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MEC-107

International Trade and Development

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Sample Preview of the Solved Sample Question Papers

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QUESTION PAPER

June – 2024

(Solved)

INTERNATIONAL TRADE AND DEVELOPMENT

MEC-107

Time: 3 Hours] ***[Maximum Marks : 100***

Note: *Attempt questions from* ***each*** *Section as per instructions given.*

SECTION – A

Note: Attempt the following questions from this section:

Q. 1. ***(a)*** **Why is 'free trade' between two countries is considered to be better than no trade ? Explain with the help of a diagram.**

Ans. Ref.: See Chapter-2, Page No. 15, 'Free Trade *versus* No Trade'.

(b) **Using the Ricardian theory of international trade as a framework, illustrate how nations derive benefits from engaging in trade.**

Ans. Ref.: See Chapter-1, Page No. 6, Q. No. 5.

Q. 2. What factors prompted the development of intra-industry trade ? Explain. How does this theory contribute to our understanding of international trade?

Ans. Ref.: See Chapter-3, Page No. 22, 'Theory of Intra-Industry Trade'.

Q. 3. Trace the evolution of Regional Trading Agreements (RTAs) and explain static and dynamic gains they offer. Differentiate between vertical and horizontal expansion of RTAs alongwith their impact on international trade.

Ans. Ref.: See Chapter-14, Page No. 133, Q. No. 4, Q. No. 5, Page No. 134, Q. No. 6 and Page No. 135, Q. No. 7.

Q. 4. Suppose a country imported automobiles. Explain the following with the help of a diagram:

(a) **What are the gains/losses to domestic manufacturers and customers.**

(b) **What are the gains/losses when externalities are also considered in the analysis.**

Ans. Ref.: See Chapter-17, Page No. 152-153, 'Trade and Environment: Linkages'.

SECTION – B

Note: Attempt the following questions from this section:

Q. 5. How would you apply technological gap model to explain the pattern of international trade? Explain.

Ans. Ref.: See Chapter-4, Page No. 31, 'Technological GAP Model and Product Life Cycle Theory' and Page No. 33, Q. No. 1.

Q. 6. Examine the impact of environmental standards and logistics cost on the location of the production and international trade.

Ans. Ref.: See Chapter-4, Page No. 35, Q. No. 7.

Q. 7. Explore the effects of tariff on volume of trade and terms of trade for a small country and a large country. Explain with the help of a diagram.

Ans. Ref.: See Chapter-6, Page No. 50, Q. No. 5.

Q. 8. What is Capital Account Convertibility (CAC)? How are capital account and current account convertibility different ?

Ans. Ref.: See Chapter-9, Page No. 88, Q. No. 9.

Q. 9. Enlist different types of international financial markets. Highlight the importance of international financial markets and instruments.

Ans. Ref.: See Chapter-11, Page No. 101, 'Types of International Financial Markets' and Page No. 102, 'Importance of International Financial Markets Markets and Instruments'.

Q. 10. Describe the main components of the Mundell-Haming model. Explain the process involved in the model.

Ans. Ref.: See Chapter-9, Page No. 84, Q. No. 2 and Q. No. 3.

Q. 11. What are the key challenges that India encounters in its foreign trade? How do these challenges affect the country's ability to engage effectively in the global economy?

Ans. Ref.: See Chapter-19, Page No.179, 'Challenges Faced by Foreign Trade in India' and Page' No. 181, Q. No. 4.

Q. 12. Write short notes on the following:

(a) **Impossible Trinity**

Ans. Ref.: See Chapter-9, Page No. 83, Q. No. 1.

(b) **Balance of Payments**

Ans. Ref.: See Chapter-8, Page No. 71, Q. No. 1.

Sample

QUESTION PAPER - 1

(Solved)

INTERNATIONAL TRADE AND DEVELOPMENT

MEC-107

Time: 3 Hours] ***[Maximum Marks : 100***

Note: *Attempt questions from* ***each*** *Section as per instructions given.*

SECTION – A

Note: Attempt the following questions from this section:

Q. 1. ***(a)*** **Differentiate between Adam Smith and Ricardo's theory of international trade.**

Ans. Ref.: See Chapter-1, Page No. 5, Q. No. 4.

