CHAPTER

7

International Economics

"Economies are linked internationally through trade in goods and through financial markets".

- Dornbusch, Fischer and Startz

Learning Objectives

1. To explain the importance of international trade and different theories of international trade.
2. To provide an understanding about the exchange rate determination, variation in exchange rate and Balance of Payments.
3. To provide an insight into FDI and Trade.

7.1 Introduction

The subject 'International Economics' evolved from a simple theory of international trade was formulated to answer a few basic questions. The subject first originated in Western Europe on account of increasing importance of foreign trade in that part of the world. The contributions of classical economists like Adam Smith, David Ricardo, F.W. Taussig, Haberler, J.S.Mill and Bela Balassa shaped the subject matter of International Economics.

Haberler

International Economics studies the entire range of international economic transactions that consist of not only trade in goods and services but also capital flows, technology transfer, the rate of exchange, balance of payments, and issues relating to tariffs, protection, free trade, investment flows, role of fiscal and monetary policies pursued by individual countries.

7.2 Meaning of International Economics

International Economics is that branch of economics which is concerned with the exchange of goods and services between two or more countries. Hence the subject matter is mainly related to foreign trade.

In other words, International Economics is a specialized field of Economics which deals with the economic interdependence among countries and studies the effects of such interdependence and the factors that affect it.

7.3 Subject Matter of International Economics

The subject matter of International Economics includes large number of segments which are classified into the following parts.

1. Pure Theory of Trade

This component explains the causes for foreign trade, composition, direction and volume of trade, determination of the terms of trade and exchange rate, issues related to balance of trade and balance of payments.

2. Policy Issues

Under this part, policy issues such as free trade vs. protection, methods of regulating trade, capital and technology flows, use of taxation, subsidies and dumping, exchange control and convertibility, foreign aid, external borrowings and foreign direct investment, measures of correcting disequilibrium in the balance of payments etc are covered.

3. International Cartels and Trade Blocs

This part deals with the economic integration in the form of international cartels, customs unions, monetary unions, trade blocs, economic unions and the like. It also discusses the operation of Multi National Corporations (MNCs).

4. International Financial and Trade Regulatory Institutions

The financial institutions like International Monetary Fund IMF, IBRD, WTO etc which influence international economic transactions and relations shall also be the part of international economics.

7.4 Meaning of Trade

Trade is one of the powerful forces of economic integration. The term 'trade' means exchange of goods, wares or merchandise among people.

Trade is of two types. They are:

a) Internal Trade and
b) International Trade.

7.4.1 Internal Trade

It refers to the exchange of goods and services within the political and geographical boundaries of a nation. It is a trade within a country. This is also known as 'domestic trade' or 'home trade' or 'intra-regional trade'.

7.4.2 International Trade

It refers to the trade or exchange of goods and services between two or more countries. In other words, it is a trade among different countries or trade across political boundaries. It is also called as 'external trade' or 'foreign trade' or 'inter-regional trade'.

7.4.3 Differences between 'Internal Trade' and 'International Trade'

Sl.No.	Internal Trade	International Trade
1.	Trade takes place between different individuals and firms within the same nation.	Trade takes place between different individuals and firms in different countries.
2.	Labour and capital move freely from one region to another.	Labour and capital do not move easily from one nation to another.
3.	There will be free flow of goods and services since there are no restrictions.	Goods and services do not easily move from one country to another since there are a number of restrictions like tariff and quota.
4.	There is only one common currency.	There are different currencies.
5.	The physical and geographical conditions of a country are more or less similar.	There are differences in physical and geographical conditions of the two countries.
6.	Trade and financial regulations are more or less the same.	Trade and financial regulations such as interest rate, trade laws differ between countries.
7.	There is no difference in political affiliations, customs and habits of the people and government policies.	Differences are pronounced in political affiliations, habits and customs of the people and government policies.

7.5 Theories of International Trade

7.5.1 The Classical Theory of International Trade

Introduction

Adam Smith (1776) developed the theory of absolute cost advantage. But it was David Ricardo who formulated as an explicit and precise theory, namely, the theory of comparative cost advantage, which was later improved and refined by the economists like J.S Mill, Cairnes, Bastable,Taussig and Haberler. We shall first discuss the Adam Smith's theory of absolute cost advantage.

Classical Trade Theories

Mercantilism (pre - 16th century)

- Takes an us-versus - them view of trade
- Other country's gain is our country's loss

Free Trade theories

- Absolute Advantage (Adam Smith, 1776)
- Comparative Advantage (David Ricardo, 1817)
- Specialization of production and free flow of goods benefit all trading partner's economies

Free Trade refined

- Factor - proporations (Heckscher - Ohlin, 1919)
- International Product life cycle (Ray Vernon, 1966)

7.5.2. Adam Smith's Theory of Absolute Cost Advantage

Adam Smith argued that all nations can be benefitted when there is free trade and specialisation in terms of their absolute cost advantage.

The Theory

According to Adam Smith, the basis of international trade was absolute cost advantage. Trade between two countries would be mutually beneficial when one country produces a commodity at an absolute cost advantage over the other country which in turn produces another commodity at an absolute cost advantage over the first country.

Assumptions

1. There are two countries and two commodities (2 x 2 model).
2. Labour is the only factor of production.
3. Labour units are homogeneous.
4. The cost or price of a commodity is measured by the amount of labour required to produce it.
5. There is no transport cost.

Illustration

Absolute cost advantage theory can be illustrated with the help of the following example.

Absolute Cost Advantage

Country	India	China
	(Output per unit of labour)	
Wheat	20	8
Cloth	6	14

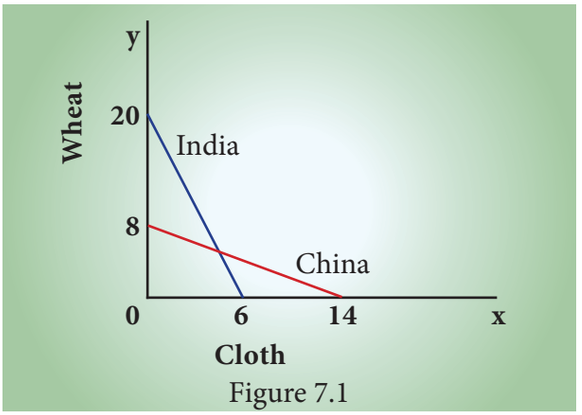


Figure 7.1

From the illustration, it is clear that India has an absolute advantage in the production of wheat over China and China has an absolute advantage in the production of cloth over India. Therefore, India should specialize in the production of wheat and import cloth from China. China should specialize in the production

of cloth and import wheat from India. This kind of trade would be mutually beneficial to both India and China.

