MODULE I: INTERNATIONAL TRADE

CHAPTER 1: THEORIES OF INTERNATIONAL TRADE

Q.1. EXPLAIN IN DETAIL ADAM SMITH'S INTERNATIONAL TRADE THEORIES.

ANS: INTRODUCTION: According to classical economists, given the natural resources, it is the ability of the labour that enables a country to specialize in the production of a commodity. Thus, international trade is the result of advantages a country possesses in producing a particular commodity at a lower cost. ***Adam Smith*** explained this is in the form of ***"Absolute Differences in Cost"*** and ***"Equal Differences in Cost"***. Subsequently, ***David Ricardo*** improved the explanation in the form of ***"Comparative Differences in Cost"***.

ADAM SMITH'S THEORY OF ABSOLUTE COST DIFFERENCE: It was Adam Smith who primarily, through his theory of Absolute Cost Differences, initiated the theoretical explanation of international specialization. Smith argues that international trade is advantageous for all the participating countries only if they enjoy absolute differences in the cost of production of the commodity which they specialize in. Like any other economic theory, the classical principle of international trade is derived from a variety of assumptions as enlisted below:

Assumptions of the Theory:

1) A Two countries, Two Commodities and a Single Factor (2.2.1) model.
2) Labour is regarded as the only factor of production.
3) Application of Labour Cost Theory. It is assumed that cost of production is expressed in real terms i.e. in terms of quantity of labour required to produce a commodity.
4) Homogeneous labour.
5) Perfect mobility of labour within and perfect immobility between the countries.
6) Existence of perfect competition.
7) Full Employment of labour.
8) Absence of Transport cost.
9) Constant returns to scale.
10) Free Trade i.e. absence of artificial policy measures influencing free movement of goods.

On the basis of above assumption the classical economists tried to explain the pattern of international specialization and trade. The starting point of any specialization is logically the existence of cost differences.

Output produced by One Day of Labour

Country	***Commodity X***	***Commodity Y***	***Internal Exchange Rate X:Y***		
India	20	10	***2***	***1***	***1X : ½ Y***
Russia	10	20	***1***	***2***	***½ X : 1Y***

From the above table, it is clear that:

- India has an absolute advantage in the production of commodity X *(20>10)* and Russia has an absolute advantage in the production of commodity Y *(10<20)*.
- IF India and Russia enter into international trade with an ***international exchange rate of 1X : 1Y***, both the countries stand to benefit. India will get 1Y : 1X as against ***½Y : 1X*** within in its own country. Whereas Russia, will get 1X : 1Y as against ***½X : 1Y*** within in its own country.
- According to Smith, for international trade to be beneficial, each country must enjoy absolute cost difference in the cost of production.

ADAM SMITH'S THEORY OF EQUAL COST DIFFERENCE: Adam Smith, in order to strengthen his argument in favour of absolute cost differences, pointed out that trade is not possible if countries operate under equal cost differences. Equal Cost Differences are said to exist when the domestic rate of exchange between the two commodities is same in both the countries. As a result of this no country will enjoy any gains from specialization and trade. Hence, no international trade can take place under the conditions of equal cost difference. This is demonstrated in the following example.

Output produced by One Day of Labour

Country	***Commodity X***	***Commodity Y***	***Internal Exchange Rate X:Y***	
India	20	10	***2***	***1***
Japan	10	5	***2***	***1***

From the above table, it is clear that:

- The internal exchange rate in both the countries is 2X : 1Y.
- Neither India nor Japan can derive any benefits through specialization. Naturally no trade will take place.
- Hence both India as well as Japan will produce domestically both the products.

Q.2. EXPLAIN IN DETAIL RICARDIAN THEORY OF COMPARATIVE COST.

ANS: INTRODUCTION: *David Ricardo offers a more practical and universally valid argument in the form of his principle of comparative costs*. David Ricardo agreed that absolute cost differences give a clear reason for trade to take place between the countries. However, Ricardo went on to argue that, *even when a country has absolute advantage in the production of both the commodities, it is beneficial for that country to specialize in the production of that commodity in which it has a greater comparative cost advantage. The other country can be left to specialize in the production of that commodity in which it has less comparative cost advantage*.

According to Ricardo, the true basis of international trade and specialization is not the *Smithian Absolute Cost Differences Advantage Approach* but *Comparative Cost Differences Advantage Approach*.

Assumptions of the Theory:

1) There are Two Countries and Two Commodities
2) Existence of Perfect Competition in both Commodity and Factor Markets.

3) Cost of Production is expressed in terms of Labour and Commodities are also exchanged on the basis of Labour content of each commodity.
4) Labour is the only factor of production other than natural resources.
5) Labour is Homogenous.
6) Labour is perfectly mobile within the country and perfectly immobile between the countries.
7) Existence of Free Trade between countries.
8) Production is subject to constant return to scale.
9) Constant Technology.
10) Trade between two countries takes place on Barter System
11) Full employment in existence in both the countries.
12) No Transport Costs

David Ricardo explains the comparative cost advantage approach by means of a concrete example, involving two countries i.e. England and Portugal, and two commodities i.e. wine and cloth, based on assumptions, the cost is measured in terms of labour hours as follows:

Comparative Cost Differences Advantage

Country / Commodity	***Wine***	***Cloth***	***Internal Exchange Rate***
England	120 L	100 L	***1 Wine = 1.2 Cloth***
Portugal	80 L	90 L	***1Wine = 0.89 Cloth***

From the above table, it is clear that:

- Portugal has absolute advantage over England, in producing both wine as well as cloth. This is because it can produce wine by using 80 labourers as against 120 labourers of England and requires 90 labourers as against 100 labourers of England for producing a unit of cloth.
- On comparison it is found that, Portugal is more superior in wine and less superior in cloth to England, while England is more inferior in wine and less inferior in cloth to Portugal.
- It will benefit both Portugal in the specialization of Wine (greater comparative advantage) and England by specialization in the production of cloth (smaller comparative disadvantage) respectively.
- The gains to a participating country occur if, it can get more of a commodity from other country than what it receives domestically. It has to offer a smaller quantity of its product than what it has to domestically. For Example, ***Portugal will benefit, if 1 unit of wine brings more than 0.89 unit of cloth*** and ***England will gain if it can obtain 1 unit of wine for less than 1.2 units of cloth***. In order that both countries reap the advantage from specialization and trade, the exchange rate between Portuguese wine and English cloth should be such that ***1 unit of wine is exchange for > 0.89 units of cloth but < 1.2 units of cloth***.
- Suppose the ***International Exchange Rate*** is ***1 W = 1 C***, *Portugal gets (1 - 0.89) = 0.11 more units of cloth per unit of wine exported and England saves (1.2 – 1) = 0.2 units of cloth per unit of wine imported.*

Q.3. <u>CRITICALLY EVALUATE THE RICARDIAN THEORY OF COMPARATIVE COST</u>.

<u>ANS</u>: <u>INTRODUCTION</u>: David Ricardo is credited with the explanation of international trade in terms of comparative cost advantage. There have been different explanations of comparative advantage that have been put forward over a period of time, but the principle of comparative cost advantage has remained as the foundation of international trade. However, the theory has its limitations. The following are the drawbacks of the theory.

<u>MAJOR DRAWBACKS / LIMITATIONS</u>:

1) ***<u>Restrictive Model</u>*:** Ricardo's Theory is based on only two countries and only two commodities. But international trade is among many countries with many commodities.

2) ***<u>Labour Theory of Value</u>*:** Value of goods is expressed in terms of labour content. Labour Theory of value developed by classical economists has too many limitations and thus is not applicable to the reality. Value of goods and services in the real world is expressed in money i.e. the prices are the values expressed in units of money.

3) ***<u>Full Employment</u>*:** The assumption of full employment helps the theory to explain trade on the basis of comparative cost advantage. The reality is far from full employment. Cost of production, even in terms of labour, may change as the countries, at different levels of employment move towards full employment.

4) ***<u>Ignore Transport Costs</u>*:** Another serious defect is that the transport costs are not consider in determining comparative cost differences. It makes the theory meaningless. Goods do not move free of charge and when cost is included the comparative costs advantage may change.

5) ***<u>Demand is ignored</u>*:** The Ricardian theory concentrates on the supply of goods. Each country specialises in the production of the commodity based on its comparative advantage. The theory explains international trade in terms of supply and takes demand for granted.

6) ***<u>Mobility of Factor of Production</u>*:** As against the assumptions of perfect immobility between the countries, we witness difficulties in the mobility of labour and capital within a country itself. At the same time their mobility between nations was never totally absent.

7) ***<u>No Free Trade</u>*:** Ricardian theory assumes free trade i.e. no restriction on the movement of goods between the countries. Though it is unrealistic to assume not to have any restrictions, real world witnesses is a lot tariff and non-tariff barriers on international trade. Poor countries find it difficult to enjoy the comparative advantage in the production of labour intensive commodities due to the protectionist policies followed by developed countries.

8) ***Static Theory*: The modern economy is dynamic and the comparative cost theory is based on the assumptions of static theory. It assumes fixed quantity of resources. It does not consider the effect of growth.

9) ***Complete Specialisation***: In the Ricardian example, England is specialising fully on cloth and Portugal on wine. Such complete specialisation is unrealistic even in two countries and two commodities model. It is possible if two countries happen to be almost identical in size and demand. Again, complete specialisation in the production of less important commodity is not possible due to insufficient demand for it.

10) ***Not applicable to Developing Countries***: Ricardian theory is not applicable to developing countries as these countries are nowhere near to full employment. They are in the process of change in quality of their labour force, quality of capital, technology, tapping of new resources etc. In other words developing countries exhibit all the characteristics of dynamic economy.

11) ***Constant Returns to Scale***: Another drawback is that the theory assumes constant Returns to scale and thus constant cost of production in both the countries. The doctrine holds that if England specialises in cloth; there is no reason why it should produce wine. Similarly if Portugal has a comparative advantage in producing wine, it will not produce cloth; but import all cloth from England. If we examine the pattern of international trade in practice, we find it is not so. A time will come when it will not be reasonable for Portugal to import cloth from England because of increasing cost of production. Moreover, in actual practice a country produces a particular commodity and also imports a part of it. This phenomenon has not been explained by the theory of comparative costs.

Q.4. EXPLAIN THE PRACTICAL APPLICABILITY OF RICARDIAN THEORY OF COMPARATIVE COST.

ANS: INTRODUCTION: Despite the drawbacks of David Ricardo's Comparative Cost Theory, his supporters namely Prof. Haberler and Prof. Taussig have attempted to prove practical applicability of the theory, as follows:

1) ***Practical in Real Situation***: It is assumed that the cost would not change as the countries operate with conditions like full employment, free trade, perfect competition, etc. The Supporters argued that the assumptions could be relaxed and the theory can be applied to real world situation, where each country specializes in the production of those goods and services in which it has comparative cost advantage under the changing conditions.

2) ***Trade with Neighboring Countries***: The theory assumes that there are no transport costs, which is highly unrealistic. However, the supporters argue that with the addition of transport costs to the cost of production, each country will be able to produce goods in which it enjoys comparative cost advantage. After additions of transport costs, a country may not enjoy the cost advantage against distant countries like USA, England, etc., but India may have an advantage in selling the goods in the neighboring countries like Sri Lanka, Pakistan, and so on.

