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International Trade and Business

SEMESTER - VI

COMMERCE

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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BACHELOR OF COMMERCE

INTERNATIONAL TRADE AND BUSINESS

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COURSE INTRODUCTION

This course **"International Trade and Business"** has been structured for the learners of B. Com.(Finance Specialisation) programme to give broad idea of international trade and business. This course contains 15 units. In the first four units we will discuss the concept of international business, operations of international business, international business environment and different theories of international trade. In the fifth unit we will discuss the concept of gains from trade and terms of trade, sixth unit will give us an idea of tree trade, protection, tariffs and quotas. In unit seven we will discuss balance of payment which is arise out of international trade. Foreign exchange and Forex market is discussed in unit eight. Financing of foreign trade is discussed in unit nine and ten. Unit 11,12 and 13 discuss some international financial agencies and agreements. Unit 14 of the course has been entitled Regional Economic Integration among Developing Countries. In this unit, the concept and types of different regional economic integration has been discussed. Particular emphasis has been given on the different regional economic integrations in the South Asian region. Some issues of international business like social issues, ethical issues, labour issues, environmental issues, political issues etc are discussed in unit 15. The unit also discusses outsourcing and role of IT in international business.

While going through a unit, you will notice that some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some ''ACTIVITY'' (s) has been included to help you to apply your own thoughts. Again, we have included some relevant concepts in ''LET US KNOW'' along with the text. At the end of sections, you will get ''CHECK YOUR PROGRESS'' questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ''ANSWERS TO CHECK YOUR PROGRESS'' given at the end of each unit.

UNIT 1 : INTRODUCTION TO INTERNATIONAL BUSINESS

UNIT STRUCTURE

1.1 Learning Objectives
1.2 Introduction
1.3 Concept of International Business
1.4 The Basis and Need of International Trade
1.5 Domestic vs. International Trade
1.6 Complexities of International Business
1.7 Modes of Entry into International Business
1.8 Let Us Sum Up
1.9 Further Reading
1.10 Answer to Check Your Progress
1.11 Model Question

1.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain the meaning of international business
- know the complexities of international business
- modes of entry into international business.

1.2 INTRODUCTION

Just as no individual is self-sufficient, in a similar way no country is self-sufficient. A country cannot produce all the goods and services as required by its people. Those commodities which are not produced by the country are to be imported from the rest of the world. Hence, the absence of self-sufficiency is the cause of mutual interdependence among the countries. The mutual interdependence at the international level is reflected in the transaction of commodities and inputs and these transactions constitute international trade. This results in to international trade.

In this unit we will discuss the concept of international business/

trade, needs of international business, difference between domestic trade and international trade etc.

1.3 CONCEPT OF INTERNATIONAL BUSINESS

Business activities done across national border is International Business or international trade. International Business is the purchasing and selling of the goods and services outside national borders. Such trade modes might be owned by the state or privately owned organization. In which, the organization explores trade opportunities outside its national border to extend their own particular business activities, for example, manufacturing, mining, construction, agriculture, banking, insurance, health, education, transportation, Communication and so on.

Nations that were away from each other, because of their geological separations and financial and social contrasts are now connecting with each other through international trade. World Trade Organization established by the major contributory factors to the expanded connection and the business relationship among the countries.

The national economy are dynamically getting borderless and fused into the world economy as it is clear that the world has today come to be known as a 'global village'. Numerous organizations are making passage into a worldwide business which present them with opportunities for development and tremendous benefits.

India was trading with different nations for quite a while, yet it has quickened its progress of incorporating with the world economy and expanding its foreign trade and investment.

Different nations all over the world are experiencing an essential change in the way they deliver and market various items, products and services. The national economies that were accomplishing the objective of self-sustainability are currently developing route towards International Business. The factor for this crucial change is the development of correspondence, innovation, communication, infrastructure and so on.

The study of international business involves understanding the effects that the above activities have on domestic and foreign markets, countries,

governments, companies, and individuals. Successful international businesses recognize the diversity of the world marketplace and are able to cope with the uncertainties and risks of doing business in a continually changing global market.

1.4 THE BASIS AND NEED OF INTERNATIONAL TRADE

One of the fundamental questions asked in the subject of International Economics is 'Why do nations trade?' Nations trade each other basically for the same reason that individuals trade with each other. Just like the resources of an individual are not sufficient to fulfill ones' all wants, the resources of one country are also not sufficient to meet all the needs of the country and the individual living therein. Owing to many constraints, e.g., constraints in natural resource endowments, human resources, technological resources, financial resources or others it is not possible for a country to meet all the needs of the country and its people.

Thus, it is evident that countries trade with each other when, on their own, they do not have the resources, or capacity to satisfy their own needs and wants. By developing and exploiting their domestic scarce resources on certain specific uses, countries can produce a surplus, and trade this for the resources they need.

Trade between countries dates back to thousands years. Today, in the current phase of globalisation, international trade occupies the centre stage. In fact, many economists in a global economy credits international trade for the development and prosperity of the modern industrialised world. Goods and services are likely to be imported from a different country for several reasons. For example, imported goods and services may be cheaper, or of better quality. In many instances, there may not be local alternatives available, making importing an all essential. For example, Japan has no oil reserves of its own. But it is the world's fourth largest consumer of oil.

In the eighteenth century, Adam Smith explained the basis of international trade on two major grounds: (a) the division of labour and (b)

specialisation. Division of labour means breaking down production into small, interconnected tasks, and then allocating these tasks to different workers based on their suitability to undertake the task efficiently. While looked at the perspectives of international trade, a division of labour means that country produce just a small range of goods or services, and may contribute only a small part to finished products sold in the global markets. For example, a car manufacturer may import specific parts from specific countries and then finally assemble those to offer the final product 'car' to the customers. In that way, an individual country may contribute, perhaps, just one ingredient to the final product. Specialisation is the second fundamental principle pointed out by Smith. In fact, specialisation results from the division of labour. Now, when each worker or each producer undertakes a specialist role, they are likely to become efficient contributors to the overall process of production, and to the finished product. Hence, specialisation can generate further benefits in terms of efficiency and productivity. Now, specialisation can be applied to different levels: say to individuals, firms, machinery and technology, and to a country as a whole. Looking from the perspectives of international economics, owing to international specialisation, countries would be able to use their scarce resources to produce just a small range of products in high volume. In this way, mass production would generate a surplus of the good produced, which can then be exported. This means that goods and resources must be imported from other countries that have also specialised, and produced surpluses of their own.

As a result of specialisation, countries are likely to become more efficient over time. This is partly because a country's producers will become larger and exploit economies of scale. Faced by large global markets, firms may be encouraged to adopt mass production, and apply new technology to increase their level of production and quality. This can provide a country with a price and non-price advantage over less specialised countries, making it increasingly competitive and improving its chances of exporting in the future.

Thus, the basis of international trade is the gains or profits to be

made from exchange of goods and services. In the absence of such profits, there will not be any motivation for international trade between countries.

1.5 DOMESTIC VS. INTERNATIONAL TRADE

Domestic trade is the kind of trade that is limited geographically within a country. A domestic Trade involves commercial exchanges that are only done within the country. A trade which can also be referred to as an internal business involves a producer and a client, who lives within the same nation. This means that the laws, business practices and customs used in a business transaction shall be of the designated country.

International trade is a trade whose production and consumer base is drawn from more than one country. An international trade does not fall so much to the dispensation of local law, but within international agreements for business practice. International trade involves transactions between two or more than two countries.

Therefore, the difference between the International trade Vs. domestic trade are detailed below-

Basic	**Domestic trade**	**International trade**
1. Meaning	A business is said to be domestic when its economic transactions are conducted within the geographical boundaries of the country.	International business is one which is engaged in economic transaction with several countries in the world.
2. Area of operation	Within the country	Whole world.
3. Quality standard	Quite low	Very high.
4. Deals in	Single currency	Multiple currencies.
5. Capital investment	Less	Huge.
6. Restrictions	Few	Many.
7. Nature of customers	Homogeneous	Heterogeneous.
8. Business research	It can be conducted easily	It is difficult to conduct research.
9. Mobility of factors of production	Free	Restricted.
10. Exchange and trade	Within the country is free flow of	There is no free flow of goods and

control	goods and services	services from one country to another.
11. Politically different	Home or internal trade takes place within the same political unit	International or foreign trade takes place between politically different unit.
12. Transportation cost	Internal or domestic trade involves less transportation cost	International trade involves comparatively greater transportation cost.
13. Risk	Comparatively less	There is greater risk.
14. Time	It is less time consuming.	It is a time consuming.

1.6 COMPLEXITIES OF INTERNATIONAL BUSINESS

International business is not all that lovely because of difference in practices in different countries. Therefore the major complexities are detailed below:

1) **Different trade patterns:** International business has to deal with the business patterns among the various countries of the world. It has to take into account the business policies of various countries which govern their imports and exports. These policies and practices impose certain constraints and restrictions on International business.

2) **Lop sided Development of Developing countries:** Developed countries are equipped with sophisticated, technologies capable of transforming raw materials into finished goods on a large scale. Developing countries on the other hand lack technological knowledge and latest equipment. It leads to the lop sided development in the International Business.

3) **Economic Unions:** These are an increasing tendency among nations to form small groups of economic unions which help them to negotiate terms for the business with other countries.

4) **Huge Foreign Indebtedness:** The developing countries with less purchasing power are lured into a dept trap due to the operations of MNC's in these countries. For Example- Mexico, Kenya, Poland etc.

5) **Corruptions:** Corruption has become an international phenomenon. The higher rate bribes and kick backs discourage the foreign investors to expand their operations.

6) **Long distance:** Due to greater geographical distance between countries the cost and time involved in transport are high.

7) **Laws and regulations:** International business has to follow the rules and regulations of several countries. These rules and regulations are not uniform but differ from country to country.

8) **Cultural differences:** Cultural differences are one of the most difficult complexities in the international business. Many domestic markets however are also not free from cultural diversities.

9) **Trade and investment restriction:** Trade and investment restriction are very important problems in international business.

10) **Differences in the language:** An international market often encounter problems arising out of differences in the language different languages are used in different countries, customs, attitudes, lifestyle and other cultural factors also differ from country to country.



CHECK YOUR PROGRESS

Q 1: Meaning of international business.

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Q 2: Meaning of domestic business.

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1.7 MODES OF ENTRY INTO INTERNATIONAL BUSINESS

The long-term advantages of doing international business is a particular country depend upon the following factors:-

- Size of the market demographically.
- The purchasing power of the consumer in the market.
- Nature of competition.

By considering the above mentioned factors, firm can rank countries in terms of their attractiveness and profitability. The timing of entry into a nation is very important factor. If a firm enters the market ahead of other firms, it may quickly develop a strong customer base for its products.

As we know that it is one of the most important decisions in international business to select the mode of entering in to the foreign market. There are several major modes of entering into an international business which are detailed below:-

1. **Licensing & Franchising**: Licensing and franchising which involves minimal commitment or resources. And effort on the part of the international marketer, are easy ways of entering the foreign markets. Under international licensing a firm in one country (the licensor) permits a firm in another country (the licensee) to use its intellectual property. The monetary benefit to the licensor is the loyalty or fess which licensee pays. In many countries, such fees or loyalties are regulated by the government; it does not exceed 5% of the sales in many developing countries.

   In franchising a parent company (The Franchisor) grants another independent entity (branches, the franchisee) the right to do business in a prescribed manner. This right can take the form of selling the franchisor's products, using its name, production & marketing techniques, or general business approach. The common forms of franchising involve the franchisor supplying and import integrated (part, materials) for the finished product. For example cocacola supplying the syrup to the bottlers.

2. **Exporting:** Exporting, the most additional mode entering the foreign trade, is quite a common one even now, international trade has been growing much faster than the world output resulting in greater world economic integration & Exporting is attractive than other modes particularly when under utilize capacity exists. Even when there is no excess times be easier and less costly than setting up production facilities abroad, further, may government, as in India, provides incentives for establishing facilities for export production.

3. **Contract manufacturing:** Under contract manufacturing a company doing contracts with firms in foreign countries to manufacturer or assemble the products while retaining the responsibilities or marketing of product. This is a common practice in international business. There are a number of multinationals and affiliates of multi-nations which employee this strategy in India in respect of some of the products they market, like Hindustan Unilever etc.

   Contract manufacturing has the following advantages:

   i) The company does not have to commit resource for setting up production facilities.

   ii) It frees the company from the risk of investing in foreign country.

4. **Management contracting:** Management contracting is the process by which a firm legally obtains the operations control on behalf of another company. In simple term, in a management contract, the supplier brings together a package of skills that will provide an integrated service to the client without incurring the risk and benefit of ownership. Kotler observes management contracting is low risk method of getting into a foreign market and it starts yielding income right from the beginning.

   Management contracts involved not just selling a method of doing things but involve actually doing them. A management contract can involved a wide range of functions, such as technical operations of a production facility, management of personnel, accounting, marketing services and training.

5. **Assembly or branch operations:** An assembly operation is a variation of the subsidiary. Some parts of the products may be produced in various countries (multisourcing) in order to gain each country´s comparative advantage. Capital-intensive parts may be produced in advanced countries, and labour-intensive assemblies may be produced in less developed countries (LDCs), where labour is abundant and labour costs are low. Having assembly facilities in foreign markets is very ideal when there are economics of a scale in the manufacture of parts and components and when assembly operation are labour

incentive and labour is cheap in the foreign country. It may be noted that a number of US manufacturer shift the parts components to the developing countries get the product assemble their and bring it at home.

6. **Fully owned manufacturing facility:** A number of factors like trade barriers differences in the production and other cost govt. policies etc. Encourage the establishment of production facilities in the foreign market. Establishment of manufacturing facilities abroad has several advantages. It provides the firm with complete control over production and quality. It does not have the risk of developing potential competitors as in the case of licensing and contract manufacturing. Fully owned enterprises may not be allowed or favoured in some countries, Particularly in low priority areas. Moreover, this methods demands sufficient financial and managerial resources on the part of the company.

7. **Joint Ventures:** In this system an MNC established a company in foreign country in paternship with local firms. The multinational and foreign firm share the ownership and control of the business. Generally the multinational provides technology and managerial skills and the day to day management is left to the local partner.

