

(To be filled by the Candidate)

Date of Exam: 08.03.18 Class: M.A.

Paper code: 2372 Year: Final

Paper International Economics

PART - A



DUNDEEKHAND UNIVERSITY JHANSI, U.P.
OMR ANSWER BOOK (40 Pages)

PART - B		PART - C	
TO BE FILLED BY THE EXAMINER			
SECTION A	SECTION B	SECTION C	
Q. No.	MARKS	Q. No.	MARKS
1	1	1	1
2	1	2	1
3	1	3	1
4	1	4	1
5	1	5	1
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38	1	38	1
39	1	39	1
40	1	40	1

Evaluation of Answer Report

Signature of Examiner

Examiner Name

Paper Code

1 Section - B



Ans-6-1 Comparative Cost advantage:

- (i) Introduction
- (ii) Ricardo's theory of Comparative Cost advantage
- (iii) Types of cost advantage

Introduction- International trade (Import and Export) is now a causal part of world Economics. What are the reasons for this international trade? That is the question which answered by many Economist. Some of them are classical theory and some are Modern International Trade theory. In classical theory the main theory is given by David Ricardo and the theory was "Comparative Cost theory". What does this theory presents? that is there are difference in cost of production of goods and services and this difference create a chance for import and Export of goods and Services in international trade. Ricardo's theory is accepted by many economist since a long time ago.



Ricardo's theory of Comparative Cost theory

Ricardo proposed this theory according to which there is some advantage to a country upon cost of production of a goods or services upon another country which is main cause of international trade.

Assumptions of Ricardo's theory:

- (i) There are Two Countries and Two products - First assumption of Ricardo's theory was that assume there are two states and there are two products
- (ii) There is only One factor of cost (Labour Cost) - Ricardo's theory based on this assumption that Labour Cost is main cost of production and other cost are negligible.
- (iii) Perfect Mobility of Labour from One product to another - Labour can be perfectly mobility from one product to another production.



- (iv) Trade in take place by Barter System - Ricardo accepted Barter System as the medium of trade between two countries
- (v) No Transportation Cost - Ricardo's next assumption was that there is no transportation cost.

Types of Cost Differences

- i) absolute Cost differences - When in the price of a good is absolutely differ in one country to another country that is called absolute cost difference. For Example - Like Coffee (1kg) price in India produces in 5₹ and in China produces in 10₹ then this is absolute cost difference and normally trade between these two countries can take place.
- ii) Equal Cost differences - When two countries are producing same goods and the difference between these goods cost is equal to both that is called Equal cost differences.
- iii) Comparatively Cost differences - In this theory One Country is more cheaper in production of both goods than other country. For Example - India produces Jute 100kg and Rice 100kg by using 1 unit of labour and Sri Lanka produces Jute 90kg and Rice 60kg by using 1 unit of labour. This cost difference is comparative cost difference.



Comparative Cost Theory:

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	<u>India</u>		<u>Sri Lanka</u>	
<u>Product</u>	Jute	Rice	Jute	Rice
<u>Amount produced</u>	100kg	100kg	90kg	60kg
<u>Unit of Resources</u>	1 unit	1 Unit	1 Unit	1 Unit

<http://www.upadda.com>

Now we can see India's take advantage in production of both products. By using one unit of production factor India can produce 100 kg of Jute and 100 kg of rice whereas Sri Lanka can produce 90 kg of Jute and 60 kg of Rice.

Then in comparison between these data we can see that if India Export Jute to Sri Lanka then difference is 10 kg but if Export Rice to Sri Lanka then difference is 40 kg.

By Comparative theory it is beneficial to India to Export



Rice to Sri Lanka and Import Jute from Sri Lanka while Sri Lanka can Export Jute rather than rice because in comparison Sri Lanka suffer less loss in Jute rather than rice.

Thus Comparative Cost advantage theory proposed that Besides all there are profit in Exporting both the goods but it is beneficial to India to Export Rice and Import Jute.

The Ratio of ~~Rice~~ of India & Sri Lanka is

100 : 60 that mean 5:3

that means if India Export Rice then India can get 1.66 unit : 1 unit of Ratio and can achieve yet

India Should be Specialist in Production of Rice and Sri Lanka must be specialist in production of Jute. That is beneficial to both.

What about Present day's Scenarios?

Ricardo's theory is criticised by many modern economist because of many reasons and wrong assumptions and they are correct by studying

These theories and criticism. There are many discrepancies in this theory like

(i) This theory assume only Two Nations and Two goods which is not correct.

