UNIT-II
THEORIES OF INTERNATIONAL TRADE
INTERNATIONAL ORGANISATIONS AND ARRANGEMENTS

1. Name the theories of international business.

Ans. Theories of Foreign Trade/International Business is Classified into:

A. Classical Theory (Country-Based)

1. Mercantilism
2. Absolute Advantage
3. Comparative Advantage
4. Heckscher-Ohlin.

B. Modern Theory (Firm-Based)

1. Country Similarity.
2. Product Life Cycle.
3. Global Strategic Rivalry
4. Porter's National Competitive Advantage.

2. What Is Mercantilism?

Ans. Mercantilism was an economic system of trade that spanned from the 16th century to the 18th century. Mercantilism is based on the principle that the world's wealth was static, and consequently, many European nations attempted to accumulate the largest possible share of that wealth by maximizing their exports and by limiting their imports via tariffs.

3. Explain the Mercantilism theory of international business. What are its limitations?

Ans. Mercantilism is a philosophy from about 300 years ago. This theory is institutionalised with commercial revolution, that connote trade transition from local to national economies, from feudalism to capitalism, from a rudimentary trade to a wider international trade. Mercantilism, as an economic system was accepted by major trading nations during 16th, 17th and 18th century which was based on the round that national wealth and power were best serve and utilised by augmenting exports and accumulating metals in return.

This theory also stresses on collection and accumulation of precious metals like gold and silver on the basis of which the welfare of society was based on according to the people's belief. This idea of collection of wealth through precious metals steered trade in Europe from 16th century which continued to exist till 18th century.

Therefore the theory of mercantilism states that there is limited and fixed amount of wealth and in order to add more wealth to a country's account requires exchange of some wealth from another. So, this tendency, to export more and import less and to receive in exchange of gold (the deficit is paid in gold) is called MERCANTILISM.

Criticisms of Mercantilism

(i)It stands contrast to the free-trade theory which argues that reduction in trade barriers can enhance the economic well being of a nation. Unlike the free trade concept of Adam smith's and David Ricardo's theory, mercantilism emphasized on protectionist policy of trade. That is why mercantilist advocated import restrictions and export promotion.

(ii)Mercantilism is a philosophy of a **zero-sum game** – wherein one country's gain is another country's loss. It is not a philosophy for increasing global growth and reducing global problems.

(iii) Mercantilism which stresses government regulation and monopoly often lead to inefficiency and corruption.

4. Explain the Absolute Cost Theory of international business.

Ans. Mercantilists' views were challenged by Adam Smith who advocated free trade based on absolute advantages of nations. Adam Smith, (1776) the father of economics propounded that the basis of international trade is absolute cost advantage. According to Adam Smith, when the countries differ in their ability to produce goods in context with their resources, they enjoy Absolute cost advantage. Therefore he proposed that absolute cost advantage theory of international trade. Absolute advantage refers to the ability of a person or a country to produce a particular good at a lower absolute cost than another. This theory explains that trade between two countries would be beneficial if one country would produce one commodity at an absolute cost advantage over another country and another country could in turn produce some another commodity at an absolute advantage over the first. In other words this theory believed that a nation should specialize in producing those goods that it can produce at a cheaper cost than that of other nations. These goods should be exchanged with other goods that are being cheaply produced by the other nations.

Absolute Cost Advantage of Production

	US	**UK**
No. of units of wheat/unit of labour	10	4
No. of units of cloth/unit of labour	3	7

In the above example US has an absolute advantage in the production of wheat over UK and vice-versa. Hence Adam Smith states that US should specialise in the production of wheat and meet its requirement of cloth through import from UK and vice-versa. In short according to Smith's theory of international trade 3 kinds of gains are accrued:

(i)Productivity gain

(ii)Absolute cost gain

(iii)Vent for surplus gain.

Assumptions: The theory is based on following assumptions

(i)Trade is between two countries i.e. the theory is based on bilateral trade and not multilateral trade.

(ii)Only two commodities are trade.

(iii)There exists free trade between the countries.

(iv)Labour is the only element of cost of production.

(v) Labour was mobile within the country but immobile between the countries.

Criticism of Smith's theory: The theory was criticised on following grounds:

(i) Size of the country varies.

(ii)Country differs in specialisation.

(iii)Other factors of production are ignored.

(iv)Does not take into account transportation costs involved in selling the product in international market.

5. Explain the Comparative Cost Advantage Theory of international business.

Ans. The main limitation of absolute cost advantage theory is that it does not explain what happens when one country has an absolute advantage in the production of all goods. David Ricardo removed this limitation in his book, **'Principles of Political Economy'** published in 1817. According to Ricardo's theory of comparative cost advantage, it is beneficial for a country to specialise in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries.

Let us assume that the cost of producing one unit of tea and cloth in India and China are as shown in following:

Comparative Costs of Production

Country	Cost Per Unit	
	Tea	Cloth
India	10	15
China	16	20

India has absolute cost advantage in both commodities. A country's comparative cost advantage in the production of a commodity is measured by the relative value of one commodity in terms of the other commodity. In India, cloth costs 1.5 times the cost of tea while in China cloth costs only 1.25 times the cost of tea. Thus, India has a comparative cost advantage in the production of tea while China has comparative cost advantage in the production of cloth. Therefore, it would make sense for India to specialise in the production of tea and to import cloth from China in exchange of surplus tea.

Ricardian theory or comparative cost theory is based on certain **assumptions**

(i)They produce the same two commodities and tastes are similar in both countries.

(ii)There are two countries and two commodities

(iii) Labour is the only element of cost of production

(iv)Labour is homogenous

(v)There is full employment.

(vi) There are only two countries and two commodities (vii)Production is subject to law of constant returns

(viii)Prices of the two commodities are determined by labour cost Country.

Though Ricardian theory is based on number of assumptions that have been proven wrong, it is still regarded as an important landmark in the development of theory of international trade. The theory doctrine however is not complete in itself and hence it is not free from some defects. Thus it has been severely **criticized** for its wrong assumptions.