   For example Maruti Udyog is the govt. of India and Suzuki of Japan have jointly supplied capital. Suzukui supplied technolgy and day to day management is lies with the govt. of India.

8. **Third country location:** Third country location is sometimes used as an entry strategy. When there is no commercial transaction between two nations because of political reasons or when direct transaction between two nations are difficult due to political reasons or the like, a firm in one of these nations which wants to enter the other market will have to operate from a third country base. Third country location may also be helpful to make advantage of the friendly trade relation between the third country and the Foreign market concerned.

   There are several causes of countries not having direct commercial transaction. For example it was true of Israel and Arab

countries. In the past, govt. of India they did not permit trade with South Africa and Mauritius.

9. **Mergers and acquisitions:** A merger is corporate strategy of combining different companies into a single company in order to enhance the financial and operational strength of both organisation.

An acquisition is a situation whereby one company purchase most of all of the another companies shares in order to take control. An acquisition occurs when a buying company operate more than 50% ownership in a target company. As part of exchange, the acquiring company often purchases the target companies stock and other assets, which allows the acquiring company to make decision regarding the newly acquired asset without the approval of target companies shareholders.

For example Bharati Airtel acruired Zain Africa Feb 2010. At present Bharati Airtel is the largest mobile network in India. It is also operating its reaches through out the globe.

In February 2010, Bharati Airtel added 180 million new customers in its list acquiring an Africa Mobile Network provider called Zain Africa. This acquisition took place an against amount of $107 billion.

10. **Strategic Alliance:** Strategic alliance has been becoming more and more popular in international business. This strategy seeks to enchance the long competitive advantage of the firm by forming allinace with its competitors, existing or potential in critical areas, instead of competiting with each other. The goals are to liberates critical capabilities, increase the flow of innovation and flexibility in responding to market and technologious changes.

Strategic alliance is also sometimes used as a market entry startegy. For example a firm may enter a foreign market by forming an alliance with a firm with foreign market for (mktg) marketing or distributing the farmer's product.

11. **Counter trade :** All though the major reason for the substances growth of counter trade is its use as a stragety to increase exports, particularly by the developing countries. Counter trade has been successfully use

by a number of companies as an entry strategy. Counter trade is a form of international trade in which certain export and import transaction are directly linked with each other.



CHECK YOUR PROGRESS

Q 3: What is multi domestic?

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Q 4: What is franchising?

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1.8 LET US SUM UP

In this unit we have discuss the following points-

- International trade is a trade whose production and consume base is drawn from more than one country.
- International trade has a great amount of risk.
- All international trade has a different pattern.
- IB is a particular country depends upon the size of the market demographically.
- Franchising and exporting are the two major modes of entry into an international market.
- Contract manufacturing frees the company from the risk of investing foreign country.



1.9 FURTHER READING

1) International business: text and cases- Francis cherunilam.

2) International trade: C.R. Kothari.

1.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: International business is one which is engaged in economic transaction with several countries in the world.

Ans to Q No 2: A business is said to be domestic when its economic transaction are conducted within the graphical boundaries of the country.

Ans to Q No 3: Multi domestic is a strategic business model that involves promoting products and service in various markets around the world adopting the product and services to the culture norms taste, religious customs of the various markets.



Ans to Q No 4: Franchising is an arrangement where franchisor (one party) grants or licenses some rights and authorities to franchise (another party).

1.11 MODEL QUESTIONS

Q 1: Explain the concept of international business?

Q 2: What are the complexities of international business?

Q 3: What are the modes of entry for international business?

*** ***** ***

UNIT 2 : INTERNATIONAL BUSINESS OPERATIONS

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Stages of Internationalization

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- 2.3.2 Domestic Company with Some Foreign business
- 2.3.3 International Company
- 2.3.4 Multinational Company/Global Company
- 2.3.5 Transnational company

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  - 2.6.1.2 Indirect Exporting
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2.7 Contractual/ Transfer Mode

- 2.7.1 Licensing
- 2.7.2 Franchising
- 2.7.3 Turnkey Contracts
- 2.7.4 Partnership and Strategic Alliance
- 2.7.5 Contract Manufacturing

2.8. Investment Mode/ Assembly and Production Facilities Abroad

- 2.8.1 Wholly Owned Subsidiaries
  - 2.8.1.1 Greenfield investments
  - 2.8.1.2 Acquisition

2.8.2 Joint Ventures
2.9 Let Us Sum Up
2.10 Further Reading
2.11 Answers To Check Your Progress
2.12 Model Questions

2.1 LEARNING OBJECTIVES

After going through the unit, you will be able to:

- understand the stages through which a company passes in its transition to a global business.
- Know various forms of international businesses
- discuss various modes of entry into the international business and their inherent advantages and shortcomings.

2.2 INTRODUCTION

Globalization implies the rise of a world market with no borders, no hurdles and a freely competitive economy. In the global economy only the fittest will survive and prosper. Businesses now a day are increasingly eyeing the international business arena and recognizing its immense potential. But along with opportunities international business environment also creates many challenges for the businesses. It is the necessity for the businesses to understand fully the technicalities of various international business operations for successful entry and growth in the global business arena. In this unit we will discuss some issues related to international business operations.

2.3 STAGES OF INTERNATIONALISATION

Most of the companies pass through different stages before going fully international. While some companies deliberately and systematically design their strategy to gradually enter the international market, some may enter international business in response to some external stimuli, though their initial attitude towards internalization might be passive and unintentional.

These different stages of a firm's transformation from a purely domestic to a global entity can be described as the following five stages:

2.3.1 Purely Domestic Company

At this stage firms or companies strictly limit operations within the home country, i.e. the country where it started its operations. Most of the business concerns start their operations targeting a particular market segment within the country of their origin. This is so because of relatively newness of their business and lack of exposure to international operations, lack of adequate funds and experience, and limited product lines or services designed specifically targeting a particular segment of the domestic market. As the company grows it may go for diversification, targeting newer customer bases within the domestic market.

2.3.2 Domestic company with some foreign business

Once a company substantially establishes and expands itself within the domestic market and gains knowledge and experience, it may go for foreign business. Generally, at this stage such company will enter the foreign market on an experimental basis where their entry into the foreign market, in most of the cases, is only an extension of its domestic operations with their primary focus still on the domestic market. This experimentation with international trade may start in the forms of direct or indirect exporting, licensing, or franchising etc.

2.3.3 International Company

When a company initially finds success in foreign operations and its experiments with foreign businesses are successful it may look forward to establishing its foothold in the international market. Gradually such companies would try to enlarge their foreign businesses and in due course would establish branches, offices or subsidiaries abroad. During this expansion, however, companies

still hold their domestic marketing mix, business models and practices. Thus their focus is mostly on the segments of the foreign markets with characteristics similar to that of the domestic market. This attitude of the companies in international business is known as the Ethnocentric Orientation. Ethnocentric firms believe that products and processes which are successful in the domestic market are superior and thus can be sold everywhere without adaptation.

2.3.4 Multinational Company/Global Company

Gradually international companies learn that this extension strategy, i.e. venturing foreign markets with the same domestic product, processes and operations, is inadequate if they want to expand their international business significantly. Though being a low cost and effort strategy, ethnocentric orientation limits the capability of such companies to fully exploit international business opportunities. This leads to the need for designing a multi- country business model and strategy, instead of just extending home country strategy to the international markets. At this stage, international companies gradually turns into multinational companies, also called global companies, where they will formulate different strategies for different international markets as they gradually realize that each national market is distinctive. Here companies start adapting to the market characteristics of different foreign markets which help them better exploit the market potential of each market. This is known as Polycentric orientation. Polycentric firms believe that local processes, personnel and techniques are best suited only to local market conditions, and each local market is inherently different from each-other. Such companies establish subsidiaries in overseas markets where each subsidiary operates independent of each other and formulates their own marketing plans, processes and strategies for their own markets. As this type of companies functions like domestic companies in each country of their operation- with distinct policies and strategies suitable to the country concerned, adapting to the

local laws, customs and culture, and a substantial focus on local ways of doing business- they are also called multi-domestic companies.

2.3.5 Transnational company

At the extreme level there are transnational companies where company products, markets, investments and operations are spread across the world. A transnational company is a purely multinational company that links global markets and does not consider any particular country as its home. It loses its affiliation with the home country and becomes a global trading entity in its true sense. Transnational companies are organizations with specialized operations dispersed worldwide and are linked through interdependent relationships. However its structure is flexible and changeable as needed.

2.4 STAGES OF INTERNATIONAL BUSINESS DEVELOPMENT

Developing a business into an international entity is the result of a series of well thought out policies and activities. Right from deciding to enter a foreign country, selecting a particular market segment, market research, products and marketing strategy development, to becoming a full-fledged international market player, every international business has to take a series of important strategic decisions and actions.

The important stages in international business development are discussed as follows:

2.4.1 Establishment in the Domestic Market

Before entering the complex environment of international market, domestic market helps businesses to test their products and strategies and fine tune their performances. The performance of a business in the domestic market can give valuable indications

regarding its possibility of success or failure in the international markets. As international market development requires huge amount of resources and expertise, it is thus appropriate for businesses to first establish a firm grip in the domestic market so that its international operations do not adversely affect its core business and survival.

However, for certain businesses, which are establishes solely by targeting a foreign market, this may not be an appropriate strategy. For example, a company in India, established with product lines specifically designed for a foreign market, do not have the option as well as the necessity to test its products and marketing strategies in the domestic market.

2.4.2 Target Market Selection

A business well established in the domestic market may plan to expand its operations in the international market. A business may also be established right from the beginning targeting an international market. In both the cases, properly selecting a target market is a crucial step which will determine its future growth prospects in the international business arena. The selection of a target market for its products in a particular country or a region, with customers having peculiar socio-cultural characteristic, determines how and how much an enterprise will have to adapt its basic value propositions. Thus, the extent of a company's capabilities and resources to orient its offerings around the world broadens or limits its possibilities of successfully entering new markets or cultures.

The attractiveness of a foreign market and is selection is based upon many factors. The size of the market and its growth rate, cultural and geographical alikeness and proximity, economic and legal environment, competitive environment, etc. determines whether a foreign market is worth targeting or not.

2.4.3 Market Research and Planning

Often, when business entities begin trading abroad, they target a country or a segment of a foreign market which is similar to its domestic market. However, before entering a newer market, companies should prepare themselves sufficiently so that they can face the challenges as well as grab the opportunities thrown at them by the new market environment.

The process of collecting information about a market or a target customer group is known as market research. The essence of market research is to gather useful information and gain an in-depth understanding about the target market. This enables a company to know the probability of gain or otherwise of a proposed product or service in the target market, thereby helping it in devising proper strategies and plans to fine tune its marketing mix. Another advantage of undertaking international market research is it helps a company to identify and select the most suitable mode of entry into the target foreign market. This further gives the company an indication of what should be its future market expansion strategy.

2.4.4 Entry into the Foreign Market

Once a firm has done market research and made necessary changes, if required, in its product or service intended for the particular target foreign market; the next thing is to finally start its operations abroad. Entry into a foreign market involves selection of an appropriate entry method considering its target market, nature of the proposed product/ service, business environment of the foreign market, and such other relevant factors.

2.4.5 Making Permanent Investments Abroad

When the company has successfully entered the foreign market and its business is growing well, it may choose to strengthen its presence in that market. Expanding its operations in the market

will help the company in gaining a strong foothold there. Moreover this may also serve as a stepping stone to expand its reach to the adjacent markets. At this stage companies may consider making permanent investments in that market. For example, opening production facilities and R & D divisions, opening local offices, tightening connections with local partners, buying an existing local company, forming joint ventures, etc. This brings in newer opportunities as well as challenges for such a company, compared to the one that is based elsewhere and is simply operating remotely in a foreign market. This is because the scope of a company broadens as it takes on a permanent physical presence in a market with its distinct business environmental elements.



CHECK YOUR PROGRESS

Q 1: What is market research?

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Q 2: mention some of the factors which a company needs to assess before selecting a market to enter.

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2.5 MODES OF INTERNATIONAL BUSINESS ENTRY

In international business one of the most important strategic decisions is the mode of entry into the foreign market. There are a number of entry modes available for a company seeking to enter a foreign market. All these alternatives vary in the amount of involvement the company is willing to undertake. On one extreme, a company may completely manufacture the product domestically and export it to the foreign market, while on the other extreme the company may also manufacture its products to be sold in the foreign market itself. Between these two there are several other alternatives and the selection of the most suitable entry mode depends upon various relevant company specific factors as well as the foreign market

related factors. Each mode of market entry has advantages and disadvantages. Firms need to evaluate their options to choose the entry mode that best suits their strategy and goals.

There may also be such situations where alternatives available are limited due to the business environment of the target foreign market. For example, government policy of some countries may not favour foreign investments or complete foreign ownership of companies operating there.

Similarly a company may use different methods for entering different markets for the same product or even different methods for the same product line in the same market. Further the mode of operation may undergo changes over time with the level of changing business environment and the level of involvement sought by the company. For example a company entering a market initially with exporting may go for establishing production facilities there if it gradually finds the business environment supporting and conducive.

All the important international market entry strategies can be divided into three broad categories, viz. Trade Mode, Contractual Mode or Transfer Mode, and Investment Mode/ Assembly and Production Facilities Abroad.

2.6 TRADE MODE

Trade mode is the most basic and traditional mode of entering and operating in a foreign market. It involves the production of the proposed goods within the domestic territory of the company and then selling it to other countries, where there is a market for the product exists. Thus, this type of method involves marketing, i.e. exporting and importing of the products. Importing refers to buying of goods and services from another country.

2.6.1 Exporting

One of the most easy and commonly practiced international business entry strategies is exporting. In the initial stage most of the companies prefer exporting as it requires comparatively less involvement and resources. Exporting is the sale of products and

services in foreign markets that are sourced from the exporting company's home country. The advantage of this mode of entry is that firms do not have to bear the expense of establishing operations in the new country. Firms must, however, have a way to distribute and market their products in the new country, which is generally done through contractual agreements with local distributors or companies. While choosing exporting, the company will also have to decide on labeling, packaging, and pricing the offering appropriately for the market. In terms of marketing and promotion, the firm will also need to let the potential buyers know of its offerings through appropriate promotional strategies like advertising, trade shows, or a local sales force, etc.