7.5.3. Ricardo's Theory of Comparative Cost Advantage

David Ricardo , the British economist in his 'Principles of Political Economy and Taxation' published in 1817, formulated a systematic theory called 'Comparative Cost Theory'. Later it was refined by J.S Mill, Marshall, Taussig and others.

Ricardo demonstrates that the basis of trade is the comparative cost difference. In other words, trade can take place even if the absolute cost difference is absent but there is comparative cost difference.

According to Ricardo, a country can gain from trade when it produces at relatively lower costs. Even when a country enjoys absolute advantage in both goods, the country would specialize in the production and export of those goods which are relatively more advantageous. Similarly, even when a country has absolute disadvantage in production of both goods, the country would specialize in production and export of the commodity in which it is relatively less disadvantageous.

Assumptions

1. There are only two nations and two commodities (2x2 model)
2. Labour is the only element of cost of production.
3. All labourers are of equal efficiency.
4. Labour is perfectly mobile within the country but perfectly immobile between countries.
5. Production is subject to the law of constant returns.
6. Foreign trade is free from all barriers.
7. No change in technology.
8. No transport cost.
9. Perfect competition.
10. Full employment.
11. No government intervention.

Illustration

Ricardo's theory of comparative cost can be explained with a hypothetical example of production costs of cloth and wheat in America and India.

Comparative Cost Advantage

(Units of labour required to produce one unit)

Country	Cloth	Wheat	Domestic Exchange Ratios
America	100	120	1 wheat =1.2 cloth
India	90	80	1 wheat=0.88 cloth

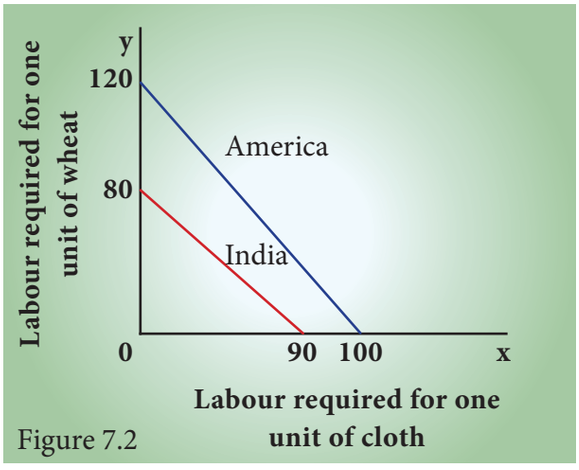


Figure 7.2

Note: Slopes are not equal

It is evident from the example that India has an absolute advantage in production of both cloth and wheat.

However, India should concentrate on the production of wheat in which she enjoys a comparative cost advantage. (80/120 < 90/100). For America the comparative cost disadvantage is lesser in cloth production. Hence America will specialize in the production of cloth and export it to India in exchange for wheat. (Any exchange ratio between 0.88 units and 1.2 units of cloth against one unit of wheat represents gain for both the nations). With trade, India can get 1 unit of cloth and 1 unit of wheat by using its 160 labour units. In the absence of trade, for getting this benefit, India will have to use 170 units of labour. America also gains from this trade. With trade, America can get 1 unit of cloth and one unit of wheat by using its 200 units of labour. Otherwise, America will have to use 220 units of labour for getting 1 unit of cloth and 1 unit of wheat.

Criticisms

1. Labour cost is a small portion of the total cost. Hence, theory based on labour cost is unrealistic.
2. Labourers in different countries are not equal in efficiency.

7.5.4. Modern Theory of International Trade

Introduction

The modern theory of international trade was developed by Swedish economist Eli Heckscher and his student Bertil Ohlin in 1919. This model was based on the Ricardian theory of international trade. This theory says that the basis for international trade is the difference in factor endowments. It is otherwise called as '**Factor Endowment Theory'.**

Factor endowment model

- Developed by Heckscher and Ohlin
- Countries with a relative factor abundance can specialise and trade
  - Abundance of skilled labour → specialisation → export → exchange for goods are services produced by countries with abundance of unskilled labour
  - **Exports** embody the **abundant factor**
  - **Imports** embody the **scarce factor**
  - Assumes a high degree of **factor mobility**

The Theory

The classical theory argued that the basis for foreign trade was comparative cost difference and it considered only labour factor. But the modern theory of international trade explains the causes for such comparative cost difference. This theory attributes international differences in comparative costs to:

i) difference in the endowments of factors of production between countries, and

ii) differences in the factor proportions required in production.

Assumptions

1. There are two countries, two commodities and two factors. (2x2x2 model)

2. Countries differ in factor endowments.
3. Commodities are categorized in terms of factor intensity.
4. Countries use same production technology.
5. Countries have identical demand conditions.
6. There is perfect competition in both product and factor markets in both the countries.

Heckscher - Ohlin (H-O) theorem

(H-O theorem)

"A capital abundant country will export the capital - intensive good, while the labor - abundant country will export the labor - intensive good."

Factor

Factor proportions model which links exports and imports to factor endowments.

Exports

A country exports those commodities produced with relatively large quantities of the country's relatively abundant factor.

Explanation

According to Heckscher - Ohlin, "a capital-abundant country will export the capital –intensive goods, while the labour-abundant country will export the labour-intensive goods". A factor is regarded abundant or scare in relation to the quantum of other factors. A country can be regarded as richly endowed with capital only if the ratio of capital to other factors is higher than other countries.

Illustration

Particulars	India	America
Supply of Labour	50	24
Supply of Capital	40	30
Capital-Labour Ratio	40/50 = 0.8	30/24 = 1.25

In the above example, even though India has more capital in absolute terms, America is more richly endowed with capital because the ratio of capital in India is 0.8 which is less than that in America where it is 1.25. The following diagram illustrates the pattern of word trade.

Limitations

1. Factor endowment of a country may change over time.

2. The efficiency of the same factor (say labour) may differ in the two countries. For example, America may be labour scarce in terms of number of workers. But in terms of efficiency, the total labour may be larger.

7.5.5 Comparison of Classical Theory and Modern Theory

S.No	Classical Theory of International Trade	Modern Theory of International Trade
1.	The classical theory explains the phenomenon of international trade on the basis of labour theory of value.	The modern theory explains the phenomenon of international trade on the basis of general theory of value.
2.	It presents a one factor (labour) model	It presents a multi - factor (labour and capital) model.
3.	It attributes the differences in the comparative costs to differences in the productive efficiency of workers in the two countries.	It attributes the differences in comparative costs to the differences in factor endowments in the two countries.

7.6 Gains from International Trade

International trade helps a country to export its surplus goods to other countries and secure a better market for it. Similarly, international trade helps a country to import the goods which cannot be produced at all or can be produced at a higher cost. The gains from international trade may be categorized under four heads.

I. Efficient Production

International trade enables each participatory country to specialize in the production of goods in which it has absolute or comparative advantages. International specialization offers the following gains.