(ii) Labour is not only resource of production but other factors mainly Capital is ignored by this theory

(iii) Transportation Cost is main factor between trade in Two countries

(iv) Size of Economy is also matter like India and Sri Lanka. Sri Lanka can not fulfill all demands of India and if India become specialist in any goods then all goods can not be sold in Sri Lanka.

So According to view of these criticism we can say that comparative cost advantage theory is not applicable in today's scenario

Ans-3

International Monetary Fund: (IMF)

(i) Introduction

(ii) Workings of IMF

(iii) functions of IMF

(iv) Conclusion

Introduction) At the Bretton Woods Conference in 1944 the proposal of three institution are presented in front of conference ① World Bank

② International Trade Organisation ③ International Monetary Fund (IMF)

IMF established after Bretton Woods conference and started working from 1945. International Monetary fund (IMF) is difference in working and functions with International Bank for Reconstruction and Development (IBRD)

IMF has No^e 189 member countries which are receiving grants and loans from I.M.F. Its establishment was in view of the necessary that in international Trade there may be critical losses



In Balance of Payment disequilibrium situation. So the main objective of International Monetary Fund is to maintain Equilibrium and help its member countries to maintain Equilibrium in international Trade.

Governing Bodies of I.M.F.

- (I) Board of Governors
- (II) Executive Board
- (III) Managing Director

(I) Board of Governors is the Body that is membership by 187 member countries. All member countries appointed a governor or may be finance minister attend the meeting.

(II) Executive Board:- in this there are only 23 member countries and among them 8 countries representing only one country and rest members (15) representing more than one country for 189 countries.



(III) Managing Director:- This is main governing Body. The Managing Director of IMF is now Christine Lagarde.

Functions of International Monetary Fund

- (I) Financial function
- (II) Advisory & Technical Assistance function
- (III) Supervision function

(I) Financial function: This is the main function of I.M.F. This institution is mainly provide short term and medium term Loan fund to its member countries. The Loans are provided not for the purpose of reconstruction or development. This institution provided loan mainly for the checking International Trade and to correct and manage disequilibrium Condition of Balance of Payment (BOP).

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Most countries are developing countries and they also heavy importing from rest of the world.

and their Balance of Payments (BoP) is always in a condition of disequilibrium (^{unfavorable}) situation. So to manage this loss IMF provided short term finance to its member countries.

(i) Advising and Technical Assistance: I.M.F. also provides technical assistance to its member countries and the experts provide advice to member country to manage and adopt favorable policy of International Trade.

IMF provides new technology for production, accounting and other new services to its member countries for better performance in International Trade.

(ii) Supervision function: I.M.F. acts as a supervisor for its member countries. That they are following rules and regulation and Time to time IMF provides guidance to its countries to adopt new technology.

IMF have a look upon economical situation of countries like if there is any discrepancy in economy and provide help and guidance.

Criticism-I Criticism of International Monetary Fund (I.M.F.)

(i) I.M.F acts only for Maintain Equilibrium of Balance of Payments

many economists criticised I.M.F by this theory that it only works as a assistance of Balance of Payments. It only provides tools to maintain equilibrium in BoP. But it can do better jobs in International Trade. By providing some other facilities.

The main drawback of this institution is this, that This Institution works as a equilibrium tools of BoP not other things.

Working of I.M.F.

(i) facilitate International Trade to Developing Countries: I.M.F provides loans

and aids to developing countries for International Trade. India is the biggest borrower of I.M.F. and gets a lot of advantage by this institution.

① Provides Technical (Know-how) to Underdeveloped Countries

I.M.F. also helps to Underdeveloped Countries to produce some quality goods by providing technical assistance and help to raise living standards.

Criticism - 2 (I.M.F works as a Agent of Developed Countries)

As the Developed Countries are largest donator of fund into this organisation so they have more voting rights than developing countries so these developed countries (Like U.S.A, Japan etc) manipulate the functioning, rule and regulation to provide loan for developing countries by I.M.F. The rules are manipulated in favour of these developed Nations many times.

Ans - 4:

Importance of International Trade

Introduction: International Trade generally means the trade between countries or two country or import and export of goods and services. This is also called globalization. Means this world is only a single market.

There are many benefits of international Trade for countries and consumers also. Many of them are follows—

(i) Benefit of Large scale of Production: In International Trade Companies produce not only to fulfil domestic demand but also to fulfill demand of rest of the world. Large scale of production started and production cost declined due to this.

(ii) Got different kinds of Products: By International Trade different companies provides different kinds of products and this is beneficial to consumers and also for economy to know new product and services.

(iii) Increase Efficiency of domestic Companies: Due to International trade domestic companies tries to increase efficiency to compete with MNCs in international market and this is beneficial to them to control cost and produce



Quality goods to consumer.

