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Chp 9 International Trade

Countries enter into foreign trade to overcome scarcity of resources and obtain cost benefits. Foreign trade is monitored by world Trade organisation.

→ Advantages:

1. Foreign capital (FDI, FII)
2. Advance technology
3. Research & Development → HR
4. Better quality goods at low cost
5. Increases employment
6. Peace & Harmony.

All the above points lead to economic growth and development

→ Disadvantages:

1. Rivalry because of competition
2. Exploitation of natural resources.
3. Threat to domestic industries
4. Loss of cultural identities
5. No employment to semiskilled / unskilled labour

→ Units:

1. Theories of International Trade
2. Instruments of Trade Policy
3. Trade Negotiations.
4. Exchange Rate and it's economic effects.
5. International capital movement.

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1] Theories of International Trade →

* Absolute cost Advantage Theory:

concept given by: Adam Smith

→ Assumptions:

i. Trade between 2 countries.
Only 1 factor (labour)
2 commodities.
} 2:2:1 model.

ii Full employment

iii only labour days taken

iv trade has no restrictions (in real life, there are many restrictions)

commodity	no. of days		cost-ratio	
	Australia	India	Australia	India
wheat	10	20	10/20 = 0.5	20/10 = 2
Jute	20	10	20/10 = 2	10/20 = 0.5

In this, either country has advantage in one of the good
In above table, 1 is taken as base in cost ratio

∴ In case of wheat: Australia gains 0.5
India loses extra 1

Similarly incase of jute: Australia loses 1
India gains 0.5

∴ Australia should produce wheat & sell to India
India should produce jute & sell to Australia.

It should ~~always~~ never be zero sum ~~change~~ game, ~~i.e~~ it must be win-win situation. one party should not gain or lose more than the other

more no. of days, more cost, } direct
less no. of days, less cost } relation.

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* Comparitive cost Advantage Theory:

Concept by: David Ricardo.

Assumptions: Same as Absolute cost Theory.

Commodity	No. of days		Cost Ratio	
	Australia	India	Australia	India
Wheat	10	15	10/15 = 0.66	15/10 = 1.50
Jute	20	25	20/25 = 0.80	25/20 = 1.25

In this, one country has benefit in both goods
∴ Australia will produce in which it has more advantage ie wheat (0.66) while India will produce in which it has less loss, ie jute (1.25)

* Hecksher - Ohlin Theory:

Also known as modern theory / factor endownment theory
factor equilisation theorem/
~~instead of exchange of goods~~, exchange of factors.
Concept by: Hecksher, Ohlin & Paul Samuelson
(2-2-2 model)
Assumptions:
i. 2 countries, 2 commodities, 2 factors (capital, labour)
rest all assumptions are same.

eg: USA → country 1 → capital surplus → $I_1 \uparrow$ (interest), $W_1 \uparrow$ (wages) (USA)
India → country 2 → labour surplus → $I_2 \downarrow$ (interest), $W_2 \downarrow$ (wages) (India)

∴ before trade: $I_1 < I_2$; $W_1 > W_2$
after trade: $I_1 = I_2$, $W_1 = W_2$

USA $\underset{\text{labour}}{\overset{\text{capital}}{\rightleftarrows}}$ India

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when USA sends capital to India, ROI in USA will increase ∴ I_1 will try to come closer to I_2. But according to book $I_1 = I_2$ after trade. (IRL gap decreases).

Similarly, when India sends labour to USA, wage rate in USA decreases ∴ W_1 will try to come closer to W_2. But according to book $W_1 = W_2$ after trade (IRL, gap decreases).

* **New Trade Theory:**
  - → Economies of Scale: reduce cost due to large scale production.
  - → Network effect: ~~b~~and wagon effect
    ↓
    more people buy due to influence.

eg: Iphone.

15 mins 5] INTERNATIONAL CAPITAL MOVEMENTS :

Any money which comes from abroad.

major sources

- FDI (foreign direct investment)
- FPI / FII (foreign portfolio investment) (foreign institutional investment)

* Foreign Direct Investment → [FDI]

→ Money comes from abroad from:
foreign government / investor / company

→ Money enters and is invested in India's business.

