

7. MODULE-5

1. ADVANTAGES AND DISADVANTAGES OF INTERNATIONAL TRADE

A. ADVANTAGES OF INTERNATIONAL TRADE

1. ADVANTAGES OF SPECIALIZATION AND DIVISION OF LABOUR

It is beneficial in several respects. Important advantage is the division of labour and the consequent specialization. Different regions are endowed with different types of productive agents. It is to the advantage of each nation or region to specialize in the production of those goods for which their factor equipment is most suited.

For example: Britain-rich in iron ores and coal. Middle east countries - oil resources, South east countries - Tin and rubber, India and Sri lanka - Tea. So countries which have a special advantage of one article can specialize in the production of that article and exchange it for another commodity from another country which is eminently suited. Import which is cheaper than producing a particular commodity in the home country.

2. AVAILABILITY AND CHEAPNESS OF COMMODITIES

Because of international trade the consumers can get access to foreign goods at lower prices. Normally foreign goods are imported because of their relative cheapness in comparison with the prices of domestic goods.

3. LARGE SCALE PRODUCTION

Due to specialization, factors of production are put to the best use. Specialization followed by large scale production and introduction of machinery will result in greater output. It also results in stimulating their consumption and demand which cause further specialization which lower the prices of goods and services all over the world.

4. CREATION OF INDUSTRIAL SOCIETY

International trade through specialization of large-scale production, usage of machinery and exploitation of natural resources has resulted in the creation of a new industrial society.

5. STABILIZATION OF INTERNAL PRICE

With the help of international trade the surpluses of the country could be exported to the other country and the deficits of one country may be made up by imports. This will ultimately lead to stabilization of internal price level.

6. AVAILABILITY OF COMMODITIES WHOSE COSTS OF PRODUCTION ARE HIGH

With the help of international trade, the countries are able to acquire commodities which they cannot produce locally due to the non-availability of factors of production, insufficient quantity, and due to high costs of production. Europe and Africa could get tea and penicillin, respectively, only because of international trade.

7. IMPROVEMENT IN TRANSPORT

International trade has resulted in the improvement in the means of transport in all parts of the world.

8. SOVEREIGN REMEDY IN TIMES OF WAR AND FAMINE

During times of famine, scarcity and war, international trade enables the people of a country to maintain themselves through import of food, cloth and medicine from abroad.

9. DEVELOPMENT OF BACKWARD NATIONS

With the help of international trade, the economically backward and under-developed countries are able to import machinery and capital goods in exchange for their raw materials, agricultural products and food stuffs.

10. REDUCES MONOPOLISTIC EXPLOITATION

The sense of competition enables the domestic producers keep up the standard in the methods of production. There is no fear of monopoly and competition makes the producers keep the prices at a lower rate.

11. NATIONAL WELL-BEING

For many nations, international trade is literally matter of life and death. For example: for UK and Japan, it is impossible for them to feed, cloth and house their present population, without imports from other countries. The survival of these countries depends on the exports of their manufactured goods. Costs of self-sufficiency will be very high when compared to importing. For Americans, the morning cup of coffee would become a luxury without international trade.

12. CHANGES IN THE QUALITY OF LABOUR AND CAPITAL

International trade brings about fundamental changes in the quality of labour and capital in trading countries. Trade changes the quality of the people by teaching them to consume new things also use old things in new ways, change in technical knowledge results in division of labour and specialization etc.

13. POOR AND BACKWARD NATIONS CAN BECOME RICH AND FORWARD

This is possible only due to international trade. Example: OPEC nations [Organization of the Petroleum Exporting Countries] have developed. The vast petrol reserves would have remained unexploited and Middle East Countries would have remained world's poorest desert countries. Due to international trade, they have become world's richest nations.

14. FACILITATES DEBT PAYMENT

International trade depends on the multi-lateral payment system which makes it possible to effect payments from debtor to creditor countries by enabling the former [debtors] to create the necessary amount of export surplus in the Balance of Trade. Thus there are numerous advantages arising from the exchange of goods between individuals living in different countries.

B. DISADVANTAGES OF INTERNATIONAL TRADE**1. EXHAUSTION OF ESSENTIAL MATERIALS**

International trade may result in the exhaustion of essential materials and minerals of a country. Most of the minerals were exported to other countries. If they had been preserved they would have brought better returns to the country.

2. AFFECTS DOMESTIC INDUSTRIES

International trade may adversely affect the consumption pattern of a country due to the import of cheaply manufactured and at times harmful commodities. Indian handicrafts suffered a severe setback through free trade and unrestricted imports of English textiles.

3. LOPSIDED ECONOMIC DEVELOPMENT

Due to the operation of comparative costs, international trade leads to specialization and one sided economic development which is not conducive to the prosperity of the country.

4. EVIL EFFECTS OF DUMPING

Sometimes, certain countries use international trade to dump their goods on other countries with a view to cheapen the value of the latter goods.

5. DEPENDENCE ON OTHER NATION

Though it ensures higher standard of living for a nation, it makes the countries dependent on foreign markets not only for raw materials but also for selling their finished products. This dependence

should be reduced or eradicated.

6. AGAINST NATIONAL DEFENCE

It is argued that a nation which depends on foreign sources of supply lacks defence during the war. Eg: England - during the two world war is cited as a proof. England was blocked by German submarines, which completely blocked the imports of goods and essential raw materials.

7. INSTABILITY AND ECONOMIC PLANNING

It is a source of economic instability and it stands in the way of national economic planning for development and growth.

2. ABSOLUTE AND COMPARATIVE ADVANTAGE THEORY

1. INTERNATIONAL TRADE

International trade is the exchange of capital, goods, and services across international borders or territories. Trading-partners reap mutual gains when each nation specializes in goods for which it holds a comparative advantage and then engages in trade for other products. In other words, each nation should produce goods for which its domestic opportunity costs are lower than the domestic opportunity costs of other nations and exchange those goods for products that have higher domestic opportunity costs compared to other nations.

Countries benefit from producing goods in which they have comparative advantage and trading them for goods in which other countries have the comparative advantage which means the ability of a party to produce a particular good or service at a lower marginal and opportunity cost over another. Because of specialization and trade, the absolute quantity of goods available for consumption is higher than the quantity that would be available under national economic self-sufficiency.

2. REASONS FOR TRADE

1. DIFFERENCES IN FACTOR ENDOWMENTS:

Countries have different amounts of land, labor, and capital. Saudi Arabia may have a lot of oil, but perhaps not enough timber. It will thus have to trade for timber. Japan may be able to produce technological goods of superior quality, but it may lack many natural resources. It may trade with Indonesia for inputs.

2. GAINS FROM SPECIALIZATION:

Countries may gain economies of scale from specialization, experiencing long run average cost declines as output increases.

3. POLITICAL BENEFITS:

Countries can strengthen trade to shape closer cultural and political bonds. International connections also help to promote diplomatic (rather than military) solutions to international problems.

4. EFFICIENCY GAINS:

Domestic firms will be forced to become more efficient in order to become competitive in the global market.

5. BENEFITS OF INCREASED COMPETITION:

A greater degree of competition leads to lower prices for consumers, greater responsiveness to

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5. BENEFITS OF INCREASED COMPETITION:

A greater degree of competition leads to lower prices for consumers, greater responsiveness to consumer wants and needs, and a wider variety of products.

Thus international trade benefits mostly all trading partners and generates substantial value for the global economy.

3. ABSOLUTE ADVANTAGE THEORY

Absolute advantage refers to the capability to produce more of a given product using less of a given resource than a competing entity. A country has an absolute advantage in the production of a good when it can produce it more efficiently than other countries OR a country that has an absolute advantage can produce a good at lower marginal cost (fewer materials, cheaper materials, in less time, with fewer workers, with cheaper workers, etc.) A country with an absolute advantage can sell more of the good than the country that does not have the absolute advantage. Absolute advantage differs from comparative advantage, which refers to the ability to produce specific goods at a lower opportunity cost.

