CHAPTER 1
CONCEPTUAL FRAMEWORK

International Trade

**Trade:** The term is as old as human society itself, as no man is or was ever sufficient unto himself. Thus the trade began with the human society. In the beginning it was in the form of the barter system i.e. exchange of goods and services for the same. There was no monetary exchange. But with the passage of time and the development of human society the demands of the individual as well as the society has multiplied numerously and has become much more complex than in the former centuries. Today, the trade has developed from the primitive concept of barter to that of monetary exchange and from inter-personal to that of international trade. Now, in the modern world, the boundaries of trade have expanded beyond limits. The distance between regions have been shortened or linked with the help of various means of transport i.e. air, water and land. Efficient and modern transport system has solved the time and distance problem.

More and more resources have been discovered and exploited for the benefit of mankind as a whole and with these development have enlarged newer ideas of international trade. "Business going global" is the right phrase to define the term. It cuts across the frontiers that divide the nations.
So, we observe that an important characteristic of economic life of the past has been the shift in the objectives of trade between nations.

Only three decades ago it was deemed to be sufficient that the foreign trader persuade his own interest in arranging his international transactions. According to Adam Smith - "The invisible hand guided these transactions" so that the foreign trader in pursuing his own, also worked in the interest of the society. But, today we are much more demanding and we can no longer leave it to chance or co-incidence or to the invisible hand to assure that international trade serves national interest. International trade must therefore, coincide with the domestic objective of the economy.

However, the fundamental question is that why does international trade take place? Nations trade with each other for the same reason that individual trade with each other.

Nature has distributed unequally the various sources of raw-materials and factors of production over the surface of the earth. Different countries, located on different latitude and longitude, differ in their natural endowment. Different climatic conditions, mineral resources, technology, mines, labour, capital, entrepreneurial and managerial skills etc. are responsible to the variation. These factors decide the capacity and capability of various countries to produce goods
and services. The difference in production possibilities leads to situation where one country can produce some goods more efficiently and cheaply than other, but there is no single country that can produce all the goods cheaply and efficiently e.g. Japan can produce electronics and automobiles more efficiently than any other country and Malaysia can produce rubber in abundance. Production in both the countries of their respective products is in such abundance that they can not consume all, so they can export the excessive to other countries and import those items which they can not produce efficiently and cheaply. Thus this division of factors of production among the world nations is similar to the division of labour among individuals.

Thus, the immediate cause of international trade is the existence of difference in prices of goods and services between nations. Price difference arises either because of the difference in the supply condition (or production possibilities) or because of difference in demand conditions (or taste patterns) or because of some combination of both.

Let us consider a simple model of two countries and commodities in order to understand the basic causes of international trade.

Let's study the following graphs:
Fig 1: Identical demand conditions but different supply conditions

Fig 2: Identical supply conditions but different demand conditions
In the above diagrams x-axis represents the quantity demanded and supplied where as y-axis represents the price of commodities. The left side represents the foreign country and exports where as the right side shows home country and its imports.

Price in the foreign country is $P_F$ i.e. the point where demand curve D and supply curve S intersects. Similarly, $P_H$ is the price in the home country.

From both the figures we can see that price in foreign country ($P_F$) is lower than in the home country ($P_H$) for a given product. This is in the absence of trade between the two countries. This price differential ($P_H > P_F$) is due to (a) different supply conditions in diagram (A) where the foreign supply curve is more elastic than the domestic supply curve (b) different demand conditions in the diagram (B) where the domestic demand curve is more elastic than the foreign demand curve.

The price in the foreign country $P_F$ is at the point of intersection between the demand and the supply curve (point 1) in the foreign country. $P_H$ at point 2 is such a point for the home country. Prices in the home country attracts imports of the goods into this country from the foreign country where the price of that good is relatively lower. Once the two countries brought together into trade relations with each other, the foreign country would emerge as an exporter and the home country would become the importer of that product. The goods will be continued to be exchanged until the price differential is completely wiped off. This point is
reached at (P) price. From \((P_F)\) the price will rise to \((P)\) in the foreign country. This is due to increasing export demand. From \((P_H)\) the price will drop to \((P)\) in home country and this is due to increase in import arrivals from the foreign country. Once \((P)\) price established, reducing the price differential in the countries \((P_H\) and \(P_F)\) to zero. Quantities of exports, in the foreign country and of imports in the home country are stabilized and are equal to each other at \((P)\) price.

This, therefore, suggests that incentive to trade continues as long as there are differentials, and the incentive to trade ceases to exist as soon as the price equalization is achieved.

Price differentials or the difference in demand and supply are not the only cause of international trade. There are many other reasons for international trade between the countries. One can be that nature has decreed important and enduring differences between countries. Some are rich in copper and other are rich in petroleum, some have huge waterfalls, others have fertile plains. Some countries have heavy rainfall to grow enough rice and cotton, others have next to none. One may have the plains and rainfall needed to grow wheat, another may have rich deposits of iron ore next to a waterway that can carry ore to coal. Finally some countries have large population to develop complex industries, but others are so very under populated that their land can not even be worked or their ores extracted.

In one sense people are natural resources while in another there are a
major burden on resources. More number like in India, may not be the gift of nature, but the skills, attitude, talent, intelligence of the masses strongly influence a country's comparative advantage. A nation rich in people but poor in skills may be suited to certain tasks but not for the production and exports of manufactured goods. A nation that has very few persons per square mile but has lavished its energies on technical training is likely to enjoy comparable advantage in production of precision goods. So, we can finally conclude that it is not only demand and supply that leads to international trade but also other reasons.

There were various economists who have been working hard to explain the international trade, so they propounded various theories having different assumptions. Assumptions are the simplified form of reality. The real world in which we live generally, turn out to be too complex for the economists to capture fully into their economic models. The validity of conclusions drawn from economic theories depends largely on how realistic are the assumptions made. If the assumptions are plucked from the air, rather than drawn from observed reality, the theory would turn out to be unreal and will hardly be useful for the practical policy formulation. Thus only that theory is useful as well as successful which has practical application to the world reality.