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(D) Increases Technological Knowledge: International Trade also a source of new technology for domestic companies. Trade in services and intellectual properties are helpful to know about new research and development.

(E) Increase the growth Rate of Economy: International Trade provide a platform to export the specialist goods and services to rest of the world. This world is biggest market and all the countries and companies thinking to use it for increasing growth rate of Economy.

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(F) Generation of New Employment: A country with closed Economy can not have such sources of resource to give employment to all its population. International Trade provide a bigger platform to do business. New Multinational Companies invest into countries and provides new opportunity for Employment. This is also beneficial to economy and national Income of a country.



Internal Trade:

Generally Internal Trade refers to trade among domestic companies in domestic region and entry of foreign companies are banned. This type of Economy is called Closed Economy.

This Theory is also Called "Protectionism Theory".
This theory was in existence in many decades. In this theory the control of government upon the entry of foreign firm.

Properties of Internal Trade: These are some important properties of Internal Trade -

(i) Trade between domestic companies in domestic region of any country

(ii) Government adopt Protection policy for its production sector

(iii) This is uses mostly in developing or Underdeveloped Countries

(iv) In this policy Government Impose many Tariffs and Non-Tariff Barrier in Entry of any foreign product or company.

International Trade - International trade means open economic condition in any country. The trade done internationally. There are not any barriers or less barriers imposed by government and protectionism is not in economy.

Properties of International Trade -

- (I) Country follows the rules and regulation of any international organization like WTO or IMF
- (II) There are not or less Tariffs and Non-Tariff barriers in doing business
- (III) There are open competition between domestic companies and foreign companies
- (IV) Government can not make policy to favour domestic companies

Section - A

Ans 1 :- Tariff - "Tariff is a tool to control international trade (import and export) and a tool for protect domestic companies.

~~Tariff~~ Tariff is imposed by Government of any country for revenue purpose or for protection purpose whatever needed by that government.

" Tariff means Tax imposed by Government upon Import and Export".

If tariff is imposed upon Import that is Import tariff and if tariff is in export that is called Export tariff.

Broadly There are two type of tariff.

(A) Revenue Tariff: When Tariff imposes by Government in Revenue purpose this is called Revenue Tariff. Government wants to earn some revenue and there are heavy import of any good then this tariff is imposed upon some imported goods.

(B) Protection Tariff: If government want to protect domestic companies

from competing with foreign Countries then government impose tariff that is called protection tariff.

From this view tariff are following types-

- (1) Specific Tariff :- When tariff is imposed by government on the basis of per unit import in specific amount. For Example: £10 per unit of import of sugar is called specific tariff.
- (2) Ad-Valorem Tariff :- When tariff is imposed by government by percentage of quantity of imported goods. Like - 10% of quantity of import.
- (3) Compound Tariff :- Sometimes Government Imposes both Specific and Ad-Valorem tariff at same time then this is called Compound Tariff. For Example - Tariff is fixed £10 per kg upon sugar and also 5% of imported quantity. Then this can be called Compound tariff.

Ans-3 :- Balance of Payments (B.o.P)

Definition :- "Balance of Payments" is a systematic record of all economic transaction between residents of a country and rest of the world" or

Balance of Payments is the record of inflow of foreign Exchange and Outflow of foreign Exchange in a given period of time.

Components of Balance of Payment :- There are mainly Two components in Balance of Payments and those are

(A) Current Account of B.o.P :- Current Account of Balance of Payments records those transaction which is mainly done by maximising profit by parties. It includes (Do not cause any change in Assets and Liabilities).

(B) Import and Export of Goods :- Import and Export of goods is recorded in current account and this is also called Balance of Trade. This is record of only visible items.

(ii) Import and Export of Services: In Current Account Import and export of services are recorded. Import recorded debit side and Export recorded credit side of Balance of Payments.

(iii) Unilateral Transfers: These transfers refer to One Sided Transfers like Grants, Donations, Remittances, Scholarships and many more like old age pension etc. These item if received then entered in Credit Side and Payment record at debit Side.

B Capital Accounts

Capital Account.

Second Account of Balance of Payment is

Capital Account is that account which causes changes in assets and liabilities of any country.

(i) Foreign Direct Investment (FDI): F.D.I done and received by rest of the world are recorded in Capital Account. FDI done in ROW recorded in debit side and FDI receives

from Rest of the world is recorded in Credit Side of Capital Account.

(ii) Portfolio Investment: Portfolio Investment means investing in securities of foreign companies/Government and by foreigner investment in domestic countries.