For example, the Canadian economy, which is rich in low cost land, has an absolute advantage in agricultural production relative to some other countries. China and other Asian economies export low-cost manufactured goods, which take advantage of their much lower unit labor costs. Many consumer electronics are manufactured in China. China can produce such goods more efficiently, which gives it an absolute advantage relative to many countries.

ILLUSTRATION OF ABSOLUTE ADVANTAGE

The given table shows that one hour of labor time produces six bushels of wheat in the United States but only one in the United Kingdom. On the other hand, one hour of labor time produces six

ABSOLUTE ADVANTAGE		
	U.S.	U.K.
Wheat (bushels/hour)	6	1
Cloth (yards/hour)	4	6

yards of cloth in the United Kingdom but only four in the United States. Thus, the United States is more efficient than, or has an absolute advantage over, the United Kingdom in the production of wheat, whereas the United Kingdom is more efficient than, or has an absolute advantage over, the United States in the production of cloth. With trade, the United States would specialize in the production of wheat and exchange part of it for British cloth. The opposite is true for the United Kingdom. If the United States exchanges six bushels of wheat (6W) for six yards of British cloth (6C), the United States gains 2C or saves 1/2 an hour or 30 minutes of labor time (since the United States can only exchange 6W for 4C domestically). Similarly, the 6W that the United Kingdom receives from the United States for 6 yards of cloth is equivalent to or would require six hours of labor time to produce 36C in the United Kingdom (6 hours times 6 yards of cloth per hour). By being able to exchange 6C (requiring one hour to produce in the United Kingdom) for 6W with the United States, the United Kingdom gains 36C, or saves six labor - hours. The fact that the United Kingdom gains much more than the United States is not important at this time. What is important is that both nations can gain from specialization in production and trade.

Absolute advantage, however, can explain only a very small part of world trade today, such as some of the trade between developed and developing countries. Most of world trade, especially trade

among developed countries, could not be explained by absolute advantage. It remained for David Ricardo, with the law of comparative advantage, to truly explain the basis for and the gains from trade. Indeed, absolute advantage will be seen to be only a special case of the more general theory of comparative advantage.

If there is no trade, then each country will consume what it produces. Adam Smith said that countries should specialize in the goods and services in which they have an absolute advantage. When countries specialize and trade, they can move beyond their production possibilities frontiers, and are thus able to consume more goods as a result.

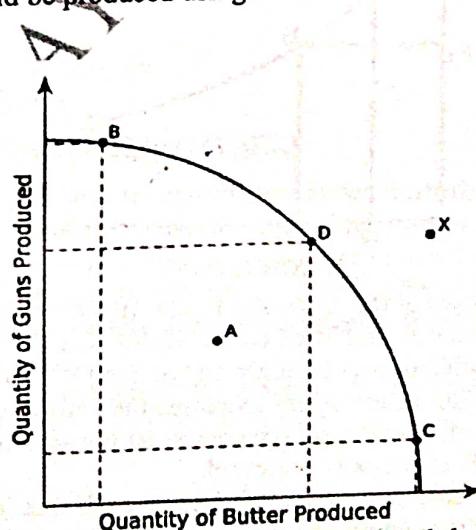
4. COMPARATIVE ADVANTAGE THEORY

1. THE PRODUCTION POSSIBILITY FRONTIER

The production possibility frontier shows the combinations of output that could be produced using available inputs. A production possibility curve is the locus of such combinations of two commodities that a country can produce, given the techniques of production and the fullest utilization of all the available factors of production. It is also called as production frontier, transformation curve, product substitution curve or an opportunity cost curve. If all the available productive resources are employed in the production of commodity X, there can be maximum possible production of this commodity with no output of the other commodity Y.

The production possibility curve shows the maximum possible quantities of two commodities that a country can produce with the given techniques and the most efficient and fullest utilization of the productive resources. The country does not possess the capacity beyond the limit specified by the production possibility curve or the opportunity cost curve, i.e. points outside the production possibilities curve are unattainable with existing resources and technology if trade does not occur with an external producer. Without trade, each country consumes only what it produces. In this instance, the production possibilities frontier is also the consumption possibilities frontier. Trade enables consumption outside the production possibility frontier.

It represents the production frontier of the country. It is a graph that shows the combinations of two commodities that could be produced using the same total amount of each of the factors of production.



PPFs are normally drawn as extending outward around the origin, but can also be represented as a straight line. An economy that is operating on the PPF is productively efficient, meaning that it

would be impossible to produce more of one good without decreasing the production of the other good. For example, if an economy that produces only guns and butter is operating on the PPF, the production of guns would need to be sacrificed in order to produce more butter. If production is efficient, the economy can choose between combinations (i.e., points) on the PPF: B if guns are of interest, C if more butter is needed, or D if an equal mix of butter and guns is required.

The slope of the opportunity cost curve is measured by the Marginal Rate of Transformation of Y into X (MRT). It is ratio of a change in the quantity of commodity Y to a change in the quantity of X commodity.

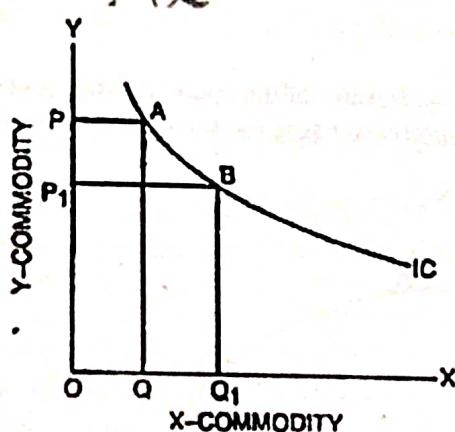
$$MRT_{xy} = \frac{\delta y}{\delta x}$$

If production is efficient, the economy can choose between combinations on the PPF. Point X, however, is unattainable with existing resources and technology if trade does not occur. The world PPF is made up by combining countries' PPFs. When countries' autarkic productions are added (when there is no trade), the total quantity of each good produced and consumed is less than the world's PPF under free trade (when nations specialize according to their comparative advantage). This shows that in a free trade system, the absolute quantity of goods available for consumption is higher than the quantity available under autarky.

2. COMMUNITY INDIFFERENCE CURVE

In international trade theory a community indifference curve or social indifference curve represents such combinations of two commodities which give equal satisfaction to the community and it is indifferent about those combinations.

The community indifference curves are derived by the aggregation of the indifference curves of all the individuals in the society. Since all combinations on a social indifference curve yield the same level of satisfaction, the increase in the quantity of one commodity must correspond with some decrease in the quantity of other commodity. Consequently the community or social indifference curve slopes



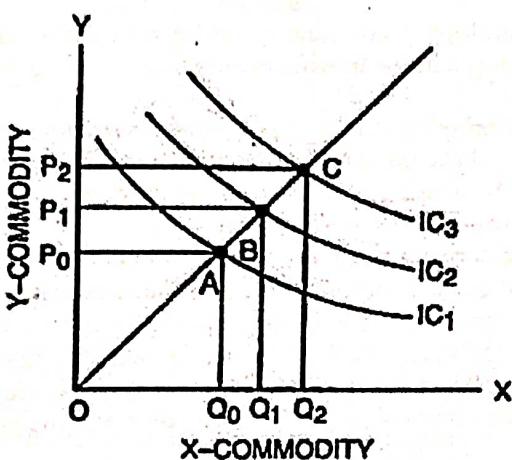
downwards from left to right as shown in the following figure. In the figure, IC is the community indifference curve. The two combinations A and B of commodities X and Y are supposed to give equal satisfaction to the community. Combination A includes OQ of X + OP of Y and combination B includes OQ_1 of X + OP_1 of Y. In combination B, as society increases the consumption of X by QQ_1 , it reduces at the same time, the consumption of Y by PP_1 so that compensating variation in satisfaction takes place and both the combinations A and B are equally preferred.

If a series of community indifference curves is shown such that higher the indifference curve, higher is the level of satisfaction from combinations lying upon it and vice-versa, that series of social indifference curves represents the community indifference map, which is shown in the following figure.

