 at the Bretton Woods Conference, New Hampshire Set up to help put in place an ECONOMIC structure that would help prevent the problems experienced by many countries in the 1930s Aims to stabilise the international monetary system and help when monetary flow from trade causes problems Provides help and advice as well as funds to countries experiencing balance of payments problems

**IMF:**

IMF IMF gets its funds from its 184 member states – called ‘quotas’ Current funds in excess of $310 billion Quotas determined by the ECONOMIC size of the member state The Headquarters of the IMF in Washington DC.

**The World Bank:**

The World BANK An agency of the United Nations A group of five organisations which focus on providing funds for projects aimed at alleviating poverty, inequality and promoting development Currently has 184 members

**The World Bank:**

The World Bank The 5 institutions: The International Bank for Reconstruction and Development (IBRD) – provides LOANS and advice to poor countries to assist development The International Development Association (IDA) – interest free credits and grants to countries who are not able to borrow through normal market channels International Finance Corporation (IFC) – providing finance through the private sector for development The Multilateral Investment Guarantee Agency (MIGA) – providing investors with protection against risk to promote investment in developing countries The International Centre for the Settlement of Investment Disputes (ICSID) – arbitration service in the event of investment disputes

**Special Drawing Rights (SDRs):**

Special Drawing Rights (SDRs) Originally set up in 1969 to support fixed XCHANGE RATES Value based on a basket of international currencies – currently 1.24 SDRs to the £ Now used as a potential claim on currencies of IMF members – currencies can be bought in exchange for SDRs held by members Ghana participates in the Heavily Indebted Poor Countries Initiative (HIPC) scheme administered by the IMF as it attempts to reduce poverty. The scheme helps it to build new facilities such as this Salvation Army hostel.

**International Finance Facility (IFF):**

International Finance Facility (IFF) Aiming to bridge the gap between the funds currently pledged and those needed to meet the Millennium Development Goals (MDGs) Aims to raise an extra $50 billion per year between now and 2015 Uses the long term commitments of donor countries as security for raising further funds on international CAPITAL MARKETS There is concern from some about the technical feasibility of the scheme and whether the funds will be used in the correct way to achieve the MDGs

**Foreign Direct Investment (FDI):**

Foreign Direct Investment (FDI) Policies to attract investment Such investment often associated with multinational CORPORATIONS (MNCs) Policies need to focus on having the right conditions in place – Infrastructure Security Peace Local laws and regulation Government corruption Freedom of the market Local labour supply Legal issues – protection for the investor, property rights, etc. Tax regime has been criticised as being a means by which MNCs can exploit poorer countries

**Aid:**

Aid Bilateral – from one country to another Multilateral – aid distributed by an agency who coordinate donations Aid can be useful for important infrastructure projects such as dams which help to generate electricity as well as providing irrigation schemes.

**Aid:**

Aid Benefits: Help to kick-start economic development Used to help develop vital infrastructure needed to encourage other investment Costs: Not always used for appropriate purposes Can be linked to various ‘strings’ that may not be in the recipient countries’ interests Crowding out of domestic investment Creates a dependency culture Distorts the WORKING of the market

**Tax Measures:**

Tax Measures Tobin Tax – a tax imposed on CURRENCY TRADING Aims to reduce short term speculative trades and stabilise currency flows Funds raised used to finance development projects Political will to implement such a tax?

**Tax Measures:**

Tax Measures International aid to help developing countries improve tax systems to generate tax revenue more efficiently International taxes on pollution, air transport, arms, rent on deep sea mineral extraction – funds raised used to help fund development Issues of how far such taxes could raise sufficient funds and whether they would distort markets too much.

**Exchange Rate**

**Points to be remembered:**

**Foreign Exchange (FOREX):** A currency unit of a country.

**Rate of Exchange:** The value of domestic currency in terms of a unit of foreign currency.

**Devaluation:** A fall in the external value of domestic currency under a fixed exchange rate system.

**Depreciation:** A fall in the external value of domestic currency under flexible exchange rate system.

**Balance of Trade:** An account of the value of visible exports and the value of visible imports by a country during a year.

