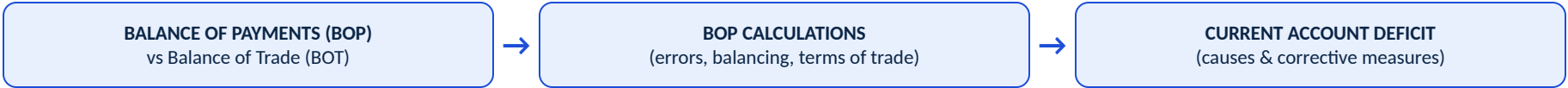


1 CHAPTER ROADMAP



Theme: keeping a systematic record of a country's trade with the rest of the world lets policymakers take corrective action. Balance of Trade covers only visible goods; Balance of Payments is the fuller record covering visible AND invisible items, split across current, capital and financial accounts.

2 KEY DEFINITIONS

Balance of Payments (BOP)
A comprehensive record of a country's economic transactions with the rest of the world during the course of one year.

Balance of Trade (BOT)
Concerned with the trade of only VISIBLE (tangible) goods – narrower than BOP.

Visible Goods
Tangible items recorded via customs duties, with measurable value (cars, machinery, shoes).

Invisible Goods
Intangible items – financial services, insurance, capital flows.

Net Errors and Omissions
The value needed to ensure the BOP statement's accounts sum to zero – compensates for discrepancies.

Terms of Trade (TOT)
The ratio of export prices to import prices – the amount of import goods an economy can buy per unit of export goods.

Current Account Deficit
A net outflow of demand versus income coming into a country – the country is "not paying its way".

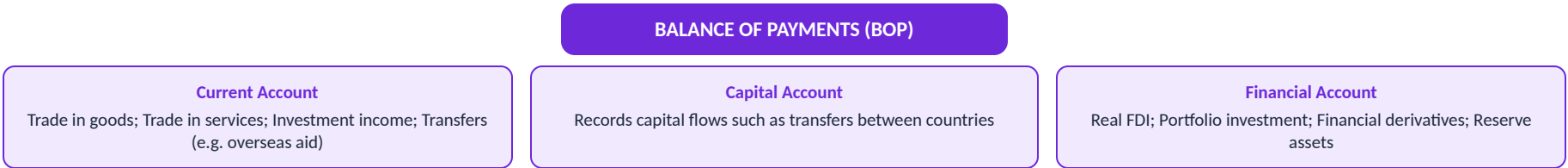
3 SURPLUS VS DEFICIT

State	Condition
Surplus	Receipts > Payments
Deficit	Receipts < Payments

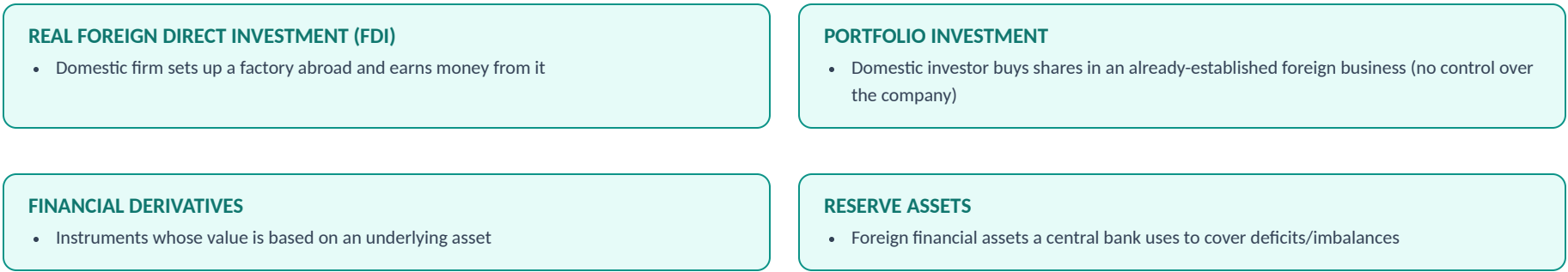
4 BALANCE OF TRADE VS BALANCE OF PAYMENTS

	Balance of Trade (BOT)	Balance of Payments (BOP)
Scope	VISIBLE goods only	VISIBLE + INVISIBLE goods (fuller/wider record)
Examples included	Cars, machinery, shoes	All of BOT + financial services, insurance, capital flows

5 COMPONENTS OF BALANCE OF PAYMENTS



6 FINANCIAL ACCOUNT – KEY TERMS



7 WORKED EXAMPLE: BUILDING A BOP STATEMENT

BOP Item	Rs. bn	Net Balance
Exports (visible)	10	–
Imports (visible)	22	–
Trade Balance (visible)		–12
Export (services)	11	–
Import (services)	29	–
Trade Balance (invisible)		–18
Investment Income (net)		+4
Net Transfers		–24
CURRENT ACCOUNT BALANCE		–50
Capital Account (net transfers)		+15
Financial Account (FDI, portfolio, reserves, errors)		+35
CAPITAL + FINANCIAL ACCOUNT BALANCE		+50
Overall Balance of Payments		0

The current account deficit (–50) is exactly offset by the capital + financial account surplus (+50) – illustrating how a current account deficit is financed elsewhere in the BOP so the OVERALL balance nets to zero.

