



ALAGAPPA UNIVERSITY

(Accredited with 'A+' Grade by NAAC (with CGPA: 3.64) in the Third Cycle and Graded as category - I University by MHRD-UGC)

(A State University Established by the Government of Tamilnadu)



KARAIKUDI – 630 003

DIRECTORATE OF DISTANCE EDUCATION

M.A. (ECONOMICS)

Second Year – Third Semester

362 33 –INTERNATIONAL ECONOMICS

Reviewer:

Dr. M. Janarthanan Pillai,

Assistant Professor & HOD

PG & Research Department of Economics

Alagappa Government Arts College

Karaikudi – 01

“The Copyright shall be vested with Alagappa University”

All rights reserved. No part of this publication which is material protected by this copyright notice may be reproduced or transmitted or utilized or stored in any form or by any means now known or hereinafter invented, electronic, digital or mechanical, including photocopying, scanning, recording or by any information storage or retrieval system, without prior written permission from the Alagappa University, Karaikudi, Tamil Nadu.

SYLLABUS	Page NO
BLOCK I: Introduction to Foreign Trade	1-6
Unit-1: Foreign Trade: Need - Meaning - Nature - Inter Regional and International Trade.	
BLOCK II: Theories of International Trade	7-17
Unit-2: Theories of International Trade: Adam Smith - Ricardo, Haberler and Heckscher - Ohlin Theory.	
Unit-3: Terms of Trade: Concepts of Terms of Trade, Determinants of Terms of Trade - Static and Dynamic Gains from Trade - Terms of Trade between Agriculture and Industry.	18-29
Unit-4: Free Trade: Meaning - Case for and against Free Trade.	30-34
Unit-5: Protection: Meaning - Arguments for and Against Protection - The Effect of Growth on Trade.	35-46
Unit-6: Technical Progress and Trade - Meaning of Technical Progress - Neutral, Capital Saving, Labor Saving.	47-56
Unit-7: Trade Policy: Tariff - Quota - Trade problems of Developing Countries.	57-72
BLOCK III: International Organizations	73-79
Unit-8: International Organizations - I: UNCTAD - GATT and Tokyo Declaration.	
Unit-9: International Organizations - II: WTO - Import Substitution and Export Promotion- its Importance.	80-87
Unit-10: Economic Orders: North South Dialogue and New International Economic Order - Usefulness.	88-93
BLOCK IV: Balance of Payments, Trade and Export Assistance	94-108
Unit-11: Balance of Payments (BoP): Meaning, Structure, Importance of Balance of Payments.	

Unit-12: Balance of Trade (BoT): Meaning, Disequilibrium in BoP & BoT - **109-118**
Causes for Disequilibrium in BoP.

Unit-13: Measures for Correcting Disequilibrium, Relationship between BoP **119-128**
& BoT.

Unit-14: Strategies of International Business: International Marketing **129-144**
Operations. Exporting, Importing and Counter Trade - Export and Import
Finance - Export Assistance.

**INTERNATIONAL ECONOMICS
CONTENTS**

Sl. No.	Title	Page No
	BLOCK I: Introduction to Foreign Trade	
	Unit-1: Foreign Trade	1-6
1.1.	Foreign Trade: Need	
1.2.	Meaning	
1.3.	Nature	
1.4.	Inter Regional and International Trade	
1.5.	Check your progress Questions.	
1.6.	Answer to check your progress Questions	
1.7.	Summary	
1.8.	Key words	
1.9.	Self Assessment Questions and Exercises.	
	Short Answer Questions and Long answer Question.	
1.10.	Further Readings.	
	BLOCK II: Theories of International Trade	
	Unit-2: Theories of International Trade	7-17
2.1.	Theories of International Trade: Adam Smith – Ricardo	
2.2.	Haberler and Heckscher - Ohlin Theory	
2.3.	Check your progress Questions.	
2.4.	Answer to check your progress Questions.	
2.5.	Summary	
2.6.	Key words	
2.7.	Self Assessment Questions and Exercises.	
	Short Answer Questions and Long answer Questions.	

2.8. Further Readings.

Unit-3: Terms of Trade

18-29

3.1. Concepts of Terms of Trade

3.2. Determinants of Terms of Trade

3.3. Static and Dynamic Gains from Trade

3.4. Terms of Trade between Agriculture and Industry

3.5. Check your progress Questions.

3.6. Answer to check your progress Questions.

3.7. Summary

3.8. Key words

3.9. Self Assessment Questions and Exercises.

Short Answer Questions and Long answer Questions.

3.10. Further Readings.

Unit-4: Free Trade

30-34

4.1. Free Trade: Meaning

4.2. Case for and against Free Trade

4.3. Check your progress Questions.

4.4. Answer to check your progress Questions.

4.5. Summary

4.6. Key words

4.7. Self Assessment Questions and Exercises.

Short Answer Questions and Long answer Questions.

4.8. Further Readings.

Unit-5: Protection

35-46

- 5.1. Protection: Meaning**
- 5.2. Arguments for and Against Protection**
- 5.3. The Effect of Growth on Trade.**
- 5.4. Check your progress Questions.**
- 5.5. Answer to check your progress Questions.**
- 5.6. Summary**
- 5.7. Key words**
- 5.8. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 5.9. Further Readings.**

Unit-6: Technical Progress and Trade

47-56

- 6.1 Meaning of Technical Progress and Trade**
- 6.2. Neutral, Capital Saving, Labour Saving.**
- 6.3. Check your progress Questions.**
- 6.4. Answer to check your progress Questions.**
- 6.5. Summary**
- 6.6. Key words**
- 6.7. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 6.8. Further Readings.**

Unit-7: Trade Policy

57-72

- 7.1. Trade Policy: Tariff**
- 7.2. Quota**
- 7.3. Trade problems of Developing Countries.**
- 7.4. Check your progress Questions.**
- 7.5. Answer to check your progress Questions.**
- 7.6. Summary**
- 7.7. Key words**
- 7.8. Self Assessment Questions and Exercises.**
- 7.6 Short Answer Questions and Long answer Questions.**
- 7.9. Further Readings.**

BLOCK III: International Organisations

Unit-8: International Organizations – I

73-79

- 8.1. International Organizations - I: UNCTAD**
- 8.2. GATT and Tokyo Declaration.**
- 8.3. Check your progress Questions.**
- 8.4. Answer to check your progress Questions.**
- 8.5. Summary**
- 8.6. Key words**
- 8.7. Self Assessment Questions and Exercises.**
- Short Answer Questions and Long answer Questions.**
- 8.8. Further Readings.**

Unit-9: International Organizations – II

80-87

- 9.1. WTO**
- 9.2. Import Substitution and Export Promotion**
- 9.3. Its Importance**
- 9.4. Check your progress Questions.**
- 9.5. Answer to check your progress Questions.**
- 9.6. Summary**
- 9.7. Key words**
- 9.8. Self Assessment Questions and Exercises.**
Short Answer Questions and Long answer Questions.
- 9.9. Further Readings.**

Unit-10: Economic Orders

88-93

- 10.1. North South Dialogue and New International Economic Order**
- 10.2. Usefulness**
- 10.3. Check your progress Questions.**
- 10.4. Answer to check your progress Questions.**
- 10.5. Summary**
- 10.6. Key words**
- 10.7. Self Assessment Questions and Exercises.**
Short Answer Questions and Long answer Questions.
- 10.8. Further Readings.**

**BLOCK IV: Balance of Payments, Trade and Export
Assistance**

Unit-11: Balance of Payments (BoP) 94-108

- 11.1. Meaning**
- 11.2. Structure**
- 11.3. Importance of Balance of Payments**
- 11.4. Check your progress Questions.**
- 11.5. Answer to check your progress Questions.**
- 11.6. Summary**
- 11.7. Key words**
- 11.8. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 11.9. Further Readings.**

Unit-12: Balance of Trade (BoT) 109-118

- 12.1. Meaning**
- 12.2. Disequilibrium in BoP & BoT**
- 12.3. Causes for Disequilibrium in BoP**
- 12.4. Check your progress Questions.**
- 12.5. Answer to check your progress Questions.**
- 12.6. Summary**
- 12.7. Key words**
- 12.8. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 12.9. Further Readings.**

Unit-13: Measures for Correcting Disequilibrium 119-128

- 13.1. Measures for Correcting Disequilibrium**
- 13.2. Relationship between BoP & BoT.**
- 13.3. Check your progress Questions.**
- 13.4. Answer to check your progress Questions.**
- 13.5. Summary**
- 13.6. Key words**
- 13.7. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 13.8. Further Readings.**

Unit-14: Strategies of International Business 129-144

- 14.1. International Marketing Operations**
- 14.2. Exporting, Importing and Counter Trade**
- 14.3. Export and Import Finance**
- 14.4. Export Assistance.**
- 14.5. Check your progress Questions.**
- 14.6. Answer to check your progress Questions.**
- 14.7. Summary**
- 14.8. Key words**
- 14.9. Self Assessment Questions and Exercises.
Short Answer Questions and Long answer Questions.**
- 14.10. Further Readings.**

BLOCK I: INTRODUCTION TO FOREIGN TRADE

Foreign trade

Notes

UNIT-1: FOREIGN TRADE

Structure:

- 1.1. Foreign Trade: Need
- 1.2. Meaning
- 1.3. Nature
- 1.4. Inter Regional and International Trade.
- 1.5. Check your progress Questions.
- 1.6. Answer to check your progress Questions.
- 1.7. Summary
- 1.8. Key words
- 1.9. Self Assessment Questions and Exercises. Short Answer Questions
and Long answer Questions.
- 1.10. Further Readings.

1.1. Foreign Trade: Need

International Economics is a specialized branch of Economics focusing on the external trading relations of nations. Generally external trade involves the exchange of goods and services among nations crossing the national territories. Trade not only strengthens the economic interdependence among nations but promotes consumer welfare also by providing a variety of commodities. Since it involves several countries a different set of rules and regulations are necessary for the smooth functioning of the system. This is why international economics is treated as a separate branch of study.

What is International Economics?

International economics is a field of study which assesses the implications of international trade in goods and services and international investment.

There are two broad sub-fields within international economics: international trade and international finance.

International trade is a field in economics that applies microeconomic models to help understand the international economy. Its content includes the same tools that are introduced in microeconomics courses, including supply and demand analysis, firm and consumer behavior, perfectly competitive, oligopolistic and monopolistic market

structures, and the effects of market distortions. The typical course describes economic relationships between consumers, firms, factor owners, and the government.

The objective of an international trade course is to understand the effects on individuals and businesses because of international trade itself, because of changes in trade policies and due to changes in other economic conditions. The course will develop arguments that support a free trade policy as well as arguments that support various types of protectionist policies. By the end of the course, students should better understand the centuries-old controversy between free trade and protectionism.

International finance applies macroeconomic models to help understand the international economy. Its focus is on the interrelationships between aggregate economic variables such as GDP, unemployment rates, inflation rates, trade balances, exchange rates, interest rates, etc. This field expands macroeconomics to include international exchanges. Its focus is on the significance of trade imbalances, the determinants of exchange rates and the aggregate effects of government monetary and fiscal policies. Among the most important issues addressed are the pros and cons of fixed versus floating exchange rate systems.

Broadly the subject matter in International Economics can be categorized into five broad groups.

1.2. Meaning

International Trade Theory

It concentrates on the theoretical aspects of trade like reasons of trade, gains of trade etc. Different schools of theories are discussed in this section.

International Trade Policy

This area deals with the international rules and regulations regarding the flow of transactions. It includes various trade restrictions like tariffs, quotas, changes in exchange rates etc. The regulatory mechanisms and various international institutions for monitoring it are also come under this section.

Balance of Payment

With the progress of trade, nations have to make and receive payments. All these economic transactions of a nation with the rest of the world are systematically recorded in this account. The fluctuations in BOP and the associated policy regulations are also included in this section.

1.3. Nature

Foreign trade

MERCANTILISM

The trade theory that states that nations should accumulate financial wealth, usually in the form of gold, by encouraging exports and discouraging imports is called mercantilism. Rather than a full fledged trade theory it was actually an economic policy of wealth accumulation. According to this theory other measures of countries' well being, such as living standards or human development, are irrelevant. They simply focused on the accumulation of gold. Mainly Great Britain, France, the Netherlands, Portugal and Spain used mercantilism during the 1500s to the late 1700s. Mercantilism proposed that a country should try to export more than its imports, in order to receive gold. For this they advocated strict controls on trade in the form of tariffs and quotas. Mercantilist countries practiced the zero-sum game, which meant that world wealth was limited and that countries could increase their share only at the expense of other countries. This protectionist policy decelerated the long term growth.

Notes

1.4. Inter Regional and International Trade

Theories of International Trade Introduction

International trade theories postulate different aspects of trading practices like basis for trade (reasons for trade), terms of trade (exchange ratio between products), and the gains from trade. It also helps to predict the size, content and direction of trade flows. Depending on the differences of arguments various economists put forward different models of trade pattern. The three phases of the trade theories are pre classical, classical and modern schools. Mercantilism represents the pre classical version. Adam Smith, David Ricardo and John Stuart Mill are associated with the classical theory. The modern version is linked with two Swedish economists Eli Heckscher and Bertil Ohlin.

Features

- Restrictive trade aiming at the acceleration of exports and reduction of imports
- Strict focus on the wealth accumulation than welfare promotion
- No simultaneous gains or sharing of gains among countries are possible. One country can benefit only at the cost of other countries
- Adoption of trade protectionism
- Owing to these unrealistic practices it faded in the following era. Later by the publication of “Wealth of Nations” by Adam Smith this doctrine completely lost its relevance. But in recent times it is slowly emerging with slight variations. Neo mercantilism is the modern version of mercantilist practices, through the formation of local trading blocks and promotion of

trade with imposition of tariffs and quotas.

Foreign trade

Balance of Payment Adjustments or Open Economy Macro economics. With the progress of transactions, sometimes either the credit or the debit may outweigh the other side. It will lead to imbalances in BOP. This situation is normally coined BOP disequilibrium which demands correction either automatically or externally imposed by the governments. The external repercussions are also brought into the study.

NOTES

International Organizations

1st fast growing economies also have a dynamic trade sector. When a firm or an individual buys a good or a service produced more cheaply abroad, living standards in both countries increase. There are other reasons consumers and firms buy abroad that also make them better off—the product may better fit their needs than similar domestic offerings or it may not be available domestically. In any case, the foreign producer also benefits by making more sales than it could selling solely in its own market and by earning foreign exchange (currency) that can be used by itself or others in the country to purchase foreign-made products. The gains(importance) of trade is generally reflected in the following manner.

Acquisition of Capital Goods Industries: The under-developed countries (UDCs) are enabled by foreign trade to obtain in exchange for their goods capital equipment and heavy engineering machines to foster their countries' economic development. For example, India exports spices, cotton and cotton textiles, marine products, germs and jewellery and in exchange we import heavy machinery, defence equipments, and other capital equipment from the developed countries.

Market Extension The foreign trade can extend the scope of the business to the international market. The domestic market is limited; the foreign trade sector opens new vistas, new marketing channels and new markets. When the markets are extended, the economies of scale are reaped; the efficiency and productivity will increase. Accordingly, the forces of development will set themselves in motion.

Foreign Investment: The foreign trade is also helpful in attracting foreign investment. The foreign investors are attracted towards active trading countries and invest in the form of capital goods and technical expertise. In this way, the assembling plants, the manufacturing plants and the latest technology will come into the country. Foreign Direct Investments and off shoring will stimulate the economic climate of a nation.

National Income: When there is imports and exports of goods and services, the government can earn the revenue in form of tariffs, custom duty, import license fees, etc.

Employment Opportunities: Moreover, the external sector also opens the employment opportunities for the country-men in the foreign countries. Hundreds of thousands of Indians are working abroad. India is

earning billions of dollars through foreign exchange remittances and stands in the second position just behind China. Therefore, such remittances are proved to be a major source of foreign exchange earnings.

Foreign trade

1.5. Check your progress Questions.

Notes

Check your Progress-1

Note: a).Write your answer in the space given

below

b)Compare your answer with those given at the end of the unit

1..What is Foreign trade?

Check your Progress-2

Note: a).Write your answer in the space given

below

b)Compare your answer with those given at the end of the unit

1..State the Trade theory?

1.6. Answer to check your progress Questions.

1. International trade is a field in economics that applies microeconomic models to help understand the international economy. Its content includes the same tools that are introduced in microeconomics courses, including supply and demand analysis, firm and consumer behavior, perfectly competitive, oligopolistic and monopolistic market structures, and the effects of market distortions. The typical course describes economic relationships between consumers, firms, factor owners, and the government.
2. The trade theory that states that nations should accumulate financial wealth, usually in the form of gold, by encouraging exports and discouraging imports is called mercantilism. Rather than a full fledged trade theory it was actually an economic policy of wealth accumulation. According to this theory other measures of countries' well being, such as living standards or human development, are irrelevant.

1.7. Summary

In this unit you have learnt about the Meaning, Definition nature of Foreign Trade. This knowledge would make your understand what is Foreign Trade and it can be worked at a economic. The concept such as Intel Regional and international would have make you to distinguish these

activities from the trade activities and you might have learnt about the meaning and difference in the trade concept.

1.8. Key words

Foreign trade, Balance of payment

1.9. Self Assessment Questions and Exercises.

Short Answer Questions

1. What is International Economics?
2. What is International Trade Policy?

Long answer Questions.

1. Describe Inter regional and International Trade.
2. Explain the International Trade.

1.10. Further Readings.

Soderston, B. and G. Reed (1999), “**International Economics**”, McMillan Press Ltd., London.

BLOCK II: THEORIES OF INTERNATIONAL TRADE

Theories of international trade

UNIT-2: THEORIES OF INTERNATIONAL TRADE

NOTES

Structure:

- 2.1. Theories of International Trade: Adam Smith – Ricardo
- 2.2. Haberler and Heckscher - Ohlin Theory
- 2.3. Check your progress Questions.
- 2.4. Answer to check your progress Questions.
- 2.5. Summary
- 2.6. Key words
- 2.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 2.8. Further Readings.

2.1. Theories of International Trade: Adam Smith – Ricardo

THEORY OF ABSOLUTE ADVANTAGE: ADAM SMITH

The Scottish economist Adam Smith developed the trade theory of absolute advantage in 1776 through his legendary book “An Enquiry into the Nature and Causes of Wealth of Nations”. He developed the theory as an attack against the then prevailing mercantilist view of restrictive trade with the slogan ‘free trade’. Smith's argument was that the wealth of nations depends upon the goods and services available to their citizens, rather than the gold reserves held by the nation. Maximizing this availability depends primarily on fuller utilization of resources and then, on the ability to obtain goods and services from where they are produced most cheaply (because of “natural” or “acquired” advantages), and to pay for them by production of the goods and services produced most cheaply in the country. Human skill up gradation, division of labour and specialization and the economies of scale are the sources of acquired advantage for cheaper production. Natural advantages may emerge out of natural factors.

As the name indicates this theory proposes that a country should engage in the production and exchange of those commodities where it has an absolute advantage. Such a country produces greater output of a good or service than other countries using the same amount of resources. Absolute advantage is defined as the ability to produce more of a good or service than competitors, using the same amount of resources. Smith stated that tariffs and quotas should not restrict international trade; it should be allowed to flow according to market forces. Contrary to mercantilism Smith argued that a country should concentrate

on production of goods in which it holds an absolute advantage. No country would then need to produce all the goods it consumed. The theory of absolute advantage destroys the mercantilist idea that international trade is a zero-sum game. According to the absolute advantage theory, international trade is a positive-sum game, because there are gains for both countries to an exchange.

Assumptions

There are two countries and two commodities

- One country has absolute advantage in one commodity and the second country has advantage in another commodity
- Technology is assumed to be constant
- Labour is the only factor of production
- labour is homogeneous, that means each unit of labour produces same level of output value of a commodity is measured in terms of its labour content
- There is no technological improvement
- Labour is perfectly mobile within the country but perfectly immobile between the countries. It means that workers are free to move between industries within the nation but migration to other countries is impossible.
- A system of barter prevails
- Zero transportation cost

Based on these assumptions the theory can be explained with an example. Suppose there are two countries- India and Cuba producing tea and sugar. By employing a worker for one hour India can produce either 10kilograms of tea or 5 kilograms of sugar. Similarly if a Cuban worker is employed she is capable of producing 10 kilograms of sugar or 5 kilograms of tea.

Table 1: Output per hour (kg)

Country	Sugar	Tea
India	5	10
Cuba	10	5

From the table it is clear that by spending an hour's labour India is capable of producing twofold of tea than Cuba similarly in the case of sugar Cuba is able to generate double the production in India. In short Cuba has absolute advantage in sugar and India in tea. In this situation by concentrating on the respective absolute advantageous areas both nations can benefit by fully channelizing their resources to absolutely advantageous commodity.

Since there is perfect factor mobility within a country, India can channelize labourers into tea sector and Cuba into sugar industry. If India transfer one labour from sugar to tea sector sugar production may fall by 5 kilograms but can produce 10 more kilograms of tea. By exchanging this one unit effort India is capable of purchasing 10 kilograms of sugar from Cuba. So it is beneficial for India. If India goes for domestic exchange, due to the increased cost it will not benefit India. The same is true for Cuba in the case of sugar.

NOTES

There is a potential problem with absolute advantage. If there is one country that does not have an absolute advantage in the production of any product, will there still be benefit to trade, and will trade even occur? The answer may be found in the extension of absolute advantage, the theory of comparative advantage..

COMPARATIVE ADVANTAGE: DAVID RICARDO

NOTES

The most basic concept in the whole of international trade theory is the principle of comparative advantage, first introduced by David Ricardo in 1817. It remains a major influence on much international trade policy and is therefore important in understanding the modern global economy. Comparative advantage is the ability of a firm or individual to produce goods and/or services at a lower opportunity cost than other firms or individuals.

A comparative advantage gives a company the ability to sell goods and services at a lower price than its competitors and realize stronger sales margins. David Ricardo stated in his theory of comparative advantage that a country should specialize in producing and exporting products in which it has a comparative advantage and it should import goods in which it has a comparative disadvantage. Out of such specialization, it will accrue greater benefit for all.

Assumptions

There are two countries and two commodities

- One country has absolute advantage in both commodities and the second country has in another commodity
- Technology is assumed to be constant
- Labour is the only factor of production labour is homogeneous, that means each unit of labour produces same level of output
- Technology is assumed to be constant value of a commodity is measured in terms of its labour content
- There is no technological improvement
- Labour is perfectly mobile within the country but perfectly immobile between the countries. It means that workers are free to move between industries within the nation but migration to other countries is impossible.
- A system of barter prevails
- Zero

transportation

cost Example:

Table 2: Output per hour (kg)

Country	Wheat	Tea
India	10	10
Burma	4	5

In this example Indian labourers are capable of producing both wheat and tea in absolute advantage. Burma is disadvantageous in both cases. But still there

is a possibility for trade. Burma has fewer disadvantages in tea than wheat. So it is its comparative advantage. If India concentrates in wheat it is capable of producing more than two fold wheat, but in tea it can produce only two fold than Burma. Although India has an absolute advantage in the production of both tea and wheat, India has a comparative advantage only in the production of wheat. This is because its advantage in wheat is comparatively greater than its advantage in tea. In this situation India can concentrate on wheat and Burma on tea and both can benefit from trade.

In this theory there are several assumptions that limit the real- world application. The assumption that countries are driven only by the maximization of production and consumption and not by issues out of concern for workers or consumers is a mistake.

2.2. Haberler and Heckscher - Ohlin Theory

Haberler's Opportunity Cost Theory

Gottfried Haberler has attempted to restate the comparative costs in terms of opportunity cost. He demonstrates that the doctrine of comparative costs can hold valid even if the labour theory of value is discarded. The theory determines the cost of producing a commodity in terms of the alternative production that has to be foregone for producing the commodity in question.

Elaborating upon the opportunity cost, Haberler writes that “the marginal cost of a given quantity X of a commodity A must be regarded as that quantity of commodity B which must be foregone in order that X, instead of (X-1) units of A can be produced. The exchange ratio on the market between A and B must equal their costs in this sense of the terms.”

The opportunity cost is what has been given up in order to have some quantity of another thing. If an additional unit of one commodity has to be produced, the productive resources are to be diverted from the production of some other commodity to the given commodity.

The resultant decrease in the quantity of the second commodity represents the opportunity cost of the additional quantity of the given commodity.

Assumptions of Haberler's Opportunity Cost Theory:

- (i) The economic system is in a state of full employment equilibrium.
- (ii) There is perfect competition in commodity and factor markets.
- (iii) Price of each commodity equals the marginal cost of producing it.
- (iv) Price of each factor equals its marginal productivity.
- (v) The supply of factors is fixed.
- (vi) The state of technology is given.

- (vii) There are two trading countries A and B.
- (viii) Each country produces two commodities, say X and Y.
- (ix) Each country has two productive factors- capital and labour.
- (x) There is perfect factor mobility within each country.
- (xi) The factors of production are perfectly immobile between the two countries.
- (xii) Neither of the two countries imposes any restrictions upon international trade.

NOTES

On the basis of the above assumptions, it is possible to determine the opportunity cost curve or the production possibility curve of any country.

The production possibility curve indicates different combinations of two commodities that a country can produce with the given factor endowments and technology. The slope of the production possibility curve is determined by the ratio of units of the commodity given up in order to have one unit of the other commodity. This ratio is termed as a marginal rate of transformation (MRT).

HECKSCHER OHLIN THEORY

In the early 20th century, Swedish economists Eli Heckscher and Bertil Ohlin identified the role of labor and capital, so-called factor endowments, as a determinant of advantage. In 1979 Ohlin was awarded Nobel Prize jointly with James Meade for his work in international trade theory. The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production uses intensively the factor of production that is relatively abundant in the country. Countries well-endowed with capital—such as factories and machinery—should export capital-intensive products, while those well-endowed with labor should export labor-intensive products. According to Bertil Ohlin, trade arises due to the differences in the relative prices of different goods in different countries. The difference in commodity price is due to the difference in factor prices (i.e. costs). Factor prices differ because endowments (i.e. capital and labour) differ in countries. Hence, trade occurs because different countries have different factor endowments.

The Heckscher Ohlin theorem states that countries which are rich in labour will export labour intensive goods and countries which are rich in capital will export capital intensive goods. Heckscher- Ohlin's theory explains the modern approach to international trade on the basis of following assumptions :-

There are two countries involved.

- Each country has two factors (labour and capital).
- Each country produce two commodities or goods (labour intensive and capital intensive).
- There is perfect competition in both commodity and factor markets.
- All production functions are homogeneous of the first degree i.e.

production function is subject to constant returns to scale.

- Factors are freely mobile within a country but immobile between countries.
- Two countries differ in factor supply.
- Each commodity differs in factor intensity.
- The production function remains the same in different countries for the same commodity. For e.g. If commodity A requires more capital in one country then same is the case in other country.
- There is full employment of resources in both countries and demands are identical in both countries.
- Trade is free i.e. there are no trade restrictions in the form of tariffs or non-tariff barriers.
- There are no transportation costs.

Given these assumption, Ohlin's thesis contends that a country export goods which use relatively a greater proportion of its abundant and cheap factor. While same country imports goods whose production requires the intensive use of the nation's relatively scarce and expensive factor.

Understanding the Concept of Factor Abundance

In the two countries, two commodities & two factor model, implies that the capital rich country will export capital intensive commodity and the labour rich country will export labour intensive commodity. But the concept of country being rich in one factor or other is not very clear. Economists quite often define factor abundance in terms of factor prices. Ohlin himself has followed this approach. Alternatively factor abundance can be defined in physical terms. In this case, physical amounts of capital and Labour are to be compared. Price Criterion for defining Factor Abundance

A country where capital is relatively cheaper and labour is relatively costly is said to be capital rich country. Whereas a country where labour is relatively cheaper and capital is relatively costly is said to be labour rich country.

Explaining Heckscher Ohlin's H-O Theory

Let us take an example of same two countries viz; England and India where England is a capital rich country while India is a labour abundant nation.

In the above diagram XX is the isoquant (equal product curve) for the commodity X produced in England. YY is the isoquant representing commodity Y produced in India. It is very clear that XX is relatively capital intensive while YY is relatively labour incentive. The factor capital is represented on Y-axis while the factor labour is represented on the horizontal X-axis.

PA is the price line or budget line of the country England. The price line PA is tangent to XX at E. The price line PA is also tangent to YY isoquant at K. The point K will help us to find out how much of capital and labour is required to produce one unit of Y in England.

P1B is the price line of the country India, The price line P1B is tangent to YY at I. The price line RS which is drawn parallel to P1B is tangent to XX at M. This will help us to find out how much of capital and labour is required to produce one unit of commodity X in India.

Under the given situations, the country England will choose the combination E. Which means more specialisation on capital goods. It will not choose the combination K because it is more labour intensive and less capital intensive.

Thus according to Ohlin, England will specialise on production of goods X by using the cheap factor capital extensively while India specialises on commodity Y by using the cheap factor labour available in the country.

The Ohlin's theory concludes that :-

- The basis of internal trade is the difference in commodity prices in the two countries.
- Differences in the commodity prices are due to cost differences which are the results of differences in factor endowments in two countries.
- A capital rich country specialises in capital intensive goods & exports them. While a Labour abundant country specialises in labour intensive goods & exports them.

Limitations of Heckscher Ohlin's H-O Theory:

Heckscher Ohlin's Theory has been criticised on basis of following grounds :-

Unrealistic Assumptions :

Besides the usual assumptions of two countries, two commodities, no transport cost, etc. Ohlin's theory also assumes no qualitative difference in factors of production, identical production function, constant return to scale, etc. All these assumptions makes the theory unrealistic one.

Restrictive :

Ohlin's theory is not free from constrains. His theory includes only two commodities, two countries and two factors. Thus it is a restrictive one.

One-Sided Theory:

According to Ohlin's theory, supply plays a significant role than demand in determining factor prices. But if demand forces are more significant, a capital abundant country will export labour intensive good as the price of capital will be high due to high demand for capital.

Static in Nature:

Like Ricardian Theory the H-O Model is also static in nature. The theory is based on a given state of economy and with a given production function and does not accept any change.

Wijnholds's Criticism :

According to Wijnholds, it is not the factor prices that determine the costs and commodity prices but it is commodity prices that determine the factor prices. Consumers' Demand ignored: Ohlin forgot an important fact that commodity prices are also influenced by the consumers' demand.

Haberler's Criticism :

According to Haberler, Ohlin's theory is based on partial equilibrium. It fails to give a complete, comprehensive and general equilibrium analysis.

Leontief Paradox:

American economist Dr. Wassily Leontief tested H-O theory under U.S.A conditions. He found out that U.S.A exports labour intensive goods and

NOTES

imports capital intensive goods, but U.S.A being a capital abundant country must export capital intensive goods and import labour intensive goods than to produce them at home. This situation is called Leontief Paradox which negates H-O Theory.

Other Factors Neglected:

Factor endowment is not the sole factor influencing commodity price and international trade. The H-O Theory neglects other factors like technology, technique of production, natural factors, different qualities of labour, etc., which can also influence the international trade.

There are four major components of the HO model:

- Factor Price Equalization Theorem,
- Stolper-Samuelson Theorem,
- Rybczynski Theorem, and
- Heckscher-Ohlin Trade Theorem.

Factor Price Equalization Theorem:

Among the four main results of the HO theory, FPE is the most fragile theorem. If any of the eight assumptions is violated, it will not hold. However, perhaps this is the single most important finding in trade theory; it shows how trade affects income distribution of the global economy. It states that international trade will bring about equalization in the returns to homogeneous factors across countries.

Stolper-Samuelson Theorem:

The theorem intends to show that the change in commodity prices change the distribution of real incomes between capital and labor. It states that the international trade will reduce the income of the scarce factor of production and increase the income of the abundant factor of the country. This is because when trade promotes nations will export commodities which are intensive in its abundant and cheap factor. This will earn more income to that factor. Since imports are on the scarce factor the income will flow to abroad leading to a net decline in its earnings.