**Balance of Payments:** A monetary statement of the total receipts and total payments of foreign exchange of a country during a year.

**Introduction:**

International trade is different from domestic trade because all the transactions in domestic trade are settled by means of domestic currency. For example—you want to buy a car or you want to consult a doctor. You make the payment in Saudi Riyal. But Saudi Riyal is legal tender money only within the political boundaries of Kingdom of Saudi Arabia. Beyond these political boundaries Saudi Riyal loses all value. It becomes simple piece of paper. It does not command any purchasing power. Therefore, if you need to purchase a good or a service from anywhere in the rest of the world, you need to have the currency of that country.

Currencies of other countries are known as foreign exchange.

We need to have foreign exchange to settle our transactions with the rest- of- the world.

Some foreign currencies are treated as *‘soft’* currencies and some are treated as *‘hard’* currencies.

The demand for soft currencies is very limited.

Hard currencies are those currencies which are accepted throughout the world, although they are not legal tender.

Nobody will accept Indian rupee outside India as a means of International payment. But American dollar, British pound-sterling, the Japanese yen, the French franc, and the Italian lira are accepted throughout the world.

**Rate of Exchange:**

Rate of exchange refers to the external value of a currency that is; it is the purchasing power of a currency in terms of other currencies.

In other words, rate of exchange refers to the number of units of foreign currency that can be exchanged against a unit of domestic currency.

**Some Concepts of Rate of Exchange:**

**Spot Rate:** It refers to the rate at which foreign currency is available on the spot.

**Forward Rate:** The rate at which a future contract for foreign currency is bought and sold is called forward rate. It is quoted at a premium or discount over the spot rate.

**Fixed Exchange Rate:** It refers to the system under which the rate of exchange of a currency is fixed in terms of gold or in terms of another currency.

**Flexible Exchange Rate:** It is the type of exchange rate system which involves keeping the exchange rate fixed over short period and changing it from time to time according to need.

**Floating Exchange Rate:** When the currency unit of a country is free to fluctuate and find its own level, according to conditions of demand and supply in the foreign exchange market.

**Multiple Rates:** If a country adopts more than one rate of exchange for its currency, it is said to follow a system of multiple exchange rates.

**Two Tier Exchange Rate System:** It is a form of multiple exchange rate system under which the government maintains two rates- a higher rate for commercial transactions and a lower rate for capital transactions.

**Determination of Rate of Exchange:**

The recent history of the determination of rate of exchange can be divided into two periods:

1. Between 1946 and 1971, and
2. Since 1972.

**Between 1946 and 1971 (Fixed Exchange Rates):**

The International Monetary Fund (IMF) was set up in 1945. The member countries of the IMF agreed among themselves to set up a fixed exchange rate system. All the member countries were asked to communicate the gold values of their respective currencies to the IMF. The IMF established the parity between the gold values of different currencies. These became the rates of exchange of different currencies.

**For Example:**

Suppose the gold values of the three currencies, Saudi Riyal, American dollar, and British pound were as follows:

SR 1 = 1 oz of gold

$ 1 = 2 oz of gold

£ 1 = 4 oz of gold Then,

£ 1 = 2$ = SR 4

Or,

SR 1 = $0.5 = £0.25

This is how the rates of exchange of all other countries were determined.

The member countries were not allowed to change their rates of exchange without the prior permission of the IMF.

This system worked with fair degree of success till 1971.

*Devaluation of currency* means to bring down the external value of its currency. It encourages exports and discourages imports.

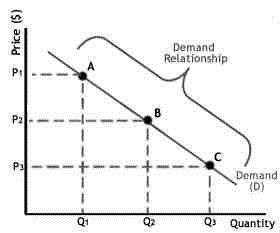
*Revaluation of currency* means to raise the external value of its currency. It encourages imports and discourages exports.

**Since 1972:**

The rate of exchange of a currency is determined by demand for and supply of foreign exchange in its foreign exchange market. This is known as the market- determined rate of exchange.

