Business Economics

- D.K. Dubey
- Mahendra Mishra
- Manikandan Iyer
- S.K. Mishra

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Business Economics

(Paper: VI)

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Durgesh Kumar Dubey
M.A.,B.Ed., UGC-NET
Assistant Professor
Department of Business Economics
Hinduja College of Commerce,
Charni Road, Mumbai - 400 004

Mr. Mahendra Mishra
M.A., M. Phil, UGC-SET
Assistant Professor
Department of Economics
K.J.Somaiya College of Arts and Commerce
Vidyavihar, Mumbai - 400077

Mr. Manikandan Iyer
M.A., UGC-SET
Assistant Professor
Department of Economics
M.M.K. College of Commerce and Economics
Bandra (W), Mumbai - 400050

Dr. S.K. Mishra
Ph. D., M.A., B. Ed.,
HOD – Business Economics
Department of Business Economics
K.P.B. Hinduja College of Commerce,
Charni Road, Mumbai - 400 004

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New Delhi	:	"Pooja Apartments", 4-B, Murari Lal Street, Ansari Road, Darya Ganj, New Delhi - 110 002. Phone: 011-23270392, 23278631; Fax: 011-23256286
Nagpur	:	Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018. Phone: 0712-2738731, 3296733; Telefax: 0712-2721216
Bengaluru	:	No. 16/1 (Old 12/1), 1st Floor, Next to Hotel Highlands, Madhava Nagar, Race Course Road, Bengaluru - 560 001. Phone: 080-22286611, 22385461, 4113 8821, 22281541
Hyderabad	:	No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda, Hyderabad - 500 027. Phone: 040-27560041, 27550139
Chennai	:	New-20, Old-59, Thirumalai Pillai Road, T. Nagar, Chennai - 600 017. Mobile: 9380460419
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Lucknow	:	House No 731, Shekhupura Colony, Near B.D. Convent School, Aliganj, Lucknow - 226 022. Phone: 0522-4012353; Mobile: 09307501549
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Ernakulam	:	39/176 (New No: 60/251) 1st Floor, Karikkamuri Road, Ernakulam, Kochi – 682011. Phone: 0484-2378012, 2378016 Mobile: 09387122121
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Indore	:	Kesardeep Avenue Extension, 73, Narayan Bagh, Flat No. 302, IIIrd Floor, Near Humpty Dumpty School, Indore - 452 007 (M.P.). Mobile: 09303399304
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Preface

It gives us immense pleasure to put forth the first edition of the textbook on **Business Economics Paper – VI,** prepared strictly according to the revised syllabus and paper pattern (75:25 paper pattern) for credit-based semester system introduced for T.Y. B.COM degree course of the University of Mumbai.

It is our sincere effort to make the topics simple and present them to the brilliant as well as average and below average students. At the end of the chapters, review questions and especially objective type question will help the students for preparation in their exams. We hope this book will meet the expectations and serve the purpose of the students and teachers.

We also take this opportunity to extend our thanks to the learned teachers and students community for their overwhelming response to our first edition for Semester – V textbook. We are also thankful to you for your valuable suggestions and recommendations for the improvement of the content for the book making it more user-friendly.

We acknowledge our special gratitude to all those authors and publishers, whom we have referred in the course of writing this book. We also take this opportunity to express our deep sense of gratitude to our Principal, Teacher Colleagues, our family members and friends for their support in this Endeavour. We would like to express our sincere thanks to Shri S.K. Srivastava and Ms Nimisha and other staffs of M/s Himalaya Publication House Pvt. Ltd.

We hope that this book will also warmly accepted by the students and teachers. Constructive and valuable suggestions are welcomed from the students and teaching fraternity for further improvement of the book.