Here, IC_1 , IC_2 and IC_3 represent a community indifference map. The combinations A, B and C lie on IC_1 , IC_2 and IC_3 respectively. The combination B includes more quantities of both the commodities than the combination A. The quantities of the two commodities in combination C are more than in combination B. Thus combination C gives more satisfaction than B and latter gives more satisfaction than A. Hence higher the indifference curve, higher is the level of satisfaction and vice-versa. The slope of the indifference curve is measured by the marginal rate of substitution of X for Y (MRS_{xy}), MRS_{xy} is the quantity of Y which the society gives up in order to have some quantity of X commodity. It is measured by the ratio of a change in quantity of Y commodity to a change in the quantity of X commodity.

$$MRS_{xy} = -(\delta y / \delta x)$$

As the community increases the consumption of an additional unit of X, it may be willing to give up less and less quantities of Y. Consequently, the MRS_{xy} goes on diminishing and the community indifference curve follows the path of a negatively sloping convex curve to the origin.



PROPERTIES

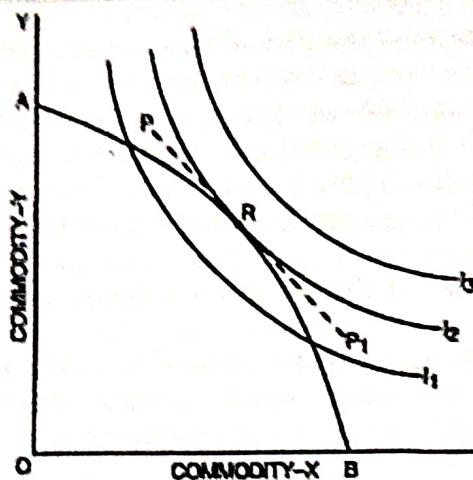
- (i) It slopes negatively;
- (ii) It is convex to the origin; and
- (iii) It is non-intersecting.

3. TRADE EQUILIBRIUM UNDER AUTARKY

In a closed economy, the general equilibrium is determined, when the production and consumption sectors are both in equilibrium. The equilibrium in the consumption sector takes place if the marginal rate of substitution of one commodity, say X, for the other commodity, say Y, becomes equal to the price ratio of those two commodities ($MRS_{xy} = P_x/P_y$). The equilibrium in the production sector is possible, when the marginal rate of transformation between these two commodities become equal to their price ratio ($MRT_{xy} = P_x/P_y$).

So the condition of the equilibrium of the whole system gets satisfied when:

$$MRS_{xy} = MRT_{xy} = P_x/P_y$$



Under equilibrium, the slope of community indifference curve will be exactly equal to the slope of the production possibility curve or the transformation curve. Such a situation is shown in the following figure.

Here, commodity X is measured along the horizontal scale and commodity Y is measured along the vertical scale. I_1 , I_2 and L_1 show the map of community indifference curves. AB is the production possibility curve. The line PP_1 measures the domestic price ratio of X and Y commodities. The consumption equilibrium is determined at R when $MRS_{xy} = P_x/P_y$ or the slope of community indifference curve L_1 is exactly equal to the slope of the price line. At this point, the community neither wants to buy more or less units of any of the two commodities. The production equilibrium is also determined at R where the price line PP_1 is tangent to the production possibility curve AB. At this point MRT_{xy} is equal to the price ratio of X and Y ($MRT_{xy} = P_x/P_y$) and there is neither a rise nor a fall in the production of either of the two commodities. Thus R is the point of general equilibrium, where the price line is simultaneously tangent to both the community indifference curve and the production possibility curve and $MRS_{xy} = MRT_{xy} = P_x/P_y$.

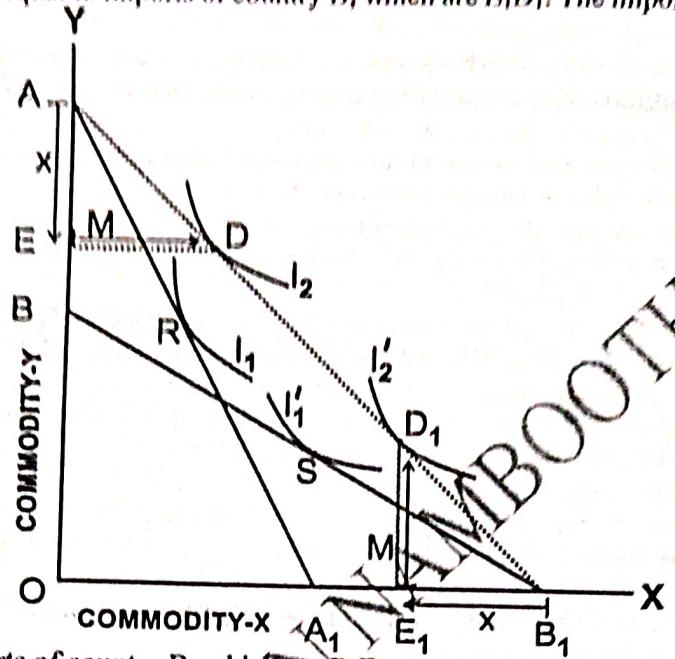
5. COMPARATIVE ADVANTAGE

1. TRADE EQUILIBRIUM UNDER CONSTANT OPPORTUNITY COSTS

A country has a comparative advantage over another when it can produce a good or service at a lower opportunity cost. Here it is supposed that both countries A and B are producing at constant costs so that their opportunity cost curves are negatively sloping straight lines. In the diagram, AA_1 and BB_1 are the production possibility curves or opportunity cost curves of countries A and B respectively. Since the production in both countries is governed by constant costs, the slopes of opportunity cost curves remain unchanged and these are negatively sloping straight lines. I_1 and I_2 are the community indifference curves of country A whereas I_1' and I_2' are the community indifference curves of country B. Under autarky (absence of trade), the consumption and production equilibrium of A occurs at R and that of B is at S because of the tangency between their respective opportunity cost curves and indifference curves.

If trade takes place, country A specialises in the production of Y as it has comparative cost advantage in the production of Y. Country B specialises in the production of X, as it possesses comparative cost advantage in the case of this commodity. Their respective comparative cost advantages or specialisations are evident from the differences in the slopes of their opportunity cost curves. Since there is complete specialisation, the points of production for countries A and B are respectively A and B_1 .

By joining these points, the international exchange ratio line AB_1 can be drawn. It is tangent to indifference curve I_2 of country A and indifference curve I'_2 of country B. Therefore, D is the point of consumption equilibrium of A and D_1 is the point of consumption equilibrium of B. Country A exports AB quantity of Y. It is equal to imports of country B, which are B_1D_1 . The imports of country A are BD .

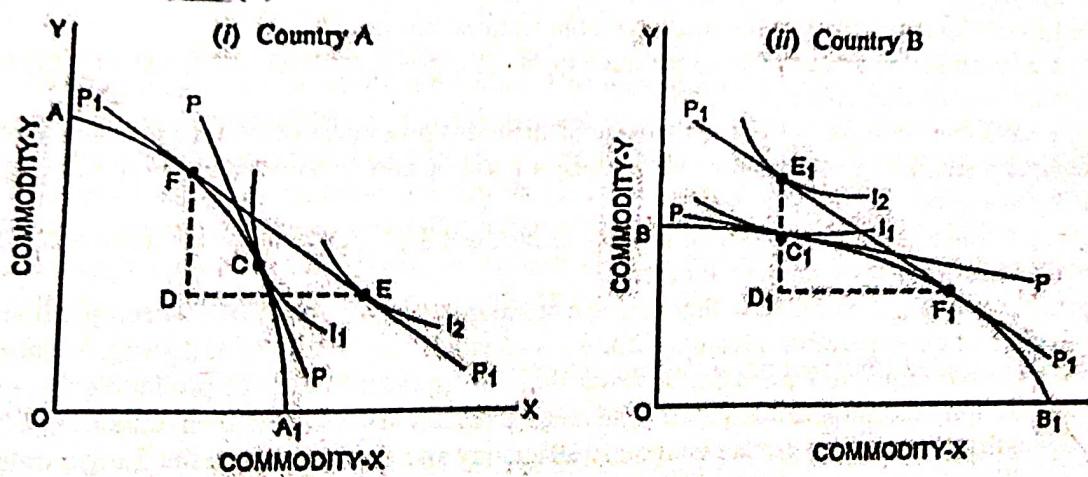


These are equal to exports of country B, which are B_1E_1 .

