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INTERNATIONAL ECONOMICS

D.M. Mithani

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D. M. MITHANI
M.A., Ph.D.,

Professor Emeritus,
L.J. Institute of Business Management (MBA),
Ahmedabad, India.

Adjunct Professor,
Oriental Institute of Management,
Vashi, Navi Mumbai.

Former Professor, OYA Graduate School of Business,
Universiti Utara Malaysia (UUM), Malaysia.

Former Reader,
Department of Commerce, University of Mumbai,
Mumbai, India.

Former Head of Economics Department,
Maharashtra College of Arts, Science and Commerce,
Mumbai.

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Nagpur : Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018.
Phones: 0712-2738731, 3296733; Telefax: 0712-2721216

Bengaluru : Plot No. 91-33, 2nd Main Road, Seshadripuram, Behind Nataraja Theatre,
Bengaluru - 560 020. Phone: 080-41138821; Mobile: 09379847017, 09379847005

Hyderabad : No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda,
Hyderabad - 500 027. Phone: 040-27560041, 27550139

Chennai : New No. 48/2, Old No. 28/2, Ground Floor, Sarangapani Street, T. Nagar,
Chennai - 600 012. Mobile: 09380460419

Pune : "Laksha" Apartment, First Floor, No. 527, Mehunpura, Shaniwarpeth (Near Prabhat Theatre),
Pune - 411 030. Phones: 020-24496323, 24496333; Mobile: 09370579333

Lucknow : House No. 731, Shekhupura Colony, Near B.D. Convent School, Aliganj,
Lucknow - 226 022. Phone: 0522-4012353; Mobile: 09307501549

Ahmedabad : 114, "SHAIL", 1st Floor, Opp. Madhu Sudan House, C.G. Road, Navrang Pura,
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Ernakulam : 39/176 (New No. 60/251), 1st Floor, Karikkamuri Road, Ernakulam, Kochi - 682 011.
Phones: 0484-2378012, 2378016; Mobile: 09387122121

Bhubaneswar : Plot No. 214/1342, Budheswari Colony, Behind Durga Mandap,
Bhubaneswar - 751 006. Phone: 0674-2575129; Mobile: 09338746007

Kolkata : 108/4, Beliaghata Main Road, Near ID Hospital, Opp. SBI Bank,
Kolkata - 700 010. Phone: 033-32449649; Mobile: 07439040301

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Dedicated as a token of Love and Respect to

Prof. Y.K. Bhushan

Senior Advisor and Campus Head

ICFAI, Business School (IBI), Mumbai

The Legend of Management Education

in India and an Iconic Institution builder

having completed

Sixty Glorious Years of his Career in Teaching

PREFACE TO THE NINTH REVISED EDITION

This volume on International Economics is revised in seeking to explore the economic analysis incisively applied to examine the global economic events and the exciting dynamism of new economic order of the foreign trade and finance in the fast changing world of the 21st Century. In the globalising process of the world economy today, foreign trade and investments are growing faster than the production along with rising capital flows in these days of revolutionary information and communication technology. There is an increasing trend of national economic integration and interdependence, projects and policies tied together in achieving the common goals in the gamut of shifts from competition to contacts and collaboration.

In this edition, the book has been thoroughly revised and recast to incorporate a broader range of events and analysis more rigorously in an updated manner to facilitate the reader to have a better comprehension and improved ability to understand the development in the global economic fields. It is more data-oriented and research-based in its synthesization of ideas and analysis. This edition also incorporates several relevant case studies for the benefit of the reader and purposeful classroom discussions and pragmatic courses at the graduate and undergraduate levels of studies in India and abroad.

Towards acceleration of India's Development Journey Ahead.

"Those who resist change will become irrelevant in the 21st century."

— ***Shri Narendra Modi***

(Prime Minister of India)

D. M. MITHANI

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Ramzan Idd + Maharana Pratap Jayanti
16th June, 2018 **D. M. MITHANI**

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1

Importance of International Economics

1. Internal and International Trade

The term “trade” is commonly understood to mean exchanges of goods, wares or merchandise among people. It comprehends every species of exchange or dealing in goods. Trade may be internal or external. By internal or domestic trade is meant transactions taking place within the geographical boundaries of a nation or region. It is also known as intra-regional or home trade. External or international trade, on the other hand, is trade among different countries or trade across political frontiers. International trade thus, refers to the exchange of goods and services between one country or region and another. It is also sometimes known as inter-regional or foreign trade. Briefly, trade between one nation and another is called “international” trade; and trade within the territory (political boundary) of a nation “internal” trade.