Authors

Syllabus

Module I **International Trade**	Theories of International Trade: Comparative Cost Theory, Heckscher-Ohlin Theory, Terms of Trade: Meaning & Types – Gains from Trade (with Offer Curves)	(15 Lectures)
Module II **Balance of Payment and WTO**	Concept & Structure of BOP, Causes of Disequilibrium, Measures to Correct Disequilibrium in BOP – India's BOP Position since 1991 - WTO Agreements with reference to TRIPS, TRIMS and GATS	(10 Lectures)
Module III **Foreign Exchange Market**	Concept of Foreign Exchange Market: Functions and Dealers – Exchange Rate Systems – Spot and Forward Exchange Rate – Hedging, Arbitrage and Speculation.	(10 Lectures)
Module IV **Exchange Rate Management**	Exchange Rate Determination – Purchasing Power Parity Theory – Role of Central Banks in Foreign Exchange Market – RBI's Intervention in Foreign Exchange Rate Management Since 1991 (stages)	(10 Lectures)

Paper Pattern

Internal Examination:

The Internal Examination will be of 25 marks and is split into:

(i) Test Paper of 20 marks consisting of questions of objective types and case studies.

(ii) 5 marks for responsible behavior and active class participation

External Examination: **Time : 2.30 Hrs**

Question Paper Pattern for Semester End Examination.

There will be Five questions in all. All the questions are **COMPULSORY** and will have internal choice. **(Total 75 marks)**

Q1. Module I **(Total marks 15)**
Three questions: A **OR** B **OR** C. Attempt any Two

Q2. Module II **(Total marks 15)**
Three questions: A **OR** B **OR** C. Attempt any Two

Q3. Module III **(Total marks 15)**
Three questions: A **OR** B **OR** C. Attempt any Two

Q4. Module IV **(Total marks 15)**
Three questions: A **OR** B **OR** C. Attempt any Two

Q5. Module I to IV **(Total marks 15)**

A. True or False with reasons. Attempt any Four out of Eight:
Two from each module. **(2 marks each)**

B. Choose the correct option. Attempt any Seven out of Twelve:
Three from each module. **(1 marks each)**

Contents

Module - One
International Trade

Synopsis

- Introduction of International Trade
- Theories of International Trade I: Classical Theory
- Theories of International Trade I: Modern Theory
- Term of Trade: Meaning and Types
- Gains from Trade

Chapter 1

Introduction to International Trade

Chapter Contents:

1.1 INTRODUCTION

International trade means trade between the two or more countries. International trade involves different currencies of different countries and is regulated by laws, rules and regulations of the concerned countries. Thus, International trade is more complex.

1.2 MEANING AND DEFINITION

- According to Wasserman and Haltman, "International trade consists of transaction between residents of different countries".
- According to Anatol Marad, "International trade is a trade between nations".
- According to Eugeworth, "International trade means trade between nations".

1.3 INTERNAL VS INTERNATIONAL TRADE

Internal and International trade are the two very frequently employed terms, the former implying an exchange between the two parties belonging to the same nation while the latter suggesting the trade between two political independent sovereign nations. Internal trade is also referred to as interregional or domestic trade, while international trade is termed as external or foreign trade. Thus, a trade between two regions, say Mumbai and Chennai becomes internal or domestic trade while that between India and South Africa is called external or international trade.

Two basic questions arise in this context. First, is there any fundamental difference between domestic and foreign trade. Second and more important issue relates to why countries produce and export certain goods and why do they import certain others rather than producing them domestically? In other words what determines the international specialization. An answer to first question can be had by explaining the similarities and dissimilarities between internal and international trade. The answer to the second question lies in the analysis of trade theories.

Similarities

At the outset, it must be understood that broadly both the types are same in many aspect such as :

- Specialization is the basis of both, domestic as well as foreign trade.
- Both have same requisites, viz., two parties, two commodities and determination of relative prices.
- Gains or benefits, is the primary concern of the regions or nations involved in trade.
- In both cases cost of production is the chief criterion. Individuals, regions or nations produce and sell those commodities in which they are more efficient, i.e., can produce at a lower cost. As against it, they buy from others those goods which they either cannot produce or require higher cost.

Dissimilarities (Differences)

The economist like, Adam Smith, David Ricardo, J.S. Mill, etc., strongly believed that international trade exhibits such peculiar, features which distinguish it clearly from internal trade. Frederich List of Germany aptly observes, "Domestic trade is among us. International trade is between us and them." Major dissimilarities between domestic and foreign trade can be summerised as follows.