Generally exporting is an appropriate mode when one or more of the following conditions prevail:

- When the expected volume of foreign business is not very large, and thus does not justify heavy investments like production in the foreign market.
- When the company is undertaking international business only on an experimental basis.
- Production cost is less in the home country as compared to that in the foreign country.
- The company does not have permanent interest in the foreign market or when there is doubt regarding the existence of the market for long time.
- Economic and legal policies of the foreign country do not favour foreign investments.
- Business environment of the foreign market is not conducive for permanent physical investment in the country.

There are mainly two ways of exporting, viz. Direct Exporting and Indirect Exporting.

2.6.1.1 Direct Exporting

Direct export refers to the sale in the foreign market by the manufacturer directly without the involvement of any independent export intermediaries. The company may sell directly to the customers or to a middleman located in the overseas market. In direct export the responsibility of selling and marketing activities in the foreign market lies with the exporter. Though there may be involvement of intermediaries but they are in a way dependant organization that will carry on these activities on behalf of the exporter. A company may establish overseas sales branches or subsidiaries or may employ travelling salesmen for the overseas market depending upon the nature of the product or service and the target customer group. Direct export may also be done by a company through importing distributors who purchase the product in their own right and resell it in their local market to market intermediaries or to the customers.

Direct marketing is suitable when the sales volumes are small. Large volumes of export may, however, attract protectionist moves from the foreign country.

2.6.1.2 Indirect Exporting

Indirect exporting involves exporting through independent export intermediaries. Here the exporter uses the services of different international marketing middlemen. Under indirect exporting, the manufacturer fully transfers the responsibility of making the international selling activities to the intermediary. The exporter no longer retains control over its products in the foreign market. Indirect exporting is most suitable and popular among the companies which are just starting their exporting activities. As in indirect exporting the company does not have to build up a separate overseas marketing infrastructure, the

investment is less and the involved risk is also less. This also provides a fast marketing access to the target market.

The major disadvantage of indirect export is that the manufacturer possesses little or no control over distribution, marketing and sales in the foreign market and thus development of the overseas market depends substantially on the middlemen and not on the company.

2.6.2 Service Exporting

Now many developing countries like India is increasingly involved in service exports. Service export has become a easy way of entering foreign markets for service companies. With the advancement of technology it has become much easier for companies to export services to distant places through the use of information and communication technology.

World Trade Organisation (WTO) has identified four different modes of service exporting depending on the nature of the services:

Cross-border supply: where neither the buyer nor the seller is mobile and transfer of service is completely dependent upon technology. Call centers, consultancy firms, business outsourcing, knowledge outsourcing, etc. are a few such examples.

Consumption abroad: where the buyer is mobile but seller is immobile. Tourism & travelling service providers, medical tourism, etc. are the examples of this type.

Commercial Presence: it refers to the cases where a company sets up its branches or subsidiaries in a foreign market for providing services to the customers. For example banks, international logistics services, etc.

Movement of natural Persons: here individuals travel from one country to another for providing their services. For example, educational trainers, professional speakers, architects, sports coaches and trainers, etc.



CHECK YOUR PROGRESS

Q 3: What is export?

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2.7 CONTRACTUAL/TRANSFER MODE

2.7.1 Licensing

Licensing is defined as “the method of foreign operation whereby a firm in one country agrees to permit a company in another country to use the manufacturing, processing, trademark, know-how or some other skill provided by the licensor”. Licensing mainly involves renting or leasing of an intangible asset.

Under international licensing one firm in one country, called the licensor, provides a firm in another country, called the licensee, the permission to use formers intellectual property such as copyrights, patents, trademarks, technical know- how, or such other specific skills which is its exclusive possession. It is a form of agreement where the benefit to the licensor is the royalty or fee which the licensee agrees to pay. Licensing involves minimal commitment of resources and effort on the part of the licensor company. Thus it is a preferred mode of entry as a low risk manufacturing relationship arrangement.

There may be various types of licensing arrangements with different terms and conditions depending on the nature of the product and the extent to which such licenses are to be granted. The most common agreements are:

- software licence agreements (eg, end-user licence agreements, master agreements, click wrap agreements, browse wrap agreements, etc.);
- copyright licence agreements;
- trademark licence agreements;

- patent licence agreements;
- technology licence agreements;
- research collaboration agreements;
- brand licensing;
- service licences;
- compulsory licences and statutory licences; etc.

A licensing many also be in the form of **cross-licensing** whereby both the licensor and licensee mutually agree to exchange their know-how or intellectual property rights with each other. This is a both direction agreement and the payment of fee may or may not be there.

2.7.2 Franchising

It is a specialized form of licensing where the licensor (franchisor) not only transfers the right to use its intangible properties but also assists actively the licensee (franchisor) in its operations, like helping in sales promotion, conducting trainings supplying ingredients, etc. This right can also take the form of selling the franchisor's products by the franchisee in the former's name, using franchisor's production and marketing techniques etc. One of the common forms of franchising involves the franchisor providing the franchisee with some important ingredients of the finished product like materials, parts, etc.

There are two types of franchising, Direct and Indirect. In direct one the franchisor retains the control of framing policies, marketing strategies, and directs the activities of the franchisee in the foreign country. In indirect franchising, the franchisor frames the policies and strategies, but there are sub-franchisors who ultimately direct and oversee the activities of the franchisees in the foreign country.

Franchising also gives the same benefits as in licensing agreements. It is less risky and less costly than directly investing in a foreign market. However as, franchising needs policy formulation

and monitoring on the part of the franchisor, it involves more cost than a simple licensing arrangement.

2.7.3 Turnkey Contracts

Industrial companies which specialize in complex production technologies normally use turnkey projects as a market entry strategy. Turnkey contracts are commonly found in cases of designing, erecting, and commissioning of new facilities or plants and also in training personnel, like in oil refineries and explorations, cement mills and fertilizer plants etc.

This type of contracts involve agreement by the seller to provide the buyer with fully functional and ready to be used facility along with the responsibility of training the buyer's personnel for operating the facility. It is commonly seen in fast- food franchising where the franchisor agrees to build the facility and train the franchisee and its employees.

2.7.4 Partnership and Strategic Alliance

Another way to enter a foreign market is through a strategic alliance with a local partner there. "A strategic alliance involves a contractual agreement between two or more firms stipulating that the involved parties will cooperate in a certain way for a certain time to achieve a common purpose". Such alliances seeks to enhance the long term competitive advantage of a firm by forming bonds with local competitors and potential rivals in critical areas whereby all will mutually benefit from each other.

The advantages of alliances with a local firm are that the local firm understands the customers, local culture, market, and ways of doing business better than an outside company. Partners are especially valuable if they already have a recognition and reputable brand in that foreign market or have existing relationships with customers that the outside firm might want to access.

Strategic alliances are also suitable for a successful firm with limited resources and expertise seeking entry into a foreign market. It may not be possible for such a firm to enter a foreign market itself and operate profitably there for longer durations. Alliances give the shared benefit of synergy as well as minimize harmful competitions.

The main disadvantage is that the firm's goal may differ from its partner's goal and there may be clashes at times regarding the way of doing business which will be destructive for all the firms involved in such alliance. Moreover there is a lack of direct control in such alliances as compare to a fully owned manufacturing and marketing facility abroad.

2.7.5 Contract Manufacturing

In contract manufacturing a company contracts with a firm in the foreign country to manufacture or assemble its products, while retaining the responsibility of marketing the product. It is a form of outsourcing a part or full manufacturing process of a product to a third-party abroad. The main advantage is that the company does not have to commit its resources while having access to production facilities abroad. The cost involved is also less compared to when the same had to be produced by the company in the foreign country. Moreover it is a less risky strategy to enter a market as the host country does not see the foreign company as a potential threat to its business units.

However, there are certain limitations involved in this type of arrangement. The contractor company usually has less control over the manufacturing process which may hamper the quality of products. There may also loss of potential profits from manufacturing. Contract manufacturing is not very suitable in case of products involving high use of technology or processes which involves trade secrets.



CHECK YOUR PROGRESS

Q 4: Name two contractual mode of international business entry.

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Q 5: What is strategic alliance?

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2.8 INVESTMENT MODE/ ASSEMBLY AND PRODUCTION FACILITIES ABROAD

2.8.1 Wholly Owned Subsidiaries

Companies with long term and substantial interest in a particular foreign market may open wholly owned subsidiaries there. This may be done in two ways, viz. Greenfield Investment and Acquisitions.

2.8.1.1 Greenfield investments

This involve establishment of a new subsidiary abroad with assembling full manufacturing facilities and/ or marketing facilities under its control. It provides full control of operations to the firm and has the potential to generate above average return. Greenfield investment is more preferred where physical capital intensive plants are required for operating in a country as well as close contact with the customers with highly professional skills, specialized know-how and customization is required. This strategy is attractive if there is no competent firm in the host foreign country to transfer its production process, know-how and special intellectual assets.

This is however a complex process and involves huge investments. The risk involved is also very high due to very

high cost of establishing a new business in a foreign country. There may also be restrictions from government of some countries in such investments in certain sectors. Moreover it is much slower and time consuming process due to the need of establishing new operations, distribution networks, and the necessity to learn and implement appropriate marketing strategies to compete in the new market.

2.8.1.2 Acquisition

Another form of establishing a wholly owned subsidiary is to acquire an already existing firm in the foreign market. It provides a quick access to the foreign market. It is also comparatively less expensive than greenfield investments due to the higher cost of establishing a completely new business in a new country. Many multinational corporations frequently apply acquisition strategy to achieve greater market power by buying a competitor, a supplier, a distributor, or a business in highly related industries and to capture competitive advantage in the market. Acquisition also involves less risk than greenfiled investments as the outcomes of an acquisition can be calculated more precisely beforehand. It is an attractive strategy for entering a new market for big business houses and more so if there are well established firms already operating in the target market.

2.8.2 Joint Ventures

Another very common strategy of market entry is through joint ventures. In its broadest sense any kind of association between companies to collaborate for more than a transitory period is joint venture. The essence of a joint venture is the sharing of ownership and management of business between the foreign firm and a local firm. The five common objectives in any joint venture is to facilitate market entry, risk & reward sharing, sharing of technology, joint

product development and conforming to the government rules and regulations.

Joint ventures are often preferred where:

- both the firms strategic goals converge with divergent competitive goals.
- the capacity in terms of size, market share, and resources of the firms is not at par or is less than the industry leaders.
- there is scope for learning from each other and developing with each other while limiting access to their proprietary skills.

In some countries, where foreign fully owned businesses are not allowed, joint venture is the most suitable alternative if the marketer has a substantial long term interest in that market. Many foreign companies have used this method to enter developing countries with strict entry barriers.

However, joint ventures may also involve some conflicting pressures to cooperate and compete between the firms. There may arise certain situations where the partners seek to maximize their gain but also to maximize their own competitive power. Each firm may hold back and protect its proprietary resources while the essence of joint ventures is to sharing of resources. In such situations many joint ventures fail to attain their common objectives and this could naturally lead to the break-down of the alliance.



CHECK YOUR PROGRESS

Q 6: What do you understand by Greenfield investment?

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2.9 LET US SUM UP

In this unit we have discussed the following points-

- Different stages through which a firms in international business passes before becoming a fully global market player.
- Stages of international business entry.
- Different modes or strategies through which a firm can enter into international business.
- The advantages and disadvantages as well as suitability of different entry modes.
- What is trade mode of entry and its types.
- Contractual modes of entry into a foreign market and its various important forms.
- Entry through direct investment and its forms.



2.10 FURTHER READING

1) Cherunilam, Francis.(2013). *International Business-Text and Cases.* PHI Learning Pvt. Ltd. 5th Edition.

2) Sarkar, S.S., Sharma, R.K., & Gupta. S.K. (2008). *Business Studies-II.* Kalyani Publishers.



2.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The process of collecting information about a market or a target customer group is known as market research.

Ans to Q No 2: Nature of the proposed product/ service, business environment of the foreign market etc.

Ans to Q No 3: Exporting is the sale of products and services in foreign markets that are sourced from the exporting company's home country.

Ans to Q No 4: Licensing and Franchising

Ans to Q No 5: "A strategic alliance involves a contractual agreement between two or more firms stipulating that the involved parties will cooperate in a certain way for a certain time to achieve a common purpose".

Ans to Q No 6: This involve establishment of a new subsidiary abroad with assembling full manufacturing facilities and/ or marketing facilities under its control.

2.12 MODEL QUESTIONS

Q 1: Discuss briefly various international market entry strategies.

Q 2: Discuss briefly the various stages of international business development.

Q 3: Give a brief account of exporting as a entry strategy.

Q 4: Write a short note on franchising. What is the difference between direct and indirect franchising?

Q 5: Discuss the different modes of service exporting.

Q 6: What do you mean by direct exporting and indirect exporting? In which situations exporting can be a suitable international market entry strategy?

Q 7: What is international contract manufacturing?

Q 8: What is a turnkey contract?

Q 9: Write a note on international joint ventures along with its advantages and disadvantages as a market entry approach.

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UNIT 3 : INTERNATIONAL BUSINESS ENVIRONMENT

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Business Environment

3.4 Importance of Business Environment

3.5 National and Foreign Business Environment

3.6 Components of International Business Environment

- 3.6.1 Economic Environment
- 3.6.2 Social and Cultural Environment
- 3.6.3 Political Environment
- 3.6.4 Legal Environment

3.7 Let Us Sum Up

3.8 Further Reading

8.9 Answers To Check Your Progress

3.10 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit you will be able to

- explain the meaning of Business Environment
- know the importance of Business Environment
- discuss the Components of International Business Environment.

3.2 INTRODUCTION

A business cannot function in isolation. It is a part and parcel of the environment surrounding it. Business activities are thus, to a substantial extent, influenced and determined by the various environmental variables. Every business has to understand well and design their business processes and operations accordingly for their long term survival. In this unit we will discuss the environment in which international business operates.

