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Your Roll No. ....

MIB / I Sem. **A**

Course 517 – INTERNATIONAL TRADE AND POLICY FRAMEWORK

(Admissions of 2004 and onwards)

Time : 3 hours *Maximum Marks* : 70

(Write your Roll No. on the top immediately on receipt of this question paper.)

Attempt all questions. All questions carry equal marks.

1. *David Ricardo's* theory of comparative advantage was criticized as ignoring two important factors of production, i.e. land and capital, and of being based on labour values alone. Which theory was propounded based on the limitations of the comparative advantage theory and acted as a remedy by explaining trade in terms of relative factor intensities? Discuss the theory in detail.

Or

Vernon, in his theory, tried to explain the relationship between the stages in the product life cycle in international markets and trade. Explain *Vernon's* International Product Life Cycle theory and its effect on international trade.

2. What do you mean by foreign capital? Why do multinational firms make investments in foreign countries? What are the various forms of investments? Despite liberal policies why is India not able to attract enough volume of FDI?

Or

Attempt the following:

(a) 'Regional economic integration has proved to be a blessing in disguise in promoting globalization of international economy'. Do you agree?

(b) Distinguish between *Trade creation* and *Trade diversion*.

3. Considering imports and exports separately, highlight the changes that have taken place in the composition and direction of the country's foreign trade since 1991. Point out their significance.

Or

(a) On what grounds is the strategy of *export-led growth* held justified for an underdeveloped country? Critically examine its suitability for India.

Turn over

(b) How does foreign trade contribute to economic development? What could be the major '*barriers to trade*' in obstructing its role as an '*engine of growth' to an economy?*

Describe the salient features of India's balance of payment. What measures would you suggest for improving the balance of payments position in India?

Or

Explain foreign exchange rate regime. What are its different forms? What does capital account convertibility imply? Would you advocate capital account convertibility? Why has India been slow on capital account convertibility?

5. Carefully study the following passage and attempt the questions given at the end of the passage. Your answer need not necessarily be based on the passage but also on your understanding of the topic.

"Another way of looking at international trade is to examine total exports and total imports between pairs of countries. That is, for a country like Australia, which countries does it export to, and which countries does it import from? For Australia's exports, the top ten destination countries in 2004, in order from the largest down, were Japan, China, the United States, South Korea, New Zealand, India, Britain, Indonesia, Singapore and Thailand. For Australia's imports, the top ten sources countries, again starting with the largest, were the United States, China, Japan, Germany, Singapore, Britain, Malaysia, New Zealand, South Korea and Italy.

In looking at these lists, we can note three things. The first is that they are mostly the same countries in the two lists. The top three trade partners are the same for Australia's exports and imports, and seven of the top ten are the same. The second is that many of these countries, including the United States, Japan, China, Britain, Germany, and Italy, have large economies. The third is that New Zealand is in both lists. Although New Zealand has a small economy, it is geographically close to Australia.

When we look at other countries, we see similar patterns for its major trading partners. Such observations have led to the development of the gravity model of trade, so called because it has similarity to the Newton's law of gravity, which states that the force of gravity between two objects is larger as the sizes of the two objects are larger, and as the distance between them is smaller.

The gravity model of international trade posits that trade flows between two countries will be larger as

- The economic sizes of the two countries are larger
- The geographic distance between them is smaller, and
- Other impediments to trade are smaller

In statistical analysis of data on trade between pairs of countries, the gravity model explains the patterns very well.

Economic Size: Our theory of trade based on product differentiation and monopolistic competition can explain why the economic sizes of the countries matter. Consider first differences across the importing countries. Using basic demand analysis, we expect that an importing country that has a larger national income will buy (as imports) more of the product varieties produced in other countries. Now consider differences across the exporting countries. If the exporting country has a larger overall production capability, then it will have the resources to produce a larger number of varieties of the products. With more varieties offered to foreign buyers, it will sell more (as exports) to these foreigners.

Economic size is usually measured by a country's gross domestic product (GDP), which represents both its production capability and the income that is generated by its production. Consider Australia's trade with the United States and Canada. U.S. GDP is about 14 times that of Canada, and Australia trades about 8 times as much with the United States as it does with Canada. In statistical analysis, the elasticity of trade values with respect to country size (GDP) is usually found be about 1 (so that, for instance, a country with twice the GDP tends to do twice the trade with a particular partner country, other things being equal).

Distance: Most obviously, distance shows the importance of a cost that we have generally ignored in our theoretical analysis, the cost of transporting goods internationally. It costs more to transport goods longer distances. Consider Australia's trade with New Zealand and Ireland, the latter a country that is over seven times as far from Australia as is New Zealand. Even though Ireland's GDP is twice that of New Zealand, Australia's trade with Ireland is only one-seventh that of its trade with New Zealand. (Not all of this huge trade difference is due to the large difference in distances, because Australia and New Zealand also have a preferential trade agreement, but much of the difference is due to distance.)

In statistical analysis, a typical finding is that a doubling of distance between partner countries tends to reduce the trade between them by one-third to one-half. This is actually a surprisingly large effect, one that cannot be explained by the monetary costs of transport alone, because these costs are not that high. This finding has led us to think about other reasons why distance matters.

One other reason is that shipping things a longer distance, especially by ocean transport, takes a longer time. The longer time for shipment could lead to greater risks that the goods would be physically damaged or deteriorate. In addition, there is a greater risk that conditions could change in the importing country. For instance, the styles that are in fashion could change, or the importer could go bankrupt.

Other Impediments: Government policies like tariffs can place impediments to trade and the gravity model can show how these reduce trade between countries.

policy barriers. Even for trade between the United States and Canada, this border effect is very large.

A series of studies (starting with McCallum and including Anderson and van Wincoop) have used the gravity model to examine inter-provincial trade within Canada, interstate trade within the United States, and international trade between Canadian provinces and U.S. states. As usual, province and state GDPs are important, that there is also an astounding 44 per cent less international trade than there would be if the provinces and states were part of the same country. This extremely large border effect exists even though any government barriers are generally very low, and it is not easy to see what the other impediments could be. There's something about the national border. For Canada, the result is that provinces trade much more with each other and much less with U.S. states.

The gravity model has been used to examine the effects of many other kinds of impediments (or removal of impediments) to trade.

Questions:

(a) Why do countries that share a common language trade more with each other?

(b) Explain that countries having historical links (for example, colonial) trade more with each other.

(c) How do you justify that countries which are members of a preferential trade area trade more with each other?

(d) Do you agree with the following statement (give reasons):
(i) "Countries that have a common currency trade more with each other".

Or

Attempt the following in relation to International Trade in Services:

(i) Distinguish between services and merchandise. Enumerate major services.
(ii) Main issues of international trade in services.
(iii) Difficulties in trading services internationally.
(iv) Identify various important services in India's trade.

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