1. Better utilization of resources.
2. Concentration in the production of goods in which it has a comparative advantage.
3. Saving in time.
4. Perfection of skills in production.
5. Improvement in the techniques of production.
6. Increased production.
7. Higher standard of living in the trading countries.

II. Equalization of Prices between Countries

International trade may help to equalize prices in all the trading countries.

1. Prices of goods are equalized between the countries (However, in reality it has not happened).
2. The difference is only with regard to the cost of transportation.
3. Prices of factors of production are also equalized (However, in reality it has not happened).

III. Equitable Distribution of Scarce Materials

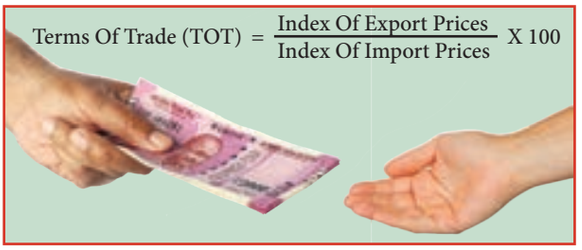
International trade may help the trading countries to have equitable distribution of scarce resources.

IV. General Advantages of International Trade

1. Availability of variety of goods for consumption.
2. Generation of more employment opportunities.
3. Industrialization of backward nations.
4. Improvement in relationship among countries (However, in reality it has not happened).
5. Division of labour and specialisation.
6. Expansion in transport facilities.

7.7 Terms of Trade

The gains from international trade depend upon the terms of trade which refers to the ratio of export prices to import prices.



7.7.1 Meaning

It is the rate at which the goods of one country are exchanged for goods of another country. It is expressed as the relation between export prices and import prices. Terms of trade improves when average price of exports is higher than average price of imports.

7.7.2 Types of Terms of Trade

The different concepts of terms of trade were classified by Gerald M.Meier into the following three categories:

Terms of Trade related to the Ratio of Exchange between Commodities

- Terms of Trade
  - Net Barter Terms of Trade - Taussig
  - Gross Barter Terms of Trade - Taussig
  - Income Terms of Trade - G.S.Dorrance

1. Net Barter Terms of Trade

This type was developed by Taussig in 1927.The ratio between the prices of exports and of imports is called the "net barter terms of trade'. It is named by Viner as the 'commodity terms of trade'.

It is expressed as:

$$T_n = (P_x / P_m) \times 100$$

Where,

T_n = Net Barter Terms of Trade
P_x = Index number of export prices
P_m = Index number of import prices

This is used to measure the gain from international trade. If 'Tn' is greater than 100, then it is a favourable terms of trade which will mean that for a rupee of export, more of imports can be received by a country.

2 Gross Barter Terms of Trade

This was developed by Taussig in 1927 as an improvement over the net terms of trade. It is an index of relationship between total physical quantity of imports and the total physical quantity of exports.

$$T_g = (Q_x/Q_m) \times 100$$

Where, Q_m = Index of import quantities
Q_x = Index of export quantities

If for a given quantity of export, more quantity of import can be consumed by a country, then one can say that terms of trade are favourable.

3 Income Terms of Trade

The income terms of trade was given by G.S.Dorrance in 1948. It is the index of the value of exports divided by the price index for imports multiplied by quantity index of experts. In other words, it is the net barter terms of trade of a country multiplied by its exports-volume index.

$$T_y = (P_x / P_m)Q_x$$

Where, P_x = Price index of exports
P_m = Price index of imports
Q_x = Quantity index of exports

7.7.3. Terms of Trade related to the Interchange between Productive Resources

1 The Single Factoral Terms of Trade

Viner has devised another concept called "the single factoral terms of trade" as an improvement upon the commodity terms of trade. It represents the ratio of export-price index to the import-price index adjusted for changes in the productivity of a country's factors in the production of exports. Symbolically, it can be stated as

$$T_f = (P_x / P_m) F_x$$

Where, T_f stands for single factoral terms of trade index. F_x stands for productivity in exports (which is measured as the index of cost in terms of quantity of factors of production used per unit of export).

2 Double Factoral Terms of Trade

Viner constructed another index called "Double factoral terms of Trade". It is expressed as

$$T_{ff} = (P_x / P_m) \ (F_x / F_m)$$

which takes into account the productivity in country's exports, as well as the productivity of foreign factors.

Here, F_m represents import index (which is measured as the index of cost in terms of quantity of factors of production employed per unit of imports).

7.8 Balance of Trade Vs Balance of Payments

Balance of Trade and Balance of Payments are two different concepts in the subject of international trade.

7.8.1 Balance of Trade (BOT)

Balance of Trade (BOT) refers to the total value of a country's exports of commodities and total value of imports of commodities. Only export and import of commodities are included in the statement of Balance of Trade of a country. Movements of goods (export and imports of commodities) are also known as **'visible trade',** because the movement of commodities between countries can be seen by eyes and felt by hands and can be verified physically by custom authorities of a country.

Favourable BOT

When the total value of commodity exports of a country exceeds the total value of commodity imports of that country, it is said that the country has a **'favourable'** balance of trade.

Unfavourable BOT

If total value of commodity exports of a country is less than the total value of commodity imports of that country, that country is said to have an **'unfavourable'** balance of trade.

7.8.2 Balance of Payments (BOP)

BoP is a systematic record of a country's economic and financial transactions with the rest of the world over a period of time.

When a payment is received from a foreign country, it is a credit transaction while a payment to a foreign country is a debit transaction. The principal items shown on the **credit side** are exports of goods and services, transfer receipts in the form of gift etc., from foreigners, borrowing from abroad, foreign direct investment and official sale of reserve

assets including gold to foreign countries and international agencies.

The principal items on the **debit side** include imports of goods and services, transfer payments to foreigners, lending to foreign countries, investments by residents in foreign countries and official purchase of reserve assets or gold from foreign countries and international agencies.

7.8.3. Components of BOPs

The credit and debit items are shown vertically in the BOP account of a country. Horizontally, they are divided into three categories, i.e.

a) The current account,

b) The capital account and

c) The official settlements account or official reserve assets account.

a) The Current Account: It includes all international trade transactions of goods and services, international service transactions (i.e. tourism, transportation and royalty fees) and international unilateral transfers (i.e. gifts and foreign aid).

b) The Capital Account: Financial transactions consisting of direct investment and purchases of interest-bearing financial instruments, non-interest bearing demand deposits and gold fall under the capital account.

c) The Official Reserve Assets Account: Official reserve transactions consist of movements of international reserves by governments and official agencies to accommodate imbalances arising from the current and capital accounts.

The official reserve assets of a country include its gold stock, holdings of its convertible foreign currencies and Special Drawing Rights (SDRs) and its net position in the International Monetary Fund (IMF).