(iii) Repayment of Loan / Providing Loan: Repayment of Loan / Providing

loan is also recorded in Capital Account. Repayment of Loan recorded at debit side and Providing loan is a favourable condition to be recorded at credit side of Capital Account.

In short -

Current Account having Autonomous Item (profit motives) and in Capital Account mostly there are Accommodating Items.

Ans-4) "Exchange Rate"

Introduction: In today's International Trade system This is very important to convert domestic currency in foreign Currency or convert foreign Currency into domestic Currency. There are much needed for this facility because of many reasons -

- (i) Receiving of Loan in foreign Currency and Payment in foreign Currency need to exchange rate.
- (ii) for purpose of Investment in foreign country needed Exchange System

Definition: "Exchange rate is the rate of domestic currency in terms of foreign currency"

or

Exchange rate is the rate at which domestic currency can purchase a single unit of foreign currency

for Example 1 Dollar = ₹ 65 that means ₹ 65 is need to purchase

one dollar mean $1\text{₹} = \frac{1}{65}\text{ dollar}$

Types Exchange Rate: There are mainly three types of Exchange Rate System adopted

(i) Fixed Exchange Rate System:

(a) Gold Standard System: This System is also called "Gold Standard System" or "Bretton Woods System". In this System The Rate of currency were in terms of gold

(b) Bretton Woods Systems: In this System Exchange rate of Currencies were in form of Dollar and dollar was treated valued in term of gold.

(i) Flexible Exchange Rate System: This Type of Exchange rate is decided by market forces and that are demand and Supply for specific currencies.

(ii) Managed floating Rate System: This Exchange rate system is like Flexible exchange rate decided by market forces but because of some problems of flexible Exchange rate this system is managed by Central Bank authority of a country and government of country. This is also called "Dirty floating" because the rate is managed by central bank authority.



Ans-15-1

Demerits of International Trade → International Trade has some merits like large scale of production, Improvement efficiency etc but it has many disadvantages for Economy as like follows-

(i) Economically dependence

International trade means highly dependency upon foreign market and the rules and regulation of foreign countries. A slight change in policy can create a great impact upon economic condition of a country.

(ii) Politically dependence → International Trade generally influence political view of a country. Government have to make policies regarding to rules and regulations of foreign and international organizations.

(iii) Import of harmful products: In this trade many harmful products are also imported during Trading process. It was known later that which products is harmful to natural resources of any country.

(iv) Low chance of developing Domestic Companies: Multinational Companies have a huge Capital balance and new technology to produce any product and domestic companies of Underdeveloped or developing



Countries do not have sufficient capital and technology to compete with

(v) Multinational Companies:

(vi) Huge Investment in Research and Development by domestic Companies and government to cope-up with Multinational Companies and this create a worse effect upon the availability of funds.

(vii) Create Dis-Equilibrium in Balance of Payments: International Trade for developing countries and Underdeveloped countries is not much beneficial but it creates many problems like dis-equilibrium in Balance of payment because of heavy import

(viii) Huge Debtiness : for coping with Multinational Companies and International Trading Country suffer with DisEquilibrium in Balance of payment (Unfavorable condition) and to maintain Equilibrium Country has to borrowed loan from International Money Market, IMF and also from foreign Countries also.



Ans - 5

Main Functions of World Bank: - World Bank established in 1945 provided Grants and funds, Loans to developed and Underdeveloped Countries for Reconstruction and development.

- (i) Provide Loan for Reconstruction and Development - After World War II many economies were in disastrous form and destroyed. World bank provided Loans for Reconstruction and Development of those economies. World Bank provided Long term Loan / funds for reconstruct all infrastructure and many facilities.
- (ii) Provide Loan (Long term and Short term) for development of Underdeveloped and developing Countries - World Bank also provides loans even short term and Long term for Underdeveloped Countries for many development action like manufacturing Dams, Roads, Schools, Hospitals, Colleges and also to fight with many diseases.
- (iii) Assist Developing Countries for raising living Standards - World Bank helps developing Countries Government to make policies and do development for raised living standards of poor people by providing better health facility, Education, Employment and many other facilities.



To finance Private Project with Government Security: World Bank also provides Loan / funds to Private Sector also with the government security. It is like a Investor in private project like Refinery project and like project for producing Electricity.

- (i) Assistance given to Developing and Underdeveloped Countries for Infrastructure. Developing and Underdeveloped Countries do not have much capital to introduce in infrastructural Expenses like - making Roads, Railways, Electricity, Hospitals, Dams, Schools, Colleges and also provides better health facility then World Bank provides loan to Government to facilitate and Expend upon Infrastructure to raise living standard.



