UNIT 7 INTERNATIONAL ECONOMICS

INTRODUCTION

INTERNATIONAL ECONOMICS :

MEANING

International Economics is that branch of economics which is concerned with the exchange of goods and services between two or more countries.

SUBJECT MATTER OF INTERNATIONAL ECONOMICS

- ❖ Pure Theory of Trade
- ❖ Policy Issues
- ❖ International Cartels and Trade Blocs
- ❖ International Financial and Trade Regulatory Institutions

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.

TRADE THEORIES :

MERCANTILISM

- ❖ 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)

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

TERMS OF TRADE :

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.

$$\text{Terms of Trade} = \frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \times 100$$

VARIOUS KINDS

- ❖ Net Barter Terms of Trade - Taussig ; Tn= (Px / Pm) x 100
- ❖ Gross Barter Terms of Trade - Taussig: Tg= (Qm/Qx) x 100
- ❖ Income Terms of Trade - G.S.Dorrance : Ty = (Px / Pm)Qx

BALANCE OF PAYMENTS: MEANING AND COMPONENTS

MEANING:

The balance of payments of a country is a systematic record of all economic transactions between residents of a country and residents of foreign countries during a given period of time.

BALANCE OF TRADE AND BALANCE OF PAYMENTS

BALANCE OF TRADE:

Balance of trade is the difference between the money value of exports and imports of material goods (visible item)

BALANCE OF PAYMENTS:

Balance of payments is a systematic record of all economic transactions between residents of a country and the residents of foreign countries during a given period of time.

BALANCE OF PAYMENT (BOP) ACCOUNT CHART

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

B.O.P DISEQUILIBRIUM

Occurs when: Disequilibrium Demand ≠ Supply Debit > Credit → Deficit

DEVALUATION:

It means official reduction in the value of a currency in terms of gold or other currencies.

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 .

FOREIGN DIRECT INVESTMENT (FDI)

(FDI) means an investment in a foreign country that involves some degree ofcontrol and participation in management. It corresponds to the investment made by a multinational enterprise in a foreign country.

FOREIGN PORTFOLIO INVESTMENT (FPI)

(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.

FOREIGN INSTITUTIONAL INVESTMENT (FII)

(FII) is an investment in hedge funds, insurance companies, pension funds and mutual funds.

BOOK EXERCISE QUESTIONS - MULTIPLE CHOICE QUESTIONS

PART - A

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 in one or two sentences

21. What is 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.

22. Define international trade.

❖ International trade 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'.

23. State any two merits of trade.

❖ Trade is one of the powerful forces of economic integration.

❖ 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.

24. What is the main difference between Adam Smith and Ricardo with regard to the emergence of foreign trade?

❖ 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.

25. Define Terms of Trade.

❖ Terms of Trade 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.

$$\text{Terms of Trade (TOT)} = \frac{\text{Index of Export prices}}{\text{Index of Import prices}} \times 100$$

26. What do you mean by balance of payments?

❖ Balance of payment 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.

27. What is meant by Exchange Rate?

❖ Exchange rate may be defined as the price paid in the home currency (say ₹ 75) for a unit of foreign currency (say 1 US $).

❖ The transactions in the exchange market are carried out at exchange rates. It is the external value of domestic currency.

PART - C

Answer the following questions in one Paragraph.

28. Describe the subject matter of International Economics.

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.

29. Compare the Classical Theory of international trade with Modern Theory of International trade.

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	In presents a multi-factor (labour and capital) model.
3.	It attributes the differences in the comparative costs to difference in the productive efficiency of workers in the two contries.	It attributes the differences in comparative costs to the differences in factor endowments in the two countries.

30. Explain the Net Barter Terms of Trade and Gross Barter Terms of Trade.

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:

$$\boxed{Tn = (Px / Pm) \times 100}$$

Where,

Tn = Net Barter Terms of Trade

Px = Index number of export prices

Pm = Index number of import prices

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.

$$Tg = (Qm/Qx) \times 100$$

Where, Qm = Index of import quantities

Qx = Index of export quantities

31. Distinguish between Balance of Trade and Balance of Payments.

BASIS FOR COMPARISON	BALANCE OF TRADE	BALANCE OF PAYMENT
Meaning	Balance of Trade (BOT) refers to the total value of a country's exports of commodities and total value of imports of commodities.	BoP is a systematic record of a country's economic and financial transactions with the rest of the world over a period of time.
Records	Transactions related to goods only. vwww	Transactions related to both goods and services are recorded.
Capital Transfers	Are not included in the Balance of Trade.	Are included in Balance of Payment.
Limit	It gives a partial view of the country's economic status.	It gives a full view of the economic position of the country.
Effect	It can be Favorable, Unfavorable or balanced.	Both the receipts and payment sides tallies.
Component	It is a component of Current Account of Balance of Payment.	Current Account and Capital Account.

32. What are import quotas?

i. Meaning

❖ The import quota means physical limitation of the quantities of different products to be imported from foreign countries within a specified period of time, usually one year.

❖ The import quota may be fixed either in terms of quantity or the value of the product.

ii. Example

❖ For instance, the government may

specify that 60,000 colour T.V. sets may be imported from Japan.

- ❖ Alternatively, it may specify that T.V. sets of the value of Rs. 50 crores can be imported from that country during a given year.