Balance of Payment (BOP) Account Chart

Credit (Receipts) – Debit **(Payments)** = Balance **[Deficit (-) , Surplus (+)]**

Deficit if Debit > Credit

7.8.4. Balance of Payments Disequilibrium

The BoP is said to be balanced when the receipts (R) and payments (P) are just equal, i.e,

R / P =1.

B.O.P DISEQUILIBRIUM

Occurs when:

Demand ≠ Supply

Debit > Credit → Deficit

Favourable BoP

When receipts exceed payments, the BoP is said to be favourable. That is,

R / P > 1.

Unfavourable BOP

When receipts are less than payments, the BoP is said to be unfavourable or adverse.That is

R / P < 1.

7.8.5. Types BOP Disequilibrium:

There are three main types of BOP Disequilibrium, which are discussed below.

(a) Cyclical Disequilibrium,
(b) Secular Disequilibrium,
(c) Structural Disequilibrium.

a) Cyclical Disequilibrium: Cyclical disequilibrium occurs because of two reasons. First, two countries may be passing through different phases of business cycle. Secondly, the elasticities of demand may differ between countries.

b) Secular Disequilibrium: The secular or long-run disequilibrium in BOP occurs because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports, as it happens in India since 1951.

c) Structural Disequilibrium: Structural changes in the economy may also cause balance of payments disequilibrium. Such structural changes include development of alternative sources of supply, development of better substitutes, exhaustion of productive resources or changes in transport routes and costs.

7.8.6. Causes for BoP Disequilibrium

The following are the major causes producing disequilibrium in the balance of payments of a country.

1. **Cyclical Fluctuation:** Cyclical disequilibrium in different countries is caused by their cyclical fluctuations, their phases and magnitude. World trade shrinks during depression while trade flourishes during prosperity

2. **Structural Changes:** Structural disequilibrium is caused by the structural changes brought by huge development and investment programmes in the developing economies. Such economies may have high propensity to import for want of capital for rapid industrialization, while export may not be boosted up to that extent.

3. **Development Expenditure:** Development disequilibrium is caused by rapid economic development which results in income and price effects. The less developed countries in the early stage of development are not self sufficient. Income, savings and investment are abysmally low. They depend upon developed countries for import of commodities, capital and technology. Export potential is low and import intensity is high. So the LDCs suffer from adverse BoP.

4. **Consumerism:** Balance of payments position of a country is adversely affected by a huge increase in consumption. This increases the need for imports and decreases the capacity to export.

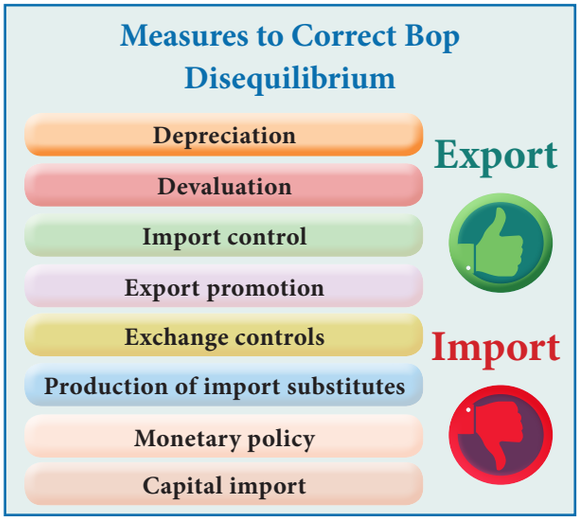
5. **Demonstration Effect:** Deficit in the balance of payments of developing countries is also caused by demonstration effect which influences the people in UDCs to imitate western styled goods. This will raise the propensity to import causing adverse balance of payments. This is good for the developed countries.

6. **Borrowing:** International borrowing and investment may cause a deficit in the balance of payments. When the international borrowing is heavy, a country's balance of payments will be adverse since it repays loans with interest. Servicing of debt is a huge burden. That is why the UDCs are forced to borrow more.

7. **Technological Backwardness:** Due to technological backwardness, the people (Indians) are unable to use the energy (Solar) available with them. As a result they import huge petroleum products from foreign countries, increasing the trade deficit.

8. **Global Politics:** The rich countries (Eg. USA) need to sell their weapons to promote their economy and generate employment. Hence, wars between countries (for example Iran and Irag, Pakistan and India) are stimulated In order to win the wars, the poor countries are forced to buy the weapons from weapon – rich countries, using their export earnings and creating trade deficit. Thus UDCs are trapped forever.

7.8.7. Measures to Correct BOP Disequilibrium



There are a number of measures available for correcting the balance of payments disequilibrium. They are divided into two broad groups, namely, (i) automatic correction and (ii) deliberate measures.

I. Automatic Correction

If the market forces of demand and supply are allowed to play freely, equilibrium will be automatically restored in course of time. Under the free exchange rate system, the automatic adjustments of the balance of payments can take place through changes in the variables like price, interest, income and capital flows.

1. Price Adjustments

As a result of foreign exchange outflow from a deficit country to a surplus country, there will be a fall in the money supply in the deficit country and increase in the money supply in the surplus country. This will result in rise in the price in the