Thus exports of each country are just sufficient to pay for her imports and there is equilibrium in respect of demand and supply in both the countries. In addition, the trade shifts consumption equilibrium in both the countries to their higher community indifference curves. That is a measure of gain from trade for both the countries.

2. TRADE EQUILIBRIUM UNDER INCREASING COSTS:

The production under the conditions of constant costs is only a special case which may not exist in real life. Eventually the law of diminishing returns or increasing costs becomes applicable in almost all the fields of production. Since the cost ratio tends to rise, the opportunity cost curves or production



possibility curves pertaining to the trading countries are negatively sloping concave curves to the origin. The trade equilibrium related to two countries under the conditions of increasing costs is explained using the following diagram.

Here commodity X is measured along horizontal scale and commodity Y is measured along the vertical scale. Part (i) is concerned with country A and part (ii) is concerned with country B. AA_1 is the production frontier or opportunity cost curve of country A and BB_1 is the production frontier of country B.

In part A, C is the point of consumption and production equilibrium of country A in the absence of trade because it is the point of tangency between the community indifference curve I_1 and domestic exchange ratio line PP and also the point of tangency between the opportunity curve AA_1 and the exchange ratio line PP . If trade commences, this country will specialise in the production of commodity Y. This is evident from the slope of AA_1 .

Given the international exchange ratio line P_1P_1 , the production equilibrium of country A gets determined at F where P_1P_1 is tangent to AA_1 . The consumption equilibrium is determined at E where P_1P_1 is tangent to the higher community indifference curve I_2 of country A. This country will export FD quantity of Y to country B and import DE quantity of commodity X from country B.

Under part (ii) C₁ is the point of consumption and production equilibrium of country B in the absence of trade. At this point, domestic exchange ratio line PP is tangent to both the production possibility curve BB_1 and the community indifference curve I_1 . If trade commences, this country will decide to specialise in the production of commodity X. This is evident from the slope of the opportunity cost curve BB_1 of this country.

The international exchange ratio line P_1P_1 is tangent to BB_1 at F₁ which is the point of production equilibrium and it is tangent to higher community indifference curve I_2 at E₁ which is the point of consumption equilibrium. Since the consumption equilibrium in both the countries shifts to their respective higher indifference curves, both derive gain from trade. Country B exports D₁F₁ (=DE) quantity of commodity X to country A. At the same time, B imports D₁E₁ (=DF) quantity of commodity Y from the country A.

POINTS TO REMEMBER

1. Countries should import goods if the opportunity cost of importing is lower than the cost of producing them locally.
2. Competitive advantage is distinct from comparative advantage because it has to do with distinguishing attributes which are not necessarily related to a lower opportunity cost.
3. Opportunity cost: The cost of an opportunity forgone (and the loss of the benefits that could be received from that opportunity); the most valuable forgone alternative.
4. Absolute advantage: The capability to produce more of a given product using less of a given resource than a competing entity.
5. Absolute advantage compares the productivity of different producers or economies. The producer that requires a smaller quantity inputs to produce a good is said to have an absolute advantage in producing that good.
6. Comparative advantage: The ability of a party to produce a particular good or service at a lower marginal and opportunity cost over another.
7. Competitive advantage: Something that places a company or a person above the competition.
8. The existence of a comparative advantage allows both parties to benefit from trading, because each party will receive a good at a price that is lower than its opportunity cost of producing that good.

Specialization according to comparative advantage results in a more efficient allocation of world resources. Specialization leads to greater economic efficiency and consumer benefits. Larger outputs of

both products become available to both nations. The outcome of international specialization and trade is equivalent to a nation having more and/or better resources or discovering improved production techniques. Even if one country is more efficient in the production of all goods (has an absolute advantage in all goods) than another, both countries will still gain by trading with each other. More specifically, countries should import goods if the opportunity cost of importing is lower than the cost of producing them locally. Each country will continue to trade until the price equals the opportunity cost, at which point it will decide to just produce the other good domestically instead of trading. Thus both countries benefit from specializing and then trading.

BENEFITS OF SPECIALISATION

However, specialization can have both positive and negative effects.

1. Benefits of specialization include greater economic efficiency, consumer benefits, and opportunities for growth for competitive sectors.
 2. Even if one country has an absolute advantage in the production of all goods, it can still benefit from trade.
 3. Specialization according to comparative advantage results in a more efficient allocation of world resources. A larger quantity of outputs becomes available to the trading nations.
 4. Greater efficiency: Countries specialize in areas that they are naturally good at and also benefit from increasing returns to scale for the production of these goods. They benefit from economies of scale, which means that the average cost of producing the good falls (to a certain point) because more goods are being produced. Similarly, countries can benefit from increased learning. They become skilled at making the product because they have specialized in it. These effects both contribute to increased overall efficiency for countries. Countries become better at making the product they specialize in.
 5. Consumer benefits: Specialization means that the opportunity cost of production is lower, which means that globally more goods are produced and prices are lower. Consumers benefit from these lower prices and greater quantity of goods.
 6. Opportunities for competitive sectors: Firms gain access to the whole world market, which allows them to grow bigger and to benefit further from economies of scale.

DISADVANTAGES OF SPECIALISATION

Of course, there are also some potential drawbacks to specialization:

1. The disadvantages of specialization include threats to uncompetitive sectors, the risk of over-specialization, and insecurity.

2. Threats to uncompetitive sectors: Some parts of the economy may not be able to compete with cheaper or better imports. For example, firms in United States may see demand for their products fall due to cheaper imports from China. This may lead to structural unemployment.

3. Risk of over-specialization: Global demand may shift, so that there is no longer demand for the good or service produced by a country. For example, the global demand for rubber has fallen due to the availability of synthetic substitutes. Countries may experience high levels of persistent structural unemployment and low GDP because demand for their products has fallen.

4. Strategic vulnerability: Relying on another country for vital resources makes a country dependent on that country. Political or economic changes in the second country may impact the supply of goods or services available to the first.

As a whole, economists generally support specialization and trade between nations. Comparative advantage is the driving force of specialization and trade.

6. HECKSCHER - OHLIN THEORY

We can state the Heckscher-Ohlin theorem as follows: A nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor. In short, the relatively labor-rich nation exports the relatively labor-intensive commodity and imports the relatively capital-intensive commodity. H-O theorem isolates the difference in relative factor abundance, or factor endowments, among nations as the basic cause or determinant of comparative advantage and international trade. For this reason, the H-O model is often referred to as the factor-proportions or factor-endowment theory.

Classicals always laid emphasis on comparative advantage theory as they explain quite well how two nations can gain based on their comparative costs. The country with the lower comparative (or opportunity) cost has advantage in production of that commodity and hence completely specializes in the production of that commodity and export it to another nation. Similarly, it imports the commodity with the higher comparative cost produced by the other nation cheaply than others.

According to Ricardian model, labor is the only factor of production and comparative advantage arises only because of international differences in labor productivity which then leads to changes in opportunity costs and hence prices. But it does not explain why such differences arise in the first place. Heckscher and Ohlin have attempted to explain the factors which cause differences in the comparative costs of different countries.

The Heckscher-Ohlin (H-O) model was first conceived by two Swedish economists, Eli Heckscher (1919) and Bertil Ohlin (1933). According to Heckscher and Ohlin, trade is only partly explained by differences in labor productivity. It also reflects differences in countries' resource endowments i.e. how much capital and labor does a country have and how do these factor endowments shape the content of trade. So according to Heckscher-Ohlin, trade is not solely dependent on labor productivity but also due to differences in a country's resource and factor endowments. Hence Heckscher-Ohlin model does not invalidate the classical theory of comparative costs, rather it powerfully supplements it because it also accepts comparative advantage as the basic cause of international trade.

1. ASSUMPTIONS

1) TWO COUNTRIES, TWO COMMODITIES AND TWO FACTORS.