Rybczynski Theorem:

It states that at constant commodity prices, an increase in the quantity of one factor increases the production of the commodity intensive in this factor and reduces the output of the other commodity which is intensive in the constant factor. For example if labour force increase in a country and it turns to be more profitable to employ them, then naturally the country intensify the production of labour intensive commodities at the cost of capital intensive commodity.

Heckscher-Ohlin Trade Theorem:

It maintains a country will produce and export those commodities in which its abundant factor is intensively used and import those commodities in which the relatively scarce factor is immensely used.

LEONTIEF'S PARADOX

In 1953, Wassily Leontief published a study named, "Domestic

production and foreign trade: the American capital position re-examined" where he tested the validity of the Heckscher-Ohlin theory. Using data available from the 1947 input-output (I-O) model of the US economy, Leontief calculated the K and L requirements for the production of \$1 million of US exports and \$1 million of US production in import-competing industries. He found that the former required a higher proportion of L than the latter. The study showed that the U.S. was more abundant in capital compared to other countries; therefore the U.S. would export capital-intensive goods and import labour-intensive goods. Leontief found out that the U.S.'s export was less capital intensive than import. Heckscher-Ohlin's theory of factor endowments stressed that a country should produce and export goods that require resources (factors) that are abundant in the home country. Leontief tested the Heckscher-Ohlin theory in the U.S. and found that it was not applicable in the U.S.

Possible explanations of the Leontief paradox

US demand for K-intensive products outstripped its capacity to provide them domestically. So there was no other alternative than imports.

"Factor-intensity reversal" — Leontief had no idea of the input mix for manufacturing in other countries; he measured the K-intensity of US production in import-competing industries, not of US imports. If L is expensive in the US, then US industries facing import competition would have to reduce their use of L, by substituting K. However, this would mean that production functions (i.e., input mix; technology) vary for the same products in different places, which renders the Heckscher-Ohlin theorem nearly useless.

Perhaps international trade flows were not rationalized according to comparative advantage in 1947, immediately after the destruction and disruption of World War 2. After all, comparative advantage is a normative concept. 4. The US imported natural-resource commodities whose extraction is K-intensive, but in which other nations have an absolute advantage.

"Human-skills theory" — L is a heterogeneous factor, and should be analyzed as separate factors according to skills levels. Perhaps the US is actually skilled- and technical-L rich, and therefore has a comparative advantage in production that requires much skilled or technical L. H-O formulations should be expanded to allow for more than one L factor. [Difficult to test, but can be added to the H-O theorem]. Related to this is the recognition of international differences in factor productivity. US labor is more productive than the labor of most countries (because of skills, work organization, capital/worker, and technology), and is paid more per hour; this helps explain why US labor looms larger as a cost in US exports.

Technology itself is a nation-specific factor of production, rather than being a universal attribute of production. Furthermore, technology is a factor that is produced within a given nation (much like a commodity), but is not perfectly mobile or tradable. This kind of thinking has led to "neo-technology theories of trade".

The US Government and private companies lent (or otherwise invested) so much capital in particular sectors of particular foreign economies, that these enclaves became, essentially, capital-rich.

2.3. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What are the four main components of HO model?

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is Foreign trade?

2.4. Answer to check your progress Questions.

1. The four main components of HO model

- Factor Price Equalization Theorem,
- Stolper-Samuelson Theorem,
- Rybczynski Theorem, and
- Heckscher-Ohlin Trade Theorem.

2. The opportunity cost is what has been given up in order to have some quantity of another thing. If an additional unit of one commodity has to be produced, the productive resources are to be diverted from the production of some other commodity to the given commodity.

The resultant decrease in the quantity of the second commodity represents the opportunity cost of the additional quantity of the given commodity.

2.5. Summary

In this unit you have learnt about the meaning of International Trade. This knowledge would make you understand what is International Trade and it can be worked at a economy. The concept such as Adam Smith and Ohilin theory would have make you to distinguish these activities from the trade activities and you might have learnt about the meaning and difference in the trade concept.

2.6. Key words

Absolute advantage, Opportunity cost

2.7. Self Assessment Questions and Exercises.

*Theories of international
trade*

Short Answer Questions

1. Mention any two Limitations of Heckscher Ohlin's H-O Theory:
2. What is comparative Advantage?

Long answer Questions.

1. Explain the Haberler and Heckscher - Ohlin Theory?
2. Describe the Adam Smith – Ricardo's International trade theory?

NOTES

2.8. Further Readings.

Carbaugh, R. J. (2008), “**International Economics**”, Thomson South Western, New Delhi

UNIT-3: TERMS OF TRADE

Structure:

- 3.1. Concepts of Terms of Trade
- 3.2. Determinants of Terms of Trade
- 3.3. Static and Dynamic Gains from Trade
- 3.4. Terms of Trade between Agriculture and Industry
- 3.5. Check your progress Questions.
- 3.6. Answer to check your progress Questions.
- 3.7. Summary
- 3.8. Key words
- 3.9. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 3.10. Further Readings.

3.1. Concepts of Terms of Trade

It is the ratio of export prices to import prices of the country. It is a measure of the exchange of exports and imports or how much a nation can import in terms of its exports. If export prices exceed the import prices it will be favorable to the home country and vice versa. It can be stated as:

Terms of Trade = Export prices/ Import prices = P_x/P_m

Net barter Terms of Trade (N)

This is the ratio of price index of exports to the price index of imports

$$N = P_x/P_m \times 100$$

Gross Barter Terms of Trade (G)

It is the ratio of quantity of imports to quantity of exports $G = Q_m/Q_x \times 100$

Income Terms of Trade (I)

It is the product of net barter terms of trade and the quantity of exports. It is a yardstick of a country's capability to import based on its export earnings.

$$I = P_x/P_m \times Q_x$$

Net Barter Terms of Trade:

The most widely used concept of the terms of trade is what has been named the net barter terms of trade which refers to the relation between prices of exports and prices of imports. **In symbolic terms:**

$$T_n = P_x/P_m$$

Where T_n stands for net barter terms of trade.

P_x stands for price of exports (x),

P_m stands for price of imports (m).

When we want to know the changes in net barter terms of trade over a period of time, we prepare the price index numbers of exports and imports by choosing a certain appropriate base year and obtain the following ratio:

$$P_{x1}/P_{m1} : P_{x0}/P_{m0}$$

Gross Barter Terms of Trade:

This concept of the gross terms of trade was introduced by F.W. Taussig and in his view this is an improvement over the concept of net barter terms of trade as it directly takes into account the volume of trade. Accordingly, the gross barter terms of trade refer to the relation of the volume of imports to the volume of exports. Thus,

$$T_g = Q_m/Q_x$$

Where

T_g = gross barter terms of trade, Q_m = quantity of imports

Q_x = quantity of exports

Income Terms of Trade:

In order to improve upon the net barter terms of trade G.S. Dorrance developed the concept of income terms of trade which is obtained by weighting net barter terms of trade by the volume of exports. Income terms of trade therefore refer to the index of the value of exports divided by the price of imports. Symbolically, income terms of trade can be written as

$$T_y = P_x.Q_x/P_m$$

Where

T_y = Income terms of trade

P_x = Price of exports

Q_x = Volume of exports

P_m = Price of imports

Income terms of trade yields a better index of the capacity to import of a country and is, indeed, sometimes called 'capacity to import. This is because in the long run balance of payments must be in equilibrium the value of exports would be equal to the value of imports.

3.2. Determinants of Terms of Trade

The terms of trade which is ultimately decided upon by the two trading farmers will depend on a variety of different and distinct factors. Below we

describe many of these factors.

Preferences

In order for any trade to occur, each farmer must desire some of the other commodity and be willing to give up some of his own good in order to obtain it. In other words, the expected utility of consuming some quantity of oranges by Farmer Jones must be greater than the expected disutility of not consuming some quantity of apples. It seems reasonable in this case that each farmer would prefer to consume a variety of goods, and thus the incentive to trade exists. However, how many oranges will be exchanged for how many apples will still depend on a many other things.

Uncertainty

In this situation each farmer is unlikely to have well-defined preferences. Farmer Smith may never have tasted an apple and Farmer Jones may never have tasted an orange. One simple way to resolve this uncertainty is for the farmers to offer free samples of their products before an exchange is agreed upon. Without a sample, the farmers would have to base their exchanges on their expectations of how they will enjoy the other product. Free samples, on the other hand, can be risky. Suppose a sample of oranges is provided and Farmer Jones learns that he hates the taste of oranges. He might then decide not to trade at all.

Scarcity

The relative quantities of the two goods available for trade will affect the terms of trade. If Farmer Smith came to the market with 100 oranges to Farmer Jones' 10 apples, then the terms of trade would likely be different than if the farmers come to the market with an equal number. Similarly, if the farmers come to the market with 10 oranges and apples respectively, but recognize that they have an entire orchard of apples and an entire grove of oranges waiting back at home, then the farmers are more likely to give up a larger amount of their product in exchange.

Size

The size of the apples and oranges are likely to influence the terms of trade. One would certainly expect that Farmer Smith would get more apples for each orange if the oranges were the size of grapefruits and the apples the size of golf balls than if the reverse were true.

Quality

The quality of the fruits will influence the terms of trade. Suppose the apples are sweet and the oranges are sour. Suppose the apples are filled with worm holes. Suppose the oranges are green rather than orange. What is the vitamin, mineral, and calorie contents of each of the fruits? Quality could also be assessed by noting the number of uses for each product. For example, apples can be eaten raw, turned into applesauce, squeezed into juice, made into pies and covered with caramel.

Effort

Although a pure exchange model assumes that no production takes place, imagine momentarily that some effort is required to harvest the fruit. What if apples grew at the top of tall trees that required a precarious climb? What if predatory wolves lived in the orange grove? Surely these farmers would want to

take these factors into account when deciding the terms for exchange.

Persuasion

The art of persuasion can play an important role in determining the terms of trade. Each farmer has an incentive to embellish the quality and goodness of his product, while diminishing the perception of quality of the other product. Farmer Smith might emphasize the high quantities of Vitamin C found in oranges, while noting that apples are relatively vitamin deficient. He might argue that oranges are consumed by beautiful movie stars who drive fast cars, while apples are the food of peasants. He might also under-emphasize his own desire for apples. The more persuasive Farmer Smith, the more likely he is to get a better deal in exchange. Note that the farmer's statements need not be truthful as long as the other farmer is uncertain about the quality of the other product. In this case, differences in the persuasive abilities of the two farmers can affect the final terms of trade.

Expectations of Future Relationship

If the farmers expect that the current transaction will not be repeated in the future then there is a potential for the farmers to misrepresent their product to the other. Persuasion may take the form of outright lies if the farmers do not expect to meet again. However, if the transaction is hoped to be the first of many to come, then untruthful embellishments will be less likely.

Government Policies

If a taxman stands ready to collect a tax based on the amounts traded between the two farmers, this is likely to affect the terms of trade. Also if laws forbid someone to misrepresent their product to another or face penalties, then this will also affect the farmer's behavior in determining the terms of trade.

Morality

Imagine that Farmer Smith was raised to always tell the truth while Farmer Jones missed those lessons during his upbringing. In this case Farmer Jones might be more likely to misrepresent his apples and extract a more favorable terms of trade.

Coercion

Finally, the terms of trade can also be affected by coercion. If Farmer Jones threatens Farmer Smith with bodily injury, he might be able to force an exchange that Farmer Smith would never agree to voluntarily. At the extreme, he could demand all of Farmer Smith's oranges and not give up any apples in exchange.

Production and Consumption Efficiency Gains from Free Trade

The aggregate welfare gains from free trade can generally be decomposed into the production efficiency gains and consumption efficiency gains. However since production cannot shift in either country when moving to free trade, there are no production efficiency gains in the immobile factor model.

3.3. Static and Dynamic Gains from Trade

Static and Dynamic Gains from Trade

Gains from trade are commonly described as resulting from: specialization in production from division of labor, economies of scale, scope,

Terms of trade

NOTES

and agglomeration and relative availability of factor resources in types of output by farms, businesses, location and economies resulting increase in total output possibilities trade through markets from sale of one type of output for other, more highly valued goods.

NOTES

Market incentives, such as reflected in prices of outputs and inputs, are theorized to attract factors of production, including labor, into activities according to comparative advantage, that is, for which they each have a low opportunity cost. The factor owners then use their increased income from such specialization to buy more-valued goods of which they would otherwise be high-cost producers, hence their gains from trade. The concept may be applied to an entire economy for the alternatives of autarky (no trade) or trade. A measure of total gains from trade is the sum of consumer surplus and producer profits or, more roughly, the increased output from specialization in production with resulting trade.[8] Gains from trade may also refer to net benefits to a country from lowering barriers to trade such as tariffs on imports.

David Ricardo in 1817 first clearly stated and proved the principle of comparative advantage,[10] termed a "fundamental analytical explanation" for the source of gains from trade.[11] But from publication of Adam Smith's *The Wealth of Nations* in 1776, it was widely argued, that, with competition and absent market distortions, such gains are positive in moving toward free trade and away from autarky or prohibitively high import tariffs. Rigorous early contemporary statements of the conditions under which this proposition holds are found in Samuelson in 1939 and 1962.[12] For the analytically tractable general case of Arrow-Debreu goods, formal proofs came in 1972 for determining the condition of no losers in moving from autarky toward free trade.[13]

It does not follow that no tariffs are the best an economy could do. Rather, a large economy might be able to set taxes and subsidies to its benefit at the expense of other economies. Later results of Kemp and others showed that in an Arrow-Debreu world with a system of lump-sum compensatory mechanisms, corresponding to a customs union for a given subset set of countries (described by free trade among a group of economies and a common set of tariffs), there is a common set of world' tariffs such that no country would be worse off than in the smaller customs union. The suggestion is that if a customs union has advantages for an economy, there is a worldwide customs union that is at least as good for each country in the world.

Measurement

Classical economists maintain that there are two methods to measure the gains from trade: 1) international trade increases national income which helps us to get low priced imports; 2) gains are measured in terms of trade. To measure the gains from the trade, comparison of a country's cost of production with a foreign country's cost of production for the same product is required. However, it is very difficult to acquire the knowledge of cost of production and cost of imports in a domestic country. Therefore, terms of trade method is preferable to measure the gains from trade.

Factors affecting gains from trade

There are several factors which determine the gains from international trade:

Differences in cost ratio:

The gains from international trade depends upon the cost ratios of differences in comparative cost ratios in the two trading countries. The smaller the difference between exchange rate and cost of production the smaller the gains from trade and vice versa.

Demand and supply:

If a country has elastic demand and supply gains the gains from trade are higher than if demand and supply are inelastic.

Factor availability:

International trade is based on the specialization and a country specializes depending upon the availability of factors of production. It will increase the domestic cost ratios and thereby the gains from trade.

Size of country:

If a country is small in size it is relatively easy for them to specialize in the production of one commodity and export the surplus production to a large country and can get more gains from international trade. Whereas if a country is large in size then they have to specialize in more than one good because the excess production of only one commodity cannot be exported fully to a small sized country as the demand for good will reduce very frequently. So the smaller the size of the country, the larger the gain from trade.

Terms of Trade:

Gains from trade will depend upon the terms of trade. If the cost ratio and terms of trade are closer to each other more will be the gains from trade of the participating countries.

Productive Efficiency:

An increase in the productive efficiency of a country also determines its gains from trade as it lowers the cost of production and price of the goods. As a result, the country importing gains by importing cheap goods.

Static and dynamic gains from trade

The gains from trade can be clad into static and dynamic gains from trades. Static Gains means the increase in social welfare as a result of maximized national output due to optimum utilization of country's factor endowments or resources. Dynamic gains from trade, are those benefits which accelerate economic growth of the participating countries.

Static gains are the result of the operation of the theory of comparative cost in the field of foreign trade. On this principle countries make the optimum use of their available resources so that their national output is greater which also raises the level of social welfare in the country. When there is an introduction of foreign trade in the economy the result is called the static gains from trade.

Dynamic gains from trade relate to economic development of the economy. Specialization of the country for the production of best suited commodities which result in a large volume of quality production which promotes growth. Thus the extension of domestic market to foreign market will accelerate economic growth.

Terms of trade

NOTES

3.4. Terms of Trade between Agriculture and Industry

NOTES

The growth process is generally initiated in the agricultural sector. In the initial stages, labour and capital are transferred from the agricultural sector to the industrial sector. Under these circumstances, most of the economists believe that there is a strong possibility of the terms of trade turning in favour of agriculture as development proceeds.

There are many reasons for it. Per capita output and income will be increasing at a much more rapid pace in the industrial sector than in the agricultural sector. This will bring about relatively greater increase in the demand for agricultural products than that for the industrial products.

Relatively more rapid rate of technical progress in the industrial sector will bring about a larger increase in the supply of industrial products than in that of agricultural products. Both these developments will make agricultural products cost more in terms of the industrial products. With this change, capital flow from the agricultural sector to the industrial sector will slow down. Rate of growth of the industrial sector will then begin to fall.

There is a further possibility that capital may move from the industrial sector to the agricultural sector as marginal productivity of capital becomes higher in the agricultural sector. This is what was experienced at one time in Southern United States.

And there are various models which try to show that terms of trade will change in favour of agriculture as development proceeds. The model given by W.A. Lewis only mildly concludes as such.

This is because the model does not intensively analyse the changes taking place in the agricultural sector. Model given by Fei and Ranis and that by Jorgenson strongly bring out the fact that the terms of trade will change in favour of agriculture as the industrialization goes ahead.

Jorgenson's model is similar to that of Fei and Ranis in contents with the only difference that whereas Fei and Ranis feel that terms of trade change only after the surplus labour in the agricultural sector has been exhausted, Jorgenson is of the view that terms of trade start changing in favour of agriculture as soon as the industrialisation starts through transfer of labour and capital from the agricultural sector to the industrial sector.

When terms of trade turn against industry (i.e., in favour of agriculture), industrial development is likely to suffer. And, if there is no interference by the state, there is every likelihood that the terms of trade will turn against the industrial sectors as the development proceeds.

Many economists have therefore suggested that steps should be taken to keep the terms of trade against agriculture in the initial stages, through artificial means like price control etc. or through heavy taxes on the agricultural sector.

It may be noted, in this connection that some economists like Nasir Ahmed Khan and Okhawa are of the view that resources from agricultural sector (saving etc.) cannot be mobilised easily through taxation, borrowing or small savings. And even if these measures are successful, the yield will be quite small.

So, they emphasise that direct manipulation of agricultural and industrial prices is necessary for changing the terms of trade against agriculture. Only through such a measure, resources, from the agricultural sector will be available

for industrial development.

According to Khan, a change in the terms of trade against agriculture, will not only transfer savings to the industrial sector where these will be used for productive purposes, but will also result in more marketed surplus.

Raj Krishan however, gives only a qualified support to this suggestion. His view is that there is a critical minimum rate of growth of agricultural output which must be ensured if industrial development is to continue smoothly. Terms of trade against agriculture should be so manipulated that this critical minimum is not hit.

Mellor, however, does not agree with the above conclusions about the trend in the terms of trade between agriculture and industry vis-a-vis the development of the economy does not believe that the terms of trade will automatically change in favour of agriculture after the process of industrialisation proceeds to some extent. He feels that two important points have been ignored while arriving at the above conclusions.

Firstly, the price elasticity of demand for agricultural products is near unity in under developed countries. This will dampen the effect on prices of agricultural products when demand for agricultural products rises but, the supply of such products does not increase to the same extent.

Secondly, in the initial stages of development, the rise in income which is the major source for rise in demand for agricultural products is itself mainly the result of increase, in production in the agricultural sector. So, increase in demand for agricultural products and increase in the supply of agricultural products will go hand in hand. Agricultural prices, thus, will not rise or these will rise only marginally. Terms of trade, according to Mellor, therefore, are not likely to change in favour of agriculture, as the development proceeds.

At the theorem level, economists may, thus, differ about how the terms of trade between agriculture and industry change as the economic development gets underway. However, there has been near unanimity among planners that terms of trade have to be deliberately (if so needed), kept against agriculture in the initial stages of development. Various examples from developing economies can be cited to prove this point.

In the United Kingdom, the free trade movement culminating in the repeal of corn laws in the 19th century had the aim of reducing the relative prices of food and raw materials in relation to the prices of manufactured goods. In the U.S.S.R. collectivization of agriculture was carried out to extract from the peasantry their whole surplus output at a low price for the rapid expansion of the industrial sector.

The terms of trade were kept against agriculture, firstly, by fixing high delivery quotas which left a limited volume of products in kind for home consumption secondly, by fixing low prices for the agricultural products and thirdly, by fixing higher prices for manufactured goods. The government had to appropriate surplus in the agricultural sector at low prices to make it available to the industrial sector.

In Japan, the terms of trade in statistical terms were steady. These did not show any movement in favour of agriculture (or against it) as the industrial development proceeded. This was because unlike the U.S.S.R., Japan experienced simultaneously a rapid increase in agricultural productivity due to expanded use of chemical fertilizers, selective breeding, distribution of

improved seeds for rice, improved method of transplantation of plants and inter-culture.

However, in reality, the trade were turned against agriculture through heavy taxes. Most of the gains in agricultural productivity were siphoned off through land taxes in order to finance industrial expansion. No doubt, landlords also earned a handsome amount due to high rent but income so earned was invested by landlords in small scale industries in rural areas. The land tax provided about 70% of Government revenue during 1878-1907.

In Argentina too, the terms of trade were kept against agriculture to supply capital for rapid expansion of the non-agricultural sector. The negative price policy which was adopted in Argentina, was summed up as follows:

“During the period from 1944 to 1955, prices received by farmers were kept low and part of the foreign exchange received for exports was diverted for the benefit of industry by means of multiple exchange rates. At the same time Argentina industrialists were protected by high import duties on competing products and by a system of import licensing. These had the double effect of lowering agricultural incomes and raising farmer’s cost of production”.

In India too, the Government had followed for sometimes, a negative price policy so far as the agricultural products are concerned. Since the beginning of planning era in India terms of trade remained against agriculture till 1963. The following views expressed by F.A.O. in 1958 regarding price policies in Asian countries confirm the general nature of this trend. According to F.A.O, “In the formulation of food and agricultural price policies in the countries of the region (with the exception of Ceylon and Japan) the interests of agricultural producers have generally been relegated to second place.”

However, terms of trade cannot be kept against agriculture for long after the development process has been initiated. Terms of trade against agriculture will affect its growth adversely. Coale & Hoorer have pointed out, “If one sector limits the growth of the other, it is more likely to be the case of agricultural growth limiting non- agricultural growth than vice- versa”.

This assertion, though of a general nature, is more relevant after the process of economic development through industrialisation has gone under way.

The critical minimum rate of growth in agricultural production as suggested by Raj Krishana and according to Raj Krishana, this critical minimum rate has been quite high in various developing countries due to the following reasons:

- (1) Mortality rate in these countries has gone down considerably because of provision of improved medical facilities. This has resulted in a rapid increase in population and has thus necessitated a higher rate of growth in agricultural production.
- (2) The growing income of these countries has led to a greater increase in demand for agricultural products. Growing demand for food could, no doubt, be met by imports from outside. However, option of importing grains at low rates is not available in the present situation. Foreign assistance in terms of food grains like P.L. 480, too is on a limited scale, and
- (3) The political and social awakening in the peasantry is also persuading it to pitch its production targets at a higher level.

Under these circumstances, a situation favourable to the growth of

agricultural sector has to be created. Changing the terms of trade, favourable to agriculture is one of the desired measures to achieve this objective. It is felt that negative price policy for agriculture cannot be followed without risk.

Terms of trade

It was because of this reason that F.A.O. in 1965 pointed out that:

“It has been increasingly realised that the relative low level at which, in the interest of consumer, prices had hitherto been held in many of these (developing) countries is incompatible with the incentive needed for a steady increase in production. System of guaranteed prices for basic food crops are increasingly being adopted in developing countries, in addition to the national stabilisation schemes for export products that were already in operation in earlier years.”

NOTES

This is the reason why attempts were made by various Governments, at a later stage of economic development, to change the terms of trade in favour of agriculture by decontrolling the prices of agricultural products or by deliberately raising their support prices if such a system existed and by arranging the supply of agricultural inputs at subsidized rates. India, for example, decontrolled food prices in 1964 and set up the Agricultural Prices Commission in 1965. Subsidy on fertilizers and agricultural machinery was also introduced/raised.

In Soviet Russia, prices of agricultural commodities have been successively increased since 1953. For example, the prices of agricultural commodities were trebled, prices major grains and potatoes were raised by 8 to ten times and of meat animals by 12 to 14 times between 1952 and 1959.

Efforts were made to turn the terms of trade in favour of agriculture by reducing the delivery quotes for the state and by increasing the prices of agricultural commodities during the sixties in many East-European countries. In China, in 1963, food grain prices were 61% higher when compared with those prevailing in 1951.

Of late, minimum floor prices have been guaranteed in a number of countries in Asia, Africa, and Latin America. The above examples show that at a later stage in the development process, the terms of trade have to be changed in favour of agriculture if agriculture is not to act as a limiting factor for the development of the industrial sector.

Now a question crops up. Will not the terms of trade favourable the agriculture ultimately affect the growth of the industrial sector? The answer is in affirmative if the inter-dependence between the agricultural and industrial sector remains as strong as ever.

And, that is why it is said that it is not the agricultural sector alone in whose favour, the terms of trade have to be changed. Rather, the terms of trade, during the process of development, have to be manipulated in favour of one sector or the other from time to time according to circumstances.

3.5. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..What is Net Barter Terms of Trade?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..What are the two methods to measure the terms of trade?

3.6. Answer to check your progress Questions.

1. Net Barter Terms of Trade:

The most widely used concept of the terms of trade is what has been called the net barter terms of trade which refers to the relation between prices of exports and prices of imports. **In symbolic terms:**

$$T_n = P_x/P_m$$

Where T_n stands for net barter terms of trade.

P_x stands for price of exports (x),

P_m stands for price of imports (m).

2. Classical economists maintain that there are two methods to measure the gains from trade: 1) international trade increases national income which helps us to get low priced imports; 2) gains are measured in terms of trade.

3.7. Summary

In this unit you have learnt about the Meaning, Concept, Determination and Difference of terms of Trade. This knowledge would make you understand what is terms of Trade and how it can be functioned at a trade. The concept such Agriculture and industry would have make you to distinguish these activities and you must have learnt about the meaning and determination in the trade activities.

3.8. Key words

Commodities, Net barter trade, Static gain, dynamic gain

3.9. Self Assessment Questions and Exercises.

Short Answer Questions

1. What means Gross Barter Terms of Trade?
2. What is Income Terms of Trade:

Long answer Questions.

1. Explain the Determinants of Terms of Trade ?
 2. Describe the Terms of Trade between Agriculture and Industry?
-

3.10. Further Readings.

Krugman P. R. and M. Obsfeld (2006), “**International Economics: Theory and Policy**”, Addison Wesley, New Delhi.

Terms of trade

NOTES

UNIT-4: FREE TRADE

Structure:

- 4.1. Free Trade: Meaning
- 4.2. Case for and against Free Trade
- 4.3. Check your progress Questions.
- 4.4. Answer to check your progress Questions.
- 4.5. Summary
- 4.6. Key words
- 4.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 4.8. Further Readings.

4.1. Free Trade: Meaning

Free trade may be defined as a policy of a government which does not discriminate against imports or interfere with trade by applying tariffs (to imports) or subsidies (to exports). In other words it is the unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas. Free trade enables nations to focus on their core competitive advantages, thereby maximizing economic output and fostering income growth for their citizens. The idea that free trade is welfare enhancing is one of the most fundamental doctrines in modern economics dating back at least to Adam Smith (1776) and David Ricardo (1816). But the policy of free trade has been in controversy all the time because the countries were not taking choice between free trade and autarky (no trade). They always choose one policy from among a spectrum of free trade regimes with varying degrees of liberalization. Here are some arguments which are placed in favour of the free trade regime.

4.2. Case for and against Free Trade

Arguments in favor of Free Trade**1. The theory of comparative advantage**

This explains that by specializing and trading goods in which countries have a lower opportunity cost or greater comparative advantage, there can be an increase in economic welfare for all countries. Free trade enables countries to specialize in those goods where they have a comparative advantage. Free trade in lines of comparative advantage is expected to mutually benefit the countries engaged in free trade.

2. Trade as a vent for surplus.

Trade is identified as a vent for surplus output of an economy. The

dictum is related to Adam Smith who identified the importance of division of labour. Smith also maintained that the division of labour is limited by the size of the market. Hence division of labour is expected to raise the domestic production. A deficiency in Aggregate demand may reduce the domestic prices. Here trade can act as a vent for surplus production brought forth through technology and division of labour. Free trade is expected to smoothen this process.

Free trade

NOTES

3.Reducing Tariff barriers leads to trade creation

Trade creation occurs when consumption switches from high cost producers to low cost producers. Reducing the tariff barriers with an objective to bring about free trade in an economy may help countries for trade creation. The following diagram explains the above idea. The removal of tariffs leads to lower prices for consumers and an increase in consumer surplus of areas 1 + 2 + 3 + 4

Imports will increase from Q3-Q2 to Q4-Q1

The government will lose tax revenue of area 3

Domestic firms producing this good will sell less and lose producer surplus equal to area 1

However overall there will be an increase in economic welfare of 2+4 (1+2+3+4 – (1+3))

The magnitude of this increase depends upon the elasticity of supply and demand. If demand elastic consumers will have a big increase in welfare

1.Economies of Scale.

If countries can specialize in certain goods they can benefit from economies of scale and lower average costs. Economies of scale refer to the capacity of firms to change their output more than proportionately to changes in inputs. This is especially true in industries with high fixed costs or that require high levels of investment. The benefits of economies of scale will ultimately lead to lower prices for consumers. Lowering of trade restrictions enhances this outcome.

2.Increased Competition.

With more trade domestic firms will face more competition from abroad. As a result of this there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.

1. Trade is an engine of growth.

World trade has increased by an average of 7% since the 1945, causing this to be one of the big contributors to economic growth.

2. Make use of surplus raw materials

Middle Eastern countries such as Qatar are very rich in reserves of oil but without trade there would be not much benefit in having so much oil. Japan on the other hand has very few raw material without trade it would be very poor.

3. Tariffs encourage inefficiency

If an economy protects its domestic industry by increasing tariffs

Free trade

industries may not have any incentives to cut costs. Trade liberalization is often justified in terms of the efficient market outcome and efficient price fixation through a competitive price fixing mechanism.

NOTES

Arguments against Free Trade

Infant Industry Argument: Governments are sometimes urged to support the development of infant industries, protecting home industries in their early stages, usually through subsidies or tariffs. Subsidies may be indirect, as in when import duties are imposed or some prohibition against the import of a raw or finished material is imposed. If developing countries have industries that are relatively new, then at the moment these industries would struggle against international competition. However if they invested in the industry then in the future they may be able to gain Comparative Advantage. **The Senile industry argument:** If industries are declining and inefficient they may require large investment to make them efficient again. Protection for these industries would act as an incentive to for firms to invest and reinvent themselves. However protectionism could also be an excuse for protecting inefficient firms

To diversify the economy: Many developing countries rely on producing primary products in which they currently have a comparative advantage. However relying on agricultural products has several disadvantages. One of the most important determinants of Agricultural Prices is the environmental factors. Hence they can fluctuate with climatic changes. Agricultural commodities have a low income and price elasticity of demand. Therefore with proportionate rise in economic growth will lead to less than proportionate rise in demand. Agricultural commodities have relatively low price elasticity of supply. A proportionate rise in prices will lead to less than proportionate rise in supply of agricultural commodities. This is because of the time lag involved in the production of agricultural goods. This is given by the fact that the production of agricultural goods at time t is determined by the prices prevailing in time ' $t-1$ '.