33. Write a brief note on flexible exchange rate.

- ❖ 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.
- ❖ The economic position of the country determines the market demand and supply for its currency.
- ❖ In this system, the currency price is market determined, concerning other currencies, i.e. the higher the demand for a particular currency, the higher is its exchange rate and the lower the demand, the lesser is the value of currency compared to other currencies.
- ❖ Therefore, the exchange rate is not under the control of the government or central bank.

34. State the objectives of Foreign Direct Investment.

FDI has the following objectives.

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

PART - D

Answer the following questions in about a page.

35. Discuss the differences between Internal Trade and International Trade.

Sl. No.	Internal Trade	International Trade
1.	Trade takes place between different individuals and firm 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 no move easily from one nation to another.
3.	There will be freef 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.
7.	Trade and financial regulations are more or less the same	Trade and financial regulations such as interest rate, trade laws differ between countries.
8.	There is no difference in political afiliations, customs and habits of the people and government policies.	Differences are pronounced in political affilitations, habit and customs of the people and government policies.

36. Explain briefly the Comparative Cost Theory.

Introduction

David Ricardo , the British economist in his 'Principles of Political Economy and Taxation' published in 1817, formulated a systematic theory called 'Comparative Cost Theory'.

Meaning of Comparative Cost

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.

Explanation

i. According to Ricardo, a country can gain from trade when it produces at relatively lower costs.

ii. 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.

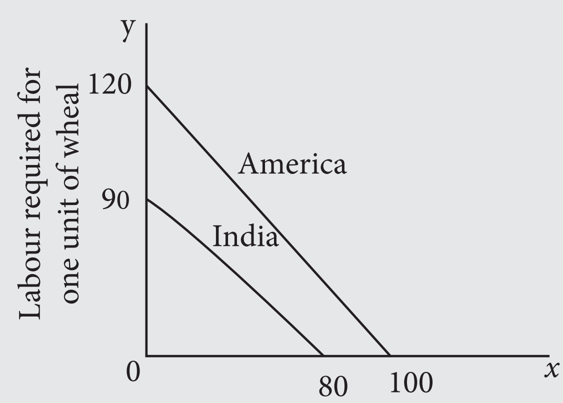
iii. Similarly, even when a country has absolute disadvantage in production of both goods, the country would specialize in production and export of the commodity in which it is relatively less disadvantageous.

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.

Table and Diagrammatic Illustration

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



Note: Slopers are not equal

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

Diagrammatic Explanation

i. However, India should concentrate on the production of wheat in which she enjoys a comparative cost advantage. (80/120 < 90/100).

ii. For America the comparative cost disadvantage is lesser in cloth production.

iii. 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).

iv. 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.

v. With trade, America can get 1 unit of cloth and one unit of wheat by using its 200 units of labour.

vi. Otherwise, America will have to use 220 units of labour for getting 1 unit of cloth and 1 unit of wheat.

37. Discuss the 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.

Meaning

This theory says that the basis forinternational trade is the difference in factor endowments. It is otherwise called as '**Factor Endowment Theory**'.

The 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

The Theory

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.

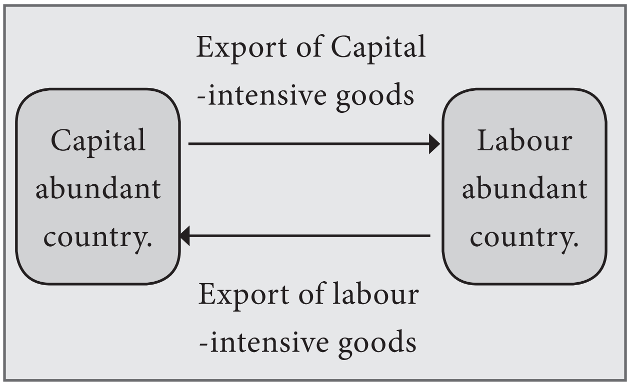
Explanation

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.

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.

H-O: Illustration Chart



38. Explain the types of Terms of Trade given by Viner.

1. Net Barter Terms of Trade or Commodity 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:

$$\boxed{Tn = (Px / Pm) \times 100}$$

Where,

Tn = Net Barter Terms of Trade

Px = Index number of export prices

Pm = 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. 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

$$\boxed{Tn = (Px / Pm) \times 100}$$

Where, Tf stands for single factoral terms of trade index. Fx 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).

3. Double Factoral Terms of Trade

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

$$\boxed{Tff = (Px / Pm)\ (Fx / Fm)}$$

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

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

39. Bring out the components of balance of payments account.

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.

40. Discuss the various types of disequilibrium in the balance of payments.

Occurs when: Disequilibrium **Demand ≠ Supply Debit > Credit → Deficit**

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:

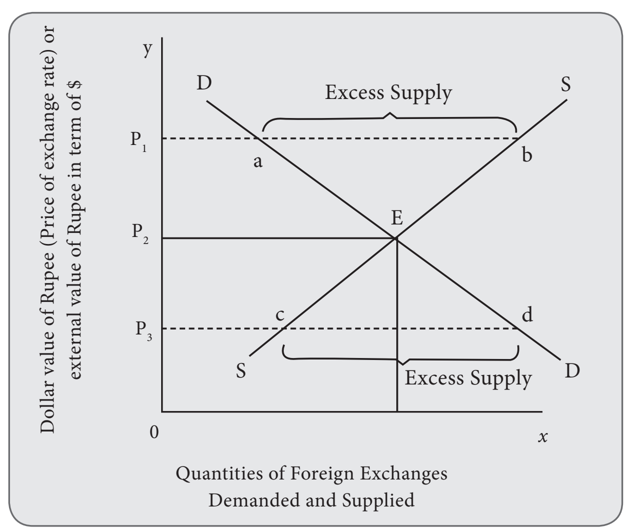
The secular or long-run disequilibrium in BOP occurs because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports, as it happens in India since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

c) Structural Disequilibrium:

Structural changes in the economy may also causesuch structural changes include development of alternative sources of supply, development of better substitutes, exhaustion of productive resources or changes in transport routes and costs.