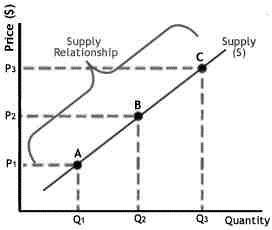
Every country has foreign transactions in goods, services and capital which involve payments and receipts of foreign exchange. Payments in foreign exchange results in demand for foreign exchange and receipts in foreign exchange result in supply of foreign exchange. Demand and supply of foreign exchange interact to determine the rate of exchange.

**Demand for foreign exchange:**

Demand for foreign exchange arises due to imports of goods, services and capital, tourists going abroad, remittances by foreigners working in home country and by multi- nationals, foreign institutional investors, repayment of interest and loans, extension of loans to foreigners. In short, any transactions that involves a payment, we need foreign exchange and we demand for foreign exchange.

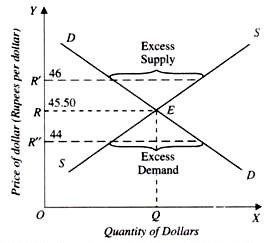
There are inverse/ opposite relationship between the price of foreign exchange and the quantity demanded of foreign exchange. The demand for foreign exchange curve slopes downward to the right.

**Supply of Foreign Exchange:**

In the same way, any transaction that involves receipts of foreign exchange leads to an increase in the supply of foreign exchange. The supply of foreign exchange can be increased by exports of goods, services and capital, foreign tourists coming in the country, remittances by country men working abroad, foreign direct investment by multi- national companies, purchase of stocks by foreign institutional investors, etc. In short, any transaction that results in a receipt of foreign exchange in the country adds to the supply of foreign exchange.

There are direct relationship between the supply of foreign exchange and the price of foreign exchange. In other words, the supply curve of foreign exchange goes upward to the right.

**Equilibrium Rate of Exchange:**

Equilibrium rate of exchange is determined where demand for foreign exchange (dollar) and supply for dollar cut each other. In Fig. OR is the price at which the quantity demanded and the quantity supplied of dollars are equal.

At a price higher than the equilibrium price (i.e., OR’),

there will be an excess supply of foreign exchange in India’s foreign exchange market and Indian rupee will tend to appreciate.

On the other hand, if the price is lower than the equilibrium price (say for example OR”), then there will be deficit in the supply of foreign exchange and Indian rupee will tend to depreciate.

**Balance of Payments**

**Meaning:**

Balance of payments is an annual statement of accounts of all monetary transactions of a country with the rest of the world.

Monetary transactions between countries arise due to transactions in the flow of goods, services and capital.

All the transactions, in goods, services and capital, are accounted for in foreign exchange.

When a country exports goods, services and capital, it receives payment in foreign exchange. Similarly, when a country imports goods, services and capital, it makes payment in foreign exchange to the other country. Balance of payments statement records all these transactions on an annual basis.

Balance of payments has two sides: debit and credit. Payments are recorded on the debit side and receipts on the credit side. Debit side are recorded with a minus (-) sign and credit items are recorded with plus (+) sign.

The balance of payments accounts are prepared on the double- entry system of accounting. Hence the sum of all debits should necessarily be equal to the sum of all credits. That is why it is said that balance of payments is always balanced in accounting sense.

**Components of Balance of Payments:**

Balance of payments statement is divided into two parts:

* Balance of payments on Current Account; and  Balance of payments on Capital Account.

**Balance of payments on Current Account:**

This component of balance of payments is further divided into two parts:

* Balance of Trade/ Visible; and  Balance of Invisibles.

**Balance of Trade/ Visible:** In balance of trade we include the value of exports and imports of all visible goods (tangible goods only) during a year.

The difference between the value of exports and value of imports is called balance of trade. It may be favorable (positive), unfavorable (negative) or balanced.

When the value of exports is greater than the value of imports during the year, it is called trade surplus or favorable trade of positive balance of trade.