Raise revenue for the government: Import taxes and tariffs can be used to raise money for the government.

4.3. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is the theory of comparative advantage?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What means the economic scale?

Free trade

NOTES

4.4. Answer to check your progress Questions.

1. This explains that by specializing and trading goods in which countries have a lower opportunity cost or greater comparative advantage, there can be an increase in economic welfare for all countries. Free trade enables countries to specialize in those goods where they have a comparative advantage. Free trade in lines of comparative advantage is expected to mutually benefit the countries engaged in free trade.

2. Economies of scale refer to the capacity of firms to change their output more than proportionately to changes in inputs. This is especially true in industries with high fixed costs or that require high levels of investment. The benefits of economies of scale will ultimately lead to lower prices for consumers. Lowering of trade restrictions enhances this outcome.

4.5. Summary

In this unit you have learnt about the meaning of free Trade. This knowledge would make you understand what is terms of free Trade and how it can be functioned at a trade. The concept such case against would have make you to distinguish these activities from the trade activities and you must have learnt about the meaning and determination in the trade activities.

4.6. Key words

Tariff barriers, Economies of Scale

4.7. Self Assessment Questions and Exercises.

Short Answer Questions

1. What means the free trade?
2. What means the economic scale?

Long answer Questions.

1. Explain the free trade and Case for and against Free Trade?
2. Describe Arguments in favor of Free Trade and Arguments against Free Trade.

Free trade

NOTES

4.8. Further Readings.

Soderston, B. and G. Reed (1999), **“International Economics”**,
McMillan Press Ltd., London.

UNIT-5: PROTECTION

Protection

Structure:

NOTES

- 5.1. Protection: Meaning
- 5.2. Arguments for and Against Protection
- 5.3. The Effect of Growth on Trade.
- 5.4. Check your progress Questions.
- 5.5. Answer to check your progress Questions.
- 5.6. Summary
- 5.7. Key words
- 5.8. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 5.9. Further Readings.

5.1. Protection: Meaning

Trade protectionism is defined as a nation, or sometimes a group of nations working in conjunction as a trade bloc, creating trade barriers with the specific goal of protecting its economy from the possible perils of international trading. This is the opposite of free trade in which a government allows its citizenry to purchase goods and services from other countries or to sell their goods and services to other markets without any governmental restrictions, interference, or hinderances. The objective of trade protectionism is to protect a nation's vital economic interests such as its key industries, commodities, and employment of workers. Free trade, however, encourages a higher level of domestic consumption of goods and a more efficient use of resources, whether natural, human, or economic. Free trade also seeks to stimulate economic growth and wealth creation within a nation's borders.

5.2. Arguments for and Against Protection

Arguments for Protection:

The economists at different times put forward different arguments to justify the policy of protection. Some of the arguments are, however, proved to be fallacious and so cannot be accepted. There are some other arguments which prove to be good and so these are widely accepted.

We may discuss both types of arguments for protection:

1. Infant Industries:

Many developing countries, like India, Pakistan, Sri Lanka and Bangladesh have the conditions necessary to compete successfully in the

international market, but they lack experience and expertise which take time to acquire.

NOTES

The infant industry argument suggests that new industries should be given temporary protection in order to enable them to build up this experience. This argument applies where the industry is small and young, and where costs are high but fall as the industry grows.

According to this argument, there are some industries in which a country would really have comparative advantages if and only if it could get them started. If faced with foreign competition, such infant (young and growing) industries would not be able to pass the initial period of experiment and financial stresses.

But given protection for a short period, they can be expected to develop economies of mass production and they would ultimately be able to face foreign competition without protection. So, at the infant stage such industries should be protected for a period till they can face competition independently.

The central idea of this argument is embodied in the saying- 'Nurse the baby, protect the child, and free the adult'. This argument is now widely accepted in India as a good ground of protection for a temporary period for promoting home industries at the early stages.

Critics, however, argue that most infant industries never grow up- that they continue to demand protection; so their customers continue to pay high prices. Once protection is given to such industries, it is a practice (mainly for political reasons), to remove it.

2. Diversification of Industries Argument:

A policy of production is also advocated to diversify a developing country's industrial structure. A country cannot rely on one or a few industries only; it is necessary that a large number of industries of diverse varieties develop in the long run. This strategy will reduce the risk of losing foreign markets; for, in case of failure to export one commodity, other goods may be exported.

3. Employment Protection:

The dynamics of the world economy mean that at any time some industries will be in decline. If those industries were responsible for a significant amount of employment in a country in the past, their decline would cause problems of regional unemployment. There is justification for a country to protect a contracting industry to slow down its rate of decline so that time is given for people to find jobs elsewhere in the economy.

4. Employment Creation:

Protection to home industries may create employment opportunities in the country, and thus reduce the magnitude of unemployment. But this argument is also fallacious; for protection may create employment in some home

industries, but by reducing imports it reduces employment opportunities in the foreign countries.

Protection

So, such a beggar-my-neighbour high-tariff policy might create employment in the short run only before other nations retaliate. Protection can of course increase employment in another way. By improving the balance of trade it can increase employment and income provided the other countries do not retaliate. But even this argument is not convincing as protection cannot maintain high employment indefinitely through export surplus.

NOTES

5. Balance of Trade:

Some countries experience imbalance in their trade with the rest of the world. If they are importing too many goods they may correct a temporary problem by imposing tariffs on imports. A suitable tariff policy can create and maintain a favourable balance of trade.

The restrictions on imports for the purpose of protection will create a surplus in the balance of trade of the country. But this argument is wrong. If all countries simultaneously follow this policy, none would find foreign buyers for the sale of goods and so none would gain. However, Sir Arthur Lewis has put forward a counter argument here.

As he says: “National income cannot be increased by adding imports, since this would result only in diverting resources to the production of articles of domestic consumption, thereby with drawing them from the most profitable export markets. Nor can domestic employment be increased by reducing imports because this would reduce exports to the same extent”.

6. Dumping to Reflect Low Marginal Cost of Production:

Dumping is a problem which confronts many countries. It is an example of price discrimination at the international level. By following the practice of dumping foreign sellers try to capture the home market by selling their goods at low prices.

Protection of home industries is necessary to resist such a policy. It refers to the selling of products on overseas markets at prices below those prevailing on domestic markets. The danger here is that the dumping of products could cause prices to drop drastically.

This could benefit the consumers in the short run. But, in the long run, domestic producers could be forced out of business making room for the foreign suppliers in the future. Producers may be off-loading products on foreign markets to keep prices up in their home markets. The price of a Japanese camera, for example, is higher in Tokyo than in New York. Therefore, the effects of dumping are undesirable and, if it can be detected, some protection against its adverse effects is justified.

7. Improving the Terms of Trade:

Countries can improve their position when they are the sole (or dominant) buyer of a commodity. This is rare, but if American importers of tea

agreed with one another to restrict imports' then the world price would fall. Of course, this would lower the incomes received by the producers of tea and so might be thought undesirable as they are mostly poor countries.

8. Retaliation:

Protecting an industry as a retaliation for protection introduced by other countries is questionable. It was used by the USA when it felt that the European Union was using hidden subsidies to lower the price of steel exported to the USA.

9. Unfair Foreign Competition:

Often countries follow a policy of protectionism against unfair foreign competition. 'Unfair' competition can take a variety of forms. Sometimes, foreign governments can subsidise their export industries. This means that domestic industries cannot compete fairly.

Similarly, foreign firms may 'dump' their products overseas, either because they cannot be sold on their domestic market, or in order to destroy competitor. They could then increase their prices and make large profit. Countries also require protection against low-cost imports.

It is often argued that declining industries need a period of protection in order to allow the decline to take place gradually, so that workers can retrain as new industries develop. A variation of this approach says that industries in high wage countries should have protection against goods made by low-paid labour.

This, of course, denies the advantages of comparative advantage which derive from lower- costs. Instead, the argument is that if foreign firms pay low wages, this is a form of unfair competition and domestic firms should be protected. This would safeguard the position of domestic workers. Critics, however, argue that this would, in fact, reduce the wages of workers in poor countries and make consumers of rich countries pay higher prices.

Protecting an industry against 'unfair' competition is also questionable. Countries often will claim that competition is unfair when, in fact, a country may just be using its comparative advantage to lower costs.

This argument is used against some of the low-wage economies and the difficult issue is to decide whether wages are low due to the abundance of labour as a factor of production or whether exploitation is present. If the latter is the case, protection may not be the answer to the problem.

Fallacious Arguments:

The following arguments for protection are found to be fallacious:

1. Keeping Money at Home Argument:

According to Abraham Lincoln, protection prevents the purchase of foreign goods and thereby keeps money at home. But this argument loses much of its weight when we observe that owing to protection the people of the country are to pay higher prices for home-produced goods.

2. Home Market Argument:

It is argued by Henry Clay and other American protectionists that the restriction on the imports of foreign goods will create a wide domestic market for the products of the home industries. But this argument is also fallacious because protection, by curtailing imports, will reduce exports' too. It is true that home industries will lose the foreign markets if the same policy is pursued by foreigners.

3. National Defence Argument:

Industries which are essential for the defence (e.g., arms and ammunitions, military equipment, etc.) of the country are to be protected to preserve the national independence of a country. The policy of discriminating protection as adopted in India also in 1949-50 prescribed protection for defence industries at any cost.

4. National Self-Sufficiency Argument:

Protection is also advocated to attain self-sufficiency in essential goods. The industries which are essential for national self-sufficiency are to be protected. This is really a convincing argument for protection in developing countries like India. In fact, national interest is the sole criterion for granting protection to industries in such countries.

Arguments Against Protection:

The policy of protection is also criticised on various grounds:

(a) It creates obstacles or barriers to free multinational trade. Due to high tariffs imposed by other countries, a country is not allowed to produce goods in which it has cost advantages. So, protection reduces world production and consumption of internationally traded goods,

(b) Owing to higher tariff on imports, the consumers are compelled to buy home goods, often of inferior quality and often at higher prices,

(c) Protection gives shelter to weak home industries. If it is permanent, home industries would not get any incentive to compete freely with their foreign counterparts. There would be need for continuation of protection for an indefinite period,

(d) Protection may lead to trade wars and international conflicts among trading nations,

(e) Protection give rise to such abuse as 'wire-pulling' in political quarters, vested interest in the protected sector, etc.

Although protection has some disadvantages, the developing countries like India can follow the policy of protection at the early stages of industrial revaluation. The ultimate object should be to accelerate the rate of economic growth and the pace of development.

According to Alan S. Blinder, the case against protectionism, described as a negative-sum game, where the losing consumers lose more than the winning protected producers win, involves even more problems. There are four other problems with trade restrictions.

First, protectionism allows high-cost producers that would otherwise fail to survive. Second, trade restrictions have a habit of affecting other industries. For example, automobiles need protection because the ball bearings, steel and textiles that provide inputs to automobiles are protected.

Third, foreign nations often retaliate against protectionism. Tit-for-tat is the modus operandi in international trade: Country A raises barriers on product X because Country B did it to product Y. Fourth, trade restrictions are not really job-saving or job-creating, but job-swapping.

Protectionism raises the exchange rate, hurting exports in unprotected industries. Because in the long run the value of exports must be equal to the value of imports, we end up exchanging the products of inefficient unprotected industries for those inefficient protected industries.

5.3. The Effect of Growth on Trade.

Economic growth manifests itself in the accumulation of factors and technical progress. Such changes create impact upon trade through the variations in the pattern of production, consumption and the international terms of trade. In this article we will discuss about the production and consumption effects of growth on trade.

Production Effects of Growth:

As the process of economic growth facilitates the increased supplies of factor inputs, there can be some change in the domestic output of exportable commodities. The increased production of exportable goods brings about an expansion in the volume of trade. The large production of importable goods, on the other hand, causes a contraction in the volume of trade.

Although the effect of factor growth upon production was analysed by Rybczynski in a quite simple manner, a more elaborate analysis on this issue was made by H.G. Johnson. He identified growth as neutral, export-biased, ultra-export biased, import-biased and ultra-import biased.

Growth is said to be neutral, when the output of both exportable and importable goods increases in the same proportion, consequent upon accumulation of factors and growth. Growth is said to be export-biased or pro-trade, if the increase in the output of exportable goods is more than proportionate to an increase in the output of importable goods.

The growth is supposed to be ultra-export-biased or ultra-trade-biased, if the increased production of exportable goods involves some reduction in the

In Fig., the labour-intensive commodity X, which is the exportable commodity, is measured along the horizontal scale. The capital-intensive commodity Y, which is the importable commodity, is measured along the vertical scale. Originally PP_1 is the production possibility curve, given the factor supplies and technology. TT_1 is the term of trade line. The production takes place at R where TT_1 is tangent to the production possibility curve.

As growth occurs, the factor supplies increase and the production possibility curve shifts to the right. The terms of trade line is T_2T_3 which runs parallel to the original terms of trade line TT_1 . It signifies that international price ratio of X and Y remains unchanged despite growth. If production equilibrium occurs at S, the growth is neutral because there is equi-proportionate increase in output of two commodities and the two factors grow in the same proportion. If the production takes place in the range S and N, the growth is export biased. In this range, the proportionate change in the output of exportable commodity X is greater than the proportionate change in the output of importable commodity Y. It also signifies that the use of labour is proportionately more than that of capital.

If the production equilibrium is determined in the range N to T_3 , the growth is ultra-export biased because the increased production of exportable commodity X involves a reduced production of the importable commodity Y. In case the production equilibrium is determined in the range S to M, the growth is import-biased.

In this range, the output of importable commodity increases more than proportionately compared with the increase in output of exportable commodity. In this type of growth, the use of capital is proportionately greater than the use of labour. If the production equilibrium gets determined in the range M to T_2 , the growth is said to be ultra-import biased or ultra-antitrade biased.

In this situation, the increased production of the importable commodity Y involves a decline in the production of exportable commodity X. The process of production in this range involves an increased use of capital with possibly no increase in labour. The ultra-export biased and ultra-import biased patterns of growth are the extreme cases in terms of their effects on the self-sufficiency or trade-dependence of a growing country and may exist in very few cases.

Consumption Effects of Growth:

The process of growth in a given country denoted by the factor growth can bring about changes in its consumption pattern. If there is an increased consumption of the importable commodity, the volume of trade is likely to get enlarged. On the opposite, if the consumption of exportable commodity registers an increase, there is likely to be decline in the volume of trade. As in the case of production, Johnson has classified the consumption effects of factor growth as neutral, export-biased, ultra-export-biased, import-biased and ultra-import-biased.

The process of growth in a country, expressed through increased factor supplies, can bring about an increase in real income. This can result in changes in the consumption of exportable and importable commodities in varying quantities. The relative changes in the quantities consumed of these

commodities determine the nature of growth process having varying implications for international trade.

The growth process is said to be neutral, if the increase in the demand for exportable commodity (X) takes place in the same proportion in which the demand for importable commodity (Y) increases. Growth is import-biased or anti-trade-biased, if the increase in demand for importable good is less than proportionate compared with the increase in demand for exportable good.

The process of growth can be regarded as ultra-import biased or ultra-anti-trade-biased, if the demand for importable commodity decreases in absolute terms. There is export-biased or pro-trade-biased growth, when the demand for importable commodity increases more than proportionately compared with the increased demand for the exportable commodity. When the demand for exportable commodity decreases in absolute terms, the growth process is said to be ultra-export biased or ultra-pro-trade biased.

H.G. Johnson pointed out that the output elasticity of demand for importables can measure the nature of growth in relation to trade. The growth process is import-biased, neutral or export-biased, if the output-elasticity of demand for importable commodity is less than, equal to or greater than unity respectively. If the output-elasticity of demand for importable commodity is negative, the growth process is ultra-import-biased. On the opposite, if the output elasticity of demand for exportable commodity is negative, the process of growth is ultra-export-biased.

The consumption effect of growth, given the constancy of tastes, terms of trade and distribution of income can be shown through Fig.

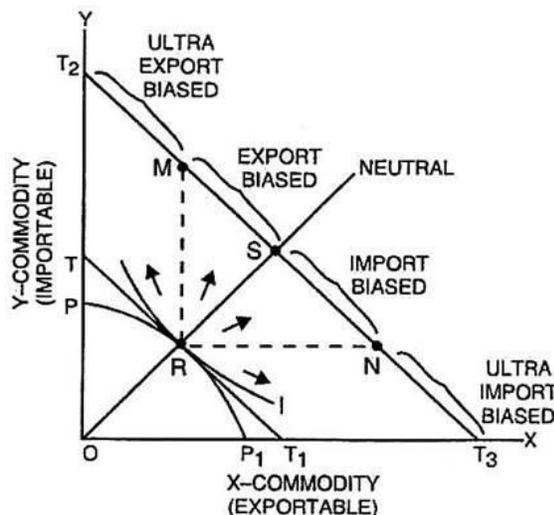


Fig.

In Fig., the original position of production and consumption equilibrium is determined at R. At this point, the terms of trade line TT₁ is tangent to the production possibility curve PP₁, on the one hand, and tangent to the community indifference curve I, on the other. If growth takes place, the production

equilibrium shifts to S. It is assumed that terms of trade remain unchanged so that the terms of trade line T_2T_3 is parallel to TT_1 .

The consumption equilibrium may get determined at any position on T_2T_3 where it becomes tangent to some higher commodity indifference curve. If the consumption takes place at S, and there are proportionate increases in the consumption of two commodities, growth is neutral. If consumption takes place in the range S to M, the growth is export-biased as the demand for importable commodity Y increases at a proportionately greater rate than the demand for exportable commodity.

If consumption takes place in the range M to T_2 , the consumption effect of growth is ultra-export-biased. In case, if consumption occurs in the range S to N, there is an import-biased consumption effect. When the consumption takes place in the range N to T_3 , the consumption effect of growth is ultra-import-biased.

The output or income elasticity of demand for imports can determine the implication of growth on trade, if the growth results from some factor other than population growth. In this connection, H.G. Johnson writes, "If growth is due to some other cause than population change, income per hand will rise, and the type of growth will depend on the average income elasticity of demand for imports. If imports are luxury goods, growth will be pro-trade-biased; if they are necessary goods, growth will be anti-trade-biased; if imports are inferior goods, growth will be ultra-anti-trade-biased and if exports are inferior goods, growth will be ultra-pro-trade-biased."

So far in this analysis, it was supposed that the tastes pattern and distribution of income remain the same. With the expansion in income, subsequent to growth, there can be change in tastes pattern and income distribution. These factors can bring about significant change in the relative demand for the two commodities.

5.4. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What means Trade protectionism?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is the Employment protection?

5.5. Answer to check your progress Questions.

1. Trade protectionism is defined as a nation, or sometimes a group of nations working in conjunction as a trade bloc, creating trade barriers with the specific goal of protecting its economy from the possible perils of international trading. This is the opposite of free trade in which a government allows its citizenry to purchase goods and services from other countries or to sell their goods and services to other markets without any governmental restrictions, interference, or hinderances.

2. The dynamics of the world economy mean that at any time some industries will be in decline. If those industries were responsible for a significant amount of employment in a country in the past, their decline would cause problems of regional unemployment. There s justification for a country to protect a contracting industry to slow down its rate of decline so that time is given for people to find jobs elsewhere in the economy.

5.6. Summary

In this unit you have learnt about the meaning of protection. This knowledge would make what is protection and how it can be practiced at a trade level. The concept such as orguemets of protection and against protection would have make you to distinguish these activities from the on growth trade activities and you must have learnt about the meaning it effects of growth in the trade context.

5.7. Key words

Retaliation, Production Effects

5.8. Self Assessment Questions and Exercises.**Short Answer Questions**

1. What are the effects of growth?
2. What is trade protectionaism?

Long answer Questions.

1. What are the Arguments for and Against Protection?
2. Describe the effects of growth?

Protection

5.9.Further Readings.

Soderston, B. and G. Reed (1999), “**International Economics**”,
McMillan Press Ltd., London.

NOTES

UNIT-6: TECHNICAL PROGRESS AND TRADE

Technical progress and trade

Structure

NOTES

- 6.1 Meaning of Technical Progress and Trade
- 6.2. Neutral, Capital Saving, Labour Saving.
- 6.3. Check your progress Questions.
- 6.4. Answer to check your progress Questions.
- 6.5. Summary
- 6.6. Key words
- 6.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 6.8. Further Readings.

6.1 Meaning of Technical Progress and Trade

It had been assumed that growth manifested itself in the factor growth. Several empirical studies, however, have led to the conclusion that contribution of technical progress in an increase in national income or product is much more significant than that of growth of labour supply or capital accumulation. The effect of technical progress on growth process and trade is much more complex than that of factor growth.

J.R. Hicks has classified the technical progress into neutral, labour-saving and capital-saving.

Whatever is the nature of the technical innovations, they cause a shift of the isoquant towards the origin, the level of output remaining the same. It means the technical progress enables a firm to produce the same quantity of a commodity by employing lesser quantities of the factor inputs.

The technical progress is neutral, when it raises the marginal productivity of capital and labour in the same proportion at the given capital-labour ratio or alternatively, it leaves the capital-labour ratio unchanged.

The technical progress is said to be labour-saving, when it raises the marginal productivity of capital relative to that of labour at constant ratio of capital to labour. In other words, in case of labour-saving or capital-using technical progress, the capital-labour ratio marks an increase.

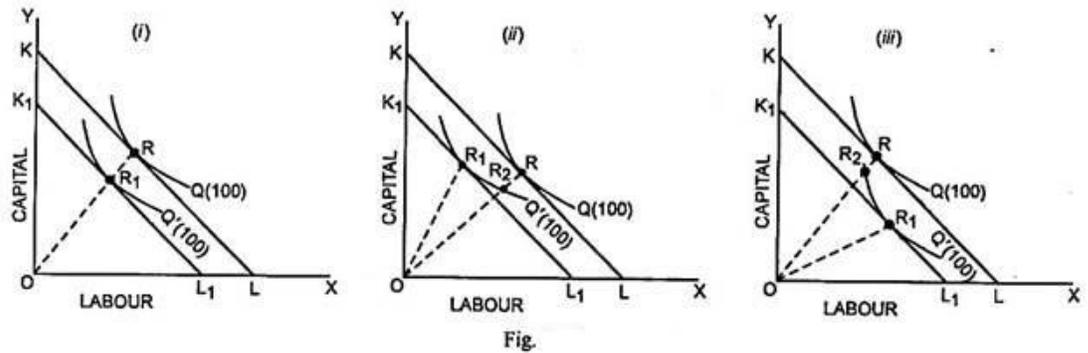
6.2. Neutral, Capital Saving, Labour Saving.

The technical progress is capital-saving or labour-using, when it causes an increase in the marginal productivity of labour relative to capital at the given

capital-output ratio. In case of such technical progress, the capital-labour ratio undergoes a decline.

The neutral, labour-saving and capital-saving technical progress is shown through Fig.

NOTES



In Fig. 11.8, labour is measured along X-axis and capital along the Y-axis. Given the prices of two factors, the original factor price line is KL. The original isoquant Q indicates the output of 100 units of, say commodity A. The tangency of line KL and Q occurs at R. In Fig. 11.8. (i), as technical progress occurs, the isoquant Q shifts to the left Q' and the equilibrium shifts from R to R₁. The capital-labour ratio (K/L) is measured by the slope of the same line OR and OR₁. It means there is no change in capital-labour ratio. This signifies that technical progress is neutral.

In Fig. 11.8, (ii), the technical progress shifts the isoquant from Q to Q' and the equilibrium shifts from R to R₁. The K/L was measured initially by the slope of the line OR and subsequently by the slope of the line R₁. Since OR₁ is more steep than OR, the K/L has increased. At R₂, the K/L is the same as at R but there is less use of labour than at R. Even at R₁, there is less use of labour than at R. It is, therefore, clear that technical progress is of the nature of labour-saving and it raises K/L.

In Fig. 11.8, (iii), the technical progress shifts equilibrium from R to R₁. K/L is lower at R₁ than at R because the slope of the line OR₁ is less than that of OR. If K/L remains constant, 100 units of A can be produced at R₂ where less input of capital is employed than at R. Even at R₁, there is less use of capital than at R. It signifies the technical progress is capital-saving or labour-using.

Assumptions:

The three different types of technical progress can have varying effects on output and international terms of trade.

This analysis is attempted on the basis of the following assumptions:

- (i) The home country experiences growth on account of technical progress.
- (ii) This country produces two commodities X and Y.
- (iii) X is a labour-intensive but Y is a capital-intensive commodity.
- (iv) The production functions related to two commodities are linear homogenous.
- (v) The level of output of each commodity is expressed through its respective isoquant.
- (vi) The isoquants can cut only once.
- (vii) There is no change in the supplies of factors.
- (viii) The factors of production are mobile.

(ix) There are the conditions of perfect competition in the economy.

1. Neutral Technical Progress and Trade:

If the technical progress is of a neutral character and it takes place in export industry of the country, it will lead to a deterioration of terms of trade of the country. On the opposite, if the neutral technical progress occurs in the import-competing industry of the country, it will result in the improvement in the terms of trade of this country.

NOTES

The impact of neutral technical progress in the export industry producing capital-intensive commodity Y upon the capital-labour ratio, factor and commodity prices, output and terms of trade is explained through Figs. 11.9 and 11.10.

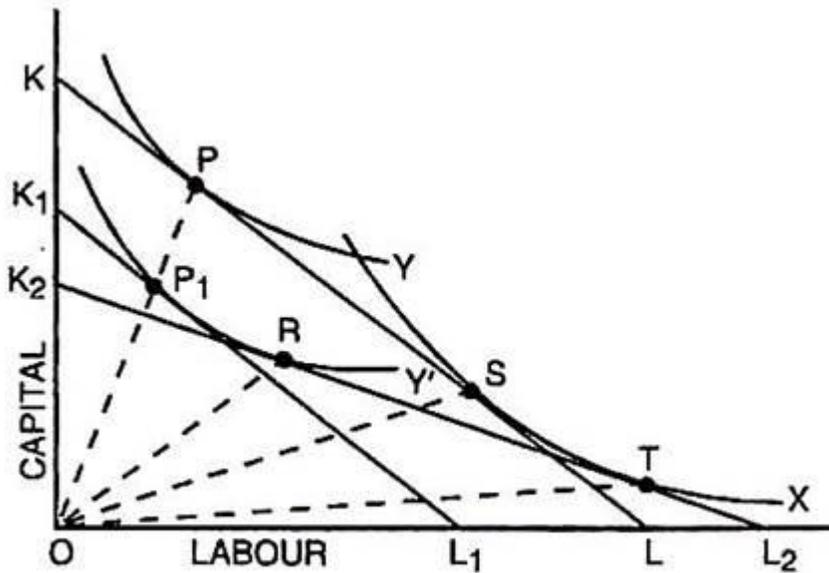


Fig.

In Fig. 11.9, labour is measured along the horizontal scale and capital along the vertical scale. X is the labour-intensive importable commodity and Y is capital-intensive exportable commodity. Originally KL is the factor price line and isoquant X of commodity X and isoquant Y of commodity Y are tangent to this factor price line at S and P respectively. The K-L ratio at P is measured by the slope of line OP and K-L ratio at S is measured by the slope of line OS.

If there is neutral technical progress in the export industry Y, the isoquant of Y shifts to Y'. Given the same factor prices, tangency between K₁L₁ (parallel to KL) and Y' takes place at P₁ where K-L ratio, measured by the slope of line OP₁, remains the same as at P. But at P₁ the marginal productivity of both the factors has increased. The producers in this industry will bid at constant factor prices for more quantities of the factors.

Since commodity Y is capital-intensive, there is particularly greater demand for capital. It will result in a rise in the price of capital relative to labour so that new factor price line is K₂L₂. It becomes tangent to Y' at R and X at T. The K-L ratio at R is measured by the slope of line OR. Since OR is less steep than OP₁, there is a decrease in K-L ratio in the production of Y. In case of X commodity also K-L ratio at T, measured by the slope of line OT, is less than this ratio at S. It

NOTES

means the methods of production have become more labour-intensive in both industries.

How the technical progress will affect the level of output is explained through Fig. 11.10. In this box diagram, O is the origin for good X and O' is the origin for good Y. OO' is the non-linear contract curve. X being a labour-intensive good, the contract curve goes below the diagonal. Originally the equilibrium is at R where isoquants X and Y concerning the two commodities are tangent to each other. The K-L ratio in X commodity at R is measured by the slope of the line OR. The K-L ratio in Y commodity at R is measured by the slope of line O'R.

As technical progress occurs in industry Y, its isoquant shifts to the left to a higher position at Y_1 . It becomes tangent to isoquant X_1 of the good X. Thus after neutral technical progress takes place, the equilibrium point occurs at R_1 . The K-L ratio at R_1 in X and Y commodities is measured by the slopes of the lines OR_1 and $O'R_1$ respectively. Since OR_1 is less steep than OR and $O'R_1$ is less steep than O'R, the production of Y commodity (export good) increases from O'R to OR_1 , whereas the production of X commodity (import-competing good) decreases from OR to OR_1 subsequent to technical progress in industry Y.

The relative shortage of X commodity and increased output of Y commodity will push up the price of X commodity and lower the price of Y commodity. As the price of export good Y falls relative to that of import-competing good X, there will be deterioration in the terms of trade for this country. On the opposite, if technical progress takes place in the import-competing industry, there will be an improvement in the terms of trade of the country.

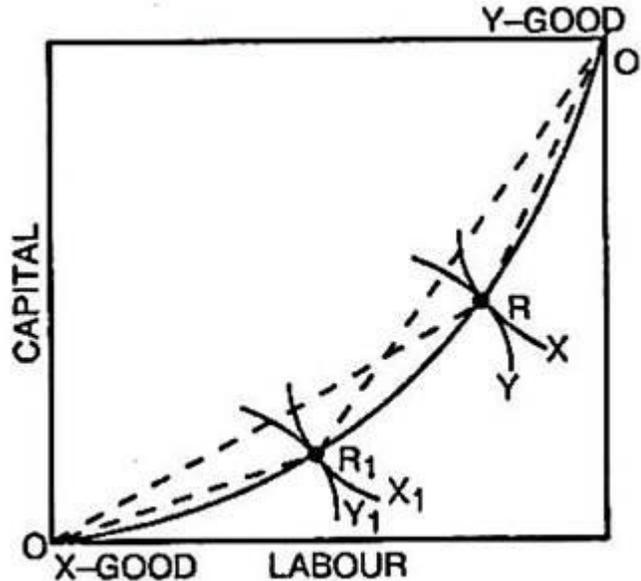


Fig. 11.10

The extent to which terms of trade will be favourable or unfavourable subsequent to neutral technical progress depends upon the magnitude of income elasticity of demand for importable. The lower the value of income elasticity of demand for importable, less is the deterioration in the terms of trade in the unfavourable case and more the improvement in the favourable case.

2. Labour-Saving Technical Progress and Trade:

If the labour-saving technical progress takes place in capital-intensive export industry, the effects on terms of trade of the country are not clear-cut. These are rather indeterminate. The effects of such technical progress on capital intensity, factor and commodity prices, output and terms of trade are explained through Figs. 11.1 and 11.2.