This theory has been criticized on following grounds:

(i) Based on only two countries and two commodities: The theory is unrealistic because it is related to trade between two countries on the basis of two commodities. But in actual sense international trade is among countries trading many commodities.

(ii)Ignorance of other factors of production: The most severe criticism of the comparative advantage doctrine is that it considers only labour as factor of production and neglects costs of other factors involved in the production of commodities which is highly unrealistic.

(iii) Based on unrealistic assumptions: Like all classical theories, the theory of comparative advantage is based on the assumption of full employment that sounds unrealistic.

(iv)There exists perfect immobility between the countries: The doctrine assumes that factors of production are perfectly mobile internally and immobile internationally. This is unrealistic because even within a country, factors of production do not move freely from one industry to another or from one region to another thus making the theory less reliable.

6. What is Factor Endowment?

Ans. Heckscher-Ohlin theory is known as factor endowments theory or factor proportions theory because it emphasises the interplay between the proportions in which different factors of production are available in different countries, and the proportions in which they are used in producing different goods. True basis of international trade is to be found in the comparative advantage that emerges due to the difference in the factor endowments.

7.Explain the Factor Endowment theory (Heckscher Ohlin Model) of international business.

Ans. Though the Ricardian theory has been regarded as an important landmark in the development of international trade of theories it was severely criticized for its wrong assumptions and the theory doctrine however is not complete in itself. Factor endowment theory was developed by Swedish economist Eli Filip Heckscher ("The Effect of Foreign Trade on the Distribution of Income", 1919) and his student Bertil Ohlin ("Interregional and International Trade" 1933). Samuelson and Stopler have also made significant contribution to this theory. The theory consists of two important **theorems:**

(a)Factor Price Equalisation Theorem: An important implication of the Heckscher-Ohlin theorem is that free international trade between two countries will cause factor prices in the countries to become more equal. If both countries continue to produce both goods with free trade, their factor prices will actually be equal.

(b)Heckscher Ohlin Theorem: According to this theory relative endowment of the factors of production i.e. land, labour, and capital determine a country's comparative advantage. This is because the profitability on goods is determined by its input costs whereas, the other two classical theories (Absolute advantage and comparative cost advantage) states that the basis of international trade were comparative cost differences. But these theories made very little effort to explain the causes of such differences. Hence the alternative theory developed by H & O attempts to throw light on why comparative cost difference exists internationally. The reasons would be:
(a) Differences in prevailing endowment of factors of production.

(b)Factors of production are used with different degrees of intensity.

Therefore H & O theory explains that the country would specialise in the production /export of those commodities in which the country is blessed with abundant factors of production. In other words The Heckscher-Ohlin theorem states that countries which are rich in labour will manufacture and export labour intensive goods and countries which are rich in capital will export capital intensive goods.

Leontief Paradox Theory

This econometric finding was the result of Leontief's attempt in the early 1950s to test H-O theory empirically for which he used input-output trade table of US economy. As per this theory, a country with higher capital per worker has a lower capital/labour ratio in exports than imports. Wassily W. Leontiff, a Russian born American economist, studied the US economy closely and profoundly and noted that the United States was abundantly bestowed with capital resources and, therefore, had an outlook that US should export more of capital-intensive goods. However, the research he conducted using actual data showed the opposite. In 1953, Leontief found that though US, which was the most capital abundant nation in the world exported commodities that were labour intensive then also was importing more capital-intensive goods in contradiction with Heckscher Ohlin Theory. His analysis came to be known as the Leontief Paradox because it was the reverse of what was expected by the factor proportions theory.

8. Explain the Product Life Cycle Theory of International Trade

Ans. Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. Products come into the market and steadily depart all over again. According to Raymond Vernon, each manufactured goods has a definite life cycle that begins with its expansion and ends with its decline. Product Life Cycle is defined as, “the sequence through which every product goes through from introduction to removal or ultimate downfall.”

The theory, originating in the field of marketing, stated that a Product life cycle has three distinct stages:

(a)New product: In this stage, a firm in a developed or developing country will innovate or manufacture a fresh product for their customers. The market for these manufactured goods will be little and sales will be comparatively small as a result. The firm’s marketing executives have to strongly observe buyer reactions to ensure that the new product satisfies customer needs.
Characteristics of this stage include:
(i)Vast promotional costs are compulsory to enhance the consciousness of customers.

(ii)A marketer has to undertake procedural and manufacture troubles.
(iii)The sale is low and growing at a lesser rate.
(iv)There is a loss or an insignificant profit.

(b) Maturity Stage: In the maturity stage of the Product Life Cycle, the manufactured goods are generally known and are bought by many customers. The innovating firm builds new factories to enlarge its competence and convince home and overseas demand for the products. Characteristics of this stage include:
(i)Sales enlarge at a decreasing rate.
(ii)Profits initiate to decline.
(iii)Marginal competitors put down the market.
(iv)Customer preservation is given more prominence.

(c) Standardized product stage: The market for manufactured goods stabilizes. The product becomes more of a commodity, and firms are pressured to lesser their industrialized costs as much as probable by shifting production to facilities in countries with small labour costs. Characteristics of this stage include:
(i)Sales reduce quickly.
(ii)Profits reduce more quickly than sales.
(iii)Steadily, the company prefers to move resources to new products.
(iv)Most of the sellers remove from the market.

The decline stage – At some point, however, the market becomes saturated and the product is no longer sold and becomes unpopular.

TVs, calculators and mobile phones are the most general examples of products which undergo the three-phase cycle. Although products which endure this life-cycle may be found, the legality of this theory is very limited.

Assumption

The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II.

This theory assumed the product progresses through these stages, and the production will happen in the country it was invented. However, this theory doesn't explain current international trade patterns when it comes to manufacturing and innovation around the world.

9. Explain the Michael Porter's Competitive Advantage of Nations theory of international business.

Ans. Michael Porter of the Harvard Business School believed that existing theories of international trade did not explain fully a country's competitiveness. For example, the theory of comparative advantage does not explain why Switzerland is more productive in the production of precision instruments than Great Britain or Germany. He carried out intensive research into 100 industries in

10 countries to determine why some nations succeed and others fail in international competition. He sought answers to questions like: Why does Japan excel in the automobile industry? Why does Switzerland do so well in the production and export of precision instruments and pharmaceuticals? Why do Germany and the United States succeed in the chemical industry? Porter published the results of his research in 1990.