In continuation with the Ricardian model assumption of two countries and two commodities, H-O model further assumes that there are two factors of production (labor and capital) instead of a single factor of production assumed earlier and that both factors are employed in the production of both commodities. In short, it is a $2 \times 2 \times 2$ model.

2) EACH COMMODITY IS PRODUCED UNDER CONSTANT RETURNS TO SCALE

The two commodities are produced under constant returns to scale, that is, if both inputs are doubled, the output will also double.

3) PERFECT COMPETITION IN ALL MARKETS

This assumption rules out monopolistic and oligopolistic market structures. It also rules out price and wage rigidities. Every firm is a price-taker. Each country is too small to exert market power and

influence market price. Also perfect competition means that in the long run, there are no economic profits, each factor is paid according to their marginal product and everyone in the economy has perfect knowledge.

4) TECHNOLOGY IS GIVEN AND IDENTICAL.

The two commodities are produced with the same technology in both nations. The available means of production are same no matter where we are. This is an unrealistic assumption but it is assumed to focus one's attention on differences in factor endowments alone in explaining trade.

5) CONSUMER TASTES ARE IDENTICAL ACROSS COUNTRIES

Consumer demands are assumed to be approximately similar in both countries. And since consumer preferences are represented by Indifference Curves, this assumption implies that ICs for the two countries will be identical. This is again assumed to make factor endowment the key operating force at the margin.

6) FACTORS ARE MOBILE WITHIN EACH COUNTRY BUT IMMOBILE BETWEEN COUNTRIES

Factors (labor and capital) can move across industries within each country but they cannot move across countries. This means that factors can move from high paying industry to low paying industry until earnings are equalized in all industries. But there is zero international factor mobility so that international differences in factor earnings would persist in the absence of trade.

7) NO TRANSPORTATION COSTS

Transportation costs are assumed to be zero. It is true that transportation costs inhibit and reduce trade volume but it does not reverse the trade pattern between the countries. The purpose is not to ignore reality but to illuminate the pure effects of trade.

8) FREE TRADE

H-O Model is based on the assumption that final outputs are traded freely.

9) COMMODITIES ARE RANKED IN TERMS OF THEIR FACTOR INTENSITY

If a nation has two commodities and two factors then one commodity will require relatively more of one factor than the other commodity and thus can be ranked in terms of capital-labor ratio. This is being done to make the theorem simpler to analyse.

10) COMPLETE SPECIALIZATION NOT POSSIBLE

The introduction of international trade does not cause complete specialization in the production of goods in either country. This means that both nations will be producing both commodities after trade.

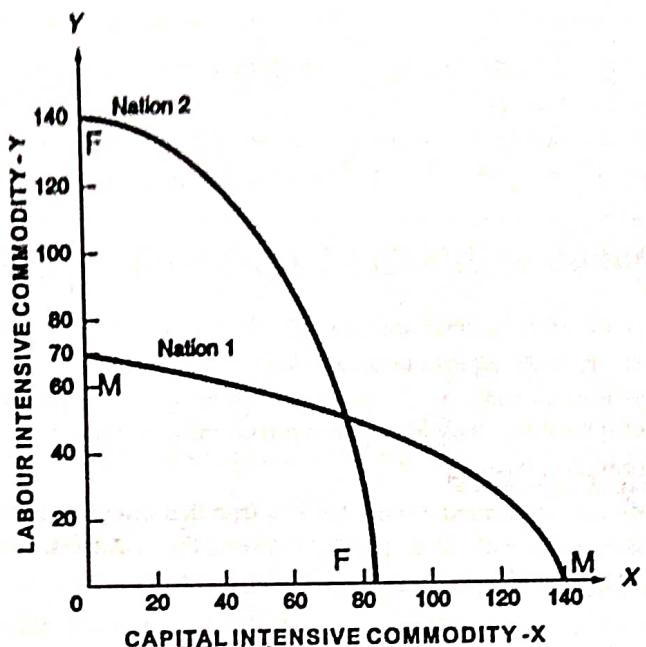
In the last assumption we stated that commodities are ranked in terms of their factor intensity, and then one commodity will be labor intensive having a lower capital-labor ratio and other commodity will necessarily be capital intensive having a high capital-labor ratio.

Let's assume there are two countries - Nation 1 and Nation 2. The two commodities are- commodity X (capital intensive commodity) and commodity Y (agriculture commodity-labour intensive). Take Commodity X be capital-intensive, that is, they can be produced with less labor relative to capital and it has a higher capital-labor ratio and Commodity Y be labor-intensive commodity, that is, it requires a substantial amount of labor relative to capital.

Further assume that Nation 1 specializes in producing the capital intensive commodity and Nation 2 is considered to be an agricultural country and thus specializes in labour intensive commodity. Plotting capital and labor values on a diagram shows us that steeper the line, greater the slope and hence the product with steeper slope is more capital-intensive.

2. FACTOR ABUNDANCE

We will assume that Nation 1 is capital-abundant nation and Nation 2 is labor-abundant. We all know that demand and supply together determines the price of a commodity. But here we assume that demand conditions are same everywhere, and it is only the supply of various factors of production that differ. Hence it becomes the sole determinant of the factor prices. So factor prices will be different

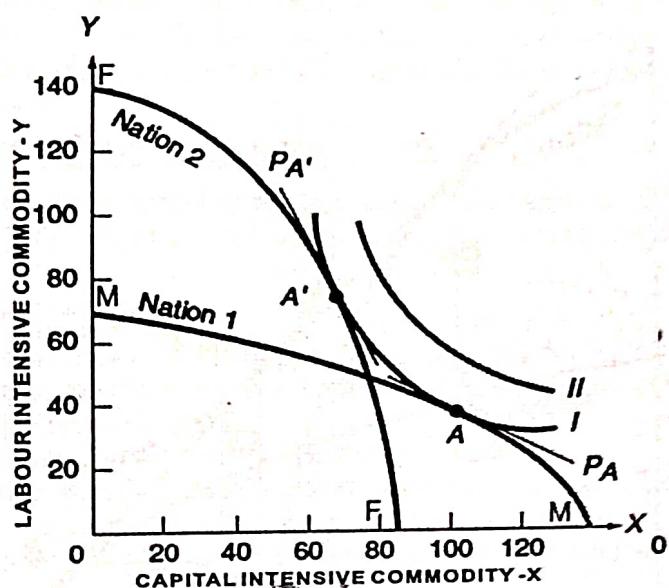


among different nations due to different factor endowments. As stated above, nation 1 is the capital abundant nation and each factor is paid according to their marginal product so the price of capital will be lower in Nation 1 relative to Nation 2 where labor will be cheaply available as it is a labor abundant country.

Since nation 1 as the capital abundant nation and commodity X is the capital-intensive commodity, Nation 1 can produce relatively more of commodity X and at a lower cost than Nation 2. Nation 2 is the Labour abundant nation and commodity Y is the labour intensive commodity, Nation 2 can produce relatively more of commodity Y and at a lower cost than Nation 1. This gives us the production frontier (PPF) for the two nations. Nation 2 PPF is skewed towards output of commodity Y (represented by FF) and Nation 1 PPF is skewed towards commodity X (represented by MM). The different shapes of different production possibility frontiers are due to the fact that the two countries have different amount of the two factors of production. The PPF is biased towards the factor in which they have abundance.

The theorem states that a nation should produce and export the commodity whose production requires the intensive use of the nation's relatively abundant (and cheap) factor and import the commodity whose production requires the intensive use of the nation's relatively scarce (and expensive) factor. In simple words, capital-intensive country exports capital intensive product and labor intensive country exports labor-intensive product.

It is only the difference in physical availability of resources or supply of factors of production that causes the difference in relative commodity prices in different nations and hence creates a basis for trade. The H-O theorem examines resource differences as the only source of trade. It shows the proportions in which different factors of production are available in different countries and the proportions in which they are used in producing different commodities, it is also referred to as factor-proportions or factor-endowment theory.