Technical progress and trade

NOTES

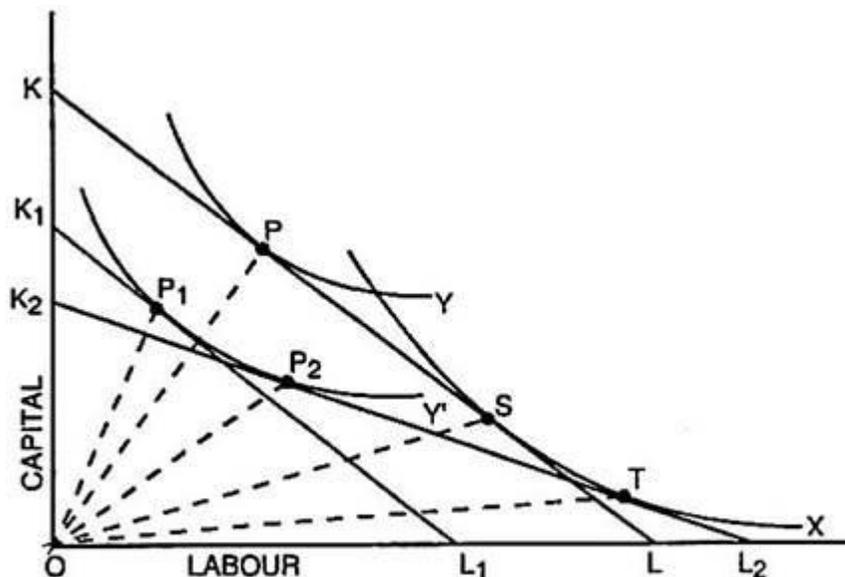


Fig. 11.11

In Fig. 11.11, the isoquant Y is related to the capital-intensive export good Y and isoquant X is related to import-competing commodity X . Given the factor price line KL , the equilibrium occurs in respect of the production of X and Y commodities at P and S respectively. The K - L ratio in Y commodity at P is measured by the slope of line OP and it is measured in case of X commodity by the slope of the line OS . As technical innovations take place in industry Y , the isoquant shifts from Y to Y' . If the factor prices remain the same, the new factor price line is K_1L_1 which is tangent to Y' at P_1 .

Since the K - L ratio at P_1 is measured by a more steep line OP_1 , it follows that K - L ratio in the production of Y commodity has increased. The technical progress can either be capital-using and labour-saving. If the commodity prices remain unchanged, greater use of capital in the capital-intensive industry will increase the price of capital. On the other hand, the technical progress being labour-saving, the demand for labour gets reduced and price of labour tends to fall.

As a result, the new factor price line is K_2L_2 . It is tangent to Y' at P_2 where the K - L ratio is measured by the slope of the line OP_2 . It signifies that the K - L ratio is lower than in the original position. In case of commodity X , however, the capital-labour ratio falls because the line OT is less steep than OS . Had the price of capital increased relative to labour by a larger measure than shown through the line K_2L_2 , the technical progress would have led to a fall in K - L ratio compared with the original situation in Y commodity. This possibility can arise because the labour has become relatively much cheaper and producers

can employ labour-intensive methods both in the production of X and Y commodities.

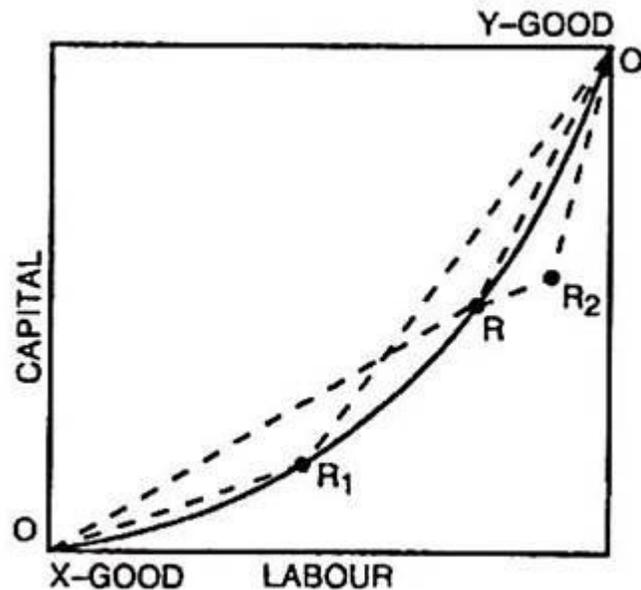


Fig. 11.12

As regards the effects on production, the box diagram 11.12 shows that O is the origin of good X and O' is the origin of export good Y which is capital-intensive. OO' is the non-linear contract curve bulging down. Originally production takes place at R where the K-L ratios in X and Y commodities are measured by the slopes of the lines OR and O'R respectively. If technical progress takes place in industry Y the point of production shifts to R₁ where the K-L ratio in X is measured by the slopes of OR₁ and in Y by the slope of the line O'R₁. The K-L ratio falls in case of both the commodities signifying that lines of production in both the industries can become labour-intensive.

The implication concerning output of two commodities is clear. Since the length of the line O'R₁ is more than of O'R, the production of Y commodity has increased. At the same time the length of line OR₁ is less than of OR, the production of commodity X has fallen. In this situation, the price of export good Y is likely to fall and that of X is likely to rise. Consequently, the terms of trade are likely to deteriorate. Had the technical progress taken place in the import-competing commodity Y, the terms of trade would have got improved.

The labour-saving technical progress in the capital-intensive industry can have some other implications for output and terms of trade. If the technical-progress leaves K-L ratio in X commodity unchanged as at point R₂ and causes a rise in K-L ratio in Y commodity, there is an increased output of X. The output of Y is lower at R₂. Such a situation will result in higher price of the export good Y and a lower price of X so that the terms of trade become favourable to this country.

It, therefore, suggests that the labour-saving innovation in the capital-intensive export industry can have any effect on output and relative prices and the impact of such technical progress on terms of trade may be indeterminate.

3. Capital-Saving Technical Progress and Trade:

A process of capital-saving technical progress in the capital-intensive export industry is likely to result in the worsening of the terms of trade. The effects of such technical progress upon capital-intensity, factor and commodity prices, output and terms of trade are explained through Figs. 11.13 and 11.14.

Technical progress and trade

NOTES

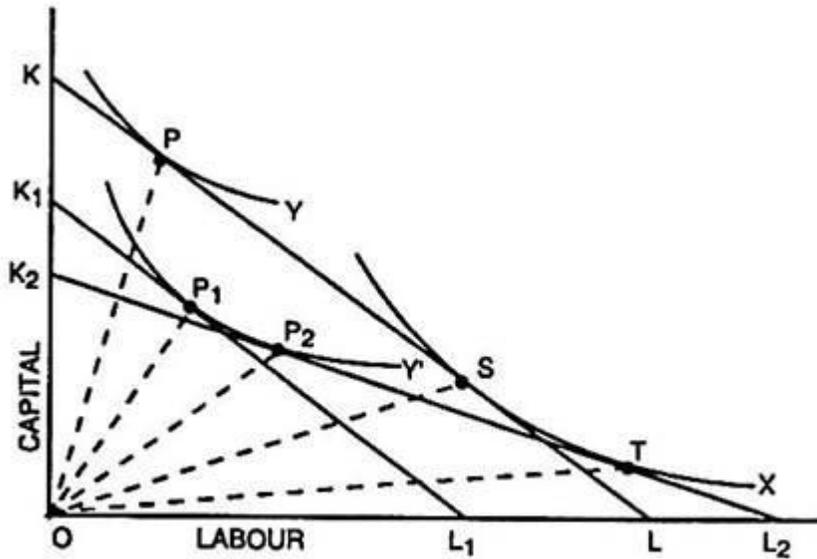


Fig. 11.13

In Fig. 11.13, given the prices of capital and labour, KL is the factor price line which is tangent to the isoquant X of import-competing good X at S and to the isoquant Y of capital-intensive export good Y at P . The K - L ratios at P and S are measured by the slopes of the lines OP and OS respectively.

As capital-saving innovations take place in the export-industry Y , assuming factor prices to remain unchanged, the factor price line shifts to K_1L_1 but it is parallel to KL . K_1L_1 is tangent to the isoquant Y' at P_1 . Y' has undergone shift due to technical progress. The K - L ratio of P_1 is measured by the slope of the line OP_1 .

Since OP_1 is less steep than OP , there is a fall in K - L ratio in the production of Y commodity. If the commodity prices remain unchanged, the factor prices must change in favour of capital. Consequently, the new factor price line is K_2L_2 . It is tangent to Y' at P_2 and to X at T . The K - L ratios at P_2 and T are less when compared with the original positions P and S respectively. It means the techniques of production become more and more labour-intensive in both the industries.

The effects on production are studied through Fig. 11.14. Given the non-linear contract curve OO' bulging down, production originally takes place at R . The K - L ratios in X and Y commodities at R are measured through the slopes of lines OR and $O'R$ respectively. The lengths of these lines indicate production of respective commodities before technical progress. As there are capital-saving innovations in the export industry Y , production takes place at R_1 . The K - L ratios in X and Y commodities at R_1 are measured through the slopes of the lines OR_1 and $O'R_1$ respectively.

At this point, K - L ratios have decreased in case of both the products. It means the techniques have become more labour-intensive in both the industries.

The production of X and Y commodities at R_1 is measured by the lengths of the lines OR_1 and $O'R_1$ respectively. Fig. 11.14 shows that the production of Y has increased and that of X has fallen. Such a situation will cause a fall in the price of X whereas the price of Y will rise.

Consequently, the terms of trade get deteriorated for this country. If the technical progress had taken place in the import-competing industry X, the terms of trade would have become favourable to this country.

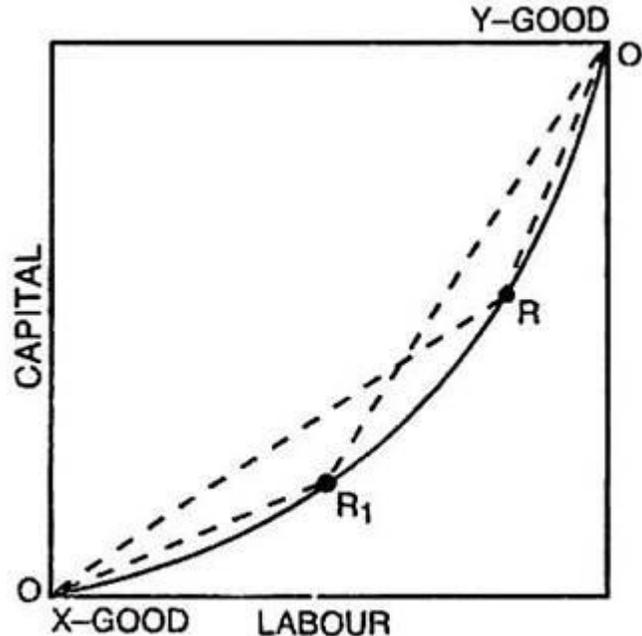


Fig. 11.14

To sum up, a neutral technical progress in the export sector will cause deterioration in the terms of trade. There will be improvement in the terms of trade, if neutral technical progress takes place in the import-competing sector. In case the technical progress is capital-saving and it takes place in the capital-intensive export sector, there is worsening of the terms of trade.

When the labour-saving technical progress occurs in the capital-intensive export sector or capital-saving technical progress in labour-intensive import-competing sector, there can be possibilities of worsening or improvement in the terms of trade. In such a situation, the impact of such a technical progress can be considered indeterminate.

6.3. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What means technical progress?

Check your Progress-2

Note: a).Write your answer in the space given below

b)Compare your answer with those given at the end of the unit

1..What are the stages of technical progress?

NOTES

6.4.Answer to check your progress Questions.

1. The technical progress is neutral, when it raises the marginal productivity of capital and labour in the same proportion at the given capital-labour ratio or alternatively, it leaves the capital-labour ratio unchanged.

2. Neutral, Capital Saving, Labour Saving

6.5.Summary

Unit-6

In the unit you have learnt about the meaning of Technical progress as trade this knowledge would make you understand what is technical progress as how it can be practical at a trail level the concept such as capital saving as labour saving would have you to distinguish these activities from the Technical progress activities as you must have learnt about the meaning as the activities in the trail context

6.6. Key words

Neutral, Capital Saving, Labour Saving

6.7.Self Assessment Questions and Exercises.

Short Answer Questions

1..What means technical progress?

2. What are the stages of technical progress?

Long answer Questions.

1.Describe Neutral, Capital Saving, Labour Saving.

2.Explain the technical process and trade.

6.8. Further Readings.

Carbaugh, R. J. (2008), “**International Economics**”, Thomson
South Western, New Delhi

NOTES

UNIT-7: TRADE POLICY

Trade policy

Structure:

- 7.1. Trade Policy: Tariff
- 7.2. Quota
- 7.3. Trade problems of Developing Countries.
- 7.4. Check your progress Questions.
- 7.5. Answer to check your progress Questions.
- 7.6. Summary
- 7.7. Key words
- 7.8. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 7.9. Further Readings.
- 7.1. Trade Policy: Tariff

NOTES

Meaning of Tariffs:

A tariff is a duty or tax imposed by the government of a country upon the traded commodity as it crosses the national boundaries. Tariff can be levied both upon exports and imports. The tariff or duties imposed upon the goods originating in the home country and scheduled for abroad are called as the export duties. Countries, interested in maximising their exports generally avoid the use of export duties. Tariffs have, therefore, become synonymous with import duties.

The import duties or import tariffs are levied upon the goods originating from abroad and scheduled for the home country. Sometimes a country may also resort to what is called as a transit duty. It is imposed upon the goods originating in the foreign country and scheduled for a third country crossing the borders of the home country. For instance, if India imposes tariffs on goods that Bangladesh exports to Nepal through the Indian Territory, these will be called as transit duties. Such duties are usually a matter of much concern for the land-locked countries.

The imposition of import tariff results in the relative changes in prices of products and factors.

That brings about a significant change in the structure of international trade. High tariffs certainly have the effect of restricting the volume of international trade. A negative tariff or subsidy is often supposed to expand foreign trade over and above its volume in the absence of subsidy.

Types of Tariffs:

Tariffs are of several types and these can be classified into different groups or sub-groups as below:

(1) Classification on the Basis of Criterion for Imposition:

On the basis of the criterion for imposition of tariffs.

These can be of such types as:

- (a) Specific tariff,
- (b) Ad Valorem tariff,
- (c) Compound tariff and
- (d) Sliding scale tariff.

(a) Specific Tariff:

Specific tariff is the fixed amount of money per physical unit or according to the weight or measurement of the commodity imported or exported. Such duties can be levied on goods like wheat, rice, fertilisers, cement, sugar, cloth etc. Specific duties are quite easy to administer, as they do not involve the evaluation of the goods.

The determination of the value of the traded goods may be difficult as there are several variants of price such as demand price, supply price, market price, contract price, invoice price, f.o.b, (free on board) price, c.i.f (cost, insurance, freight) price etc. The resort to specific duties enables the government to keep out of complexities of prices.

However, the specific duties cannot be levied on high valued goods such as diamonds, jewellery, watches, T.V. sets, motor cars, works of arts like paintings etc. These articles can be taxed either on the basis of weight, surface area covered or the number of articles.

(b) Ad Valorem Tariff:

‘Ad Valorem’ is the Latin word that means ‘on the value.’ When the duty is levied as a fixed percentage of the value of the traded commodity, it is called as valorem tariff. Such duties are levied on the products the value of which is disproportionately higher compared to their physical characteristics such as weight or measurement.

These duties are more equitable as the costly goods, generally consumed by the rich, bear greater burden of duty, while the cheaper goods bought by the poor, bear lesser burden of tariff. For instance, if the import of watches is subject to 70 percent ad valorem tariff, a watch valued at Rs. 1000 will be subject to a duty of Rs. 700 and a watch valued at Rs. 1200 will be subject to a tariff amounting to Rs. 840. The ad valorem duties have an additional advantage that the international comparison of tariffs, in their case, can be easily made.

(c) Compound Tariff:

The compound tariff is a combination of specific and ad valorem tariff. The structure of compound tariff includes specific duty on each unit of the commodity plus a percentage of ad valorem duty. The compound tariffs not only impart a greater elasticity to revenues but also assure a more effective protection to the home industries.

(d) Sliding Scale Tariff:

The import duties which vary with the prices of the commodities are termed as sliding scale duties. These may either be on specific or ad valorem basis. In practice, these are generally on a specific basis.

(2) Classification on the Basis of Purpose for Which Tariff is Imposed:

On the basis of purpose of levying the tariff.

These can be of two types:

(a) Revenue Tariff and

(b) Protective Tariff.

(a) Revenue Tariff:

The tariff, which is imposed primarily for generating more revenues for the government is called as the revenue tariff. In advanced countries, the introduction and diversification of direct taxes has reduced the importance of tariff as a source of government revenues. But in the less developed countries, there is still much reliance of the governments on this source of revenue.

Generally pure revenue tariff is not possible. The imposition of tariff, even for the purpose of securing revenues, does have protective effect when it leads to switch of demand by the domestic consumers from the imported to home- produced goods.

(b) Protective Tariff:

The tariff may be imposed by the government to protect the home industries from the cut-throat competition from the foreign produced goods. The higher the tariff, greater may be the protective effect of tariff. A perfect protective tariff is likely to prohibit completely the import from abroad.

In practice, the perfect protective tariff may not exist. If the domestic demand for import remains strong, there can be the possibility of smuggling imported goods. In addition, such a tariff will not yield any revenue to the government. A high rate of protective tariff can make the domestic producers more lethargic and inefficient and unable to face foreign competition even in the long run.

(3) Classification on the Basis of Discrimination:

If the tariff is influenced by the consideration of discrimination.

NOTES

There can be two types of tariffs-

(a) Non-discriminatory and

(b) Discriminatory.

NOTES

(a) Non-Discriminatory Tariff:

If the uniform tariff rates are applicable to all the commodities irrespective of the country of origin, these are known as non-discriminatory tariffs. It is possible that low rates of tariffs on certain commodities exist because of commercial agreements with some countries but the tariff-imposing home country extends the same low tariff rates to the commodities of all the countries.

Such a system of nondiscriminatory tariff is called as single column tariff. This system of tariff is easy and simple to administer. There is, however, one deficiency that it is not elastic enough to adjust according to the changing needs of the industries of the home country. From the viewpoint of revenues too, it may not be satisfactory for the tariff-imposing country.

(b) Discriminatory Tariff:

In case of discriminatory tariff, the varying tariff rates exist for different commodities. The products originating from favoured countries are subject to a lower tariff rate than those of other countries. The discriminatory tariffs can be double or multiple column tariffs.

In case of the double column tariff, two different rates of duty exist for all or some commodities. Both the rates are either announced by the government right from the beginning and the two rates come into existence after the country enters into favoured-nation commercial agreement with some foreign countries. The favoured rates of tariff may either be on a unilateral basis or on a reciprocal basis.

The double column tariff can be further classified as:

(i) General and conventional tariff

(ii) Maximum and minimum tariff

(iii) Multiple Column Tariff.

(i) General and Conventional Tariff:

The general tariff schedule is determined by the state legislature. It also makes provision for the adjustment in tariff rates as and when required to fulfill the obligations of international commercial agreements. The conventional tariff schedule is evolved through the commercial agreements of the home country with other countries. It does not permit changes in tariff rates according to the changes in domestic conditions or requirements.

The changes can be possible only after negotiations and agreements are reached between the concerned countries or after the expiry of the existing agreement. It is clear that there is some rigidity in the conventional tariff schedule. In contrast, the general tariff schedule is more flexible

(ii) Maximum and Minimum Tariff:

Under this system, a country has maximum and minimum tariff rates for every commodity. These tariff rates are fixed by the legislature and the government is authorised to apply specific rates of tariff to the goods imported from the different countries. The minimum tariff rates are applied to the products originating from the countries treated as ‘The Most Favoured Nations’. The maximum tariff rates are applied for the purpose of improving the bargaining position of the home country vis-a-vis the foreign countries.

(iii) Multiple Column Tariff:

The multiple column tariff consists of three different rates of tariff – a general rate, an international rate and a preferential rate. The general and international tariff rates can be considered equivalent to the maximum and minimum tariff rates discussed above. The preferential tariff is generally applied by a subject country to the products originating from the colonial countries.

The preferential tariff rate is kept lower than the general rate of tariff. For instance, the goods imported by India from Britain before independence were subjected to a lower tariff or duty free on account of Imperial Preferences. On the other hand, the goods imported from other countries such as Japan, Germany and others were subject to higher rates of tariff.

(4) Classification on the Basis of Products:

Whether a product is imported or exported can be the basis of tariff.

On this basis, the tariffs can be of the types of:

(a) Import duties and

(b) Exports duties.

(a) Import Duties:

If the home country imposes tariff upon the products of the foreign countries as they enter its territory, the tariff is known as import tariff or import duty.

(b) Export Duties:

If the products of the home country become subject to tax as they leave its territory to be sold in the foreign market, the tax or duty is called as export tariff or export duty.

The import tariffs have remained the matter of deep interest both for analytical and policy reasons. These are far more wide-spread, and almost every country takes resort to them. In contrast, the export duties are applied to a very limited extent. Some countries like the USA have prohibited export duties by

NOTES

law. Even in those countries, where these are in vogue, the basic purpose is to secure larger revenues.

(5) Classification on the Basis of Retaliation:

On this basis, the tariffs can be of the types of

- (a) Retaliatory tariffs and
- (b) Countervailing tariffs.

(a) Retaliatory Tariffs:

If a foreign country has imposed tariffs upon the exports from the home country and the latter imposes tariffs against the products of the former, the tariffs resorted to by the home country will be regarded as the retaliatory tariffs. The home country, while adopting this measure does not either has the object of raising revenues or protecting home industries but of acting in retaliation.

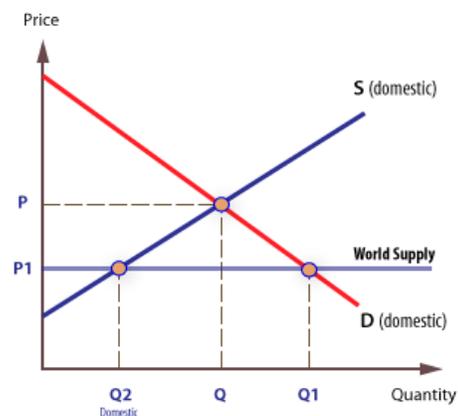
(b) Countervailing Tariffs:

If the foreign country has been exporting large quantities of its products in the market of the home country on the strength of export subsidies, the home country can neutralise the 'unfair advantage' enjoyed by foreign products through imposing duties upon them as they enter the territory of the home country. The latter has full justification for resorting to these countervailing duties in order that the unfair advantage given by exports subsidies to the foreign products is offset and the competition takes place on equal footing between the foreign and home produced goods.

7.2. Quota

Quotas

A quota is a limit to the quantity coming into a country.

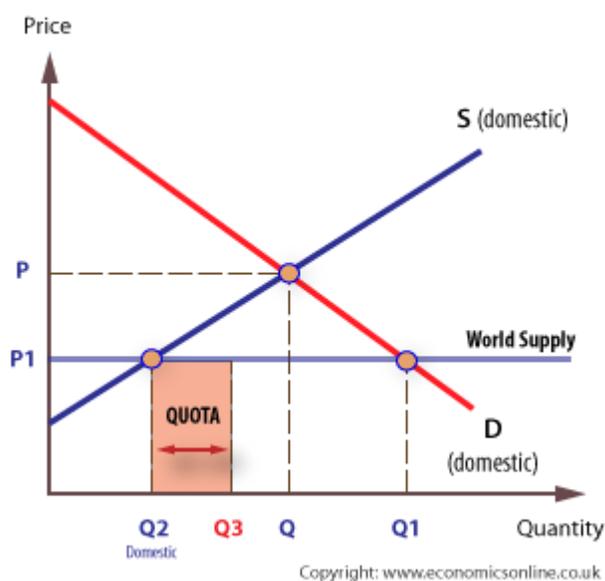


With no trade, equilibrium market price in the country will exist at the price which equates domestic demand and domestic supply, at P , and with output at Q . However, the world price is likely to be lower, at P_1 , than the price in a country that does not trade. If the country is opened up to free trade from the rest of the world, the world supply curve will be perfectly elastic at the world price, P_1 .

The new equilibrium price is P_1 and output is Q_1 . The domestic share of output is now Q_2 , compared with Q , the self-sufficient quantity. The amount imported is the distance Q_2 to Q_1 .

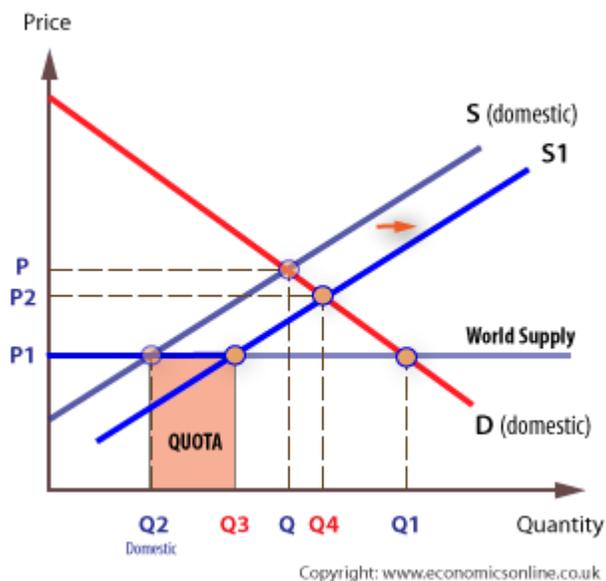
Imposing a quota

In an attempt to protect domestic producers, a quota of Q_2 to Q_3 may be imposed on imports.



This enables the domestic share of output to rise to Q_2 to Q_3 , plus Q_3 to Q_4 .

NOTES



The quota creates a *relative shortage* and drives the price up to P_2 , with total output falling to Q_4 . The amount imported falls to the quota level. It is this price rise that provides an incentive for less efficient domestic firms to increase their output.

One of the key differences between a tariff and a quota is that the welfare loss associated with a quota may be greater because there is no tax revenue earned by a government. Because of this, quotas are less frequently used than tariffs.

Tariffs

Tariffs, or customs duties, are taxes on imported products, usually in an *ad valorem* form, levied as a percentage increase on the price of the imported product. Tariffs are one of the oldest and most pervasive forms of protection and barrier to trade.

The impact of tariffs

The imposition of tariffs leads to the following:

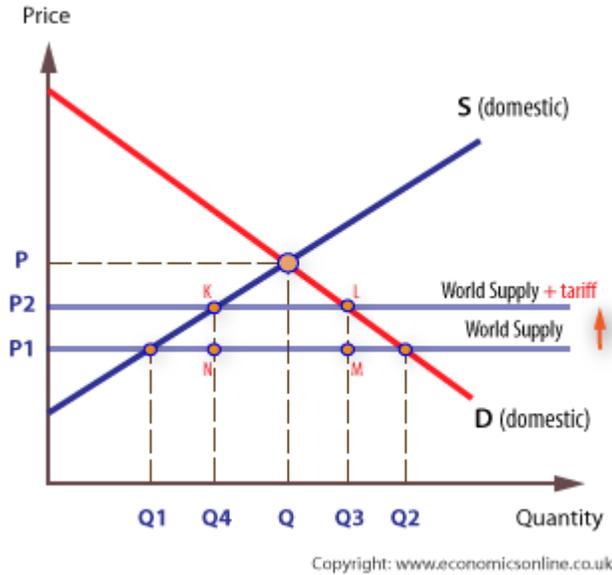
Higher prices

Domestic consumers face higher prices, which also means that there is a loss of consumer surplus. However, there is a gain in domestic producer surplus as producers are protected from cheap imports, and receive a higher price than they would have without the tariff. However, it is likely that there is an overall net welfare loss.

Without trade, the domestic price and quantity are P & Q .

If a country opens up to world supply, price falls to P_1 , and output increases from Q to Q_2 . As a result, domestic producers' share falls to Q_1 and imports now dominate, with the quantity imported Q_1 to Q_2 .

Trade policy



NOTES

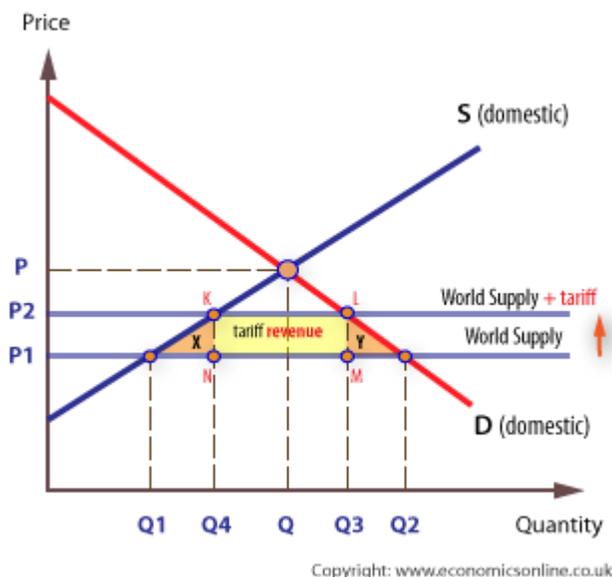
The imposition of a tariff shifts up the world supply curve to *World Supply + Tariff*.

The price rises to P_2 , and the new output is at Q_3 . Domestic producers share of the market rise to Q_4 , and imports fall to Q_4 to Q_3 . The result is that domestic producers have been protected from cheaper imports from the rest of the World.

Given that domestic consumers face higher prices, they also suffer a loss of consumer surplus. In contrast, domestic producers increase their producer surplus as they receive a higher price than they would have without the tariff. Increased market share also means that jobs will be protected in the domestic economy.

Welfare loss

However, the reduction in consumer surplus is greater than the increase in producer surplus. Even when adding the tariff revenue (area K,L,M,N) there is still a net loss. The net welfare loss is represented by the triangles X and Y .



Distortion

There is a potential distortion of the principle of comparative advantage, whereby a tariff alters the cost advantage that countries may have built up through specialisation.

Retaliation

There is the likelihood of retaliation from exporting countries, which could trigger a costly trade war.

However, in the short run tariffs may protect jobs, infant and declining industries, and strategic goods. Tariffs may also help conserve a non-renewable scarce resource. Selective tariffs may also help reduce a trade deficit, and reduce consumption.

7.3. Trade problems of Developing Countries.

International trade and international investment have grown rapidly since the beginning of Industrial Revolution (1740).

For example, exports as a percentage of total national output grew from just 1% of the total value of world output in 1820 to about 14.1% in 2002. The process that we often refer to as globalisation in fact appears to be related to the economic growth that nations have enjoyed over the same period.

The increasingly close relationship between economies, or globalisation, involves more than just the growth of international trade in goods and services. The flows of capital and people across national borders have also been growing rapidly in recent years.

Several recent economic crisis in developing countries such as the Mexican crisis of 1994 and the Thai currency crisis of 1997 have been linked to international capital mobility. This very fact suggests that capital flows can, under certain circumstances, slow economic growth. In fact, international lending, investing and aid are to all linked to economic growth in more ways than one.

There has occurred a rapid growth of world trade in the past two centuries (since the time of Britain's industrial revolution). However, trade patterns today are quite different from those of the 19th century. Production at the centre of the world economy tends to be resource-saving instead of resource-using, and synthetics have replaced many raw materials. Furthermore, the trade policies of today's industrialised countries are less liberal than those of the 19th century, which had no multi-fibre agreement (MFA) or common agricultural policy (CAP) of EU and no counter-veiling duties on Brazilian steel.

After World War I, tariffs rose sharply in both the USA and in Europe. In addition, many countries started to use quotas and other controls to protect their economies against the spread of the depression. Trade liberalisation began in 1947 with the signing of the General Agreement on Tariffs and Trade and first rounds of GATT negotiations.

During the 1950s, protectionist pressures in the USA slowed down trade liberalisation, but it regained momentum with the formation of the EEC, and the Kennedy Round of tariff cuts. In the 1970s, trade liberalisation took a new track. In the Tokyo Round, governments attempted to reduce non-tariff barriers, along with tariffs, and agreed on codes of conduct dealing with government purchases and with subsidies and dumping.

But protectionist pressures built up strongly in the 1970s and 1980s, when economic growth slowed down and unemployment rose especially in Europe. The new protectionism also testifies to the success of previous trade liberalisation. Economies have become more open and more sensitive to global competition. Old industries such as textiles, steel and automobiles have been exposed to intense competition from new producers and new industries.

Growing protectionist pressures have also led to the more frequent use of antidumping and counter-veiling duties and to the introduction of market-operating measures in place of more traditional GATT procedures for settling trade disputes.