This theory is also referred to as the Porter's Diamond Theory of National Advantage. The theory is designed to help understand the competitive advantage that nations enjoy due to certain resource factors available to them, and to explain how governments can act as a catalyst to improve a country's position in a globally competitive economic environment.

Many traditional theories that were developed have mentioned various elements or factors such as land, location, natural resources, labour etc as a primary determinant. These factors if are abundantly available can add to a country's comparative economic advantage. But Porter diamond suggests that the countries can create and enhance new factor advantages for themselves such as technology, industry, skilled labour, and government support. These factors if available can gain competitive advantage at international level. Michael Porter's four keys to a nation's competitive advantage in relation to other countries are:

(i)Firm's strategy, structure and rivalry: Competition, national governments and firm's strategy can create conditions which facilitate and nurture such conditions. These factors drive innovation and quality. It keeps the companies on their toes for developing more innovative and qualitative products.

(ii)Factor endowments: (Land, labour, capital, workforce, infrastructure) some factors can be created.

(iii)Demand conditions: Large and sophisticated domestic consumer base offers an innovation friendly environment and a testing ground.

(iii) Related and supporting industries: The presence of supplier and related industries.

10. What is Commercial Policy?

Commercial policy is popularly known as trade policy. It refers to the policy of a country regarding its international trade. It is a governmental policy governing trade with other countries. This covers tariffs, trade subsidies, import quotas, voluntary export restraints, and restrictions on the establishment of foreign-owned businesses, regulation of trade in service, and other barriers to international trade.

11. What is Commercial Policy Instrument? State its objectives.

Ans. Commercial policy instruction (CPI) is defined as a set of all measures that affect directly the amount, composition, and direction of trade flows. It implies designing regulatory framework for international trade and commerce. CPI helps in identifying various policy measures that encourages exports and regulate imports of the country. The commercial policy also signifies imposition of tariff and non-tariff barriers as a measure instrumental to influence trade and commerce activities of the country beyond the national boundaries.

Objectives of Commercial Policy Instruments

The main objective of commercial policy is to boost international trade of nation by reducing or eliminating quantitative restrictions and reduction of tariffs. This favourable commercial policy measures has extended the dimension of bilateral and multilateral trade. Following are the objectives of commercial policy instructions:

(i)To regulate and restrict imports that results into capital flight causing unfavourable balance of payment.

(ii)To protect domestic industries from extensive foreign competition and to encourage use of domestic production the domestic market by making the country self-sufficient.

(iii) To encourage trade with other countries of the world.

(iv) To encourage bilateral and multilateral trade.

(v) To augment exports in order to earn foreign exchange reserves

(vi) To restrict/resist dumping.

(vii) To earn revenue by imposing heavy duties.

12. What is Trade Barriers?

Trade barriers are artificial restrictions imposed by the government on free flow of goods and services between the countries. Various types of restrictions are imposed by one country on the other in order to regulate or safeguard the interest of their own. Such imposed restriction on trade is called trade barrier. Trade barriers are artificial restrictions imposed by the government on free movement of goods and services between countries. They are also treated as instruments of trade policy.

Trade barriers are classified into two: **(a) Tariff barriers and (b) Non-tariff barriers.**

13. What is Tariff? Explain the different types of tariff barriers.

It refers to taxes or duties imposed on internationally traded commodities when they cross national border. Tariffs are also a policy tool to protect domestic industries. Tariffs are in the form of custom duties and operate as a price mechanism. Tariff is a most common barrier to trade. It raises the prices of imported goods relative to domestic goods.

Tariff serves the following function: (i) Act as source of Revenue.
(ii) Protection to domestic industries.
(iii) Remedy to trade distortion.

Tariffs are classified on the following basis:

(I) On the basis of purpose

(i)Revenue Tariff: This tariff is basically imposed by the government with an intention of earning revenue to the government. Through such imposition government aims at collecting substantial revenue on the items of mass consumption. It consists of low rate and do not obstruct the free flow of imports.

(ii)Protective tariff: In order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports. Normally, a very high duty is imposed, so as to either discourage imports or to make the imports more expensive as that of domestic products.

(iii)Anti-dumping duties: Dumping is a term used in the context of international trade. It is a commercial practice of selling goods in the foreign market at a price below their normal price. Dumping is used by the foreign companies to penetrate and capture foreign markets. As a result of dumping, domestic industries find it difficult to compete with imported goods. To offset anti-dumping effects, duties are levied in addition to normal duties.

(iv)Countervailing duties: It is imposed on certain imports where products are subsidised by exporting governments. As a result of government subsidy, imports become cheaper than domestic goods. To nullify the effect of subsidy, this duty is imposed in addition to normal duties.

II. On the basis of trade relations

(i) Single column Tariff: When only one rate of duty is imposed on goods imported irrespective of its origin is called single column tariff. It indicates fixed tariff rate for various commodities and the same rates are charged for imports from all countries. There is uniformity in rates and no discrimination in the tariff rates on imports and exports exist for different countries. There may be some reduced tariff rates for those countries with which the importing country has signed any free trade agreement. This system of tariff is easy and simple to administer

(ii) Double Column Tariff: A double column tariff is a tariff which has two different duty rates for a particular product. In this system import tariff rate depends upon the country of origin. The trade relation between exporting and importing country is the base of tariff rate assessment. The rates may be lower to affable countries who are partners of peace and growth. The other countries are imposed high tariff rates with whom there exist no bilateral or multilateral trade agreement.

(iii)Triple Column Tariff: Under the triple column tariff rate, three different rates exist:

(a) General Rate. (b) International rate. (c) Preferential rate.

The system consists of three autonomously determined tariff schedules. General and international rates are similar to lower and higher rates, while preferential rates are substantially lower than the general rates and is applicable to friendly countries with trade agreement or with close trade relation.