41. How the Rate of Exchange is determined? Illustrate.

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.



- 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 P2.

42. Explain the relationship between Foreign Direct Investment and economic development

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 deve 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).

Additional One marks

1. International economics first originated in ....on account of increasing importance of foreign trade in that part of the world.

a. Eastern Europe

b. Western Europe

c. North America

d. None

2. Who is not associated with those who shaped the subject matter of International Economics.

a. F.W. Taussig   b. Haberler

c. BelaBalassa   d. J.M. Keynes

3. Which of the following is not a subject matter of economics?

a. Pure Theory of Trade

b. International Cartels and Trade Blocs

c. Fiscal Federalism

d. International Financial and Trade Regulatory Institutions

4. Identify the odd one out.

a. IMF b. IBRD

c. WTO d. RBI

5. Which of the following is not an another term used for Internal Trade?

a. 'domestic trade'

b. 'home trade'

c. 'external trade;

d. 'intra-regional trade'.

6. Which of the following is not an another term used for International Trade?

a. 'inter-home trade'

b. 'external trade'

c. 'foreign trade'

d. 'inter-regional trade'.

7. Mercantilism

a. Is the philosophy of free international trade.

b. Was a system of export promotion and barriers to imports practiced by governments.

c. Was praised by Adam Smith in The Wealth of Nations.

d. Both (a) and (c).

8. Match the items in the List – I with items in List – II. Select the correct answer from the code given below :

	List – I			List – II
I.	Absolute Advantage	-	1.	Ray Vernon
II.	Factor - proportions	-	2.	Adam Smith
III.	Comparative Advantage	-	3.	Heckscher – Ohlin
IV.	International Product life cycle	-	4.	David Ricardo

Codes :

	I	II	III	IV
a.	3	2	1	4
b.	2	4	1	3
c.	**2**	**3**	**4**	**1**
d.	1	2	3	4

9. 9. Who is the author of 'Principles of Political Economy and Taxation'?

a. David Ricardo b. J.S Mill

c. Marshall d. Taussig

10. 10. Assertion (A)A country can gain from trade when it produces at relatively lower costs.

Reason (R) 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.

a. Both (A) and (R) are true and (R) is the correct explanation of (A).

b. Both (A) and (R) are true, but (R) is not the correct explanation of (A).

c. (A) is true, but (R) is false.

d. (A) is false, but (R) is true.

11. Find the missing flow of concept of H-O Theorem. Abundance of skilled labour → specialisation → ....?........→ exchange for goods are services produced by countries with abundance of unskilled labour

a. import b. export

c. devaluation d. factor endowment

12. The modern theory of international trade explains the causes for ....?

a. comparative cost difference

b. absolute cost difference

c. comparative cost similarities

d. absolute cost similarities

13. Which is of the following statement is modern theory of trade

a. It presents a one factor (labour) model

b. It attributes the differences in the comparative costs to differences in the productive efficiency of workers in the two countries.

c. the phenomenon of international trade on the basis of labour theory of value

d. It presents a multi - factor (labour and capital) model

14. The different concepts of terms of trade were classified by ....?

a. Gerald M.Meier

b. Morris D. Morris

c. John M. Keynes

d. Joseph A. Schumpeter

15. Find the incorrect representation. Net Barter Terms of TradeTn= (Px / Pm) x 100

a. Tn = Net Barter Terms of Trade

b. Px = Index number of export prices

c. Pm = Index number of import prices

d. Tn = Gross Barter Terms of Trade

16. Find the correct representation. Gross Barter Terms of Trade, Tg= (Qm/Qx) x 100

a. Qm = Index of import quantities

b. Qx = Index of net export quantities

c. Qm = Index of net import quantities

d. None of the above

17. The income terms of trade was given by ....?

a. G.S.Dorrance b. J.S Mill

c. Marshall d. Taussig

18. Movements of goods (export and imports of commodities) are also known as............

a. invisible trade

b. visible trade

c. new trade

d. conventional trade

19. The principal items shown on the..................are exports of goods and services, transfer receipts in the form of gift etc.

a. BoT side b. debite side

c. credit side d. BoP side

20. The principal items on the .... include imports of goods and services, transfer payments to foreigners, lending to foreign countries.

a. BoT side b. debite side

c. credit side d. BoP side

21. Find the odd one out with respect to components of BoP.

a. The current account

b. The capital account

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

d. The export import account

22. How many main types of BOP Disequilibrium are there?

a. Three b. Two c. Five d. Six

23. ....in BOP occurs because of long-run and deep seated changes in an economy as it advances from one stage of growth to another.

a. The structural disequilibrium

b. The secular disequilibrium

c. The cyclical disequilibrium

d. The seasonal disequilibrium

24. Assertion (A)If the market forces of demand and supply are allowed to play freely, equilibrium will be automatically restored in course of time.