In short two distinct trends have emerged in the post Second World War period, viz.:

- (1) the growing use of non-tariff barriers to protect domestic industries; and
- (2) the frequency with which dumping by foreign firms and subsidies by foreign governments have been used to justify protectionism.

NOTES

In general, developed nations export mainly primary products, viz., food and raw materials in exchange for manufactured goods from developed countries. Until the 1980s, it was widely believed that international trade and the functioning of the present international economic system hindered development through declining terms of trade in the long run and widely fluctuating export earnings for developing countries.

This is why development economists advocated industrialisation through import substitution (i.e., the domestic production of manufactured goods previously imported). They did not place much reliance on international trade for promoting growth in developing countries.

They also advocated reforms of the present international economic system to make it more responsive to the special needs of developing countries. But most economists today believe that international trade, based on comparative advantage, can contribute significantly to the process of development of LDCs.

Developing countries are generally more dependent on trade than are developed countries. While large countries are understandably less dependent on trade than are small countries, at any given size, developing countries tend to devote a larger share of their output as merchandise exports than do developed countries.

Large countries like Brazil and India, which have had unusually closed economies, tend to be less dependent on foreign trade in terms of national income than relatively small countries like those in tropical Africa and East Asia. On the other hand, LDCs like India, Nepal, Bangladesh, etc. are more dependent on foreign trade in terms of its share in national income than the very highly developed countries are.

The greater share of developing country exports in GDP is probably due in part to the much higher relative prices of non-traded services, in developed than in developing countries. Moreover, the exports of LDCs are much less diversified than those of the developed countries.

Trade Related Problems Faced by Developing Countries:

1. Deterioration of the Terms of Trade:

According to some economists such as Prebisch, Singer and Myrdal, the commodity terms of trade (which is the ratio of the price index of exports to the price index of imports) -tend to deteriorate over time.

There are two main reasons for this:

(i) Productivity increase:

Most or all of the productivity increases that take place in developed nations are passed on to their workers in the form of high wages and income. But productivity increases in developing countries lead to fall in commodity prices.

(ii) Income elasticity of demand:

The demand for the manufactured exports of developed nations tends to grow much faster than the latter's demand for the agricultural exports of developing countries. This is due to much higher income elasticity of demand for manufactured goods than for agricultural commodities. For these reasons, self-sufficiency (no trade) is at times better than trade. As J. N. Bhagwati has argued, the deterioration in the terms of trade of developing nations could be so great as to make them worse-off with trade than without it. This is known as immiserising growth.

2. Export Instability and Economic Development:

McBean has pointed out, apart from deteriorating long-run or secular terms of trade, developing countries may face large short-term fluctuations in their export prices and foreign exchange receipts that could seriously hamper their development. This point is illustrated in Fig. 8.2. D_0 and S_0 refer, respectively, to the demand and supply curves of developing countries.

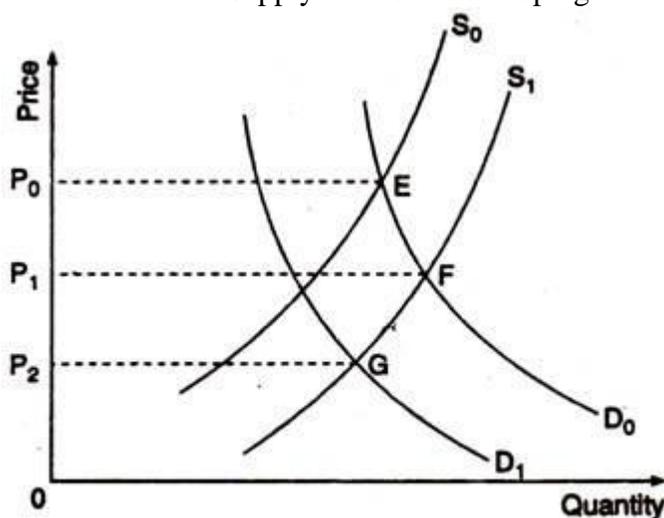


Fig. 8.2. Price instability and primary exports

With D_0 and S_0 , the equilibrium price of primary exports of developing countries is P_0 . If D shifts to D_1 or S to S_1 , the equilibrium price falls sharply to P_1 . If both D and S shift to D_1 and S_1 the equilibrium price falls even more to P_2 . If D_1 and S_1 again shift back to their original positions, i.e., D_0 and S_0 , the equilibrium price moves back upto P_0 .

NOTES

Thus, price inelastic and unstable D and S curves may lead to sharp price fluctuations. Here the range of price fluctuations is fairly wide P_0 - P_2 . Thus inelastic (i.e., steeply inclined) and unstable (i.e., shifting) demand and supply curves for the primary exports of developing countries can lead to large fluctuations in the prices of the exportable products of developing countries.

The demand for primary products in world markets is both price inelastic and shifting. It is price inelastic because most households in developed countries spend only a small proportion of their income on such commodities as coffee, tea, sugar and cocoa. Consequently when the prices of these items change, households do not increase their purchases of these items much.

As a result the demand for such items becomes price-inelastic. On the other hand, the demand for various minerals is price inelastic because substitutes are not readily available. At the same time, the demand for the primary products of developing countries is unstable because of trade cycles in advanced countries.

The supply of most primary exports developing countries is price inelastic because of long gestations period in case of tree crops, especially plantations. Rubber trees require 10-15 years to grow. Moreover we find internal rigidities and inflexibilities in resource use in most developing nations. Supplies are unstable and shifting because of weather conditions, pests and so on.

Due to wide fluctuates in export prices, the export earnings of developing countries also vary significantly from year to year. This in its turn leads to fluctuations in national income, consumption, savings and investment. This type of economic fluctuations or business cycle movements render development planning (which depends on imported machinery, funds, raw materials) much more difficult.

International Commodity Agreements:

Some developing countries, especially in Africa, have attempted to stabilise export prices for individual products by purely domestic schemes such as the marketing board set up after World War II. These operated by purchasing the output of domestic producers at the stable prices set by the board, which would then export the commodities at fluctuating world prices. In years of bumper crops, domestic prices would be set below world prices so that the board could accumulate funds, which it would then disburse in bad years, by paying domestic producers higher than world prices.

However, international commodity agreements offered most developing countries a strong chance of increasing their export prices and earnings. Such agreements are of three types: buffer stocks, export controls, and purchase contracts.

Buffer stocks involve the- purchase of the commodity (to be added to the stock) when the commodity price falls below the agreed minimum price, and

sale of the commodity. Out of the stock its open market price rises above the established maximum price.

Trade policy

Export controls seek to regulate the quantity of a commodity exported by each nation in order to stabilise, commodity prices. This method completely avoids the cost of maintaining stocks.

NOTES

Purchase contracts are long-term multilateral agreements that fix a minimum price at which importing nations agree to purchase a specified quantity of the commodity and a maximum price at which exporting countries agree to sell certain fixed amounts of the commodity. Purchase contracts thus avoid the disadvantages of buffer stocks and export controls but result in a two-price system for the commodity.

7.4. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is import and export duties?

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is tariff?

7.5. Answer to check your progress Questions.

1. (a) Import Duties:

If the home country imposes tariff upon the products of the foreign countries as they enter its territory, the tariff is known as import tariff or import duty.

(b) Export Duties:

If the products of the home country become subject to tax as they leave its territory to be sold in the foreign market, the tax or duty is called as export tariff or export duty.

2. A tariff is a duty or tax imposed by the government of a country upon the traded commodity as it crosses the national boundaries. Tariff can be levied both upon exports and imports.

NOTES

7.6.Summary

In the unit, you have learnt about the meaning, definition of tariff of trade policy this knowledge would make you medals tow what is tariff as quota as how it can be practiced at a trade police the concept such as Quota and tariff would have made you to distinguish fuse activities form the trade policy as you must have learnt about the meaning as the problems in the developing countries

7.7. Key words

Discriminatory, Distortion, Retaliation

7.8.Self Assessment Questions and Exercises.

Short Answer Questions

- 1.What is Retaliatory Tariffs?
- 2.What is Protective Tariff?

Long answer Questions.

- 1.Explain Trade problems of Developing Countries.
- 2.Describe Trade Policy: Tariff and quota.

7.9.Further Readings.

Carbaugh, R. J. (2008), “**International Economics**”, Thomson South Western, New Delhi

BLOCK III: INTERNATIONAL ORGANISATIONS

International organizations - I

UNIT-8: INTERNATIONAL ORGANIZATIONS - I

NOTES

- 8.1. International Organizations - I: UNCTAD
- 8.2. GATT and Tokyo Declaration.
- 8.3. Check your progress Questions.
- 8.4. Answer to check your progress Questions.
- 8.5. Summary
- 8.6. Key words
- 8.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 8.8. Further Readings.

8.1. International Organizations - I: UNCTAD

United Nations Conference on Trade and Development (UNCTAD), permanent organ of the United Nations (UN) General Assembly, established in 1964 to promote trade, investment, and development in developing countries. Headquartered in Geneva, Switzerland, UNCTAD has approximately 190 members.

Negotiations at UNCTAD's meetings resulted in the Global System of Trade Preferences (1988), an agreement that reduced tariffs and removed or reduced nontariff trade barriers among participating developing countries; the Common Fund for Commodities (1989), an intergovernmental financial institution that provides assistance to developing countries that are heavily dependent on commodity exports; and various agreements for debt relief. In the 1990s UNCTAD's efforts were directed toward the challenges globalization poses to developing countries, and special attention was focused on measures to help the poorest and least developed countries become integrated into the world economy.

The highest policy-making body of UNCTAD is the Conference, which meets once every four years to set policy guidelines and to formulate a program of work. The UNCTAD Secretariat, whose members form part of the UN Secretariat, performs policy analysis, monitors and implements the decisions of UNCTAD's intergovernmental bodies, and provides for technical

NOTES

cooperation and exchanges of information. It comprises four divisions—on globalization and development strategies; international trade; investment, technology, and enterprise development; and services infrastructure—as well as the Office of the Special Co-ordinator for Least Developed, Land-locked, and Island Developing Countries (OSC-LDC). The Trade and Development Board, UNCTAD's executive body, is responsible for the operations of the organization when the Conference is not in session.

A free trade area is a form of economic integration where in all barriers on trade among members are removed, but each nation retains its own barriers on trade with the nonmembers. In a free trade area the group of countries will invoke little or no price control in the form of tariffs or quotas between each other. Free trade areas allow the agreeing nations to focus on their competitive advantage and to freely trade for the goods they lack the experience at making, thus increasing the efficiency and profitability of each country. Eg: European Free Trade Association (EFTA in 1960) North American Free Trade Agreement (NAFTA in 1993) European Union (EU) formed in 1957. NCTAD was established by the UN General Assembly in December 1964 to promote international trade, particularly that of developing countries, with a view to accelerating economic development.

It has now become a principal instrument of the General Assembly for deliberation and negotiations in the field of international trade and related issues of international economic cooperation.

UNCTAD covers the entire spectrum of politics, both in developed and developing countries which influence the external trade and economic development, particularly those of developing countries.

UNCTAD-IX was held in Midland, South Africa from 27th April to 11th May, 1996. The Indian delegation was led by the Commerce Secretary. The period from 1992 to 1996 witnessed drastic changes in the international trade scenario, particularly, the emergence of WTO and changes in the global economic context.

These changes and the financial crisis being faced by the UN system had generated an apprehension before UNCTAD-IX, that UNCTAD's mandate, role and work programme may undergo substantial pruning and downsizing.

Some of the developed countries had also felt that UNCTAD should confine its activities to the least developed countries.

The Indian delegation made a strong plea for retaining UNCTAD's broad mandate for promoting trade and development on a global basis and stated that globalisation and liberalisation cannot be accepted as a panacea for resolving developmental problems of developing countries. The latter must develop their own natural resources, human resources and infrastructure to the maximum extent. The intergovernmental machinery of UNCTAD has been restructured to make it more focused so that it concentrates on the areas of its strength. The intergovernmental machinery with Trade and Development Board (TDB) at the apex, will have three Commissions viz.,

- Commission on trade in goods and services and commodities.
- Commission on investment, technology and related financial issues.
- Commission on enterprise, business facilitation and development.

- The Commission will convene expert meetings on specific issues. The total number of expert meetings will not exceed 10 in a year, of which, up to 4 may be convened by the Commission on trade and up to three each by the other two.

8.2. GATT and Tokyo Declaration.

NOTES

General Agreement on Tariff and Trade (GATT)

GATT an international organization created in 1947. It's Head Quarters in Geneva (Switzerland), for the promotion of Free Trade through multilateral trade negotiations. Originally it was thought that GATT would become part of the International Trade Organization (ITO). GATT was vested on three basic principles.

- i) Non discrimination
- ii) Elimination of Non-Tariff Trade
- iii) Consultation among nations in solving trade disputes within the GATT frame work.

The GATT (General Agreement on Tariff and Trade) was created in 1947. This is an international institution and its headquarter is in Geneva (Switzerland). The main objective of this institution was to reduce the barriers of trade through reduction of tariff, quota and subsidies. Originally, it was thought that GATT would become part of the International Trade Organization (ITO), whose charter was negotiated in Havana in 1948 to regulate international trade. When US senate and the governments of other nations have not passed ITO, then GATT (which was less ambitious then ITO) was restored.

Objectives of GATT

There are three basic objectives of GATT. Expansion of international trade Elimination of tariff barriers, quantitative restrictions and barriers to trade Full utilization of World's resources. These objectives can be achieved by GATT through unrestricted and multilateral trade.

GATT is based on three basic principles: Nondiscrimination:

Nondiscrimination is the basic principle of GATT contained in Article I. Contracting parties accept the so-called most-favoured- nations (MFN) clause i.e, all countries have same kind of treatment to all the contracting parties of GATT. This clause says that "any advantage, favour, privilege or immunity granted by a contracting party to any product originating in or destined for any country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all contracting parties." This clause was to encourage multilateralism and to discourage bilateralism so that world trade expanded in an orderly manner.

Reciprocity:

Reciprocity requires that if one country receives any benefits from another country should equivalent concession in return.

Free Trade:

GATT have 9 rounds of trade negotiation up still now. Main agenda of

GATT is to reduce tariffs (custom duties) on imported goods and non-tariff barriers (quotas), except for agriculture goods.

Solving trade disputes:

GATT helps in solving trade disputes between member countries. There were 123 member nations by 1993 including USA and other major countries; however, China, Taiwan, and former USSR are not members. The whole agreement covers more than 90% of world trade, tariff were reduced by almost 35% under the five different trade negotiations held between 1947 to 1962. Preferential trade treatment, to underdeveloped countries was introduced in 1965, which allow them to benefit from tariff reductions negotiated among industrial countries.

Before 1962 tariff negotiations was conducted on product-by-product basis and hence they were not achieved any great success. This was mainly because of serious protectionist devices by US government in the renewals of trade agreement acts.

Kennedy Round.In 1962, Trade Expansion Act was introduced which includes wide-ranging multilateral trade negotiations (known as Kennedy Round). As a result of this round, tariff rates on industrial products decreased by 35 percent of their 1962 level to be phased in 5 years. At the end of 1972 tariff rates in industrial nations were reduced and these are less than 10 percent on industrial products. but there are some non-tariff barriers particularly in agriculture sector.

Tokyo Round (1974), The major achievement of this round is further liberalization of trade by tariff reductions of up to 60 percent, which was accepted by 102 member countries. The major failure of this was that agriculture problem still unsolved and there was no reduction in the non-tariff barriers to trade.

Uruguay Round (1986-1994), In this round, new areas such as agriculture, textile services, etc were introduced. The major goods of this round were to improve the market access for agriculture goods, reducing subsidies and quotas on agriculture products, and textile and clothing.

The signing of the final round (Uruguay Round) of GATT in 1994, one of the most important changes was the setting up of World Trade Organization (WTO). WTO Agreement starts from Jan 1, 1995 with 75 existing GATT members and European Communities. India was also a founder member of the WTO. At present, there are 160 members' countries as on 26th June, 2014. The GATT was legal arrangement whereas WTO was new international organisation as a permanent body. It deals with the global rules of trade between nations. Operation of multilateral trade agreement and plurilateral trade agreement.

It was basically "designed to play the role of a watchdog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights etc." There are five functions of WTO as set in article III.

The organization may oversee the implementation administration and operations of Multilateral Trade Agreement and Plurilateral Trade Agreement through Trade Policies Review Body(TPRB).It provides the forum for negotiations among member countries for settling disputes. To administer rules

and procedures concerning settlement of disputes among the trading partners. To facilitate the administration, operationalisation and implementation of multilateral trade agreements. To work in tandem with IMF, World Bank and their affiliated organizations for better world trade.

All the decisions on multilateral trade were taken by Ministerial Conference, which has to meet at least once in two years.

Followings are the categories of WTO agreements:

NOTES

Trade in agriculture:

Under this agreement, all the participating nations do not maintain any types of non tariff quantitative import restrictions, variable import levies, minimum import prices, discretionary import licensing, etc. All the member nations have to reduce domestic support price if it is greater than 5 percent of the total value of production in case of developed countries and 10 percent of the total value of production in case of developing nations. WTO promotes competition in product market. WTO endeavours to increase market access, by decreasing trade barriers and elimination of discriminatory trade practices.

Agreement on Trade of Textile and Clothing:

The aim objective of this agreement is having free exports of textile and clothing across the countries. It requires the complete eliminations of Multi-Fiber Arrangements (MFAs), which had been in practice up to December 1994. MFAs were a series of bilaterally negotiated quota restrictions to limit the access of developing countries 'textile exports to the developed countries. This agreement envisaged that by January 1, 2005, all non tariff barriers in textile and clothing industries would be done away with elimination of non-tariff was to be implemented in phases and the developing countries were permitted to practice non tariff barriers if the imports were threatening their domestic industries.

General Agreement on Trade In Service (GATS):

The aim of this agreement is to attain progressively a liberalized, multinational mechanism of trade in services (like banking, insurance, telecommunications, air transport, and shipping tourism etc.) under the lens of transparency. This would expand and promote economic growth among the trading countries and would also help under developed countries in the following condition:

MNCs are permitted to operate across all member countries. Each trading partner would accord immediately and unconditionally to services and service provider of any other country. It has been agreed that "Most Favoured Nation" (MFN) would not be possible for every service activity, so parties may ask for specific exemptions which would be reviewed after five years.

This agreement i.e extremely important for India as it possesses a vast reservoir of specialists like IT professionals, chartered, and cost accountants, doctors, technicians to the entire world. Therefore, GATS would accelerate the trade of professional services.

8.3. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What means UNCTAD ?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is GATT?

8.4. Answer to check your progress Questions.

1. United Nations Conference on Trade and Development (UNCTAD), permanent organ of the United Nations (UN) General Assembly, established in 1964 to promote trade, investment, and development in developing countries. Headquartered in Geneva, Switzerland, UNCTAD has approximately 190 members.

2. General Agreement on Tariff and Trade (GATT)

GATT an international organization created in 1947. It's Head Quarters in Geneva (Switzerland), for the promotion of Free Trade through multilateral trade negotiations. Originally it was thought that GATT would become part of the International Trade Organization (ITO). GATT was vested on three basic principles.

i) Non discrimination

ii) Elimination of Non-Tariff Trade

iii) Consultation among nations in solving trade disputes within the GATT frame work.

8.5. Summary

In this unit you have learnt about the meaning definition international origination this knowledge would make you understand what is UNCTAD and how it can be practiced at a origination level The concept such as GA77 and Tokyo

declaration would have made you to distinguish these activities from the International origination activities as you must have learnt about the meaning as the origination in the international level

8.6. Key words

Non-Tariff Trade, Nondiscrimination

8.7. Self Assessment Questions and Exercises.

Short Answer Questions

1. What means UNCTAD ?
2. What is GATT?

Long answer Questions.

1. Explain the International Organization UNCTAD
 2. Describe GATT and Tokyo Declarations.
-

8.8. Further Readings.

Soderston, B. and G. Reed (1999), “**International Economics**”,
McMillan Press Ltd., London.

NOTES

UNIT-9: INTERNATIONAL ORGANIZATIONS - II

NOTES

Structure

- 9.1. WTO
- 9.2. Import Substitution and Export Promotion
- 9.3. Its Importance
- 9.4. Check your progress Questions.
- 9.5. Answer to check your progress Questions.
- 9.6. Summary
- 9.7. Key words
- 9.8. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 9.9. Further Readings.

9.1. WTO

World Trade Organization (WTO)

Internationally coordinated tariff reduction as a trade policy dates back to the 1930s. In 1930 the United States passed a tariff law known as the Smooth – Hawley Law. Under the act the tariffs rose sharply. US Trade volume fell sharply. It is argued by many economists that the Act is the reason behind the great depression of 1930's. US administration argued that the tariff should be reduced. But the reductions were not possible due to the pressure from the interested groups in US states. The only possible way is to go for bilateral negotiations. Such bilateral negotiations helped US to reduce their average level of tariffs from 59% in 1932 to 25 percent in the II world war period. Multinational negotiations started immediately after the II world War.

It was imagined that an international organisation called the International Trade Organisation (ITO) would be established along with the IMF and the World Bank. But a group of 23 countries began the trade negotiations to establish the General Agreement on Tariff and Trade (GATT). GATT was an official Agreement and not an organisation. The countries participated in the agreement were known as the contracting parties. GATT maintained a permanent secretariat in Geneva. In 1995 the World Trade Organisation (WTO) was established. The basic logic and the rules remains the same.

The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible. The World Trade Organization

(WTO) is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments.

The following are the main methods in which the WTO system works:

NOTES

More open

Lowering trade barriers is one of the most obvious ways of encouraging trade; these barriers include customs duties (or tariffs) and measure such as import bans or quotas that restrict quantities selectively.

Predictable and transparent

Foreign companies, investors and governments should be confident that trade barriers should not be raised arbitrarily. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices.

More competitive

Discouraging 'unfair' practices, such as export subsidies and dumping products at below cost to gain market share; the issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.

More beneficial for less developed countries

Giving them more time to adjust, greater flexibility and special privileges; over three-quarters of WTO members are developing countries and countries in transition to market economies. The WTO agreements give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions.

Protect the environment

The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health. However, these measures must be applied in the same way to both national and foreign businesses. In other words, members must not use environmental protection measures as a means of disguising protectionist policies.

Trade negotiations

The WTO agreements cover goods, services and intellectual property. They spell out the principles of liberalization, and the permitted exceptions. They include individual countries' commitments to lower customs tariffs and other trade barriers, and to open and keep open services markets. They set procedures for settling disputes. These agreements are not static; they are renegotiated from time to time and new agreements can be added to the package. Many are now being negotiated under the Doha Development Agenda, launched by WTO trade ministers in Doha, Qatar, in November 2001.

Implementation and monitoring

WTO agreements require governments to make their trade policies transparent by notifying the WTO about laws in force and measures adopted. Various WTO councils and committees seek to ensure that these requirements are being followed and that WTO agreements are being properly implemented.

All WTO members must undergo periodic scrutiny of their trade policies and practices, each review containing reports by the country concerned and the WTO Secretariat.

Dispute settlement

The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore for ensuring that trade flows smoothly. Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgements by specially appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

Building trade capacity

WTO agreements contain special provision for developing countries, including longer time periods to implement agreements and commitments, measures to increase their trading opportunities, and support to help them build their trade capacity, to handle disputes and to implement technical standards. The WTO organizes hundreds of technical cooperation missions to developing countries annually. It also holds numerous courses each year in Geneva for government officials. Aid for Trade aims to help developing countries develop the skills and infrastructure needed to expand their trade.

Outreach

The WTO maintains regular dialogue with non-governmental organizations, parliamentarians, other international organizations, the media and the general public on various aspects of the WTO and the ongoing Doha negotiations, with the aim of enhancing cooperation and increasing awareness of WTO activities.

Trade Rounds

These methods are used to improve the trade system through different Trade Rounds. In each Trade rounds groups of countries get together to negotiate a set of tariff reductions and other measures to liberalize trade. Eight trade rounds have been completed since 1947. The last round was the Uruguay round of trade negotiations in 1994. In 2001 there was the ninth round which is known as the Doha Round. The eighth round of trade negotiations started in the year 1986 at Punta de Este in Uruguay. After Eight long years of negotiations the participants could finally produce a document which is signed at Marrakesh in Morocco.

9.2. Import Substitution and Export Promotion

Most economists and policymakers view LDCs as consisting of large “**traditional**” and “**modern**” sectors. Hence development has come to be seen as a process of contracting the traditional sector and its growth-retarding institutions in favour of a growing modern industrial sector.

Less developed countries (LDCs) have adopted two alternative strategies for achieving industrialisation— viz., inward-looking strategy and outward-looking strategy.

An inward-looking strategy is an attempt to withdraw, at least in the short run, from full participation in the world economy. This strategy emphasises import substitution, i.e., the production of goods at home that would otherwise be imported.

This can economise on scarce foreign exchange and ultimately generate new manufactured exports without difficulties associated with the exports of primary products if economies of scale are important in import substituting industries and if the infant industry argument applies. The strategy uses tariffs, import-quotas and subsidies to promote and protect import-substitute industries.

In contrast, an outward-looking strategy emphasises participation in international trade by encouraging the allocation of resources in export-oriented industries without price distortions. It does not use policy measures to shift production arbitrarily between serving the home market and foreign markets.

In other words, it is an application of production according to comparative advantage; the current expression is that, the LDCs should 'get prices right'. This strategy focuses on export-promotion, whereby policy measure such as export subsidies, encouragement of skill formation in the labour force and the use of more advanced technology, and tax concessions generate more exports, particularly labour intensive manufactured exports in accordance with the principle of comparative advantage.

Import Substitution Strategy:

For various reasons, many LDCs have ignored primary-exports-led growth strategies in favour of import substitution (IS) development strategies. These policies seek to promote rapid industrialisation and, therefore, development by erecting high barriers to foreign goods in order to encourage domestic production. A package of policies, called import substitution (IS), consists of a broad range of control, restriction and prohibitions such as import quotas and high tariffs on imports.

The trade restrictions are intended to **“protect”** domestic industries so that they can gain comparative advantage and substitute domestic goods for formerly imported goods. IS policies are largely based on the belief that economic growth can be accelerated by actively directing economic activity away from traditional agriculture and resource-based sectors of the economy towards manufacturing.

The broad range of tariffs, quotas and outright prohibitions on imports that are part of IS policies are clearly not a form of infant industry protection. The infant-industry argument states that sectors and industries that can reasonably be expected to gain comparative advantage, after some learning period, should be protected.

But the broad protection under IS policies usually protect all industries indiscriminately, whether they generate technological externalities or have any chance of achieving competitive efficiency.

NOTES

NOTES

IS policies were advocated due to a very sharp decline in the prices of commodities and raw materials exported by many LDCs. Prebisch and Singer convincingly argued that low-income elasticity of demand for primary products implied that, in the long run, the terms of trade of primary product exporters would deteriorate.

In short, the IS approach to development applies the strategic argument for protection to one or more targeted industries in the LDCs. That is, the government determines those sectors best suited for local industrialisation, erects barriers to trade on the products produced in these sectors in order to encourage local investment and then lowers the barriers over time as the industrialisation process gains momentum.

If the government has targeted the correct sectors, the industries will continue to thrive even as protection comes down. In practice, however, the trade barriers are rarely removed. In the end, countries that follow IS strategies tend to be characterised by high barriers to trade that grow over time.

9.3. Its Importance

Development through Import Substitution Versus Exports:

During the 1950s, 1960s and 1970s, most developing nations made a deliberate attempt to industrialise rather than continuing to specialise in the production of primary commodities (food, raw materials, and minerals) for export as prescribed by the traditional trade theory.

Having decided to industrialise, the developing nations had to choose between industrialisation through import substitution and export-oriented industrialisation. Both policies have advantages and disadvantages.

An import substitution industrialisation (ISI) strategy has three main advantages:

- 1 The market for industrial product already exists, as evidenced by imports of the commodity. So risks are reduced in setting up an industry to replace imports.
2. It is easier for LDCs to protect their domestic market against foreign competition than to force developed nations to lower trade barriers against their manufactured exports.
3. Foreign firms are induced to establish so-called tariff factories to overcome the tariff walls of LDCs.

Against these advantages are the following disadvantages:

1. Domestic industries can grow by being accustomed to protection from foreign competition and have no incentive to become more efficient.

2. Import substitution can lead to inefficient industries because the narrow size of the domestic market in many LDCs does not allow them to take advantage of economies of scale.

3. After the simpler manufactured imports are replaced by domestic production, IS becomes more and more difficult and costly (in terms of higher protection and inefficiency) as more capital-intensive and technologically advanced imports have to be replaced by domestic production.

4. IS policies tend to limit the development of industries that supply inputs to protected industries, which produce consumer goods. The concept of the effective rate of protection suggests that tariffs tend to escalate by stages of processing.

5. The countries that pursue IS strategies tend not to apply high tariffs to capital goods. As such, imported capital goods are used extensively in domestic production. Supported by other domestic policies (e.g., minimum wage laws that tend to raise labour costs) domestic firms utilise relatively capital-intensive production techniques. This means that employment in a newly industrialising sector does not grow at the desired rate.

6. Finally, because the whole development strategy depends upon the choices made by government officials, considerable resources are devoted to rent-seeking activities. In any event, the resources used in these activities could have been devoted to productive enterprises and hence represent additional economic waste over and above the usual deadweight loss of protection.

Evidence:

In the post-Second World War (1939-45) period, many LDCs, after achieving independence, tried to reduce their reliance on imports, focused on IS policies, and a few, like Brazil, had a short period of success following that strategy. But, by and large, the countries following these strategies stagnated or grew very slowly.

Protectionist barriers were erected mainly to help support domestic industries but also to help some firms which enjoy high profits by being insulated from outside competition. In some cases, the inefficiencies were so great that the value of the imported inputs was higher than the volume of output at international prices.

Protection had been granted at times by using the infant-industry argument — the argument that new industries had to be protected until they could establish themselves properly to meet the competition. But in many of the developing countries, the infants never seemed to grow up—protection became permanent.

NOTES

9.4. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..What are the import substitution industrialisation (ISI) strategy has three main advantages ?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..Define WTO ?

2. It is easier for LDCs to protect their domestic market against foreign competition than to force developed nations to lower trade barriers against their manufactured exports.

3. Foreign firms are induced to establish so-called tariff factories to overcome the tariff walls of LDCs.

2. The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible. The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments

9.6. Summary

In this unit you have learnt about the meaning definition, Objectives of w to .This knowledge would make you indies tow what is import substation as how it can be practiced at international as w to level the concept such as import substitution export promotion would have made you to distinguish these activities form the WTO activities as you might have important in the international context.

9.7. Key words

Less developed countries, World Trade Organization

9.8. Self Assessment Questions and Exercises

Short Answer Questions

1. What are the import substitution industrialisation (ISI) strategy has three main advantages ?
2. Define WTO ?

Long answer Questions.

1. Describe WTO.
2. Explain Import Substitution and Export Promotion and its importance.

9.9. Further Readings.

Krugman P. R. and M. Obsfeld (2006), “**International Economics: Theory and Policy**”, Addison Wesley, New Delhi.

9.5. Answer to check your progress Questions.

1. 1. The market for industrial product already exists, as evidenced by imports of the commodity. So risks are reduced in setting up an industry to replace imports.

UNIT-10: ECONOMIC ORDERS

NOTES

Structure:

10.1. North South Dialogue and New International Economic Order

10.2. Usefulness

10.3. Check your progress Questions.

10.4. Answer to check your progress Questions.

10.5. Summary

10.6. Key words

10.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.

10.8. Further Readings.

10.1. North South Dialogue and New International Economic Order

NIEO: New International Economic Order:

At the Sixth Special Session of the United Nations General Assembly in 1975, a declaration was made for the establishment of a New International Economic Order (NIEO). It is regarded as “a turning-point in the evolution of the international community.”