III. On the basis of criteria

(i)Specific duty: Specific tariff is the fixed amount of tariff per physical unit or according to the weight or measurement of the commodity imported or exported. It is difficult to determine the value of goods traded due to various variants prices. Therefore specific duty is simple to calculate and enables the government to reduce the complexities in determining the duty. However, the specific duties cannot be levied on high valued goods such as diamonds, jewellery, watches, T.V. sets, motor cars, works of arts like paintings etc. These articles can be taxed either on the basis of weight, surface area covered or the number of articles. For example: Rs. 10 per meter of cloth.

(ii)Ad valorem duty: Ad valorem duties are charged on the value of imports. The Latin phrase dictates Ad valorem as “according to value”. When the duty is levied as a fixed percentage of the value of the traded commodity, it is called as valorem tariff. They are charged in the form of a specific percentage of the value of goods. Such duties are levied on the products the value of which is disproportionately higher compared to their physical characteristics such as weight or measurement. For example: Indian duties on certain rayon fabrics are 15 percent ad valorem

(iii)Compound duty: It is a combination of the specific duty and ad valorem duty on a single product. For instance, there can be a combined duty when 10% of value (ad valorem) and Re 1/- on every meter of cloth is charged as duty. Thus, in this case, both duties are charged together.

IV. On the basis of origin and destination

(i)Import duty: Import duty is a tax collected on imports. Import duties are levied with different objectives. Import duty is also known as customs duty, import tax or import tariff. It may enable the local government to raise income through revenue earnings and also give market advantage to locally produced goods. A third related goal is sometimes to penalize a particular nation by charging high import duties on its products.

(ii)Export duty: Export duties consist of general or specific taxes on goods or services that become payable when the goods leave the economic territory or when the services are delivered to non-residents of the country. The export duty represents a tax which is applied to the exported goods, by the customs authorities of a country. This is a part of the international trade policy of a country, may be used to raise state revenue and also to safeguard domestic supplies. It act as a form of protection to domestic industries.

(iii)Transit duty: This type of duty is levied on commodities that originate in one country, cross another, and are consigned to a third. As the name implies, transit duties are levied by the country through which the goods pass. The most direct and immediate effect of transit duties is to reduce the amount of commodities traded internationally and raise their cost to the importing country.

14. What is meant by non-tariff barriers? Explain the different types of non-tariff barriers.

Ans. A non tariff barrier is any barrier other than a tariff that raises an obstacle to free flow of goods in overseas markets. Non-tariff barriers, do not affect the price of the imported goods, but only the quantity of imports.

Some of the important non-tariff barriers are as follows:

(i)Quota System: Under this system, a country may fix in advance, the limit of import quantity of a commodity that would be permitted for import from various countries during a given period. The quota system can be divided into the following categories:

(a)Tariff/Customs Quota: Certain specified quantity of imports is allowed at duty free or at a reduced rate of import duty. Additional imports beyond the specified quantity are permitted only at increased rate of duty. A tariff quota, therefore, combines the features of a tariff and an import quota.

(b)Unilateral Quota: The total import quantity is fixed without prior consultations with the exporting countries.

(c)Bilateral Quota: In this case, quotas are fixed after negotiations between the quota fixing importing country and the exporting country.

(d) Multilateral Quota: A group of countries can come together and fix quotas for exports as well as imports for each country.

(ii)Embargoes: Embargoes are when a country–or several countries–officially ban the trade of specified goods and services with another country. Governments may take this measure to support their specific political or economic goals.

(iii)Product Standards: Most developed countries impose product standards for imported items. If the imported items do not conform to established standards, the imports are not allowed. For instance, the pharmaceutical products must conform to pharmacopoeia standards.

(iv)A voluntary export restraint: Voluntary export restraints (VERs) fall under the broad category of non-tariff barriers. VER is a trade restriction on the quantity of a good. This limit is self-imposed by the exporting country. Basically voluntary export restraint is a restriction set by a government on the quantity of goods that can be exported out of a country during a specified period of time. This restriction is implemented upon the insistence of the importing nations. VER was introduced in 1930s and gained lot of importance in 1980s.

Some interesting examples of VERs occurred with auto exports from Japan in the early 1980s and with textile exports in the 1950s and 60s.

(v)Import Licensing: As a part of liberalisation system majority of the items have been delicencsed for international trade in many countries. However there are number of items which are subject to compulsory licensing. Here imports are allowed under license that is permission from the government which is lengthy and time consuming process.

(vi)Consular formalities: Many countries impose strict rules and consular formalities in order to restrict the inflow of inferior quality of goods in the economy. Consular formalities include certificate of origin, certified consular invoice etc. to be obtained. Sometimes, it is also insisted that such documents should be drawn in the language of importing countries. They countries may also levy heavy penalty for non-compliance of such formalities.

(vii)State Trading: In many countries import and export transactions are handled by certain State Agencies. These agencies carry international trade strictly according to Government Policies. In India some products decided by the government is imported only through the State Trading Corporation (STC). Export of raw materials such as iron ore, mica are handled by MMTC (Minerals and Metals Trading Corporation).

(viii)Product Labelling: Certain nations insist on specific labelling of the products. For instance, the European Union insists on product labelling in major languages spoken in EU. Such formalities create problems for exporters.

(ix)Preferential Arrangements: Some nations form trading groups for preferential arrangements in respect of trade amongst themselves. Imports from member countries are given preferences, whereas, those from other countries are subject to various tariffs and other regulations.

(x)Foreign Exchange Regulations: The importer has to ensure that adequate foreign exchange is available for import of goods by obtaining a clearance from exchange control authorities prior to the concluding of contract with the supplier.

15. What is meant by Balance of Payments Accounts? Explain its features.

Balance of payment account is a statement that summarises a country's economic transactions with other countries of the world during a specific time period. According to the Reserve Bank of India, BPO is a statistical statement that systematically summarises, for a specific time period, the economic transactions of an economy with the rest of the world.

The balance of payments accounts have the following characteristics:

(i)Summary: Balance of payment account is a summary prepared according to the double entry system of accounting. It has two sides - debit and credit, like any other account.