(b) **With reference to the Ricardian theory of international trade, explain how nations gain from trade.**

Ans. Ref.: See Chapter-1, Page No. 6, Q. No. 5.

Q. 2. Under what conditions can no trade take place between two nations with different production possibility curves?

Ans. Ref.: See Chapter-2, Page No. 18, Q. No. 6.

Q. 3. Describe Grubel Lloyd (GL) index for Measuring the Intensity of IIT.

Ans. Ref.: See Chapter-3, Page No. 12, Q. No. 29.

Q. 4. ***(a)*** **Enumerate the case for protectionism.**

Ans. Ref.: See Chapter-5, Page No. 43, Q. No. 12.

(b) **Why the governments should not resort to protectionism policy?**

Ans. Ref.: See Chapter-5, Page No. 43, Q. No. 13.

SECTION – B

Note: Attempt the following questions from this section:

Q. 5. Explain the differences between fixed and flexible exchange rate systems and the advantages and disadvantages of each.

Ans. Ref.: See Chapter-7, Page No. 59, Q. No. 7.

Q. 6. Explain the process involved in *the Mundell-Fleming* model.

Ans. Ref.: See Chapter-9, Page No. 84, Q. No. 3.

Q. 7. What are the distinctive features of elasticity, absorption, and the Keynesian approach to BoP?

Ans. Ref.: See Chapter-10, Page No. 94, Q. No. 4.

Q. 8. How did the Global Financial Crisis of 2007 began?

Ans. Ref.: See Chapter-12, Page No. 115, Q. No. 2.

Q. 9. Explain how was WTO created and why?

Ans. Ref.: See Chapter-13, Page No. 124, Q. No. 2.

Q. 10. Briefly discuss the Free Trade Area as one of the stages of economic cooperation.

Ans. Ref.: See Chapter-14, Page No. 132, Q. No. 3.

Q. 11. What is GSTP? Highlight the achievements of Sao Paulo round.

Ans. Ref.: See Chapter-15, Page No. 141, Q. No. 3.

Q. 12. Write short notes on the following:

(a) **Trade and Climate Change**

Ans. Ref.: See Chapter-17, Page No. 153, 'Trade and Climate Change'.

(b) **Trade Policy**

Ans. Ref.: See Chapter-18, Page No. 163, Q. No. 1.

Sample Preview of The Chapter

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INTERNATIONAL TRADE AND DEVELOPMENT

Classical and Neo-Classical Theories of International Trade

1

INTRODUCTION

We will talk about the main theories of international commerce in this chapter. We will attempt to define international trade at the outset of this chapter and discuss its distinctions from domestic trade. The motives for international trade there will also be discussion of others. Having grasped them, the principal philosophies of changes in international trade, such as absolute advantage theory and comparative theory as well as H-O theory will be discussed. Moreover, theories such as Stolper's Factor Price Equalization Theory, Rybczynski Theorem, and Samuelson Theorem also covered will be the developments made by expanding the H-O model.

CHAPTER AT A GLANCE

THEORY OF MERCANTILISM

The practice of mercantilism dates back more than 500 years. The "commercial revolution," which marked the shift from regional to national economies, from feudalism to capitalism, and from small-scale local trade to more extensive international trade, served as the theoretical foundation for this theory.

According to the mercantilist theory, nations ought to promote exports and oppose imports. Mercantilism is the inclination to import less, export more, and receive gold in return (since gold served as the means of commerce).

ABSOLUTE ADVANTAGE THEORY

In his book, Adam Smith introduced the idea of absolute advantage, which holds that a nation should focus on producing goods that it can do so efficiently – efficiency being determined by total labour costs. According to this view, labour is the only element of production. "If a foreign country can supply us with a commodity cheaper than we can make it, better buy it of them with some part of the produce of our industry, employed in a way in which we have some advantage," wrote Adam Smith in "The Wealth of Nations."