NIEO is to be based on “equity, sovereign equality, common interest and co-operation among all States, irrespective of their social and economic systems, which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steadily accelerating economic and social development and peace and justice for present and future generations.”

Though the declaration on the NIEO by the General Assembly (GA) is of recent origin, the idea is not altogether a new one. In fact, a similar resolution was adopted by the GA itself long back in 1952.

Again, similar demands were raised from time to time by the UNCTAD since its inception in 1964. A.K. Das Gupta, however, says that what is spectacular about the NIEO Declaration is its timing.

The NIEO aims at a development of the global economy as a whole, with the set up of interrelated policies and performance targets of the international community at large.

Origin of NIEO:

The movement for the establishment of the NIEO is caused by the existing deficiencies in the current international economic order and the gross

failures of the GATT and the UNCTAD in fulfillment of their vowed objectives.

The present international economic order is found to be a symmetrical in its working. It is biased. It is favouring the rich- advanced countries. There has been over dependence of the South on the North. Rich countries tend to have major control over vital decision making in the matter of international trade, terms of trade, international finance, aids, and technological flows.

As a matter of fact, the basis for the NIEO is constituted by the Resolution in 1971, in the seventh special session on “Development and International Economic Co-operation” with various reforms in the area of international monetary system transfer of technology and foreign investment, world agriculture and cooperation among the Third World Countries.

The Resolution categorically mentions that “Concessional financial resources to developing countries need to be increased substantially and their flow made predictable, continuous and increasingly assured so as to facilitate the implementation by developing countries of long-term programmes for economic and social development.” It emphasises global interdependence. It seeks radical changes in allied social, economic, political and institutional aspects of international relations.

New developing sovereign countries of the South have insisted on the NIEO. It has been further supported by the non-aligned nations which vehemently criticised the politicalisation of development and trade issues by the developed nations. The developing nations are now asserting their right to participate in the decision making processes of the international institutions like the IMF, World Bank, GATT, UNCTAD, etc.

The origin of North-South dialogue for a new economic order may be traced back to over 30 years ago, at the Afro-Asian Conference at Bandung held in 1955. However, the formal idea of the NIEO was put forward in the Algiers Conference of non-aligned countries in 1973. In 1975, a declaration for the establishment of NIEO was adopted along with a programme of action in the Sixth Special Session of the UNCTAD.

10.1 The North-South Dialogue:

In 1977, there was a negotiation between the North and South at the Paris talks. The developed countries agreed to provide an additional U.S. 1 billion towards the Aid Fund for the development of the poor nations. In December 1977 the Willy Brandt Commission was set up with a view to review the issues of international economic development. The WB Commission’s Report (1980) stresses the need for North-South co-operation.

Beside establishment of a common development fund, its recommendations include strengthening the structure of development lending a code of conduct for the multi-national co-operation as well as the need for inter-governmental co-operation in monetary and fiscal areas along with the trade policies. It also proposed for the increasing participation of developing nations in

NOTES

the decision-making processes at international level.

As Mehboob-ul-Haque observes, the demand for NIEO is to be viewed as a part of historical process rather than a set of specific proposals. Its important facets are the emergence of non-aligned movement, the politicisation of the development issue and the increased assertiveness of the Third World countries.

The NIEO led to a serious thinking on the part of the developed countries (DC) to solve the problems of trade of LDCs. There has been a move towards programmed actions in two directions: (i) Commodity Agreements, with a view to stabilise prices of exportable of LDCs; and (ii) Compensatory Financing through IMF's liberal loans to LDCs having deficits due to fluctuations in prices.

Objectives of the NIEO:

In essence, the NIEO aims at social justice among the trading countries of the world. It seeks restructuring of existing institutions and forming new organisations to regulate the flow of trade, technology, capital funds in the common interest of the world's global economy and due benefits in favour of the LDCs. It has the spirit of a 'world without borders.'

It suggests more equitable allocation of world's resources through increased flow of aid from the rich nations to the poor countries.

It seeks to overcome world mass misery and alarming disparities between the living conditions of the rich and poor in the world as large.

Its aim is to provide poor nations increased participation and have their say in the decision-making processes in international affairs.

Among to other objectives, the NIEO envisages the establishment of a new international currency the implementation of SDR aid linkage, the increased stabilisation of international floating exchange system and the use of IMF funds as interest subsidy on loans to the poorest developing countries.

The crucial aim of the NIEO is to promote economic development among the poor countries through self- help and South- South co-operation.

The NIEO intends to deal with the major problems of the South, such as balance of payments disequilibrium, debt crisis, exchange scarcity etc.

PROGRAMME OF ACTION FOR THE NIEO:

- In essence, the UNCTAD resolutions provide a source of programme of action for the international economic order.
- The NIEO is not in favour of the existing system of free market orientation. It is biased in the less developed countries through interventionist approach.
- Its action programme narrates the need for a more rapid economic development of the poor countries and their increasing share in the world's trade at favourable terms of trade.
- Its line of action is to adopt discriminatory approach in trade favouring the LDCs.
- It also insists on de-politicalisation in the flow of official as well as private direct investment from the rich to the poor countries.

- It contains that aid has to be of multi-lateral form with a view to facilitate structural adjustments in the less developed countries.
- It also stresses the need for restructuring the international monetary system.
- There has been always a great opposition from the rich countries. They have vested interests which do not allow for the healthy outcome and actions in various negotiations and their implementation. Again, the poor countries have weak bargaining power in negotiations. Further, there is very weak trade link between LDCs and the socialist blocs.
- So far, however, no result-oriented action programme has been undertaken. Nevertheless, the zeal for an NIEO should be continued in the interest of the global welfare.

NOTES

Technological Progresses and Trade

As knowledge of new and more efficient methods of production become available, technology changes.

Furthermore new inventions may result in the increase of the efficiency of all methods of production. At the same time some techniques may become inefficient and drop out from the production function.

These changes in technology constitute technological progress.

Graphically the effect of innovation in processes is shown with an upward shift of the production function (figure 3.27), or a downward movement of the production isoquant (figure 3.28). This shift shows that the same output may be produced by less factor inputs, or more output may be obtained with the same inputs.

Technical progress may also change the shape (as well as produce a shift) of the isoquant. Hicks has distinguished three types of technical progress, depending on its effect on the rate of substitution of the factors of production.

Capital-deepening technical progress:

Technical progress is capital-deepening (or capital-using) if, along a line on which the K/L ratio is constant, the MRSL K increases. This implies that technical progress increases the marginal product of capital by more than the marginal product of labour. The ratio of marginal products (which is the MRSL K) decreases in absolute value; but taking into account that the slope of the isoquant is negative, this sort of technical progress increases the MRSL K. The slope of the shifting isoquant becomes less steep along any given radius.

Labour-deepening technical progress:

Technical progress is labour-deepening if, along a radius through the origin (with constant K/L ratio), the MRSL, K increases. This implies that the technical progress increases the MPL faster than the MPK. Thus the MRSL, K, being the ratio of the marginal products $[(\partial X/\partial L)/(\partial X/\partial K)]$, increases in absolute value (but decreases if the minus sign is taken into account). The downwards-shifting isoquant becomes steeper along any given radius through the origin. This is shown in figure 3.30.

Neutral-technical progress:

Technical progress is neutral if it increases the marginal product of both factors by the same percentage, so that the MRSL K (along any radius) remains

constant. The isoquant shifts downwards parallel to itself.

NOTES

10.2. Usefulness

It suggests more equitable allocation of world's resources through increased flow of aid from the rich nations to the poor countries.

It seeks to overcome world mass misery and alarming disparities between the living conditions of the rich and poor in the world as large.

Its aim is to provide poor nations increased participation and have their say in the decision-making processes in international affairs.

Among to other objectives, the NIEO envisages the establishment of a new international currency the implementation of SDR aid linkage, the increased stabilisation of international floating exchange system and the use of IMF funds as interest subsidy on loans to the poorest developing countries.

The crucial aim of the NIEO is to promote economic development among the poor countries through self- help and South- South co-operation.

The NIEO intends to deal with the major problems of the South, such as balance of payments disequilibrium, debt crisis, exchange scarcity etc.

10.3. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. Define NIEO?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What are the Technical progress at NIEO ?

.....

10.4. Answer to check your progress Questions.

1. NIEO is to be based on “equity, sovereign equality, common interest and co-operation among all States, irrespective of their social and economic systems, which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steadily accelerating economic and social development and peace and justice for present and future generations.”

2. Technical progress is neutral if it increases the marginal product of both factors by the same percentage, so that the MRSL K (along any radius) remains constant. The isoquant shifts downwards parallel to itself.

NOTES

10.5. Summary

In this unit have learnt about the meaning, usefulness of economic World. This knowledge would make you understand what is economic orders as how it can be practiced at a north south Dialogue. The concept such as north south Dialogue and new illustration Economic order would have made you to distinguish these activities from the Economic world activities and you must have learnt about the meaning and its usefulness in the illustration economic order concept.

10.6. Key words

New International Economic Order, Capital-deepening technical progress

10.7. Self Assessment Questions and Exercises.

Short Answer Questions

1. What are the objectives in NIEO?
2. Write about the Labour-deepening technical progress.

Long answer Questions.

1. Explain North South Dialogue and New International Economic Order
2. Describe NIEO and its usefulness.

10.8. Further Readings.

Soderston, B. and G. Reed (1999), “International Economics”,
McMillan Press Ltd., London.

BLOCK IV: BALANCE OF PAYMENTS, TRADE AND EXPORT ASSISTANCE

UNIT-11: BALANCE OF PAYMENTS (BOP):

11.1. Meaning

11.2. Structure

11.3. Importance of Balance of Payments

11.4. Check your progress Questions.

11.5. Answer to check your progress Questions.

11.6. Summary

11.7. Key words

11.8. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.

11.9. Further Readings.

11.1. Meaning

Balance of Payment (BOP) is a summary statement of all economic transactions of the residents of a nation with the residents of Rest of the World (ROW) during a particular period of time. BOP is recorded usually for a Calendar year. In other words B O P is a systematic statistical statement or record of the character and dimensions of the country's economic relationship with the rest of the world. Balance of payments is integral parts of national accounts for an open economy.

The main purpose of the Balance of Payment is to inform the Government of the international economic position of the nation and to help in formulating its of monetary, fiscal and trade policies. The Foreign Governments also use the Balance of Payment accounts for the purpose of formulating trade relation with other countries. Other economic agents like Bank firms and individual may also depend upon the Balance of Payment accounts for various purposes. The Balance of Payment account serves another purpose. The balance of Country's foreign transactions and accompanying issues of the exchange date

and reserves (whether of Gold or of foreign currencies) has long been a focus of interest for policy members. Thus the state of B.O.P plays an essential role in providing information to economic agents and Governments. According to Sodersten, “The B.O.P is nearly a way of listing receipts and payments in international transactions for a country”.

The Balance of Payment account have significant role in an open economy. An open economy is one which has economic relations with the rest of the world. An economic transaction is an exchange of value, involving a payment or receipts of money in exchange of a good, a service or an asset for which payment is made between the resident of a country with resident of the rest of the world. In ‘barter trade’, goods are exchanged for goods and in some cases assets are transacted against assets. Some goods are transferred to other as a gift, without expecting payment known in economics as the transfer payments or unilateral transfers. Each of these transactions occurs between the residents of a country and between the economic agents residing in two different countries. If the exchange is happening between the residents of two countries, that transaction is an International economic transaction. An international economic transaction is systematically recorded in the books of accounts of balance of payments. Balance of payments are maintained in a ‘Double entry book keeping principle’. Under such principle each transaction in the balance of payments is entered as a Credit or a Debit entry. A ‘Credit entry’ in Balance of Payments refers to an inflow or that transaction is the one that shows a receipt of funds from the rest of the world. Similarly a ‘Debit entry’ Balance of Payments refers to an outflow or that transaction is the one that shows a payment of funds to the rest of the world. According to the Double entry book keeping principle, for each Debit entry a corresponding Credit entry is made to keep the balance of payment always in balance.

Balance of payments (bop):

NOTES

11.2. Structure

Inflow or Credit

Resident of the Resident of ROW the Domestic Nation

Outflow or Debit

In the above flow chart diagrams the 1st flow shows an inflow of value which may appear as a Credit entry in the books of accounts of Balance of payments on the Domestic Country. This Inflow of value includes the receipts that the Resident of the domestic territory gets in return for the Export of commodities or Services (also known as the invisibles), unilateral transfers and the Foreign Capital receipts. 2nd flow shows an outflow of value. This may appear as a Debit entry in the books of accounts of Balance of payments of the Domestic Country. This outflow of value includes the payments that the Resident of the domestic territory makes in return for the Imports of commodities or Services (also known as the invisibles), unilateral transfers and the Investments abroad.

Balance of payments and balance of trade

All countries engaging in International Exchange of value may import some commodities and services from other countries. They also export certain other

NOTES

commodities and services which are surplus in their country. The difference between the value of goods and services exported out of a country and the value of goods and services imported into the country is known as the Balance of Trade. If a country has a balance of trade deficit, it imports more than it exports, and if it has a balance of trade surplus, it exports more than it imports. The balance is said to be favorable when the value of the exports exceeded that of the imports (i.e. exports exceed imports), and unfavorable when the value of the imports exceeded that of the exports (i.e. imports exceed exports). In other words it is the difference between the value of goods and services exported out of a country and the value of goods and services imported into the country. The balance of trade is the official term for net exports that makes up the balance of payments. The official balance of trade is separated into the balance of merchandise trade for tangible goods and the balance of services.

A balance of trade surplus is most favorable to domestic producers responsible for the exports. However, this is also likely to be unfavorable to domestic consumers of the exports who pay higher prices. Alternatively, a balance of trade deficit is most unfavorable to domestic producers in competition with the imports, but it can also be favorable to domestic consumers of the exports who pay lower prices. Balance of Payments is essentially maintained in double entry book keeping principle. They record all international transactions between the residents of one country with the residents of other countries. Here residents refer to the individuals, business and governments and their agencies.

International organizations are also regarded as foreign residents. Balance of payment accounts are kept in standard Double entry book keeping principle. International transactions are recorded in the balance of payments as a credit and a debit transaction. Credit transaction is that transaction which involves the receipt from the residents of the rest of the world. A debit transaction on the other hand involves a payment to the foreign residents. Under this method, each international transaction undertaken by the residents of a country are entered as a debit and credit entry of equal size, into the balance of payments. For example an export entered as credit in a country's balance of payment is followed by a debit entry of equal size, to show the manner in which the transaction is undertaken. Import transactions are entered as a debit transaction in the balance of payments and a credit entry of equal size is made in the books of account.

On the basis of its value 3 possibilities are there. They are: If Debit balance $>$ Credit balance it leads to Balance of Payment deficit. Here the inflow will be lesser than the outflow. Hence the nation experiences a deficit in its Balance of Payment accounts. On the other hand if the Debit balance $<$ Credit balance we have a Balance of Payment Surplus. Here the outflow will be lesser than the inflow. If Debit balance = Credit balance then we can say that the nation's Balance of Payment is in balance.

Balance of Payment Accounts consists of the two sub accounts. They are Current account and Capital Account. Current account includes visible items (commodities) and Invisible items (Services). Capital account consists of long term and short term capital flows. Let us explain them in detail.

11.3.Importance of Balance of Payments

Balance of payments (bop):

The Current Account

The current account includes exports and imports of goods and services & unilateral transfers. Exports, weather it is goods or services are by convention entered as a credit items in the account. Imports are normally calculated free on board. That means that the cost of transportation, insurance etc are not included. Imports are normally calculated c.i.f (cost, insurance, freight). Transportation, insurance cost and freight are included.

Balance of payment accounts usually make differences between trade in goods and trade in services. In the current account of Balance of payment accounts, we have a visible part of commodities' and Invisibles part of Services'. The net of exports and import of visibles in Balance of payment accounts is called the merchandise trade balance. The net of exports and import of invisibles or services in Balance of payment accounts is called the services trade balance. Travel, Business Process outsourcing, Medical Transcription etc are examples for international trade in Services. The Capital account, on the other hand, consists of long term and short term capital flows. Let us explain them in detail.

Invisible trade is much more heterogeneous them the trade in goods. Trade in the latter, of which shipping, banking and insurance services and payments by residents as tourists abroad are usually the most important, Exports and imports of such services are flows of outputs whose values will be determined by the same variable that could affect the demand on supply for goods unilateral transfer or transfer payments.

Unilateral transfers are receipts which the residents of a country receive for free, without making any present or future service transaction in return. Unilateral receipts from abroad are entered as positive items and they are credited. Unilateral payments abroad are entered as negative items and they are debited. Unilateral transfers may be private unrequited transfers, which may be in the form of gifts received by domestic residents from foreign residents. Secondly official unrequited transfers, is the payment of pure aid by governments in developed countries to government in less developed countries (LDCs). A third form of unilateral transfer has been important reparation payments. Typically such payments occurred when a morally and physically superior country came out of war and was in a position to make the foreign country or its former enemy pay indemnities.

The net value of the balance of visible trade and invisible trade and of unilateral transfers defined the balance on current account. It is, however, services and transfer payments or invisible items of the current account that reflect the true picture of the balance of payments account. They, along with the visible items, determine the actual current account position. If export of goods and services exceed import of goods and services, the balance of payments is said to be favorable. In the opposite case, it is unfavorable. In the current account, the exports of goods and services and the receipts of transfer payments are entered as credit because they represent the receipt from foreigners. On the other hand, the imports of goods and services and transfer of payments to foreigners are entered as debits because they represent payments to foreigners.

NOTES

The Capital Account

The capital account records all international financial transactions that involve resident of the country concerned- changing either his assets with or his liabilities to a resident of another country. Transactions in the capital account reflect change in a stock – either assets or liabilities. It is often useful to make distinctions between various forms of capital account transactions. The basic distinctions are between private and official transaction; between portfolio and direct investments. Distinction between private and official transaction is fairly transparent and need not concern us too much. On the other hand, portfolio investments are the acquisition of an asset that does not give the purchaser control over it. An example is the purchase of shares in a foreign company or of bonds issued by a foreign government. Loans made to foreign firms or governments come into the same broad category. Foreign Direct investment (FDI) is the act of purchasing an asset and at the same time accruing control of it. The acquisition of a firm residing in one country by a firm in another country is an example.

The purchase of an asset in another country whether it is direct or portfolio investment, would appear as a debit item in the capital account for the country of the firm which purchase it and as a negative item in the capital account for the other country. The capital account outflows appear as a debit item in country's balance of payments and capital inflows as credit items. The net value of the balance of direct and portfolio investment defines the balance on capital account.

Errors and Omissions

The balances of payments accounts are completed by the entering some other minor items that can be identified but do not fall comfortably into one of the standard categories. Errors and omissions, which reflect transactions that have not been recorded for various reasons and cannot be entered under a standard heading, may cause Errors and omissions. Balance of payments is constructed as an accounting identity with each transaction theoretically recorded twice, the sum total of debits and credits should in theory always be equal. That means that if a debit entry is made to record an outflow of value, a corresponding credit entry is to be made in some other part of the books of account for theoretically maintaining balance in the books of accounts of the balance of payments. However one or other of the parts of transaction takes more than one year. Discrepancy may arise and the Balance of payment may not balance.

Official Reserves Account

The official reserves account measures the changes in the official reserves and changes the foreign official assets in the country during the year. Official reserves consist of gold, Special Drawing Rights (SDRs) borrowed from the IMF, and holding of foreign convertible currencies. The changes in the country's reserves must reflect the net value of all the other recorded items in the balance of payments. These changes will of course be recorded accurately, and it is the discrepancy between the changes in reserved and the net value of the other recorded items that allows identifying the errors and omissions.

Increase in official reserves represents capital outflows from the country and are recorded as debits in the official reserves accounts of the books of accounts of Balance of Payments of the country. Any decrease in the official reserves is recorded as capital inflows and are credit entries in the reserves accounts of the books accounts of Balance of Payments of the country. The entries are similar to that of private capital but we are here dealing with the official capital. The items of the balance of payments account of the country can be noted (distinguishing credits and debits) as shown below:

- Export of Goods
- Export of Services
- Current Account
- Import of Goods
- Import of Services
- Balance of Payments
- Capital Receipts (Direct Investment, Portfolio Investment) and other capital receipts.
- Capital Account
- Capital payments (Direct Investment, Portfolio Investment) and other capital payments abroad.
- Official Reserve assets
- Official Reserve Accounts
- Official Reserve liabilities.

Autonomous and Accommodating Flow

It is useful to distinguish between autonomous and accommodating items in the balance of payments. All transactions in the current and capital account are called automatic transactions. Transactions are said to be autonomous if their value is determined independently of the balance of payments. They take place for business or private motive. Accommodating items are transactions that come under the official reserve account and are determined by the net consequences of the autonomous items. They are required to balance international transactions. Alternatively items are said to be above the line (autonomous) or below the line (accommodating). Obviously the sum of the accommodating and autonomous items must be zero, since all entries in the balance of payment s accounts must come under one of the tw3o headings. A deficit in a nation's balance of payments is given by a net debit balance in the nation's autonomous items and a surplus is given by a net credit balance. In order to correct the deficit the accommodating flows to be positive in the first case and negative in the second.

The autonomous capital flow could take many forms. It could have been caused, for instance, by a foreign resident paying back a loan to a firm or it could be that a person or a company took up a loan abroad, by issuing bonds for instance. In all these cases it is a question of private persons or firms having international capital transaction. These transactions have an effect on the country's balance of payments but they are in no way caused by balance of

Balance of payments (bop):

NOTES

payments considerations. In fact, they are all examples of autonomous capital movements.

The accommodating inflow of capital can take various forms. Foreign firms might accept short term claims on firms in the country or perhaps a foreign government extends a loan to the country. In the case of a less developed country, it might even be possible that a foreign government is willing to ease the balance of payments situation of the country by making it a gift amounting to the value of the accommodating inflow. Or possibly the county in question has had to deplete its reserves of foreign currency to settle its imbalance in autonomous capital inflow. In short the accommodating capital movements are a direct consequence of the balance of payments situation. Accommodating capital inflows are unforeseen capital flows, which have to be made to bring the balance of payments into equilibrium.

Equilibrium and Disequilibrium in the Balance of Payments

Balance of payments should always be in equilibrium. Disequilibrium in the balance of payments of a country appears either as a surplus or as a deficit. A Surplus in the balance of payments implies receipts from the rest of the world exceed payments made to rest of the world. A Deficit in the balance of payments occurs as the payments made to foreigners exceed receipts from the Rest of the world. As a BOP is in equilibrium any positive balance in its current accounts is exactly offset by a negative balance on its capital account and vice versa. In an accounting sense, the balances of payments always balance.

There is difference of opinion with regard to the primary cause of imbalances in Balance of Payments. Conventionally it is believed that the factors with regard to the current accounts are the primary causes of imbalance. They include the appreciation or a depreciation of exchange rate, the government's fiscal deficit, business competitiveness, and private behavior such as the willingness of consumers take debt to finance extra consumption. An alternative view, as argued by Ben Bernanke, the chairman of the American Federal Reserve, in a 2005 paper, is that the primary driver of Balance of payment deficit is the capital account. He maintained that the cause of Balance of payment disequilibria of US is a global savings glut which caused a runs ahead of savers in surplus countries, over the available investment opportunities, which resulted in excess consumption and asset price inflation.

Balance of Payments Adjustments with Exchange Rate Changes

Under flexible exchange rates, the disequilibrium in the balances of payments is automatically solved by the forces of demand and supply for foreign exchange. An exchange rate is the price of a currency which is determined, like any other commodity, by demand and supply. The exchange rate varies with varying supply and demand conditions, but it is always possible to find an equilibrium exchange rate which clears the foreign exchange market and creates external equilibrium. This is automatically achieved by a depreciation (or

appreciation) of a country's currency in case of a deficit (or surplus) in its balance of payments. Depreciation (or appreciation) of a currency means that its relative value decreases (or increases). Depreciation has the effect of encouraging exports and discouraging imports. When exchange depreciation takes place, foreign prices are translated into domestic prices.

Balance of payments (bop):

Suppose the Rupee depreciates in relation to dollar. It means that the price of a rupee falls in relation to the dollar in the foreign exchange market. For example assume that the value of Indian currency was around Rs 40 = 1\$ in 2008. Imagine that there is a deficit in India's BOP.

NOTES

Deficit is due to large imports compared to its exports. In 2013, depreciation of Indian rupee caused the exchange rate to increase to RS 68 = 1\$. This causes exports to increase and imports to fall. In 2008 an Indian citizen could purchase 1 \$ worth commodity with Rs 40, but the same dollar worth commodity is worth RS 68 today. Hence the Imports fall and exports increase. The Balance of payment moves back to equilibrium. The effect of depreciation of a currency is to make imports dearer and exports cheaper. Thus, this leads to the lowering of the prices of Indian exports in US and raising the prices of US imports in the India. When import prices are higher in the India, Indians will purchase fewer goods from the U S. On the other hand, lower prices of Indian exports will increase their sales to U S. Thus the India exports will increase and imports diminish, thereby bringing equilibrium in the balance of payments.

ASSUMPTIONS

The analysis is based on the following assumptions

- There are only two countries.
- Both are on flexible exchange rate system
- BOP disequilibrium is automatically adjusted by changes in exchange rates 4, Prices are flexible in both the countries
- There is free trade between the two countries
- Given these assumptions, the adjustment process is explained in terms of the following
- In the above figure D is the Indian demand curve of U S \$ which is a derived demand from the demand for U S imports, and S is the U.S. supply curve of foreign exchange representing its exports to India.

At p the demand and supply of the Indian foreign exchange is in equilibrium where the rate of exchange between Indian Rupee and US \$ is $o_d = o_{ss}$ and the quantity of exchange is $o_d = o_{ss}$. If the exchange rate is at p_1 the demand for U S dollar is greater than its supply. This implies that the import from US is greater than exports, and hence a deficit in India's BOP. This causes the Rupee to depreciate and the exchange rate finally sets at p and BOP reaches back to equilibrium. The currency needs to be depreciated by p_1/p amount for the BOP to be in balance. The exact opposite happens when the exchange rate is at p_2 (a

surplus in BOP).

The above analysis based on the assumptions of relative elasticity of demand and supply of foreign exchange. However, in order to measure the full effect of depreciation on relative prices in the Balance of payment of the country we have to take the impact of these elasticity also. It is not necessary that the demand and supply conditions to be relatively elastic as shown in the above diagram. N additional demand and supply curve as illustrated in the below given diagram requires more depreciation to correct the disequilibrium in the BOP.

Where the original less elastic demand and supply curves of foreign exchange are d and s respectively which intersect at p and the equilibrium exchange rate is op . Here the new sets of demand and supply curves (d' and s') intersects at a higher point iee' and p_1p_2 depreciation is insufficient to bring about equilibrium in the BOP. here we need p_1p_2 depreciation in the domestic currency. Hence greater depreciation is needed when the Demand and Supply of foreign currency is relatively inelastic.

Automatic price adjustment under gold standard Under the international gold standard which operated between 1880-1914, the currency in use was made of gold or was convertible in to gold at fixed rate. The central bank of the country was always ready to buy and sell gold at the specified price. The rate at which the standard money of the country was convertible into gold was called the mini price of gold. This rate was called the mint parity or mint par of exchange because it was based on the mint parity by the cost of shipping gold between the two countries.

Suppose the US had a deficit in its balance of payments with Britain. The difference between the value of imports and exports would have to be paid in gold by US importers because the demand for pounds exceeded the supply of pounds. But the transshipment of gold involved transportation cost and other handling charges insurance, etc. Suppose the shipping cost of gold from the US to Britain was 3 cents. So the importers would have to spend \$6.03(\$6+.03c) for getting£1. This could be the exchange rate which was the US gold export point or upper specie point. No US importer would pay more than \$6.03 to obtain £1 because he could buy \$6 worth of gold from the US treasury and ship it to Britain at a cost of 3 cents per ounce. Similarly, the exchange rate of the pound could not fall below \$5.97 to a pound was the US gold import point or lower specie point.

The exchange rate under the gold standard was determined by the forces of demand and supply between the gold points and was prevented from moving outside the gold points by shipments of gold. The main objective was to keep BOP in equilibrium. Deficit or surplus in BOP under the gold standard was automatically adjusted by the price-specie-flow mechanism. For instance, BOP deficit of a country meant a fall in its foreign exchange reserves due to an outflow of its exports and reduce its imports. This adjustments process in BOP was supplemented by a rise in interest rates as a result of reduction in money supply. This led to the inflow of short-term capital from the surplus country. Thus the inflow of short-term capital from the surplus to the deficit country helped in restoring BOP equilibrium. Adjustment mechanism of balance of

payments under income approach In examining the price adjustment mechanisms, we implicitly assumed that national income remained constant. However, a change in the level of trade affects national income, which in turn induces a change in the value of imports.

Balance of payments (bop):

For example starting from an equilibrium position in the balance of trade and less than full employment domestically, an autonomous increase in the value of exports causes real national income (Y) to rise by an amount equal to the increase in X times the foreign trade multiplier k, if the marginal propensity to save or $MPS = \Delta S / \Delta Y = 0$, then $k = 1 / MPM$, where is the marginal propensity to import, OR $\Delta M / \Delta Y$. In this case, the induced increase in M resulting from the increase in Y equals the original autonomous increase in X, and so the adjustment in the balance of payments is complete. If, on the other hand (more realistically) $MPS > 0$, $K = 1 / (MPS + MPM)$ and the induced increase in M falls short of the increase in X and the adjustment is incomplete

NOTES

Trends in India's BOP

The true index of economic prosperity or disparity of a country in relation to the other countries of the world is provided by the balance of payments account. A typical problem of the developing countries is that of a chronic BOP deficit, India being no exception. This mainly due to unequal sharing of gain from trade, deterioration in under developed countries Terms of Trade. India has been facing BOP disequilibrium right since independence, culminating into a disaster in 1990-91, the year of the acute BOP crisis. Indian foreign reserves fell below \$1 billion, barely sufficient to finance a month's import bill. India approached the International Bank for Reconstruction and Development (IBRD), popularly known as World Bank and the International Monetary Fund (IMF), and received \$7 billion as loan to manage the crisis. For available the loan, these international agencies expected India to liberalise and open up the economy by removing restrictions on the private sector, reduce the role of the government in many areas and remove trade restrictions.

BOP situation pre-reform period

The India's BOP always under pressure and had huge deficits due to high imports of food grains and capital goods, the heavy external borrowings and its payment and poor exports. India's aim after attaining independence was to attain economic self-reliance. For this the country had to tap both the internal as well as the external resources. Not only was our technology backward then, there was food scarcity too. Large amounts of food grains had to be imported to feed the huge population. Self reliance was to be achieved through import substitution. For this basic industries had to be set up which required import of capital goods. Heavy capital goods were imported but other imports were severely restricted to shut off competition in order to promote domestic industries. All focus was on import substitution, with gross neglect of exports. Such inward looking protectionist policies did result in some self-reliance in the consumer goods industries, but the capital goods industries remained mostly import intensive. The high degree of protection to Indian industries led to

NOTES

inefficiency and poor quality products due to lack of competition. The high cost of production further eroded our competitive strength. These are the some internal factors that causes for the deficit in BOP.

Rising petroleum products demand, the two oil shocks, harvest failure, all put severe strain on the economy. The BOP situation remained weak throughout the 1980s, till it reached the crisis situation in 1990-91. When India was on the verge of defaulting due to heavy debt burden and constantly widening trade deficit. India had to resort to large scale foreign borrowings for its developmental efforts in the field of basic social and industrial infrastructure. The country's resources were very much limited due to low per capita income and savings. The situation worsened because Government of India resorted to heavy foreign borrowings to correct the BOP situation in the short run out of panicky. By 1985-1990 India had to resort to large scale foreign borrowings for its developmental efforts in the field of basic social and industrial infrastructure. The country's resources were very much limited due to low per capita income and savings. The situation worsened because Government of India resorted to heavy foreign borrowings to correct the BOP situation in the short run out of panicky.