• Features:

1. Long term
2. Money is invested in some particular business.
3. No speculation.
4. Stake will always be more than or atleast 10%. (greater decision making)
5. There is asset creation & capital formation.
6. Employment generation (skilled)
7. Techaology transfer (Research & Development ↑, cost ↓)

• Types / Modes of FDI :

1. Horizontal FDI →
Invested in various countries but in SAME line of business.
eg: Vodafone, Toyota.

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2. Vertical FDI →
Foreign company will buy stake in that Indian company which will support it's main business, i.e investment in India's ancillary industries.
↓
which provide raw material / spare parts.

eg: Suzuki Nexa might buy stake in a tyre company

3. Conglomerate FDI →
One company which is into several business and several countries.
eg: Tata, Reliance (Indian), ~~M/s~~ Mitsubishi (Japan)

4. Greenfield FDI →
A foreign company coming to India and starting from scratch. There is no tie-up / merger with any Indian company.
eg: IKEA

5. Brownfield FDI →
A foreign company coming to India & having a tie-up / merger or acquiring an Indian company.
eg: Tata-Starbucks, Vodafone-Idea.

* Foreign Portfolio / Institutional Investment: [FPI/FII]
Money is invested in India's stock / bonds market.
↓
SEBI → regulator

• Features:
1. Short term
2. No speculation
3. Stake is less than 10%.
4. No employment generation or asset creation (only financial assets)

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POV of investors

- **Reasons for FDI:** Higher ROI, cheaper labour, low tax, FDI attractive policies in India, no recession in India, economies of scale (∵ cost↓), they want to promote their products in several countries.

refer module

~~POV of~~ investors

- **Factors that discourage FDI:** lack of infrastructure, inflation, balance of payments, lack of literacy, low level of skilled labour, rigidity in labour, legal formalities, corruption, political instability, language barriers.

- **Benefit of FDI:** refer module.
- **Problems of FDI:** refer module

- **Areas where FDI is not allowed:** refer module.

FDI is done through → automatic route
→ govt approval. (railway, defence).

It is usually prohibited in agriculture, railway, defence. (if allowed, only upto small extent)
No foreigner can buy TDR (Transfer development rights), chitfunds, 'NIDHI' companies (type of NBFC)

- Higher the quantity, higher the tariff
  lower " " , lower " " Same for price.
- Both which is high
- main part pai alag, Spare pai alag

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2] INSTRUMENTS OF TRADE POLICY :

biggest instrument of trade policy is $\boxed{\text{Tariff}}$ टारीफ कोन भरता उसकी ?

↓ type of tax / import duty

trade policy is something which will aim to increase exports & decrease imports.

main objective is to protect domestic industry (to make domestic goods cheaper, foreign goods more expensive)

Objectives of Trade Policy: refer module

main instrument

☆☆ Types of Tariff →

1. Specific Tariff →

Imposed on QUANTITY / VOLUME.

Qty ↑ , Traiff ↑ ; Qty ↓ Tariff ↓

2. Add-valorem Trariff →

Imposed on MRP

3 Mixed Tariff →

Imposed on either specific (qty) or ad-valorem (MRP), whichever is higher.

4. Compound Tariff →

Imposed on both specific (qty) and ad valorem (MRP)

5 Technical Tariff →

Imposed on main part alag se and spare part alag se.

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6. Tariff Rate Quotas →
It is a normal upto certain limit, after limit is crossed, higher rate is imposed

[WTO not allowed] 7. Most favoured nation tariff →
Only if countries are part of [preferential agreement] lower rate is charged
eg: OPEC, NAFTA, EU. SAFTA, BRICS

8. Variable tariff →
varying the tariff rate as per domestic situations

9. Preferential Tariff →
same as (7)

10. Bound / Binding Tariff →
Country binds itself with a legal/written commitment that it will not increase tariff beyond certain limit. There is an upper limit benchmark
• Applicable Tariff.