So, it is logical to make a review of the different theories on international trade.
1. **Classical theory on international trade by Adam Smith**

He propounded the theory of absolute advantage. He was a great defender of free trade on the ground that this automatically promoted international division of labour. By allowing nations to concentrate their production on the goods which could be made most cheaply, with all the consequent benefits of division of labour.

Let's take an example, assume that Malaysia is much more suitable for growing rubber than the U.K. and the same amount of labour can produce more rubber than UK. On the other hand, the same number of labour in UK can produce much more computers.

This leads to the situation of absolute advantage. This situation can more easily be understood by the following given chart.

<table>
<thead>
<tr>
<th>Labour cost of production</th>
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<tbody>
<tr>
<td>Rubber</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>U.K.</td>
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<tr>
<td>Malaysia</td>
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</tbody>
</table>

It will be of obvious advantage to both the countries to employ the principle of division labour and to produce the goods in which each has an absolute advantage and the two countries should undertake international
2. **The theory of comparative advantage by David Ricardo**

According to him, a country will concentrate its resources on the production of those things in which it has the greatest relative advantage over other countries and it will get from abroad those goods in the production of which it has least relative advantage.

**Comparative Difference in Costs.** When the comparative advantage is different, trade will arise and it will continue. Suppose that

In Country A

\[
\begin{align*}
&\text{Marginal cost of producing wheat is Rs. 70 a qtl.} \\
&\text{Marginal cost of producing cotton is Rs. 140 a qtl.}
\end{align*}
\]

In Country B

\[
\begin{align*}
&\text{Marginal cost of producing cotton is Rs. 70 a qtl.} \\
&\text{Marginal cost of producing wheat is Rs. 50 a qtl.}
\end{align*}
\]

In this case, country B can produce both wheat and cotton cheaper than country A. But the comparative advantage is higher in the production of cotton than in that of wheat. On the other hand, A has a comparative disadvantage in the production of both the commodities but the disadvantage is lower for wheat than for cotton.
Thus:

Country A:

1 qtl. of wheat = 1/2 qtl. of cotton  \[1:2\]

Country B:

1 qtl. of wheat = 5/7 or .71 qtl. of cotton  \[1:1\frac{2}{5}\]

It will, therefore, pay country B to specialize in the production of cotton and A in wheat.

**Gain with Comparative Differences in Costs.** In this case a surplus arises with specialization.

**Without Specialization:**

A = 1 quintal of wheat + .50 quintal of cotton.

B = 1 quintal of wheat + .71 quintal of cotton.

A + B = 2 quintals of wheat + 1.21 quintals of cotton.

With Specialization, A producing wheat and B producing cotton only:

A = 2 quintals of wheat.

B = 1.42 quintals of cotton.

A + B = 2 quintals of wheat + 1.42 quintals of cotton.

Surplus = .21 quintal of cotton.
This is the gain from trade.

We may sum up the theory of comparative cost in general terms. An individual is able to perform many tasks but he does not perform them all. He selects that work which pays him the most. A doctor can also do the dispensing but he does not do it; a lawyer can perhaps type, but he does not do it; a professor can teach his son reading in a school but he does not do it. All these people find to their advantage, and it is also to the advantage of the community, that the inferior work is left to inferior persons. In that case, time and energy are more profitably employed.

The same principle works in international trade. Considering climatic conditions, distribution of mineral and other natural resources, geographical position and physical configuration, every country seems to be better suited for the production of certain articles rather than for others. It will be to the advantage of each country, as well as to the advantage of the world as a whole, that each country specializes in the production of those commodities for which it has greater relative advantage. In that case, the productive resources of the countries concerned will be more remuneratively employed.

Thus the theory explains us how the trade takes place due to comparative advantage, but it has certain weaknesses on the basis of which it has been criticized. They are:

(a) It assumes only one factor of production i.e. labour and ignores the rest.
(b) It considers only supply side and ignores the demand side.

(c) Transportation is completely ignored.

(d) Gains from the trade somehow accrue to the country as a whole.

(e) It is only two country and two commodity model whereas in international trade it is not so.

3. Heskher - Ohlin theorem

Recent contribution to the pure theory of the international trade have relied heavily on the factor proportions analysis developed by the two Swedish economists EL Heskher (1919) & BERTIL OHLIN (1933).

They propose that the production function for a given commodity is the same irrespective of the country of production. An identical absolute input of productive factors will result in the same output of a given good in any country while production function for any goods are identical from country to country, they do however vary from commodity to commodity. One production function weight require a relatively large supply of labour to combine with capital and hence give rise to a labour intensive goods, while the other production function might require relatively smaller supply of labour and therefore its associated good is capital intensive. This factor intensity difference in the production function of the two commodities in conjunction with observable differences in comparative cost of relative factor endowments of the countries accounts for international differences in comparative advantage, has been formulated in the famous Heschker Ohlin
theorem; a country tends to export commodity which uses intensively that factor with which the country is relatively plentifully endowed. Thus the theory is passed upon general equilibrium assumptions:

a) Trade may be considered between two regions.
b) Qualitative difference between factors of production can be ignored.
c) Factors of production are intra regionally fully mobile while inter regionally immobile.
d) Everything else is freely mobile.
e) Exports and imports can only be considered in terms of only transactions of good.
f) Each region possesses a separate currency only on paper. Practically it is exchange of goods that matters.

Analyzing the consideration for relative differences in prices between two regions Ohlin goes onto state that the prices of goods in a country depends upon prices of demand and supply and will be same if the following condition could prevail:

(i) Wants and preferences of consumers as well as their income were identical.

(ii) The factor of production were available in both the regions in more or less the same proportions.
Any differences in the supply of factors could be balanced by an exactly compensating difference in demand conditions.

Criticism of Heckscher Ohlin theory:

1. Since it is based upon over simplified assumptions, it is unrealistic.

2. Haberler has pointed out that although Ohlin's theory is more realistic, yet it remains a partial equilibrium analysis. Ohlin has failed to develop a comprehensive general equilibrium analysis.

3. One assumption underlying Ohlin's theory is that relative factor price reflect relative factor endowments. This gives under importance to supply and attaches less importance to demand. But we know that demand conditions also explain the basis of International trade.