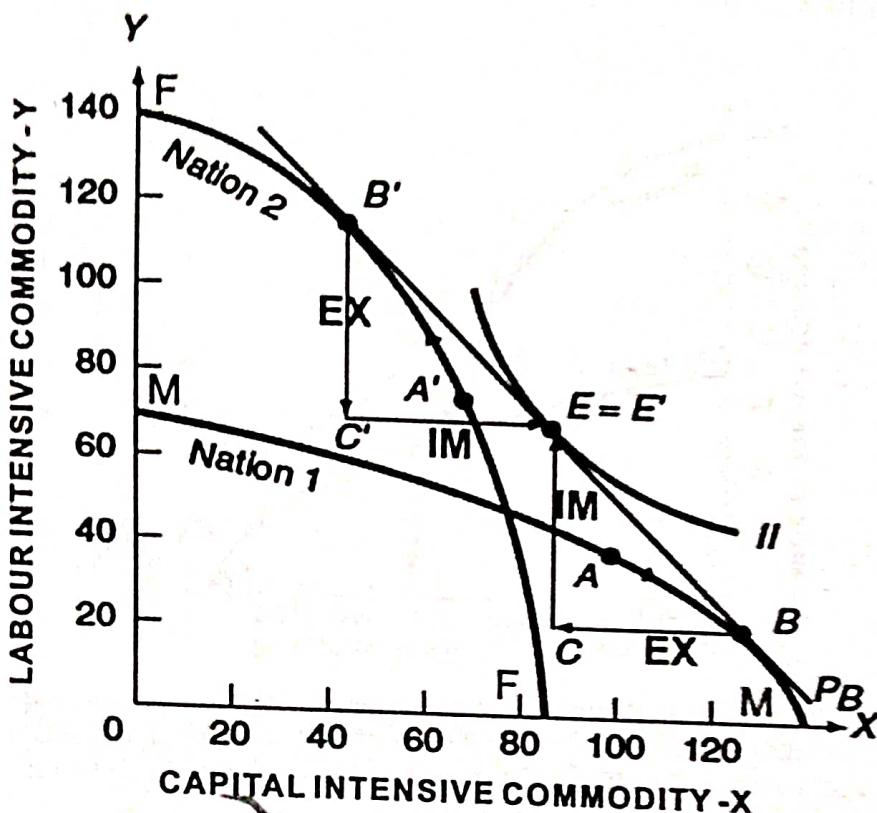
In the above diagram, as shown earlier, the PPF for Nation 2 is skewed towards commodity Y - the labor-intensive commodity shown by FF and PPF for Nation 1 is skewed towards commodity X, the capital-intensive commodity represented by MM. Since tastes are assumed to be the same in both nations, the preferences of consumers can be represented by a single IC, for the sake of simplicity. The same IC1 is tangent to both nations' PPF at point A and A' respectively. This is the autarky (no-trade) equilibrium where the production and consumption points are A and A' respectively for both nations. The price lines for both nations are given by PA and PA' respectively.

From the above diagram it can be clearly seen that $P_X < P_Y$, from the slope of the price line for the Nation 1 and thus holds comparative advantage in producing commodity X and $P_X > P_Y$ (price of good X in terms of good Y) is greater for Nation 2 has a comparative advantage in commodity Y.

3. STATEMENT OF THE THEOREM

The figure below shows how the two countries reach equilibrium when they trade. Nation 2 will specialize in production of commodity Y and will reach point B'. Similarly, Nation 1 will specialize in production of commodity X and will reach point B where the PPF of the two nations are tangent to their relative price line i.e. the rate at which they exchange with each other. Nation 2 will export commodity Y and Nation 1 will export commodity X and in this process they both will reach equilibrium point E on IC. Here we can see that, Nation 2 exports of commodity Y equals Nation 1 imports of commodity Y and Nation 1 exports of commodity 1 equals Nation 2 imports of commodity X. The two trade triangles BCE and B'C'E are equal. At point E, Nation 2 has more of commodity X but less of commodity Y than before but it still gains because point E is on a higher IC. Similarly, at point E Nation 1 gets

more of commodity Y and less of commodity X but it is also better off by trading because it is also on a higher IC. So both nations gain from trade by consuming on a higher Indifference Curve. Hence following the H-O theorem, the two nations gain from trade



7. BALANCE OF PAYMENTS – COMPONENTS

I. MEANING OF BALANCE OF PAYMENTS (BOP):

According to Kindle Berger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time". OR The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It is a double entry system of record of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time. When we say balance of trade we are referring to the transactions of its citizens and government.

It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners. The balance of payments (henceforth BOP) is a consolidated account of the receipts and payments from and to other countries arising out of all economic transactions during the course of a year.

Here, by 'residents' we mean individuals, firms and government. By all economic transactions we mean transactions of both visible goods (merchandise) and invisible goods (services), assets, gifts, etc. In other words, BOP shows how money is spent abroad (i.e. payments) and how money is received domestically (i.e., receipts). Thus, a BOP account records all payments and receipts arising out of all economic transactions.

All payments are regarded as debits (i.e., outflow of money) and are recorded in the accounts with a negative sign and all receipts are regarded as credits (i.e., inflow of money) and are recorded in the accounts with a positive sign. The International Monetary Fund defines BOP as a "statistical statement that subsequently summarises, for a specific time period, the economic transactions of an economy with the rest of the world."

II. COMPONENTS OF BOP ACCOUNTS:

According to the broad nature of the transactions concerned, the BOP of a country is divided into two main parts: (i) the current account, and the (ii) capital account. The other part is official reserve account.

(I) THE CURRENT ACCOUNT:

The current account of BOP includes all transaction arising from trade in currently produced goods and services, from income accruing to capital by one country and invested in another and from unilateral transfers, both private and official.

The current account is usually divided in three subdivisions;

The first of these is called visible account or merchandise account or trade in goods account. This account records imports and exports of physical goods. The balance of visible exports and visible imports is called balance of visible trade or balance of merchandise trade [i.e., items 1(a), and 2(b) given in the following table].

THE SCHEMATIC BOP	
A. Current Account	
1. Merchandise Trade	a) Visible exports b) Visible imports
2. invisible Trade	a) Invisible exports b) Invisible imports
3. Other Flows	a) Investment income b) Unrequited transfers
B. Capital Account	a) Long term capital transactions b) Short term capital transactions
C. Balancing Item	Net Errors and Omissions
D. Official Reserve Account	

The second part of the account is called the invisibles account since it records all exports and imports of services. The balance of these transactions is called balance of invisible trade. As these transactions are not recorded in the customs office unlike merchandise trade we call them invisible items.

It includes freights and fares of ships and planes, insurance and banking charges, foreign tours and education abroad, expenditures on foreign embassies, transactions out of interest and dividends on foreigners' investment, and so on. Items 2(a) and 2(b) comprise services balance or balance of invisible trade.

The difference between merchandise trade and invisible trade (i.e., items 1 and 2) is known as balance of trade. There is another flow in current account that consists of two items [3(a) and 3(b)]. Investment income consists of interest, profit and dividends on bonus and credits. There may be similar

money inflow (i.e., credit item). Unrequited transfers include grants, gifts, pension, etc. These items are such that no reverse flow occurs. Residents of a country receive these cost free. Thus unilateral transfers are one-way transactions. The first three items of the BOP account are included in the current account. The current account is said to be favourable (or unfavourable) if receipts exceed (falls short of payments.)

(II) THE CAPITAL ACCOUNT:

The capital account shows transactions relating to the international movement of ownership of financial assets. It refers to cross-border movements in foreign assets like shares, property or direct acquisitions of companies' bank loans, government securities, etc. In other words, capital account records export and import of capital from and to foreign countries. The capital account is divided into two main subdivisions one is the short term and another is the long term movements of capital. A short term capital is one which matures in one year or less, such as bank accounts. A long term capital is one whose maturity period is longer than a year, such as long term bonds or physical capital.

Long term capital account is, again of two categories: direct investment and portfolio investment. Direct investment refers to expenditure on fixed capital formation, while portfolio investment refers to the acquisition of financial assets like bonds, shares, etc. India's investment (e.g., if an Indian acquires a new Coca-Cola plant in the USA) abroad represents outflow of money. Similarly, if a foreigner acquires a new factory in India it will represent inflow of funds. Thus, through acquisition or sale and purchase of assets, capital movements take place. Investors then acquire controlling interest over the asset.