(ii) Economic Transactions: The summary is of economic transactions of a country with the rest of the world. These transactions involve receipts on account of exports of goods and services, and capital received by residents; and payments made for imports of goods and services, capital transferred to non-residents/foreigners; income on investments remitted abroad or received from aboard; and increase or decrease in the international reserves of the country.

(iii)Country with Rest of the World: Balance of payment contains transaction between a country with other countries; Transactions between the residents of the same country are not included in it. However, increase in a country's monetary gold and foreign assets exchanged between residents may be included in the balance of payment account.

(iv)A Flow Statement: Balance of payment account is a compilation of the flow of economic transactions. It is not a statement of the position on a particular date. It is more like a funds flow statement rather than like a balance sheet.

(v)Definite Time Period: Balance of payment account covers a specific time period, usually one year. However, it may be prepared for shorter time period such as six months three months or even one month depending upon a country's requirement.

(vi)Double Entry System: Transactions in BOP are recorded as per the double entry system of bookkeeping. Each transaction results in a debit entry and credit entry of equal account. Therefore, balance of payment account must always balance. The total amount of debits must equal the total amount of credits. In some cases, the balancing item errors and omissions is added to balance the BOP account.

16. What are the Components of balance of Payment Account? Explain.

The various items recorded in the balance of payment account can be classified under the following heads:

(i) Current Account, (ii) Capital Account, (iii) Unilateral Payments Account and (iv) Official Reserves/Assets Account

(i)Current Account: The current account includes all transactions that increase or decrease the country's national income. It consists of two major groups of items:
(a) visible or merchandise exports and imports, and (b) invisible or service exports and imports.

(a) Visible or merchandise exports and imports: Merchandise exports or sale of goods abroad are credit entries because these create monetary claims on foreigners. On the other hand, merchandise imports or purchase of goods from abroad are debit entries because these create money claims of foreigners on the home country.

(b) Invisible or service exports and imports: Invisible exports or sale of services abroad are credit entries while invisible imports or purchase of services from aboard are debit entries. Invisible exports include sale of services to foreigners. Transportation, insurance, tourism, banking, financial services, salaries, interests and dividends received on loans and investments abroad/are included in invisible exports. Invisible imports include the purchase of services like insurance, tourism, transportation, banking, financial services, and salaries, interests and dividends paid to foreigners.

Various items included in the current account are shown in following Table:

Items under Current Account

Debits	Credits
1. Merchandise Imports (purchase of goods) 2. Invisible Imports (purchase of services) (a) Transport services (b) Tourism services (c) Insurance services (d) Other services (e) Interest and dividend paid on foreign loans and investments (f) Salaries and fees paid to foreigners	1. Merchandise Exports (sale of goods) 2. Invisible Exports (sale of services) (a) Transport services (b) Tourism services (c) Insurance services (d) Other services (e) Interest and dividend received on loans and investments made abroad (f)Salaries and fees received from abroad

(ii)Capital Account: Capital account is divided into three parts- (a) private capital, (b) banking capital, and (c) official capital.

(a) Private capital: The private account includes short term and long term capital transactions. Short term capital is with a maturity period of one year whereas long term capital has a maturity period of more than one year. Long term capital consists of foreign investments (both direct and indirect), long term loans, foreign currency deposits, etc.

(b)Banking capital: Banking capital includes movements in the external financial assets, and liabilities of commercial banks and cooperative banks which are authorised to deal in foreign exchange.

(c)Official capital: Official capital refers to Reserve Bank of India's holdings in foreign currency and Special Drawing Rights with the Government.

Inflows of capital from abroad are treated as credit items whereas capital inflows from the home country are treated as debit items. For example, if Tata Motors invests 500 crore in the United

Kingdom, it will appear as a debit entry in India's balance of payment and as a credit item in the balance of payment of the United Kingdom.

Capital Accounts Inflows and Outflows

Debits	Credits
1. Long-term investments abroad (less redemptions and repayments) (a) Direct investments abroad (b) Investments in foreign securities (c) Other investments abroad (d) Government loans to foreign countries, 2. Short-term investments abroad..	1. Foreign long-term investments in the home country (less redemptions and repayments) (a) Direct investments in the home country (b) Foreign investments in domestic securities (c) Other investments of foreigners in the home country (d) Foreign Governments' loans to the home country. 2. Foreign short-term investments in the home country

(iii)Unilateral Transfers Account: Private remittances, government grants, repo ratings, disaster relief and gifts are included in the unilateral transfers account. Unilateral payments made to foreign countries are debits and unilateral payments received from abroad are credits.

Unilateral Transfers Account Inflows and Outflows

Debits	Credits
1. Private remittances abroad 2. Pension payments abroad 3. Government grants abroad	1. Private remittances received from abroad 2. Pension payments received from abroad 3. Government grants received from abroad

(iv)Official Reserves Account: Government's holdings or means of payment held by official agencies that are generally accepted for the settlement of international claims are included in the official reserves account. These are official purchases and sales of foreign currencies and other reserves.

Official Reserves Account Inflows and Outflows

Debits	Credits
1. Official purchases of foreign currencies or other service assets.	1. Official sales of foreign currencies or other reserve assets abroad.

17. What is Current Account? Explain the different items of current accounts.

Ans. See Question No. 16(i)

18. What is Capital Account? Explain the different items of capital accounts.

Ans. See Question No. 16(ii)

19. Explain the causes of disequilibrium in the balance of payments.

Ans. The balance of payments of a country is said to be in equilibrium when the demand for and supply of foreign currency are equal. Disequilibrium in balance of payments means either a surplus or deficit in it. When the demand for foreign currency exceeds its supply there will be a deficit in the balance of payments. A surplus in the balance of payments means the supply of foreign currency exceeds its demand.

Disequilibrium in the balance of payments is caused by the following factors:

1. Economic Factors: These include the following:

(a) Development Disequilibrium: Developing countries undertake heavy expenditure on the development of industries, power plants, bridges, roads, ports, hospitals, universities, etc. These developmental activities require huge imports of machinery, equipment and other capital goods. In addition, such developmental activities increase income and demand and imports of consumer goods. Large scale imports of capital goods and consumer goods result in deficit in the balance of payments.

