LESSON 24

CONCEPT OF INTERNATIONAL TRADE

Introduction:

In the era of Globalisation there is hardly any country which is able to satisfy all the needs of its citizens with its available resources. The increasing trend of consumerism amongst the people attracts country to buy and sell the goods and services from other countries. In such conditions to assume any country to have closed economy is absurd. Every country is engaged in trade and other economic transactions with various countries in order to fulfill the wants (needs) of its population.

We will first try to understand the close and open economy.

Closed economy:

A close economy of a country is so called when it has no economic transactions or trade with another country. It is self sufficient, provides all goods and services produced within the economy's borders.

Open economy: It is an economy in which there is mutual transaction of goods & services and trade of financial assets with other countries.

For example in India we consume many goods and services imported from other countries. Similarly, some part of our production is also exported abroad.

Meaning of International Trade

Generally, the meaning of trade refers to purchase and sale of goods and services. There is internal and international trade. In internal or domestic trade transaction takes place within the geographical boundries of a nation between different regions. For example banana, rice and coconut from southern India are sent to other parts of the country under internal trade. Similarily, other examples include apples, spices, saffron produced in Kashmir. On the contrary international trade refers to exchange of goods and services between two or more countries. Thus trade across the political frontiers is called international trade, for example the trade between India and America is called international trade. In simple words it is called foreign trade.

Need of International Trade :

The need for International Trade can be understood by the following points

1. All the countries are not equally efficient in producing all types of goods.They have to depend on the other countries for some goods. For example oil is required by all countries but as it is found in few have international trade for it takes place.
2. There is unequal distribution of resources in the world viz fertile land, mineral resources, forest resources etc. Climate also differs. There is no perfect substitution between the factors of production, hence every country specialises in the production of those goods for which the factors are found in abundance. In doing so, its cost of production becomes less. To earn profit the country exports these goods. On the contrary, due to non-availability and scarcity of resources and due to their high prices, such goods are imported from other countries. Thus it makes efforts to decrease its production cost and earn profit through international trade.
3 The development of backward and developing countries is possible by acquiring advanced technology from international trade.
4. The international trade also increases the competitiveness amongst the domestic industries, to earn profit from international trade they increase both the quality and quantity of goods.
5. At present the revenue earned from international trade has a large share in gross national produce. International trade is a responsible factor for the development of all developing countries.

Importance

The definitions given by renowned economists reveals the importance of international trade.

According to Jacob Viner- "Foreign trade thus involves some degree of specialization"

According to Walter Krause "International trade permits more people to live to gratify more varied tastes and to enjoy a higher standard of living than would be possible in its absence". The Importance of International Trade can be explained through the following points :-

1. It gives more opportunities to consumers, producers and investors by providing choice of more goods.
2. It is helpful in optimum use of natural resources.
3. Every country gets an equal opportunity for development.
4. It is helpful in providing necessary goods in condition of natural calamity.
5. It enhances the possibilities of rapid industrialization in developing countries by promotion of financial facilities and advanced technology.
6. International trade helps in harmonizing the mutual relations amongst nations.

Trade Balance and Balance of Payment-

There is a marked distinction between balance of trade and balance of payment. Balance of trade is a component of balance of payment. Every country exports and imports goods and services. Some items are visible and some invisible. Visible items refers to physical goods which can be seen and measured. The value of these goods is included in balance of trade. Thus balance of trade refers to the visible items only. If the export of any country is more in comparison to its imports than the balance of trade is favourable. On the contray if imports are more than exports then balance of trade is unfavorable. Balance of payment is a broader concept and it includes both visible and invisible items. The invisible items includes services like banking, insurance, technical knowledge etc. There are payments between the nations but there is no account of them on the harbour (ports). Some famous economists has defined the balance of payment as follows :-