4. Also, it may be pointed out that if demand conditions are given due weight the commodity price ratios may not correspond to cost ratios.

5. The criticism have also urged that differences of relative factor endowments (which is the very basic of Ohlin's theory) are only one of the several explanation for the commodity price differences of the internationally traded goods differences in production techniques or in factor techniques; Consumer's demand etc. are also important in this connection.

6. It is also said that the prices of commodity are not determined by factor costs, but it is the other way about i.e. the price of factor of production,
(e.g. raw material) are determined by the prices of final goods paid by the consumers.

Two more attempts have been made to explain why international trade takes place:

(i) Kranis argues that due to lack of natural resources relative to demand or technological advances and product differentiation which allow the innovating country to have temporary monopoly powers. Natural and artificial scarcity therefore creates this availability. This unavailability leads to trade between nations.

(ii) Linden distinguishes between trade in manufacture and trade in primary products which is of course natural resource incentive and can be explained in terms of relative factor endowment.

There are the latest theories on international trade and though not brilliantly successful, are significant.

4. **Factor price equalization and Income distribution:**

   It states that under certain conditions international trade in commodities like international movements of the productive factor, causes the absolute returns to each of the factors of production; to be identical in each of the countries participating in the trading network. If absolute factor returns are the same, so are the relative factor prices.
5. **Theory of opportunity cost:**

Harberler re-states the theory of comparative costs by taking two factors of production:

Labour and capital in terms of opportunity costs. According to Harberler, each country exports goods which it produces at lower opportunity cost and import those with higher opportunity costs. Let us take an example to understand the theory:

Let's suppose that India can produce 100 bushels of rice or 100 kg of tea when all its factor of productions are fully employed, but naturally a country will not produce any single products but a large of goods. So, lets assume that India produces both rice and tea in various proportion as shown in the graphs with the help of all resources available to her.

X-axis represents the kg of tea and Y-axis represents the Bushels of rice that India can produce with the available factors of production. PP Curve represents all the possible combinations of the various quantity of both products that can be produced. The opportunity cost of rice in terms of tea 1:1.

At point K, India produces 50 bushels of rice and 50 kg of tea and at any point outside the curve, e.g. K₁ kg is the point of inefficient position or under utilization of resources or factors of production.

Similarly the PP curve of another country say U.K. can also be drawn, but it can produce only 100 kg of tea or 50 Bushels of rice with the available
resources. So the opportunity cost of tea in terms of rice is 100 is to 50 or 1:1:5.

X-axis represents 100 kg of tea and Y-axis 50 bushels of rice that U.K. can produce with the available resources.

For India opportunity cost of rice in terms of tea is 1:1 as against U.K. is 1:1/2. Thus trade will benefit both the countries as long as the rate of exchange between rice and tea lies between:

1 unit of tea : from ½ unit of rice to 1 unit of tea.

From the above data, it can be concluded that between the two countries, rice will be cheaper in India and tea will be cheaper in U.K. this is because in order to have an additional unit of rice, India has to forego one unit of both, whereas U.K. has to give up two units to tea. On the other hand, in order to have an additional unit of tea India has to give up one unit of rice, whereas U.K. has to give up ½ unit of rice, this clearly means that India has a comparative advantage in production of rice and U.K. has advantage in producing tea.

Thus, India will export rice and import tea, while U.K. will export tea and import rice. By doing so both the countries gain and trade takes place.

Thus, the various above theories give explanation of international trade. International trade benefits all the nations and the consumers avail large variety of commodities from far and near which helps to raise their standard of living. In other words international trade adds a global dimensions to traditional domestic economic. Analysis concerning how individuals, families and organizations
balance their expanding needs and wants against the limited resources available to satisfy them. The people around the world continually seek to maximize their welfare by a wide variety of interactions and exchanges across boundaries. Differences in aspiration, human, natural and capital resources, technology culture, social and political systems and other factors are always apparent and lay the foundation for mutually advantageous economic relationship.

Differences in natural and political endowments have created a gap among economies of the nations and therefore economies of some nations are highly developed, some are developing while others are underdeveloped.

Thus, nations are categorized according to their economic strength and weaknesses and stage of development i.e. developed, developing and underdeveloped.

**Developed nations** are those which have achieved substantial manufacturing and service capability in addition to advanced techniques in agriculture and raw material extraction. They have latest technology in everything. Their people have high standard of living.

**Developing nations** are those whose production sector is dominated by agriculture and mineral resources, are still in the process of building up their industrial sector. They don’t have much advanced techniques in most of the sector i.e. agriculture as well as industrial. They are striving hard to compete with the developed nations.
Under developed nations are the poor countries and are called third world countries. The limitation of the third world in trade expansion comprise heavy dependence on agriculture with low and poor productivity; poor per capita income and low level of investment; inadequate exploitation of natural resources; lack of skills and technologies almost at every level of economic activity; reverse transfer of technology and skills; weak infrastructure; limited development of industrial and cottage sector; shortage of financial and credit facilities and many other such draw backs.

The generalization is often made that most of the richer nations are located in the northern hemisphere and the poorer in the southern hemisphere. This gives rise to the expressions “North/South” in reference to many international problems, confrontations and dialogues.

Most of the trade takes place between industrialized countries and rest of the nations strive to strengthen their economies by trade, barter, and concessions from the major developed nations, e.g. OPEC: Organization of Petroleum exporting countries controls much of the world's immediately available energy resources which the industrial nations need to keep their economies functioning.

As a result, the global economy has suffered from serious imbalances in recent years in the wake of adverse international economic developments, characterized by energy crisis, worldwide inflation, recession, mounting unemployment, unstable exchange rate, availing growing protectionism in the major
markets. A yawning gap has emerged in economic disparities between industrialized countries and the non oil-developing economies. The inherent weakness of developing countries manifests itself in their technological backwardness hampering high quality production and value added manufactures and semi-manufacturers at competitive prices.

Similarly, many nations enjoy recognized comparative advantage i.e. relative superiority in cost quality and services from certain good, due to, may be natural advantages, which can benefit many or all the nations if such advantage are widely made available. But such advantages can be lost over time. When this happens or where non comparative advantage exists, demands on domestic government frequently arise for protection against job losses and sales and profit reductions from foreign made goods and services.

