I INTERNAL III SEM B.COM-AUGUST 2019

INTERNATIONAL TRADE AND FINANCE-I

ANSWER ANY ONE **(16*1=16)**

1) **Explain the comparative cost theory with an example.**

Ans: This theory has been introduced by the eminent classical economist, David Riccardo in his book "The principles of Political economy and taxation". It is an improvement of Adam Smith's theory of International trade.

According to Adam smith, International trade takes place because of absolute differences in cost of production of the commodities in different countries. David Riccardo successor of Adam Smith has modified Smith's theory and pointed out that a country can gain from International trade even if it doses not have an absolute advantage. This is possible by a comparative cost advantage. The core of the theory is that international trade arises due to comparative cost of production of the commodities in different countries

Assumptions:

1)Labour theory of value: It assumes labour is only factor of production

2)Factor immobility Between countries: Factors od production are perfectly mobile in the country and immobile between the countries.

3)Two countries two commodities: There are only two counties and two commodities in the trade.

4)Existence of perfect competition: There is existence of perfect competition in the commodity and factor market.

5)Existence free trade: There are no restrictions on trade between countries.

6)Zero transport cost: The transport cost does not influence prices of internationally traded goods.

7)Existence of barter system: A country exchanges goods with goods with another country.

8)Static conditions: It implies that the taste, preferences, resources, technology remain the same.

9)No change in distribution of income: It follows the assumption of static economy

10)Constant returns: It is based on law of constant returns.

Illustration:

Riccardo considered this theory by giving an example between two countries England and Portugal.

Countries	Wine	Cloth
Portugal	80	90
England	120	100

From the above illustrations it appears that Portugal as edge over England in both the commodities. But I the opinion of Riccardo Portugal has comparative advantage in production of wine than in cloth. England has disadvantage in both the commodities, but more in production of wine than in cloth.

According to Riccardo both the counties stand to gain by specialising themselves in the production and export one commodity in exchange for the other. If Portugal specializes in the production of wine for which one unit of wine it produces it can save 10 units of labour. Thus Portugal has comparative advantage in the production of wine than cloth.

If England concentrates in the production of cloth it can save 20 units of labour. Portugal should export wine and import cloth and England should export cloth and import wine.

Criticisms:

1) Unrealistic labour theory of value
2) Two country two commodity model
3) No perfect competition
4) Factor mobility
5) Transport cost
6) No free trade
7) Overlooks monopoly
8) Overlooks technological changes
9) To emphasis on supply condition
10) Lack of complete specialisation
11) Nominate approach
12) Neglects product varieties
13) Not relevant to less developed countries
14) Economic rigidity

2.Explain arguments for and against International trade.

Ans. The need for International trade are:

1) International division of labour and specialisation: It insures the application of the principal of labuor and specialisation to the fields of production and international exchange of commodities between various countries.
2) Optimum use of world resources: By promoting product and factor specialisation among international trade helps optimum utilisation of world resources.
3) Stabilisation of prices: The domestic surplus in production can be offset through exports and shortages could be removed through imports.
4) Technological Progress: It leads to development of technological progress.
5) Easy Flow of capital: It facilitates long term flows of capital among the countries
6) Promotion of competition: The competition increases the productive efficiency
7) Greater balance of payment lateral Co-operation: It creates consciousness about problems faced by different countries.
8) Basis of economic survival: Both developed and less developed countries are dependent on international trade.
9) Growth of international economic institutions: World bank, IMF, WTO have come to existence.
10) Export led growth: Both developed and less developed countries reach higher success due to this trade.

The disadvantages of international trade:

1) Exploitation of Resources and markets: It leads to exploitation of less developed countries.
2) Balance of payment problems: The increase in imports have caused balance of payment problems.
3) Unfavourable terms of trade: The less developed counties are suffering from adverse effects of this trade.
4) International debt problems: It has created acute problem of international debt.
5) Transmission of business cycles: It has destabilized the economic system of the countries.
6) Lack of industrial diversification: It has led to specialisation and discouraged diversification.
7) No Exchange Stability: The exchange rate has no stability due to this trade.
8) Discriminating Trade policy: The advance countries have been practising discrimination against less developed countries
9) Political Interference: This has led to political interference in less developed countries
10) Cause of war: It has led to economic jealousy among countries.

Answer any two: **(8*2=16)**

3. Write a note on factor endowment theory.

Ans. This theory is associated with the names of two Swedish economistHeckscher Olin and Bertilin Olier. It is also known as H-o theory. It says that international trade takes place because of factor prices are different in different countries. The distribution of factor resources are different in different countries.

1) It considers three countries, commodity and factors of production.
2) There is perfect competition.
3) There is free and unrestricted trade
4) Demand function for different goods are identical.
5) Techniques of production are constant
6) There is absence of transport cost.
7) It leads to factor price equalisation
8) Factors of products are perfectly mobile within the country and immobile between the countries.
9) Factor endowments are different
10) Factor intensities are different.