Reason (R) 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.

a. Both (A) and (R) are true and (R) is the correct explanation of (A).
b. Both (A) and (R) are true, but (R) is not the correct explanation of (A).
c. (A) is true, but (R) is false.
d. (A) is false, but (R) is true.

25. Devaluation means deliberate reduction of the official rate at which..................?

a. domestic currency is exchanged for another currency
b. domestic currency is blocked for another currency
c. domestic import is exchanged for another import
d. none of the above

26. Find the incorrect one with respect to Indian rupee devaluation.

a. On 29th September, 1949
b. On 6th June, 1966
c. On 1st July, 1991
d. On 9st August, 1990

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

a. Gunnar Mirdal b. RagnerNurkse
c. Schumpeter d. Bertil Ohlin

28. .... 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.

a. Foreign Government Investment
b. Foreign Portfolio Investment
c. Foreign Institutional Investment
d. Foreign Direct Investment

29. ....is an investment in hedge funds, insurance companies, pension funds and mutual funds.

a. Foreign Institutional Investment
b. Foreign Portfolio Investment
c. Foreign Institutional Investment
d. Foreign Direct Investment

30. Suppose the exchange rate between Indian Currency and US Dollar is Rs.1= \$65. If it changes to Rs.1 = \$55, the value of which currency increased and decreased?

a. both currency value will increase
b. both currency value will decrease
c. Indian currency value will increase and US Dollar Value will decrease
d. Indian currency value will decrease and US Dollar Value will increase

31. 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?

a. The current account
b. The capital account
c. State account of expenses
d. The official settlements account or official reserve assets account.

32. The trade balance of a country is represented by

a) the difference between imports and exports

b) the total imports and exports

c) the report between imports and exports

d) the difference between income and expenditure

33. When there is a chronic imbalance in the trade balance (more imports than exports), it can theoretically be reduced by means of a package of tax measures

a. decrease of customs duties

b. increase of customs duties

c.stimulating imports.

d. stimulating exports

34. A main advantage of specialization results from

a. Economics of large scale production

b. The specializing country behaving as a monopoly

c. Smaller production runs resulting in lower unit costs

d. High wages paid to foreign workers

35. International trade in goods and services is sometimes used as a substitute for all of the following except

a. International movements of capital.

b. International movements of labor.

c. International movements of technology

d. Domestic production of different goods and services

36. If a nation has an open economy it means that the nation

a. Allows private ownership of capital

b. Has flexible exchange rates

c. Has fixed exchange rates

d. Conducts trade with other countries

37. International trade forces domestic firms to become more competitive in terms of

a. The introduction of new products

b. Product design and quality

c. Product price

d. All of the above

Use the information in the table below to answer the next six questions (38 to 43)

Country	Tons of steel	DVDs
China	80	40
India	20	20

38. The opportunity cost of one DVD in India is

a. One ton of steel

b. Two tons of steel

c. Three tons of steel

d. Four tons of steel

39. The opportunity cost of one DVD in China is

a. One-half ton of steel

b. One ton of steel

c. One and one-half tons of steel

d. Two tons of steel

40. According to the principle of absolute advantage; India should

a. Export steel

b. Export DVDs

c. Export steel and DVDs

d. There is no basis for gainful specialization and trade

41. According to the principle of comparative advantage

a. China should export steel

b. China should export steel and DVDs

c. India should export steel

d. India should export steel and DVDs

42. With international trade, what would be the maximum amount of steel that China would be willing to export to India in exchange for each DVD

a. One-half ton of steel

b. One ton of steel

c. Two tons of steel

d. Two and one-half tons of steel

43. With international trade, what would be the maximum number of DVDs that India would be willing to export to China in exchange for each ton of steel

a. One DVD b. Two DVDs

c. Three DVDs d. Four DVDs

44. The earliest statement of the principle of comparative advantage is associated with

a. Adam Smith b. David Ricardo

c. Eli Heckscher d. Bertil Ohlin

45. If the international terms of trade settle at a level that is between each country's opportunity cost

a. There is no basis for gainful trade for either country

b. Both countries gain from trade

c. Only one country gains from trade

d. One country gains and the other country loses from trade

46. The classical trade theories of Smith and Ricardo predict that

a. Countries will completely specialize in the production of export goods.

b. Considerable trade will occur between countries with different levels of technology

c. Small countries could obtain all of the gains from trade when trading with large countries

d. All of the above.

47. According to the classical theory of international trade:

a. Only countries with low wages will export

b. Only countries with high wages will import

c. Countries with high wages will have higher prices

d. All the above are false

48. 48. In the classical model of Ricardo, the direction of trade is determined by:

a. absolute advantage

b. comparative advantage

c. physical advantage

d. which way the wind blows

49. 49. Absolute advantage is determined by:

a. actual differences in labor productivity between countries.

b. relative differences in labor productivity between countries.

c. both (a) and (b)

d. neither (a) nor (b)

50. Comparative advantage is determined by:

a. actual differences in labor productivity between countries.

b. relative differences in labor productivity between countries.

c. both (a) and (b)

d. neither (a) nor (b)

51. The Heckscher-Ohlin theory explains comparative advantage as the result of differences incountries':

a. Economies of large-scale production.

b. Relative abundance of various resources.

c. Relative costs of labor.

d. Research and development expenditures.