The principal trading partners of developing countries are developed economies of North America, Western Europe and Japan, which are no match for the former. An analysis of region wise trade indicates that over two third of exports of developing countries are directed to industrialized markets, major shares being accounted from by EEC, USA and Japan.

According to the latest available international trade statistics only 27.3% of their export trade to, is with third world nations, including 4.4% with OPEC region and 22.9% with co-developing economies with nearly 70% of annual exports directed to developed market economies. The third world has the major trading partners in EEC with 26.5% share individual important markets, however are the
USA and Japan with 20% and 13.9% share respectively.

After acknowledging why international trade takes place, let's throw some light on the consequences or result of international trade:

(i) **Equalization of commodity prices**

Obviously, direct effect of international exchange of goods is to equalize the price of similar goods in the trading countries. Exact equalization is out of question, because export and import of goods also includes transport charges and other service charges which varies from country to country. Thus, there must always be some difference in prices of the internationally traded goods to compensate for these costs.

(ii) **Equalization of factor prices**

Commodity prices in the ultimate analysis depends on the factor prices, hence equalization of commodity prices. The prices of relatively source factors will fall since the goods in which they are used will be imported and demand for such factor will diminish. On the other hand, there will be greater demand for the relatively cheap and abundant factors, for the goods in which they enter will be exported. Their prices will therefore tend to rise. But absolute equalization should not be expected.

(iii) **Equitable distribution of source materials**

Nature has endowed different countries with different raw materials in varying proportion e.g. – Oil in Arabs, Jute in Bangladesh and gold in Africa.
Some countries may have rich deposits of natural products, whereas others may be poor, in the same product. Thus through international trade, these materials are equally distributed among various countries of the world.

(iv) **Effect on factor supplies**

It is also possible that the fall in the prices of scarce factors may lead to contraction in their supply and rise in the prices of abundant factors may result in the extension of their supply. This may accentuate differences in factor supply of the two countries.

(v) **Specialization and international division of labour**

International trade leads to specialization of goods whose cost of production is comparatively lower and this leads to international division of labor, which is of mutual advantage to the trading countries. Not only will their standard of living rise but they will also progress economically and industrially. Their productive resources will be part to optimum use. Disadvantage arising from uneven distribution of factor endowments will disappear. Although, it must be admitted that the gain accruing from international trade will not be distributed equally. Advanced countries will gain relatively more than the underdeveloped countries.

(vi) **International trade effects people taste and desires**

Demand for certain goods will increase and for some new goods will arise. So, international trade will both effect the nature and volume of demand.
After considering the consequences of international trade, we can conclude that benefits from foreign trade arise from specialization on the basis of comparative cost theory. It brings about improvements in production and promotes economies development. It presents monopolies and is beneficial to consumers by providing them new and cheap commodities. It also facilitates international payments. There is no doubt that the participating countries enjoy numerous benefits from international trade.

The gains or benefits from international trade can broadly be classified into static dynamic gains:-

**Static gains** arise from optimum use of the countries factor endowments and resources in men, money and material, so that the national output is maximized resulting in social welfare.

**Dynamic gains** on the other hand refer to those benefits which promotes economic growth of the participating countries.

We can safely conclude that in the present world no nation can survive without international trade.

**FREE TRADE Vs PROTECTION**

‘Protection’, refers to the policy of governmental interference in international trade when the government of a country deliberately interferes in its imports and exports business, it is in fact embarking on a policy of protection. Under this policy an unfavourable treatment is accorded to the goods
manufactured by foreign country and a favourable treatment is given to the product of home industries. 'In other worlds discrimination is practiced against foreign goods.

If the government doesn't practice any protection polices and puts no artificial barriers to trade it is called "Free trade". Under free trade there are no restrictions & economy is left free for all nations to trade with the home country or we can say that where goods and services flow across the international boundaries on the primary basis of comparative advantage.

In the words of Adam Smith, the term 'Free Trade' has been used to denote "That system of commercial policy which draws no distinction between domestic and foreign commodities and therefore neither imposes additional burden on the latter, nor grants any special favours to the former". Free trade however do not require the removal of all duties on commodities. It only insists that they shall be imposed exclusively for revenue and not at all for protection.

The doctrine of free trade is the extension of the doctrine of division of labour to the international field. Free trade theory is that such a policy enables every country to denote itself to those forms of production for which it is best suited on the basis of comparative advantage.

Though free trade is commonly under attack from protectionists has its own supporting argument. They are:

(i) Free trade leads to maximum utilization of the productive resources
available in the whole world as under free trade each country will specialize in the production of those goods for which it is best suited and import those which are produced at comparative disadvantage.

(ii) Under free trade division of labour occurs on an international scale leading to greater specialization, efficiency and economy in production.

(iii) The competition is more intense.

(iv) Domestic monopolies are discouraged.

(v) There is less scope of corruption which is more rampant under protection.

Before 1850, Britain was in a strong position to have free trade. It was financially and industrially more established than any other western countries. But soon had to adopt protection policy for various reasons.

Unfortunately, the world never had free trade universally. There would always be one or the other transitional period in most of the nation's cases even if every country agreed to change over to the free trade. If such a transition were to occur, then the less efficient industries at present supported by various state protections would be eliminated and numerous pressure groups would oppose such a thing.

During the early modern period, roughly 16\textsuperscript{th} and 18\textsuperscript{th} centuries there grew up a widely accepted body of doctrine that centered round the idea that exports were good and imports were bad and that foreign trade should lead to an influx of the precious metals brought about by an excess of exports over imports. This
doctrine called the "Mercantilist doctrine", was applies in practice to built up elaborate schemes of protective tariffs, embargoes, export subsidies and other devices. It was a period of rivalry between countries constantly faced with the threat of war. The central aim of economic policy was therefore, to built up the nations internal economic strength – self sufficiency in both resources and industries, stimulated both by subsidy and by trade barriers against competing imports.