India mainly primary product exporters, the price of which fluctuated heavily with fluctuations in world market demand. Primary products exporting countries have an unfavorable term of trade. The earnings from primary product exports were low and unstable. The quality of Indian products was not up to the world standards due to which we could not sustain markets. The instability of the exchange value of the rupee was another problem. The constant devaluations (to promote exports) raised the amount of external debt. The value of rupee was managed by the central bank (fixed exchange rate). The strict foreign exchange controls also encouraged hawala trade.

India followed a strongly inward looking policy, laying stress on import substitution. Ideally, imports should be financed by export earnings. But because there was export pessimism, the deficit was financed either by the invisible earnings or by foreign aid or depletion of valuable foreign exchange reserve. India's BOP was thus beset with several problems. The process of liberalization began from the mid 1980s. Restriction on certain imports were removed, particularly those which were used as inputs for export production. But by then the situation was already bad and all the mismanagement ultimately led to the 1990-91 BOP crisis..

TRENDS IN INDIA'S BOP POST AND PRE REFORM PERIODS

It is clear from the Table1 the Balance of Payment situation started

improving since 1991 except for the years 1995-96 and 2008-09. The reasons for satisfactory performance of BOP are as follows :-

Balance of payments (bop):

High earnings from invisibles: The positive earnings from invisibles covered a subpart of the trade deficit with the result that the account deficit was reduced significantly. Earning invisibles exceeds the deficit on trade account in 2001-02, 2002-03 and 2003-04 with the result that there surplus on current account in these years. The software exports and private remittances that are the main new contributors to improve in the balance of payment situation recently.

NOTES

Rise in external commercial borrowing: External commercial borrowings have been an important source of funds for the government. Over the years the net external commercial borrowings have increased. In 1991-92 the external commercial borrowing was \$1456 million

During 2001-02 to 2003-04 external commercial borrowing were negative. During 2007-08, the external commercial borrowing were \$22609 million which was 21.0 percent or one-fifth of total capital inflow (net). In 2008-09, external commercial borrowings were only \$7941 million

Non-Resident deposits: The non-resident deposits add to the capital account of BOP. In 1990-91, non-resident deposits (net) were 1.5 US \$ billion, which increased to 2.9 US \$ billion in 2009-10. The various schemes of incentives announced by Indian government helped in attracting huge deposits from non-resident Indians.

Role of Foreign Investment: Foreign investment is constituted of (1) foreign direct investment and (2) portfolio investment. portfolio investment, in turn consists of (a) foreign institutional investment and (b) euro equities and others (which includes Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Offshore funds and others). Since 1991 the government has been offering various concessions, facilities and incentive to the foreign investors with a view to encouraging foreign investment into the country. These measures have helped in increasing foreign investment substantially in the recent years. In 1993-94, the foreign was \$4,235 million which was 43 percent of the total capital inflows (net) of \$9882 million in the country. In 2002-03 it was \$4161 million and rose to \$14753 million in 2007-08 and \$3467 million in 2008-09 because of Global recession investors withdrawal of portfolio investment.

Table1 India's BOP Indicators (1980-2012) (US \$ million)

Year	Net Balance	Balance Invisible	Current A/C	Balance A/C	Overall Balance	Reserve Increase
1980-81	-7869	5065	-2804	1665	-1140	654
1981-82	-7273	4094	-3179	657	-2523	1812
1982-83	-6978	3572	-3407	2087	-1319	-649
1983-84	-6714	3499	-3216	2655	-561	-750
1984-85	-5654	3238	-2417	3147	730	-779
1985-86	-7833	2967	-4867	4506	-361	577
1986-87	-7316	2756	-4560	4512	-47	573

Balance of payments (bop):

NOTES

1987-88	-7168	2316	-4852	5047	195	737
1988-89	-9361	1364	-7997	8064	68	1001
1989-90	-7456	615	-6841	6977	136	740
1990-91	-9437	-242	-9680	7188	-2492	1278
1991-92	-2798	1620	-1178	3777	2599	-3384
1992-93	-5447	1921	-3526	2936	-590	-698
1993-94	-4056	2897	-1159	9694	8535	-8723
1994-95	-9049	5680	-3369	9156	5787	-4644
1995-96	-11360	5447	-5912	4690	-1222	2937
1996-97	-14815	10196	-4619	11412	6793	-5818
1997-98	-15507	10008	-5499	10010	4511	-3893
1998-99	-13246	9208	-4038	8260	4222	-3829
1999-00	-17841	13143	-4698	11100	6402	-6142
2000-01	-12460	9794	-2666	8535	5868	-5842
2001-02	-11574	14974	3400	8357	11757	-11757
2002-03	-10690	17035	6345	10640	16985	-16985
2003-04	-13718	27801	14083	17338	31421	-31421
2004-05	-33702	31232	-2470	28629	26159	-26159
2005-06	-51904	42002	-9902	24954	15052	-15052
2006-07	-61782	52217	-9565	46171	36606	-36606
2007-08	-91467	75731	-15737	107901	92164	-92164
2008-09	-119519	91605	-27915	7835	-20079	20080
2009-10	-118202	80022	-38180	51622	13441	-13441
2010-11	-130593	84648	-45945	58996	13050	-13050
2011-12	-189759	111604	-78155	65324	-12832	12831

Source: RBI, Hand book of statistics on Indian Economy

From the table-1 it is clear that India's trade balance shows a deficit through-out all years, which is shown in the figure-1. The intensity of deficit, shows an increasing rate. It is because of a continuous and faster increase in import compared to its export. After 2004-05 India's trade balance shows a much more higher deficit mainly due to increase in crude oil price in international market, depreciation of Indian currency which worsen the import bill, fall in export earnings due the financial crisis.(table-3, Fig-3)

India's current account also reflects a continuous deficit in all years except 2001-02, 2002-03, 2003-04. It is because of strong capital inflows during that periods. It is shown in fig-2. Current account deficit is comparatively low when we compared to trade deficit it is because higher earnings from invisibles which covers huge part of trade deficit.

In capital account all years appear with a surplus value. There is a low capital inflow during 2008-09 periods because of high withdrawal of portfolio investment due the financial crisis. It also affects overall balance of payment of our country. The overall balance of payment of our county shows a fluctuating trends. In 1980-81 to 1983-84, 1985-86 to 1986-87, 1990-91, 1996-97, 2008-09 and 2011-12 shows a deficit trend.

CONCLUSION

“The balance of payment of a country is a systematic record of all economic transactions between the residents of the country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and the payments made by them on account of goods imported and services received and capital transferred to non-residents or foreigners.” (Balance of Payment manual for India, September 2010). The main purpose of the balance of payment is to inform the government of the international position of the nations and to help it its formulation of monetary, fiscal and trade policies.

The transactions are presented in forms of double-entry book keeping. That means the transactions are classified as ‘credit or debit’. Credit transactions are those that involve the receipts of payments from foreigners. The export of goods and services, unilateral transfers from foreigners and capital inflows are credited and entered with a positive sign. Debit transactions are those that involve the making payments to foreigners. The import of goods and services, unilateral transfers to foreigners, and capital outflows are debited and entered with a negative sign. Each transaction is recorded twice, once as a credit and once as a debit of an equal amount. This is known as double-entry book keeping. If a nation’s inflows are greater than its outflows (credit > debit) the BOP said to be in surplus. If a nation’s out flows are greater than its inflows (debit> credit) the BOP said to be in deficit.

NOTES

11.4. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is Balance of Payment (BOP)?

.....

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What are the types of quota?

11.5. Answer to check your progress Questions.

1. Balance of Payment (BOP) is a summary statement of all economic transactions of the residents of a nation with the residents of Rest of the World (ROW) during a particular period of time. BOP is recorded usually for a Calendar year. In other words B O P is a systematic statistical statement or record of the character and dimensions of the country's economic relationship with the rest of the world. Balance of payments is integral parts of national accounts for an open economy.

2. the tariff or custom quota,
the unilateral quota,
the bilateral quota,
the mixing quota, and
import licensing.

11.6. Summary

In this unit have learnt about the meaning of Balance of payments. This knowledge would make you understand what is balance of payments at how it can be practiced at a national level. The concept such as balance of payments and balance of trade would have made you to distinguish these activities from the balance of payments concept and you might have learnt about the meaning on its structure and importance in the bop context.

11.7. Key words

Equilibrium, Devaluation

11.8. Self Assessment Questions and Exercises.

Short Answer Questions

1. What are the main purpose of Balance of payments?
2. What are the measures to Correct Balance of Payment Disequilibrium.

Long answer Questions.

1. Explain the meaning and structure of Balance of Payment?
2. Describe the Importance of Balance of Payments

11.9. Further Readings.

Salvatore, D. (2007), “**International Economics**”, Wiley India, New Delhi.

UNIT-12: BALANCE OF TRADE (BOT)

Balance of trade (bot)

Structure:

- 12.1. Meaning
- 12.2. Disequilibrium in BoP & BoT
- 12.3. Causes for Disequilibrium in BoP
- 12.4. Check your progress Questions.
- 12.5. Answer to check your progress Questions.
- 12.6. Summary
- 12.7. Key words
- 12.8. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 12.9. Further Readings.

NOTES

12.1. Meaning

Definition trade balance:

- The balance of trade measures net exports of goods and services (NX).
- It is the value of exports – the value of imports.
- It forms the major component of the current account, although it ignores international investment flows and current transfers.
- The balance of trade refers to both trade in goods (visibles) and services (Invisibles) – Though people may refer to a specific balance of trade in goods.

What Is Balance of Trade (BOT)?

- The balance of trade is the difference between the value of a country's imports and exports for a given period. The balance of trade is the largest component of a country's balance of payments. Economists use the BOT to measure the relative strength of a country's economy. The balance of trade is also referred to as the trade balance or the international trade balance.

The balance of trade is the value of a country's exports minus its imports. It's the most significant component of the current account. That also makes it the biggest component of the balance of payments that measures all international transactions.

The trade balance is the easiest component to measure. All goods and many services must pass through the customs office.

The current account measures a country's net income earned on international assets. The current account also includes trade balance plus any other payments across borders.

12.2. Disequilibrium in BoP & BoT

Measures to Correct Balance of Payment Disequilibrium

Persistent disequilibrium in the balance of payments, particularly a deficit in balance of payments, is undesirable because it

- (a) weakens the country's economic position at the international level, and
- (b) affects the progress of the economy adversely. It must be cured by taking appropriate measures. There are many measures to correct disequilibrium in the balance of payments. Important among them are discussed below:

2. Deflation:

In the wake of Deficit in a nation's Balance of Payments it can resort to tight monetary policy. The currency authority may try to lower the prices by reducing the quantity of money in circulation or follow a deflationary monetary policy. Deflation is the classical medicine for correcting the deficit in the balance of payments. Deflation refers to the policy of reducing the quantity of money in order to reduce the prices and the money income of the people. This is done by the central bank of the country through raising the bank rate, by selling the securities in the open market and by other methods can reduce the volume of credit in the economy which will lead to a fall in prices and money income of the people. Fall in prices will stimulate exports and reduction in income checks imports. Thus, deflationary policy restores equilibrium to the balance by encouraging exports through reduction in their prices and (b) by discouraging imports through the reduction in incomes at home. Moreover, a higher interest rate in the domestic market will attract foreign funds which can be used for correcting disequilibrium. However, deflation is not considered a suitable method to correct adverse balance of payments because of the following reasons:

- (a) Deflation means reduction in income or wages which is strongly opposed by the trade unions,
- (b) Deflation causes unemployment and suffering to the working class, (c) In a developing economy, expansionary monetary policy rather than contractionary (deflationary) monetary policy is required to meet the developmental needs.

3. Depreciation:

Another method of correcting disequilibrium in the balance of payments is depreciation or appreciation of the exchange rate.

Depreciation means a fall in the rate of exchange of one currency (home currency) in terms of another (foreign currency). A currency will depreciate when its supply in the foreign exchange market is large in relation to its demand. In other words, a currency is said to depreciate if its value falls in terms of

foreign currencies, i.e., if more domestic currency is required to buy a unit of foreign currency. An appreciation on the other hand is the rise in the value of a currency relative to the foreign currency. Depreciation helps a country to achieve a favorable balance of payments by checking imports and stimulating exports. The following are the defects of this method

- It is not suitable for a country which follows a fixed exchange rate system.
- It makes international trade risky and thus reduces the volume of trade.
- The terms of trade go against the country whose currency depreciates because the foreign goods have become costlier than the local goods and the country has to export more to pay for the same volume of imports.
- Experience of certain countries has indicated that exchange depreciation may generate inflationary pressure by increasing the domestic price level and money income.
- The success of the method of exchange depreciation depends upon the cooperation of other countries. If other countries also start depreciating their exchange rates, then these methods will not benefit any country.

NOTES

4. Devaluation:

Devaluation refers to the official reduction of the external values of a currency. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the government, depreciation means an automatic fall in the external value of the currency by the market forces; the former is arbitrary and the latter is the result of market mechanism.

Thus, devaluation serves only as an alternative method to depreciation. Both the methods imply the same thing, i.e., decrease in the value of a currency in terms of foreign currencies.

Both the methods can be used to produce the same effects; they discourage imports, encourage exports and thus lead to a reduction in the balance of payments deficit.

- The success of the method of devaluation depends upon the following conditions
- The elasticity of demand for the country's exports should be greater than unity.
- The elasticity of demand for the country's imports should be greater than unity.
- The exports of the country should be non-traditional and the increasingly demanded from other countries.
- The domestic price should not rise and should remain stable after devaluation.
- Other countries should not retaliate by resorting to corresponding devaluation. Such a retaliatory measure will offset each other's gain.
- Devaluation also suffers from certain defects:

- Devaluation is a clear revelation on the country's economic weakness.
- It reduces the confidence of the people in country's currency and this may lead to speculative outflow of capital.
- It encourages inflationary tendencies in the home country.
- It increases the burden of foreign debt.
- It involves large time lag to produce effects.
- It is a temporary device and does not provide a permanent remedy to correct adverse balance of payments.

5. Exchange Control:

Exchange control is the most widely used method for correcting disequilibrium in the balance of payments. Exchange control refers to the control over the use of foreign exchange by the central bank. Under this method, all the exporters are directed by the central bank to surrender their foreign exchange earnings. Foreign exchange is rationed among the licensed importers. Only essential imports are permitted. Exchange control is the most direct method of restricting a country's imports. The major drawback of this method is that it deals with the deficit only, and not its causes. Rather it may aggravate these causes and thus may create a more basic disequilibrium. In short, exchange control does not provide a permanent solution for a chronic disequilibrium.

6. Tariffs

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduce the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes. Non-essential imports can be drastically reduced by imposing a very high rate of tariff.

Drawbacks of Tariffs :-

- Tariffs bring equilibrium by reducing the volume of trade.
- Tariffs obstruct the expansion of world trade and prosperity.
- Tariffs need not necessarily reduce imports. Hence the effects of tariff on the balance of payment position are uncertain.
- Tariffs seek to establish equilibrium without removing the root causes of disequilibrium.
- A new or a higher tariff may aggravate the disequilibrium in the balance of payments of a country already having a surplus.
- Tariffs to be successful require an efficient & honest administration which unfortunately is difficult to have in most of the countries. Corruption among the administrative staff will render tariffs ineffective.
- Quotas
- Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the

deficit is reduced and the balance of payments position is improved.

Balance of trade (bot)

Types of Quotas :-

- the tariff or custom quota,
- the unilateral quota,
- the bilateral quota,
- the mixing quota, and
- import licensing.

NOTES

Merits of Quotas :-

- Quotas are more effective than tariffs as they are certain.
- They are easy to implement.
- They are more effective even when demand is inelastic, as no imports are possible above the quotas.
- More flexible than tariffs as they are subject to administrative decision. Tariffs on the other hand are subject to legislative sanction.

Demerits of Quotas :-

- They are not long-run solution as they do not tackle the real cause for disequilibrium.
- Under the WTO quotas are discouraged as they are constraints on free trade.

We examined the method of correcting a deficit in a nation's current account or balance of payments by depreciation or a devaluation of the nation's currency. Depreciation implies a flexible exchange rate system. Devaluation, on the other hand, refers to the deliberate (policy) increase in the exchange rate by the nation's monetary authorities from one fixed or pegged level to another. However since both a depreciation and a devaluation operate on prices to bring about adjustment in the nation's current account and the balance of payments, they are both referred to as the price adjustment mechanism.

Balance of Trade

Balance of trade, the difference in value over a period of time between a country's imports and exports of goods and services, usually expressed in the unit of currency of a particular country or economic union (e.g., dollars for the United States, pounds sterling for the United Kingdom, or euros for the European Union). The balance of trade is part of a larger economic unit, the balance of payments (the sum total of all economic transactions between one country and its trading partners around the world), which includes capital movements (money flowing to a country paying high interest rates of return), loan repayment, expenditures by tourists, freight and insurance charges, and other payments.

If the exports of a country exceed its imports, the country is said to have a favourable balance of trade, or a trade surplus. Conversely, if the imports exceed exports, an unfavourable balance of trade, or a trade deficit, exists. According to the economic theory of mercantilism, which prevailed in Europe from the 16th to the 18th century, a favourable balance of trade was a necessary

means of financing a country's purchase of foreign goods and maintaining its export trade. This was to be achieved by establishing colonies that would buy the products of the mother country and would export raw materials (particularly precious metals), which were considered an indispensable source of a country's wealth and power.

The assumptions of mercantilism were challenged by the classical economic theory of the late 18th century, when philosophers and economists such as Adam Smith argued that free trade is more beneficial than the protectionist tendencies of mercantilism and that a country need not maintain an even exchange or, for that matter, build a surplus in its balance of trade (or in its balance of payments).

A continuing surplus may, in fact, represent underutilized resources that could otherwise be contributing toward a country's wealth, were they to be directed toward the purchase or production of goods or services. Furthermore, a surplus accumulated by a country (or group of countries) may have the potential of producing sudden and uneven changes in the economies of those countries in which the surplus is eventually spent.

Generally, the developing countries (unless they have a monopoly on a vital commodity) have particular difficulty maintaining surpluses since the terms of trade during periods of recession work against them; that is, they have to pay relatively higher prices for the finished goods they import but receive relatively lower prices for their exports of raw materials or unfinished goods.

12.3. Causes for Disequilibrium in BoP

Causes of disequilibrium in BOP:

There are several factors which cause disequilibrium in the BOP indicating either surplus or deficit.

Such causes for disequilibrium in BOP are listed below:

(i) Economic Factors:

(a) Imbalance between exports and imports. (It is the main cause of disequilibrium in BOR),

(b) Large scale development expenditure which causes large imports,

(c) High domestic prices which lead to imports,

(d) Cyclical fluctuations (like recession or depression) in general business activity,

(e) New sources of supply and new

(ii) Political Factors:

Experience shows that political instability and disturbances cause large capital outflows and hinder Inflows of foreign capital.

(iii) Social Factors:

(a) Changes in fashions, tastes and preferences of the people bring disequilibrium in BOP by influencing imports and exports;

(b) High population growth in poor countries adversely affects their BOP because it increases the needs of the countries for imports and decreases their capacity to export.

NOTES

2. Measures to correct disequilibrium in BOP:

Sustained or prolonged deficit has to be settled by short term loans or depletion of capital reserve of foreign exchange and gold.

Following remedial measures are recommended:

(i) Export promotion:

Exports should be encouraged by granting various bounties to manufacturers and exporters. At the same time, imports should be discouraged by undertaking import substitution and imposing reasonable tariffs.

(ii) Import:

Restrictions and Import Substitution are other measures of correcting disequilibrium.

(iii) Reducing inflation:

Inflation (continuous rise in prices) discourages exports and encourages imports. Therefore, government should check inflation and lower the prices in the country.

(iv) Exchange control:

Government should control foreign exchange by ordering all exporters to surrender their foreign exchange to the central bank and then ration out among licensed importers.

(v) Devaluation of domestic currency:

It means fall in the external (exchange) value of domestic currency in terms of a unit of foreign exchange which makes domestic goods cheaper for the foreigners. Devaluation is done by a government order when a country has adopted a fixed exchange rate system. Care should be taken that devaluation should not cause rise in internal price level.

(vi) Depreciation:

Like devaluation, depreciation leads to fall in external purchasing power of home currency. Depreciation occurs in a free market system wherein demand for foreign exchange far exceeds the supply of foreign exchange in foreign exchange market of a country (Mind, devaluation is done in fixed exchange rate system.)

NOTES

BASIS FOR COMPARISON	BALANCE OF TRADE	OF BALANCE OF PAYMENT
Meaning	Balance of Trade is a statement that captures the country's export and import of goods with the remaining world.	Balance of Payment is a statement that keeps track of all economic transactions done by the country with the remaining world.
Records	Transactions related to goods only.	Transactions related to both goods and services are recorded.
Capital Transfers	Are not included in the Balance of Trade.	Are included in Balance of Payment.
Which is better?	It gives a partial view of the country's economic status.	It gives a clear view of the economic position of the country.
Result	It can be Favorable, Unfavorable or balanced.	Both the receipts and payment sides tallies.
Component	It is a component of Current Account of Balance of Payment.	Current Account and Capital Account.

12.4. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..What is Balance of Trade?

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1..What is Balance of Payment (BOP)?

NOTES

12.5. Answer to check your progress Questions.

1. The balance of trade is the difference between the value of a country's imports and exports for a given period. The balance of trade is the largest component of a country's balance of payments. Economists use the BOT to measure the relative strength of a country's economy. The balance of trade is also referred to as the trade balance or the international trade balance.

2. Devaluation of domestic currency:

It means fall in the external (exchange) value of domestic currency in terms of a unit of foreign exchange which makes domestic goods cheaper for the foreigners. Devaluation is done by a government order when a country has adopted a fixed exchange rate system. Care should be taken that devaluation should not cause rise in internal price level.

126. Summary

In this unit have learnt about the meaning, definition causes of balance of trade. This knowledge would make you understand what is balance of Trade and how it can be practiced at a national level. The concept such as balance of Trade and Balance payments would have made you to distinguish these activities from the Balance of Trade activities and you might have learnt about the meaning and its Balance of Trade context.

12.7. Key words

Export promotion, Disequilibrium

12.8. Self Assessment Questions and Exercises.

Short Answer Questions

1. What is balance of trade?
2. Which means Devaluation of domestic currency?

Long answer Questions.

1. Explain Balance of Trade (BoT)?

Balance of trade (bot)

2.Detail the Disequilibrium in BoP & BoT and the Causes for Disequilibrium in BoP?

12.9.Further Readings.

NOTES

Krugman P. R. and M. Obsfeild (2006), “**International Economics: Theory and Policy**”, Addison Wesley, New Delhi.

UNIT-13: MEASURES FOR CORRECTING DISEQUILIBRIUM

*Measures for correcting
disequilibrium*

- 13.1. Measures for Correcting Disequilibrium
- 13.2. Relationship between BoP & BoT.
- 13.3 Check your progress Questions.
- 13.4 Answer to check your progress Questions.
- 13.5. Summary
- 13.6. Key words
- 13.7. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 13.8. Further Readings.

NOTES

13.1. Measures for Correcting Disequilibrium

Here we detail about the four methods adopted to correct disequilibrium in balance of payments.

Method 1# Trade Policy Measures: Expanding Exports and Restraining Imports:

Trade policy measures to improve the balance of payments refer to the measures adopted to promote exports and reduce imports.

Exports may be encouraged by reducing or abolishing export duties and lowering the interest rate on credit used for financing exports. Exports are also encouraged by granting subsidies to manufacturers and exporters.

Besides, on export earnings lower income tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competitive in the world markets.

On the other hand, imports may be reduced by imposing or raising tariffs (i.e., import duties) on imports of goods. Imports may also be restricted through imposing import quotas, introducing licenses for imports. Imports of some inessential items may be totally prohibited.

Before the economic reforms carried out since 1991. India had been following all the above policy measures to promote exports and restrict imports so as to improve its balance of payments position. But they had not achieved full success in their aim to correct balance of payments disequilibrium.

NOTES

Therefore, India had to face great difficulties with regard to balance of payments. At several occasions it approached IMF to bail it out of the foreign exchange crisis that emerged as a result of huge deficits in the balance of payments. At long last, economic crisis caused by persistent deficits in balance of payments forced India to introduce structural reforms to achieve a long-lasting solution of balance of payments problem.

Method 2# Expenditure-Reducing Policies:

The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that aim at reducing aggregate expenditure in the economy. The fall in aggregate expenditure or aggregate demand in the economy works to reduce imports and help in solving the balance of payments problem.

The two important tools of reducing aggregate expenditure are the use of:

- (1) Tight monetary policy and
- (2) Concretionary fiscal policy.

We explain them below:

Tight Monetary Policy:

Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods.

This therefore leads to the reduction in investment and consumption expenditure. Besides, availability of credit to lend for investment and consumption purposes is reduced by raising the cash reserve ratio (CRR) of the banks and also undertaking of open market operations (selling Government securities in the open market) by the Central Bank of the country.

This also tends to lower aggregate expenditure or demand which will helps in reducing imports. But there are limitations of the successful use of monetary policy to check imports, especially in a developing country like India. This is because tight monetary policy adversely affects investment increase in which is necessary for accelerating economic growth.

If a developing country is experiencing inflation, tight monetary policy is quite effective in curbing inflation by reducing aggregate demand. This will help in reducing aggregate expenditure and, depending on the income propensity to import, will curtail imports. Besides, tight monetary policy helps to reduce prices or lower the rate of inflation. Lower price level or lower inflation rate will curb the tendency to import, both on the part of businessmen and consumers.

But when a developing country like India is experiencing recession or slowdown in-economic growth along with deficits in balance of payments, use of tight monetary policy that reduces aggregate expenditure or demand will not help much as it will adversely affect economic growth and deepen economic recession. Therefore, in a developing country, monetary policy has to be used along with other policies such as a appropriate fiscal policy and trade policy to tackle the problem of disequilibrium in the balance of payments.

NOTES

Contractionary Fiscal Policy:

Appropriate fiscal policy is also an important means of reducing aggregate expenditure. An increase in direct taxes such as income tax will reduce aggregate expenditure. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in expenditure.

The other fiscal policy measure is to reduce Government expenditure, especially unproductive or non-developmental expenditure. The cut in Government expenditure will not only reduce expenditure directly but also indirectly through the operation of multiplier.

It may be noted that if tight monetary and contractionary fiscal policies succeed in lowering aggregate expenditure which causes reduction in prices or lowering the rate of inflation, they will work in two ways to improve the balance of payments. First, fall in domestic prices or lower rate of inflation will induce people to buy domestic products rather than imported goods. Second, lower domestic prices or lower rate of inflation will stimulate exports. Fall in imports and rise in exports will help in reducing deficit in balance of payments.

However, it may be emphasised again that the method of reducing expenditure through contractionary monetary and fiscal policies is not without limitations. If reduction in aggregate demand lowers investment, this will adversely affect economic growth. Thus, correction in balance of payments may be achieved at the expense of economic growth.

Further, it is not easy to reduce substantially government expenditure and impose heavy taxes as they are likely to affect incentives to work and invest and invite public protest and opposition. We thus see that correcting the balance of payments through contractionary fiscal policy is not an easy matter.

Method 3# Expenditure – Switching Policies: Devaluation:

A significant method which is quite often used to correct fundamental disequilibrium in balance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching policies help in correcting disequilibrium in balance of payments.

NOTES

The important form of expenditure switching policy is the reduction in foreign exchange rate of the national currency, namely, devaluation. By devaluation we mean reducing the value or exchange rate of a national currency with respect to other foreign currencies. It should be remembered that devaluation is made when a country is under fixed exchange rate system and occasionally decides to lower the exchange rate of its currency to improve its balance of payments.

Under the Bretton Woods System adopted in 1946, fixed exchange rate system was adopted, but to correct fundamental disequilibrium in the balance of payments, the countries were allowed to make devaluation of their currencies with the permission of IMF. Now, Bretton Woods System has been abandoned and most of the countries of the world have floated their currencies and have thus adopted the system of flexible exchange rates as determined by market forces of demand for and supply of them.

However, even in the present flexible exchange rate system, the value of a currency or its exchange rate as determined by demand for and supply of it can fall. Fall in the value of a currency with respect to foreign currencies as determined by demand and supply conditions is described as depreciation.

If a country permits its currency to depreciate without taking effective steps to check it, it will have the same effects as devaluation. Thus, in our analysis we will discuss the effects of fall in value of a currency whether it is brought about through devaluation or depreciation. In July 1991, when India was under Bretton-Woods fixed exchange rate system, it devalued its rupee to the extent of about 20%. (From Rs. 20 per dollar to Rs. 25 per dollar) to correct disequilibrium in the balance of payments.

Now, the question is how devaluation of a currency works to improve balance of payments. As a result of reduction in the exchange rate of a currency with respect to foreign currencies, the prices of goods to be exported fall, whereas prices of imports go up. This encourages exports and discourages imports. With exports so stimulated and imports discouraged, the deficit in the balance of payments will tend to be reduced.

Thus policy of devaluation is also referred to as expenditure switching policy since as a result of reduction of imports, people of a country switches their expenditure on imports to the domestically produced goods. It may be noted that as a result of the lowering of prices of exports, export earnings will increase if the demand for a country's exports is price elastic (i.e., $e_r > 1$). And also with the rise in prices of imports the value of imports will fall if a country's demand for imports is elastic. If demand of a country for imports is inelastic, its expenditure on imports will rise instead of falling due to higher prices of imports.

Devaluation: Marshall Lerner Condition. It is clear from above that whether devaluation or depreciation will lead to the rise in export earnings and

reduction in import expenditure depends on the price elasticity of foreign demand for exports and domestic demand for imports.

Measures for correcting disequilibrium

Marshall and Lerner have developed a condition which states that devaluation will succeed in improving the balance of payments if sum of price elasticity of exports and price elasticity of imports is greater than one. Thus, according to Marshall-Lerner Condition, devaluation improves balance of payments if

$$e_x + e_m > 1$$

where

e_x stands for price elasticity of exports

e_m stands for price elasticity of imports

If in case of a country $e_x + e_m < 1$, the devaluation will adversely affect balance of payments position instead of improving it. If $e_x + e_m = 1$, devaluation will leave the disequilibrium in the balance of payments unchanged.

Income-Absorption Approach to Devaluation:

Further, for devaluation to be successful in correcting disequilibrium in the balance of payments a country should have sufficient exportable surplus. If a country does not have adequate amount of goods and services to be exported, fall in their prices due to devaluation or depreciation will be of no avail.

This can be explained through income-absorption approach put forward by Sidney S Alexander. According to this approach, trade balance is the difference between the total output of goods and services produced in a country and its absorption by it.

By absorption of output of goods and services we mean how much of them is used up for consumption and investment in that country. That is, absorption means the sum of consumption and investment expenditure on domestically produced goods and services.

Expressing algebraically we have;

$$B = Y - A$$

Where:

B = trade balance or exportable surplus

Y = national income or value of output of goods and services produced

A = Absorption or sum of consumption and investment expenditure

It follows from above that if expenditure or absorption is less than national product, it will have positive trade balance or exportable surplus. To create this exportable surplus, expenditure on domestically produced consumer and investment goods should be reduced or national product must be raised sufficiently.

NOTES

NOTES

To sum up, it follows from above that for devaluation or depreciation to be successful in correcting disequilibrium in the balance of payments, the sum of price elasticities of demand for a country's exports and imports should be high (that is, greater than one) and secondly it should have sufficient exportable surplus. The devaluation will also not be successful in the achievement of its aim if other countries retaliate and make similar devaluation in their currencies and thus competitive devaluation of the exchange rate may start.

After Independence India devalued its currency three times, first in 1949, the second in June 1966 and third in July 1991 to correct the disequilibrium in the balance of payments. The devaluation of June 1966 was not successful for some time to reduce deficit in the balance of payments.