(b) Cyclical Disequilibrium: Such disequilibrium arises due to fluctuations in imports and exports caused by business cycles. The boom in business activity in a country increases aggregate demand, consumption and prices. The country imports more consumer goods to meet the increase in demand. It also increases imports of capital goods to expand production. On the other hand, depression in a country leads to increase in its exports because production exceeds home demand. Thus, both boom and depression create disequilibrium in the balance of payments.

(C) Secular Disequilibrium: Disequilibrium in a country's balance of payments persists for long periods due to secular trends in its economy. In a developed country like the United States, disposable incomes and aggregate demand are generally very high. At the same time, costs of production are high on account of high wage rates. High costs result in higher prices. Therefore, the country imports goods from other countries where quality goods are produced at lower costs. Huge imports create a deficit in the balance of payments of even a developed country like USA.

(d) Structural Disequilibrium: Structural changes in the economy include shift from agriculture to service sector, development of alternative sources of supply development of better substitutes, exhaustion of productive resources, changes in transport routes and costs. These structural changes increase the imports of both capital goods and consumer goods, causing a deficit in the balance of payments.

2. Political Factors: Political instability, civil war, riots, terrorism, external war and such other political disturbances create a threat for industry and investment. These factors may lead to large capital outflows and decline in domestic production and exports. SriLanka, Pakistan, Bangladesh and Nepal have faced such a situation.

3. Sociological Factors: Changes in tastes, preferences, fashions may affect imports and exports which in turn create disequilibrium in the balance of payments.

20 . Write a detailed note on WTO.

Ans. WTO – World Trade Organisation was established in 1995 as the heir organisation to the GATT (General Agreement on Trade and Tariff). GATT was founded in 1948 with 23 nations as the global (international) trade organisation to serve all multilateral trade agreements by giving fair chances to all nations in the international exchange for trading prospects.

WTO is a forum for governments to negotiate trade agreements. It is a place for them to settle trade disputes. WTO operates a system of trade rules. Essentially, this organisation is a place where member governments try to sort out the trade related problems they face with each other. WTO is required to build a rule-based trading government in which countries cannot place unreasonable constraints on trade.

In addition, its mission is to increase stock and trade of services, to assure maximum utilisation of world resources and to preserve the environment. The WTO deals include trade in commodities as well as services to promote international trade (bilateral and multilateral) through the elimination of the tax as well as non-tariff obstacles and implementing greater marketplace access to all member nations.

Objectives of WTO

1. To raise the standard of living in member countries.
2. Development of a multilateral trading system.
3. To reduce Tariff and Non-Tariff barrier.
4. To eliminate discriminatory treatment in international trade relationships.
5. To make coordination between trade policies, environmental policies and sustainable development

Members: On 1st January 1995, 123 nations signed the agreement to replace the General Agreement on Trade and Tariff (GATT). At present, there are 164 member countries of WTO as on 29th July 2016. Afghanistan is the 164th member of WTO. All members are obliged to follow laws and policies framed under WTO rules.

Principles: All the WTO agreements are based on a number of simple and fundamental principles. These principles serve as the foundation of the multilateral trading system. These principles are as follows:

(i) Non-Discrimination: According to this principle, no member country shall discriminate between the members of the WTO in the conduct of international trade. In order to ensure non-discrimination, the member countries agreed to apply the principle of most favoured nation (MFN) to all import and export duties. This means concession given to a trading partner (e.g., low rate of customs duty) should be extended to all other member nations. The principle does not imply giving special status to any country. Some exceptions are, however, allowed to the principle of non-discrimination.

(ii)Free Trade: WTO expects its member countries to reduce tariff and non-tariff barriers to encourage free trade. Quantitative restrictions are prohibited. However, developing countries and countries facing difficulties in their balance of payments are allowed to reduce trade barriers gradually.

(iii)Predictability: Under WTO agreements, member countries bind their commitments to open their markets for goods and services. They are not allowed to raise trade barriers arbitrarily. A country can change its commitment but only after negotiating with its · trading partners, which could imply compensating them for loss of trade.

(iv)Consultation: WTO seeks to resolve disagreements among member countries through consultation. It provides a forum for continuing consultation among members.

(v)Fair Competition: WTO is dedicated to open, fair and undistorted competition. Various WTO agreements aim to support fair competition in goods, services and intellectual property. The agreement on government procurement extends rules of competition to purchases by thousands of government entities in several countries.

(vi)Development and Reforms: The purpose of WTO system is to facilitate economic development in the world. It allows developing countries the necessary flexibility and time in implementing the WTO agreements. Thus, WTO principles are designed to ensure free, fair and transparent trade between the member countries.

Functions: The main functions of the WTO are as follows:

(i) Administering and implementing the WTO trade agreements

(ii) Acting as a forum for trade negotiations among the member countries

(iii) Settling trade disputes between the member countries.

(iv) Monitoring national trade policies.

(v) Providing technical assistance and training for developing countries

(vi) Cooperating with other international organisations like the UNCTAD, IBRD and IMF concerned with global economic policy making.

Organisation Structure

The WTO is run by its member countries. All major decisions are made normally by consensus. WTO has a four-level structure:

(i) Ministerial Conference: It is the top level decision-making body of the WTO. It consists of representatives of all the member countries. The Ministerial Conference meets at least once every two years to take decisions.

(ii)General Council: This is the second-level body which meets several times a year in the Geneva headquarters. The General Council also works as the Trade Policy Review Body and the Dispute Settlement Body. It consists of all the WTO members. The General Council reports to the Ministerial Council.

(a)The Trade Policy Review Body reviews the trade polices of all member nations. Major trading powers are reviewed every two years and others every four years.

(b)The Disputes Settlement Body usually meets twice a month to hear complaints of violations of WTO rules and agreements. It also oversees procedures for settling disputes among member countries. It sets up expert panels to study disputes and decide if the rules are being broken.