11. Escalated Tariff →
Higher tariff for finished goods, lower tariff for raw materials

China
12. Anti-Dumping Duty → Tariff as respond
also applicable to counter vailing duty
Also known as 'protectionist' or 'tariff as response' or 'trigerred price mechanism'.
Anti-dumping duty is imposed by DOMESTIC govt. on foreign inputs/imports which it believes to be priced below fair market value

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exports point of view

13 Counter vailing duties →
These are tariff that aim to offset the artificially low price charged by exporters who enjoy export subsidy or tax concession offered by their home country

* Non Tariff Measures →

→ Technical Measures :→

① Sanitary / Phytosanitary Measure →
Coming from abroad
applicable on food products which are imported or affecting the plant life, animal life, nature can be banned. eg ~~Potat~~ Swine flu in poultry products.

② Technical Barrier to Trade →
applicable on food & other products also every product has to go through mandatory regulation. If the product doesn't match the standards, the country has the right to reject the product.

→ Non - Technical Measures :→

State Trading Corporation

① Imported Quotas (tariff rate quota)
② Price control (ad-valorem tariff)
③ Non- automatic licensing (license can be cancelled before expiry)
④ Financial Measure govt $\xrightarrow{help}$ RBI $\xrightarrow{help}$ comm bank
no overdraft ↑ROI increase currency ∴ ↑ cost of borrowing
⑤ Measures affecting competition → govt will outsource 3rd party as an economic agent
⑥ Restriction on post sale service must be outsourced to locals.
⑦ Safeguard measures

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⑧ Trade Related to investment Measures:
type of multi lateral trade agreement measures:
1 20-25% indian raw material
2 employment should majorly go to locals
3 products made 75-80% should be sold in India

⑨ Embargos :→
putting a heavy ban / complete restriction on foreign products entering domestic territory
1 bad political relation
2 product might hurt religious sentiments
} reasons.

* Voluntary Export Restraints (VER) : [They do for relation]
when domestic country requests the exporting country to voluntarily ~~reduce~~ restrict export for sometime.

Traiff will prevent from enjoying gain arising ~~from out~~ of comparative and absolute cost adv.

* Effects of Tariff →
1. creates obstacles in trade & thereby discourages import.
2 tariff encourages production & consumption of domestic (protecting domestic industries)
3 tariff prevents country from enjoying the gains arising out of comparitive & absolute cost advantage.
4 Increases revenue of domestic government & producer

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4] EXCHANGE RATE AND ITS ECONOMIC EFFECTS

Exchange rate is the rate at which one country's currency is exchanged for another.

Direct Quote	Indirect Quote
no. of units of (local) domestic currency exchanged for one unit of foreign currency.	no. of units of foreign currency exchanged for one unit of domestic currency.
→ foreign currency is base currency & domestic currency is counter currency.	→ domestic currency is base currency & foreign currency is counter currency

* **Cross Rate** → Dollar is called vehicle currency / universal currency

3 different countries currencies are involved out of which one will be a common currency, which will help us to decide the rate of other 2 currencies

Cross Rate is an exchange rate of 2 different currencies that are not quoted against each other but are quoted against one common currency

$$\frac{INR}{\$} \times \frac{\$}{PESO} = \frac{INR}{PESO}$$

abhi ka rate

* **Nominal and Real Exchange Rate** →

Nominal Exchange Rate is the current exchange rate, decided on the spot by market forces of demand and supply.

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Real Exchange Rate is the rate at which a person can trade the goods & services of one country for goods & services of another country. It describes how many of a goods & services in one country can be trade for one of that good or service in another country.

$$\text{Real Exchange Rate} = \text{Nominal Exchange Rate} \times \frac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$$

* Types of Exchange Rates →
1. Fixed Exchange Rate / Pegged Exchange Rate
   - soft pegged
   - hard pegged
2. Floating Exchange Rate / Flexible Exchange Rate
3. Spot Exchange Rate
4. Forward Exchange Rate.