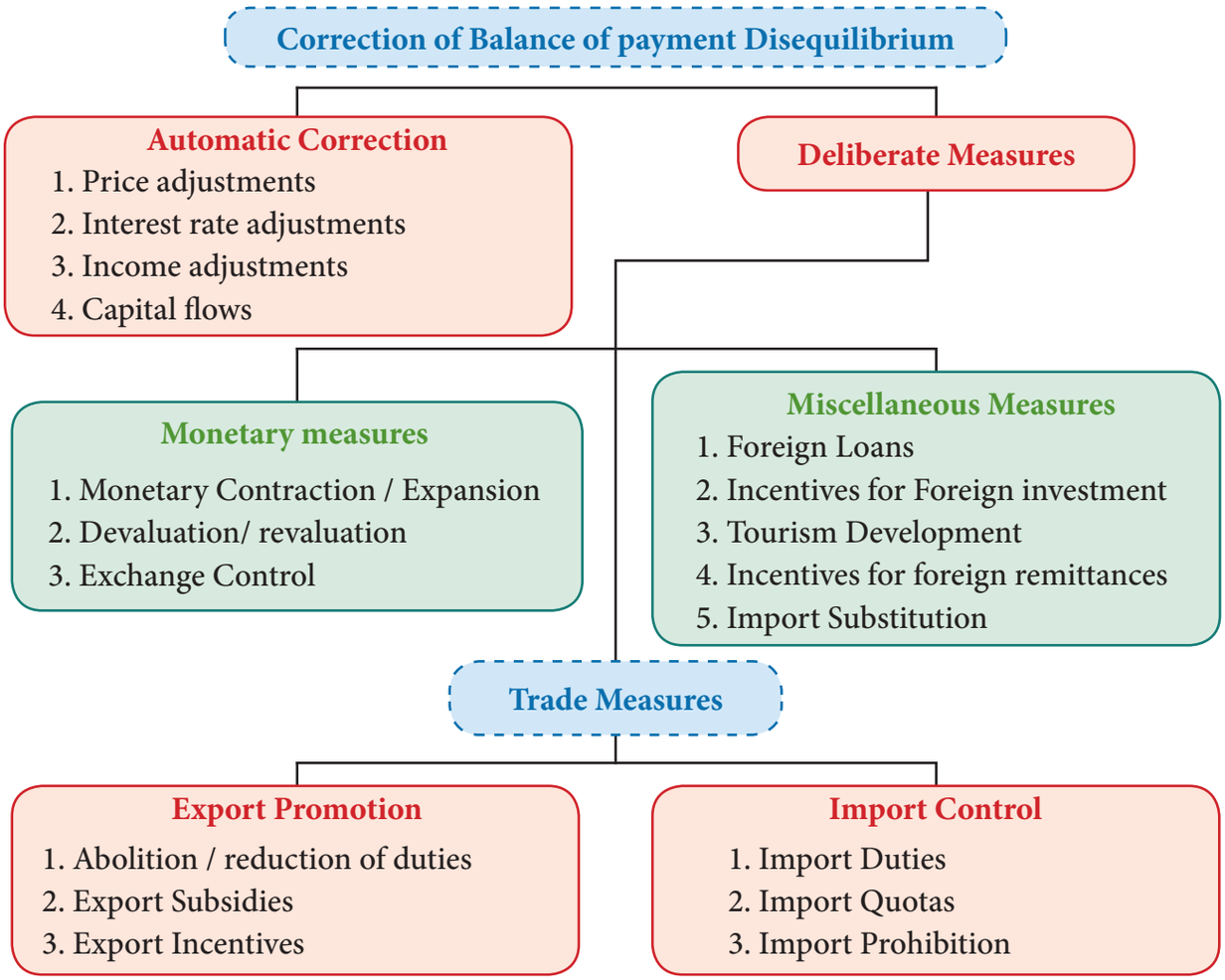
surplus country which will encourage imports and discourage exports. Fall in prices in the deficit country will encourage exports and discourage imports, leading to restoration of BoP equilibrium.

2. Interest Rate Adjustments

The contraction or expansion of money supply resulting from the BoP deficit or surplus leads to a rise or fall in the interest rates. A rise in interest rate in the deficit country will encourage investors to withdraw their funds from abroad and invest in their home country. The opposite happens in the surplus country.

3. Income Adjustments

A nation with payments surplus will experience rising income which will increase imports and thereafter equilibrium is restored in Balance of Payments.



4. Capital Flows

Changes in the interest rate consequent to the BoP disequilibrium will encourage capital flows from the surplus nations to deficit nations helping restoration of the BoP equilibrium.

II. Deliberate Measures

The deliberate measures may be broadly grouped into (a) monetary measures (b) trade measures and (c) miscellaneous measures.

a. Monetary Measures

1. Monetary Contraction

High domestic price level is responsible for high imports and low exports. In order to control inflation, the central monetary authority controls credit. As a result, the prices come down and exports increase. This will help to correct adverse BoP. However, if credit is controlled, investment will decline, production will go down, prices will increase. This is the cause of confusion between government and RBI in India in 2010s.

2. Devaluation

Devaluation means deliberate reduction of the official rate at which domestic currency is exchanged for another currency. In other words, devaluation refers to a reduction in the external value of a currency in the terms of other currencies. For instance, instead of 70 ₹ per US$, making ₹ 80 per US$.

Devaluation of Indian Currency

Indian rupee was devalued three times since 1947.

1. On 29th September, 1949.
2. On 6th June, 1966
3. On 1st July, 1991

A country with fundamental disequilibrium in the balance of payments may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium. Devaluation makes exports cheaper and imports dearer. That means making Indian good cheaper for foreigners, and foreign goods costlier for Indians.

3. Exchange Control

Exchange control means the state intervention in the forex market. It is a popular method employed to influence the balance of payments position of a country. Under exchange control, the government or central bank assumes complete control over the foreign exchange reserves and earning of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government / central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports. Does it happen in India? Too much of imports control would invite more and more smuggled goods. Smuggling of gold into Indian airports regularly happens, as per the reports in the media.

III. Trade Measures

Trade measures include measures to promote exports and to reduce imports.

1. Export Promotion

Exports may be encouraged by i).reducing or abolishing export duties, ii). providing export subsidy, iii).encouraging export production by giving monetary, fiscal, physical and institutional incentives. (Then local people and domestic industries would suffer)

2. Import Control

Imports may be controlled by i).imposing or enhancing import duties, ii).restricting imports through import quotas, iii).licensing and even prohibiting altogether the import of certain non-

essential items. But this would encourage smuggling.

IV. Miscellaneous Measures

In addition to the measures mentioned above, there are a number of other measures that can help make the balance of payments position more favourable, like i). foreign loans, ii).encouraging foreign investment in the home country, iii).development of tourism to attract foreign tourists, iv).providing incentives to enhance inward remittances and v). import substitution.

7.9 Exchange Rate

7.9.1 Meaning of Foreign Exchange (FOREX)

FOREX refers to foreign currencies. The mechanism through which payments are effected between two countries having different currency systems is called FOREX system . It covers methods of payment, rules and regulations of payment and the institutions facilitating such payments.

7.9.2 Definition of FOREX

"FOREX is the system or process of converting one national currency into another, and of transferring money from one country to another".

7.9.3 Rate of Exchange

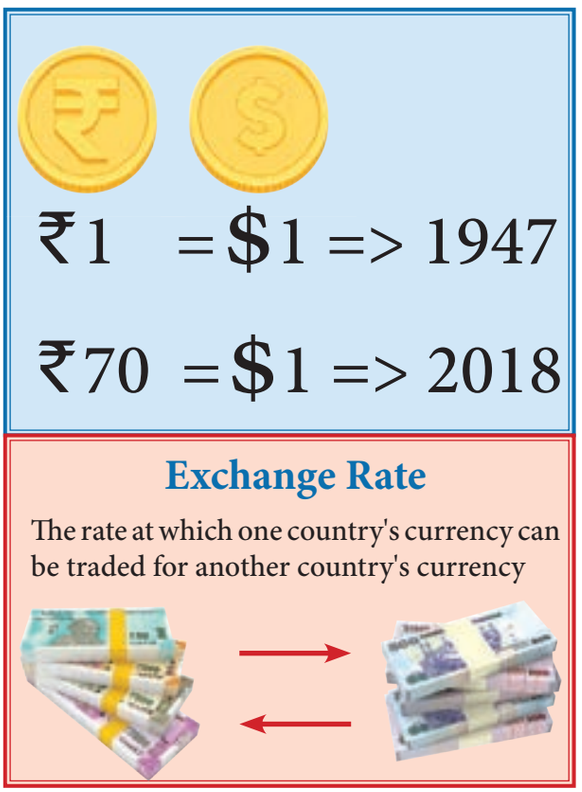
The transactions in the exchange market are carried out at exchange rates. It is the external value of domestic currency. Thus, exchange rate may be defined as the price paid in the home currency (say ₹ 75) for a unit of foreign currency (say 1 US $). It can be quoted in two ways:

1. One unit of foreign money (1 USD) to so many units of the domestic currency (₹); or
2. A certain number of units of foreign currency (USD)to one unit of domestic money (₹ 1)

For instance:

1 U.S Dollar = ₹ 70 , or

₹ 1 = U.S.1.42 cents



7.9.4. Definition of Equilibrium Exchange Rate

"The equilibrium exchange rate is that rate, which over a certain period of time, keeps the balance of payments in equilibrium".

- Ragner Nurkse

7.9.5. Determination of Equilibrium Exchange Rate

The equilibrium rate of exchange is determined in the foreign exchange market in accordance with the general theory of value, i.e., by the interaction of the forces of demand and supply. Thus, the rate of exchange is determined at the point where demand for forex is equal to the supply of forex.

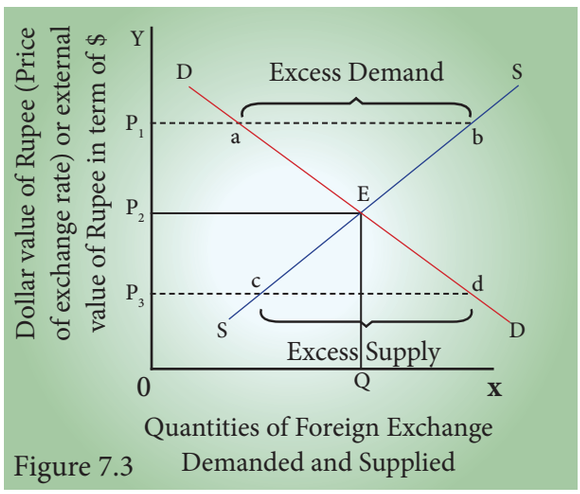


Figure 7.3

In the above diagram, Y axis represents exchange rate, that is, value of rupee in terms of dollars. X axis represents demand and supply of forex. E is the point of equilibrium where DD intersects SS. The exchange rate is P_2.

7.9.6. Types of Exchange Rate Systems

Broadly, there are two major exchange rate systems, namely, (1) fixed (or pegged) exchange rate system and (2) flexible (or floating) exchange rate system. Managed Floating Exchange Rate system also prevails in some countries (like India).

1. Fixed Exchange Rates

Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed rate as determined by the Government. Under the gold standard, the value of currencies was fixed in terms of gold.

2. Flexible Exchange Rates

Under the flexible exchange rate (also known as floating exchange rate) system, exchange rates are freely determined in an open market by market forces of demand and supply.

7.9.7. Types of Exchange Rates

Exchange rates are also in the form of (a) Nominal exchange rate (b) Real exchange rate (c) Nominal Effective Exchange Rate (NEER) and (d) Real Effective Exchange Rate (REER)

If 1 US Dollar = ₹ 75,

Nominal exchange rate = 75/1 = 75.

This is the bilateral nominal exchange rate.

$$\text{Real Exchange rate} = \frac{eP_f}{P}$$

P = Price levels in India

P_f = Price levels in abroad (say US)

e = nominal exchange rate.

If a pen costs ₹ 50 in India and it costs 5 USD in the US,

$$\text{Real Exchange Rate} = \frac{75x5}{50} = 7.5$$

If real exchange rate is equal to 1, the currencies are at purchasing power parity.

It the price of the pen in US is 0.66 USD,

then the real exchange rate = $\frac{0.66x75}{50}$ ₹

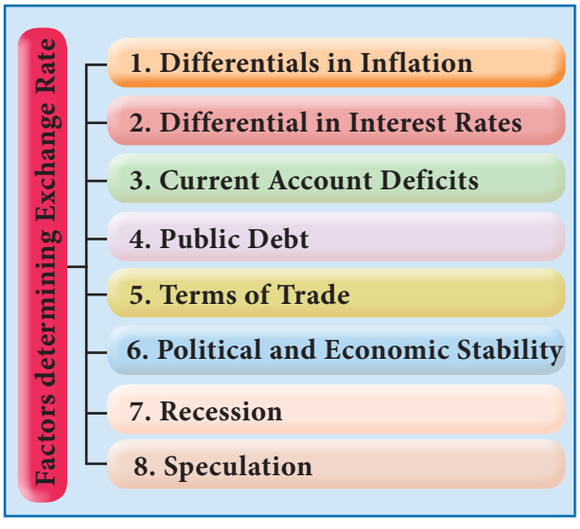
then it could be said that the USD and Indian rupee are at purchasing power parity.

NEER and REER are not explained here.

Interested students and teachers can search for them.

7.9.8. Determinants of Exchange Rates

Exchange rates are determined by numerous factors and they are related to the trading relationship between two countries.



1. Differentials in Inflation

Inflation and exchange rates are inversely related. A country with a consistently lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies.

2. Differentials in Interest Rates

There is a high degree of correlation between interest rates, inflation and exchange rates. Central banks can influence over both inflation and exchange rates by manipulating interest rates. Higher interest rates attract foreign capital and cause the exchange rate to rise and vice versa.

3. Current Account Deficits

A deficit in the current account implies excess of payments over receipts. The country resorts to borrowing capital from foreign sources to make up the deficit. Excess demand for foreign currency lowers a country's exchange rate.

4. Public Debt

Large public debts are driving out foreign investors, because it leads to inflation. As a result, exchange rate will be lower.

5. Terms of Trade

A country's terms of trade also determines the exchange rate. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade will improve. Favorable terms of trade imply greater demand for the country's exports and thus BoP becomes favorable.

6. Political and Economic Stability

If a nation's political climate is stable and economic performance is good, its currency value will be appreciated by attracting more foreign capital.

7. Recession

Interest rates are low during the recession phase. This will decrease inflow of foreign capital. As a result, a currency will be depreciated against other currencies, thereby lowering the exchange rate.