52. The factor endowment model of international trade was developed by

a. Adam Smith

b. David Ricardo

c. John Stuart Mill

d. Eli Heckscher and Bertil Ohlin

53. According to the factor endowment model of Heckscher and Ohlin, countries heavily endowedwith land will:

a. Devote excessive amounts of resources to agricultural production.

b. Devote insufficient amounts of resources to agricultural production.

c. Export products that are land-intensive.

d. Import products that are land-intensive.

54. According to the Heckscher-Ohlin model, the source of comparative advantage is a country's:

a. technology

b. advertising

c. factor endowments

d. both (a) and (c)

55. The Heckscher-Ohlin model rules out the classical model's basis for trade by assuming that________ is (are) identical between countries.

a. factor endowments

b. factor intensities

c. technology

d. opportunity costs

56. The comparative advantage model of Ricardo was based on

a. intraindustry specialization and trade

b. interindustry specialization and trade

c. demand conditions underlying specialization and trade

d. income conditions underlying specialization and trade

57. The Heckscher-Ohlin theorem states that a country will have comparative advantage in the goodwhose production is relatively intensive in the ________ with which the country is relativelyabundant.

a. tastes b. technology

c. factor/resource d. opportunity cost

58. The Heckscher-Ohlin assumes that ________ are identical between countries.

a. tastes and preferences

b. technology levels

c. factor endowments

d. both (a) and (b)

59. According to the Heckscher-Ohlin model

a. everyone automatically gains from trade

b. the gainers from trade outnumber the losers from trade

c. the scarce factor necessarily gains from trade

d. none of the above

60. Assume that Country A is relatively abundant in labor and Country B is relatively abundant inland. Note that wages are the returns to labor and rents are the returns to land. According to thefactor price equalization theorem, once Country A begins specializing according to comparative advantage and trading with Country B.

a. wages and rents should fall in Country A

b. wages and rents should rise in Country A

c. wages should rise and rents should fall in Country A

d. wages should fall and rents should rise in Country A

61. The most widely traded currency in the foreign exchange market is the

a. euro
b. Chinese yuan
c. British pound
d. U.S. dollar

62. Which among the following are the major assumptions of Absolute advantage theory?

a. There are two countries and two commodities and one country has absolute advantage in one commodity and the second country has advantage in another commodity.

b. Labour is the only factor of production and labour is homogeneous, that means each unit of labour produces same level of output. Value of a commodity is measured in terms of its labour content

c. Labour is perfectly mobile within the country but perfectly immobile between the countries. It means that workers are free to move between industries within the nation but migration to other countries is impossible.

d. All the above

63. Which among the following is NOT an assumption of H-O Theorem

a. There are two countries involved. Each country has two factors (labour and capital) and produce two commodities either labour intensively or capital intensively.

b. There is no perfect competition in both commodity and factor markets. All production functions are hertogenious. Production function is subject to increasing or decreasing returns to scale.

c. There are no transportation costs.

d. Factors are freely mobile within a country but immobile between countries.

64. The foreign exchange rate is NOT

a. The price of one currency expresses in terms of another.

b. Rate at which of one commodity expresses in terms of another.

c. The value of one currency in terms of another

d. Fixed for ever.

65. Under a fixed exchange rate system, ______________________are official changes in the value of a country's currency relative to other currencies.

a. devaluation
b. Depreciation and appreciation
c. revaluation
d. Both a and b.

66. Assertion (A) : According to Adam Smith, the basis of international trade was absolute cost advantage.

Reason (R) : 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.

a. Both A and R are true and R is the correct explanation of A.

b. Both A and R are true but R is not the correct explanation of A.

c. A is true but R is false.

d. A is false but R is true.

67. Assertion (A) : According to HO theorem, a country can gain from trade when it produces at relatively lower costs.

Reason (R) : 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.

a. Both A and R are true and R is the correct explanation of A.

b. Both A and R are true but R is not the correct explanation of A.

c. A is true but R is false.

d. A is false but R is true.

68. Assertion (A) : The classical theory argued that the basis for foreign trade was comparative cost difference and it considered only labour factor.

Reason (R) : But the modern theory of international trade explains the causes for such comparative cost difference.

a. Both A and R are true and R is the correct explanation of A.

b. Both A and R are true but R is not the correct explanation of A.

c. A is true but R is false.

d. A is false but R is true.

69. Assertion (A) : International trade helps a country to export its surplus goods to other countries and secure a better market for it.

Reason (R) : International trade doesn't helps a country to import the goods which cannot be produced at all or can be produced at a higher cost.

a. Both A and R are true and R is the correct explanation of A.

b. Both A and R are true but R is not the correct explanation of A.

c. A is true but R is false.

d. A is false but R is true.

70. Assertion (A) : Viner has devised another concept called "the single factoral terms of trade" as an improvement upon the commodity terms of trade.

Reason (R) : 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.

a. Both A and R are true and R is the correct explanation of A.

b. Both A and R are true but R is not the correct explanation of A.

c. A is true but R is false.

d. A is false but R is true.

71. The economist who said that international trade was based upon the concept of absolute advantage was:

a. David Ricardo

b. Adam Smith

c. J.S.Mill

d. Bertil Ohlin

72. In a portfolio investment

a. investors are directly involved in managing the operations.

b. as in direct investment, investors export goods and services abroad.

c. investors transfer the technology to local investors.

d. investors have no control over operations.

73. The balance on current account

I equals the absolute value of the balance on capital account.

II is financed by savings.