3) ***Production Cost in Money Terms***: The theory expresses the production cost of a commodity in terms of labour units. However, the total cost of production, including that of labour can be expressed in money terms. Therefore, countries can specialize in the production of those commodities, where it enjoys comparative advantage in money terms relating to the cost of production, and not necessarily in terms of labour units.

4) ***Applicable to all Commodities and Countries***: The theory is explained by considering only two countries and only two commodities. However, the theory can be applied to any number of commodities and countries. Each country then will specialize in the production of those commodities in which they have comparative advantage. By doing so, the countries can export their surplus at a higher comparative price, and import the other items available at lower comparative cost.

5) ***Changes in Technology***: The assumptions of constant returns and no change in technology can also be relaxed. With changes in technology and production being subject to law of returns, countries would specialize on the basis of cost advantage both under increasing and decreasing cost conditions.

CHAPTER 2: TERMS OF TRADE

Q.1. EXPLAIN IN DETAIL THE CONCEPT OF TERMS OF TRADE.

ANS: INTRODUCTION: In international trade, countries gain from specializing in the production of commodities in which they have comparative cost advantage. The gain from international trade is shared by the participating countries, depending upon the terms of trade. The **terms of trade refer to, *the rate at which one country exchanges its goods for the goods of other countries.*** As there is hardly any barter exchange, but purchase and sale of goods between countries, the terms of trade depend on the prices of exports of a country and the prices of its imports.

***The terms of trade can be favourable or unfavourable*:**

a) ***Favourable Terms of Trade*:** A country will obtain favourable terms of trade when its share of gain from international trade is relatively larger. This is possible when the *prices of its exports are higher as compared to its imports*, as it would be in a position to get greater quantity of imports for a given amount of its exports.

b) ***Unfavourable Terms of Trade*:** A country's terms of trade would be unfavourable when its share of gain from international trade is relatively smaller. This takes place when the *price of its exports are relatively lower as compared to its imports*, as it would be getting lower quantity of imports for a given quantity of its exports.

Thus, it can be stated that the terms of trade of a nation refers to the ratio of price of its exports commodity to the price of its import commodity. This can be stated as follows:

$$T = \frac{Px}{Pm}$$

Where, ***T*** = ***Terms of Trade***
Px = ***Price of Exports***
Pm = ***Price of Imports***

When a single commodity is exported and imported, the price ratio of exports and imports is multiplied by 100. For Example, If the price of exports is 80, and the price of imports is 100, the terms of trade is as follows:

$$T = \frac{80}{100} \times 100 = 80$$

Terms of trade above hundred is favourable to the exporting country, and the terms of trade below hundred is unfavourable. In the example above, the terms of trade is unfavourable because the nation gets lower price for its exports that the price which it pays for imports.

***Concepts or Different Methods of Terms of Trade*:**

1) Net Barter Terms of Trade
2) Gross Barter Terms of Trade
3) Income Terms of Trade
4) Single Factoral Terms of Trade.
5) Double Factoral Terms of Trade.

Q.2. EXPLAIN IN DETAIL CONCEPT OF NET BARTER TERMS OF TRADE.

ANS: INTRODUCTION: It is also known as *Commodity Terms of Trade*. It refers to, ***the ratio between prices of exports and prices of imports***. It is expressed as:

$$Tn = \frac{Px1}{Pm1} \times 100$$

Where,

Tn = ***Net Barter Terms of Trade***
P = ***Price Index***
x = ***Exports***
m = ***Imports***
1 = ***Current Year***
Base Year Index = 100

***Example*:** Taking the base year as 2011 and expressing the price index of both exports and imports as 100. In 2015, if the price index of exports has increased to 160 and that the price index of imports has increased to 120, the terms of trade in the current year would be:

$$Tn = \frac{160}{120} \times 100 = 133.33$$

- ✓ It implies that there was an improvement in the net barter terms of trade of India by ***33% in 2015*** as compared with the ***Base Year 2011***. In above illustration, the net barter terms are favourable, as more imports can be obtained for given exports.
- ✓ If the prices of exports of a nation rise relatively greater than that of its imports, terms of trade will be favourable. However, if the prices of imports rise relatively greater than that of its exports, the terms of trade would be unfavourable.

***Criticisms/Limitations*:** Net barter terms of trade is criticized on the following:

1) ***Ignores Change in Quality of Product*:** Commodity terms of trade are based on the index numbers of export and import prices. But they do not take into account changes taking place in the quality and composition of goods entering into trade between two countries. At best, commodity terms of trade index shows changes in the relative prices of goods exported in the base year. Thus, net barter terms of trade does not take into account for large change in the quality of goods that are taking place in the world, as also new goods that are entering in international trade.

2) ***Problem of Selection of Period*:** Problem arises in selecting the period over which the terms of trade are studied and compared. If the period is too short, no meaningful change may be found between the base date and the current period. On the other hand, if the period is too long, the structure of the country's trade might have changed and export and import commodity content may not be comparable.

3) ***Problems in Construction of Index Numbers*:** Changes in net barter terms of trade are understood through the changes in price index of exports and imports. Terms of trade based on index numbers are subject to the problems associated with the construction of index numbers. Even if the index number is constructed by taking only the traded goods, the composition of exports and imports may change thus, making comparison difficult.

4) ***Causes of Changes in Prices*:** This concept merely indicates the changes in export and import prices and not how such price changes take place. In fact, there is a qualitative difference when a change in the commodity terms of trade index is caused by a change in export prices relative to import prices; as a result of changes in demand for exports abroad, and ways or productivity at home.

5) ***Neglects Import Capacity*:** The concept of the net barter terms of trade does not consider the import capacity of a nation. Suppose there is a fall in the net barter terms of trade in India. It means that a given quantity of Indian exports will buy a smaller quantity of Indian exports will buy a smaller quantity of imports than before.

6) ***Ignores Productive Capacity*:** The commodity terms of trade also ignores a change in the productive efficiency of a country. Suppose the productive efficiency of a country increases. It will lead to a fall in the cost of production and in the prices of its export goods.

7) ***Not Helpful in Balance of Payment Disequilibrium*:** The concept of commodity terms of trade is valid if the balance of payments of a country includes only the export and imports of goods and services, and the balance of payments balances in the base and in the given years. If the balance of payments also includes unilateral receipts/payments such as gifts, remittances from and to the other country, etc., leading to disequilibrium in the balance of payments, the commodity terms of trade is not helpful in measuring the gains from trade.

Q.3. EXPLAIN IN DETAIL CONCEPT OF GROSS BARTER TERMS OF TRADE.

ANS: INTRODUCTION: This concept of the terms of trade was introduced by ***Frank William Taussig***. *Gross barter terms of trade refers to*, ***the ratio of volume of imports to volume of exports***. According to F W Taussig, this concept is an improvement over the concept of net barter terms of trade.

$$Tg = \frac{Qm1}{Qx1} \times 100$$

Where,

Tg = ***Gross Barter Terms of Trade***
Qm = ***Physical Quantity of Imports***
Qx = ***Physical Quantity of Exports***
1 = ***Current Year***
Base Year Index = 100

***The value of Tg can be either less than 1 or greater than 1*:**

✓ If it is less than 1, the gross barter terms of trade are said to be unfavourable.
✓ If it is greater than 1, the gross barter terms of trade are said to be favourable.

***Example*:** Taking 2011 as the base year and expressing quantity index of India's both imports and exports as 100, if we find that the index of quantity imports had risen to 180 and that of quantity exports to 120 in 2015, then the gross barter of trade had changed as follows:

$$Tg = \frac{180}{120} \times 100 = 150$$

It implies that there was an improvement in the gross barter terms of trade of India by ***50% in 2015 as compared with 2011***. In the above illustration, the gross barter terms are favourable, as more imports can be obtained for given exports.
Equilibrium in Balance of Trade

Criticisms/Limitations**:** The concept of gross barter terms of trade has been criticized on the following grounds:

1) ***Ignores Value*****:** This concept states the terms of trade in terms of quantity, and not in terms of price. For all practical purposes, terms of trade is expressed in value of price which is more relevant.

2) ***Ignores Factor Productivity*****:** This concept ignores the effect of improvement in factor productivity on the terms of trade of a nation. A nation may have unfavourable gross barter terms of trade due to increase in factor productivity in the export sector. This increased factor productivity, in turn, reflects the gain for the exporting country.

3) ***Neglects Balance of Payments*****:** The concept of gross barter terms of trade relates to the trade balance and ignores the influence of international capital receipts and payments of a trading nation.

4) ***Ignores Improvements in Production*****:** This concept measures the terms of trade in terms of physical quantities of exports and imports but ignores qualitative improvements in the production of exportable and importable goods.

5) ***Not True Index of Welfare*****:** An improvement in gross barter terms of trade is regarded as an index of a higher level of welfare on account of trade. When a nation enjoys favourable terms of trade, it gets more imports for its exports. But this may not be true if tastes & preferences of people change and nation may not import more.

6) ***Aggregates all Receipts and Payments*****:** It aggregates all receipts and payments such as unilateral receipts and payments which do not depend on trade. Such receipts & payments are based on factors which are mostly unrelated to trade.

Q.4. EXPLAIN IN DETAIL CONCEPT OF INCOME TERMS OF TRADE.

ANS: INTRODUCTION: ***G.S. Dorrance*** has improved upon the concept of net barter terms of trade by formulating the concept of income terms of trade. *Income terms of trade refers to,* ***the ratio between the values of exports to the import prices***. In other words, it refers to, *the index of the exports value divided by the price of imports*.

$$Ty = \frac{Px}{Pm} \times Qx$$

Where,

Ty	=	***Income Terms of Trade***
Px/Pm	=	***Commodity or Net Barter Terms of Trade***
Qx	=	***Physical Quantity of Exports***

- The income terms of trade is also called as 'capacity to import'. This is because in the long run, balance of payments must be in equilibrium, i.e., the value of exports would be equal to the value of imports. The changes in income terms of trade depend on the price and volume of exports.
- Improvement in income terms of trade indicates that country can obtain larger volume of imports or its capacity to import has increased. Therefore, some economists consider it as a better explanation of gains of trade. Other things being equal, the capacity to import increases when (i) Export prices increase or (ii) Import prices decrease or (iii) Volume of import increases for a given quantity of exports.

***Criticisms / Limitations*:**

1) ***Ignores Total Capacity to Import*:** The income terms of trade indicate only the export-based capacity to import and not the country's total capacity to import. The total capacity to import depends upon factors like capital inflow, receipts from invisibles, and unilateral payments.

2) ***Real Gains from Trade*:** A change in the income terms of trade need not necessarily reflect the real gains from trade. Even when export prices fail and import prices remain constant, the income terms of trade will improve, if the physical volume of exports increases more than in proportion to the fall in export prices.

3) ***Inferior to Commodity Terms of Trade*:** Since the index of income terms of trade is based on commodity terms of trade and leads to contradictory results, the concept of the commodity (net barter) terms of trade is usually used in preference to the income terms of trade concept for measuring the gain from international trade.

4) ***Neglects Foreign Exchange Receipts from Other Sources*:** This concept takes into account the import capacity of a country based on export receipts only. It neglects foreign exchange receipts from other sources. A country's capacity to import does not depend only on export receipts but on total foreign exchange receipts.

Q.5. EXPLAIN IN DETAIL CONCEPT OF TERMS OF TRADE BASED ON PRODUCTIVITY OF FACTORS.