Table 24.1 Balance of Payment Account

Credit (Receipts)			**Debit (Payment)**		
Current Account					
S.No.	**Item**	**₹ (Crores)**	**S.No.**	**Item**	**₹ (Corese)**
1.	Goods exported	300	8.	Goods imported	400
2.	Services exported	100	9.	Services imported	200
3.	Income from foregin investment	200	10.	Foreign income from investment at home	100
4.	Unilateral receipts	100	11.	Unilateral payment	100
		700			**800**
Capital Account					
5.	Long term borrowings	200	12.	Long term lending	100
6.	Short term borrowings	200	13.	Short term lending	100
7.	Sale of gold assets	100	14.	Purchase of gold assets	100
		500			**300**
			15.	Errors & omission	100
	Grand Total	**1200**			**1200**

According to Bo Sodersten- "The balance of payment is merely a way of listing receipts and payments in international transactions for a country".

Balance of payment can easily be understood by the following hypothetical table:

In the above (table 24.1) 100 crore rupees deficit is depicted in balance of trade. The goods exported are worth 300 crore whereas goods imported are worth 400 crore. But both (credit and debit) side of balance of payment are 1200 corers rupees. Balance of payment is exactly balanced, it always remains balanced because it includes both visible and invisible goods.

Meaning of Foreign Exchange Rate :-

According to Sayers "The prices of currencies in terms of each other are called foreign exchange rates."

According to Haynes "Exchange rate is the price of one currency stated in terms of another currency"

The definitions of Sayers and Haynes clearifies that exchange rate is the rate at which one currency is exchanged for another currency like one rupee in India is equal to 0.015 dollar or 1 US dollar is equal to 68.26 Indian rupees. If an Indian tourist visits America, inorder to fulfill his daily wants he has to exchange the Indian currency into dollar, for one dollar he will give 68.26 rupees. The foreign exchange rate is determined in foreign exchange market.

Foreign exchange market is where two or more countries exchange their currencies. Foreign exchange markets are made up of commercial banks, authorized dealers and monetary authorities.

Exchange rate is of various types namely spot rate, favourable and unfavourable, fixed and flexible rate of exchange. Economists is have propounded many theories of foreign exchange like demand and supply theory, purchasing power, parity theory, balance of payment theory and mint par parity theory.

Determination of Exchange rate :

Demand and Supply Theory - Like the determination of price of commodity in the market by demand and supply of commodity, similarly the foreign exchange rate is also determined in the foreign exchange market by the demand for supply of foreign exchange. With the help of simple example we can make an effort to understand it. Like in India the demand for foreign exchange (dollar) is because India imports goods and services from America. For this India makes capital transfer to America. In exchange America provids US dollars because payments of imports have to be made in dollars. The slope of the demand curve for dollar is negative. It implies that lower the exchange rate the larger will be quantity of dollars demanded. This is because in India goods and services will become cheaper. The import elasticity of demand affects the demand curve.

Supply

It arises from India's export of goods and services and capital movements from America to India

Rupees are offered in exchange of dollars because American holders of dollars wish to make payments in rupees to India.The supply curve is positive which depicts a positive relationship. As the exchange rate increases the greater is quantity of rupees supplied. The elasticity of supply influences the supply curve.