(iii)Goods Council, Services Council and Intellectual Property Council: At the third level, these councils deal with trade in goods, services and intellectual property respectively. They are responsible for the working of agreements relating to their respective trade areas.

(iv) Subsidiary Bodies: At the fourth level are specialised committees, working groups and working parties. These deal with individual agreements and other areas such as environment, development, membership applications, regional trade agreements and administrative issues. Various subsidiary bodies keep the General Council informed of their activities regularly.

21. Distinguish between GATT and WTO.

Ans.

Basis	GATT	WTO
1.Meaning	GATT refers to an international multilateral treaty, signed by 23 nations to promote international trade and remove cross-country trade barriers.	WTO is a global body, which superseded GATT and deals with the rules of international trade between member nations.
2.Instituition	GATT is a simple agreement, there is no institutional existence, but have a small secretariat.	WTO is a permanent institution along with a secretariat.
3.Parties	The participating nations are called as contracting parties in GATT.	The participating nations are called as member nations in WTO.
4.Commitments	GATT commitments are provisional in nature, which after 47 years the government can make a choice to treat it as a permanent commitment or not.	On the other hand, WTO commitments are permanent, since the very beginning.
5. Domestic Laws	The domestic legislation is allowed to continue in GATT.	WTO does not allow such legislation.
6. Dispute Settlement System	The dispute settlement system of GATT was slower, less automatic and susceptible to blockages.	In WTO dispute settlement system is very effective.
7. Scope	GATT rules control trade in merchandise.	WTO is wider scope. It covers trade in goods and services, investments, trade related aspects of intellectual property.

22. Write a note on United Nations Conference on Trade and Development (UNCTAD)

Ans. United Nations Conference on Trade and Development (UNCTAD) is a permanent organ of the United Nations (UN) General Assembly, established in 1964 to promote trade, investment, and development in developing countries. Headquartered in Geneva, Switzerland, UNCTAD has approximately 190 members.

Negotiations at UNCTAD's meetings resulted in the Global System of Trade Preferences (1988), an agreement that reduced tariffs and removed or reduced nontariff trade barriers among participating developing countries; the Common Fund for Commodities (1989), an intergovernmental financial institution that provides assistance to developing countries that are heavily dependent on commodity exports; and various agreements for debt relief. In the 1990s UNCTAD's efforts were directed toward the challenges globalization poses to developing countries, and special attention was focused on measures to help the poorest and least developed countries become integrated into the world economy.

Objectives The objective of UNCTAD is:
(a) to reduce and eventually eliminate the trade gap between the developed and developing Countries, and
(b) and to accelerate the rate of economic growth of the developing world.

Principles: The UNCTAD I held in 1964 specified that action programmes and priorities of the UNCTAD would be based upon the following basic principles:
(i) Sovereign right of each member country to dispose of freely its natural resources in the interest of its development, well-being of its population and furtherance of its trade with other countries.
(ii) International economic and trade relations shall be based on such principles as respect for sovereign equality of states, self-determination and non-interference in the internal affairs of the others.
(iii) No discrimination among member countries on account of differences in socio-economic system and independent pursuit of economic and other policies.
(iv) Extension of preferential concessions.
(v) Greater market access for the products of the less developed countries.
(vi) Reduction in tariff and non-tariff restrictions on trade.
(vii) Unconstrained flow of international aid.

Functions: The main functions of the UNCTAD are as follows:
(i) Promoting international trade between the developed and under-developed countries having diverse socio-economic organisations with special emphasis upon the accelerated development of the under-developed countries.
(ii) Formulating the principles and policies concerning international trade and related problems of economic development.
(iii) Making proposals for putting the said principles and policies into effect and to adopt measures that may be relevant to this end.
(iv) To generally review and facilitate the coordination of activities of other institutions within the fold of the United Nations related to international trade and economic development.
(v) To be available as a centre for harmonious trade-related policies of governments and the regional economic groupings in pursuance of Article 7 of the Charter of the United Nations.

23. Write note on The Organization of the Petroleum Exporting Countries (OPEC).

Ans. The Organization of the Petroleum Exporting Countries (OPEC) was founded in Baghdad, Iraq, with the signing of an agreement in September 1960 by five countries namely Islamic Republic of Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. They were to become the Founder Members of the Organization.

These countries were later joined by Qatar (1961), Indonesia (1962), Libya (1962), the United Arab Emirates (1967), Algeria (1969), Nigeria (1971), Ecuador (1973), Gabon (1975), Angola (2007), Equatorial Guinea (2017) and Congo (2018).

Ecuador suspended its membership in December 1992, rejoined OPEC in October 2007, but decided to withdraw its membership of OPEC effective 1 January 2020. Indonesia suspended its membership in January 2009, reactivated it again in January 2016, but decided to suspend its membership once more at the 171st Meeting of the OPEC Conference on 30 November 2016. Gabon terminated its membership in January 1995. However, it rejoined the Organization in July 2016. Qatar terminated its membership on 1 January 2019.

This means that, currently, the Organization has a total of 13 Member Countries.

Functions / Objectives of the Organisation of Petroleum Exporting Countries (OPEC)

The organisation was formed in order to achieve the following functions and objectives:

(i) Control of Price of Crude Oil in the World Market: OPEC determines the minimum prices using different means of stabilising and controlling the sales in international oil market for member countries.

(ii) To Regulate the Production Level for Member Countries: OPEC determines oil production levels for member countries in order to reduce over production – through specification or quota.

(iii) It Helps Member Countries to be involved directly in the Exploitation of Their Natural Resources: This is done by helping member countries to stimulate the development of an indigenous technological base and research institutions for the production of oil.

(iv) To Protect the Interest of Their Member Countries: This is achieved through establishing the legal institutional machinery with which the operations of the oil companies in their respective countries were brought under control.

(v) It Controls Government Influence Over Oil Production in Member Countries:
OPEC controls government influence over oil production following the resolution passed asking each member country to reduce control in oil companies operating in their territories so as to have a fair role of crude oil exploration, production and sales.