ANS: INTRODUCTION: To overcome the limitations of commodity or net barter terms of trade, ***Prof. Jacob Viner*** developed various concepts like:

a) Single Factoral Terms of Trade
b) Double Factoral Terms of Trade

These concepts admit the changes in productivity of factors involved in producing exports.

1) ***Single Factoral Terms of Trade*:** ***Prof. Jacob Viner*** developed the concept of single factoral terms of trade as an improvement over the commodity terms of trade. *It refers to,* ***the ratio of export price index to import price index, adjusted for changes in the productivity of factors used by a nation in export production***. This concept can be expressed as follows:

$$Ts = \frac{Px}{Pm} \times Zx$$

Where,

Ts	=	***Single Factoral Terms of Trade***
Px/Pm	=	***Commodity or Net Barter Terms of Trade***
Zx	=	***Productivity Index of Export Sector***

***Example*:** If net barter terms of trade are $95/110$ and the productivity index in the export sector of a nation rises from **100 in 2011 to 125 in 2015**, then the single factoral terms of trade will be:

$$Ts = \frac{95}{110} \times 125 = 107.95$$

Thus, exporting nation received ***7.95%*** more imports per unit of domestic factors of production embodied in its exports in 2015 as compared to the year 2011.

***Criticisms / Limitations*:**

1) Improvement of productivity in the export sector need not be due to its internal economies. Instead, it may be the result of an improvement in the productivity in its input-supplying sectors such as due to technological innovations, discovery of new sources of supply, etc.
2) Generally, an improvement in productivity would be experienced by the entire economy and not by its export sector only.
3) The index of productivity in the export sector has to have the same base period as the one used for export and import price index numbers.
4) Zx – the index of productivity in the export sector suffers from all the limitations of a typical index number covering a large number of heterogeneous items. This means it is difficult to construct a productivity index.
5) It does not consider the production cost of imported goods in the supplier's country.
6) Comparison between periods (base period and current year period) becomes impractical as composition of exports and imports may change.

2) ***Double Factoral Terms of Trade*:** To overcome the limitations of single factoral terms of trade, Prof. Jacob Viner introduced the Double Factoral terms of trade. This concept takes into account factor productivity changes associated with both the exports and imports. It can be expressed as follows:

$$Td = \frac{Px}{Pm} \times \frac{Zx}{Zm} \times 100$$

Where,

Td	=	***Double Factoral Terms of Trade***
Px/Pm	=	***Commodity or Net Barter Terms of Trade***
Zx	=	***Productivity Index of Export Sector***
Zm	=	***Productivity Index of Import Sector***

***Example*:** If net barter terms of trade are 95/110 and the productivity in the export sector of a nation rises from 100 in 2011 to 130 in 2015, and so the productivity in the import sector rises from 100 in 2011 to 105 in 2015, then the double factoral terms of trade will be:

$$Td = \frac{95}{110} \times \frac{130}{105} \times 100 = 106.92$$

In the above example, the double factoral terms of trade are in favour of exporting country as its productivity efficiency of the factors involved in exports has increased relatively to that of factors involved in imports. In simple words, we receive more units of factors of production for a given unit involved in our exports.

***Criticisms / Limitations*:** These concepts suffers from the following limitations:

1) ***Lacks Practical Value*:** This measure has no practical use. The purpose of a country in estimating terms of trade should be to incorporate the changes in productivity of its exports and import-competing industries.

2) ***Irrelevant for Domestic Economy*:** It incorporates the productivity changes in the industries being operated by foreign economies. In Itself, the productive efficiency of foreign industries is irrelevant for the domestic economy. What is relevant is the price which it has to pay for its imports in the form of its exports.

3) ***Difficulty in Estimating the Productivity Changes in Supplier's country*:** In practice, it is very difficult to estimate productivity changes in foreign countries. The difficult increases still further because, normally, a country imports from several countries and their data cannot be compared.

4) ***Difficult to construct Productivity Index*:** It is difficult to construct productivity index of the exporting country, and more so that of the importing country.

Q.6. EXAMINE THE FACTORS INFLUENCING TERMS OF TRADE.

ANS: INTRODUCTION: Terms of trade may be favourable or unfavourable to a particular nation. There are certain factors that determine the terms of trade:

1) ***Changes in Factor Endowment*:** The availability of factors of production in a country may increase or decrease over a period of time. An increase in factors of production enables a nation to produce and export more, whereas, a decrease in factors of production may lead to increase in imports. The increase and decrease in factors of production affected the terms of trade.

2) ***Elasticity of Supply*:** The nature of elasticity of supply influences the country's terms of trade. If the supply of a country's exports is more elastic than the imports, the terms of trade will tend to be favourable. This means when the elasticity of supply of exports is more than its imports, a nation will be able to increase more exports, thereby enabling the nation to enjoy favourable terms of trade.

3) ***Elasticity of Demand*:** The elasticity of demand for exports and imports of a country influence its terms of trade. If the demand for a country's exports is less elastic as compared to its imports, the terms of trade will tend to be favourable because the exports can command higher price than imports. However, if the demand for imports is less elastic than that for exports, the terms of trade will be unfavourable.

4) ***Nature of Goods*:** If a country is producing and exporting only primary goods, and importing manufactured goods, the terms of trade will be unfavourable. This is because, the primary goods command lower prices in the world markets mainly on account of subsidies by the developed nations for promoting export of agriculture related items. However, the price of manufactured items, especially that of capital goods is higher. This will lead to less inflow of foreign exchange on account of exports and more outflow of foreign exchange on account of expensive manufactured import items.

5) ***Economic Development*:** The economic Development has two types of effects:
   a) ***The Demand Effect*:** It refers to the increase in demand for imports as a result of increase in income associated with economic development.
   b) ***The Supply Effect*:** It refers to the increase in supply of import substitutes. The supply effect may also include the increase in supply of superior quality of goods on account of economic and technological development. The net effect of economic development depends upon the extend of these two effects.

   If the supply effect is greater than the demand effect, a nation may enjoy favourable terms of trade. However, if the demand effect is greater than the supply effect, a nation will enjoy unfavourable terms of trade.

6) ***Tariff Policy*:** Tariffs and quotas also influence the terms of trade. The tariffs and quotas are mostly imposed on imports rather than exports. Tariffs are duties imposed on imports, and quotas are restrictions on quantity of imports. The tariffs will increase the price of the imported goods, and quotas will reduce the quantity of imports. These measures, if not retaliated by other countries, improve a country's terms of trade by restricting imports.

7) ***Degree of Competition*:** If a country enjoys monopoly power in case of its exports and there are many alternative sources of supply of its imports, then it will have favourable terms of trade. For instance, the OPEC countries enjoy a considerable hold over the oil and petroleum markets in the world, and therefore, they enjoy favourable terms of trade.

8) ***Size of Population*:** An overpopulated country will have larger demand for imports. Also due to overpopulation, a nation may be forced to cut down on its exports due to the increasing domestic demand. As a result, the terms of trade will tend to be unfavourable as compared to those countries which are under-populated.

9) ***Rate of Exchange*:** The exchange rate also influences terms of trade. For instance, if the domestic currency depreciates, the exporters would be more willing to export as they gain when they convert the foreign currency into encourages more exports, and imports become expensive in terms of domestic currency. Therefore, when the domestic currency depreciates, the terms of trade will be in favour of that country whose currency is depreciated.

CHAPTER 3: GAINS FROM INTERNATIONAL TRADE

Q.1. EXPLAIN THE VARIOUS GAINS INTERNATIONAL TRADE.

ANS: *Gains from trade refers to various benefits which a country derives out of international trade.*

(A) GAINS FROM TERMS OF TRADE (*Cost Difference*): *The terms of trade refers to the exchange ratio of exports and imports of goods or their price ratio. It is the ratio of price of country's exports and its imports.* Terms of trade determine the gains from trade. The improvement in terms of trade will improves gains from trade and vice-versa.

COST IN TERMS OF LABOUR

Labour	Country	Machines	Clothes	Domestic Exchange Rate	
				Machines	Clothes
10 Days Labour	USA	10	10	1	1
10 Days Labour	INDIA	2	8	1	4

- ❖ Let us suppose that the international terms of trade is **1:1.5**. This terms of trade is nearer to the internal terms of trade of U.S.A. The gain is minimum for U.S.A and India's gain is maximum.
- ❖ Let us suppose that the international terms of trade is **1:3.5**. This terms of trade is nearer to India's internal terms or trade. It is more favourable to U.S.A. thus the gains from trade to U.S.A. is maximum and to India it is minimum
- ❖ It is clear from above example that the improvement terms of trade for a country also improves gains from trade.

(B) INCREASE IN WORLD PRODUCTION: Another important gains from international trade is increase in the world production.

PRODUCTION IN UNITS

Country	Labour Days	Cloth	Machines	Total Output
INDIA	10	20	4	24
USA	10	10	20	30
TOTAL		**30**	**24**	**54**

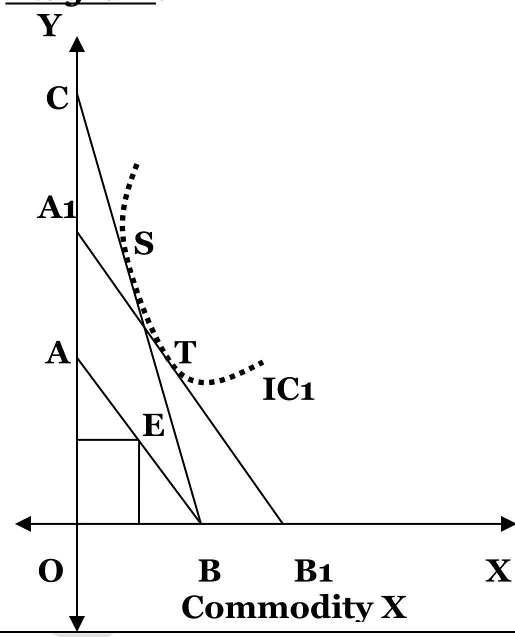
1) It is clear from above table that the total production of both countries is ***54 units***.
2) It is clear from above table *India* has *comparative advantage* in the production of cloth and USA in production of machines
3) If India and U.S.A. goes for complete specialization and applies its labour for production only one commodity then ***India will produce 40 units of cloth*** and ***U.S.A. 40 units of machines***. Thus the total output will increase to 80 units after complete specialization.
4) The total gains from international trade in terms of increase in world output is ***26 units i.e. 80-54=26***
5) Together INDIA and USA produce ***26 units more than what they would have produced under absence of international trade***. By participating in international trade India and USA can produce more.

(C) <u>INCREASE IN CONSUMPTION</u>: The most important gains from international trade is the increase in production which further results in increase in consumption of the people of countries which participate in international trade. This can be explained with the help of following diagram:

***<u>Explanation of the diagram</u>*:**

1) In diagram, AB is production possibility curve of a country which produces commodity X and Y with a given resources.
2) Prior to trade on AB price line, the country's equilibrium position is E. In post trade situation the country's international price line is given by CB which is tangent to the community indifference curve IC, at point S.
3) It is clear from above diagram that without trade for a country to reach indifference curve at T, it requires additional resources represented by A1B1.
4) Due to international trade the country has a larger combination of goods X and Y at points. Thus, international trade leads to higher consumption of goods and increase in economic welfare.