III is net grants minus remittances.

IV includes goods, services, and unilateral transfers.

a. I and II only.

b. II and III only.

c. I and IV only.

d. None of the above.

74. Use the following Table to answer the next three questions

TABLE 1 Comparative Costs of Textiles and Steel in India and Japan

	India	Japan
Textiles (price per meter)	Rs. 50	Y300
Steel (price per ton)	Rs. 200	Y400

The ratio of the price of steel to that of textiles is ________in Japan and _______ in India.

a. 4:3; 4:1.

b. 3:4; 1:4.

c. 0.75; 0.25.

d. cannot be determined.

75. India has a comparative cost advantage in

a. textiles. b. steel.

c. both of them d. none of them

76. Japan has comparative cost in

a. steel.

b. textiles.

c. both of them.

d. cannot be determined.

77. Assume a foreign exchange market with a flexible exchange system. Suppose the demand for a country's currency decreases. This results in a _______________ in its currency.

a. depreciation b. appreciation

c. devaluation d. revaluation

78. If the value of a country's currency falls, what is the effect on exports and imports, assuming all else remains unchanged?

a. Exports will fall, and imports will rise.

b. Exports and imports will both fall.

c. Exports will rise, and imports will fall.

d. Exports and imports will both rise.

79. Match the correct codes

1	Mercantilism	i	Takes an us-versus - them view of trade
2	Free Trade theories	ii	Absolute Advantage
3	Free Trade refined	iii	David Ricardo
4	Comparative Advantage	iv	Heckscher - Ohlin

Codes

a. (1) – (i) (2) – (ii) (3) – (iv) (4) – (iii)

b. (1) – (ii) (2) – (iii) (3) – (iv) (4) – (i)

c. (1) – (iv) (2) – (iii) (3) – (i) (4) – (ii)

d. (1) – (i) (2) – (ii) (3) – (iii) (4) – (iv)

80. Match the correct codes

1	Absolute Advantage - Adam Smith	i	1966
2	Comparative Advantage - David Ricardo	ii	1776
3	Factor –proporations- Heckscher - Ohlin	iii	1817
4	International Product life cycle - Ray Vernon	iv	1919

Codes

a. (1) – (i) (2) – (ii) (3) – (iv) (4) – (iii)

b. (1) – (ii) (2) – (iii) (3) – (iv) (4) – (i)

c. (1) – (iv) (2) – (iii) (3) – (i) (4) – (ii)

d. (1) – (i) (2) – (ii) (3) – (iii) (4) – (iv)

81. Match the correct codes

1	Tff	i	(Qm/Qx) x 100
2	Tn	ii	(Px / Pm) Fx
3	Tg	iii	(Px / Pm) x 100
4	Tf	iv	(Px / Pm) (Fx / Fm)

Codes

a. (1) – (i) (2) – (ii) (3) – (iv) (4) – (iii)
b. (1) – (ii) (2) – (iii) (3) – (iv) (4) – (i)
c. (1) – (iv) (2) – (iii) (3) – (i) (4) – (ii)
d. (1) – (i) (2) – (ii) (3) – (iii) (4) – (iv)

82. Match the correct codes

1	The BoP is said to be balanced when the receipts (R) and payments (P) are just equal	i	R / P =1.
2	When receipts exceed payments, the BoP is said to be favourable	ii	R / P > 1.
3	When receipts are less than payments, the BoP is said to be unfavourable or adverse	iii	R / P < 1.
4	BOP Disequilibrium	iv	R / P ≠1

Codes

a. (1) – (i) (2) – (ii) (3) – (iv) (4) – (iii)
b. (1) – (ii) (2) – (iii) (3) – (iv) (4) – (i)
c. (1) – (iv) (2) – (iii) (3) – (i) (4) – (ii)
d. (1) – (i) (2) – (ii) (3) – (iii) (4) – (iv)

83. Match the correct codes

1	Monetary measures	i	Import Duties
2	Export Promotion	ii	Foreign Loans
3	Import Control	iii	Abolition / reduction of duties
4	Miscellaneous Measures	iv	Monetary Contraction / Expansion

Codes

a. (1) – (i) (2) – (ii) (3) – (iv) (4) – (iii)
b. (1) – (ii) (2) – (iii) (3) – (iv) (4) – (i)
c. (1) – (iv) (2) – (iii) (3) – (i) (4) – (ii)
d. (1) – (i) (2) – (ii) (3) – (iii) (4) – (iv)

Answers

1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
b	d	c	d	c	a	b	c	a	b
11	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**
b	a	d	a	d	a	a	b	c	b
21	**22**	**23**	**24**	**25**	**26**	**27**	**28**	**29**	**30**
d	a	b	a	a	d	b	b	a	c
31	**32**	**33**	**34**	**35**	**36**	**37**	**38**	**39**	**40**
a	a	b	a	d	d	d	a	d	d
41	**42**	**43**	**44**	**45**	**46**	**47**	**48**	**49**	**50**
a	c	a	b	b	d	d	b	a	b
51	**52**	**53**	**54**	**55**	**56**	**57**	**58**	**59**	**60**
b	d	c	c	c	b	c	d	b	c
61	**62**	**63**	**64**	**65**	**66**	**67**	**68**	**69**	**70**
d	d	b	a	a	a	d	b	c	b
71	**72**	**73**	**74**	**75**	**76**	**77**	**78**	**79**	**80**
b	d	c	a	a	a	a	c	a	b
81	**82**	**83**							
c	a	c							

Additional Two Marks

1. Mention the subject matter of international economics.

1. Pure Theory of Trade
2. Policy Issues
3. International Cartels and Trade Blocs
4. International Financial and Trade Regulatory Institutions

2. What are the types Trade?

❖ a) Internal Trade and
❖ b) International Trade.