24. What is Commodities Agreements? Explain the major commodities agreements.

Ans. An international commodity agreement is an agreement between governments of leading exporting and importing countries to regulate the terms of trade in a specified commodity. It may serve to stabilise prices by balancing demand and supply in the market. The exporting country is protected against excessive competition and overproduction in the many also helps to assure adequate supply to consumers in the importing country.

The major commodities agreements are:
(i) International Natural Rubber Agreement.

(ii) International Sugar Agreement.

(iii) International Tin Agreement.

(iv) International Cocoa Agreement.

(v) International Coffee Agreement.

(vi) International Olive Oil Agreement.

(viii) International Wheat Agreement

(i)International Natural Rubber Agreement: International Natural Rubber Agreement was the first agreement signed under the UNCTAD integrated programme of commodities. It was concluded on 6th October, 1979 and came into operation in November, 1981 when the buffer stock manager started buying natural rubber in order to stabilize prolonged decline in natural rubber. This agreement uses a buffer stock.

The agreement managed to keep prices within the specified range in 1981 and 1982, but then had to adjust the range downwards. The agreement got the support of producers and consumers. The International Natural Rubber Agreement used buffer stock operation to maintain prices at specific level.

This was expected to be regular review of prices at every 18 month. Sale from buffer stock and purchase by buffer stock agency was made on the basis of stipulated price. This agreement met with mixed success during its operations. The agreement was partially successful in holding the price within the limit.

(ii) International Sugar Agreement: There have been four international sugar agreements in post-war period. The first agreement came into force in January 1954, the second in 1959. The economic provisions of the latter were suspended in 1962 following the 1960 Cuba crisis, although the remaining provisions were extended until 1968.

The next agreement, also without economic provisions, was signed in 1968, introduced in 1969 and abandoned in 1973. The next agreement, again without economic provisions, was agreed in 1977, came into operation in 1978, and ran with an extension, until the end of 1984 (without the participation of the European community).

It has been argued that it both reduced the export earnings of the developing country compared to a free trade situation and increased the instability of prices. MacBean and Snowden have stated: “This is one market where free competition would in all likelihood bring the best results in terms of stability, efficiency and inquiry.

The ISAs were palliatives diverting attention from the much greater priority of persuading the rich nations to reduce their protection of best sugar.” The International Sugar Agreement has probably the worst record of all. Sugar agreement could not achieve much success due to following reasons:

(a)Sugar is produced by developed and developing countries.
(b)There was a difference of opinions on holding stocks.

(iii)International Tin Agreement: International Tin Agreement was concluded in 1954, but became effective only in 1956. It is the mixture of buffer stock and exchange controls. It was renewed regularly in essentially unchanged, form until 1982, when United States and other two countries withdrew. The agreement was unable to cope with the major price fluctuations that occurred when prices went above the ceiling. The controlling authority (the Tin Council) ran out of money in 1985 and was finally dissolved in 1990.

(iv)International Cocoa Agreement: The International Cocoa Organization (ICCO) is a global organization, composed of both cocoa producing and cocoa consuming countries. Located in London, ICCO was established in 1973 to put into effect the first International Cocoa Agreement which was negotiated in Geneva at a United Nations International Cocoa Conference. There have since been seven Agreements. The Seventh International Cocoa Agreement was negotiated in Geneva in 2010 and came into force provisionally on 1 October 2012. With a view to strengthening the global cocoa sector, supporting its sustainable development and increasing the benefits to all stakeholders, the objectives of the Seventh International Cocoa Agreement are:

(i)To promote international cooperation in the world cocoa economy

(ii)To provide an appropriate framework for discussion on all cocoa matters

(iii)To contribute to the strengthening of the national cocoa economies of Member countries

(iv)To promote transparency in the world cocoa economy

(v)To promote and to encourage consumption of chocolate and cocoa-based products in order to increase demand for cocoa

(vi) To encourage Members to promote cocoa quality and to develop appropriate food safety procedures in the cocoa sector.

(v)International Coffee Agreement: This agreement was first established in 1963. This agreement employed an export quota system. There was second agreement in 1968 which was terminated in 1972 because there was frost damage to the Brazilian crop leading to major price increases and the mechanism collapsed. After gap of three years the third agreement came into force in 1976 the high prices of the late 1970s meant that the export quota provisions were applied only near the end of 1980.
The fourth agreement (1983) in similar to its predecessor, quotas were suspended in 1986 because of high prices, but reintroduced in 1987. There have been considerable and highly discounted sales outside the agreement. The differences of interest (between large and small procedures, and between producers and consumers) make it unlikely that it will be very effective.

(vi)International Wheat Agreement: International Wheat Agreement a multilateral contract system. The First International Wheat Agreement was signed in 1949 and was revised or extended in 1953, 1956, 1959 and 1962. It was replaced with a new agreement which consisted of the Wheat Trade Convention and Food Aid Convention in 1967.

The current Wheat Trade Convention was signed in 1971. It has been renewed regularly. The current Wheat Trade Convention contains no provisions on prices or on rights and obligations. The Food Aid Convention does still provide for annual contributions of various grains by a group of developed and grain exporting nations.

(vii)International Olive Oil Agreement: There were two International Olive Oil Agreements. The first agreement was signed in 1959. When under the auspices of the UN, 11 members participated of which 9 were exporting countries and 2 were importing countries. The duration of the agreement was 4 years.
The second agreement was signed in 1963, when 11 members participated of which 7 were exporting countries and 4 were importing countries. The duration of the agreement was 4 years. An International Olive Oil Council was established in 1963, to make studies of the olive oil market, production and prices etc. These agreements aimed at price stabilization through price control.

These agreements have not been successful to the extent. Except a few, all agreements could not achieve their objectives due to following reasons:

(i)The agreements were poorly drafted.

(ii)There was lack of consensus in implementing the agreement. Many countries continued their operations violating the agreement.

(iii)Holding of buffer stocks has been the point of conflict between countries.

(iv)Many important countries refused to join the agreement.

(v)Commodity agreements covered only seven commodities cocoa, tin, coffee, olive oil, rubber, sugar and wheat.