Table: Number of labourers used by Country A and Country B for producing 1 ton of Wheat and Rice

	Country A	Country B
Wheat (1 ton)	10 labourers	25 labourers
Rice (1 ton)	20 labourers	5 labourers

Table makes it clear that nation A has a definite advantage over nation B in the production of wheat since it can produce one ton of wheat with fewer labourers. However, compared to nation A, country B has a clear advantage in the production of rice because it can produce 1 ton of rice with fewer labourers. In this scenario, country A would produce 10 tons of wheat (100/10) and 5 tons of rice (100/20) and country B would produce 4 tons of wheat (100/25) and 20 tons of rice (100/5) if there is no trade between these two nations and resources (in this case, a total of 200 labourers) are divided equally between the two. Consequently, there are 39 tons produced overall (25 tons of rice and 14 tons of wheat) when trading is not included.

Table: Production volume of Wheat and Rice without trade

	Country A (in Tons)	Country B (in Tons)
Wheat	10	4
Rice	5	20

Now, the overall production would be higher if both nations opened up to commerce and focused on products in which they had a clear edge. In the event of a trade, Country A would employ 200 labourers to produce 20 tons of wheat, whereas Country B would use 200 labourers to generate 40 tons of rice.

Consequently, sixty units would be produced in total (20 tons of wheat and 40 tons of rice).

Table: Production volume of Wheat and Rice with trade

	Country A (in Tons)	Country B (in Tons)
Wheat	20	0
Rice	0	40

The afore-mentioned descriptive example makes it evident that, in the absence of specialization, the combined production of the nations was 39 tons, but that, thanks to trade opportunities, it rose to 60 tons following specialization. This is how trade improves welfare.

Consequently, the idea of absolute advantages demonstrates that a trade pattern based on disparities in absolute costs would be advantageous to both nations.

COMPARATIVE ADVANTAGE THEORY

In his 1817 book "Principles of Political Economy and Taxation," David Ricardo expounded upon his notion of absolute benefit. He introduced the law of comparative advantage in this book.

Trade can be advantageous for both countries, according to the Ricardian theory, even if one has a complete edge in all products and the other does not have a complete advantage in any items. According to Ricardo, "A nation, like a person, benefits from trade by importing those goods and services in which it has the least comparative advantage and exporting those in which it has the greatest comparative advantage in productivity." According to this idea, there are no trade barriers between the two countries and labour is the only factor of production in both. There are also no transportation costs. The example given in Table helps to clarify this principle.

Table: Production of Wheat and Rice by Country A and B before the trade

	Country A (in Tons)	Country B (in Tons)
Wheat	20	15
Rice	40	10

Table demonstrates that whereas nation B can use the same number of labourers (100) to produce 15 units of wheat, country A can only produce 20 units. Furthermore, nation A has the capacity to generate 40 units of rice, while nation B can create 10 units of rice with 100 labourers.

For instance, nation A has chosen to employ 150 labourers in order to produce 60 units of rice. Ten units of wheat are produced by 50 labourers. However, nation B has made the decision to cease producing rice and use all 200 labourers to produce 30 units of wheat. In this scenario, 14 units of rice produced in country A are traded for 14 units of wheat produced in country B.

Table: Production after specialization

	Country A	Country B
Wheat	10	30
Rice	60	0

Table: Situation after the trade takes place

	Country A	Country B
Wheat	24	16
Rice	46	14

Table above makes it clear that trade has benefited or increased both nations. Country A possessed 20 units of wheat and 40 units of rice prior to the trade; 24 units of wheat and 46 units of rice were present after the trade.

Similarly, prior to the trade, country B had 15 units of wheat and 10 units of rice; subsequent to the trade, it had 16 units of wheat and 14 units of rice. Therefore, even in cases where one country has a complete advantage in producing both commodities, trade can still be advantageous for both participating nations, according to the comparative advantage hypothesis.

HECKSCHER-OHLIN THEORY

The Heckscher-Ohlin (H-O) theory builds upon where Ricardo's theory leaves off. While Ricardo explained that comparative cost differences drive trade, he did not address the reasons behind these differences. The H-O theory provides this explanation, stating that trade occurs due to variations in factor endowments (such as labour or capital) across countries, which affect the relative costs and prices of goods. In essence, nations export goods that use their abundant factors intensively and import goods that require their scarce factors. The H-O theory offers a more comprehensive framework for understanding modern international trade.