3.3 BUSINESS ENVIRONMENT

The word business environment refers to the totality of all the conditions, both internal and external, within which a business operates. It is the overall climate created by the various forces and factors with which the business has to interact, directly as well as indirectly. Business environment of a firm comprises of both internal forces and external forces. Internal forces or factors, which can be termed as the internal environment is the aggregate of various internal conditions of a firm like organizational objective, organization structure, manpower, management's philosophy, organizational culture, work environment, technology, work process, etc. These internal factors affect a business firm's operations from within the concern, but are generally under the control of the enterprise. The external factors like the social factors, economic conditions, political and legal factors, cultural factors, customers, suppliers, competitors, etc. make up the external environment of a business concern. These factors influence the enterprise from outside and are generally beyond its control. Thus business environment denotes totality of all these external and internal factors which have influence on the functioning of a business concern.

3.4 IMPORTANCE OF BUSINESS ENVIRONMENT

Establishing a business is of course a difficult task, but to successfully operate it and grow it takes a lot more effort and critical decisions. To sustain a business it needs various resources. For example businesses need finance for which they have to depend upon the financial market and institutions; businesses need labour for which they have to rely on the society; for long run survival they need revenue generation for which they need acceptance of their products and services by the customers and society at large and so on. Again businesses have to depend on the nature for raw materials and other natural resources. Businesses need legal and regulatory support which depends upon the various acts and regulations in operation as well as the government of the nation. Likewise there are many other factors which influence every business organizations. All these factors and

dimensions are collectively called the business environment.

Business environment provides the necessary directions to an enterprise regarding its course of action. Various internal and external factors and forces throw various threats and opportunities to a business in its operations. To survive and grow, a business must be able to avail these opportunities and to save itself from the threats posed by these environmental forces. For this, a clear understanding of these internal and external forces is of utmost importance. On the basis of this understanding a business has to plan its policies and strategies in deciding the future course of action. Following are some of the reasons why business environment is of crucial importance for every enterprise:

1. **Planning in advance:** The businesses which are able to plan ahead and grab the opportunities are those which properly understand their business environment. If understood and evaluated properly, business environment can be a crucial element in the success of a business. Similarly, the same environment can also be a major cause of a business' failure.
2. **Indentifying Business Opportunities:** Proper scanning of the business environment enables firms to identify business opportunities and potential threats. Changes in the elements of environment may possess both newer threats as well as opportunities for business organizations. Identifying them properly and continuously adapting the business policies and strategies accordingly will determine a business' growth and long term survival.
3. **Adapting with Changes:** Every business needs to be aware of various changes going on in the environment. Various environmental factors are always undergoing changes, be it the changing tastes and preferences of customers, changing societal values, political/ legal policy changes, or the changes in the technology and so on. Awareness and understanding of the business environment enables businesses in deciding how to respond to these changes and make necessary adaptations in time.

4. **Helps in Improving Performance:** The future of an enterprise is closely related with what is happening in the business environment. The enterprises which continuously monitor their environment and adapt their business practices accordingly are the ones which not only improve their present performance but also continue to be successful in the market in the long run.



CHECK YOUR PROGRESS

Q 1: What do you mean by business environment?

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3.5 NATIONAL AND FOREIGN BUSINESS ENVIRONMENT

Business environment in general consists of many components, both internal and external factors. But external environmental factors constitute the most important part of an enterprise's business environment. A businessman cannot influence the external environment but is influenced and thus has to adjust or adapt his plans and policies according to the conditions prevailing or changes taking place in the business environment. The following figure shows the main components of business environment:



Fig. 1.1: Components of Business Environment.

A domestic business enterprise has to function in the presence of all these environmental elements. All these components of business environment do not function in isolation but are interrelated and exerts their influence altogether.

Domestic business environment is constituted by the nature of these forces and are generally same for almost every business operating within a country's boundary depending upon their degree of exposure and dependence on these various environmental factors. For example a business intensively dependent upon raw materials for its products will be influenced mostly by the natural environment as well as legal and regulatory provisions concerning the natural resources, along with more or less influences from economic, socio-cultural, technological environment and so on. However depending upon the nature of the business enterprise, the influences of these environmental factors may be more for some while at the same time same factors being less influencing for other types of businesses.

Moreover, at the same time, it is to be noted that significant difference can arise in the business environment within the same country. This may happen, particularly, if the country is geographically very vast, with huge population which is demographically diversified and socio-culturally multifarious. Dissimilar weather, topography, climatic conditions, etc. also plays an important role in this. This is evident in our country from the stark inequalities in the level and growth of industrialization in different states and different regions within the states; in which, along with other reasons, differences in business environment is one.

For a business operating at international level the difference in business environment is more prominent. In most of the cases the differences in the business environments of different countries are more substantial than that within a country.

While deciding whether a firm wants to go international or not it has to take many strategic decisions. Such strategic decisions regarding whether to enter a particular foreign market or not, what market entry strategy will be most suitable and it should adopt, what will be the firm's marketing mix for that particular market, etc. are dependent on two sets of factors, viz. firstly,

the company related factors and secondly, the foreign market related factors. Further there are some relevant global factors too. The competence of an enterprise to venture into international business is also subject to many internal factors like its mission and vision, management expertise, market experience, technical and financial resources and capabilities, organizational form and structure, and so on. Accordingly a firm engaged in international business has to deal with four sets of business environment, viz.

- Internal Environment,
- Domestic Environment,
- Foreign Environment, and
- Global Environment.

Domestic environment, in case of an enterprise engaged in international business, would mean its relevant home country environment. For example, home country rules and regulations governing foreign trade, govt. policy towards liberalization, export-import policy, govt. support, competitive advantage in terms of productive factors in home country, etc.

Foreign environment refers to the business environment of the relevant foreign market. For example, the government policy of that particular country relating to foreign businesses, customers' attitude and acceptance of foreign country products, and competitors in the market, etc. The nature of all these components of business environment generally differs from market to market.

Global environment in international business means those global factors which are relevant to businesses, like international trade related conventions, treaties and protocols, etc., global economic conditions, multilateral organizations like WTO, OECD, IMF, etc. and their principles and agreements.

A domestic company while deciding to go international and also to function at international level has to evaluate carefully all these four sets of environments. Designing a policy or business strategy and their success or failure would, to a substantial extent, depends upon how well the company understands and adapts to various environmental factors in its business environment.



CHECK YOUR PROGRESS

Q 2: What do you mean by global business environment?

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3.6 COMPONENTS OF INTERNATIONAL BUSINESS ENVIRONMENT

International business environment consist of following components-

3.6.1 Economic Environment

Economic environment consists of all those factors that regulate resources, influences factors of production, influence generation and distribution of income and wealth in a society. The nature of the economy, level of economic development, GDP and GNP growth rate, per capita income, economic system and policies like fiscal and monetary policies, capital market, demand patterns, etc. are the major components of a country's economic environment. Economic environment directly impacts every business in terms of their scope of business, business prospects and policies. Some of the economic factors are briefly described as follows:

Nature of Economy:

How much developed a country's economy is, has a lot of implications for business operating in the country whether domestic or foreign business enterprises. The general level of development of the economy determines the nature and size of demand for products and services, consumption patterns, ease of access to finance and financial services, the nature of government's policies and programs on trade and business, etc.

A widely accepted and used method of determining the level of economy of countries is on the basis of the per capita income or

the average annual income per person of a country. On this basis the countries around the world is categorizes into three types based on their level of economy, viz., low income countries, middle income countries and high income countries.

World Bank classifies economies into four income groups, viz., Low, Lower-Middle, Upper-Middle, and High Income economies. This classification is done on the basis of a country's GNI (Gross National Income) per capita. As of 2019, all economies with per capita GNI of $ 1.025 or less in 2018 are regarded as low income economies. Lower-middle income economies are those with GNI per capita between $1,026 and $ 3,995; between $ 3,996 and $ 12,375 are upper-middle and economies with GNI per capita of $ 12,376 and above are regarded as high income economies.

Structure of the Economy:

Every country is different in terms of its share of income from various sectors of the economy. How much contribution the country derives from the primary sector, secondary and tertiary sector; the growth and contribution of the small, medium and large industries to the GDP; governments participation and restrictions in the industrial sector; level of integration of the country's economy with the world economy; etc. are most important factors for the businesses operating and seeking to operate in that country. The structure of the economy determines the prospects and challenges that may arise in doing business in a country.

As we all know India has been primarily an agrarian economy with much of its productive resources engaged in the primary sector. However with economic development of a country the share of primary sector in the GDP decreases gradually than that of the other two sectors. In developed countries, generally, service sector is the largest contributor to the GDP. However, in the recent times with the growth in information and communication technology, service sector has seen a phenomenal growth in developing countries.

Economic Policies of the Government:

Economic policies are tools of the government to influence or control the behaviour of the economy in a desirable direction. Economic policies like decisions on government spending and taxation, control of money supply, trade, commerce and industry, investments, exchange rate and interest rates, cross border movement of capital, etc. have implications for businesses operating or seeking to be operative in that country. Govt. economic policies can be classified mainly into two categories, Fiscal and Monetary. Fiscal policy is concerned with government's strategy and actions regarding public expenditure and revenue and is mainly concerned with taxation and public expenditure. Monetary policy, generally the prerogative of the central bank, is concerned with monitoring and regulating the money supply and interest rates. Both these policies can have significant influence on businesses by affecting money supply, savings and investment patterns, prices, pattern of demand, tax incentives or disincentives, etc.

Economic Conditions of the Country:

General economic condition and its fluctuations affect businesses. Economies often pass through periods of boom and recessions, with several intermediate conditions or phase, often cyclically. Such economic conditions may be confined to a region within a country or may be widespread- affecting the whole country or even at international level.

All these economic factors have important implications for businesses as most of them are outside the control of businesses. What a business can do is to understand and assess them properly to decide its course of action.

3.6.2 Social and Cultural Environment

Every business is a part and parcel of the society within which it has to operate. Socio-cultural environment consists of social structure, social stratification, language, religious aspects, cultural,

moral, ethical values, social attitudes, customs and traditions, lifestyle of people, taste and preferences, social institutions, buying and consumption habits, etc. In international business it is very important that companies understand the society and culture of their respective markets. What is acceptable or preferable in one culture may not be liked by the members of some other culture. It is common for most of the companies operating at international level to modify their products and offerings to suit the features of the societies and people of different countries. One of the most significant causes of the failure of businesses in foreign markets, despite being successful in their home country markets, is their inability to properly understand the socio-cultural environment of these markets and to suitably formulate their business strategies.

Every society have their own culture, made up of various customs, values, beliefs, attitudes, habits, languages and other forms of interaction between the members of the society. Any business firm which aims at venturing into a new market for its products and services must develop complete understanding of socio-cultural environment of the society involved and adapt its strategies thereto. Three aspects may be noted in the current socio-cultural environment:

1. Changes in our life-styles and social values: For instance, changing role of women, emphasis on quality of goods instead quantity of goods, greater preference for recreation activities.
2. Major social problems: For example, concern for pollution of environment, demand for socially responsible businesses, socially responsible marketing policies, etc.
3. Growing consumerism: It is indicating consumer dissatisfaction on a large scale against unfair trade practices. Consumerism is becoming increasingly important to marketing decision process. Social environment in many countries is responsible for emphasizing social responsibility of business and customer oriented marketing approach.

Culture:

One of the distinguishing traits of human society, culture is a unique feature of every society of human beings. In the words of Greet Hofstede, noted Dutch academician, culture is "the collective programming of the mind which distinguishes the members of one group or category of people from another." Culture is a very broad word in itself which encompasses societal beliefs and values, customs and traditions, religion, morals and manners, way of conducting economic and other type of activities, and way of conducting life as a whole. Culture is of significant importance to every business. A company seeking to do business in unfamiliar cultural environment may encounter several problems if do not understand it properly.

Though consisting of many intricate and interrelated elements, the three most important component of a cultural environment are: knowledge and beliefs, ideals, and preferences.

Knowledge and Beliefs: Knowledge and beliefs refers to the prevailing idea of the reality in a cultural set up. This refers to the peoples' way of perceiving the reality. As they consist of myths and metaphysical beliefs, they are also based on scientific realities. In every society it is common for people to have some basic convictions regarding the righteousness or desirability of certain modes of conduct or goals. These are also known as values. Value system is made up of a set of values in order of their relative priorities based on their relative importance. It helps individuals and groups to make distinctions between right and wrong, what ought to be and what ought not to be. Values provide benchmarks by which individuals may be guided in their choices, decisions, conduct, and behaviour.

Ideals: Ideals refer to the societal norms which define what is customarily expected, right or proper in a given situation. In a society norms are generally enforced by sanctions, i.e., by rewarding the right behaviour and punishing the wrong behaviour.

***Preference*:** Preferences refer to society's definitions of those things which are attractive or otherwise as objects of desire. Preferences may differ from culture to culture.

All these cultural factors are very important in framing pragmatic and proactive business strategies. Ignoring customs, traditions, values and beliefs, preferences while framing policies may cost heavily.

Language: In international business, difference in languages is one of the crucial problems. There are around 4,000 to 10,000 different languages in the world. Non- verbal communications are also an important part which is perhaps more difficult problem for the businesses. The same symbols and gestures may have different meanings in different societies or cultures. For example, the 'ok' sign formed by the index finger and thumb forming an 'o' and other three fingers held straight up means 'everything is all right' in USA, while in most of the Europe it is understood as 'worthlessness', while in Japan it is used as a symbol of money or coins.

3.6.3 Political Environment

Political system, and governmental affairs and actions create the political environment of a country. Political environment encompasses the characteristics of the political parties in a nation, their ideologies, nature of the Constitution and the administrative system, various governmental policies and programs relating to the economy and business, etc. Political environment directly influences the functioning of businesses. Many political decisions have serious implications for businesses. For instance, whether to allow foreign investment in a particular sector or to restrict it is a political decision, which has important bearing for those foreign businesses which are looking to invest in the country. Economic policy of a country is very important. Several aspects of the government's policy can affect businesses as all firms have to follow the law of the country. Companies should always be ready to deal with the local and

international outcomes of the political environment. Moreover, major economic policy changes are often the result of political decisions. In fact, economic policy environment and political environment are mostly interlinked.