8. Speculation

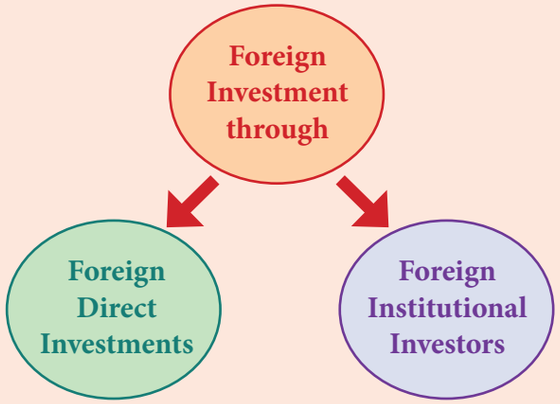
If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. This results in appreciation of the exchange rate. Beside the above determinants, relative dominance in the global politics and the power to announce economic sanctions over other countries also determine exchange rates.

7.10 Foreign Direct Investment (FDI) and Trade

FDI is an important factor in global economy. Foreign trade and FDI are closely related. In developing countries like India, FDI in the natural resource sector, including plantations, increases trade volume. Foreign production by FDI is useful to substitute foreign trade. FDI is also influenced by the income generated from the trade and regional integration schemes.

FDI is helpful to accelerate the economic growth by facilitating essential imports needed for carrying out development programmes like capital goods, technical know-how, raw materials and other inputs and even scarce consumer goods.

An investment becomes foreign investment when..



Investment done by citizens and government of one country (home country) in industries of another country (host country).

When the export earnings of a country are not sufficient to finance for imports, FDI may be required to fill the trade gap.

FDI is encouraged by the factors such as foreign exchange shortage, desire to create employment and acceleration of the pace of economic development. Many developing countries strongly prefer foreign investment to imports. However, the real impact of FDI on different sections of an economy (say India) may differ. It could be a boon for some as well as bane for others. This may be discussed in the class – room. Large demand for USD, generated by IMF and World Bank policies (FUND – BANK POLICIES), help the USD to gain value continuously. This is one of the hidden agenda of Fund – Bank policies.

7.10.1 Meaning of FDI

FDI means an investment in a foreign country that involves some degree of

control and participation in management. It corresponds to the investment made by a multinational enterprise in a foreign country. It is different from portfolio investment, which is primarily motivated by short term profit and it does not seek management control.

Foreign Portfolio Investment (FPI) means the entry of funds into a nation where foreigners deposit money in a nation's bank or make purchase in the stock and bond markets, sometimes for speculation. FPI is part of capital account of BoP.

7.10.2 Objectives of FDI

FDI has the following objectives.

1. Sales Expansion
2. Acquisition of resources
3. Diversification
4. Minimization of competitive risk.

Foreign Institutional Investment (FII) is an investment in hedge funds, insurance companies, pension funds and mutual funds. Foreign institutional investment is a common term in the financial sector of India. For example, a mutual fund in the United States can make investment in an India-based company.

7.10.3 Advantages of FDI

Foreign investment mostly takes the form of direct investment. Hence, we deal here with the foreign direct investment. The important advantages of foreign direct investment are the following:

1. FDI may help to increase the investment level and thereby the income and employment in the host country.
2. Direct foreign investment may facilitate transfer of technology to the recipient country.
3. FDI may also bring revenue to the government of host country when it taxes profits of foreign firms or gets royalties from concession agreements.
4. A part of profit from direct foreign investment may be ploughed back into the expansion, modernization or development of related industries.
5. It may kindle a managerial revolution in the recipient country through professional management and sophisticated management techniques.
6. Foreign capital may enable the country to increase its exports and reduce import requirements. And thereby ease BoP disequilibrium.
7. Foreign investment may also help increase competition and break domestic monopolies.
8. If FDI adds more value to output in the recipient country than the return on capital from foreign investment, then the social returns are greater than the private returns on foreign investment.
9. By bringing capital and foreign exchange FDI may help in filling the savings gap and the foreign exchange gap in order to achieve the goal of national economic development.

10. Foreign investments may stimulate domestic enterprise to invest in ancillary industries in collaboration with foreign enterprises.

11. Lastly, FDI flowing into a developing country may also encourage its entrepreneurs to invest in the other LDCs. Firms in India have started investing in Nepal, Uganda, Ethiopia and Kenya and other LDCs while they are still borrowing from abroad. Larger FDI to India comes from a small country (Mauritius).

7.10.4. Disadvantages of FDI

The following criticisms are leveled against foreign direct investment.

1. Private foreign capital tends to flow to the high profit areas rather than to the priority sectors.

2. The technologies brought in by the foreign investor may not be appropriate to the consumption needs, size of the domestic market, resource availabilities, stage of development of the economy, etc.

3. Foreign investment, sometimes, have unfavorable effect on the Balance of Payments of a country because when the drain of foreign exchange by way of royalty, dividend , etc. is more than the investment made by the foreign concerns.

4. Foreign capital sometimes interferes in the national politics.

5. Foreign investors sometimes engage in unfair and unethical trade practices.

6. Foreign investment in some cases leads to the destruction or weakening of small and medium enterprises.

7. Sometimes foreign investment can result in the dangerous situation of minimizing / eliminating competition and the creation of monopolies or oligopolistic structures.

8. `Often, there are several costs associated with encouraging foreign investment.

7.10.5. FDI in India

The early 1991 witnessed reforms in the economic policy. This helped to open up Indian markets to FDI. FDI in India has increased over the years. In India, FDI has been advantageous in terms of free flow of capital, improved technology, management expertise and access to international markets.

The major sectors benefited from FDI in India are:

(i) financial sector (banking and non-banking)
(ii) insurance
(iii) telecommunication
(iv) hospitality and tourism
(v) pharmaceuticals and
(vi) software and information technology.

FDI is not permitted in the industrial sectors like

(i) Arms and ammunition
(ii) atomic energy,
(iii) railways,

(iv) coal and lignite and

(v) mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper etc.,

FDI inflow in India has increased from $97 million in 1990-91 to $5,535 million in 2004-2005. It amounted to $32,955 million in 2011-2012. UNCTAD's World Investment Report 2018 reveals that FDI to India declined to $40 billion in 2017 from $44 billion in 2016.

Summary

International Economics is a valuable branch of Economics dealing with how trade benefits nations Several theories have been propounded on causes of international trade starting from Adam Smith. The controversy over the need for a separate theory has been resolved by the Modern Theory of International Trade. The gains from trade, Terms of Trade, Balance of Payments constitute the major areas of discussion.

The Exchange rate, either fixed or flexible is a major factor determining the economic strength of the nation. In the line of foreign trade and foreign capital, foreign investment (especially FDI) plays a major role in determining economic development of Less Developed Countries and developing countries. international trade has helped the economically developed countries largely and disappointed many african and asian countries.

The international economic organizations such as IMF, IBRD and WTO and the trade blocs SAARC, ASEAN and BRICS which play a vital role in international trade are covered in the next chapter.