During the 19th & early 20th century restrictions upon trade were discussed mainly in terms of protective tariffs. But in the present century other forms have come more & more in to use so that the world trade is now controlled by an incredibly complicated tangle of restrictive devices. Tariff is not the single form of restrictions on free trade. The 1930 & depression caused a large number of measures restricting international trade. Some of these measure as grew up because of preparation during the cold war period of 1930’s. This arose after world war II as a result of economic dislocation. Still more come up out of the effort of economically backward countries to stimulate their own industrial development and some appeared to be a simple reflection of the exaggerated nationalism which dominate much of the 20th century world. Modern trade restrictions, thus, reflect inter looking of economic, political and military considerations in the international economy.

Thus protection is positively favoured and acknowledged. Universally, various arguments have been produced in favour of protection.
From 1850 onwards infant industry arguments for protection won acceptance almost everywhere. Infant industry argument for protection is the oldest argument for protection. The argument in favour of protection are as follows:

(i) Infant industry argument

Policy of protection has been well expressed in the following words: "Nurse the baby, protect the child and free the adult" by Alexander Hamilton, a firm cannot compete if it is small but has to be large and strong to harvest all the economies of scale in production and become competitive. So, an infant industry is protected for some times so that it do not face competition from abroad.

(ii) Diversification argument

It is very necessary for a country to have diversified industrial base in order to maintain stability and acquire strength. Wide range of industries can be established only when all are assured protection.

(iii) Improving terms of trade

Terms of trade can only be improved and balanced by imposing tariffs, quotas, etc i.e. only protection is the way to improve the terms of trade.

(iv) Improving Balance of Payment

If a country's imports are more than its exports, it will have unfavourable B.O.P. but if duties and other restrictions are imposed on imports, they will be
discouraged, thus improving B.O.P.

(v) **Antidumping**

Protection is also restored to as an antidumping measures. Dumping harms the domestic industries though it reveals the consumers temporarily. Dumping may also encourage monopoly of the foreign firms in home country. Thus, destroying the home industries. Therefore, dumping must be discouraged through protection.

(vi) **Bargaining**

Tariff can be used as a means of bargaining to obtain from other countries lower duties on its export.

(vii) **Employment Argument**

Restrictions on imports will stimulates imports, competing industries and its spread, thus encouraging other industries to develop in the home country as a result creating more employment.

(viii) **National defense**

Depending upon foreign countries for our defense is foolishness as any change in political relation would damage it severely. As a result certain industries have to be developed and protected from strategic point of view.
(ix) Key Industry Arguments

One should develop its own key industry for the same reason given above.

(x) Keeping money at home

Abraham Linchon coded:-

"I do not know much about the tariff, but I know this much when we buy manufactured goods from abroad, we get the goods and the foreigners get the money. When we buy the manufactured goods at home, we get both the goods and money." Thus keeping the money at home.

(xi) Size of the home market

Protection enlarges the size of the home market.

(xii) Equalization of cost of production

Some protection has advocated import duties to equalize the cost of production between home and foreign producers and to neutralize any advantage foreigners may have over local producers.

There are other arguments as proper labour argument, strategic trade policy, etc.

With so many arguments for protection there are also arguments against protection; They are:-
(1) It increases prices and reduces choice and variety.

(2) It makes producers and sellers less quality conscious.

(3) It encourages domestic monopolies.

(4) Even insufficient firms will feel secure under protection, this discourages innovations.

(5) It leaves the arena open to corruption.

(6) It reduces the volume of foreign trade.

(7) Protection leads to uneconomic utilization of world resources.

On the whole we can conclude that free trade is only theoretically favourable but protection is very much essential practically, specially, for underdeveloped rations like India.

Role of protection in under-developed countries.

There is no doubt that historically speaking protection was an instrument used by industrially backward countries to catch up with the advanced countries. The U.S.A. as well as the countries of the European continent adopted the policy of protection against the United Kingdom which was industrially ahead of them.

Now protection is given extended application in developing economies. They are not backward merely in industrial development but they are backward generally in economic development. Protection may even be needed by farm products.
Protection is known to be of two varieties. The safeguarding variety and developmental variety. In India, we first introduced what came to be known as discriminating protection. This was more or less protection of the safeguarding variety.

After visualizing the arguments for and against protection lets proceed to the methods of protection. There are various methods used to restrict the international trade to protect the home industries. The are as follows:

(1) Quotas

One of the powerful method of stemming the international flow of goods is to impose import quotas. If India wishes to limit the import umbrellas it can set an absolute limit to the number of sets which can be imported in any given year. Importers are required to secure an individual license which specifies their respective allotment. In some cases the purpose of import quota may be precisely the same as that of the protective tariff, to foster domestic, production by excluding foreign products. In the post war period however, the purpose has frequently been different. Quotas are used to cut down on what are considered as essential imports, so that the foreign funds available can be used to import more essential products e.g. some important industrial machinery or some latest techniques.

Similarly exports quotas are also set in order to retain some products primarily for domestic use. But some countries control export for a very different
purpose i.e. stabilizing markets and securing monopoly prices for products of which they are the principal producers as in the case of Indian's control on tea.

(2) Rationing of foreign currencies

The purpose of import control can also be achieved by rationing of foreign currencies (Dollars or Ponds) available for the purchase of foreign goods. Rather than setting the absolute limit on the number of commodities, a nation may simply set limits to amount of dollars, pounds, marks or other currency of the commodity exporting country, which its importers will be allowed to use for the purpose of the commodity. The limited funds available are allocated among the individual importers on a percentage basis or by some other system. This is a very powerful device which provides continuous and comprehensive control over the whole range of imported goods. It may be used if there seem to be legitimate purposes, but in the hands of a totalitarian government the rationing of foreign exchange can be an instrument of control for war like purposes.

(3) Import Prohibition

Sometimes import of certain commodities is prohibited by law or allowed only under defined conditions for e.g. once the U.S.A. excluded the imports of beef from Argentina where foot and mouth disease had attacked the cattle. It was a "sanitary regulation". But sometimes countries indirectly curtail imports by refusing to export certain material until they have processed at home. E.g. Rumania do not export her oil unit, it is refined at home, where as, Hungary will
not import Rumanian oil until it is refined after being imported.