Evidently, international economics, which is the subject of the present book, is that branch of economics which is concerned with the exchange of goods and services between one country and another (foreign trade) as distinct from that trade, which is carried on within the territory of a nation (domestic trade).

The economic reason or significance of international trade is similar to that of domestic trade in a country, that is, the mutual satisfaction of wants and attainment of well-being. In fact, in the absence of international trade it would not have been possible for the world community to live a more happy and prosperous life with a high standard of living as we see today.

However, the fundamental basis of international trade lies in the fact that all countries cannot produce all things equally well or cheaply due to the unequal distribution of natural resources among them and improportionality and imperfect substitutability of their available factors of production. Moreover, for various socio-economic and political reasons, there is a lack of mobility of factors, especially labour, as between one country and another. Thus, different kinds of production which were most advantageous to them were undertaken by different countries and when the exchange of these specialised goods which took place among them gave birth to international trade. Thus, international trade insofar as it is a result of geographical specialisation fundamentally the same as trade between two regions within the same country (*i.e., domestic* trade). Each region within a country tends to specialise in the production of commodities for which it is best suited, *e.g.,* jute is manufactured in West Bengal and cotton textiles in Mumbai. The same principle of territorial division of labour is extended to the international level, too.

The difference between the two types of trade, internal and international trade (or economics) is merely an application of general economics in the particular context. From this arises questions such as: Why is international economics treated as a separate branch of economics? Are not the laws of domestic trade applicable to foreign trade? Can we not just extend the general theory of production, value, money, etc., to the problem of international trade and transactions? Why should there be a need for a separate theory?

2. Is There a Need for a Separate Theory of International Trade?

On this question, there are two views: (i) The Classical view and (ii) Ohlin's view.

The Classical View

Classical economists believed that there was a fundamental difference between home trade and foreign trade. They pointed out that, labour and capital move freely within a country but not between different countries. Thus, international immobility of factors was the basic criterion accepted by the classical economists for the emergence of international trade. Moreover, different national policies, different political units, different monetary systems, and artificial barriers like tariffs and exchange controls involved in international trade distinguish it from domestic trade. Hence, the classicists observed that the conditions which regulated the exchange of commodities within one such country did not apply to economic relations between different countries. Hence, a separate theory of international trade was necessary and justified.

Ohlin's View

Bertil Ohlin, the Swedish economist, however, challenged the traditionally accepted notion on international trade by advocating that there is no need for a separate theory of international trade. In his view "international trade is but a special case of inter-local or inter-regional trade."

He opines, that the Marshallian theory of value can be easily extended to the phenomenon of international trade by developing the "space" thesis instead of the "time" hypothesis in the Marshallian Price Theory. "Space element is vital for the international trade and should be given full consideration in the theory of pricing, through its extension from one to a number of more or less closely related markets. Such an extension can be based upon one market analysis."[1]

In economic life, the concept of "space" has the following significance:

1. The factors of production are generally confined to certain localities, and
2. Free movements of goods are also prevented by the transportation costs and other inhibitory factors.

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1. B. Ohlin: *Interregional and International Trade*, p. 4.

In short, from the "space" consideration, there arose the concept of mobility or immobility of the factors of production as located not in certain places but in certain "districts." He further laid down that the concept of "district" should fulfil at least two conditions:

1. There should be significant differences between the districts, and
2. There should be little differences within a single district.

In other words, a district satisfying these two conditions may be regarded as a "region."

Under these considerations of the space element, if we take the axiom that the factors of production are inter-regionally immobile but intra-regionally (within the region) freely mobile, then most conveniently we can extrapolate the analysis of regional or internal trade into the international sphere. Ohlin, thus, claims that, the development of the concept of one market theory can include the theory of international trade as an integral part of the general price theory, and that, therefore, there is no need for a separate theory of international trade.

Thus, on methodological grounds, Ohlin tends to reject the necessity for a separate study of international economics. We, however, cannot agree with Ohlin on this issue that a separate study of international trade is not warranted purely for methodological reasons. Apart from methodological reasons, there are various qualifications and variations within a separate branch of study which by all means render a special study quite essential. For an intensive study, a separate branch of the phenomenon is more logical and justifiable than to hold meaningless behavioural generalisations.[2]

We may, thus, say that, since there are specialised branches of economics like theory of value, theory of money, public finance, industrial economics, labour economics and so on, there must also be a special study of international trade separately called "international economics."