1. **Currency Differences:** A peculiar feature of international trade is the use of different currencies by different countries that participate in the exchange, e.g., Indian rupee, Japanese yen, British pound sterling, American dollar, etc. In contrast, domestic trade is carried out through a uniform currency. No doubt, it is possible to arrive at an exchange rate between different currencies. Nevertheless, the currency differences make international trade more complex and complicated as compared to internal trade. Frequent and wide change, in exchange rate generate an element of instability and uncertainty in respect of foreign trade from which internal trade is free.
2. **Resource Mobility:** It is rightly observed by economists like Ricardo, that labour is perfectly mobile within a country and perfectly immobile between the countries. As a result of this the factor prices and hence, the cost of production significantly differ in different countries. Moreover due to immobility of productive resources, certain countries are unable to produce certain commodities. This paves the way for international specialization and trade. In contrast a perfect mobility of factors, within a country ensures uniform factor rewards, cost of production and hence, equal prices
3. **Policy Differences:** Since international trade involves the participation of different politically independent units, it is bound to be affected by the independent economic and the other policies adopted by them. Pattern of international trade, i.e., its volume, composition and direction is significantly affected by different national policies. In contrast, in respect of domestic trade the policies are uniform throughout the nation.

4. **Endowmental Differences:** Different countries have different factor endowments. It is commonly observed that some countries have rich natural resources while in others human resources may be better both quantitatively as also qualitatively. These differences are non-existent in the context of domestic trade. Thus, a different factor endowment leads to distinction between interregional and international trade
5. **Geographical and Other Differences:** Countries widely differ in respect of geographical or natural conditions. These relate to quality and quantity of natural resources, climatic conditions, rainfall, land varieties, etc. Such differences though existing, do not have a great bearing on internal trade.
6. **Trade Restrictions:** Countries adopt certain practices which artificially restrict or enhance international transactions. Heavy import duties, customs, fixation of quotas, etc., effectively restrict imports and exports. As against it bilateral agreements, subsidies, tax concessions, etc., boost up the imports and exports. Such practices are non-existent in respect of domestic trade.
7. **Different Markets:** Different nations have different markets for selling (exports) and buying (imports). These depend upon political ideology, economic system, relations which other nations, etc. This factor distinguishes foreign trade from domestic trade.
8. **Special Issues:** International trade faces certain specific issues and problems not encountered in respect of interregional trade. Mention in this context can be made of international liquidity, international cooperation and understanding etc. These factors are bound to affect international trade but have no concern with the internal trade.

All the above differences lead to the conclusion that international trade widely differs from internal trade and hence, it is argued that both cannot be treated at par. Natural, political, social and above all economic factors play a vital role in distinguishing international trade from domestic or internal trade. The traditional belief in the need for a separate theory of international trade is founded basically on these differences.

Modern Views

Modern economists opine that the differences in internal and international trade are superfluous rather than being genuine. Bertil Ohlin must not be totally neglected when he observes, *"International trade is but a special case of inter-local and interregional trade because countries are nothing more than regions separated by political boundaries."*

The modern economists do not support the classical stand on the differences between domestic and foreign trade and argue that those differences are only apparent and not real. The classical arguments in this respect are countered on the strength of following points:

- The differences in factor mobility are of degree and not of type. Resources are neither perfectly mobile within a country nor are they perfectly immobile between. At the most, we can say that they are more mobile within and less mobile between the countries.
- Existence of different currencies is not so strong an argument as to regard international trade to be totally different from internal trade. Moreover once the exchange rate is arrived at, the issue of different currencies does not produce any services problems.
- It is wrong to argue that domestic trade is free from restrictions and encouragement. They do exist even within a country.

- Absence of transport cost is not peculiar to foreign trade alone. In fact, this relates to market structure like perfect competition and not to type of trade.
- The modern economists argue that comparative cost provides the basis not only for international trade but for domestic trade also.
- General equilibrium theory can explain the pattern of international trade.