(4) Custom duties

This is an old method. It involves imposition of import or export duties on the incoming or outgoing goods respectively. The main aim in imposing such duty is to raise the price of the goods in order to discourage its sale or purchase. It is to protect the home industries. Import duties are more common than export duties and specific duties are those which are imposed according to different countries. Preference are given to certain countries and low or no duties are imposed on goods where as, high duties are imposed on same goods while exporting to other countries. Such arrangements curtail international trade and leads to the development of trade blocks.

(5) Tariffs

it is an important tool of commercial policy, although, it is primarily a protectionists device yet it proves to be a double edged weapon. On the one hand, it limits consumer's choice by forcing him to cut consumer's choice by forcing him to cut consumption of the goods he likes and on the other, it shifts the use of resources from one use to another. The effect of tariffs is to change relative prices of goods and services and to change the relative prices of the factors of production. Some of its effects are mentioned below:-

**Protective effect:** Tariff reduces the imports of connecting foreign goods and thus encouraging home producers to produce more. Thus creating
protective effects.

**Consumption effect:** When tariff is imposed, price of the commodity rises and domestic consumption is reduced. Thus consumption is effected.

**Revenue effect:** The government also derives revenue from the tariff which is measured by the quantity of imports multiplied by the rate of the tariff. This is the revenue effect.

**Redistribution effect:** The imposition of the tariff increases the price of the commodity and thus reduces the consumers surplus.

In this way some income is transferred from the consumers to producers. This affects the distribution of income and is called redistribution effect.

**The terms of trade effect:** Take the case of two countries A and B with different factor endowments giving comparative advantage to each in the production of certain commodity. Tariff will reduce the volume of trade and the term of trade will improve for the country imposing the tariff.

**Effect on National Income:** Imposition of tariff will increase the price of foreign goods which would curtail its consumption and demand for the home product will rise and automatically production will also rise and thus employment will increase as new production unit may also be set up. Thus, finally N.I. will increase.
Thus, we can conclude that practically tariff and other methods of protection are of great importance for a country's economic development.

As, in the modern world there is hardly any country which is self sufficient in the sense that it produces all required products and services. Thus every country has to import those goods that it cannot produce at all or at higher comparative cost in the home country and export those goods which other countries prefer to buy from them.

A country while importing and exporting goods has to maintain some records to check its trade with other countries and have proper books of accounts. Thus this comprehensive record of economic transactions of the residents of a country with the rest of the world during given period of time is called Balance of Payment. The record is prepared in order to provide meaning and measure to the various components of a country's external economic transactions. Thus, the aim is to present on account of goods exported, services rendered and capital received by the resident of the country. The main purpose of keeping these records is to inform government of the international economic position of the country and to help it in to reaching decisions on monetary and fiscal policy on the one hand and trade and payment question on the other.

Balance of payment can be of current account and capital account, balance of payment on current account includes items like imports and exports, expenses on travelling, transportation, insurance, investment, income, etc.
Current account relate to current transaction.

Balance of payment on capital account is made of capital transactions e.g. borrowing and lending of capital, repayment of capital, and sale and purchase of securities and other assets to and from foreigners - individuals and governments.

When both the current and capital accounts are taken it is called over all balance of payment. It is the over all balance of payment which must balance.

Balance of payment includes the following items:

1) The chief item is the international trade in commodities. Export of commodities to foreign countries adds to our foreign receipt, while imports adds to the payments that we have to make to the foreigners. The difference between the value of exports and imports is known as the balance of trade which may be unfavourable if imports exceed exports and favourable if exports exceed imports.

2) In addition to goods, we also trade services, such services may be of various kinds for which payments have to be made or received e.g. transport charges, shipping freight, passenger fares, harbour and canal dues, commercial services (fees and commissions) financial services (broker's fees etc) and services connected with the tourists traffic and payment of interest on external department.

As against commodity or merchandise transactions, which are visible, these are called invisible item.
3) In addition to current transactions there are also capital movements between the countries, e.g. capital may move from one country to another, the country which receives capital will add to its foreign receipt at the time when such capital is received, but at the time of repayment of debt it will increase out payments to the foreigners. Capital between the two countries may move at the intergovernmental plan, i.e. loan from one government to another. It may also move on private, account when for e.g. American investors invests their capital in Indian industry.

In recent years India has been getting lots of foreign loans both from friendly nations and private investors.

4) By summing up the balance on the current account and the balance on capital account, we get a country’s over all B.O.P. If there is deficit on the overall account, the country has to draw up its reserve of foreign exchange and if its surplus, its foreign exchange will increase.

TRADE EQUILIBRIUM

This term equilibrium means a balancing of opposite forces. Any departure from there tends to set these forces in operation to restore economic balance again. It represents a state of balance of payment in a relevant period which makes it possible to sustain an open economy without severe economic distortions. Suppose, there is physical tallying of both the sides, it cannot be termed as having attained a state of equilibrium.
However, it may not be inapt to mention that equilibrium does not mean only the balancing of the two sides but should also reduce unemployment and should sustain the cyclical and seasonal fluctuations etc.

On the basis of time, an important factor the distinction between static and dynamic equilibrium can be made. The equilibrium can have short-term oscillations or long-term oscillations. Static equilibrium is reached when exports equal imports within a short-term. Dynamic equilibrium is characterized by the physical movement of short-term capital and gold. If the above factors are not strictly adhered to, then dis-equilibrium sets in. The disequilibrium may set in due to one or more of the following reasons.

(1) The first one is due to undue arbitrage in the commodity operations. If prices tend to equalize, the disequilibrium will vanish automatically.

(2) Individual disequilibrium is a phase of difference between domestic market price and the international price for the identical product. If there is parity between the two rates, it means equilibrium, if any disparity prevails, then it is known as Individual disequilibrium. This reflects itself in the Balance of Payment.

(3) Investments disequilibrium is a corollary to individual disequilibrium. When the international interest rates show divergence, the investors become hesitant and consequently they do not invest abroad.

(4) Monetary disequilibrium means that the volume of effective money in a
country does not bear in relation to the level of business activities, viz. there is visible tendency towards general expansion and/or contractions of output and income as well as employment.