Ans- 14-

Significance of Balance of Payments :- Balance of Payments is a record of inflow and Outflow of Foreign Exchange. This record is very much useful for any economy.

- (i) Indicator of Economic Condition - BOP has current account and capital account. By this account anyone can get an information about the Economic Condition of any country. If Export/Receiving is more than Import/Payment then condition is favourable otherwise not. This also indicates How much fund is needed.
- (ii) Indicates the necessity of financial Aid - Debit and Credit Balance of this BOP indicates if country needed to maintain equilibrium or not or how much financial aid is needed by country.
- (iii) Provides Information Regarding Policy (Import or Export Oriented) This account provides help and information by critically examines the items of this account that which policy must be adopt by the country. If there is high import then Export or Vice-a- Versa.



Country can adopt Export-oriented or Import-substitution policy by help of this Account. This provides information regarding areas of Correction - BOP contains Export and Import of goods and services. and this information can give an idea that what are the areas that creating dis-equilibrium in country's Balance of Payment and which areas are need to take a look.

- (iv) Indicates Level and Extent of foreign trade - Balance of Payment also indicates the level of foreign (International) Trade. According to this Account Government is able to take decision regarding tariff or Non-tariff.

Ans-12 Impact of Devaluation

"Devaluation" means decreasing the value of domestic currency by the central authority (Central Bank).

When Central Bank / Government declares the low exchange rate of domestic currency in terms of foreign currency that is called devaluation of Money. Devaluation has many heavy impact upon economy some of which are -

- (i) Import becomes Costly So it discourages Imports - By devaluation of currency import becomes costly because much money have to spend to purchase goods from international market and thus import discouraged by government.
- (ii) Export becomes cheaper - Export become cheaper that means foreigners have to pay less amount to purchase same product by devaluation of currency. This situation is favourable for Export orientation of a country. Export increases and foreign Exchange Increases.

(iii) ~~Hurts Export~~ ^{Increase} Inflation: When there is high rate of inflation then devaluation of currency means decreasing value of currency and this situation is called inflation. So it increases inflation rate in economy.

(iv) Export Promotes: Devaluation of Currency automatically Promotes Export of a country. With low price (Exchange rate of currency) Import become costly and Export become cheaper then automatically country export more goods and services.

(v) Repayment of Loan become Costly: By devaluation of Currency there is many bad impact upon Economy like Repayment of Loan to foreign countries and International organization. Because Country have to pay more unit of currency than before to Re-pay the Loan.

(vi) Corrective Measures for Dis Equilibrium of Balance of Payments = By devaluation of Currency Import become costly and Export become cheaper then Import discourages and Export promotes. This situation is favourable for Balance of Payment situation of making Equilibrium.



Ans-6: Failures of I.M.F. I.M.F have done many helpful and good jobs for international Trade but there are some failures also.

(i) Only a body to maintain Equilibrium in Balance of Payment

I.M.F. from its establishment was an monetary organization for finding the equilibrium condition in International Trade.

If there is Trade related payment problem then only IMF provides funds to Countries.

IMF must have some broad Areas to cover up. This is treated only a tool to equilibrium of Balance of Payment.

(ii) A Tool in hands of Developed Countries:- Developed Countries

have a large part in the fund donation of IMF so these country having much power to regulate this organization according to their wish.



(iii) IMF have not enforcement power:- IMF only provides short term and mid-term loan to maintain Equilibrium of BoP at a given interest rate but it do not have any enforcement power to control developed countries.

(iv) fail to raise living standard of Underdeveloped Countries:- IMF has a motive to help developing and Underdeveloped Countries by providing loan to maintain Equilibrium.

The motive behind the establishment of this Organization was to provide help to poor countries in international Trade but it fails because of many reasons.

Developed Countries like USA, UK, JAPAN manipulate the rules and regulations of IMF for providing loan/ aid to developing countries.

Developed Countries uses IMF as a tool to make pressure upon poor and Underdeveloped Countries to follow and to make policy according to the interest of their countries and their trade policies.

Ans-7

Dumping

"Dumping means - "To sell the product in foreign Country at lowest level rather than cost of product."

Means When a company sells its products in another country at comparison lower price than domestic country. That behaviour is called Dumping.

(i) Selling at low price than selling in domestic Country is called Dumping.

Dumping is a method uses by Multinational Companies and developed Countries to cover the market share of any country

and create a high gain rather than Underdeveloped companies.

Sometime Multinational Companies adopt this policy to rule out domestic

Company from the competition.

(i) ~~Wrong~~ Wrong Method of Competition Dumping is a method of badly and wrongly compete with domestic companies.