***<u>Diagram</u>*:**

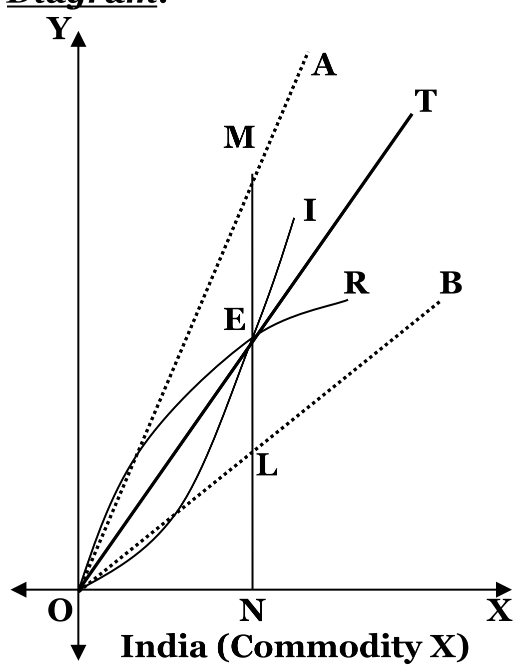


(D) <u>RECIPROCAL DEMAND</u>: The gains from international can also be explained on the basis of reciprocal demand. Reciprocal demand refers to the elasticity of one country's demand for the other country's commodity in exchange for its own goods at different terms of trade. Reciprocal demand is expressed in terms of offer curves.

***<u>Explanation of the diagram</u>*:**

1) In diagram OI is India's offer curves and OR is Russia's offer curves, equilibrium terms of trade is determined by the intersection of offer curves at point E.
2) The line OB and OA are the domestic price ratio of two countries India and Russia. India within its economy has exchange rate shown by OB line where for ON of X it get NL of Y. However by entering into trade with Russia it gets NE of Y i.e. LE of Y more than what it gets at home. Thus India's gain is LE.
3) It is clear from above diagram that Russia within its economy has exchange rate shown by OA where for ON of X it has to give NM of Y. However by entering into trade with India it secures ON of X by giving NE of Y i.e. EM less of Y. Russia thus gains EM in terms of Y by entering into trade with India.

***<u>Diagram</u>*:**



(E) <u>DYNAMIC GAINS</u>: Many other gains which are termed as dynamic gains are also enjoyed by the countries from international trade.

1) As the economies undergo changes in terms of technology, production function and finally an outward shift in production frontier.
2) New ways of production and organizing production are spread to the local economy through trade and results in development of cost-saving techniques. Due to international trade there is introduction of new tastes, preferences, generation of employment and positive culture changes.
3) Such gains are enjoyed by only those countries that participate in International trade.

(F) <u>COST RATIO</u>: Another gain from international trade is that the country can gain from importing goods if the cost of importing the goods is less than the cost of production the goods at home. This can be explained with the help of example. Let us suppose there are two countries INDIA and PAKISTAN. The country INDIA imports the goods from country PAKISTAN. The gains from international trade for country INDIA would be larger if the cost of imported goods from PAKISTAN is low. Thus, the gain in international trade increases if the cost ratio between the countries widens.

Q.2. <u>EXPLAIN THE FACTORS DETERMINING GAINS FROM TRADE.</u>

<u>ANS</u>**:** The factors determining the gain from international trade are as follows:

1) ***<u>Terms of Trade</u>*:** The first important factor determining gains from trade is the terms of trade. If the terms of trade are favorable to a country it brings more gains from international trade. On other hand if terms of trade are not favorable to a country it brings less gain from international trade.

2) ***<u>Reciprocal Demand</u>*:** The second important factor that determines gains from international trade is the reciprocal demand. *Reciprocal demand is the strength and elasticity of demand of country A for the product of country B in exchange for A's product*. Reciprocal demand is expressed in terms of offer curves which determine the terms of trade and also the gains from international trade.

3) ***<u>Cost ratio</u>*:** The cost ratio between two countries also determines the gains from trade. *A country's gains arise from imports which costs the importing country less than what if it is produced at home*. The country's gain from the international is larger if the cost of production of goods of country from which goods are imported declines. Thus, the larger the difference in cost ratio between the participating countries the greater is the gains from international trade.

4) ***<u>Level of Income</u>*:** Another important factor which determines the terms of trade is the level of income of a country. *A country with higher per capita income would enable the people of the country to import cheaper goods from abroad*. However the country stands to gain only if there are no restrictions on imports. The gains may also disappear if there is continuous rise in price of imported goods due to higher intensity in demand for imported goods.

MODULE – I: SELECT CORRECT OPTION

CHOOSE THE CORRECT OPTION AND REWRITE THE STATEMENTS:

1) International trade increases the welfare of _______________. (***all participating countries***, only exporting countries, only importing countries, none of the above)

2) International trade increases the _______________ of participating countries. (***Output***, profit, risks, none of the above)

3) According to David Ricardo, International trade is beneficial under ___________ cost. (***comparative***, absolute, equal difference in cost, none of the above)

4) David Ricardo's Theory assumes perfect mobility of labour _______________ (***Within the country***, between the participating countries, within and between the participating countries, none of the above)

5) Comparative cost theory is static theory because it assumes _______________ (***there is no qualitative and quantitative change in inputs***, labour is homogeneous within the country, there is no transport cost, none of the above)

6) Ricardian theory measures comparative cost in terms of _______________. (***man days***, money, input costs, all of the above)

7) Ricardian theory assumes that labour is _______________ within the country. (***homogeneous***, heterogeneous, inefficient, all of the above)

8) Ricardian theory can be extended to _______________ (***more than two countries***, only two countries, only to developed nations, only to developing nations)

9) Hecksher Ohlin theory on international trade can explain _______________ trade. (***inter-regional and international***, only inter-regional, only international, none of the above)

10) Commodity X is capital intensive, when in its production capital/labour ratio is _____________ than Commodity Y. (***greater***, less, equal to none of the above)

11) Hecksher Ohlin theory cannot be applied to more than ____________ (***Several commodities and several countries***, two commodities, two countries, few countries)

12) According to Hecksher Ohlin theory, product price depends on _______________ (***all of the given below***, only factor intensity, only factor abundance, factor cost)

13) According to Hecksher Ohlin theory, the International trade takes place due to difference in _______________. (***Product price***, labour efficiency, advanced technology, all of the above)

14) In international trade _______________ move between nations. (***Commodities and not factors***, factors of production, factors and commodities, none of the above.

15) Terms of trade are favourable if the current index in comparison to the base year index is _______________. (***more***, less, equal, none of the above)

16) Gross barter terms of trade takes into account _______________. (***trade items and unilateral payments***, only trade items, only services, none of the above)

17) Income terms of trade takes into account changes in ______________. (***efficiency of factors of production of export goods***, export prices, import prices, demand for imports)
18) Single factoral terms of trade takes into account changes in ______________. (***efficiency of factors of production of export goods***, export prices, import prices, demand for imports)
19) Generally, the developing countries ______________ terms of trade. (***suffer from adverse***, enjoy favorable, ignore, none of the above)
20) The gain from trade is maximum if the international terms of trade are ______________. (***nearer to the internal terms of trade of trading partner***, nearer to the domestic terms of trade of importing country, equal to exporting country, none of the above)
21) An offer curve differs from ______________. (***usual demand and supply curves***, usual demand curve, usual supply curve, none of the above)
22) International trade increases the welfare of ______________. (***all participating countries***, only exporting country, only importing country, only developed countries)
23) International trade results in ______________. (***all of the given below***, innovations, reduction in costs, diversifies consumption)
24) Cultural changes due to international trade are .... (***positive and negative***, only positive, only negative, none of the above)
25) The concept of gross barter terms of trade was introduced by .... (***Frank Taussing***, Alfred Marshall, Francis Edgeworth, John S. Mill)
26) The concept of income terms of trade was introduced by .... (***Graeme S Dorrance***, Frank W Taussig, David Ricardo, Francis Edgeworth)
27) Utility terms of trade was introduced by .... (***Jacob Viner***, Adam Smith, J.S. Mill, Frank Taussig)
28) The concept of offer curves was introduced by .... (***A marshall and F Edgeworth***, Adam Smith and David Ricardo, John S. Mill and John M Keynes, None of the above)
29) Terms of trade will be favourable to a country when .... (***all of the given below***, its exports have inelastic demand, its imports have elastic demand, its supply of exports is elastic)
30) The offer curve of a country is based on .... (***relative prices of two commodities***, price of exports, price of imports, supply of exports)
31) A country will have unfavourable terms of trade when .... (***imports have inelastic demand***, imports have elastic demand, exports have elastic, supply, none of the above)
32) When supply of exports is elastic, a country will have .... Terms of trade. (***favourable***, unfavourable, different, none of the above)
33) The concept of reciprocal demand was introduced by .... (***J.S. Mll,*** J.M. Keynes, G. S. Dorrance, F.W. Taussig)
34) Reciprocal demand is expressed in terms of .... (***Offer curves***, supply curves, demand curves, cost curves)
35) The classical theory of international trade was presented by .... (***David Ricardo***, Hecksher- Ohlin, J. M. Keynes, Alfred Marshal)

36) Heckshev – Ohlin theory states that the relative factor prices in two countries are determined by .... (***differences in factor endowments***, labour efficiency, technological developments, none of the above)

37) Hecksher-Ohlin theory is also known as .... theory of international trade. (***modern***, traditional classical, none of the above)

38) Under .... type of cost difference, international trade will not take place. (***equal***, absolute, comparative, none of the above)

MODULE – I: TRUE OR FALSE WITH REASONS

1) ***The higher the difference in cost ratios, the greater will be the gains from international trade.***

Ans: TRUE

Reason: Cost differences between trading countries lead to international division of labour, and thereby, facilitates specialization. Larger the cost differences on account of specialization, larger will be the gains from international trade.

2) ***International Trade brings in many dynamic gains.***

Ans: TRUE

Reason: International trade brings in many dynamic gains in terms of technological advancement, innovation. Social and cultural welfare, increase in investments, etc. These dynamic changes are possible on account of competition, improvement in efficiency, economies of large scale, etc.

3) ***Comparative cost advantage theory cannot be extended to more than two countries.***

Ans: FALSE

Reason: Comparative cost advantage theory can be extended to all commodities and to all countries. Each country can specialize in the production of those commodities in which it enjoys comparative advantage and export the surplus. It will import those items which are available at a lower price than at home.

4) ***Ricardian theory can be explained in terms of labour units only and not in money terms.***

And: FALSE

Reason: The Ricardian theory can be explained in labour units as well as in money terms. The benefits of specialization can be calculated not only in labour units but also in money terms.

5) ***A Country that enjoys comparative cost advantage in two commodities. Yet it may specialize in the production of one commodity in which it enjoys greater comparative cost advantage.***

Ans: TRUE

Reason: According to David Ricardo, even when a country has absolute advantage in the production of two commodities, yet it can specialize in the production of that commodity in which it has greater comparative advantage, and the other commodity can be produced by another country. In this way, both countries can gain due to international trade.

6) ***Comparative cost theory is based on cost of supply but ignores demand.***
Ans: TRUE
Reason: The comparative cost advantage theory concentrates on the supply of goods. Each country focuses on the production of a commodity based on its comparative cost advantage. This theory explains international terms of trade from supply side (exporting country's point of view), and but does not consider the demand of the importing country.

7) ***The comparative cost theory is not applicable to the real world.***
Ans: False
Reason: Supporters of Ricardian theory argued that all the restrictive assumptions of the comparative cost theory could be relaxed and make the theory practical to the real world situation where each country specialize in the production of those goods and services in which it has comparative cost advantage under the changing conditions.