(5) Cyclical disequilibrium means that the income pattern of different countries with different elasticity's vary in a recurring manner.

(6) Secular disequilibrium means long term disequilibrium, came due to deep rooted changes in the economy of the country. Foreign borrowing or lending may become rather incongruous when compared to domestic savings over investments.

(7) Structural disequilibrium may arise at the level of goods when there is a fluctuation in demand or supply.

**METHOD OF ARRESTING DISEQUILIBRIUM**

(i) Correction of adverse balance of payments

Through the mechanism of price reduction, export are encouraged and imports are discouraged and curtailed. This results in shrinkage of wages, interest and other incomes and the credit will contract. In the blooming days of the Gold Standard there was an automatic but temporary efflux of gold as in this case gold could have been imported. Once gold comes in, the whole process would be reversed.
(ii) **Imposition of tariffs and quota system**

A country to maintain equilibrium may resort to imposing trade restrictions by way of tariffs and quotas. This may however cause reactions and other countries may retaliate. Thus imports can be curtailed but such a policy may lead to fall or decline in exports in the long run due to retaliatory measure by others.

(iii) **Devaluation**

A country's currency is depreciated only in terms of foreign currencies. Internal value of the currency remains unaltered. This is a very aggressive step as the devaluing country has to lose a vital portion of its large foreign investments and in the long-run results in the erosion of confidence which is hitherto in the arena of international trade.

(iv) **By exchange control**

All the corrective methods stated earlier may have devastating effects on the economy. Under the first method a strong Trade Union in the country may oppose any move to reduce the living wage conditions. It may try to topple the ruling government itself. Under the second method, the country has to get a similar retaliatory method of imposition of tariff. Devaluation may thoroughly shake the confidence of other countries which repose faith on this country. So, by statute, the Government may compel exporters to surrender their foreign currency to the central Bank and this is pooled and carefully rationed and
equitably distributed amongst the importers of the country trading to be pooled and carefully rationed and equitably distributed amongst the importers.

TRADE CONSTRAINTS

Internal Constraints

Trade constraints may deemed to be an important issue for discussion. In every type of trade, constraints do appear in some form or the other. As William Shakespeare stated that the course of true love never runs smooth, so also the course of foreign trade never runs smooth. Constraints or impediments may crop up from time to time. Some of these may be of a temporary nature and can be overcome quickly, others may be of a permanent nature requiring structural changes. These constraints are studied and discussed in this chapter with the idea of suggesting measures to ensure a smooth flow of trade.

Under a broad analysis constraints may be either internal or external. Internal constraints are having their origin within the national frontiers while external constraints are the outcome of trade emanating from other countries.

Internal constraints may be the outcome of physical political, sociological and economic factors. Physical forces may be the physiographic conditions of a country like the non-availability of raw materials, ubiquitous lack of natural potentialities, climatic hazards, poor grade of raw materials and so on. There difficulties can be overcome by careful and systematic utilization of resources. A highly developed country can overcome such hazards easily for instance the 18th
century, U.K. could import raw cotton and thereby localized cotton textile industry.

Bilateral trade agreements

When agreements are entered into between two countries to that extent both the countries surrender their rights and propogative to each other. The have to honour their commitments. Financial commitments are very vulnerable. If the payments due under agreement of trade are no made within the stipulated time, it will adversely affect the credibility and naturally the other country may insist on the payment being made as per terms and conditions. The debtor country may even seek the aid of international organization like the IMF or the World Bank (only when it is a member of their bodies) to tide over the crisis. Some can be met under the Lend Lease Agreement.

Political and social factors

Political factors are those which are the outcome of the stability or otherwise of the government. A country without political stability may lose confidence in the eyes of the rest of the world and its trade potentials may be adversely affected. The role of bureaucracy is equally important. In a highly bureaucratic system exports and imports may be handicap, while an economy with less controls will be better suited to promote trade. Thus not only the will of the political authorities important but the practices followed by it are equally significant in boosting or dampening the trade.
Social factors are the outcome of the nature of inhibitions of the society. If a community is not well advanced in the field of education, sciences and technology, it cannot foster ahead of the developed countries and may remain at their mercy. In fact all the developing countries of the world are looking to advanced countries like the U.K., the U.S.A. etc. for their development. Social mobility is an important factor which is vital for country's development. All the technical personnel are generally concentrated in the industrial towns and not in the rural areas creating imbalances amongst the regions of the country and hinders the flow of foreign trade.

Tax burden

Tax burden is another problem of the county. This constraint cannot be easily solved. Sometimes, the Government imposes capital levy as a direct tax. A tax on import and export or a regressive tax policy may injure the trade. The policy regarding tariffs and controls are either augmenting state finances or for protective purposes. The former may tend to have long term adverse impact on trade while the later being essential for a short period have short term impact.

Business Morality

Further, business morality is the high water mark of a country's level of business dealing. Unscrupulous business may bring discredit to the country's fair name. By their clandestine and questionable tactics, the good name of the country is sullied, often causing permanent damage to international trading. The
level of business morality depends on a number of factors, but it is essentially
linked with moral of the business class. There are innumerable cases of
unhealthy practices on the part of the exporters not only in India but also in other
countries. Indian trade has suffered a lot in recent years due to low business
morality.

So it will be appropriate to educate the exporters that on the long run only
fair deals will earn the goodwill for the exporter as well as for the country. It is
suggested that deterrent punishment in terms of heavy financial penalty shall be
awarded to all those who get involved in unscrupulous activities.

As a persistent feature of Indian Economy, we come across, under
internal constraints, instances of strikes lockouts and non-availability of industrial
raw material and persistent failure of power supply. Public as well as private
sector industries are victims to them. This has retarded our economic growth
and ultimately resulted in the loss of man-hour production.