Think and Do

1. Suppose the exchange rate between Indian Currency and US Dollar is ₹1= $65. If it changes to ₹1 = $55, the value of which currency increased and decreased?
2. Suppose a doctor from England is invited to diagnose the health status of a VIP in our State. The fees which we pay to the doctor are entered in to which account of the BOPs Account?

Glossary

- **International Economics:** A special branch of Economics which primarily deals with the basics of international trade.
- **Internal Trade:** A trade within the geographical boundary of a particular nation.
- **International Trade:** A trade between two or more countries and it is a trade beyond the geographical and political boundaries.
- **Absolute Cost Differences:** The difference in the actual costs of production of a commodity between two nations.
- **Comparative Cost Differences:** The difference in the absolute costs of production of two commodities between two countries.
- **Factor Endowment:** Abundance in the availability of a factor in a country.

- **Terms of Trade:** The rate at which goods of one country are exchanged for that of another country ie ratio of export price and import price.
- **Balance of Trade:** The balance between the values of goods exchanged between two countries. It is a trade in merchandise items or visible items only.
- **Balance of Payments:** The balance between the values of goods and services exchanged between two countries. It is a trade in both visible and non-visible items.
- **Devaluation:** It means official reduction in the value of a currency in terms of gold or other currencies.
- **Foreign Exchange:** The currency of another country.
- **Exchange Rate:** The rate at which one currency is exchanged for another currency.
- **Fixed Exchange Rates:** An exchange rate that is held within a narrow band by the monetary authorities..
- **Flexible Exchange Rates:** Flexible exchange rates are freely determined in an open market primarily by private dealings, and they, like other market prices, vary from day by day.
- **Foreign Direct Investment:** The investment made by a multinational enterprise in a foreign country and an investment in a foreign country that involves some degree of control and participation in management.

MODEL QUESTIONS

QBN5U

Part A

Multiple Choice Questions

1. Trade between two countries is known as ……trade

   a) External
   b) Internal
   c) Inter-regional
   d) Home

2. Which of the following factors influence trade?

   a) The stage of development of a product
   b) The relative price of factors of productions.
   c) Government.
   d) All of the above.

3. International trade differs from domestic trade because of

   a) Trade restrictions
   b) Immobility of factors
   c) Different government policies
   d) All the above

4. In general, a primary reason why nations conduct international trade is because

   a) Some nations prefer to produce one thing while others produce another
   b) Resources are not equally distributed among all trading nations
   c) Trade enhances opportunities to accumulate profits
   d) Interest rates are not identical in all trading nations

5. Which of the following is a modern theory of international trade?

   a) absolute cost
   b) comparative cost
   c) Factor endowment theory
   d) none of these

6. Exchange rates are determined in

   a) money market
   b) foreign exchange market
   c) stock market
   d) capital market

7. Exchange rate for currencies is determined by supply and demand under the system of

   a) Fixed exchange rate
   b) Flexible exchange rate
   c) Constant
   d) Government regulated

8. Net export equals ……

   a) Export x Import
   b) Export + Import
   c) Export – Import
   d) Exports of services only

9. Who among the following enunciated the concept of single factoral terms of trade?

   a) Jacob Viner
   b) G.S.Donens
   c) Taussig
   d) J.S.Mill

10. Terms of Trade of a country show ……

a) Ratio of goods exported and imported
b) Ratio of import duties
c) Ratio of prices of exports and imports
d) Both (a) and (c)

11. Favourable trade means value of exports are ……. Than that of imports.

a) More
b) Less
c) More or Less
d) Not more than

12. If there is an imbalance in the trade balance (more imports than exports), it can be reduced by

a) decreasing customs duties
b) increasing export duties
c) stimulating exports
d) stimulating imports

13. BOP includes

a) visible items only
b) invisible items only
c) both visible and invisible items
d) merchandise trade only

14. Components of balance of payments of a country includes

a) Current account
b) Official account
c) Capital account
d) All of above

15. In the case of BOT,

a) Transactions of goods are recorded.
b) Transactions of both goods and services are recorded.
c) Both capital and financial accounts are included.
d) All of these

16. Tourism and travel are classified in which of balance of payments accounts?

a)merchandise trade account
b) services account
c)unilateral transfers account
d) capital account

17. Cyclical disequilibrium in BOP occurs because of

a) Different paths of business cycle.
b) The income elasticity of demand or price elasticity of demand is different.
c) long-run changes in an economy
d) Both (a) and (b).

18. Which of the following is not an example of foreign direct investment?

a) the construction of a new auto assembly plant overseas
b) the acquisition of an existing steel mill overseas
c) the purchase of bonds or stock issued by a textile company overseas
d) the creation of a wholly owned business firm overseas

19. Foreign direct investments not permitted in India

a) Banking
b) Automic energy
c) Pharmaceutical
d)Insurance

20 Benefits of FDI include, theoretically

a) Boost in Economic Growth
b) Increase in the import and export of goods and services
c) Increased employment and skill levels
d) All of these

Answers

1	2	3	4	5	6	7	8	9	10
a	d	d	b	c	b	b	c	a	c
11	12	13	14	15	16	17	18	19	20
a	c	c	d	a	b	d	c	b	d

Part B

Answer the following questions. Each question carries 2 marks.

21. What is International Economics?
22. Define international trade.
23. State any two merits of trade.
24. What is the main difference between Adam Smith and Ricardo with regard to the emergence of foreign trade?
25. Define Terms of Trade.
26. What do you mean by balance of payments?
27. What is meant by Exchange Rate?

Part C

Answer the following questions. Each question carries 3 marks.

28. Describe the subject matter of International Economics.
29. Compare the Classical Theory of international trade with Modern Theory of International trade.
30. Explain the Net Barter Terms of Trade and Gross Barter Terms of Trade.
31. Distinguish between Balance of Trade and Balance of Payments.
32. What are import quotas?
33. Write a brief note on flexible exchange rate.
34. State the objectives of Foreign Direct Investment.

Part D

Answer the following questions. Each question carries 5 marks.

35. Discuss the differences between Internal Trade and International Trade.
36. Explain briefly the Comparative Cost Theory.
37. Discuss the Modern Theory of International Trade.
38. Explain the types of Terms of Trade given by Viner.
39. Bring out the components of balance of payments account.
40. Discuss the various types of disequilibrium in the balance of payments.
41. How the Rate of Exchange is determined? Illustrate.
42. Explain the relationship between Foreign Direct Investment and economic development

ACTIVITY

1. Students may be brought to any firm or industry which is involved in foreign trade to make them know the different procedures followed and activities done.
2. Students may be grouped as countries and directed to have a look at some available goods to be exchanged between them as if they involve in foreign trade.

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