When the value of exports is less than the value of imports during the year, it is called trade deficit or unfavorable trade of negative balance of trade.

When the value of exports is equal to the value of imports during the year, it is called balanced trade.

* Balance of Trade = Visible Exports – visible Imports
* Favourable Balance of Trade = Exports > Imports
* Unfavourable Balance of Trade = Exports < Imports

**Balance of Invisibles:** We include the value of different types of services which are also known as invisible items (intangibles), rendered to or received from rest of the world.

*Types of Services:*

* *Factor services* like services of land, labor, capital, etc.
* *Non- factor services* like tourism, transportation, insurance, banking, etc.
* *Private transfers* like donations, gifts, remittances, etc.  *Official transfers* like grants from abroad, etc.

The difference between the value of exports and value of imports of invisible goods or services is called balance of invisibles. As balance of goods trade, it may also be favorable (positive), unfavorable (negative) or balanced.

The sum total of the balance of trade (BoT) and balance of invisibles (BoI) gives us balance of payment (BoP) on current account, *i.e.,*

BoP current A/c = BoT + BoI

BoP on current account may also be favorable, unfavorable or balanced during a year.

A favorable BoP on current account means that a country has earned more foreign exchange than it has spent during the year. This situation is also known as BoP surplus or current account surplus.

An unfavorable BoP on current account means that a country has spent more foreign exchange than it has earned during the year. This situation is known as BoP deficit or current account deficit.

When a country’s total earnings is equal to its total expenditure of foreign exchange during a year, it is called balanced BoP in current account.

**Balance of payments on Capital Account:**

Capital account statement records the flows of capital. Flows of capital may take any of the following forms:

1. **Non- debt creating inflows:** 
   * Foreign direct investment (FDI); and  Portfolio investment (PI).
2. **Debt creating inflows:** 
   * External assistance;
   * External commercial borrowings;
   * Short- term credits;
   * NRI deposits

Capital flows are required to settle surplus or deficit in BoP on current account.

A country which has a current account surplus should be sending out its capital in different forms. It ought to have a capital account deficit. This deficit will cancel the current account surplus.

A country which has a current account deficit must arrange a net inflow of capital from abroad. Capital account surplus is required to finance current account deficit.

Thus, a country which has a current account surplus will manage a capital account deficit and vice versa.

Overall balance of payments is the sum total of BoP on current account and BoP on capital account.

**Distinction between Current Account and Capital Account:**

|  |  |
| --- | --- |
| **Current Account** | **Capital Account** |
| 1. Current account deals with payments for currently produced goods and services; | 1.Capital accounts, deals with the payments of debts and claims |
| 2. The current account of the balance of payments has direct influence on the level of income of a country**.** | 2. The capital account does not have such a direct effect on the level of income; it influences the volume of assets which a country holds**.** |

**Difference between Balance of Trade and Balance of Payments**

There are following difference between balance of trade and balance of payments

|  |  |
| --- | --- |
| **Balance of Trade** | **Balance of Payments** |
| 1. Balance of trade refers to the visible imports and visible exports only | 1. Balance of payments refers to account visible as well as invisible items. |
| 2. Balance of trade is only one of the parts of balance of payments. | 2. Balance of payments is much wider than the concept of balance of trade. |
| 3. There are three possible situations for balance of trade- it may be balanced, deficit, or surplus. | 3. In the case of balance of payments as a whole must always remain balanced with the total quantum of debits. |

**Significance of Balance of Payments:**

There are following significance of the balance of payments:

1. Balance of payment accounts takes the stock of county’s foreign exchange receipts and payments obligations with a view to correcting accounting aberrations.
2. It yields necessary information on the strength and weaknesses of the country international economic transactions.
3. By analyzing the balance of payments accounts of the past years, we can find out overall gains and losses from international economic transactions
4. Balance of payments accounts Caution us and provide enough signals for future policy formulations.
5. With the help of balance of payments accounts, we are able to know the manner in which national economy affects and is affected by transactions with the rest of the world markets.