In brief, there are no fundamental differences between internal and international trade. The latter only implies extension of a single market price theory of the internal trade to a multi-market theory of the latter.

1.4 ROLE AND IMPORTANCE OF INTERNATIONAL TRADE

International trade plays an important role in countries growth and development. The area like Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders. There are some important roles given below:

1. **Boost Economic Development:** Trade can help boost development and reduce poverty by generating growth through increased commercial opportunities and investment, as well as broadening the productive base through private sector development.
2. **Enhances Competitiveness:** Trade enhances competitiveness by helping developing countries reduce the cost of inputs, acquire finance through investments, increase the value added of their products and move up the global value chain.
3. **Export Diversification:** Trade facilitates export diversification by allowing developing countries to access new markets and new materials which open up new production possibilities.
4. **Encourages Innovation:** Trade encourages innovation by facilitating exchange of know-how, technology and investment in research and development, including through foreign direct investment.
5. **Expand Business Opportunities:** Trade openness expands business opportunities for local companies by opening up new markets, removing unnecessary barriers and making it easier for them to export.
6. **Expand Choice:** Trade expands choice and lowers prices for consumers by broadening supply sources of goods and services and strengthening competition.
7. **Improvement of Quality:** Trade plays a role in the improvement of quality, labour and environmental standards through increased competition and the exchange of best practices between trade partners, building capacity in industry and product standards.
8. **Cutting Government Spending:** Trade contributes to cutting government spending by expanding supply sources of goods and services and strengthening competition for government procurement.
9. **Strengthen Ties Between the Nations:** Trade strengthens ties between nations by bringing people together in peaceful and mutually beneficial exchanges and as such contributes to peace and stability.

1.5 ADVANTAGES OF INTERNATIONAL TRADE

The fundamental reason for international trade is to sell something that we don’t need and to buy something we do need. Trade creates jobs, attracts investments, attracts new technology and materials, and offers wider choice in products and services. The main advantage of international trade is as follows:

1. **Meeting Nation’s Need:** Trade is always balanced if it is fair. If 2 people trade baseball cards and one gives another 6 cards, they should get 6 back. Many businesses can create a surplus inventory of goods and services. Many nation farms produce more food than they can eat, manufacturers make more products than they use, and service providers can provide service to other countries.

   Some nation cannot produce fruits like bananas and oranges and many other products in their own nation and these products are imported. Both trading partners nation get something they need by trading something they don’t need.
2. **Job Creation:** Unlike the battering that used to go on between trading partners, now businesses receive money from selling their products or services to foreign businesses. When foreign businesses buy Indian products it creates jobs for Indians. Exports are very important for international trading partner because it increases the flow of funds to the nations and creates job opportunities. When trade is balanced, businesses remain profitable and may grow faster.
3. **Attracting Investment:** Investment follows trade. Many foreign companies will invest in an office, factory, or distribution warehouse to simplify their trade and reduce cost. This investment also creates more jobs. It also attracts international investors.
4. **New Technology and Materials:** New technology promotes competitiveness and profitability. If a business could create a machine that works better, faster, or cheaper (or all three), then the business will have produced a more competitive product for national and international markets.
5. **Diverse Products and Services:** A century ago, many products were considered a rare treat; people put them in stockings for children. Now, we can buy these products at local grocery stores thanks to better preservation and trading technologies. Foreign trade turns the world into a giant market, delivering food, fashions, etc.
6. **Transfer of Knowledge and Technology:** According to the Adam Smith International trade leads an additional benefit namely that it transfers knowledge and technology between different nations. The adoption and use of new production techniques lead to productivity growth and thus, to economic development and an increase in wealth. For example, China already has a large domestic market and would therefore primarily gain from open trade with Europe by getting access to its technology rather than by widening its market

New services such as banking, travel, and consultation are also available now. Business competition is no longer on a city scale; instead, businesses compete against worldwide businesses. The result is better quality goods, lower prices and functional design.