On the other hand, portfolio investment refers to changes in the holding of shares and bonds. Such investment is portfolio capital and the ownership of paper assets like shares does not ensure legal control over the firms.

Suppose, a US company purchases a firm operating in India. This sort of foreign investment is called capital import rather than capital export. India acquires foreign currency after selling the firm to a US company. As a result, India acquires purchasing power abroad. That is why this transaction is included in the credit side of India's BOP accounts. In the same way, if India invests in a foreign country, it is a payment and will be recorded on the debit side. This is called capital export. Thus, India earns foreign currency by exporting goods and services and by importing capital. Similarly, India releases foreign currency by importing visibles and invisibles and exporting capital.

(III) STATISTICAL DISCREPANCY-ERRORS AND OMISSIONS:

The sum of A and B (Current Account and Capital Account) is called the basic balance. Since BOP always balances in theory, all debits must be offset by all credits and vice versa. In practice, rarely it happens particularly because statistics are incomplete as well as imperfect. That is why errors and omissions are considered so that BOP accounts are kept in balance (Item C).

(IV) THE OFFICIAL RESERVE ACCOUNT:

The total of A, B, C and D comprises the overall balance. The category of official reserve account covers the net amount of transactions by government. This account covers purchases and sales of reserve assets (such as gold, convertible foreign exchange and special drawing rights) by the central monetary authority.

SUMMARY OF THE BOP DATA

Current account balance + Capital account balance + Reserve balance = Balance of Payments

$$(X - M) + (CI - CO) + \text{FOREX} = \text{BOP} \text{ where,}$$

X is exports, M is imports, CI is capital inflows and CO is capital outflows,
FOREX is foreign exchange reserve balance

8. BALANCE OF PAYMENTS DEFICIT AND DEVALUATION

When all the elements are correctly included in the BOP, it should sum up to zero in a perfect scenario. This means the inflows and outflows of funds should balance out. However, this does not ideally happen in most cases. A BOP statement of a country indicates whether the country has a surplus or a deficit of funds i.e when a country's export is more than its import, its BOP is said to be in surplus. On the other hand, the BOP deficit indicates that a country's imports are more than its exports.

SIGNIFICANCE OF BOP

A country's BOP is vital for the following reasons:

1. The BOP of a country reveals its financial and economic status.
2. A BOP statement can be used as an indicator to determine whether the country's currency value is appreciating or depreciating.
3. The BOP statement helps the Government to decide on fiscal and trade policies.
4. It provides important information to analyze and understand the economic dealings of a country with other countries.

By studying its BOP statement and its components closely, one would be able to identify trends that may be beneficial or harmful to the economy of the country and thus, then take appropriate measures. BoP thus holds substantial significance by helping a government determine the policies that shape a country's economy.

A balance of payment deficit in a country can arise if said country imports more capital, goods and services than it exports.

Balance of payment deficit is given by $(\text{Current account} + \text{capital account receipts}) < (\text{current account} + \text{capital account payments})$

BALANCE OF PAYMENT SURPLUS

Balance of payments surplus occurs when a country's total exports are higher than its imports. This helps to generate capital to fund its domestic productions. With a surplus in its BoP, a country can also lend funds outside its borders.

Balance of payment surplus occurs when-

$(\text{Current account} + \text{capital account receipts}) > (\text{current account} + \text{capital account payments})$. A surplus in BoP can help to boost the short term economic growth of a country.

CAUSES OF BOP DEFICIT

BoP deficit can arise due to several reasons.

ECONOMIC FACTORS

1. Rapid Economic Development

For fast development, developing countries import machines, technology, and other equipment. This leads to high outflow of foreign exchange to meet import demands like technology, machines, and equipment can lead to BoP deficit.

2. Inflation

Sustained rise in a country's prices can often make foreign products cheaper, leading to a high volume of imports

3. Political factors

Frequent changes in government, unstable tax structure, etc. result in loss of trust of foreign investors and discourage inflows of capital. Due to uncertainty, there may be large capital outflows and lesser inflows of foreign funds which can create an adverse position in the Balance of Payment.

4. SOCIAL FACTORS

a) Changes in taste, preferences, fashion, and style, etc.

A favorable change for imported goods increases the demand for imported goods and lead to a deficit in the balance of payment.

b) Demonstration effect

Most of the developing countries get influenced by developed nations and start adopting the foreign pattern of consumption. This results in a sharp rise in imports leading to a deficit in the Balance of Payment.

c) Population explosion

Population explosion in underdeveloped nations, also generally, results in large scale imports and causes a deficit in the Balance of Payment. Domestic investors also prefer to invest outside the economy. As a result, an adverse position created in the balance of Payment.

DEVALUATION

This BoP deficit can be balanced by utilising the country's foreign exchange reserves to meet the BoP shortfall. A BoP deficit can be corrected through an official reserve sale which denotes the sale of foreign exchange by the Reserve Bank. The monetary authorities of a country are the financiers when any deficit arises in the country's balance of payment. Conversely, they are also the recipients when there is a surplus in the country's BoP. An overall decrease in a country's official reserves signifies a deficit in balance of payments. Official reserve transactions can be accounted for only under the regime of fixed exchange rates. They cannot be considered when exchange rates are floating.

MEANING

Devaluation means reduction in the exchange value of a country's monetary unit in terms of gold, silver, or foreign monetary units. Devaluation is employed to eliminate persistent balance-of payments deficits.

The conventional answer to the question, what is the effect of a devaluation on the trade balance of the devaluing country, runs in terms of the supply and demand conditions in the devaluing country and in the rest of the world. It is presumed that the devaluation initially tends to reduce the foreign prices of the country's exports in proportion to the devaluation. At these reduced prices, foreign demand for the country's exports will be increased, thus tending to bid up the foreign prices of these exports part-way back toward their pre-devaluation levels. How much the foreign currency proceeds of the country's

exports will change then depends upon the elasticity of foreign demand for the country's exports and the elasticity of domestic supply of exported goods. Similarly, on the import side, the initial effect of the devaluation is to raise the domestic price of imports, presumably leading to some reduction in the country's demand for imports, which in turn may tend to reduce the world price of the imported goods. The size of these reactions on imports depends upon the elasticity of domestic demand for imports and the elasticity of foreign supply of imports.

In contrast to devaluation, revaluation involves an increase in the exchange value of a country's monetary unit in terms of gold, silver, or foreign monetary units. It may be undertaken when a country's currency has been undervalued in comparison with others, causing persistent balance-of-payments surpluses.

9. TRADE POLICY

1. TRADE POLICIES

Trade policies determine the size of markets for the output of firms and hence strongly influence both foreign and domestic investment. Over time, the influence of trade policies on the investment climate is growing. Changes in technology, liberalisation of host country policies towards trade and investment and the growing organisation of global production chains within multinational enterprises (MNEs) have all served to make trade policies in home and host countries alike a crucial ingredient in encouraging both foreign and domestic investment and in maximising the contribution of that investment to development.

Governments sometimes use trade policy instruments, such as import tariffs and subsidies (investment incentives) to promote investment in targeted industries. Considerable care must be taken to ensure that such measures do not distort resource allocation and damage the overall investment climate. Favoured industries, typically domestically-controlled, compete for resources with foreign and other domestic enterprises, and any policy-induced favours can crowd out investment and production in more productive activities. The promotion of investment in specific industries through trade policies should be both transparent and consistent with existing international obligations. A first-best approach is to maintain a trade regime that allows competitive industries to develop and flourish as much as possible without discrimination, rather than to try to nurture.

An importing country's trade policy may, if it is unduly restrictive, reduce the exporting country's sales abroad and therefore reduce its ability to purchase imports and attract investment. Export-oriented investment by domestic or foreign firms in developing countries depends upon market access in developed countries or other countries with large markets. If host country firms face high trade barriers to their main markets, there will be less investment by local firms and MNEs in that country. Even developing countries' traditional advantages of low labour costs and abundance of natural resources can be negatively affected. Home country governments should consider such external costs when evaluating specific domestic trade policy.