8) ***Hecksher Ohlin theory is based on unrealistic assumptions.***
Ans: TRUE
Reason: *It is based on several unrealistic assumptions, such as:*
a) There is perfect competition in both commodity and factor markets.
b) There are no restrictions on trade in form of tariff and non-tariff barriers.
c) There are no transport costs.
d) Full employment of factors of production exists in both participating nations.
e) There are two countries, two factors, and producing two commodities etc.

9) ***Hecksher Ohlin theory is based on mutual interdependence of commodity and factor market.***
Ans: TRUE
Reason: Ho theory states that a nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import that commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor. Thus, the OH theory is based on mutual interdependence of commodity and factor market.

10) ***According to Hecksher Ohlin theory, international trade is a special case of inter-regional trade.***
Ans: TRUE
Reason: According to HO theory, International trade is a special case of interregional trade. Factor immobility which was the base for a separate explanation of international trade by classical economists does not hold good as factors are mobile and immobile even between two regions of the same country. And also between two nations. It is the difference in degree rather than in nature.

11) ***In Hechsher Ohlin theory, factor intensity is measured in absolute terms.***
Ans: FALSE
Reason: In HO theory, factor (capital or labour) intensity is not measured in absolute terms but by the capital-labour (K/L) ratio, i.e., units of capital per labour units of units of labour per capital units.

12) ***Hecksher Ohlin theory is disproved on the basis of Leontier's Paradox.***
Ans: TRUE
Reason: According to HO theory, developed countries like USA being capital abundant must export capital intensive goods and import labour intensive goods than produce them at home, as labour is scarce and costly. However, W.W Leontief conducted an empirical study and found that a developed country like USA exports labour intensive goods and imports capital intensive ones.

13) ***According to Hecksher Ohlin theory, factor abundance results in low factor cost.***
Ans: TRUE
Reason: According to HO theory, abundance of a factor makes it cheaper in terms of its price, Low factor prices result in low cost of production. And in turn low commodity prices. This theory states that low commodity price is the basis of international trade.

14) ***Commodity (net barter) terms of trade compares income from exports.***
Ans: FALSE
Reason: The commodity or net barter temrs of trade is the ratio of the export prices to import prices. Therefore, it compares income inflow from exports with that of income outflow of exports. For this purpose the index number of a nation's export and import prices of the base period and the current period is used for comparison.

15) ***Commodity terms of trade do not consider quality of goods.***
Ans.: TRUE
Reason: The commodity terms of trade consider only prices and changes therein. Changes in price ratios indicate the changes in terms of trade. Price changes may also take place due to changes in quality for instance, improvement in quality may command higher prices. However, commodity terms of trade do not take into account the changes in quality of exports or imports.

16) ***Gross barter terms of trade include items other than traded goods.***
Ans: TRUE
Reason: Frank W Taussig developed the concept of gross barter terms of trade to overcome the limitations of net barter terms of trade. The gross barter terms of trade include unilateral transfer to determine and terms of trade. However, net barter terms of trade do not include unilateral transfer to determine the terms of trade.

17) ***Reciprocal demand does not affect terms of trade.***
Ans: FALSE
Reason: Law of reciprocal demand was given by J.S. Mill. Reciprocal demand refers to the relative strength and elasticity of demand of two participating nations for each other's product. The relative strength and elasticity of demand affects the terms of trade.

18) ***Income terms of trade measures a nation's capacity to import from export income.***
Ans: TRUE
Reason: The changes in income terms of trade depend on volume and price of exports an improvement in income terms of trade indicates the increased capacity of a nation to import, hence, some economists consider it as a better explanation of gains of trade.

19) ***Economic development affects terms of trade.***
Ans: TRUE
Reason: Economic development of a nation results in dynamic changes in the economy, thereby, leading to changes in composition and direction of its trade. Economic development leads to technological advancement, quality improvement, innovation, improved efficiency of labour, etc., which in turn to changes in terms of trade.

20) ***Offer curves are demand and supply curves.***
Ans: FALSE
Reason: The offer curves developed by Alfred Marshal and Francis Edgeworth differ from the ordinary demand and supply curves. For instance, the ordinary demand curve expressing various quantities of a commodity demanded at different prices, normally slope downwards from left to right, and the ordinary supply curve expressive the various quantities of a commodity supplied at different prices slopes upwards for one commodity in terms of the other, as the supply of one commodity in return for the other.

21) ***International trade increases consumption level of participating countries.***
Ans: TRUE
Reason: Interantional trade increases world output, as countries maks best use of resources to produce and export those commodities in which they enjoy comparative cost advantage, and import those items which are cheaper from abroad. The international trade facilitates specialization and therefore, the world output increases. As a result the consumption level of participating countries increases.

22) ***International trade increases welfare of only exporting nations.***
Ans: FALSE
Reason: International trade results in increased producing due to specialization. Increase in production leads to higher consumption. As a result the economic welfare of the participating countries both exporting and importing countries increase. International trade also improve social and cultural welfare of participating countries.

23) ***Intense demand for imports increases gains from trade.***
Ans: FALSE
Reason: The exact terms of trade depend on the reciprocal demand, i.e., relative strength and elasticity of demand of a nation for the product of another nation. The reciprocal demand is explained in terms of offer curves that determine the terms of trade and also the extent of gains. The position of the offer curve influences the gains. A shift in the offer curve changes the extent of gains from trade. A shift in the offer curve of a nation takes place when its demand for the other nation's commodity is not intense.

24) ***Gains from trade are not confined to economic aspects only.***
Ans: TRUE
Reason: Gains from trade are also on account of dynamic gains. This is because; international trade results in changes in terms of technology, socio-cultural changes, changes in tastes and preferences, etc.

25) ***When the price of exports is greater than the price of imports, the terms of trade will be favourable to the country.***

Ans: TRUE

Reason: When the price of exports is greater than the price of imports, the net inflow of foreign exchange will be more. Therefore, such a nation will enjoy favourable terms of trade.

26) ***When a nation exports mainly primary goods, it will enjoy better terms of trade.***

Ans: FALSE

Reason: When a nation, exports mainly primary goods such as agricultural items, it will suffer from adverse terms of trade. This is because; the price of primary goods is low in the international markets. Therefore, the value of its exports will be lower, and as such it will suffer from unfavourable terms of trade, especially when its imports are mainly manufactured goods.

MODULE – II: SELECT CORRECT OPTION

CHOOSE THE CORRECT OPTION AND REWRITE THE STATEMENTS:

1) Unilateral transfers _________. (***all of the below***, are unrequited transfers are one-way transfers, include gifts/remittances)
2) Unilateral flows in the balance of payment account refer to _________. (***Gifts and grant***s, capital flows, visible goods flows, invisible flow of services)
3) The full form of TRIMs is _________. (***Trade Related Investment measures***, trade related insurance measures, trade related investment method)
4) WTO was set up on _________. (***1st January 1995***, 1st June, 1985, 31st July, 1995, 1st January, 2000)
5) GATS stand for _________. (***General Agreement on Trade in Services***, General Agreement on Tariff and Services, General Agreement on Transport and Services)
6) Autonomous capital flows _________ other items in the balance of payments. (***are independent of***, depend on, are related to, have impact on)
7) The current account in the balance of payments _________. (***includes merchandise trade and services***, is a total of all the visible items of trade, includes borrowings, includes autonomous and accommodating flows).
8) A deficit in India's Balance of Trade in recent times is due to _________. (***all of the below***, rise in price of crude oil, increase in imports, reduction in exports)
9) Good performance on _________ has helped India to reduce its current a/c balance deficit in recent times (***invisible account***, Trade account, capital account)
10) There is an increase in _________ on India's capital a/c in recent times. (***non-debt foreign investment flows***, private transfers, private remittances, unilateral receipts).
11) After covering deficits on current a/c, excess capital a/c receipts are added to _________. (***foreign exchange reserves***, IMF account, official transfers)
12) Bank capital on India's capital a/c. includes _________ (***foreign currency deposits – NRI deposits***, foreign exchange reserves local withdrawal from NRI rupee deposits, official transfers)

13) Private transfers on India's current account include ______. (***Local withdrawal from NRI rupee deposits***, foreign currency deposits, foreign exchange reserves)
14) International trade increases the welfare of _________. (***all participating countries***, only exporting countries, only importing countries, none of the above)
15) WTO agreements incorporated _________ proposals (***Arthur Dunkel***, Adam Smith, David Ricardo, John M. Keynes)
16) _________ has given mandate to negotiate multilateral rules relating to services. (***WTO***, World Bank, IMF, ADB)
17) Foreign direct investment is a part of _________ (***Capital account***, trade account, Current account, none of the above)
18) External borrowing is treated as _________ flow. (***Accommodative***, Autonomous, Invisible, none of the above)
19) Foreign exchange reserves of India include _________ (***All of the below***, Special drawing Rights, Foreign Currency reserves, Reserve Tranche of IMF)
20) The highest authority of WTO is _________. (***The Ministerial Conference***, The Trade Policy Review Body, The General Council, The Dispute settlement Body).
21) The Agreement on Agriculture does not aim at _________. (***increasing export subsidies***, improving market access, reducing domestic subsidies, reducing domestic support)
22) Intellectual property rights include _________. (***All of the below***, copyrights, layout designs, trade marks)
23) The current account balance of BOP does not include _________. (***FDI***, Services exports, unilateral transfers, non-factor services)
24) _________ is not a part of unilateral transfers (***Short term loans***, gifts, donations, remittances by workers)
25) _________ is not a direct measure to correct BOP disequilibrium. (***Devaluation of exchange rate***, quotas, tariffs, import substitution)
26) When BOP disequilibrium is chronic in nature and lasts for a long time, it is a sign of _________ disequilibrium. (***fundamental***, cyclical, structural, monetary)
27) Disequilibrium due to changes in demand pattern for exports or imports, it is a case of ____ Disequilibrium. (***structural***, Cyclical, long term, short-term)
28) TRIMs agreement refers to treating foreign investment at _________ with domestic investment (***par***, premium, discount, inequity).
29) The effectiveness of devaluation depends on _________. (***All of the below***, International cooperation, elasticity of demand for merchandise goods, elasticity of demand for services)
30) Foreign exchange reserves of India include _________. (***All of the below***, SDRs, Foreign Currency Assets, Gold Reserves)
31) In the past several years, India's capital account balance was in _________. (***surplus***, deficit, balance, none of the above)
32) Portfolio foreign, investment is included in _________ account of BOP. (***Capital***, Current, trade, debit)
33) Expenditure switching policies to correct BOP deficit include _________ of domestic currency. (***devaluation***, appreciation, revaluation, all of the above)
34) Tariffs and quotas are imposed on imports to correct BOP deficit are called as _________ measures. (***direct***, indirect, passive, all of the above)

35) The sum of the total export – import demand elasticity must be _________. (***greater than one***, equal to one, zero, less than one)

MODULE – II: TRUE OR FALSE WITH REASONS

1) ***Balance of Payments records all economic transactions between residents of a country and rest of the world.***

Ans: TRUE

Reason: Balance of payment is a systematic record of all receipts and payments between residents of a country and rest of the world during a given period of time. The BoP record shows a country's external economic position.

2) ***The highest authority of WTO is the Ministerial Conference.***

Ans: TRUE

Reason: WTO is a group of about 160 member nations including India. The member countries make their decisions through various councils and committees, whose membership consists of all WTO members Topmost is the ministerial conference which has to meet at least once every two years. The Ministerial conference can take decisions on all matters under any of the multilateral trade agreements.

