SHETH NKTT COLLEGE OF COMERCE AND SHETH JTT COLLEGE OF ARTS, THANE

DEPARTMENT OF ECONOMICS

QUESTION BANK & MODEL ANSWER

FOR

TYBCOM (2020-21)

SEMESTER – VI

Note: These notes are brief notes and not an explanatory answer, students will have to explain the points in detail. Manan Prakashan's book on the syllabus is referred.

MODULE – I: INTRODUCTION TO INTERNATIONAL TRADE

1. Explain Ricardian theory of international trade

Ans: Ricardian theory is based on Comparative Cost Advantage. It has following assumptions.

i. There are two commodities and two countries.
ii. There is perfect competition in both factor and commodity markets.
iii. Cost of production is measured in terms of Labour.
iv. Labour is the only factor of production.
v. Labour is homogeneous.
vi. Labour is perfectly mobile within country but immobile between countries.
vii. There is free trade
viii. Production is subject to Constant Returns to Scale.
ix. There is no technological change.
x. Full employment exists in both countries.
xi. There is no transport cost.

Comparative cost benefits both countries. (shown in table below)

Country	**Wine**	**Cloth**	**Domestic Exchange Rate**
			Wine : Cloth
England	120	100	1 : 1.2
Portugal	80	90	1 : 0.89

At an international exchange rate of 1:1, England specializing in cloth and exporting one unit of cloth, gets in return one unit of wine. At home it is required to give 1.2 units of cloth for one unit of wine. England gains 0.2 of cloth. In other words, wine is cheaper to England by 0.2 units of cloth.

Similarly, Portugal gets one unit of cloth from England for its one unit of wine as against 0.89 of cloth at home thus gaining extra cloth of 0.11. Thus both countries benefit from trade.

Evaluation of Ricardian theory:

a. Theory is based on Unrealistic Assumptions, such as Perfect competition, 2-countries; two commodities, Labour theory of value, Full employment, Mobility of factors of production, absence of transport cost.
b. Static Theory-it is based on CRS.
c. Demand side is ignored-whether the country demands the product is not considered.
d. Complete specialization- the theory assumes that the country is specialized so it can produce.
e. No free trade- actually the real world has tariff and non-tariff barriers on trade.
f. Not applicable to the developing countries, because there is no full employment in these countries.

2. Examine Heckscher-Ohlin theory of international trade

Ans: H-O theory explains how new approach to comparative advantage on the basis of General theory. It is based on following assumptions:

i. There are two countries, each having two factors and producing two commodities.
ii. There is Perfect competition in both factor and commodity markets.
iii. All production functions are homogeneous.
iv. Factors are mobile within the country and immobile between the countries
v. Two countries differ in factor supply.
vi. Each commodity differs in factor intensity.
vii. Factor intensity differs between the commodities but are same in both countries for each commodity, i.e. if good-X is labour intensive, it will be so in both countries. However, goods X and Y differ in factor intensity in the same country.
viii. Full employment of factors.
ix. There Free Trade in both countries.
x. No transport cost.

A. **Factor Intensity**- It is measured in terms of factor ratios and not by absolute units.

Commodity	Capital	Labour	K/L Ratio
Y	2	2	1
X	3	12	1/4

In our example commodity Y is Capital intensive and commodity X is Labour intensive.

B. Factor Abundance-i) Abundance in Physical terms and ii) Factor abundance in terms of Factor Price. (draw suitable diagrams here)

Conclusions of the theory:

i. Each country differs in factor endowments
ii. Each country specializes in the productionof that commodity which requires more of its abundant factor.
iii. Abundance of a factor makes it cheaper in terms of its price.
iv. Low factor prices result in low cost of production and in turn low commodity prices
v. Low commodity price is the basis of international trade.

Limitations of H-O Theory:

i. Based on Unrealistic assumptions
ii. Static in nature
iii. Demand condition is neglected
iv. Leontif Paradox
v. Other factors of production are ignored.
vi. Commodities prices are neglected.

3. Discuss the types of Terms of trade.

Ans: Terms of trade are defined as 'the ratio of price of its export commodity to the price of its import commodity'. T= Px / Pm. There are different methods to measure T/T.

i. **Net Barter Terms of Trade**- it is the ratio of the prices a country gets for its exports to the prices it pays for its imports. Tc- $P_{x1}/P_{x0} \div P_{m1}/P_{m0} \times 100$.

Limitations of NBTT:

a. Quality of exported and imported good is neglected
b. Problems associated with the construction of index numbers
c. Non-mercantile items are not included
d. It concentrates on price rather than income
e. It neglects the productivity of inputs

ii. **Gross barter Terms of Trade**- it is the ratio of change in physical quantity of imports to change in physical quantity of exports. Gm= $Q_{m1}/Q_{m0} \div Q_{x1}/Q_{x0}$.

Limitations of GBTT:

a. It does not consider the prices of goods.
b. It includes payments such as unilateral payments which does not depend on trade but on factors mostly unrelated to the trade
c. GBTT does not explain the changes in the prices of export and import goods.

iii. **Income Terms of Trade**- it is the ratio of Commodity Terms of Trade (Tc) multiplied by exports quantity. The changes in ITT depend on price and volume of exports. An improvement in ITT tells us the increased capacity to import.

Limitations of ITT:

a. It does not measure precisely the gains or loss from the trade.
b. Increase in exports may be due to a decline in prices.
c. It neglects the foreign exchange receipts.
d. It fails to consider welfare aspect of trade

4. Examine the factors affecting terms of trade.

Ans: Terms of trade of a country are favourable or not depend on following factors.

i. Changes in Factor Endowments.
ii. Reciprocal demand.
iii. Improvement in technology
iv. Changes in tastes

v. Tariffs
vi. Economic development
vii. Nature of commodities
viii. Depreciation of currency

5. **Write a note on:**

   i. **Gains from trade:**

Ans: It refers to the benefits from international trade such as, increase in production, consumption, employment, economic welfare and other improvements. (Explain in detail).

Factors determining Gains from trade:

a. Terms of Trade- Favorable T/T brings more gains.
b. Reciprocal demand- i.e. the relative strength and elasticity of demand of a country A for the product of country B in exchange for A's product.
c. Cost Ratio- gains from trade depends on cost of production of traded goods.
d. Level of income
e. Nature of trade

ii. **Offer curves-** it is the geographical representation of reciprocal demand indicating various quantities of exports a country is going to offer for various quantities of import as a succession of possible terms of trade.

iii. **Reciprocal demand-** it is the mutual demand for each other's goods of trading partners. Mill explains that it is based on the assumptions such as, i) two countries, ii) two commodities, iii) Constant Returns to Scale, iv) no transport cost, v) perfect competition, vi) full employment, vii) free trade and viii) trade is based on Comparative Cost difference.

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