1.6 DISADVANTAGES OF INTERNATIONAL TRADE

The Global market has made it easy to buy and sell international goods. While this has benefits, it also presents a problem. Such trade can cause countries to be prosperous for a short time, but leads to economic exploitation, loss of cultural identity and even physical harm.

1. **Support of Non-democratic Systems:** Great hardship can be caused when people make poor decisions about land use or surplus production for export and do not take the general population's welfare into consideration. For example: Landowners in many nations want farmers to grow coffee beans because it is a very profitable cash crop, however, the farmers would like to use the land to grow more food for their families. The farmer's wishes are ignored because they do not actually own the land.
2. **Cultural Identity Issues:** Culture is a major export in the world. It displays and promotes values and lifestyles worldwide. The "culture consumer" in other countries is sometimes overwhelmed by developed nation's ideas. Products also carry cultural ideas and messages. There are values of the culture that make the product.
3. **For example:** Coca-Cola, McDonalds, Nike, and Microsoft all sell products that symbolize American values and symbolize and reflect American corporate culture.
4. **Social Welfare Issues:** Maintaining safety standards, minimum wages, worker's compensation and health benefits are all social welfare issues that cost business money. If a running shoe is made in a country where these issues are not met then the shoe can be sold for less in other nation. The downside to this is that substandard safety conditions cause death and injury in the workplace.
5. **Environmental Issues:** In international trading environment this is one of the important issues. International traders ignore the rules and regulations to clean the environment. There motive is only to make profit. They are not interested in protecting the environment because it is costly business. Due to this international traders decide to move their operations to countries where it is less regulated.
6. **Political Issues:** Precious commodities such as gold, diamond, oil or farmland are so important for countries to have control that wars have been started and as a result people are killed. Trade of these items has caused political alliances that do not help the people in the trading nation but only the powerful corporations that control the commodity.

1.7 CONCLUSION

International trade plays an important role in countries growth and development. The areas like industrialization, advanced transportation, globalization, multinational corporations and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders. Along with importance of international trade between the nations, it is not free from some problems associated with it such as economic exploitation of least developing nations by MNCs, loss of cultural identity and even physical harm etc.

Review Questions

(1) Distinguish between internal trade and international trade.
(2) In what respects domestic trade is similar to the foreign trade?
(3) Describe the features which distinguish international trade from interregional trade.
(4) Explain the role and importance of international trade.
(5) Discuss the advantages of international trade.
(6) Write short notes on:
    (a) Internal vs International Trade

(b) Role and Importance of International Trade
(c) Advantages of International Trade
(d) Disadvantages of International Trade

Objective Questions

(A) Choose the most appropriate answer and rewrite the statement.

(1) With international trade
  (a) Producer surplus increases in both the exporting and importing countries
  (b) Consumer surplus increases in exporting countries and decreases in importing countries
  (c) Consumer surplus increases in the importing countries and producer surplus increases in the exporting countries
  (d) None of these

(2) International trade
  (a) Benefits countries which export goods and hurts countries which import goods
  (b) Benefits poor, undeveloped countries and hurts wealthy, industrialized countries
  (c) Increases both producer surplus and consumer surplus throughout the world
  (d) Has a net beneficial effect only for countries with an autarky equilibrium

(3) International Trade is a trade between …
  (a) Two states (b) Two nations
  (c) Two people (d) None of these

(B) State with reason whether following statements are true or false.

1. International trade occurs for very different reasons than interregional trade within a country.
2. International trade occurs for entirely different reasons than trade among the regions of a large country such as the U.S.
3. There are a large number of institutional differences between domestic trade and international trade.
4. The only difference between domestic trade and international trade is the existence of tariffs on imported goods.
5. Prices of traded goods fall in the importing country and rise in the exporting country
6. Production of traded goods falls in countries that export them.
7. Importing countries produce more of the goods they import in order to replace those imports with domestic production.

Answers:

(A) Choose the most appropriate answer

1. (c) 2. (c) 3. (b)

(B) True or False

1. False 2. False 3. True 4. False 5. True 6. False 7. False

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