3. What are the other names of internal trade?

❖ Domestic trade
❖ Home trade
❖ Intra-regional trade

4. What are the other names of international trade?

1. External trade
2. Foreign trade
3. Inter-regional trade

5. What is the view of Mercantilism about trade?

❖ Takes an us-versus - them view of trade

❖ Other country's gain is our country's loss

6. What are the Free Trade theories ?

❖ Absolute Advantage (Adam Smith, 1776)

❖ Comparative Advantage (David Ricardo, 1817)

7. List different approaches of Classical Trade Theories.

❖ Mercantilism (pre - 16th century)

❖ Free Trade theories

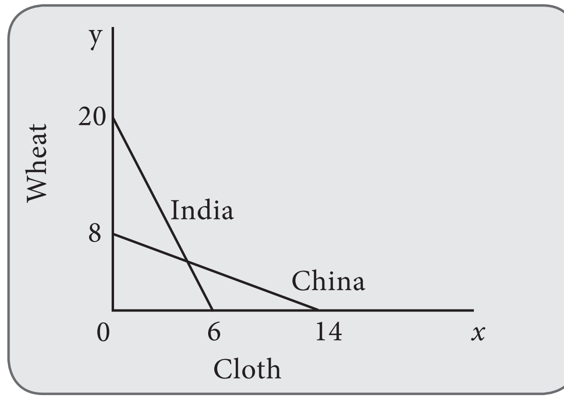
❖ Free Trade refined

8. List the assumption of Adam smith trade theory.

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.

9. Draw a diagram for the given data of absolute advantage.

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

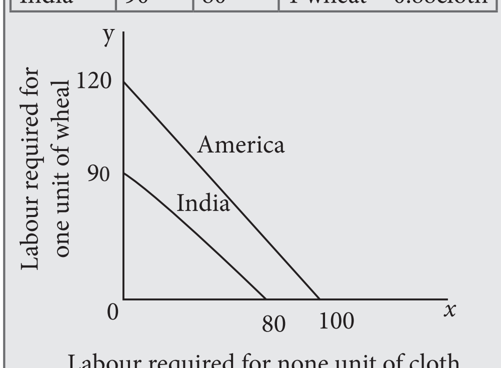


10. What are the criticisms of Ricardian theory?

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.

11. Draw a diagram for the given data of Ricardo's Theory of Comparative Cost Advantage.

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



Note: Slopers are not equal

12. How Modern theory of International Trade 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.

13. Draw the chart depicting 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 abunddant factor.

14. What is "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

$$\boxed{Tf = (Px / Pm)\ Fx}$$

15. Double Factoral Terms of Trade

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

$$\boxed{Tff = (Px / Pm)\ (Fx / Fm)}$$

16. Define - 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.

17. Define - 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.

18. Write a brief note on 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.

19. Write the Balance of Payment (BOP) Account Chart.

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

20. What is FavourableBoP?

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

R / P > 1.

21. What is Unfavourable BOP?

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

R / P < 1.

22. What are the main types of BOP Disequilibrium?

(a) Cyclical Disequilibrium,

(b) Secular Disequilibrium,

(c) Structural Disequilibrium.

23. Write a short note on 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.

24. List the Monetary measures for Correction of Balance of payment Disequilibrium.

1. Monetary Contraction / Expansion
2. Devaluation/ revaluation
3. Exchange Control

25. Mention the Import Control measures for Correction of Balance of payment Disequilibrium.

1. Import Duties
2. Import Quotas
3. Import Prohibition

26. Mention the Export Promotion measures for Correction of Balance of payment Disequilibrium.

1. Abolition / reduction of duties
2. Export Subsidies
3. Export Incentives

27. Mention the dates of devaluation of Indian Rupee.

Indian rupee was devalued three times since 1947.

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

28. FOREX – Define.

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

29. Define "Equilibrium Exchange Rate"

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

30. What are the 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.

31. What is Flexible Exchange Rate?

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.

32. List the Types of Exchange Rates Exchange rates

(a) Nominal exchange rate

(b) Real exchange rate

(c) Nominal Effective Exchange Rate (NEER) and

(d) Real Effective Exchange Rate (REER)

33. What is Foreign Portfolio Investment (FPI)

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.

34. List the limitations of Modern theory of international trade.

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.

35. Mention the Similarities of Internal and International Trade.

❖ Specialization is the basis of both, domestic as well as foreign trade.

❖ Both have same requisites, viz., two parties, two commodities and determination of relativeprices.

❖ Gains or benefits, is the primary concern of the regions or nations involved in trade.

36. What is Foreign Institutional Investment (FII)?

❖ 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.

37. Write the latest trend of FDI in India ?

i. FDI inflow in India has increased from $97 million in 1990-91 to $5,535 million in 2004-2005.

ii. It amounted to $32,955 million in 2011-2012.

iii. UNCTAD's World Investment Report 2018 reveals that FDI to India declined to $40 billion in 2017 from $44 billion in 2016.