Predicated on the subsequent suppositions:

1. The two countries in question are A and B.

2. Labour and capital are the two components of production.

3. There are two goods: X and Y; X requires a lot of labour, while Y is capital-intensive.

4. Country A has a large labour pool, while Country B has a lot of money.

The Price Criterion of Relative Factor Abundance

Regardless of the overall proportions of capital to labour compared to another country, a nation with comparatively cheap capital and relatively expensive labour is considered to have a relatively ample capital stock, as per the price criterion. In symbolic words, country E is comparatively capital-rich when:

$$(PK/PL)\ E < (PK/PL)\ I$$

(In this case, factor price is denoted by P, capital by K, labour by L, and the two respective countries by E and I.) Ohlin's theorem can be diagrammatically verified in Figure.

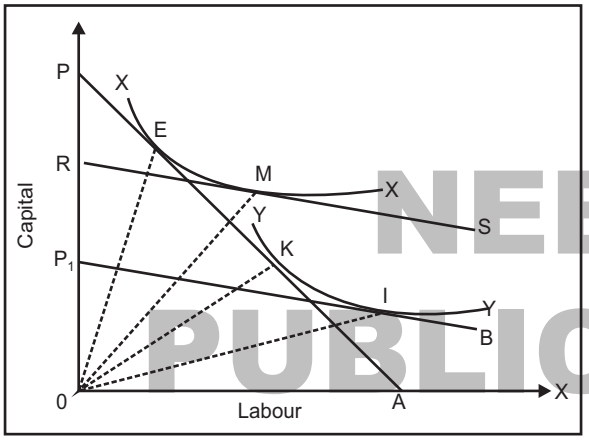

Fig.: Diagrammatic explanation of H-O model

Let's use the same two nations, England and India, as an example. England is rich in capital, whereas India has an abundance of labour.

The isoquant (equal product curve) for the commodity X produced in England is represented by the symbol XX in the diagram above. The isoquant YY stands for commodity Y that is made in India. It is evident that YY is more labour incentive-driven than XX in terms of capital intensity. The horizontal X-axis represents the factor labour, and the vertical Y-axis represents the factor capital.

The country of England's budget or price line is called PA. At point E, the pricing line PA is tangent to XX. Furthermore, at K, the pricing line PA is tangent to the YY isoquant. Point K will be beneficial. The pricing line for the nation of India is P_1B, and it is tangent to YY at I.

Drawn parallel to P_1B, the pricing line RS is tangent to XX at M. This will assist us in determining the labour and money needed to create a single unit of commodity X in India.

There are four main theorems in the H-O-S model:

1. The Heckscher-Ohlin Theorem
2. The Stolper-Samuelson Theorem
3. The Factor Price Equalization Theorem
4. The Rybczynski Theorem.

STOLPER – SAMUELSON THEOREM

The Stolper-Samuelson theorem was developed by economists Paul Samuelson and Wolfgang Stolper, both of whom made significant contributions to the field of international trade theory. This theorem plays a critical role in understanding how changes in relative product prices impact the allocation of resources, income distribution, and the broader economy. It is deeply intertwined with the Heckscher-Ohlin (H-O) model, which explores how countries trade based on their factor endowments such as labour, capital, and natural resources.

The Stolper Samuelson theorem provides insights into the relationship between product prices and factor prices such as wages for labour and returns on capital within the H-O framework. In essence, it states that an increase in the price of a good will raise the income of the factor used intensively in its production, while reducing the income of the factor that is used less intensively. For instance, if a labour-abundant country experiences a rise in the price of a labour-intensive good, wages will increase, while the returns to capital may decline. The reverse holds true for capital-intensive goods: when their prices rise, the returns to capital increase, but wages decline.

FACTOR-PRICE EQUALIZATION THEOREM

The factor-price equalization theorem states that when the costs of items are factor prices, such as those of labour and capital, get equalized between nations as a result of international commerce. This suggests that Increased commerce will level the playing field between worker pay and capital gains from rentals. In the end, everywhere in the planet.