While talking of foreign trade it will be appropriate to discuss its cause and
effect relationship with exchange rates. Changes in the supply of and demand
for foreign currency in the exchange market causes fluctuations in the exchange
rates. When two or more countries are trading with each other it is likely that the
currency of the country which enjoy an excess of exports to the world over its
imports from the world will be in higher demand. This will result an increase in
the exchange rates for that particular currency.
It may further be pointed out that with the increase of exchange rates, prices of the goods of that country will increase resulting in lower demand for its product. On the other hand importable items will cheaper consequently exports will be checked while imports will tend to increase. With this reverse trends in the items involved in foreign trade, exchange rate will decrease.

Some times orders are taken in haste. For instance under agreement India agreed to supply to Iraq the electronic and thermostatic equipments, but industrial raw material for manufacturing them was not locally available and we had to depend upon the Western European market to purchase it at a higher cost while needed huge foreign exchange. Thus we were unable to get it at a lower price, but we could not pass on the higher price to the buyer, and we were at a double disadvantage. We bought at high prices and sold at low prices. Again in our beaming over-enthusiasm, we tried to capture the Ethiopian market and offered to sell cycles at a particular time and at a particular price. The bulk order placed by the Ethiopian trade agency was fully and squarely met in a record time. But with the same speed the order was rejected as our bicycles did not meet with the specifications of the consumers of Ethiopia, and an enormous loss we had sustained. Our wagon deal with USSR was an academic example. The wagon price was fixed by them at Rs. 80,000 whereas cost of production was Rs. 1,00,000/-.

EXTERNAL CONSTRAINTS

With the depreciated value of foreign exchange the burden fell on the
country in terms of higher debt servicing ratio and repayment of loans etc. During the days of gold standard this problem never arise as the value of old of different countries was similar everywhere. To offset this problem, the country should try to have agreements of repayment in rupee terms (the currency depreciating at a faster rate). However, now a days International Monetary Fund and International Bank of Reconstruction and Development have been instrumental in helping many of the developing countries to tied up their problem of foreign exchange.

Political changes is another problems of foreign exchange external constraints. War, coup d' etat, subjugation and insubordination to international authority are the various instances. External constraints may arise due to the outcome of a war, which may end in total appihilation of the country and the government which might have already entered into commitments, might not be existing and the new military government may not agree to such subsisting agreements. After a coup d' etat a revolutionary government might be born. There is no obligation that the new government should honour the commitments of the past government. A government may be under subjugation and through military powers and strength of the neighbouring country. Such a subjugated government may not be able to honour its commitments. Though there is a committee under the United Nations, a particular member country due to reasons of its own may refuse to fulfill the obligations. Foreign governments are unable to meet their obligations due to obvious forms imposed by the other country. It may
be due to impact of foreign taxation. The classical example is given by late Lord Keynes in a very analytical way when he pointed out the sudden measures of boycott, embargo and non-intercourse my be adopted by the other country.

CONTRIBUTION OF TRADE TO A DEVELOPING ECONOMY

As mentioned earlier, mainly R. Prebisch, H.W. Singer and G. Myrdal are among the first to analyze the significance of international trade in a developing economy. R. Prebisch studied the terms of trade between British Empire and its colonies during late 19\textsuperscript{th} and early 20\textsuperscript{th} century. He concluded that international trade tended to inhibit the economic growth of colonies, for the following reasons. This analysis is applicable to developing countries as majority of them were colonies.

Firstly the primarily commodity exports in developing countries have been produced by the export sector usually owned or managed on behalf of the foreign interest, from which a major part of the investment in the sector has been originated. Though it is a fast growing sector with high productivity and return but such gains are not distributed in the domestic economy and are distributed among foreigners.

Secondly, demand for primary goods and earnings therefrom remains unstable due to changes in demand pattern in industrialized nations and gigantic price fluctuations. So terms of trade moves against the developing countries and gains are derived by the developed countries.
Thirdly, there has long been skepticism towards the effects brought to a developing economy by deployment of foreign resources, and even if the capital and technology is introduced in the domestic sector the economy is not supposed to grow with leaps and bounds owing to the inherent features of the developing economy. For example, low per capita income and consumption, low saving etc. If these forces work and even then production increases, still it will not make the domestic market as attractive as the foreign market, because the propensity to consume of a developing economy is so high that with increase in purchasing power the consumption rises at a faster rate than savings and investment resulting in a negative effect on productive efforts of the developing country. Hence multiplier effect of national income enhancement least works in such situations.

However, the above said notion was discarded by the optimist writers and thinkers as the study was based on exploitative type of international trade. The foremost important impact of foreign trade was specialization leading to higher employment and standard of living in a country. With the economy of scale and specialization of production in some of the fields leads maximum exploitation of the resources at hand resulting in high quality goods at reasonable prices and hence prosperity prevails.

To maintain the compatibility, innovations and inventions are also tried, and gradually technological advancement gets its way. In fact, technologically advanced modern industrial society is an outcome of international trade. In the
presence of international trade every body involved tries to update his products resulting in the transfer of technology among the industrialists.

It will be perfectly all right if we say that present industrial society could have not been developed in the absence of international trade. During the last half a century the overall growth of world economy is around 1% to 1.5% per annum but in this period the foreign trade has expanded at a much faster rate and according to certain estimates it is between 5% to 6% per annum.

In order to create a common market and to approximate economic policies, E.E.C. was established. E.E.C. stand for the European Economic Community. It was established on 25th March 1957 (effective from 1st January 1958). The E.E.C. was formally changed to E.C. (European Community) under the treaty on European Union (effective from 1st November 1993).

The new treaty established a European Union, which introduced citizenship thereof and aimed to increase intergovernmental cooperation in economic and monetary affairs, to establish a common foreign and security policy and to introduce cooperation in justice and home affairs. Internally as free market, EU is highly protective for outside world.

Thus the formation of E.U. has created ample opportunities for the regional cooperation amongst the member countries. However, it has simultaneously created a wall towards the outside world. A country willing to trade with any of the member countries of E.U. will have to face the industrial and technological
strength of not only that country but of the E.U. as a whole. Further, the market potential of E.U. (due to its size and high level of income) is so high that nobody can ignore the same. Thus, in order to compete and penetrate the E.U. market, India need to be very strategic and aggressive in approach. It is against this back drop that in the forthcoming chapters, a detailed analysis of Indo-E.U. trade with special reference to textile trade is presented.