3. Distinct Features of International Transactions

There are several reasons — practical as well as pedagogic — for evolving a separate theory of international trade and consequent development of a distinctive branch of economics called "International Economics" dealing with issues and problems of the international economy. International trade follows different laws of behaviour from those of domestic trade. Therefore, a separate theory is inevitable. These reasons, in a way, tend to point out the distinguishing attributes of international transactions. Following Kindleberger,[3] we may enlist the important features of international trade as under.

Immobility of Factors

The degree of immobility of factors like labour and capital is generally greater between countries than within a country. Immigration laws, citizenship requirement, etc., often restrict the international mobility of labour. International capital flows are prohibited or severely limited by different governments. Consequently, the economic significance of such mobility of factors tends to equality within but not between countries. For instance, wages may be equal in Mumbai and Pune but not in Mumbai and London. According to Harrod, it thus, follows that domestic trade consists largely of exchange of goods between producers who enjoy similar standards of life, whereas, international trade consists of

2. *Ibid.,* p. xv.
3. Kindleberger C.: *International Economics,* pp. 3-10.

exchange of goods between producers enjoying widely differing standards. Evidently, the principles which determine the course and nature of the internal and international trade are bound to be different in some respects at least.[4]

In this context, it may be pointed out that, the price of a commodity in the country where it is produced tends to equal its cost of production. The reason is that, if in an industry the price is higher than its cost, resources will flow into it from other industries, output will increase and the price will fall until it is equal to the cost of production. Conversely, resources will flow out of the industry, output will decline, the price will go up and ultimately equal the cost of production.

Therefore, among different countries, resources are comparatively immobile; hence, there is an automatic influence equalising price and costs. There may be permanent difference between the cost of production of a commodity in one country and the price obtained in a different country for it. For instance, the price of tea in India must, in the long run, be equal to its cost of production in India. But in the U.K., the price of Indian tea may be permanently higher than its cost of production in India. In this way, international trade differs from home trade.

To the extent that, there are differences in factor mobility and equality of factor returns, costs and price of goods produced and exchanged between countries as compared to those within a single country, international trade will follow different laws. A distinct set of theories will thus, be needed to analyse international transactions.

Heterogeneous Markets

In the international economy, world markets lack homogeneity on account of differences in language, preferences, customs, weights and measures, etc. The behaviour of international buyers in each case would, therefore, be different. For instance, the Indians have right-hand driven cars while Americans have left-hand driven cars. Hence, the markets for automobiles are effectively separated. Thus, one peculiarity of international trade is that, it involves heterogeneous national markets.

Different National Groups

An obvious difference between home trade and foreign trade is that trade within a country is trade among the same group of people, whereas, trade between countries runs between differently cohered groups. The socio-economic environment differs greatly between nations, while it is more or less uniform within countries. Friedrich List, therefore, put that: “Domestic trade is among us, international trade is between us and them.”[5]

Different Political Units

International trade is a phenomenon which occurs between politically different units, while domestic trade occurs within the same political unit. The government in each country is keen about the welfare of its own nationals against that of the people of other countries. Hence, in international trade policy, each government tries to see its own interest at the cost of the other country. As a matter of fact national sovereignty exerts its great influence on the character of economic activity and trade.

4. Sir Roy Harrod: *International Economics*, p. 6.
5. Quoted by C. Kindleberger: *International Economics*, p. 9.

Thus, the task of international economics is to discover a common ground, if it can, for economic relationship which will satisfy the various components of a peaceful world.

Different National Policies and Government Intervention

National rules, laws and policies relating to trade, commerce, industry, taxation, etc., are more or less uniform within a country, but differ widely between countries. Tariff policy, import quota system, subsidies and other controls adopted by a government interfere with the course of normal trade between it and other countries. Thus, state interference causes different problems in international trade while the value theory in its pure form, which assumes *laissez-faire* policy, cannot be applied *in toto* to the international trade theory.

Different Currencies

Perhaps the principal difference between domestic and international trade is that, the latter involves the use of different types of currencies. That is why there is the problem of exchange rates and foreign exchange. It is a fact that different countries follow different foreign exchange policies. Thus, one has to study not only the factors which determine the value of each country's monetary unit, but also the fact of divergent practices and exchange resorted to.

Specific Problems

International economic relations give rise to certain specific problems of a peculiar nature, *e.g.,* international liquidity, international monetary co-operation, evolution of international organisations like the European Common Market, etc. Such problems can never arise in regional economics. These are to be studied separately and solved by "international economics" against the background of world movements at large.