All the political factors affect business environment and consequently the business organizations in four main ways:

1. **Impact on the Economy:** the political environment of a country affects its economic settings. Important economic policies are often political decisions. Economic policies like industrial policy, fiscal policy, policy towards foreign capital and technology, foreign trade policy etc. often have political underpinnings. The effect of these policies on businesses operating in a country is far reaching. In India 1991 liberalization and globalization policy has brought in far-reaching changes in the economy and has substantially affected businesses in the country.
2. **Changes in Regulations:** Government often alters the rules and regulations according to their political ideologies. This in turn affects businesses. For example, promoting traditional wares in govt. offices is a government ideology which will affect the growth of this industry and related upstream and downstream business activities.
3. **Political Stability:** Lack of political stability in a country affects business operations. This is especially true for the companies which operate internationally. A stable political system is more conducive to business friendly decisions which promote local businesses and attract foreign investors.
4. **Government Taxation and Spending:** Taxation and public expenditure decisions are affected by the political system. Government collects taxes for spending in developmental activities. How a particular government selects their spending priorities and collects revenue through taxes and fees depend upon their political ideologies.

Every business firms should track their political environment very carefully. Some of the reasons why changes in the political factors require businesses to adjust their business strategies are:

- The stability of a political system can affect the appeal of a particular local market.
- Government considers business organizations as an important vehicle for social reform.
- Government is a major consumer of goods and services.
- Government's various rules and legislations have an impact on the relationship between the firm and its customers, suppliers, and other companies.
- The government is liable for protecting the public interest.
- Government actions influence the economic environment.

3.6.4 Legal Environment

As we have already learnt business policies and regulations are an, to a substantial extent, outcome of the political environment prevailing in a country. Every business has to operate within this framework of regulations and laws within the country. There is wide variation among countries in their legal framework governing businesses. For example, in some countries certain sectors are under strict monopoly of the government depending upon the level of economic development of the country. Similarly, in some countries certain business practices and strategies, followed generally by the business organizations, may be considered as unfair under the laws prevailing there. Thus it is one of the important requirements for every business to understand properly the regulatory environment of the country in which they are operating and design their business plans and policies accordingly.

Types of Legal Systems:

Legal systems that exist around the world can be mainly categorized into three categories, viz. Common Law, Civil Law, and Theocratic Law.

Common laws are based on traditions, past practices, and legal precedents set by the courts of law in various cases through interpretation of legal legislations, statutes, and past rulings. For example, the common laws derived from English law is found in England, United States, Canada, including India and several other countries which were once under English influence.

Civil law, also called Code law, is based on an all-inclusive framework of written codes of law. Under civil law the legal system can be divided into three separate codes, viz. civil, commercial, and criminal.

The theocratic laws are based on religious principles. For example the Islamic Law or Sharia which is followed in most of the Islamic countries.

From a business' perspective, there are three categories of or systems of laws relevant in case of international trade as:

- International Laws, Agreements, Treaties, Conventions, etc.
- Laws of the Foreign Countries.
- Laws of the Home Country related to business and international business.

Non compliance of legal requirements can lead businesses into great troubles. Different countries have different legislations governing trade and business, investment, competition, industries, and so on with different rules and coded of conduct. In India for doing business a fair understanding of Companies Act 2013, Industries (Development and Regulations) Act 1951, Industrial Disputes Act 1947, Factories Act 1948, Foreign Exchange Management Act and the Imports Exports (Control) Act 1947, Trade Union Act 1926, Workmen's Compensation Act 1923, Industrial Disputes Act 1947, Consumer Protection Act 1986, Competition Act 2002, and a host of such other legal enactments and their amendments from time to time is important.



3.7 LET US SUM UP

In this unit we have discussed the following points:

- What is business environment and its importance.
- Business environment in national level and at international level and their differences.
- Business environment in case of business firms operating at global level.
- Various important constituents or components of the business environment.
- The importance and implications of various components of business environment in international business.



3.8 FURTHER READING

1) Sarkar, S.S., Sharma, R.K., & Gupta. S.K. (2008). *Business Studies-II.* Kalyani Publishers.

3.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The word business environment refers to the totality of all the conditions, both internal and external, within which a business operates.

Ans to Q No 2: Global environment in international business means those global factors which are relevant to businesses, like international trade related conventions, treaties and protocols, etc.



3.10 MODEL QUESTIONS

Q 1: Give a brief account of the differences between business environment at national level and global level, and their implications for businesses.

Q 2: What is business environment? How does it affect businesses?

Q 3: Write a brief note on various components of international business environment.

Q 4: Write a note on economic environment and its various important components.

Q 5: Write a note on socio-cultural environment and its implications in international business.

Q 6: How the legal environment around the world affect business firms in international business?

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UNIT 4 : THEORIES OF INTERNATIONAL TRADE

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 International Trade Theories

- 4.3.1 What are International Trade Theories?
- 4.3.2 Three Basic Issues of International Trade
- 4.3.3 Development of International Trade Theories

4.4 Mercantilist View of International Trade

4.5 Fall of Mercantilism and Development of Free Trade Theories

4.6 Theory of Absolute Advantage

- 4.6.1 Introduction
- 4.6.2 What is Absolute Advantage?
- 4.6.3 The Theory
- 4.6.4 Assumptions
- 4.6.5 Criticisms

4.7 Theory of Comparative Advantage

- 4.7.1 Introduction
- 4.7.2 The Theory
- 4.7.3 Assumptions
- 4.7.4 Criticisms

4.8 Let Us Sum Up

8.9 Further Reading

4.10 Answers To Check Your Progress

4.11 Model Questions

4.1 LEARNING OBJECTIVES

After going through the unit you will be able to -

- understand the meaning of international trade theories
- understand development of trade theory
- understand mercantilism and its limitations

- discuss absolute advantage theory and how it is important in international trade
- discuss Ricardo's theory of comparative advantage.

4.2 INTRODUCTION

International trade refers to trade, i.e. exchange of goods and services, between countries. Also called foreign trade or external trade, international trade involves buying and selling of goods and services among different nations. For example- trade of India with USA, China, Japan, etc.

The need and desire for trade existed among people from the earliest times. From when people started living in settled places, leaving their nomadic-hunting and gathering lifestyle, they started to find out that productive resources are scarce and they alone cannot produce all of the goods and services required for their families. As a result they must choose something and give up others. Even in the most basic tribal societies people recognized their abilities to do different things well. While one family unit produced some kind of goods or services well, others did well in the production of some other produces. Thus, by exchanging some of what a family unit does well for some of what it doesn't do well, all of them will be able to have almost all goods and services they need. Starting from this humble beginning the scope and coverage of trade gradually started to increase and expand, as focuses expanded beyond the needs of family units to the needs and requirements of tribes, empires and nations.

The essence of trade between people or entities is their belief of benefitting from the exchange. Similarly countries also engage in trade with each other for deriving some benefits out of it. At the surface, though this sounds very simple; there are a great deal of theories, policies and business strategies that constitute international trade in its real form.

In this chapter we will discuss some of the important international trade theories in details.

4.3 INTERNATIONAL TRADE THEORIES

4.3.1 What are International Trade Theories?

International trade theories are simply different explanations and concepts which try to explain international trade. Why trade happens between two countries?, how does it really work?, and how should it work?, are some of the questions which such theories try to explain. The fundamental task of these theories is to explain why nations trade together.

It is a sub branch of economic theories which studies international trade- its origin, need, patterns of trade, and overall welfare aspect associated with trade so as to make some prescriptive instructions. Almost all of such theories deal with any or all of the following three basic issues of international trade.

4.3.2 Three Basic Issues of International Trade

As you have already learnt international trade involves trade among nations. There are many crucial and complex issues involved in such interactions among nations. Cross-country trades face many unique sets of challenges compared to domestic trades. However, following three are the most basic issues concerning an international exchange of commodities between two countries:

1. Gains from Trade: The first important consideration is the gains or benefits derived from such exchanges. Do both the countries gain from the exchange or only one country gains? If only one of the countries gain, why the other will enter into trade? If both the nations gain, how and where do such gains come from?
2. Structure of Trade: The second elemental issue is the structure or pattern of trade, i.e. what are the goods or services that are exported and imported by each trading nation? What are the basic principles that govern the international allocation of resources and flow of goods and services?

3. Terms of Trade: The third issue is terms of trade which means at what prices both the countries would export and import the commodities so that each gains something out of it.

4.3.3 Development of International Trade Theories

International trade theory is one of the oldest branches of economics. From ancient times, policymakers, thinkers, intellectuals and economists have tried to understand the determinants of trade between countries and tried to know what kind of trade policy is best for any nation. They tried to understand whether trade has beneficial or harmful ramifications for the economy of a nation. In doing so many theories were postulated by different thinkers, authors and economists. All these theories have, in some ways or other, tried to fit into explanations the dynamics of international trade.

The earliest systematic body of thoughts related to international trade developed in Europe between sixteenth to eighteenth centuries called Mercantilism. However, mercantilism was more of an economic philosophy rather than a theory. Mercantilist doctrines were highly nationalistic in its outlook and favoured strict state regulation of economic activities including international trade. Mercantilist ideas were strongly criticized in the eighteenth century by economists like David Hume, Adam Smith and David Ricardo. Hume and Smith's work marked the beginning of classical trade theories. This brought a paradigm shift in the arena of international trade theories by advocating a free trade regime unlike mercantilism. This was further strengthened by the classical works of Ricardo and J. Stuart Mill. Classical trade theories concentrated on the productivity of labour across industries and between countries in explaining trade. Then came the Neo-classical trade theories of economists like Marshall and Edgeworth which, unlike classical theories, emphasized the general structure of trade models. Among neoclassical theories the Heckscher-Ohlin model, also called Modern Theory, developed in the mid twentieth century was prominent with

its emphasis on distribution and the role of factor endowments among nations in determining structure of trade; which dominated trade theory for more than half a century. It is to be noted that trade theories developed till first half of twentieth century, i.e. classical and neoclassical theories, were based on certain unrealistic assumptions like perfect competition, constant returns to scale, etc. Many researchers and economists observed, in due course, that these theories are no longer suitable for explaining structure of the world trades in the modern globalised economic setup. To compensate this, economists have developed newer theories by modifying Heckscher-Ohlin model by relaxing most of its assumption. This marked the beginning of New Trade theories. The new theories which are developed after 1970s are also known as imperfect competition models for their approach of discarding traditional unrealistic assumptions like perfect competition.

Thus development of international trade theory can be divided into four phases as follows: 1. Mercantilism and Protectionism, 2. Classical Trade Theories, 3. Neo-classical Theories, and 4. New Theories of Trade.



CHECK YOUR PROGRESS

Q 1: What are International Trade Theories?

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Q 2: What are the three basic issues of international trade which trade theories try to address?

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4.4 MERCANTILIS VIEW OF INTERNATIONAL TRADE

The systematic study of trade began in the mercantilist era, roughly during 16th to 18th century in Europe. One of the earliest classical theories developed in that period was the Mercantilism theory. It was, however, not a

matured trade theory as such but more of an economic policy of governmental accumulation of wealth. It emerged as a crude set of arguments about how a nation should conduct its trade.

The mercantilists were of the view that a nation's wealth and prosperity is reflected in the stock of precious metals, viz. gold and silver, it possesses. The more gold and silver a nation had the richer and more powerful it was. At that time, these metals were the currency of trade between nations, and thus every country would get paid in gold and silver for exports, while making payment for their imports with the same. One of the ways a country could accumulate gold and silver was by exporting more and importing less.

Therefore the proponents of mercantilism were of the view that self interest of a nation can be best served by encouraging its exports to other countries while discouraging its imports. The resulting trade surplus will lead to inflow of precious metals to its exchequer and would increase nation's wealth. One of the ways nations practiced this was by imposing complete restrictions on imports. This strategy is known as protectionism. Scholars and thinkers later, however, contended the degree to which the advocates of mercantilism confused the accumulation of precious metals with increase in national wealth.

Apart from a surplus trade balance, mercantilism also concerned itself with the commodity composition of trade; i.e. kinds or types of goods traded. While exports of manufactured or final goods were preferred under mercantilism, exports of raw materials to be used by foreign manufacturers were considered harmful. Similarly imports of raw materials were considered favorable while imports of manufactured goods were considered as damaging. This is so because compared to just extraction of primary produces; processing and adding value to the raw materials generate not only more employment but also helps build up industrial sector of a nation which would strengthen the economy of a nation.

4.5 FALL OF MERCANTILISM AND DEVELOPMENT OF FREE TRADE THEORIES

The mercantilist prescriptions had some inherent drawbacks. First, mercantilists put too much importance on gold and silver which can never be considered true wealth of a nation. Various natural as well as human resources possessed by a nation, its industries and commerce etc. in essence are true wealth, as these have the capability of generating sustainable economic growth and welfare of the nation. European mercantilism ran after gold and silver, and thus failed to serve the general people properly.

Secondly, it is not possible for every nation to have an export surplus at the same time, since one's export is another import. Moreover, the amount of gold and silver was limited at any particular point of time. Following mercantilism one nation could gain only at the expense of the other. This brought conflict among the European countries. Each wanted to be more wealthy and powerful at the expense of another.

Thirdly, mercantilist viewed trade as a zero sum game, i.e. it is not possible for both the nations engaged in trade to gain at the same time. One must loose for the other to gain; which was not suitable for sustainable trade relations among nations in the long run. This view was strongly challenged by economists like Adam Smith and David Ricardo who demonstrated that trade is purely a positive sum game where each nation can gain even if some benefit more than others.

On the backdrop of these, the mercantilist view finally started to weaken by the late 18th century with emergence of newer liberal views advocating free trade between nations. These theories recognized that it was impossible for all nations to become rich simultaneously by following mercantilist prescriptions. A nation's self interest and world interest would both be served by just letting trade as they saw fit according to the situations they are in.

Two of the most important classical theories challenging mercantilism were Absolute Advantage Theory put forth by Adam Smith and Comparative Advantage Theory of David Ricardo.

The following section deals with these two theories in details.