The H-O model's presumptions form the basis of the theorem. The most important is the presumption that markets and technology are similar between the two nations are flawlessly rivalry. Factors are compensated in perfect competition according to the worth of their marginal output, which is reliant on the costs of the products. As a result, as prices vary among nations, so will their marginal productivity, so as will be paid in salary and rent. But after the costs of goods are equalized, as previously shown in the case of free trade, the values of marginal since goods are standardized across nations, those nations must also have comparable rates of pay and rental income.

RYBCZYNSKI THEOREM

According to the Rybczynski theorem, a rise in one component's endowment will increase its output of the commodity intensive in that factor by a larger percentage and decrease the output of the other commodity at constant commodity prices. The theorem is helpful when examining how immigration, emigration, and capital investment affect the H-O model.

Figure can be used to understand Rybczynski's theorem diagrammatically. Figure shows that DD represents the capital constraint, while EE discloses the labour limits. Production occurs at point A. Assume that software is a capital good and textiles are a labour-intensive good. The production of these two goods is represented by S_1 S_2 for software and C_1 C_2 for textiles. Let's now assume that labour wages rise, causing the labour constraint line to migrate outward and parallel from DD to D_1D_1. The production potential frontier likewise moves from point A to point B in this instance. Textile production, a labour-intensive good, will move from C_1 to C_2. The capital-intensive good, software production, will shift from S_2 to S_1.

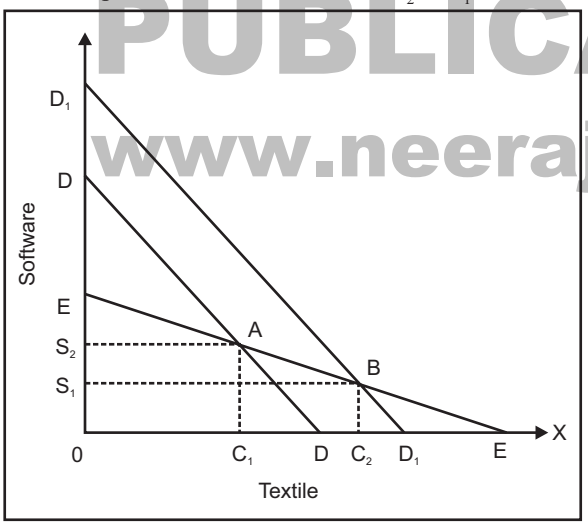

Fig.: Diagrammatic Representation of Rybczynski Theorem

The capital restriction will disappear if the endowment of capital (interest rate) rises, which will lead to a rise in software output and a fall in textile manufacturing. As previously stated, software is a capital-intensive item while textiles are a labour-intensive item due to the labour constraint curve's steeper slope than the capital constraint curve.

CHECK YOUR PROGRESS

Q. 1. Explain the difference between Domestic and International Trade.

Ans. The difference between domestic trade and international trade lies primarily in the scope and the nature of the markets they serve. Here's a breakdown:

1. Geographic Scope

- **Domestic Trade:** Refers to the exchange of goods and services within the borders of a single country. For example, buying and selling products between different states or regions within the U.S.
- **International Trade:** Involves the exchange of goods, services, and capital across international borders. This includes imports and exports between countries, such as the trade between the U.S. and China.

2. Regulations

- **Domestic Trade:** Governed by the laws, regulations, and policies of a single country. These include national taxation, labour laws, and market standards.
- **International Trade:** Subject to international agreements, treaties, tariffs, and trade regulations, such as those governed by the World Trade Organization (WTO). It involves multiple jurisdictions, and each country has its own set of trade restrictions and tariffs.

3. Currency

- **Domestic Trade:** Typically conducted in the country's national currency, such as U.S. dollars (USD) in the United States or Indian rupees (INR) in India.
- **International Trade:** Involves the exchange of different currencies, requiring currency conversion. Exchange rates can affect the cost and profitability of trade.

4. Cost and Complexity

- **Domestic Trade:** Generally, involves lower transaction costs, fewer regulations, and minimal logistical challenges compared to international trade.
- **International Trade:** Typically involves higher transaction costs due to tariffs, customs duties, and transportation costs. Logistical and legal challenges are also more complex because of different languages, cultures, and regulatory frameworks.