38. List the sectors which are not allowed for FDI in India.

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.,

39. What is the significant difference between FDI and FII?

- ❖ Foreign Direct Investment or FDI is defined as the investment made by a company in the company situated outside the country.
- ❖ Foreign Institutional Investor or FII is when investors, most commonly in the form of institutions that invest in the country's financial market.

Additional Three Marks

1. List the assumption of Comparative advantage theory of international trade.

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.

2. General Utility Functions of RBI – Discuss.

BASIS FOR COMPARISON	CURRENT ACCOUNT	CAPITAL ACCOUNT
Meaning	An account which records the export and import of merchandise and unilateral transfers done during the year by a nation are known as Current Account.	An account which records the trading of foreign assets and liabilities during the year by a country is known as Capital Account.
Reflects	Net Income of the country.	Net change in ownership in national assets.
Deals with	Receipt and disbursements of cash and non-capital items.	Sources and application of capital.
Components	Trade in goods and services, investment income, unrequited transfers.	Foreign Direct Investment, Portfolio Investment, Government loans etc.

3. List the "Role of a state" according to mercantilists?

i. Stimulate exports and export more goods than import. This approach will provide the gold inflow;

ii. Restrict the importation of goods, especially luxury goods that will provide export balance of trade;

iii. Forbid the production of the final products in its colonies;

iv. Forbid the exportation of raw

materials from the parent states to the colonies and allow free importation of raw materials, which are not obtained within the country;

v. Stimulate an export of mainly cheap raw commodities from the colonies;

vi. Forbid any trade of its colonies with other countries, except the parent state, which can resell the colonial goods abroad by itself.

4. Mention the difference between FDI and FII

BASIS FOR COMPARISON	FDI	FII
Meaning	When a company situated in one country makes an investment in a company situated abroad, it is known as FDI.	FII is when foreign companies make investments in the stock market of a country.
Entry and Exit	Difficult	Easy
What it brings?	Long term capital	Long/Short term capital
Transfer of	Funds, resources, technology, strategies, know-how etc.	Funds only.
Economic Growth	Yes	No
Consequences	Increase in country's Gross Domestic Product (GDP).	Increase in capital of the country.
Target	Specific Company	No such target, investment flows into the financial market.
Control over a company	Yes	No

5. Mention the difference between FDI and FPI

BASIS FOR COMPARISON	REPO RATE	REVERSE REPO RATE
Meaning	FDI refers to the investment made by the foreign investors to obtain a substantial interest in the enterprise located in a different country.	When an international investor, invests in the passive holdings of an enterprise of another country, i.e. investment in the financial asset, it is known as FPI.
Degree of control	High	Very less
Term	Long term	Short term
Investment in	Physical assets	Financial assets
Entry and exit	Difficult	Relatively easy.
Results in	Transfer of funds, technology and other resources.	Capital inflows

6. Write a brief note on HO - Factor endowment model theorem.

❖ 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

7. What are the assumption of Modern theory international trade?

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.

8. List the 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.

9. Discuss the elements of Automatic Correction in trade disequilibrium.

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.

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.

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.

10. State the Correction of Balance of payment Disequilibrium - 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.

11. List the major sectors benefited from FDI in India.

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

Additional Five Mark

1. Explain the determinants of Equilibrium Exchange Rate.

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.

2. What are the disadvantages of FDI?

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.

3. Discuss the state of FDI in India.

Introduction

- The early 1990s 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.,

Latest trend of FDI in India

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

to $40 billion in 2017 from $44 billion in 2016.

4. State the importance of the comparative advantage of international trade.

❖ The balance of aggregate demand and aggregate supply was first described.

❖ The cost of goods is determined by the ratio of aggregate demand and supply for them, both domestically and from abroad;

❖ He theory is true regarding any quantity of goods and any number of countries, as well as for the analysis of trade between different entities.

❖ In this case, country specialization in some goods depends on the ratio of wage levels in each country;

❖ The theory based the existence of benefits from trade for all countries, taking part in it;

❖ There become possible to develop foreign economic policy on the scientific foundation.

5. Explain 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.

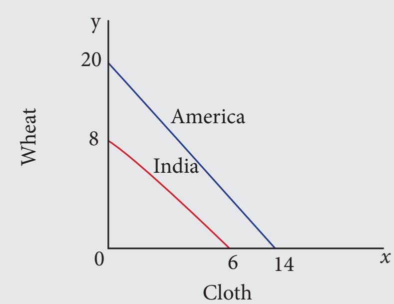
Assumptions

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.

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



❖ 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 productionof cloth and import wheat from India.

❖ This kind of trade would be mutually beneficial to both India and China.

6. Elaborate variousGains from International Trade?

Introduction

❖ 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. Compare and contrast fixed and flexible exchange rates.

BASIS FOR COMPARISON	FIXED EXCHANGE RATE	FLEXIBLE EXCHANGE RATE
Meaning	Fixed exchange rate refers to a rate which the government sets and maintains at the same level.	Flexible exchange rate is a rate that varies according to the market forces.
Determined by	Government or central bank	Demand and Supply forces
Changes in currency price	Devaluation and Revaluation	Depreciation and Appreciation
Speculation	Takes place when there is rumor about change in government policy.	Operates to remove external instability by change in Forex rate.
Self-adjusting mechanism	Operates through variation in supply of money, domestic interest rate and price.	

8. List the offers of International specialization.

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.

9. Draw the chart depicting correction of balance of payment disequilibrium.