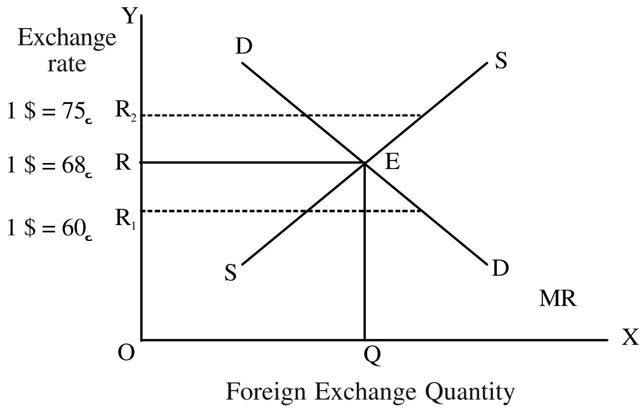

Figure 24.1

The equilibrium exchange rate is determined where DD the demand curve for foreign exchange intersects SS supply curve for foreign exchange at point E in figure 24.1. OQ is the amount of foreign exchange that is demanded and supplied. The equilibrium exchange rate is OR at which 1$ =₹ 68. At any higher rate than this ie, OR_2 the supply of foreign exchange would be larger than demand, this will lead to decline in exchange rate and equilibrium will be established at E. On the contrary, at OR_1 exchange rate the demand for foreign exchange is greater than supply of foreign exchange, which will increase the exchange rate and equilibrium will be re-established at E. Thus under flexible exchange rates the balance of payment remains in equilibrium.

The exchange rate between countries changes due to changes in demand or supply of the foreign exchange The other economic factors which can be responsible for change are quantity of export and import, capital movements of the country, bank rate, uncertainty in internal money market and political conditions of the country.

Devaluation and Revaluation

According to Paul Enzing:

"Important tool to make balance in Balance of Payment of a country are devaluation & revaluation."

Devaluation is a process of lowering the value of a country's currency with respect to foreign currency by the monetary authority (government) of that country. Devaluation means when the country devaluates the external value of its currency. It is the most commonly adopted method to correct the adverse balance of payment. The impact is that the country's imports, becomes costlier and exports become cheaper. This helps in eliminating the deficits in the balance of payment.

Revaluation is also an instrument (tool) adopted to correct the balance of payment. The value of country's currency is increased compared to foreign currency. This leads to costlier exports and cheaper imports. If rupee becames costlier to foreign currency the surplus in foreign trade can be eliminated.

Devaluation and revaluation both are done under stable exchange rate monetary system. If revaluation is implemented under unstable (Floating) exchange rate system then it is called Appreciation.

Important points

- International trade refers to exchange of goods and services between two or more countries.
- International trade enhances the spectrum of choices of goods for the consumers, producers and investors.
- Balance of trade includes import and export of goods (visible items).
- Exchange rate depicts the price of one currency in form of other currency.
- The rate of exchange is determined at a point where demand for foreign exchange is equal to supply of foreign exchange.
- Devaluation of a country's currency unit is meant to decrease in external value of unit of that currency.
- Upward increase in value of currency with respect to another currency is called revaluation.

Exercise Questions

Objective Type Questions :-

1. Foreign Exchange market can be defined as where there is -

   (A) Transactions of goods

   (B) Transactions of exchange money

   (C) Transaction of resources

   (D) Transaction of services

2. Which of the following condition depicts the trade deficit -

   (A) Imports > Exports

   (B) Exports = Imports

   (C) Imports < Exports

   (D) None of these

3. The depreciation of external value of its currency by a country is called -

   (A) Depreciation

   (B) Devalution

   (C) Revaluation

   (D) Inflation

4. Balance of trade includes -

   (A) Import of services

   (B) Export of services

   (C) Imports of assets

   (D) Import and Export of goods.

5. If value of 1 dollar changes from ₹ 65 to 60 rupees then it will be called -
   (A) Revaluation
   (B) Devaluation
   (C) Depreciation
   (D) Price increase

Very Short Answer Type Questions :

1. What is the meaning of international trade?
2. Write the meaning of foreign exchange market?
3. What do you mean by trade?
4. Explain any one importance of foreign trade.

Short Answer Type Questions :

1. Define devaluation?
2. What are invisible itemes ?
3. What is the meaning of exchange rate?
4. What do you mean by visible goods?
5. What is close economy?

Essay Type Questions :

1. Explain the determination of foreign exchange rate in detail.
2. Explain the meaning of international trade. Why is it needed ?
3. Differentiate between devaluation and revaluation?
4. "Balance of payment is a broader concept than balance of trade". Explain the statement.
5. Illustrate the various items of balance of payment with the help of a hypothetical example.

Answer Table

1	2	3	4	5
B	A	B	D	A