CHECK YOUR PROGRESS

Q 3: What is mercantilism and what are its prescriptions regarding international trade?

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Q 4: Why free trade theories opposed mercantilism?

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Q 5: Does mercantilism still hold relevance in the present globalised world economy?

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4.6 THEORY OF ABSOLUTE ADVANTAGE

Adam Smith, who is known as the father of modern economics, in his Wealth of Nation (1776) countered mercantilism by developing the concept of absolute advantage. He argued that, unlike mercantilism where one country tries to prosper at the cost of another, all nations can gain simultaneously if they practice free trade and specialize in accordance with their absolute advantage.

What is Absolute Advantage?

In economics, the term Absolute Advantage refers to the ability of an entity (an individual or a family or a firm or an industry or a country) to produce more amount of a product (goods or services) per unit of input as compare to any other entity producing the same product. Absolute advantage is when a producer can produce a commodity in greater quantity at the same cost, or the same quantity at lower cost, compared to other producers.

The Theory

The theory of absolute advantage can be understood with the help of a simple example. Take a hypothetical case where there are only two countries say India and U.S.A. There are two products X and Y and suppose labour is the only input in production of these goods. Per unit costs of producing the two goods in each country in terms of labour is given as the following table:

Table-1: Absolute difference in cost

	Unit Cost of Production (in Labour Units)	
	X	Y
India	10	4
U.S.A	5	9

As we can see from the example, to produce one unit of X, India requires 10 units of labour, whereas in U.S.A only 5 units of labour is required. For product Y, only 4 units of labour can produce one unit of Y in India but the same requires 9 labour units in U.S.A. In other words, India is more efficient in producing Y as less labour is required as compared to U.S.A. Similarly U.S.A is more efficient in producing X as compared to India. Thus it can be said that India enjoys absolute advantage with respect to product Y while U.S.A has an absolute advantage in producing product X.

Under such conditions, absolute advantage theory states that both the countries would benefit most if each produces the product in which they have absolute advantage and by having an exchange. India can gain by producing one unit of Y using 4 labour units, and exporting it to U.S.A in exchange for one unit of X. Thus, India can attain one unit of X indirectly by using only 4 units of labour, instead of producing 0.4 units of X by using the same amount of labour (or using 10 units of labour to get one unit of X). In the same way, U.S.A will benefit by producing X using 5 units of labour and exporting it to India, and in exchange importing product Y which otherwise would have needed 9 labour units to produce.

Absolute advantage theory advocates for specialization in the production of that commodity which a nation can produce most cheaply compared to others. In the same way other countries will also specialize in other commodities. Thus all countries can mutually benefit from free trade.

Assumptions

The absolute advantage theory is based on the following assumptions:

1. Labour is the only factor used for production, i.e. the cost of production consists of labour cost only.
2. Labour is mobile within a country, but cross-country movement of labour does not take place.
3. There is free trade between countries and no trade barriers for the exchange of goods.
4. The theory considered only a two country-two commodity framework.

Criticisms

The important criticisms of the theory are as follows:

1. Absolute advantage theory assumes that only bilateral trade is possible between nations and that too only in two commodities. This assumption was incomplete as bilateral trades do not always involve only two but generally involves exchange of many commodities. Similarly, given the huge consumption requirements of nations bilateral trade fails to suffice their needs.
2. Assumption of free trade is not applicable to real world international trades. Countries often impose protectionist measures in many forms to protect their economy as a part of environmental or public policy.
3. Cross country immobility of factors of production is also not a valid assumption. Cross country movement of labour and other factors of production is often a reality in the real-world economy.

4. Last but not least, most important assumption of the theory is that each of the trading countries possesses an absolute cost advantage in the production of a specific commodity. This assumption may not hold true in real situations. A country may not have any line of production in which it has an absolute advantage over other countries.



CHECK YOUR PROGRESS

Q 6: What do you understand by the term absolute advantage?

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Q 7: Give three assumptions and three criticisms of the theory of absolute advantage?

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4.7 THEORY OF COMPARATIVE ADVANTAGE

To substantiate arguments in favor of free trade among nations and fill up the gaps in Smith's theory, David Ricardo in his Principles of Political Economy and Taxation (1817) developed the principle of Comparative Advantage, also known as the principle of Comparative Cost.

Smith's theory required each nation to have some absolute advantage in producing a commodity so that mutual trade can happen. But it is possible that a country may not have absolute advantage in producing any commodity as compared to the other nation. What will happen in such a situation? Will other nations be willing to trade with such a nation? If trade takes place also, how would both the countries benefit from it? Similarly, if a country has absolute advantage in all the commodities, would it be beneficial to enter into a bilateral exchange? Ricardo tried to answer these

questions. By developing the idea comparative cost he showed that a nation can still gain from foreign trade even if it has advantages over other nations in the production of nothing or everything.

The Theory

Here we would try to understand the model using the example Ricardo used in his works. Ricardo used a case involving two countries, viz. England and Portugal where both produced two goods- wine and cloth. Labour costs for production of both goods in the two countries are shown in the following table:

Table-2: Comparative difference in costs

	Labour Cost of production (in man-hours per unit of product)	
Country	Cloth	Wine
England	100	120
Portugal	90	80

Here in Portugal a unit of cloth costs 90 man-hours and a unit of wine costs 80 man-hours; while the unit labour cost in England is 100 man-hours for cloth and 120 man-hours for wine. It is clear that Portugal has absolute advantage in production of both the commodities as compared to England. In this case, the principle of absolute advantage is not applicable. Question arises in this kind of situations can there be mutually beneficial trade between both the countries? According to Ricardo, yes, there can be if we consider the comparative cost benefits of production of the two commodities in both the countries.

In the example, the ratio of comparative cost difference for cloth between England and Portugal is 100:90 or 10:9; and for wine 120:80 or 3:2. Here England has a disadvantage in producing both the commodities; but if we observe from the ratios, the disadvantage is comparatively less in production of cloth. In other words England has a comparative advantage in producing cloth as compared to wine produced in Portugal. Similarly, though Portugal enjoys absolute

advantage in producing both the commodities, the advantage is comparatively less in cloth than that in wine. Thus, under such a situation both England and Portugal will gain if England specializes in the production of cloth and imports wine from Portugal, and Portugal specializes in the production of wine and imports cloth from England.

To further simplify the theory we can use the concept of Opportunity Cost. The opportunity cost of a commodity X is defined as the amount of another commodity, say Y, which has to be foregone in order to produce an additional unit of X; and is given as the ratio of X to Y. A country is said to have a comparative advantage in producing a commodity if the opportunity cost of producing that commodity is lower at home than in the other country. Demonstrated as the Table.3, in our example England has a lower opportunity cost (0.83) in producing cloth as compared to Portugal (1.13) for the same, i.e. in England to produce one more unit of cloth lesser amount wine production is to be given up, as compared to the amount of wine to be foregone for producing one extra unit of cloth in Portugal. Thus England enjoys a comparative advantage in production of cloth. In the same way Portugal has a comparative advantage in the production of wine as compared to England. Thus as per comparative cost theory, for both the countries to maximize their gain, England should produce and export cloth to Portugal and the latter should produce and export wine to the former.

Table-3: Differences in opportunity cost

	Opportunity Cost of Production	
	Cloth	Wine
England	100/120 = 0.83	120/100 = 1.2
Portugal	90/80 = 1.13	80/90 = .89

Assumptions

The classical theory of Ricardo is based on the following fundamental assumptions:

1. There are only two countries and two commodities.
2. Labour is the only factor of production used for producing the commodities, i.e. cost of production includes labour cost only, and all labour units are homogenous.
3. Production is possible with constant returns to scale, i.e. per unit cost of product does not vary with change in the level of output.
4. Transporting the commodities involves no cost and labour cost is the only cost of production.
5. Prices of commodities are determined by their real cost of production.
6. There prevails a perfect competitive environment both in factor and product market.

Criticisms

Following are some of the major criticisms of the theory:

1. The theory considers only labour cost as the only cost of production. It neglects costs of other factors of production of the commodities.
2. The theory put emphasis only on the supply neglecting demand for the products. This makes it an incomplete one-sided theory.
3. The assumption of constant returns to scale in production of goods is unrealistic.
4. The theory neglects transportation cost of goods. But international trade always involves huge amount of transportation costs, and are of substantial importance in decisions related to trade.
5. Last but not least, the two country two commodities model is inadequate to explain global international trades.



4.8 LET US SUM UP

In this unit we have discussed the following points:

- International trade theories are simply different explanations and concepts which try to explain international trade.
- Types of International Trade Theories.
- What is Mercantilism? Its limitations.
- Fall of mercantilism and emergence of free trade theories.
- Adam Smith's Absolute Advantage Theory.
- David Ricardo's Comparative Advantage Theory.



4.9 FURTHER READINGS

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5) Lodha, S.S., Bhatnagar, B. P., & Sharma, N.(Eds.).(2007). Global Competitive Advantage: Concepts, Approaches and Perspectives. Vol-II. Delhi: Abhijeet Publications.

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4.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: International trade theories are simply different explanations and concepts which try to explain international trade.

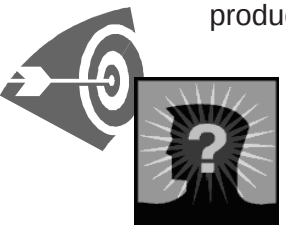
Ans to Q No 2: Gains from Trade, Terms of Trade and Structure of Trade.

Ans to Q No 3: Mercantilism were of the views that self interest of a nation can be best served by encouraging its exports to other countries while discouraging its imports.

Ans to Q No 4: Mercantilists put too much importance on gold and silver which can never be considered true wealth of a nation.

Ans to Q No 5: Absolute advantage is when a poroducer can produce a commodity in greater quantity at the same cost, or the same quantity at lower cost, compared to other producers.

Ans to Q No 6: Labour is the only factor used for production, i.e. the cost of production consists of labour cost only.



4.11 MODEL QUESTIONS

Q 1: What do you mean by absolute difference in cost of production?

Q 2: Explain with example Smith's theory of absolute advantage? What are the criticisms on the theory?

Q 3: Give the assumptions on which absolute cost advantage theory is based.

Q 4: Show with an example how, according to Ricardo, two countries can benefit mutually from trade even if one country possesses absolute advantage in no products.

Q 5: What was mercantilism? On what grounds was mercantilism criticized?

Q 6: Write a short note on the development of international trade theory.

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UNIT 5: GAINS FROM TRADE AND TERMS OF TRADE

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Gains from International Trade

5.4 Difficulties in Foreign Trade

5.5 Advantages of International Trade

5.6 Terms of Trade

5.7 Terms of Trade and the concept of Reciprocal Demand

5.8 Factors Influencing Terms of Trade

5.9 Terms of Trade and Economic Development

5.10 Let Us Sum Up

5.11 Further Reading

5.12 Answers To Check Your Progress

5.13 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- know how nations benefit from international trade
- know the concept of terms of trade
- explain the factors that may affect a country's terms of trade
- discuss how terms of trade is related to economic development.

5.2 INTRODUCTION

In the early stages of economic development, man produced most of his needs on his own with the help of the limited resources he possessed. But with time, as human wants and needs increased, it became impossible for individuals or family units to be self-sufficient. As a result, emerged the concept of barter whereby man exchanged his surplus produce with others in return for goods and services of his need. Gradually trade and commerce

have developed overtime to its present state.

Now-a-days trade is no longer restricted within the boundaries of a nation, but has spread globally. Today, no country can exist in complete isolation and every country is in a constant state of trade with each other. Unprecedented development in transport and communication has also contributed substantially in creating the world into a big interconnected market.

In this unit we will discuss gains from international trade and terms of trade.

5.3 GAINS FROM INTERNATIONAL TRADE

All the countries around the globe are not endowed with equal natural resources and are, in many cases, widely divergent in climatic and other natural conditions. As a result, products which can be produced abundantly in some countries are almost impossible to produce in others. Even if a country is endowed with every resource, still self-sufficiency through production of all goods and services required for its citizens is impractical and unattainable too. Every country must depend upon each other for satisfying their needs. International trade is a means of adding to the range of commodities available in each country, thereby helping citizens of each country to consume goods and services even if such are not produced in their countries.

John Stuart Mill, in his book Principles of Political Economy (1848), dealt with many aspects of international trade and discussed the gains from it. In his words “setting aside its enabling countries to obtain commodities which they could not produce themselves, its advantage consists in a more efficient employment of the productive forces of the world”. Division of labour is one of the most important benefits of international trade. Division of labour, in this context, means countries practising diversion of available resources from production of less beneficial requirements to the production of more beneficial requirements. Division of labour is possible due to differences of comparative costs and absolute costs of production among different nations.

Another consequential benefit of division of labour is specialization. Specialization further benefits in terms of increase in efficiency and productivity. In international trade countries focus in the production of only those commodities for which they are best fitted and gains specialization. This leads to greater efficiency in production of such goods as well as reduces the cost of production due to economies of scale. Imports become cheaper for each country and thus the consumers are benefitted.

5.4 DIFFICULTIES IN FOREIGN TRADE

There are many crucial and complex issues involved in international trade or foreign trade. Cross-country trades face many unique sets of challenges compared to domestic trades. The following are some of the special issues or in other words difficulties involved in foreign trade:

1. **Distance:** Foreign trade involves long distance dispatchment of commodities and products. Due to very long geographical distance between countries foreign trade becomes difficult and many risks creep in the process of shipment. Moreover this makes it difficult to establish and maintain close relationship between the buyers and sellers.
2. **Difficulty in Transport and Communication:** Due long distances between trading countries dispatch and receipt of goods takes a longer time, which increases the risk of damage to goods. This also increases the transportation cost and other related expenses considerably. Moreover lack of proper and quick communication also makes it difficult for the trading nations.
3. **Language Differences:** Sheer multitude of languages spoken around the world creates another problem in international trades. It becomes difficult for traders to understand the languages of traders in other countries as all correspondence are to be carried in foreign languages.
4. **Risk and Uncertainty:** Foreign trade involves much greater risk than domestic trades. As goods are to be sent over long distances they are susceptible to many risks and dangers on the transit. Goods sent overseas are susceptible to perils of seas like tides, tsunamis, icebergs, pirates, etc. Further as dipatchment and receipt of goods

involves long time durations trading in perishable commodities involves greater risk.