4. Pure and Monetary Theory of International Trade

International trade theories are usually classified into "pure" and "monetary" theory. The pure (or equilibrium) theory of international trade deals with "equilibrium" phenomena of trade. It seeks to analyse and expose the conditions of equilibrium in real terms. It probes into the economic causes and consequences of international trade. The monetary theory of foreign trade is confronted with the monetary mechanism of international economic transactions, including financial transactions and capital movements. It primarily deals with the determination of exchange rates and seeks to examine the methods and processes of adjustments in the balance of payments equilibrium.

The pure theory of international trade answers three sets of questions: First, why do nations enter into trade? Second, how are gains of trade shared by the trading nations? Third, how does international trade affect the allocation of resources in the domestic economy of the trading country?

A distinctive feature of pure theory of international trade is that it is part of general theory of value. It is, however, static general equilibrium theory (whether it be the classical theory of "comparative costs" or the modern "factor-proportions analysis"). At the most, "pure theory" is a rudimentary dynamic analysis. The monetary theory of international trade, on the other hand, is at least partly a perfect dynamic theory, which is closely related to the trade cycle theory and Keynes' General Theory of Income and Employment.[6]

In economic literature so far, however, no successful attempt has been made to explain fully how these two types of theories are interlocked. Perhaps the reason for this may not be far to seek. The pure theory of international trade fundamentally deals with the shift in the economic equilibrium from one position to another on account of dynamic changes like changes in preferences, technology, economic policy, etc. It seeks to describe and analyse the features of new equilibrium. The monetary theory of international trade, on the other hand is confined to the process of adjustment leading back to equilibrium. Pure theory generally could not very successfully analyse and describe the process of adjustment. It could only figure out equilibrium positions. As such, international monetary theory has always to confront one or the other of the following problems: either (1) it is trivially simple or (2) it involves specific and sometimes unrealistic assumptions about the nature of adjustment. The latter fact, however, puts the generality aspect of the theory in doubt. Consequently, it becomes difficult to integrate monetary theory into the skeleton of pure economic theory in a rational and realistic manner.[7]

5. International Business

International business is a wider phenomenon than international trade.

When a business firm conducts or expand its business activity beyond the domestic borders of its country it engages in **international business**.

International business virtually implies a company's enlarging business activity containing production as well as sales in more than one country.

The growth and prosperity of global economy rests on the spread of international business, in modern times.

Multinational corporations (MNCs) are the pillars of expanding global economy today. International trade and investments are pivotal in this regard. Table 1.1 summarily represents the types of economies operating in the global arena.

TABLE 1.1: TYPES OF ECONOMIES COMPRISING THE GLOBAL ARENA (ILLUSTRATIONS)

Classification	Major Characteristics	Example
1. Developed Economies	• Mature Economy • High per capita income	USA, Australia Canada, Japan
2. Developing Economies	• Extensive Growth in last two decades	Singapore, Hong Kong, Taiwan, India
3. Transition Economies	• Shift from government control system to capitalism	Indonesia, Malaysia, Thailand
4. Least developed countries (LDCs)	• Poorest Nations. • High unemployment • Lack of skills	Afghanistan, Cambodia, Yemen

6. Haberler G. V.: *A Survey of International Trade Theory*, p. 4.
7. Cooper R.N. (ed,): *International Finance,* pp. 7-8.

6. A Measure of International Trade Concentration

Concentration ratio (C_n) for International Trade is measured as follows:

$$C_n = (Q_n - X_n)/(Q - X + M)$$

Where

Qn = Sales at home and abroad by the n largest domestic firms

Xn = Exports by the n largest domestic firms

Q = Total Sales

X = Total Exports

M = Total Imports

Source: Soumyen Sikdar (2002): *Contemporary Issues in Globalisation,* Oxford University Press, New Delhi.

7. Calculation of Growth Rate

The Compound Rate of Growth (CRG)

$$CRG = (X_a/X_b)1/n - 1$$

Here,

X_n = The dollar value of international trade in the current year

X_b = The dollar value of international trade in the base year.

8. Concluding Remarks

Over the years in modern times, world economic trade has expanded dramatically with the increasing number of new participants and products in trade.

Tariffs, transportation costs and lack of adequate market access are usually regarded as major trade barriers. To this, in today's time, it is also essential to examine the following factors as the biggest barriers to trade activity of developing economies. These are:

- Contracts identification
- Understanding the customers' nature and technique in the different segments, owing to differences in cultures and eco-social environment.
- Coping with trade regulations imposed by the governments.
- Difference in legal environment.
- Building of networks and relationships.

A participant firm can overcome the contractual and cultural barriers to trade with growing experience, lowering of trade costs and enactment of bilateral trade agreements.