This theory is based on two points

1) The factor endowments are different in different countries
For example, countries like Australia have more of land, India has abundant supply of labour and USA has plenty of capital. Hence Australia has to produce more land intensive goods, India more of labour-intensive goods and USA more of capital-intensive goods. It differences in factor prices and therefore prices of goods and services in different countries.
It is clear that in the above explanation each country is specialized in production of commodity which requires less factor of production.
2) Factor price equalisation
Another concept is that it brings equalisation of factor price among trading countries. When it is assumed that labour and capital move freely wages and another factor price tend to be equal.

Merits:
1) It is based on general theory of value
2) It considers more than one factor of production
3) It considers inter-regional Theory
4) It is based on relative prices of Factors which in turn Influence the relative prices of goods.
5) It is based on assumption of production function of countries.
6) It brings successful indicator between theories of value and trade.

4. Explain features of international trade.

Ans. The features of international trade are-
1) Factor Immobility
Within the same country labour and capital are more mobile than they are between different country. People mostly prefer to invest in their own country.
2) Differences in National Endowments
Differences may arise as between countries because of Natural endowments and climatic conditions. These advantages lead to territorial division of labour.
3) Differences in national policies: It refers to trade between different independent sovereign sates which may have independent trade policies.
4) Differences in currency system: Different countries have different types of countries hence is a hindrance to trade
5) Cultural differences: Markets are differentiated by language, customs, usage, habit, taste etc.
6) Differences in transport cost: Transport cost is very high in international trade always.
7) Differences in political system: In international trade there is existence of multiple political units.
8) Differences in trade system: Different countries have different trade policies.
9) Balance of problems: It also leads to the problem of balance of payment among less developed countries.
10) Non-Homogeneity of markets: It is observed that international market observes lack of homogeneity.
11) Immobility of products: Mobility of products are more free in internal trade than in international trade.
12) Differences in geographical and climatic conditions: It is practically impossible for all countries to produce all products, hence products produced based on conditions there and hence there is interdependency.

5. Explain the concepts of terms of trade

1) Based on ratio of exchange between commodities:

a) Net barter terms of trade: It refers to ratio of price index no's of exports and imports respectively.

It is calculated as:

Tc = Px

Pm

Where,

Tc=Commodity of terms of trade

Px=Index no. of prices of exports

Pm=Index no. of prices of imports

We can compare it as follows,

N=Px1 . Px0

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Pm1 . Pm0

For ex,

If Px1= 180 and Pm1=120 we have

N=Px1/Pm1: Px0/Pm0= 180/120=100/100=1.5:1

If above example, the terms of trade in the current year indicate an improvement of 50% and if the export prices rise relative to import prices the terms of trade rise and because favourable to the country.

b) Gross barter terms of trade: It refers to the rate of exchange between which country's physical imports as compared to whole of its exports.

It may be expressed as Tg=Qm/Qx

Where,

Tg= Gross barter terms of trade

Qm=quantity of imports

Qx=quantity of exports

Tg = Qm1/Qx1:Qm0/Qx0

It does not impact change in productivity.

c) Income terms of trade: When volume of exports changes considerably the net barter terms of trade fails to measure terms of trade.

Ty=Px*Qx/Pm

Where,

Ty=Income terms of trade

Qx=Quantity of export

Px=Price of export

Pm=Price of imports

This concept is also known as "capacity to import"

2) Based on rate of exchange of factors

a) Single factoral terms of trade:

It orders to take into account the changes in productivity considered. It represents ratio of exports, export price index and import price index.

Ts=Px/Pm*Fx

Where,

Ts= Single factoral terms of trade

Px=Prices of export

Pm=Prices of import

Fx=Productive efficiency

b) Double factoral terms of trade: In this concept the production efficiency of factor of production in export sector.

Td= Px/Pm * Fx/Fm

Where,

Td= Double factoral terms of trade

Px= Prices of export

Pm=Prices of import

Fx=Productive efficiency

Fm=Factor productive of efficiency

Answer any two **(4*2=8)**

6. Explain factors affecting terms of trade

1) Reciprocal demand: It refers to elasticity of demand. If demand for foreign goods is inelastic then its unfavourable to the importing country
2) Change in factor endowments: Changes in the supply of factor of production is another factor affecting terms of trade. Increase in factor of production in domestic country than in foreign is unfavourable.
3) Changes in technology: If there is advanced technology then it is favourable terms of trade.
4) Changes in taste and preferences: changes in terms of trade can affect terms of trade.
5) Economic development: Economic effect brings two possible effects mainly demand and supply effect to the equation
6) Devaluation: Devaluation creates more demand for export, hence it becomes favourable.
7) Rate of tariff: Imposition of tariff makes terms of trade always favourable.

7. Explain argument for free trade.

i. Optimum utilisation of resources:
ii. Beneficial for consumer
iii. Prevents monopoly
iv. Expansion of markets
vi. Free from Interference

8. Explain arguments against free trade

i. Not suitable for less developed countries
ii. Economic inefficiency
iii. Danger of becoming permanent
v. Encourages conspicuous consumption