5. **Information Gap:** Due to the lack of close and direct relationship between the traders there exists an information gap between both the parties. The seller has to take extra care in assessing the creditworthiness of the foreign buyer. Lack of information regarding creditworthiness, financial position and other relevant matters on part of both the parties make foreign trades risky.
6. **Foreign Trade Restrictions:** Foreign trade policy, procedures, rules and regulations differ from country to country and keep on changing from time to time. Every country has its own set of foreign trade policies and accordingly imposes restrictions on exports and imports. Trade restrictions like tariffs, quotas, licensing, embargoes etc. are imposed by Government of various countries to protect their domestic producers from foreign competition. This is also done in some cases to protect the uniqueness of socio-cultural aspects of a nation. Exporters and importers have to fulfill all the requirements and follow the rules and regulations controlling export and import diligently.
7. **Payment and Exchange Rate Problems:** International trade involves exchange of currencies between nations as every country has its own currency and one country's currency is not a legal tender in the other country. The payments for import and exports thus involve multiple currencies. This requires the exchange of one currency with another. The rate at which one currency can be exchanged for another is called exchange rate. But these exchange rates keep on fluctuating over different points of time. Moreover, as there is a wide time gap between when the goods are dispatched and when the goods are received and paid for, there is a greater risk of bad debt in foreign trade. Remittances of money for payments in foreign trade also involves much time and expenses. These all makes payments in international trade complex and difficult.

8. **Documents and Paper-works:** Foreign trade requires importers and exporters to ensure compliance with many laws, rules and regulations, and customs of trade of both the countries. This involves the preparation of a large number of documents by both the parties. This calls for special knowledge on the part of the importer and exporter and is also expensive.

5.5 ADVANTAGES OF INTERNATIONAL TRADE

1. **Optimal use of resources:** international trade provides countries the opportunity to specialize in the production of those goods for which its resources are best suited. It leads to optimum utilization of all resources and minimizes wastage of scarce resources.
2. **Availability of Goods and Services:** Foreign trade enables countries to obtain those goods and services which it cannot produce due to lack of resources or higher cost of production; while selling its surplus produces to other countries. This enables citizens of every country to avail all types of goods and services produces around the world.
3. **Under-developed and Developing Countries:** international exchange enables countries to secure supply of technological know-how, machineries, implements, skills, capital, etc., which are essential for their economic development.
4. **Economy of Large Scale:** Foreign trade requires countries to produce commodities in large scale so that surplus produce remains for export even after satisfying home consumption. This enables every country to avail the benefits of large scale production.
5. **Lower cost of Products:** Economies of scale ,specialization in production, and producing whatever is best fitted enables each country to produce their specific products comparatively at a lower cost.
6. **Benefits to Consumers:** International trade enables consumers in all countries to enjoy those goods and services which are not produced in their country and that too comparatively at a lower cost.
7. **Global Co-operation and Understanding:** Mutual dependence, commercial and economic relation among the countries can bring

better understanding and harmony among various nations.

8. **Development of Global Transport and Communication Facilities:** International trade requires the development of transportation and communication facilities. This will compel nations to develop better and efficient transportation and communication infrastructure.



CHECK YOUR PROGRESS

Q 1: Mention two difficulties of foreign trade.

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Q 2: Give three benefits of international trade.

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5.6 TERMS OF TRADE

One of the ways to measure the gains from trade is the terms of trade (TOT) ratio. How the gain from international trade would be shared by the participating countries depends upon the terms of trade. The concept of terms of trade was introduced by economist J.S.Mill as a means to determine the gains of countries in an international exchange. TOT simply means the amount of imports which can sufficiently be made with a given level of export. TOT refers to the relationship between how much money a country pays for its imports and how much it brings in from exports. It is given as the ratio of export price to import price. For example, if an economy is exporting only rice and importing only sugar, the terms of trade would be the export price of rice divided by the import price of sugar- i.e. how much sugar can be imported by exporting a unit of rice. However, in real world situations, most countries export and import many commodities including services. Hence terms of trade have to be measured with the help of index-numbers of export prices and of import prices as follows:

Terms of Trade = (Index of Export Prices/Index of Import Prices) × 100

TOT is a measure of the purchasing power of exports of a country in terms of its imports. A country's terms of trade is said to be improved if

the price of a country's exports increases over the price of its imports. This means that for the same quantity of exports a larger quantity of imports is received or same imports can be achieved for a fewer quantity of exports. In economic terms it is called a positive movement in TOT. On the other hand, when a country's import prices rises relative to its export prices, terms of trade is said to have deteriorated.

5.7 TERMS OF TRADE AND THE CONCEPT OF RECIPROCAL DEMAND

As you have already learnt, TOT ratio reflects the share of gains of a country from international trade. In theory, a TOT which gives both the countries equal share of gains will be the TOT at which both the countries will be ready to trade. The TOT at which trade would take place between two countries is known as the equilibrium terms of trade and is determined by the reciprocal demand of each country for the product of each other.

J.S.Mill put forth the theory of Reciprocal Demand to explain the determination of the equilibrium TOT at which trade takes place. The purpose of the theory is also to ascertain the gains from trade for both the countries. Reciprocal demand means relative strength and elasticity of demand of the two trading countries for each other's products in terms of their own product. In international trade, unlike domestic trade, it is not supply and demand that interact, but its demand and demand. Trading equilibrium in such case is a reciprocal equilibrium where one country's demand for another country's product (as well as its willingness to pay for such goods with its own) matches the other country's demand for the product of the former.

To understand the concept of reciprocal demand let us take a situation of bilateral trade between two countries A and B. Both the countries, A and B, on the basis of comparative cost advantage specialise in the production of rice and sugar. Clearly, A would export rice to B and in exchange import sugar from B. Here, the intensity and elasticity of country A's demand for B's sugar, and similarly the intensity and elasticity of B's demand for A's rice signifies the reciprocal demand of both countries for each other's product.

Now suppose country A has an elastic demand for country B's sugar, A will be willing to offer a smaller quantity of its produce rice for a given quantity of imports of sugar. In this case TOT will be favourable for A while unfavourable to B and A's share of gain from trade will be relatively larger than that of B's. On the contrary, if A has an inelastic demand for B's sugar, A will be prepared to export more rice for a given amount of sugar. In this situation TOT will be unfavourable for A and favourable for B, and accordingly hare of gains will also be different for both the countries. Under these circumstances the equilibrium TOT would be determined at the point at which A's reciprocal demand, i.e. quantity of export it will be willing to do for a given quantity of import, is equal to the reciprocal demand of the other country B. Here, both A and B will have a favourable terms of trade and gains from trade will also be equivalent.

The theory of reciprocal demand can be explained graphically with the help of Offer Curves. Offer curve of a country simply shows the amount of a commodity it is willing to export at various prices for a given quantity of another country's product. In other words offer curve represents graphically the different quantities of a particular product demanded by a country from another at different relative prices of their respective products. Thus offer curves are also known as Reciprocal Demand Curves.

5.8 FACTORS INFLUENCING TERMS OF TRADE

Many factors can affect a country's terms of trade. Some of the prominent ones are given as follows:

1. **Demand and Supply Elasticity**: If a country's exports have a less elastic demand in the foreign markets, as compared to its imports, the terms of trade will often be favourable; as exports of the country can command higher prices as compared to its imports. On the other hand, a lesser elastic demand for its exports may make terms of trade to deteriorate. Similarly, elasticity of supply of both the export and import also significantly influences a country's terms of trade.
2. **Foreign Exchange Rates**: Changes in the exchange rates of currency of a country can affect terms of trade. For example, if the

value of the country's currency appreciates it would mean an increase in export prices while an equivalent decrease in import prices- thus leading to a more favourable terms of trade.

3. **Tariffs and Trade Barriers**: A country imposes tariffs when it does not want to absorb too much of a foreign product. This signifies a subsequent reduction in the demand for the foreign products in the tariff imposed country. Given the elasticity of the offer curve, the less elastic the foreign county's offer curve, the more a given tariff change will improve the home country's terms of trade.
4. **Changes in Tastes and Fashion**: Changes in tastes of the consumers may also impact terms of trade. For example, if tastes or preferences of people of the importing country reduce for the imported commodity, it will mean a reduction in demand for import. Provided the demand remains same for the other commodity in the other country to which the same is to be exported, this would result in a favourable terms of trade for the importing country.
5. **Changes in Technology**: Technological changes also affect terms of trade. If due to technological changes production of export goods increases, their supply will increase and thus prices of exports will fall relative to imports. This would make terms of trade unfavourable for the exporting country.
6. **Change in Factor Endowment**: Taste and technology remaining same, if there is an increase in the supply of factors of production related to export goods, it can affect terms of trade unfavourably for the exporting country. Because production of more export goods will lower the relative price of exports as compared to imports.

Apart from the above mentioned factors there are several other factors which can affect terms of trade of a nation like level of economic development and growth of the country, nature of goods imported and exported, transportation cost, balance of payment position, international capital flows, etc. However to get a complete picture of the effect of these factors on terms of trade we must consider the combined effect of all these factors rather than taking an isolated approach of determining each factor's effect.



CHECK YOUR PROGRESS

Q 3: What is a country's terms of trade?

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Q 4: Mention four factors which may affect a country's terms of trade.

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5.9 TERMS OF TRADE AND ECONOMICE DEVELOPMENT

The central theme of most of the theories of international trade is to ensure economic growth and development of every nation. Theories vouching for free trade have shown how every country can mutually benefit by entering into bilateral exchanges and aiming on specialization. But how do we measure the gains from a foreign trade to actually know its effects on the concerned economies. One of the widely used measures for this purpose is the Terms of Trade.

Many classical and modern economists had preoccupied themselves with the task of defining and redefining terms of trade from time to time so as to make it a true measure of the gains from trade. The original concept of terms of trade, as was developed by J.S.Mill, was for assessing the division of gains between the trading countries. Trades, based on comparative costs, would surely yield certain gains for both the countries. This gain, as we have learned, would be in terms of increased production of those goods at home in which the country has production advantage; and the import of products in which it has no comparative advantage. Every under-developed as well as developing economies are thus highly interested in their relative international trade positions, reflected as the terms of trade, because for all of them international exchange is an unavoidable way of securing supply of technological know-how, machineries, implements, skills, capital, etc. which are essential for their economic development.

Any improvement in the terms of trade of a nation is generally regarded as a factor favourably affecting economic welfare. This is because it signifies that with every unit of export the country can afford more imports which will lead to growth of the economy. On the other hand worsening terms of trade indicates that the country has to export more to get a given quantity of imports, which would mean weakening economic situations in the country. However, terms of trade in its own cannot reflect a complete picture and has to be considered with many other indicators to understand how an economy is gaining from its trades. For example, a country which has experienced a decline in its terms of trade may not necessarily mean that its economy has worsened off than before, or that the changes which have caused the decline have adversely affected its economy. This may be true in cases where a decline could be the result of desirable changes, such as increase in productivity leading to a huge increase in export which has lowered export prices finally resulting in unfavourable movement in terms of trade index. Thus, a terms of trade index cannot be properly interpreted without supplementary information, however it is an efficient way for assessing gains from international trade.



5.10 LET US SUM UP

In this unit we have discussed the following points:

- Gains and benefits of countries engaged in international trade
- Special problems associated with international trade
- The concept of terms of trade and its implications
- Reciprocal demand theory and its use in determining equilibrium terms of trade
- Factors affecting terms of trade
- Terms of trade and its relation with economic development of a country



5.11 FURTHER READING

1) Benham, F. The Terms of Trade*. Economica,* New Series, Vol. 7, No. 28 (Nov., 1940), pp. 360-376.

2) Chishti, S. & Bhattacharya, B. India's Terms of Trade. *Economic and Political Weekly*, Vol. 11, No. 11 (Mar. 13, 1976), pp. 429-435.

3) Greenfield, C.C. The Terms of Trade Index and Terms of Trade Effect*. Journal of the Royal Statistical Society*. Series D (The Statistician), Vol. 33, No. 4 (Dec., 1984), pp. 371-379.

4) Max, E. & June, S.D. (1964).*International Economics.*

5) Mehrotra, S.N. (1966). *Economic Theory.* Gauhati, Assam: New Book Stall.

6) Sarkar, S.S., Sharma, R.K., & Gupta. S.K. (2008). *Business Studies-I.* Kalyani Publishers.



5.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Difficulty in Transport and Communication and Foreign Trade Restrictions.

Ans to Q No 2: Optimal use of resources and Economy of Large Scale.

Ans to Q No 3: TOT refers to the relationship between how much money a country pays for its imports and how much it brings in from exports. It is given as the ratio of export price to import price.

Ans to Q No 4: Tariffs and Trade Barriers and Foreign Exchange Rates.

5.13 MODEL QUESTIONS

Q 1: What is terms of trade and what does it signify in the field of international trade?

Q 2: What are the benefits that a nation can derive from international trade?

Q 3: Discuss certain problems involved in foreign trade.

Q 4: Write a note on reciprocal theory of demand and its implications on terms of trade.

Q 5: Is terms of trade a valid indicator of economic development of a country? Explain.

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UNIT 6 : FREE TRADE, PROTECTION TARIFFS AND IMPORT QUOTAS

UNIT STRUCTURE

6.1 Learning Objectives
6.2 Introduction
6.3 Meaning of Free Trade
6.4 Arguments in Favour of Free Trade
6.5 Arguments against Free Trade
6.6 Meaning of Protection
6.7 Arguments in Favour of Protection
6.8 Arguments Against Protection
6.9 Protection and Developing Countries
6.10 Forms and Methods of Protection
6.10.1 Tariffs
6.10.2 Quotas
6.10.3 Exchange Control
6.10.4 State Trading
6.10.5 Dumping or Price Discrimination
6.10.6 Subsidies
6.10.7 International Cartels
6.10.8 International Commodity Agreements
6.11 Effects of Protection
6.12 Let Us Sum Up
6.13 Further Reading
6.14 Answers To Check Your Progress
6.15 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain the meaning of free trade
- state the arguments for and against free trade
- explain the meaning of protection

- state the arguments for and against protection
- explain the necessity for the adoption of the policy of protection in the developing countries
- explain the forms and methods of protection
- explain the effects of protection.