3) ***Balance of trade always balances.***

Ans: FALSE

Reason: Trade balance can be in surplus or in deficit. It will be in surplus when the value of exported goods is more than imported goods. It will be in deficit when the value of imported goods is more than exported goods. In India, there is generally trade deficit. In 2009-10. India's trade deficit was US $ 118.4 billion.

4) ***Short term lending is listed on the debit side of the BoP.***

Ans. TRUE

Reason: Debit side of BoP refers to the payment side of BoP. The debit side indicates the use of foreign exchange by a country in a particular period. Short term lending results in outflow of foreign exchange.

5) ***Items that give rise to receipts of foreign currency are listed on the debit side of Bop.***

Ans: FALSE

Reason: Items that give rise to receipt of foreign currency are listed on the credit side of BoP. The credit side of BoP indicates the sources from which the country has received the foreign exchange. The credit side items results in inflow of foreign exchange, and therefore, they are recorded on the receipts side (credit side) of BoP.

6) ***The purpose of WTO is to remove restrictions in international trade.***

Ans: TRUE

Reason: WTO was formed in 1995 to expand world trade and development. WTO aims at removal of restrictions on international trade like Trade without discrimination, promoting fair competition etc. The member nations have signed a number of agreements to expand international trade and development such as TRIPS, TRIMS, GATS, Agreement on Agriculture (AOA), etc.

7) ***In recent times, India's receipts on invisible accounts have played an important role on BoP front.***
Ans: TRUE
Reason: Net invisible, particularly the non-factor receipts, and private transfer have contributed in covering the trade deficit and helped to overcome the problems of BoP. In 2009-10, the net invisibles were US $ 80 billion.

8) ***Cyclical transmission causes disequilibrium in BoP.***
Ans: TRUE
Reason: Business cycles affect international trade. Low income and low demand are transmitted from one country (few developed countries) to another (rest of the world) .

9) ***Depreciation of a currency makes the imports cheaper.***
Ans: FALSE
Reason: Depreciation makes imports costlier. Due to depreciation of the domestic currency, the importer has to pay more in terms of domestic currency. However, appreciation of domestic currency makes imports cheaper.

10) ***Depreciation of a currency makes exports cheaper.***
Ans: TRUE
Reason: Depreciation makes exports cheaper to the foreign buyers. The foreign buyers need to pay less in terms of foreign currency.

11) ***Devaluation means official reduction in the value of the domestic currency.***
Ans: TRUE
Reason: The policy of devaluation leads to lowering the value of domestic currency vis-à-vis foreign currency. Due to devaluation, exports become cheaper and imports become costlier. Therefore, the exports of the country may increase, and the imports may decrease. As a result, the deficit in balance of trade can be corrected.

12) ***Most favoured Nation clause under WTO implies that some countries have more advantage in trade.***
Ans: FALSE
Reason: MFN Clause implies that every member nation of WTO must treat all other members equally as the most favoured trading partner. The MFN clause prevents discrimination by a country of some member nations. For instance, if USA gives tariff concessions to Japan, then such tariff concessions must be provided to other members of WTO.

13) ***The agreements of WTO are related to only non-agricultural goods.***
Ans: FALSE
Reason: The agreements of WTO are related to agricultural and non- agricultural goods and services. For instance, the Agreement on Agricultural aims at promoting agricultural by removing restrictions on agricultural trade, such as reduction in import duties, reduction in export subsidies, reduction in domestic support, and market access to agricultural imports.

14) ***Foreign exchange reserved increase when deficit in current account is more than capital account surplus.***

Ans: FALSE

Reason: When current account deficit in BoP is more than capital account surplus, the foreign exchange reserves will decrease. Foreign exchange reserves will increase only when:

Both the current account and capital account show a surplus.

The surplus in current account is more than the deficit in capital account.

The surplus in capital account is more than the deficit in current account.

15) ***Balance of Payments always balances in accounting sense.***

Ans: TRUE

Reason: Balance of payments record is based on double entry book keeping system. This system states that for every transaction entry. There is corresponding debit and credit.

16) ***A chronic disequilibrium is also called as 'fundamental disequilibrium'.***

Ans: TRUE

Reason: A chronic disequilibrium is long term in nature. It persists for a long period of time mainly on account of fundamental problems. It is difficult to overcome chronic disequilibrium. It is caused due to continous increase in demand for foreign currency rather than the supply of foreign currency.

17) ***Immediate effect of globalization is a surplus in BoP of all countries.***

Ans: FALSE

Reason: Globalisation has liberalized the world trade. Restrictions on imports and exports have been withdrawn by most countries. Therefore, in the short-run, the developed countries are in a better position to increase their exports, whereas, the developing countries face problems to increase exports due to increase in global competition. Therefore, most of the developing countries face BoP deficit on account of globalization, at least in the short-run.

18) ***Devaluation of domestic currency makes exports cheaper and imports costlier.***

Ans: TRUE

Reason: Devaluation means deliberate attempt by the Government to devalue the domestic currency against the foreign currencies. The main purpose is to increase exports and to reduce imports. So, exports become cheaper & imports become costlier.

19) ***Import substitution to correct BOP disequilibrium is not feasible in long run.***

Ans: TRUE

Reason: Import substitution encourages production in the home country of those goods which were earlier imported. The import substitute industry is given lot of incentives to produce import substitutes. Due to incentive and protection, the domestic producers become lethargic and adversely affect economic growth. Secondly, import substitution denies domestic consumers to get the benefit of high quality import goods. It also discourages competition between domestic producers and foreign suppliers.

20) ***TRIPs Agreement of WTO has benefited MNCs from developed nations.***
Ans: TRUE
Reason: The TRIPs agreement gives protection to patents, trademarks, copyrights, etc. The MNCs from developed countries spend huge sums of money on R&D and develop new products and get them patented. As a result of patents, the MNCs from developed countries get exclusive marketing rights in the world markets. Therefore, TRIPs agreement has benefited the MNCs from developed countries.

21) ***India is a founder member of WTO.***
Ans: TRUE
Reason: India, along with other 22 nations formed GATT in 1947 to increase trade and development of member nations. The GATT was replaced by WTO in 1995. All the GATT members automatically became members of WTO. Therefore, India is a founder member of WTO.

22) ***Agreement on Textiles and Clothing has replaced the Multi-Fiber Agreement.***
Ans: TRUE
Reason: In 1995, the MFA has been withdrawn and it is now replaced by agreement on textiles and clothing. The Agreement on textiles and clothing has removed the quotas on textiles and clothing by importing countries.

23) ***TRIPs Agreement can lead to transfer of R&D benefits to developing countries.***
Ans: TRUE
Reason: Under TRIPs agreement, protection is given to patents. Therefore, firms from developed countries spend huge amounts on R&D to improve productivity and to develop new products and new methods. The foreign firms can transfer the R&D benefits to developing countries by entering into tie-ups with domestic firms in developing countries.

24) ***The policy measures to correct BoP disequilibrium are direct measures.***
Ans: FALSE
Reason: The Policy measures such as monetary policy measures, fiscal policy measures, and exchange are rate policy measures are indirect measure that help to overcome the problem of BoP disequilibrium. The direct measures include tariffs, quotas, export promotion, and import substitution, which directly help to overcome the problem of BoP disequilibrium.

MODULE – III: SELECT CORRECT OPTION

CHOOSE THE CORRECT OPTION AND REWRITE THE STATEMENTS:

1) Hedging refers to _________. (***the covering of a foreign exchange risk***, foreign exchange speculation, the acceptance of foreign exchange risk, interest rate arbitrage)
2) Under flexible exchange rate system, exchange rate is determined by _________. (***the demand and supply of foreign exchange***, Central Bank intervention, the price of gold, none of the above)

3) Functions of forex market include __________. (***all the below***, provision of facilities for funds transfer, trading, short term finance)
4) __________. of the following is not a function of the foreign exchange market? (***import and export of goods and services***, transfer of purchasing power, coverage of risk, provision of credit instruments and credit)
5) __________ helps to equalize the exchange rate in all part of the foreign exchange market. (***speculation***, interest arbitrage, hedging)
6) Forward market in foreign exchange refers to __________ market. (***Short and long run***, a short run, a long run, a spot)
7) Speculation in foreign exchange market refers to __________. (***accepting risk to make profits***, hedging, interest arbitrage, none of the above)
8) India adopts __________ exchange rate system. (***Managed flexibility***, fixed exchange rate, flexible exchange rate, none of the above)
9) The Rate of which the foreign currency is exchanged at current rate is called __________ Rate. (***Spot***, forward, arbitrage, none of the above)
10) Vehicle currency is __________. (***a standard internationally accepted currency***, a currency of IMF, a currency issued by RBI, none of the above)
11) Arbitrage refers to purchase and sale of an asset __________. (***at low price in one market and its simultaneous sale at higher price in another market***, at high price in one market and its sale at lower price in another market, purchase and sale at the same price, all of the above)
12) __________ is not included in the wholesale foreign exchange market. (***small investor***, RBI, FII, Commercial Bank)
13) Speculators deal in __________. (***spot and forward exchange rate***, only spot exchange rate, only forward exchange rate, none of the above)
14) Foreign exchange market is a place where __________. (***various foreign currencies are exchanged***, only foreign tourists exchange currencies, only exporters convert the foreign currencies, only importers convent the foreign currencies)
15) Flexible exchange creates __________ in importers and exporters. (***uncertainly***, confidence, safety, none of the above)
16) __________ is not a defect of flexible exchange rate. (***Stability in international monetary system***, speculation, structural unemployment, discourages investments)
17) Under __________ exchange rate system, the exchange rate is determined by market forces. (***flexible***, fixed, managed float, all of the above)
18) Under __________ Exchange rate system, the central bank of a nation intervenes in exchange rate determination (***managed float***, fixed, flexible, none of the above)
19) Fixed exchange rate system, the exchange rate was __________. (***Stable***, unstable, fluctuating, all of the above)
20) The modern foreign exchange market operates under __________ rate system. (***floating***, fixed, highly managed float, all of the above)
21) In exchanges rate determination, the first currency in the currency pair is called __________ currency (***base***, soft, negotiable, hard)
22) __________ is not a feature of foreign exchange market, (***Limited Geographical Coverage***, Highly Liquid Market, Huge Value Market, None of the above)

23) _______ is a feature of foreign exchange market, (***operates 24 hours for 5 days in a week***, operates 24 hours for all 7 days in a week, operates 365 days in a year, None of the above)

24) _________ enables an investor to earn high returns while minimizing capital risks. (***Leverage***, Liquidity, Reserves, All of the above)

25) Transaction in foreign exchange market has become quicker due to _________. (***advanced technology***, Government Initiatives, IMF, World Bank)

26) Society for worldwide interbank financial Telecommunications (SWIFT) is a _________ communication network that facilitates 24 hours secure international exchange of payment instructions between banks, central banks, multinational corporations, and major securities firms (***Global***, Local, National, None of the above)

27) The functions of foreign exchange market that helps in clearing international transactions is known as _________. (***transfer***, credit, hedging, speculaion)

28) Provision of documentary exchange market, which is concerned with fixing of forward exchange rates is known as ________. (***Hedging***, speculation, arbitrage, transfer)

29) The foreign exchange rate of a nation is influenced by _________. (***all of the below***, speculators, hedgers, arbitrators)

30) The foreign exchange rate of a nation is influenced by _________. (***all of the below***, BoP, Interest rate, speculation)

31) _________ is not a feature of spot exchange rate. (***Clearing of payment takes place fairly long period***, demand and supply of foreign currency determines the rate, current exchange rate, all of the above)

MODULE – III: TRUE OR FALSE WITH REASONS

1) ***Exporters and importers hedge foreign exchange risks.***

Ans: TRUE

Reason: Exporters enter into hedging contacts to cover foreign exchange risk that may arise on account of appreciation of domestic currency at a future date when they would be getting their payments from importers. The importers enter into hedging contracts to cover foreign exchange risk that may arise on account of depreciation of domestic currency at a future date when they would be making the payments to the exports.