Real-world context: Pakistan's current account has run persistent deficits in most years on record (e.g. State Bank of Pakistan data shows deficits across 2017-18 through most recent years), financed mainly through the financial account and capital inflows.

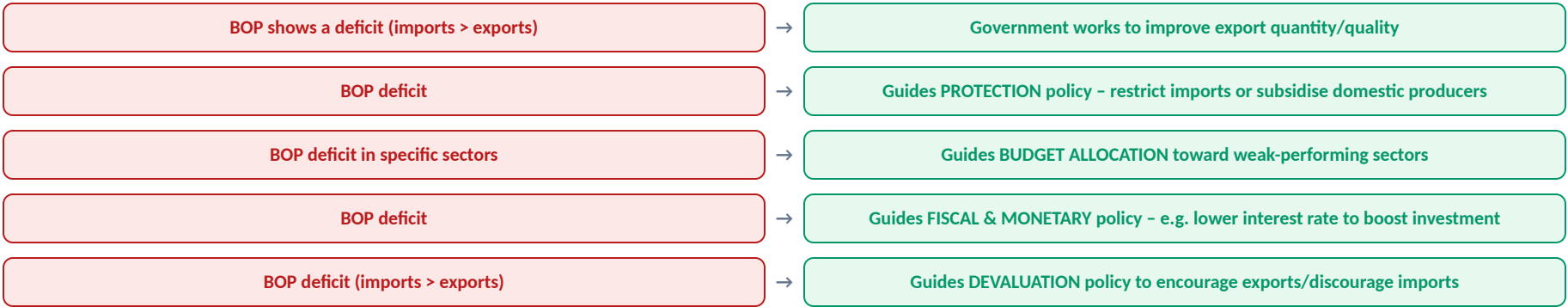
8 NET ERRORS AND OMISSIONS

In theory, BOP accounts should balance exactly; in practice they rarely do. "Net Errors and Omissions" is the plug figure that compensates for this discrepancy, ensuring the statement sums to zero.

9 BALANCING A BOP DEFICIT OR SURPLUS

Situation	Balanced By
Deficit	Selling gold/financial reserves; Borrowing from other central banks
Surplus	Buying gold/financial reserves; Paying off debts

10 IMPORTANCE OF BOP CALCULATION



11 TERMS OF TRADE (TOT)

TERMS OF TRADE

TOT = (Export Price Index of Current Year ÷ Import Price Index of Current Year) × 100

TOT > 100 = improvement; TOT < 100 = deterioration

Worked example: Export price index rises 20% (→120); import price index rises 10% (→110) ⇒ TOT = (120÷110)×100 = **109.09 (≈109)** ⇒ TOT improved by 9%.

12 IMPROVEMENT VS DETERIORATION IN TERMS OF TRADE

Situation	TOT Effect
Export prices rise FASTER than import prices	TOT IMPROVES
Import prices rise FASTER than export prices	TOT WORSENS

Important exam nuance: an improving TOT does NOT automatically improve the BOP. TOT looks only at PRICES; BOP depends on both price AND quantity. A rise in export prices (improving TOT) could cause a proportionately BIGGER fall in export demand – actually WORSENING the balance of payments. The reverse logic applies to a worsening TOT.

13 CAUSES OF A CURRENT ACCOUNT DEFICIT

- **High income elasticity of demand for imports:** strong consumer spending → imports rise fast
- **Long-term decline in manufacturing potential:** less capacity to produce/export goods
- **Changes in commodity prices:** swings in imported raw-material prices worsen the deficit
- **Inelastic imports:** a major cause – import volume doesn't fall much even as price rises
- **Domestic inflation:** makes cheaper imports more attractive, worsening the deficit

14 NON-MONETARY CORRECTIVE MEASURES

TARIFFS

- Duty on imports raises their price, making them less attractive; protects domestic suppliers