2. FREE TRADE VERSUS PROTECTION

One view says that we should make it as easy as possible for goods and services to move between

countries. This approach is based on the argument that more trade makes us wealthier and is therefore a good thing. It is known as free trade.

Another approach says that we should restrict trade. We might do this to protect certain jobs. We might think that we need certain industries - such as food production or steel-making. We might want to restrict imports from countries with lower labour or environmental standards so they can't weaken our industries. This approach is known as protectionism.

Many economists agree that some restrictions on trade are desirable, but that we should be careful, as such restrictions can make us poorer overall. For example, limits on agricultural imports may be good for British farmers, but they also increase food prices.

1. ARGUMENTS FOR FREE TRADE

There are several key arguments in favour of free trade:

1. Free trade increases the size of the economy as a whole. It allows goods and services to be produced more efficiently. That's because it encourages goods or services to be produced where natural resources, infrastructure, or skills and expertise are best suited to them. It increases productivity, which can lead to higher wages in the long term. There is widespread agreement that rising global trade in recent decades has increased economic growth.
2. Free trade is good for consumers. It reduces prices by eliminating tariffs and increasing competition. Greater competition is also likely to improve quality and choice. Some things, such as tropical fruit, would not be available in the UK without trade.
3. Reducing non-tariff barriers can remove red-tapism, thus reducing the cost of trading. If companies that trade in several countries have to work with only one set of regulations, their costs of 'compliance' come down. In principle, this will make goods and services cheaper.
4. In contrast, protectionism can result in destructive trade wars that increase costs and uncertainty as each side attempts to protect its own economy. Protectionist rules can tend to favour big business and vested interests, as they have the resources to lobby most effectively.

2. ARGUMENTS FOR PROTECTIONISM

While free trade increases the size of the economy as a whole, it isn't always good for everyone:

1. As more countries experience industrial development, traditional domestic industries can decline. In the UK, for example, the shipbuilding industry has declined in the face of international competition since the 1950s and currently steel production faces increasing competition. Protectionism can help to preserve jobs in these sectors, or at least slow the process of change.
2. Protectionism can also help to build up new industries. In sectors with high start-up costs, new firms might find it difficult to compete if there is not support from government in the form of tariffs or subsidies. Once they have become competitive, such barriers can be removed.
3. Protectionism can be used to safeguard 'strategic' industries such as energy, water, steel, armaments and food. For example, 'food security' may be seen as important so that we can feed ourselves if something terrible happens to disrupt the system of world trade.

4. Some people worry that free trade deals can lead to a lowering of standards. Such deals might require us to let in goods and services even though they don't meet our standards, which might then be cheaper than those made by domestic industries. There might also be pressure to reduce our standards for workers' rights or environmental protection so that our companies can compete with companies in countries that have lower standards.

10. TARIFF AND NON-TARIFF BARRIERS.

All nations impose some restrictions in the form of tariff (i.e., import tariff and export tariff) and non-tariff barriers (i.e., import quota, dumping, international cartels and export subsidies) on the free flow of international trade. Since these restrictions and regulations deal with the nation's trade or commerce, they are generally known as trade or commercial policy. Trade restrictions are invariably rationalised in terms of national welfare. However, practically these are advocated by those special groups in the nations that stand to benefit from such restrictions.

MEANING AND CLASSIFICATION

A tariff is a tax or duty levied on the traded commodity as it crosses a national boundary. An import tariff is a duty on the imported commodity, while an export tariff is a duty on the exported commodity. Import tariffs are more important than export tariffs.

1. GENERAL AND CONVENTIONAL TARIFF:

General tariff rate is imposed by the government on the commodity it imported. It is announced by the government at the beginning of the year under its annual tariff policy. On the other hand, conventional tariff rates are based on trade agreements or treaties between the countries. They are not flexible, as it requires consent of member countries to change the conventional tariff rate.

2. MAXIMUM AND MINIMUM TARIFF:

Government imposes two different rates for the same imported commodity from different countries. It imposes minimum tariff rate with its most favoured nation while maximum tariff rate is imposed on imported commodities of the rest of the nations.

3. REVENUE TARIFFS

Revenue tariffs are levied on luxury consumer goods. Lower import duty brings larger revenue because imposition of lower import duty on commodities normally does not shift the demand to other domestically produced commodities. The purpose of protective tariff is to protect domestic industry from imported commodity.

4. AD VALOREM TARIFF

The ad valorem tariff is expressed as a fixed percentage of the value of the

traded commodity. It may be 5 per cent, 10 per cent, or 12 per cent.

5. THE SPECIFIC TARIFF

The specific tariff is expressed as a fixed sum per physical unit of the traded commodity. For instance, specific tariff may be Rs. 50 per television, Rs. 10 per metre cloth, or Rs. 5 per litre oil. Compound duty or tariff is combination of an ad valorem duty and a specific duty.

In short, we can say that it is a duty on import item for offsetting an export subsidy given by the country of its origin.

NON-TARIFF TRADE BARRIERS (NTBs)

Non-tariff trade barriers or the new protectionism have become more important than tariffs as obstructions to the flow of international trade and represents major threats to the world trading system. NTBs are usually classified as under:

1. IMPORT QUOTA AND EXPORT QUOTA:

A quota is the most important non-tariff trade barrier. It is a direct quantitative restriction on the amount of a commodity allowed to be imported or exported. Import quota can be used to protect a domestic industry, to protect domestic agriculture, and/or balance of payment situation. Developing nation used quota to stimulate import substitution of manufactured products and for balance of payments reasons.

2. VOLUNTARY EXPORT RESTRAINTS:

Voluntary exports restraint is also known as voluntary export agreements refers to the case where an importing country induces another nation to reduce its exports of a commodity "voluntarily" under the threat of higher all-round trade restrictions, when these exports threaten an entire domestic industry. These voluntary exports restraints are sometimes called "orderly marketing arrangements".

Voluntary export restraints were less effective in limiting imports than import quotas because the exporting nations agree only reluctantly to curb their exports.

3. EXPORT SUBSIDIES:

Export subsidies are direct payments⁴ or granting of tax relief and subsidized loans to the nation's exporters or potential exporters and/ or low-interest loans to foreign buyers so as to stimulate the nation's exports. As such, export subsidies can be regarded as a form of dumping.

4. COUNTERVAILING DUTIES:

Countervailing duties are often imposed on imports to offset export subsidies by foreign governments.

Quota and voluntary export restraints are quantitative trade restriction while export subsidies,

countervailing duties, production subsidies, export credit subsidies, or tax concession on export, government procurement policies (resulted from laws requiring governments to buy from domestic suppliers) are fiscal measures trade restrictions. Besides, international trade is also hampered by numerous technical, administrative, and other regulations. These include safety regulations for automobile and electrical equipment, health regulations for the hygienic production and packaging of imported food product, and labelling requirements showing origin and contents of the products, import licensing. Other non-tariff trade barriers include dumping and international cartels.

DUMPING

Dumping is the export of a commodity at below cost or at least the sale of a commodity at a lower price abroad than domestically. Dumping is classified as persistent, predatory, and sporadic.

1. PERSISTENT DUMPING

Persistent dumping, or international price discrimination is the continuous tendency of a domestic monopolistic firm to maximise total profits by selling the portion of the commodity at a higher price in the domestic market and the remaining at a lower price in the foreign market. This is possible only if the domestic demand for that commodity is less elastic and the foreign demand is highly elastic.

2. PREDATORY DUMPING

Predatory dumping is the temporary sale of a commodity at below cost or at lower price abroad in order to drive foreign producers out of business, after which prices are raised to take advantage of the newly acquired monopoly power abroad.

3. SPORADIC DUMPING

Sporadic dumping is the occasional sale of a commodity at a lower price abroad than domestically, in order to remove an unforeseen and temporary surplus of the commodity without having to reduce domestic prices.

4. CARTELS

An international cartel is an organisation of suppliers of a commodity located in different nations (or a group of governments) that agree to restrict output and export of the commodity with the aim of maximising or increasing total profit of the organisation. For instance, Organisation of Petroleum Exporting Countries (OPEC), International Air Transport Association.