This is because the demand for bulk of our traditional exports was not very elastic and also we could not reduce our imports despite their higher prices. However devaluation of July 1991 proved quite successful as after it our exports grew at a rapid rate for some years and growth of imports remained within safe limits.

Method 4# Exchange Control:

Finally, there is the method of exchange control. We know that deflation is dangerous; devaluation has a temporary effect and may provoke others also to devalue. Devaluation also hits the prestige of a country. These methods are, therefore, avoided and instead foreign exchange is controlled by the government.

Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country and it is then rationed out among the licensed importers. None else is allowed to import goods without a licence. The balance of payments is thus rectified by keeping the imports within limits.

After the Second World War a new international institution 'International Monetary Fund (IMF)' was set up for maintaining equilibrium in the balance of payments of member countries for a short term. Member countries borrow from it for a short period to maintain equilibrium in the balance of payments. IMF also advises member countries how to correct fundamental disequilibrium in the balance of Payments when it does arise. It may, however, be mentioned here that no country now needs to be forced into deflation (and so depression) to root out the causes underlying disequilibrium as had to be done under the gold standard. On the contrary, the IMF provides a mechanism by which changes in the rates of foreign exchange can be made in an orderly fashion.

Conclusion:

In short, correction of disequilibrium calls for a judicious combination of the following methods:

- (i) Monetary and fiscal changes affecting income and prices in the country;
- (ii) Exchange rate adjustment, i.e., devaluation or appreciation of the home currency;
- (iii) Trade restrictions, i.e., tariffs, quotas, etc.;
- (iv) Capital movement, i. e., borrowing or lending abroad; and
- (v) Exchange control.

NOTES

No reliance can be placed on any single tool. There is room for more than one approach and for more than one device. But the application of the tools depends on the nature of the disequilibrium.

There are, we have said, three types of disequilibrium:

- (1) Cyclical disequilibrium,
- (2) secular disequilibrium,
- (3) Structural disequilibrium (at the goods and the factor level).

It is more appropriate that fiscal measures should be used to correct cyclical disequilibrium in the balance of payments. To correct structural disequilibrium adjustment in exchange rate should be avoided. Capital movements are needed to offset deep-seated forces in secular disequilibrium.

The main methods of desirable adjustment are, therefore, monetary and fiscal policies which directly affect income, and exchange depreciation (that is, devaluation) which affects prices in the first instance. Devaluation or depreciation of exchange rate can also have income effect through price effects. Monetary and fiscal policies affect relative prices also.

13.2. Relationship between BoP & BoT.

Balance of Trade (BOT)

- i. It records only merchandise (i.e., goods) transactions.
- ii. It does not record transactions of capital nature.
- iii. It is a part of current account of BOP.
- iv. It may be favourable, unfavourable or in equilibrium.
- v. Defect in BOT cannot be met by BOP

vi. It is not true indicator of economic relations or economic prosperity of a country.

Balance of Payment (BOP)

(i) It records transactions relating to both goods and services.

(ii) It records transactions of capital nature.

(iii) It includes balance of trade, balance of services, balance of unilateral transfers and balance of capital transactions.

(iv) It always remains in balance in the sense that receipt side is always made to be equal to payment side.

v) Defect in BOP can be met through BOT.

(vi) It is true indicator of economic performance of an economy.

NOTES

The BOP of a country is a systematic record of all economic transactions between the residents of the home country and the residents of the rest of the world during a given year. By all transactions we mean exports and imports of both goods and services, unrequited transfers as well as capital movements.

Thus, the BOP of a country is a complete picture of its international transactions. On the other hand, the 'balance of trade' (henceforth, BOT) is the difference between visible exports and visible imports. This difference is also called merchandise balance or balance of visible trade. Similarly, one obtains the balance of invisible trade which represents the difference between invisible exports and invisible imports.

The difference between a nation's exports of goods and services and its imports is called balance of trade in goods and services or 'balance of trade.' Whether invisibles are included or not in the BOT, it is clear that the BOP is a broader concept than BOT. BOT is classified into balance of visible and invisible trade.

The BOT is said to improve when exports of visible items (and invisible items) rise more than or fall less than imports of visible items (and invisible items). Conversely, the trade balance deteriorates. A country's BOP to be is and favourable if its total receipts exceed total payments.

An important point to note is that there may be a BOT deficit but a BOP surplus, or vice versa. In other words, a trade deficit does not necessarily imply that a country is losing its foreign reserves— the difference is accounted by long term capital movements.

13.3 Check your progress Questions.

*Measures for correcting
disequilibrium*

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1. What are the two important tools of reducing aggregate expenditure?

NOTES

Check your Progress-2

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1.. What is Tight monetary Policy?

13.4 Answer to check your progress Questions.

1. The two important tools of reducing aggregate expenditure are the use of:

(1) Tight monetary policy and

(2) Concretionary fiscal policy.

2. Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks.

13.5. Summar

In this unit have learnt about the meaning, measures of Balance of Trade and payments. This knowledge would make you understand what is correcting its equilibrium and how it can be practiced at a Balance of Trade on payments level. The concept such as BOP on BOT would have made you to distinguish these activities from the payment as Trade activities and you might have learnt about the meaning as it relationship in the Bop on Bot context.

13.6. Key words

Tight monetary, Income-Absorption Approach, Exchange Control

13.7. Self Assessment Questions and Exercises.

Short Answer Questions

1. What is Contractionary Fiscal Policy?
2. What are the three types of disequilibrium?

Long answer Questions.

1. Explain the Measures for Correcting Disequilibrium
2. Describe the Relationship between BoP & BoT.

13.8. Further Readings.

Krugman P. R. and M. Obsfeld (2006), “**International Economics: Theory and Policy**”, Addison Wesley, New Delhi.

UNIT-14: STRATEGIES OF INTERNATIONAL BUSINESS

Strategies of international business

Structure

- 14.1. International Marketing Operations
- 14.2. Exporting, Importing and Counter Trade
- 14.3. Export and Import Finance
- 14.4. Export Assistance.
- 14.5. Check your progress Questions.
- 14.6. Answer to check your progress Questions.
- 14.7. Summary
- 14.8. Key words
- 14.9. Self Assessment Questions and Exercises. Short Answer Questions and Long answer Questions.
- 14.10. Further Readings.

NOTES

14.1. International Marketing Operations

The economic situation of your market impacts what you offer and how you present it to your target customers. For international marketing, the economics of the target market as well as the international economy affect your marketing strategy. The local economy influences how you approach consumers, while the international economic framework limits your ability to produce, ship and distribute your products through cost and regulatory constraints. An effective international marketing strategy takes both local and international economic conditions into account.

Product

Your international marketing of goods may be successful in western economies that have a similar economic structure to the United States, but it will fail in developing markets unless you make adjustments. You have to adapt your products to the local economies. A product you market as environmentally-friendly may not be relevant in a subsistence economy. A product that saves energy will not sell if energy is subsidized and inexpensive in the foreign market. You may offer the same products internationally as you do in the United States, but your global marketing has to change for your products to make economic sense in foreign economies.

Price

Whether an international market is accessible to your company depends on whether you can offer your products at a competitive local price.

NOTES

International economic factors such as currency exchange rates, tariffs and shipping impact your costs and the prices of your goods. If the cost of offering your products in international markets is higher than that of locally-produced products, you may have to target luxury goods market segments. Sometimes mass-produced goods cost less than locally-made custom products, and your marketing strategy can price your products to achieve wide acceptance.

Production

Carrying out production locally is one way to reduce costs and limit the influence of international economic factors on your operations. Instead of incurring costs through duties and transportation, you may be able to take advantage of lower production costs in the local economy with lower labor and facility expenses. Local production can impact your marketing by affecting both price and local acceptance. Marketing your products as locally-produced competitively-priced options can be an effective marketing strategy.

Channel

The international and local economic environments influence your channel marketing. If establishing a local presence is costly, you may opt for partnering with a local or international distributor who already has experience in the target market. For some markets, it makes economic sense to market your products via direct sales, either through local representatives or via online sales. Alternatively, a low-cost, open local economy may make it feasible to create your own local distribution network. The channel you choose for your marketing initiatives depends on the economics of delivering the goods to market and the local economic situation.

14.2. Exporting, Importing and Counter Trade

Trade is what keeps economies and nations alive. Trade demands create domestic production and the inflows of funds from overseas. Countries that have limited domestic resources, such as Singapore, must be able to keep up with domestic production of various goods and services so as to maintain a trade surplus, as they cannot produce everything they need in within their own borders.

Exporting is increasing yearly, globally. This is due to various factors. First, both large and small firms export – not just large firms. Also, under the World Trade Organization (WTO) there has been a decline in trade barriers. This holds true for other regional trade agreements such as the European Union (EU) and North American Free Trade Agreement (NAFTA).

When a firm decides to export to another country, it needs to address the following:

- Market opportunities – which can it identify?
- Foreign exchange risk – how can it protect itself?
- Import and export financing – does it understand the banking systems?

- Challenges of doing business in a foreign market – does it know what it will face?

Opportunities and Risks

Exporting is a means to increase a company's overall market size. This usually occurs when a company has reached a certain saturation or limit in its domestic market and it needs to expand. This is why large firms tend to aggressively explore new export possibilities. While it is true that many small firms export, they tend to be more reactive and let opportunities come to them. Many companies, especially small, tend to underestimate the potential of the export market, and are overwhelmed by the intricacies, laws, and regulations surrounding exportation.

NOTES

Below are common pitfalls of exporting:

- Insufficient or inadequate market research and analysis
- Lack of understanding of competitive conditions
- An absence of product customization for foreign markets
- Inferior distribution or marketing program
- Ineffective or poor marketing campaigns
- Difficulty finding financing
- Miscalculation of the amount of expertise needed to enter a foreign market
- An underestimation of the differences in a foreign market
- A perception that the way of doing things back home is superior and will work abroad
- An underestimation of the bureaucracy and red tape involved

Export Expertise

However, if the proper groundwork is done, firms can avoid many of the aforementioned perils of exporting. For example, some countries offer exportation advice and help to local companies. Both Japan and Germany have established export institutions.

US firms do use the U.S. Department of Commerce to find export information. Also, the International Trade Administration and the U.S. and Foreign Commercial Service agency can even offer prospecting lists to firms. Another resource is the Small Business Administration, as well as local and state governments.

Another means is via export management companies (EMCs). These are companies that provide all the services a firm needs to export. They can work as the export department for a company or simply on behalf of the exporter.

There are two basic types of EMC relationships. The first is working

NOTES

with a view to let the exporting firm take over once the groundwork has been done. The second is for the EMC to have an ongoing responsibility to export, market, and sell the firm's products overseas. But firms that rely too heavily on the EMC may never learn the ins and outs of exporting, and thus will never build such skills.

Export Strategy

Exporting has its risks, but these risks can be mitigated in various ways.

- As previously discussed, an EMC can work as a consultant to identify markets and sort through the regulations on behalf of the company.
- Also, firms should focus on only one or just a few markets initially.
- To start, enter markets on a small scale, so as to limit the damages caused by any potential failure.
- Companies need to be realistic about the time, commitment, and resources needed.
- Firms should do their best to establish good relationships with distributors and clients.
- Whenever possible, locals should be employed in the foreign markets.
- Companies should exercise a proactive attitude.
- Firms should adopt local production in the countries they export to.

Financing

Transferring of funds internationally, to parties with which one has never done any prior business is often complicated, as there will likely be a lack of trust between them. To overcome this lack of trust, reputable international banks are included in the transaction.

- 1.Importer receives bank's promise to pay on behalf of importer
- 2.Bank promises to pay exporter on behalf of importer
- 3.Exporter makes shipment to the bank, trusting the bank to pay
- 4.Bank pays the exporter
- 5.Bank sends shipment to importer
- 6.Importer pays the bank

A letter of credit can be issued by a bank on behalf of the importer. This states that the bank will pay a certain amount to another party (usually the exporter), upon receipt of certain documents. A letter of credit instills trust as a bank is involved.

A draft, or bill of exchange, is the means normally employed for international payment. A draft is a document from an exporter that instructs an importer (or an importer's agent) to pay a certain amount of money at a certain time. There are two types of drafts: Sight drafts and time drafts. Sight drafts demand payment upon presentation, while time drafts request payment in 30, 60,

90, or 120 days.

A bill of lading is a document from the common carrier which transports the good to the exporter. It is a receipt, a contract, and a document of title.

Financial Export Assistance

Companies that wish to export can look to their government for guidance and assistance in their financial matters. In the US, the Export-Import Bank (Eximbank) offers financing, while the Foreign Credit Insurance Association offers export credit insurance.

The Export-Import Bank provides financial aid to those exporting, importing and exchanging commodities between the US and other nations. Eximbank is an independent US government agency. The main services it offers are loans and loan guarantees.

The Foreign Credit Insurance Association (FICA) is the body in the US that provides export credit insurance. Such insurance guards US exporters against importers that do not make payments. FICA offers insurance coverage against both political and commercial risks.

Such bodies are necessary to facilitate the US export of goods, and to help maintain a healthy domestic economy.

Countertrade

At times, standard goods-for-cash payment structures do not work, are cumbersome, expensive, or simply impossible. In these cases, companies can adopt *countertrade*.

Countertrade involves the exchange of goods in barter or other ways in place of money. For example, if a nation's currency is not exchangeable or no good overseas, they may offer a commodity or other product in place of cash.

Countertrade was common in the USSR in the 1960s when its currency was nonconvertible. It was their only means of purchasing foreign goods. Countertrade grew in the 1980s as many other nations did not have the foreign reserves required to make imports. Countertrade increased yet again during the Asian financial crisis in 1997, as many currencies became devalued and had severely limited buying power.

One example of countertrade was when the USSR paid Coca-Cola in vodka. Poland did the same with Coca-Cola but paid in beer.

Countertrade can be separated into five variants:

1. Barter
2. Counterpurchase
3. Offset
4. Buyback or compensation

NOTES

5. Switch trading

Barter is simply the direct trading of goods and or services between two parties with not monetary exchange. It is normally used in one-off deals with trading partners that are not trustworthy or that lack any credit. Barter is the simplest and most restrictive type of countertrade.

Counterpurchase is a mutual buying agreement which involves one party agreeing to buy a pre-specified amount of goods or services from a nation to which a sale is made.

Offset is like counterpurchase in that one firm agrees to buy goods with a certain percentage of the proceeds from the initial sale. The difference is that this party can conclude its transaction with any company or partner in the country to which the sale is made.

A buyback involves a firm building a facility or making an investment in a country and then it receives a percentage of that investment's profits as partial payment for the initial contract.

Switch-trading occurs when a third party trading house purchases a company's counterpurchase credits and resells them to another company that can make better use of them. The trading house makes a profit along the way.

Countertrade and its variants can be beneficial when it offers a company a means to finance an export transaction in the absence of other means. Companies that do not wish to engage in countertrade activities can lose export opportunities to other domestic competitors that may be willing to enter such agreements. Some governments may require that exports undertake countertrade when dealing with certain other countries.

However, countertrade can often result in firms ending up with massive quantities of unusual products that may be difficult to resell or dispose of. In such cases firms may have to establish in-house trading and distribution divisions to deal with the countertrade goods. Naturally, countertrade is best handled by large, diversified, multi-national corporations that have existing distribution channels and networks.

14.3. Export and Import Finance

Import and Export Financing Solutions

Financing solutions for exporters

Working capital loans

For your pre-export financing needs, Comerica can facilitate an Export-Import Bank of the United States (Ex-Im Bank) guaranteed working capital loan. As one of the lenders for the Ex-Im Bank Working Capital Guarantee

Program, Comerica holds the highest-level Ex-Im Bank Delegated Authority lender designation, allowing us to approve loans up to \$10 million independently. We are also one of only nine financial institutions nationwide to hold the Ex-Im Bank Fast Track lender designation, allowing us to approve loans up to \$25 million with expedited Ex-Im Bank approval.

You may use the guaranteed working capital loan to

- Purchase finished products for export
- Pay for raw materials, equipment, supplies, labor and overhead to produce goods and/or provide services for export
- Issue standby letters of credit serving as bid bonds, performance bonds or payment guarantees
- Finance foreign receivables

NOTES

Foreign receivable financing

To increase your cash flow, Comerica can facilitate foreign receivable financing for up to 360 days. This enables you to extend competitive credit terms to your buyers and allows you to borrow against foreign receivables. Various insurance options are available through Ex-Im Bank and private insurers.

Foreign receivable discounting

To meet your short-term financing needs and increase your cash flow, Comerica can facilitate for the discounting of your foreign receivables.

Foreign buyer financing

To meet your buyers' needs for financing to pay for their purchases from you, Comerica can facilitate foreign buyer financing supported by Ex-Im Bank, providing you with the required cash flow and allowing you to extend the financing required by your buyers.

Protecting Against Foreign Exchange Risk in Import and Export Financing

How do you protect yourself in a market where foreign exchange fluctuations can mean the difference between profit and loss? Sudden jumps or dips in foreign exchange can result in significant swings in your gross margin and, while some swings can be profitable, others can be devastating.

With Accord's ability to secure foreign exchange forward contracts on your behalf, you can avoid playing the foreign exchange game and focus your attention on growth, secure in the knowledge that your bottom line is protected.

Receivable Financing and Factoring as Import and Export Financing Solutions for your business

With your supplier now paid and your product successfully delivered to your customer having a continuous flow of cash is important for you to begin

NOTES

the cycle again. Your import or export business is a moving force and it is cash that drives it.

Accord turns receivables into cash, by financing your accounts receivable, allowing you, as an importer or exporter, to have the funds needed to make payroll, pay payables and set up any deposits required by suppliers in order to fulfill new orders.

In a fast-paced business, not having to wait to get paid can give you an edge and help you to attain your growth objectives. Accord's import and export financing solutions do just that.

Accounts receivable management – take the risk out of your receivables

With flexible financing in hand, your next challenge is the risk hidden in your customer list. As an importer or exporter, *if your customer can't pay you, who will?* When you guarantee your accounts receivable management through Accord, *we will.*

Accord has been managing accounts receivable for importers and exporters for nearly forty years. We know how to make sure your invoices get paid on time. And when we set credit guarantees for your customers, you get risk-free credit protection, guaranteed.

Is Accord the right fit for my import or export business?

If you have sales of over \$2 million per year and you import, export or both, we have the right solutions for you. Accord has provided import and export financing for companies such as yours, in a variety of industries, including:

- Food and beverage
- Apparel
- Automotive
- Medical equipment
- Promotional products
- Furniture and more

Import Finance is, to put it simply, the funding of the gap between receiving the goods, and sending the payment. Furthermore, it is usually seen as a short-term type of finance and is provided by a third party.

Uniquely, the need for import financing arises due to the difficulties that business face when trading overseas alone, however when importers are exploring different financial options this can add further complication.

The implementation of Import finance has helped encourage, and indeed shape the world of trade as we know it today. The level of risk and amount of

moving variables involved in trading overseas is ever present, however, the application of certain Import finance instruments can help protect businesses.

How Import Finance Works

Many transactions, and often large sums of money depends on a certain level of trust with the counterpart involved. Throughout the years, as economies and businesses expand, the trust required for these transactions is more difficult to obtain, which is where instruments of Trade Finance come into play.

NOTES

Types of Import Finance:

Usance/ Standby Letters of Credit:

- When a Usance Letter of Credit is applied in a transaction, it allows payment from the buyer to be deferred. This gives the buyer more time to inspect – and in some cases sell – the goods.
- When a Standby Letter of Credit is applied in a transaction, it allows the seller of the goods peace of mind surrounding payment, as it is a guarantee of payment – usual issues by a bank. It is usually seen as a last resort, but it prevents any risk of non-payment in a transaction.

Bank Guarantees:

- Bank Guarantees are exactly what they sound like, a guarantee from a bank that certifies the creditworthiness of a buyer. They do this, by offering to fulfil the financial obligations of the buyer, in the scenario they can not.
- The difference between a Bank Guarantee and a Letter of Credit is the way in which they are used. Traders that are involved in the regular import and export of goods a more likely to use Letters of credit. In contrast, Contractors involved in the bidding on infrastructure projects are more likely to use Bank Guarantees.

Invoice Finance:

- Invoice financing is a method of financing which involve the selling (or shift of liability) of their accounts receivables. Imagine a company sells their goods to Consumer A. They grant 90-day payment terms on the transaction, however by financing the outstanding invoices, it allows access to these funds earlier. A third party – usually an Invoice Finance firm – will purchase or commit to the invoices, paying a discounted price for them or taking a fee from the transaction.

Asset-Backed Facilities:

- Asset-Backed Facilities or Asset-Based Lending is the financial tool of a business securing a loan against their collateral (assets). The asset-based loan is secured by many and either of the following:
 - Inventory
 - Accounts Receivables
 - Equipment

NOTES

- Buildings/ any other assets on the balance sheet of the business.

Requirements

Import finance and all of the tools which the term covers are reviewed on a case-by-case basis. This being said, a financier will generally ask for the following:

- Audited Financial Statements
- Full business plans
- Future Financial Cashflow forecasts
- Credit reports
- Details and references for the Directors of the Company
- Information surrounding the liabilities of the company.

Import Finance vs. Export Finance:

In contrast, Export Finance differs from Import on the condition that goods are financed and usually exported cross-border. The distinctive difference between Import and Export finance is that Export Finance only covers finance for goods being exported. An example of export finance is a bank offering financial assistance to a firm, for the export shipping of products.

Economically, a countries exports are often a vital organ in the system. Nations such as Japan who run a Trade surplus (Exports > Imports) rely on international demand for the upkeep of their economy. By enabling business access to funds, it essentially allows them access to a wider market, inevitably increasing trade.

What type of Goods are eligible for Import Finance:

- Soft Commodities
- Children's toys
- Cars
- Oil
- Metal
- Clothing
- Televisions
- Furniture

Why use Import Finance

There are various reasons why a business would want to use a lender to finance their imports. Regardless of the biggest bonus – the access to future cash – it also instils confidence, certainty and security around transactions.

Moreover, if you can understand the cash cycle, then you can implement the correct type of import finance. The working capital requirements can,

therefore, be separated from the business cycle. This allows great freedom and gives room for further trade.

Benefits of import financing

Import finance are off-balance sheet financial instruments, which means they may not affect existing bank facilities or bank relationships. The benefits mean that importers can grow without taking on equity or angel investment, losing share of the business.

14.4. Export Assistance.

Export production assistance and export marketing assistance!

To provide effective support to the exporters, particularly new and small exporters and effective system consisting of several export promotion measures have been instituted.

Although the intensity and coverage of these measures have undergone change with the liberalization of policy, there does exist a number of schemes for export production as well as marketing. The various export assistance or promotion measures are undertaken through a number of organisations existing both at the Centre and State level.

Export assistance includes facilities for efficient export production and marketing.

1) Export Production Assistance:

Export production assistance is available right from the stage of acquiring land and building, procuring plant machinery, equipments, components, spares, technical guidance/training, to giving finance and credit in time at comparatively cheaper rate. Export production assistance includes following facilities provided to enhance the assistance:

i) Infrastructural Facilities:

Besides providing land and building to exporting units, Special Economic Zones, Technology Parks, Export Promotion Parks, Industrial Estates, etc., have been set-up in various parts of the country.

There are 8 Special Economic Zones at Kandla (Gujarat), Santa Cruz (Maharashtra), Falta (West Bengal), Noida (U.P.), Cochin (Kerala), Chennai (Tamil Nadu), Surat (Gujarat), and Visakhapatnam (Andhra Pradesh) which are functional at present (Sept '03). Whereas all the Zones, except Seepz, are multi-product Zones, the Seepz at Santa Cruz in Bombay is exclusively for Electronics and Gem and Jewellery items. Private Bonded Warehouses for Exports are also allowed to be set-up in DTA (Domestic Tariff Area) for procurement of goods from domestic manufacturers without payment of duty. Such applies are considered as physical export, provided payment for the same is made in foreign exchange.

Government has also recently permitted development of Special Economic Zones by Private/State or Joint Sector. Export Promotion Industrial Parks Scheme has been introduced with a view to involving State Government in providing infrastructural facilities for export-oriented production.

Technology Park for Electronic Hardware and Software development for export have also been set-up, mostly on the lines of SEZs providing same facilities for production and export.

ii) Manufacture-in-Bond:

Manufacture-in-bond facility is available both in the excise as well as customer regulations. Whereas rule 13 of the Central Excise Rules relates to Excise Regulations, Section 65 of the Customs Act provides facilities of manufacture in bond.

iii) Machinery and Equipments:

Besides making available machinery and equipments on lease, there is a special facility to import CG (Capital Goods) at 5% duty under EPCG, i.e., Export Promotion Capital Goods Scheme.

iv) Production Inputs:

Raw-materials, components, spares, consumables, etc., whether indigenous or imported, can be obtained for export production under various schemes. Imported inputs for use in export products are importable duty free under the Duty Exemption/Remission Scheme, popularly known as Advance Licensing Scheme, Duty Free Replenishment Certificate (DFRC), and Duty Entitlement Passbook (DEPB) Scheme, although there are several other schemes covered there under. Still another scheme known as duty free import entitlement scheme has been introduced for status holder exporters including service providers.

Goods (including CG) are also allowed to be imported without an import license or Customs Clearance Permit (CCP) for jobbing, repairing, servicing, etc., against bond, surety/security. Such goods are to be re-exported with specified minimum value addition. There are special for export of gold/silver jewellery and articles as also for specified sectors like pharmaceuticals, readymade garments other than leather garments, electronics/writing instruments, and engineering goods.

v) Technology Upgradation:

Besides allowing duty free import of technical samples/prototypes and trade samples upto specified value, simplified approval mechanism has been introduced for foreign technology agreements. Foreign exchange is also released liberally for foreign visits and testing abroad of indigenous raw materials. National Laboratories, National Test House, etc., provide technical guidance for export production. The Pilot Test House offer special technical support facilities to the industry. SISIs and Regional Testing Laboratories also provide technical support.

vi) Packing Credit:

It is also known as pre-shipment credit. It is available even if there is no export other in hand. It consists of cash credits and overdraft facilities, and given at a concessional rate of interest.

Pre-shipment credit is also available in foreign currency under the PCFC Scheme. It is applicable to both the domestic and imported inputs for export goods.

NOTES

vii) Back-to-Back Letter of Credit (L/C):

An inland Back-to-Back Letter of Credit Scheme has been instituted which makes sub-suppliers of raw-materials, samples, etc., to exporter, eligible for export packing credit on the basis of export order or L/C in the name of the export order holder.

2) Export Marketing Assistance:

A number of steps have been taken to assist the exporters in their marketing effort. These include conducting, sponsoring or otherwise assisting market surveys and research; collection, storage, and dissemination of marketing information, organising and facilitating participation in international trade fairs and exhibitions; credit and insurance facilities; release of foreign exchange for export marketing activities; assistance in export procedures; quality control and pre-shipment inspection; identifying markets and products with export potential; helping buyer-seller interaction, etc.

Some of the schemes and facilities which assist export marketing are as follows:

i) Marketing Development Fund (MDF):

This came into being in 1963-64, the nomenclature was changed to Marketing Development Assistance (MDA) in 1975. The fund is administered for providing grants/assistance to Export Promotion Councils, other export bodies, also for special schemes approved for specific export promotion efforts. The fund is on the decline, and sufficient amount had not been set apart in recent years.

Assistance under the MDA is available for market and commodity researchers; trade delegations and study teams; participation in trade fairs and exhibitions; establishment of offices and branches in foreign countries; and grants-in-aid to EPCs and other approved organisations for export promotion. Interest on Export Credit by commercial banks and approved cooperative banks enjoy a subsidy of 1.5% out of MDA. Most of the MDA expenditure in the past was absorbed by the CCS. The CCS helped the exporters to increase the price competitiveness of the Indian products in foreign markets.

ii) Cash Compensatory Support:

Cash assistance for exports, which was later termed as Cash Compensatory Support (CCS.) was introduced in 1966. The stated objectives were to enable exporters to meet competition in foreign markets, to develop marketing competence and to neutralize disadvantages inherent in the existing

stage of development of the economy. The main basis for the CCS Scheme was to provide compensation for unrebated indirect taxes (on both final and intermediate stages of production) which enter into export production but are not refundable through Duty Drawback System.

iii) Foreign Exchange:

It is released for undertaking approved market development activities such as participation in trade fairs and exhibitions, foreign travel for export promotion, advertisement abroad, market research, procurement of samples, and technical information from abroad.

iv) Trade Fairs and Exhibitions:

As trade fairs and exhibitions are effective media of promoting products, facilities are provided for enabling and encouraging participating of Indian exporters/manufacturers in such events. Foreign exchange is released for such purpose, the cost of participation is subsidized and the ITPO plays an Important role in organising and facilities participation in trade fairs/exhibitions. Besides the ITPO, some other promotional agencies also organise trade fairs. For example, the MPEDA organises sea foods trade fair in India, in every 2nd year, which attracts a number of foreign buyers and others connected with the sea foods industry.

v) Export Risk Insurance:

As international business in fraught with different types of risks, measures have been taken to provide insurance covers against such risks. The Export Credit Guarantee Corporation (ECGC) has policies covering different political and commercial risks associated with export marketing, certain types of risks associated with overseas investments and risks arising-out of exchange rate fluctuations. Further, ECGC extends the export credit risks cover the commercial banks. Marine insurance is provided by the general Insurance Corporation and its subsidiaries.

vi) Finance:

The export-import bank and commercial banks and certain other financial institutions like specified cooperative banks provide pre-shipment and post-shipment finance to exports. Some of these institutions also provide suppliers' credit including line of credit, to promote Indian exports. Export credits generally carry concessional interest rates.

vii) Quality Control and Pre-Shipment inspection:

A number of steps have been taken by the Government to improve the quality of exports and to ensure that only goods of appropriate quality are exported from the country. The Export (Quality Control and Inspection) Act empowers the Government to make necessary regulations in this respect.

viii) Institutional Assistance:

Export marketing is assisted in different ways by a number of organisations like the ITPO, EPCS, Commodity Boards, Export Development Authorities like the MPEDA and APEDA, IIFT, Indian Mission abroad, etc.

ix) Dollar Denominated Credit for Exporters:

There has been a persistent complaint, rightly so, from the exporters that the interest rates in India are higher. This consequently is reflected in the cost of the products, which makes firms non-competitive in quite a few products. Even though government agrees in principle, it is not able to bring-down the interest rates in India, due to the fact that such a move would increase the money supply, and result in inflation.

NOTES

14.5. Check your progress Questions.

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1. What is Export production assistance?

.....

Check your Progress-1

Note: a). Write your answer in the space given below

b) Compare your answer with those given at the end of the unit

1. What are the variants of countertrade?

14.6. Answer to check your progress Questions.

1. Export production assistance is available right from the stage of acquiring land and building, procuring plant machinery, equipments, components, spares, technical guidance/training, to giving finance and credit in time at comparatively cheaper rate.

2. Countertrade can be separated into five variants:

- 1. Barter
- 2. Counterpurchase
- 3. Offset
- 4. Buyback or compensation
- 5. Switch trading

14.7. Summary

In this unit have learnt about the meaning of international business. This knowledge would make you understand what in international

marketing operations as how it can be practiced at a international level. The concept such as Exporting and importing countries trade would have made to distinguish these operations from the international business and you might have learnt about meaning as its Assistance are the Export and importance.

14.8. Key words

Trade Fairs and Exhibitions, Invoice Finance, Back-to-Back Letter of Credit

14.9. Self Assessment Questions and Exercises.

Short Answer Questions

1. What is invoice financing?
2. What are the facilities includes the Export assistance?

Long answer Questions.

1. Explain International Marketing Operations and Exporting, Importing and Counter Trade..
2. Describe Export and Import Finance and Export Assistance++

14.10. Further Readings.

Soderston, B. and G. Reed (1999), “**International Economics**”, McMillan Press Ltd., London.