QUOTAS

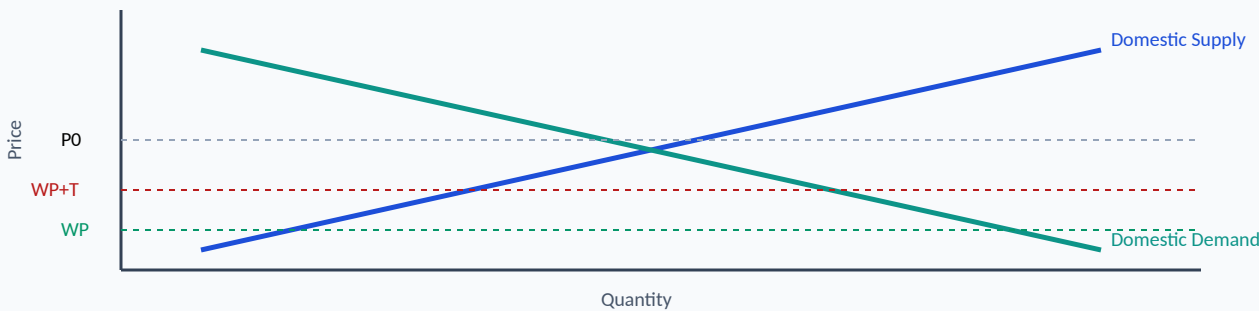
- Government fixes a maximum quantity of a good that can be imported, directly cutting import volume

EXPORT PROMOTION

- Exhibitions, trade fairs, diplomatic deals to help exporters sell abroad

IMPORT SUBSTITUTION

- Becoming self-reliant via domestic training, subsidies, tax assistance instead of importing



At world price WP , imports = Q_{s1} to Q_{d1} (a large gap). Adding a tariff raises the effective import price to $WP+T$, narrowing the import gap to $Q_{s2}-Q_{d2}$ – a SMALLER volume needs to be imported, improving the current account deficit.

15 MONETARY CORRECTIVE MEASURES

DEFLATION

- Lower domestic price level → goods more attractive abroad → exports ↑

EXCHANGE CONTROL

- Authority commands exporters to surrender forex reserves to the central bank, restricting import levels

EXCHANGE RATE DEPRECIATION

- Domestic currency made cheaper relative to foreign currency, boosting exports & discouraging imports

Worked example: Car priced Rs.40,000; exchange rate Rs.4=\$1 ⇒ costs US buyer \$10,000. Depreciate rate to Rs.5=\$1 ⇒ same car now costs only **\$8,000** – cheaper for foreign buyers, raising demand for the export and helping correct the current account deficit (while making imports costlier).

16 EXAM PATTERNS & MCQ QUICK CLUES

"Export price index ÷ import price index × 100"



Terms of Trade

"Only visible/tangible goods recorded"



Balance of Trade (not BOP)

"FDI, portfolio investment, reserve assets"



Financial Account

"Trade in goods/services, investment income, transfers"



Current Account

"Government fixes maximum import quantity"



Quota

"Currency made cheaper to foreign buyers"



Exchange rate depreciation

⚠ ECONOMICS EXAM TRAPS

Trap: Treating BOT and BOP as synonyms – BOT covers only visible goods; BOP covers visible + invisible.

Trap: Assuming an improving Terms of Trade automatically improves the Balance of Payments – TOT is PRICE-only; BOP depends on price AND quantity together.

Trap: Misclassifying Financial Derivatives or Portfolio Investment as part of the Current Account – they belong to the Financial Account.

Trap: Confusing Tariffs (price-based, raises cost of imports) with Quotas (quantity-based, caps import volume directly).

Trap: Reversing deficit vs surplus balancing methods – deficit is balanced by SELLING reserves/borrowing; surplus by BUYING reserves/paying off debt.

17 COMPLETE CHAPTER DECISION TREE

QUESTION GIVEN → BOP/BOT distinction, BOP component, TOT calculation, or current account deficit question? → Identify the specific account/measure involved → If numerical: apply the Terms of Trade formula → For deficit questions: identify monetary vs non-monetary corrective measure → Interpret & select final answer

PRC-3 ECONOMICS – CHAPTER 12 IN 60 SECONDS

- **BOT:** visible goods only. **BOP:** visible + invisible (current + capital + financial accounts).
- **Current account:** goods, services, investment income, transfers.
- **Financial account:** FDI, portfolio investment, derivatives, reserve assets.
- **Net errors and omissions** makes the BOP statement sum to zero.
- **Deficit** balanced by selling reserves/borrowing; **Surplus** by buying reserves/paying debt.
- **TOT** = (Export price index ÷ Import price index) × 100; >100 = improvement.
- Improving TOT does NOT guarantee an improving BOP (quantity effects matter too).
- **Current account deficit causes:** high import income-elasticity, weak manufacturing, commodity price swings, inelastic imports, domestic inflation.
- **Non-monetary fixes:** tariffs, quotas, export promotion, import substitution.
- **Monetary fixes:** deflation, exchange control, exchange rate depreciation.

18 CHAPTER MEMORY MAP

BOT vs BOP

Current Account

Capital Account

Financial Account

Net Errors & Omissions

Balancing Deficit/Surplus

Importance of BOP

Terms of Trade

Current Account Deficit Causes

Non-Monetary Measures

Monetary Measures