2) ***The main function of foreign exchange market is to earn foreign exchange.***

Ans: FALSE

Reason: The main functions of foreign exchange markets are Transfer of purchasing power, Provision of credit and credit instruments and Coverage of risk.

3) ***In Indian foreign exchange market, money changers operate in retail market.***

Ans: TRUE

Reason: Well established stores, hotels, travel agents, and others are permitted to buy and sell foreign currency asset to their customers. The exchange of currencies enables money changers to expand their business activities.

4) ***Commercial banks participate in retail and wholesale foreign exchange market.***
Ans: TRUE
Reason: Commercial banks participate in retail foreign exchange market when they deal with their clients relating to foreign exchange transactions. The commercials banks participate in wholesale foreign exchange market when they receive from and make payment in foreign currency to other banks involving large amount of foreign currency.

5) ***There is single exchange rate in foreign exchange market.***
Ans: FALSE
Reason: There is a variety of exchange rates in the foreign exchange market. For instance, there is spot rate at which immediate delivery of foreign exchange has to be made. There is also forward exchange rate, which is the outcome of forward transaction in forward currency markets. Further there are other rates such as sight rate (documents against payment), and usance rate (documents against acceptance of bills)

6) ***Spot exchange rate is the current exchange rate between the two currencies.***
Ans: TRUE
Reason: Speculations deal in spot exchange rate market to buy or sell at a current rate and the payment (in case of buying) or delivery of speculators deal in spot exchange rate with the expectation of changes in the exchange rate market in the near future.

7) ***Hedgers enter foreign exchange market to speculate in foreign currency rates.***
Ans: TRUE
Reason: Hedgers enter foreign exchange market to cover foreign exchange risk. For instance, an exporter may enter into hedging contract to protect him from the risk due to exchange rate in fluctuation, i.e., possible appreciation of the domestic currency. The Importers also enter in hedging contracts to protect them from the risk due to possible depreciation of the domestic currency.

8) ***Arbitrage eliminates difference in exchange rate in different markets.***
Ans: TRUE
Reason: Nowadays, in well-connected and advanced markets, arbitrage differences may not be common. And as arbitrageurs are mainly banks, they may spot the arbitrage difference quickly, exploit the opportunity, and over a passage of time, such opportunities vanish and equilibrium is established. The differences in exchange rates in two markets may be for a short period of time due to the differences in demand and supply faced by different banks or traders in foreign exchange market.

9) ***Forward exchange rate is determined at a future date.***
Ans: FALSE
Reason: Forward exchange rate is the rate of forward transactions in foreign currency. Forward transactions involve an agreement entered at a current date to purchase/sell certain amount of foreign currency at a certain rate on a specified future date.

10) ***Interest Rate Arbitrage can be covered.***

Ans: TRUE

Reason: Generally, investors of short term funds abroad want to avoid the foreign exchange risk. Therefore, interest arbitrage is covered. To do this, the investor exchanges the domestic currency for foreign currency at the current spot rate in order to purchase the short term securities from abroad, and at the same time, the investor sells forward the amount of foreign currency which he is investing plus the interest that he will earn so as to coincide with the maturity of foreign investment.

11) ***Speculators deal in spot exchange rate market and forward exchange rate market.***

Ans: TRUE

Reason: Speculators deal in spot exchange rate market to buy or sell at a current rate and the payment or delivery of foreign currency must be immediate. The speculators deal in spot exchange rate with the expectation of changes in the exchange rate market in the near future.

The speculators also enter in the forward exchange rate market in which the transactions at entered at a current date to purchase / sell foreign exchange at a certain rate at a specified future date.

12) ***Speculations may have stabilizing as well as destabilizing effect on the economy.***

Ans: TRUE

Reason: Stabilizing speculation refers to the purchasing/selling foreign currency with the expectation of charges in exchange rate. For instance, the speculator will sell the foreign currency when its price increase with the expectation that its price will soon fall, and another speculator may purchase foreign currency when its price falls with the expectation that its price will soon rise. This leads to stabilization effect.

De-Stabilizing effect takes place when a sale of foreign currency takes place when its exchange rate falls with the fear that its price will fall further. The speculator may also buy a foreign currency when it exchange rate rises with the expectation that it would rise further. Destablising speculation increase exchange rate fluctuations and have disruptive effective on international flow of trade and investment.

13) ***Tringular arbitrage takes place when three currencies and three monetary authorities are involved.***

Ans: TRUE

Reason: When three currencies and three monetary authorities are involved, it is called as triangular arbitrage. Triangular arbitrage operates in similar like that of two point arbitrage. It increases the demand for cheaper currency and increases the supply of dearer currencies, thereby, eliminating the differences in exchange rates at different exchange centres.

14) ***Short position takes place when a speculator sells a foreign currency.***

Ans: TRUE

Reason: Under short position, the speculator sells a foreign currency in the forward exchange market with the expectation of buying it at a lower price in future.

15) ***Primary dealers deal in two way quotes.***
Ans: TRUE
Reason: The primary dealers, such as banks quote a two-way rate, i.e., buy rate and sell rate. The buy rate is little than the sell rate of exchange. The difference in the buy rate and the sell rate is the margin of the primary dealers.

16) ***The foreign exchange market is the largest market in the world.***
Ans: TRUE
Reason: The foreign exchange market is the largest market and the most liquid market in the world. Daily billions of dollars are exchanged between different foreign exchange market centres across the globe.

17) ***In India, only RBI deals in foreign exchange market.***
Ans: FALSE
Reason: There are various participants that deal in foreign exchange market in India other than RBI. The various participants include commercial banks. Financial institutions, foreign exchange brokers, investment firms, authorized dealers and money changers.

18) ***Hedging facilitates international trade.***
Ans: TRUE
Reason: Exporter and importers enter in hedging contracts to protect against foreign exchange risk. Due to coverage of foreign exchange risks, the exporters and importers gain confidence, and therefore, they enter into foreign trade contracts, which facilitate the growth of foreign trade.

19) ***In managed float, there is less chance of speculation.***
Ans: TRUE
Reason: In managed float there is intervention of the central bank to overcome the problem of fluctuations in exchange rate. The central bank's intervention in exchange rate market reduces the chances of speculation, because the speculators do not have many opportunities to speculate in the foreign exchange market. Speculators get good opportunities in the flexible exchange rate market.

20) ***Forward exchange rate may be at a premium or at a discount.***
Ans: TRUE
Reason: When the forward rate is above the present spot rate, the foreign exchange rate is said to be at a premium. This means, the party concerned has to make payment in foreign currency or to receive foreign currency at a higher value at a future date than the current spot rate.
When the forward rate is below the current spot rate, the foreign exchange rate is said to be at a discount. This means, the party concerned has to make payment in foreign currency or to receive foreign currency at a higher value at a future date than the current spot rate.
When the forward rate is below the current spot rate. The foreign exchange rate is said to be at a discount. This means, the party concerned has to make payment in foreign currency or has to receive foreign currency at a lower value at a future date than the current spot rate.

21) ***Technology has boosted the growth of foreign exchange market.***
Ans: TRUE
Reason: Technology facilitates quick transactions in the foreign exchange market. For instance, SWIFT facilitates quick communications between banks in different countries relating to foreign exchange transactions.

22) ***Foreign exchange market has a wide geographical coverage.***
Ans: TRUE
Reason: The foreign exchange market has a wide geographical coverage spread across different continents of the world. This is because; every country in the world has to enter in foreign exchange transactions for imports, exports, investments, unilateral transactions and so on.

MODULE – IV: SELECT CORRECT OPTION

CHOOSE THE CORRECT OPTION AND REWRITE THE STATEMENTS:

1) The demand for foreign currency arises due to ___________. (***imports***, exports, investments from abroad, none of the above)
2) The supply of foreign currency is on account of ___________. (***exports***, imports, investments abroad)
3) ___________ rate is the rate at which a nation's currency is exchanged for some other nation's currency. (***Exchange***, Transfer, Negotiating, All of the above.)
4) The demand curve for foreign exchange slopes ___________ indicating that when the exchange rate of foreign currency falls, the demand for it increases. (***downwards***, upwards, sideways, none of the above
5) The supply curve for foreign currency slopes ___________ indicating that when the exchange rate of foreign currency increases, the supply of it increases. (***upwards***, downwards, sideways, all of the above)
6) If there is more demand for foreign currency, then foreign currency will ___________. (***appreciate***, depreciate, nil effect, none of the above)
7) When the demand curve for foreign currency, intersects the supply curve, we get ___________ exchange rate. (***equilibrium***, premium, discount, par)
8) Theory of purchasing power parity ___________. (***neglects capital account transactions***, includes transportation cost, includes prices of non-traded goods, applies only in short run)
9) Purchasing Power Parity Theory was propounded by ___________. (***Gustav Cassel***, David Ricardo, Adam Smith, None of the above).
10) Purchase of foreign currency by the monetary authority ___________ the appreciation of domestic currency. (***prevents***, aggravates, leads to)
11) ___________ is monetary authority's intervention to prevent forex fluctuations through M Policy instruments. (***Sterilized Intervention***, bank rate, open market operations, Un-sterilized intervention)
12) ___________ is monetary authority's intervention by purchase/sale of foreign current to prevent fluctuations in foreign exchange. (***Unsterilized Intervention***, Sterilized intervention, bank rate policy)
13) ___________ of goods results in demand for foreign currency. (***Import***, export, sale in domestic market, none of above)

14) ___________ results in supply of foreign currency. (***Unilateral receipts***, unilateral payments, investment abroad, none of above)
15) Equilibrium exchange rate is determined when ___________. (***the demand curve for foreign currency intersects with supply curve***, demand curve shifts upwards, supply curves slopes downwards, none of the above)
16) Exchange rate between two currencies is based on ___________. (***purchasing power of two currencies***, economic development of the two nations, political stability in the two countries, none of the above)
17) Critics of Purchasing Power Parity theory state that it has limited application for ___________ countries (***Large***, small, medium –sized, none of the above)
18) PPP Theory considers that goods in different countries are ___________. (***Identical***, differential, superior, none of the above)
19) PPP Theory ignores capital flows on account of ___________. (***capital account***, trade account, current account, none of the above)
20) There is a ___________ relationship between demand for foreign currency and the exchange rate. (***direct***, inverse, negative, indirect)
21) There is a ___________ relationship between supply of foreign currency and the exchange rate. (***direct***, inverse, negative, indirect)
22) LERMS was introduced in India in ___________. (***1992***, 2000, 2002, 2012)
23) Under managed float, the central bank of a nation intervenes to ___________ foreign currency. (***Purchase and sell***, only purchase, only sale, none of the above)
24) Under flexible exchange rate system, the exchange rate is determined by ___________. (***market forces***, central bank, commercial banks, none of the above)
25) Under IMF, the exchange rate system was ___________. (***gold standard***, currency board system, dollarization, none of the above)

MODULE – IV: TRUE OR FALSE WITH REASONS

1) ***The Purchasing Power Parity Theory is based on the international purchasing power of any 2 currencies.***

Ans: FALSE

Reason: The PPP theory is based on the internal purchasing power of any two currencies. According to absolute PPP, a rise in the domestic price level in relation to foreign price level will lead to proportional depreciation of domestic currency. The relative version of PPP theory states that the exchange rate will adjust by the amount of inflation deferential.