1. Fixed / Pegged Exchange (ER) Rate → Qatar, Hongkong, Saudi Arabia, Cuba, etc

Pegging means deciding

It is that ER which is NOT decided by market forces of demand & supply, but it is decided by country's central bank, on the condition that the country has to keep a huge amount of forex reserve with IMF (International Monetary Fund)

Advantage: less risk of inflation / currency fluctuation

Disadvantage: reserve with IMF, high level of high interference of central bank, currency manipulation

soft pegged: when for the time being, central bank allows ER to be decided by market forces of demand & supply. (very short period)

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Hard pegged: By seeing (after soft pegged) the direction of currency, whether it is going ↗ or ↙, they will take back the decision of currency under it's control.

2. Floating / Flexible Exchange Rate → India, UK, USA, Japan
It is that ER which is decided by market forces of demand & supply
Advantages: No reserve with IMF, no currency manipulation
Less intervention of central bank
Disadvantages: High risk of currency fluctuation and inflation.

3 Spot Exchange Rate → ~~of currencies~~
where buying & selling takes place on the spot without any delay
wholesale transaction: bulk, retail: small qty
(when order is placed, that rate is applicable)

4 Forward Exchange Rate →
Rate is agreed today, but applicable for buying & selling of currencies at a future specified date. (can enter - banks, traders usually)
It is a zero-sum game (both cannot benefit at once)

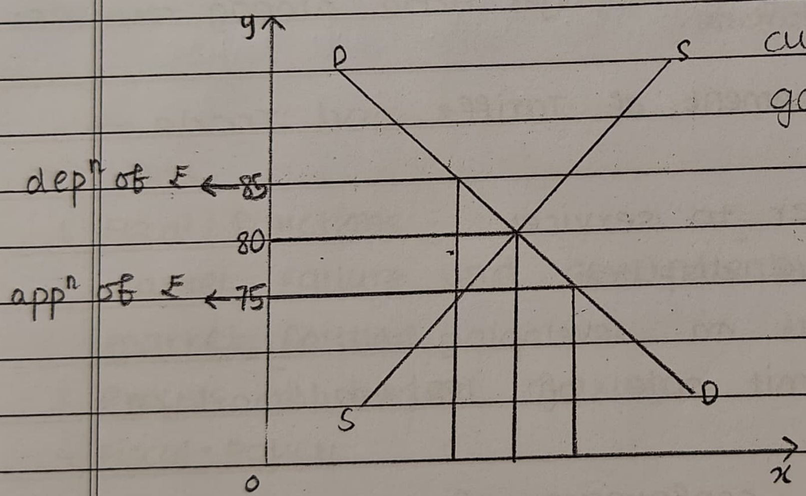
* Arbitrage →
Buying currency in one country at lower price and selling same currency in another country at higher price. Difference is profit.

* Difference between devaluation & depriciation

Devaluation	Depreciation
1. Done in fixed ER (by country's central bank)	Done in floating ER (by dd and ss)
2. Cannot be done frequently	Happens very frequenctly

* Equilibrium Exchange Rate / Appreciation & Depreciation of currency / RBI's Intervention in Forex Management / Managed Float →

RBI buys & sells currency when situation goes out of control.



Both appreciation ↓ as well as depreciation ↓ is bad.

imports will ↑ beyond limit exporters are demotivated. | imports will be v. expensive exports ↑, domestic market will be affected.

To come close to equilibrium, RBI will sell dollars incase of a depreciation & buy dollars in case of appreciation.

exchange rate → cause

demand & supply → effect.

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→ Depreciation of Home currency
exchange rate – effect, demand & supply – cause

~~supply remains constant~~
Because of imports ↑, demand for dollar ↑
∴ rupee depreciates & dollar appreciates
(effect on ER)

3] TRADE NEGOTIATIONS (not as important) WTO – South America
Headquarters in Geneva
* World Trade Organisation – settles disputes and finds solutions – manages trade among countries

* General Agreement of Tariffs and Trade →
Problems:
1. did not cater to services
2. did not solve disputes.
3. did not focus on developing country.
4. did not permit sale of IPR, trademark, etc.

* In Uruguay conference of 1986 123 countries participated – boycotted GATT.
Hence, on Jan 1, 1995 – WTO was formed.

* One more conference in Doha – mainly promoted agriculture.
(2001)

objectives, structure, guidelines of WTO