2) ***There is only a single exchange rate in the foreign exchange market.***

Ans: FALSE

Reason: There is a variety of exchange rates in the foreign exchange market. For instance, there is spot at which immediate delivery of foreign exchange has to be made. There is also forward exchange rate, which it the outcome of forward transactions in forward currency. Further there are other rates such as sight rate (documents against payment), and usance rate (documents against acceptance of bills).

3) ***Demand for foreign currency varies inversely with the rate of exchange.***

Ans: TRUE

Reason: The total demand for foreign currency is inversely related to foreign exchange rate. At a higher exchange rate – depreciation of domestic currency (say 1 US $ = ` 50), the demand for foreign currency may be lower; and at lower exchange rate – appreciation of domestic currency (say 1 US $ = ` 40), the demand may be higher. The demand for foreign currency arises due to various payment such as import of goods, investments abroad, unilateral payments, etc.

4) ***Supply o foreign currency varies directly with the rate of exchange.***

Ans: TRUE

Reason: The aggregate supply of foreign currency is directly related to foreign exchange rate. At a higher exchange rate – depreciation of domestic currency, the supply of foreign currency will be higher. And at a lower exchange rate – appreciation of domestic currency, the supply will lower. The supply of foreign currency comes from various receipts such as export of goods / services, unilateral receipts, investments from abroad, etc.

5) ***LERMS in India was introduced with a dual exchange rate system.***

Ans: TRUE

Reason: In 1992, RBI introduced LERMS. Under LERMS, a dual exchange rate was introduced on trade account – 40% of foreign exchange receipts to be surrendered to RBI at official exchange rate and 60% of foreign exchange earnings to be converted into Indian Rupees at market determined exchange rate. In 1993-94 budget, Indian Rupee was made fully convertible on trade account, and therefore, LERMS was withdrawn.

6) ***Indian has full convertibility of rupee both on the current and capital accounts.***

Ans: FALSE

Reason: In April 1994, Rupee was made fully convertible on current account. This means from April 1994 all transactions of goods and services were converted at market rate with no restrictions. However, there is partial convertibility of Rupee on capital account transactions.

7) ***India's liberalization measures in foreign exchange market include replacement of FERA by FEMA***

Ans: TRUE

Reason: FEMA was introduced in 1999 by replacing FERA. The FERA 1973, regulated / controlled foreign exchange transactions. FEMA placed emphasis on management of foreign exchange, and made foreign exchange transactions easier such as obtaining funds by Indian firms from abroad, investment by foreign firms in India, and so on.

8) ***In managed exchange rate system, the Central Bank intervenes to bring the required stability in the exchange rate.***

Ans: TRUE

Reason: Under managed flexibility, the Central Bank intervenes in exchange rate determination to bring about the required stability in exchange rate. For instance, if there is too much depreciation of the local currency, the Central Bank would release or sell foreign currency in the market so that supply of foreign currency increases, thereby, foreign currency would depreciate and domestic would appreciate to a reasonable level which in turn would bring stability in exchange rate.

9) ***Under free float, the central bank controls exchange rate.***
Ans: FALSE
Reason: Under free float, the central bank does not intervene in exchange rate determination. The exchange rate is determined by market forces, i.e., demand for foreign currency, and the supply of foreign currency. If the demand for foreign currency increases, the foreign currency appreciates. When the supply of foreign currency rate increases; the foreign currency depreciates, and vice-versa.

10) ***The demand curve slopes downwards when the domestic currency appreciates. OR***
The demand curve slopes downwards when the exchange rate is lower.
Ans: TRUE
Reason: When the domestic currency appreciates, the foreign currency depreciates. Therefore, there will be more demand for foreign currency at a lower exchange rate. And therefore, the demand curve slopes downwards when the domestic currency appreciates.

11) ***The demand for foreign currency depends on elasticity of demand for imported goods.***
Ans: TRUE
Reason: If the demand is highly elastic, The demand for imported goods will fall sharply in the importing country with an increase in exchange rate. If the demand is highly inelastic, the demand for imported goods will remain more or less same in the importing country irrespective of exchange rate.

12) ***Purchasing Power parity theory ignores capital transfers.***
Ans: TRUE
Reason: The PPP theory takes into account only trade in merchandise. It excludes trade in services, capital transfer and unilateral transfers. All such items create demand for and supply of foreign exchange, which in turn influences exchange rate.

13) ***Purchasing Power Parity theory ignores specialization in international trade.***
Ans: TRUE
Reason: The PPP theory ignores specialization effect in international trade. Countries specialize in those items in which they enjoy superior cost advantage, and accordingly produce and export such items. However, the PPP theory considers the relative purchasing power of currencies for a similar basket of goods and services.

14) ***Purchasing Power Parity Theory considers elasticity of reciprocal demand.***

Ans: FALSE

Reason: PPP theory does not consider elasticity of reciprocal demand in the two countries. For instance , the demand market due to various factors. However, the demand for a particular commodity may be inelastic in the foreign country. Such demand differences influence the exchange rate between nations.

15) ***The central bank adopts tight monetary policy to correct BoP problem.***

Ans: TRUE

Reason: Tight monetary policy leads to reduction in money supply and increase in interest rates. Therefore, savings will increase and consumption may reduced, which in turn may lead to fall in prices. The fall in prices may increase exports, and therefore, there can be more inflow of foreign exchange, which in turn can correct BoP problems.

16) ***Central Bank adopts only direct intervention in influencing exchange rate.***

Ans: FALSE

Reason: Central bank adopts direct as well as indirect intervention. Under direct invervention, the central bank undertakes foreign exchange transactions to influence exchange rate. Under indirect intervention, the central bank influences the exchange rate indirectly through capital controls, taxes and restrictions on international transactions in assets, etc.

17) ***Currently RBI intervenes to the minimum possible level in exchange rate determination.***

Ans: TRUE

Reason: Currently RBI intervention in exchange rate determination is to the minimum possible level. RBI intervenes in the foreign exchange market only to mange sharp volatility and sharp depreciation of the Indian Rupee.

MODEL QUESTIONS PAPER

Q.1. ATTEMPT ANY TWO FROM THE FOLLOWING: (15)

a) Discuss the classical theories of International trade.
b) Describe the gains from international trade with the help of offer curves.

Q.2. ATTEMPT ANY TWO FROM THE FOLLOWING: (15)

a) What is BOP? Discuss its structure.
b) Discuss the trends in India's BOP since 1991.
c) Write a note on TRIPs and TRIMs Agreements of WTO.

Q.3. ATTEMPT ANY TWO FROM THE FOLLOWING: (15)

a) What is Foreign Exchange Market? Discuss its functions.
b) Discuss the various transactions conducted in Foreign Exchange Market.
c) Write a note on Managed Flexibility its merits and demerits.

Q.4. ATTEMPT ANY TWO FROM THE FOLLOWING: (15)

a) Discuss the determination of equilibrium exchange rate.
b) Critically evaluate Purchasing Power Parity Theory.
c) Discuss The RBI's intervention in foreign exchange rate management.

Q.5. (A) STATE TRUE OF FALSE, GIVING REASONS: (ANY 4) (08)

a) When the price of exports is greater than the price of imports of a nation, it enjoys favourable terms of trade.
b) Currently RBI intervenes to the minimum possible level in exchange rate determination.
c) Forward exchange rate may be at a premium or at a discount.
d) The higher the difference in cost ratios, the greater will be the gains from the international trade.
e) International trade brings in many dynamic gains.
f) India is a founder member of WTO.
g) TRIPs agreement can lead to transfer of R&D benefits to developing nations.

Q.5 (B) CHOOSE RIGHT OPTION & REWRITE THE STATEMENTS: (Any 7) (07)

1) There is a _________ relationship between demand for foreign currency and the exchange rate.
a) inverse *c) direct*
b) straight *d) positive*

2) Under flexible exchange rate system, the exchange rate is determined by _________.
a) market forces *c) central bank*
b) commercial banks *d) none of the above*

3) LERMS was introduced in India in _________.
a) 1992 *c) 2000*
b) 2002 *d) 2012*

4) _________ is not a feature of spot exchange rate.
a) Clearing of payment takes place fairly long period
b) Demand and supply of foreign currency determines the rate
c) Current exchange rate
d) All of the above

5) The foreign exchange rate of a nation is influenced by _________.
a) Balance of Payments
b) Interest rate
c) speculation
d) all of the above

6) The function of foreign exchange market, which is concerned with fixing of forward exchange rate, is known as _________.
a) Hedging
b) Arbitrage
c) Speculation
d) Transfer

7) In international trade _________ move between nations.
a) Commodities and not factors
b) factors and commodities
c) factors of production
d) none of the above

8) Terms of trade are favourable if the current index in comparison to the base year index is _________.
a) more
b) equal
c) less
d) none of the above

9) Income terms of trade indicate increased capacity to _________.
a) import
b) investment
c) export
d) none of the above

10) Foreign direct investment is a part of _________.
a) capital account
b) current account
c) trade account
d) none of the above

11) .... is not a direct measure to correct BOP disequilibrium.
a) Devaluation of exchange rate
b) tariffs
c) quotas
d) import substitution

12) In recent times, there is an increase in _________ on India's capital account.
a) non-debt foreign investment flows
b) private remittance
c) private transfers
d) unilateral receipts

MOST IMPORTANT UNIVERSITY QUESTIONS

Module-I:

1) Explain the Classical Theories of International Trade.
2) Explain David Ricardo's Theory of International Trade.
3) Explain the Heckscher-Ohlin theory of International Trade.
4) Explain the meaning of Terms of Trade and its types.
5) Explain the concept of Gains from International Trade and Factors affecting gains from international trade.

Module-II:

1) Explain the structure of BOP.
2) Explain the causes of disequilibrium in BOP.
3) Describe the types of disequilibrium in BOP.
4) Explain the direct and indirect measures to correct disequilibrium in BOP.
5) Elucidate the trends in BOP since 1991.
6) Describe the Functions and Objectives of WTO.
7) Write a note of TRIPS, TRIMS and GATS

Module-III:

1) What is Foreign Exchange Market? Discuss its functions.
2) Write a note on dealers in Foreign Exchange Market.
3) Describe in details various transactions in Foreign Exchange Market.
4) Explain the merits and demerits of Fixed Exchange Rate Systems.
5) Explain the merits and demerits of Flexible Exchange Rate Systems.
6) Write a note on Managed Flexibility.

Module-IV:

1) Explain the Modern Theory of Exchange Rate Determination.
2) Describe the factors affecting equilibrium exchange rate.
3) Write a detailed note on Purchasing Power Parity Theory.
4) Critically examine the PPP Theory.
5) Describe the role of Central Bank / RBI in Exchange Rate management.
6) Explain the RBI's intervention in Foreign Exchange Market since 1991.