6.2 INTRODUCTION

The commercial policy of a country refers to all measures regarding the external economic relations of the country. Since the times of Adam Smith the commercial policy to be followed by a country with regard to international trade has been the subject of controversy centering round the most fundamental issue whether a country should follow a policy of free trade or protection. The present chapter is a discussion on different aspects of this controversy.

6.3 MEANING OF FREE TRADE

A trade policy of no restrictions on the movement of goods between countries is known as the policy of free trade. The policy of free trade does not impose any tariff or non-tariff restrictions on free exchange of goods and services between the trading countries. Free trade allows the flow of international commerce in its natural environment without any artificial impediments. According to Adam Smith the term free trade denotes “that system of commercial policy which draws no distinction between domestic and foreign commodities and, therefore, neither imposes additional burdens on the latter, nor grants any special favours to the former”. Therefore, the policy of free trade is a non-discriminating trade policy that places no artificial barriers upon free international movement of goods and services.

Free trade, however, does not require the removal of all duties on commodities. It only insists that duties may be imposed exclusively for revenue and not at all for protection. The policy of free trade means non-resort to any direct or indirect restraint upon the international flow of goods and services



CHECK YOUR PROGRESS

Q 1: What is free trade?

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6.4 ARGUMENTS IN FAVOUR OF FREE TRADE

Classical economists like Adam Smith, Ricardo, J. S. Mill and others were in support of the policy of free trade, as a reaction against the Mercantilist advocacy of trade barriers.

The main arguments in support of free trade are as follows.

(1) Proper utilisation of resources : When there is no tariff or non-tariff restriction upon international trade, there is an allocation of resources and manpower in accordance with the principle of comparative advantage. Comparative advantage is an extension of the principle of division of labour. Due to natural and other facilities every country is suited for the production of some specific commodities. When there is free trade each trading country engages in the production of those commodities for which it is relatively best suited and imports those commodities, which it can procure more cheaply from other countries rather than producing then itself. Besides, due to specialisation the labour and capital of a particular country will be engaged in those industries where they have optimum use and thereby can produce maximum. Hence, the production of goods can be significantly increased by an international division of labour made possible by free trade. In short, when there is free international trade, territorial specialisation brings gain to all concerned and maximises the national products.

(2) Large factor incomes : Under the condition of free trade, the factor units will be able to earn more as they can easily and quickly move either within the same country or between different countries for obtaining higher remuneration for their services. Thus under free trade

factor incomes viz. wages, rents, interests and profits will be higher than otherwise.

(3) Optimisation of consumption: Under free trade a country is able to import products from the cheapest market. The consumers are also able to import and use superior varieties of products. This increased availability of consumable goods at low prices leads to optimisation of consumption in the countries involved in free trade.

(4) Educative effect: Free trade has an educative effect. It can inculcate in the people of a country the qualities of competitiveness, urge for excellence, efficiency etc. which result in the trading countries achieving higher production frontiers.

(5) Check on monopolies: Free trade prevents or at least makes more difficult, the establishment of injurious monopolies by preserving competition.

(6) Scope for factor specialisation: Besides specialisation in production, free trade also leads to factor specialisation. This brings about optimum production with costs reduced everywhere, benefitting the entire world. On the contrary, restrictions on free trade reduces the scope of specialisation and as a result there is a reduction of the total world supply.

(7) Extensive Markets: When there is no restrictions upon international trade there is an enlargement of the size of market since each country can dispose of its surplus production in foreign markets. The markets of different countries tend to become under and more extensive under a policy of free trade. With no trade restrictions, the countries can export their commodities ever to distant places of the world.

6.5 ARGUMENTS AGAINST FREE TRADE

Despite strong support of the classical economists to free trade, the world moved away from free and unrestricted trade. To protect their economic and trade interests countries have been taking recourse to restrictions upon international trade. Objections, both theoretical and

practical, have been raised against the policy of free trade. The main arguments raised against free trade are discussed below.

(1) Absence of pre-requisites of free trade : The conditions necessary for free trade, like perfect competition, perfect factor mobility, free working of the price system and laissez faire, do not actually exist in the real world. The very absence of these requirements of free trade invalidates the policy.

(2) Harmful to Economically Underdeveloped Countries: Under the system of free trade the backward underdeveloped countries suffer very much due to competition with the advanced countries. The weak industries of the backward countries very often faces unequal competition from the well-established industries of the developed countries. Free trade policy in India adopted by the British Government has shown that the one-time flourishing industries (handicrafts) of India were completely wiped out due to foreign competition.

(3) Leads to Dumping: The developed countries, under free trade, often resort to dumping of their goods in underdeveloped countries which does irreparable damage to their economies.

(4) Import of harmful products: Free trade leads to the import of injurious and harmful commodities like narcotics, opium etc. which causes irreparable damage to the health of the people. As countries cannot allow free import of injurious and harmful products, trade restrictions become necessary.

(5) Rise of monopolies: Free trade and intense foreign competition eliminates many business firms resulting in the emergence of local monopolies or international cartels. In order to maximise profits they try to manipulate the supply and price resulting in the exploitation of people and hindrance in the free working of the price system. The possibility of the emergence of such monopolies necessitates the imposition of restrictions upon trade.

(6) Foreign dependence: Because of economic interdependence in the implementation of free trade policy, many governments experience political handicaps, especially during war times. As such in order to

maintain political independence, it was thought necessary to attain economic independence by abandoning the policy of free trade.

(7) Harmful for economic interest: Free entry of goods produced by powerful countries sometimes inflicts a permanent injury on the economic interest of a country. Thus restrictions on such items becomes necessary.

(8) Need to protect infant industries: As the backward under developed countries need to protect their infant industries the policy of free trade needs to be abandoned.



CHECK YOUR PROGRESS

Q 2: State the arguments for and against free trade.

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6.6 MEANING OF PROTECTION

Protection refers to the commercial policy of the government under which a number of restrictions are imposed on import trade with a view to protect home industries from foreign competition. Protection is usually done either through duties on imported goods, or bounties to domestic producers. An imposition of import duty makes the foreign articles sell at higher prices and as such helps the home manufacturers. Protection to home industries may also be given by restricting the imports either by banning them altogether or by subjecting them to import quotas and licenses.

The idea of protection as an instrument to stimulate economic growth was first mooted by an American economist, Alexander Hamilton, in 1791, Later another American economist, Henry Carey, supported the policy of protection. The government of the U.S.A. had accepted the policy of protection by the end of the 19th century.

In Europe, the policy of protection was first suggested in the 19th century by the famous German economist Federic List.



CHECK YOUR PROGRESS

Q 3: What is meant by protection?

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6.7 ARGUMENTS IN FAVOUR OF PROTECTION

(1) **Infant industries Argument:** Protection was favoured to help the infant industries. The infant industries in a country must be given protection against foreign competitions because they cannot stand the competition of the well organised and well established foreign industries. Infant industries thus deserve to be protected against the developed industries in foreign countries. Protective duties are 'crutches' to teach new manufacturers to walk. The benefits gained is often greater than the cost paid by consumers in the form of higher prices. This policy pf protection has been very well expressed in the following words : 'Nurse the Baby, protect the child and free the Adult'.

(2) **Diversification of Industries:** Every country should be self sufficient as far as possible because a country which is not self sufficient face a number if problems especially at a time of war. Further even in peace time, a country which depends on few industries may endanger its economy because of the operation of various external factors. The policy of protection becomes essential for a country to become self sufficient by going in for a balanced development of all industries in the country.

(3) **Home Market Argument:** When the government follows a policy of protection and cuts down its imports, the sale of home made goods within the country rises. As a result the volume of employment in the country increases. With increased employment the demand for the home made goods increases still further and this results in a further development of the home market.

(4) **Basic Industries Argument**: The basic industries are indispensable for the economic development of a country and for its further industrial expansion. The basic industries provide the foundation for the development of other industries in the country. They provide machines and materials for other industries. They serve as a base for the national economy. Basic industries like iron and steel, heavy chemicals, electric power etc. should be developed by every country through the protection policy.

(5) **Employment generation:** Protection helps to develop industries and thereby generate employment. The volume of employment in a country can be enhanced by following the policy of protection. This is because when the government follows the policy of protection new industries will be set up and people will thereby get more opportunities of employment within the country. Thus, the policy of protection can play a vital role in solving the unemployment problem of a country.

(6) **Proper utilisation of Natural Resources:** Under the policy of protection there is proper utilisation of natural resources because under this policy the natural resources are used to the best possible advantage within the country. The government can control the use of scarce resources in industries in order to preserve them for the future. But when a country follows the policy of free trade there is always wasteful utilisation of its natural resources because when it acquires specialisation in the production of a particular commodity it results in a speedy exhaustion of all those resources and materials which are used in the production of that commodity.

(7) **Idle Resources :** Under the policy of free trade many resources lie idle. This is because only those natural resources are used which enter into the production of those industries which have been established on the basis of the principle of comparative cost.

(8) **Wage Argument:** Compared to the high wage country, the production costs of the low-wage country is much lower. Thus when the low-wage country exports goods to the high-wage country the industries in the high-wage country gets adversely affected and leads to large

scale unemployment within the country. Thus inorder to protect its industries the high-wage countries need to adopt the policy of protection.

(9) National Defense : For a country it is very important to develop its defense industries in order to maintain the security and independence of the country. Thus, the government should give full protection to help these industries to develop in the country.

(10) Improvement in the Balance of Payments : Sometimes, protection is given with an intension to correct an adverse balance of payments situation. Protection reduces imports and the balance of payments situation can be improved, although temporarily.

(11) Dumping Argument : The foreign industrialists sometimes start dumping their goods in backward and underdeveloped countries. By doing this the foreign industrialists desire to crush the industries of the country concerned. In this situation the government of the concerned country can protect its industries by imposing certain anti-dumping duties.

6.8 ARGUMENTS AGAINST PROTECTION

(1) Low economic utilisation of Natural Resources: Under the policy of free trade every country produces goods in accordance with the principle of comparative cost and as such enjoys the advantages of territorial division of labour. On the contrary under the policy of protection production of a country is not based on territorial division of labour and so the country produces even those goods in which it enjoys no comparative advantage.

(2) Encouragement to Inefficient Industries: Removal of foreign competition perpetuates weak and inefficient concerns. When there is competition, only sound and healthy concern will remain in the field. Although it may adversely affect some individual manufacturers, yet removal of unhealthy concerns is considered to be good for the society as a whole.

(3) Establishment of Monopoly: By eliminating foreign competition the policy of protection helps the indigenous industrialists to set up monopolistic organisations and exploit the consumers and the workers.

(4) Loss to Consumers: Under protectionism the consumers have to suffer losses as they have to pay higher prices on account of the absence of any foreign competition.

(5) Violation of consumer's freedom of choice : The policy of protection limits the choice of consumer goods. Because of the various protective policies like tariffs, quotas and exchange control the availability of foreign goods is severely limited. The consumer is forced to buy poor quality home produced goods at higher prices.

(6) Inequalities in the distribution of national income: The policy of protection imposes a burden on the home consumer because he has to pay a higher price than before on account of the imposition of import duties. Further, the home industrialists earn increased profits as a result of the policy of protection. The economic inequalities within the country thus increases.

(7) Reduction in foreign trade: There is a danger of retaliation from abroad. When a country through a policy of protection reduces its imports, its exports also decline as the other countries retaliate by imposing import duties on its exports. Hence, the policy of protection leads to a decline in the foreign trade.

(8) Political corruption : Under the policy of protection there is also the danger of corruption. The big industrialists try to secure protection for their industries by offering bribes to political leaders and government officials.

(9) Misdirection of resources: The policy of protection diverts labour and capital and other factors of production into set channels. Very often they are prevented from seeking their most remunerative employment and as a result there is a decrease in the national dividend. This misallocation of the available resources into unsuitable channels cannot be economically justified.



CHECK YOUR PROGRESS

Q 4: State the arguments for and against protection.

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6.9 PROTECTION AND DEVELOPING COUNTRIES

The developing countries have just and special reasons for adopting the policy of protection. The main arguments in support of protecting the home industries in the developing countries are as follows.

(1) Growth of infant industries: The protection of infant industries in the developing countries is very essential. It is necessary that the newly started or the infant industries are protected from destructive competition from the industries of the developed countries.

(2) Diversification of industries: Since in the developing countries, there is an excessive dependence on agriculture, diversification is very much needed in these countries. Protection helps to bring about diversification in industries and thereby gives economic stability to them.

(3) Greater domestic capital formation: The nature of import restrictions of the developing countries are different from that of the developed countries and as such the advanced countries should not resent or retaliate the tariffs of the developing countries. Imposition of tariff on foreign produced luxury consumer products reduces their consumption in the developing countries which results in an increase in savings. This increased savings can be used for investment within the home countries. Again the foreign exchange conserved through import restrictions can be spent for importing capital goods. Hence, increased saving and home investment resulting from the imposition of the protection policy can raise the rate of domestic capital formation in these developing countries.

(4) To Check the deterioration in the terms of trade : The developing countries mostly export primary products whose prices are not rising

as fast as the prices of the manufactured goods they import. In such a situation a policy of tariff protection becomes essential if the deterioration in the terms of trade of these developing countries is to checked in an effective way.

(5) To promote investment of foreign capital: The developing countries are deficient in capital resources and because of the lack of adequate supply of capital their economic development is often retarded. The policy of protection helps in promoting the investment of foreign capital in the economy. When foreign goods are prohibited in the developing countries through protection, the foreign multinational corporations are tempted to set up new industries within the country itself in order to escape the tariff protection.

(6) Increase in government revenue: For the government of the developing countries the custom duties form a significant proportion of tax revenues. The yield from the direct taxes is low in these countries and as such protection to industries can make a sizeable addition to the revenues of the government.

(7) Off setting the balance of payments deficit : The developing countries are faced with chronic balance of payments deficit. Imposition of tariffs upon foreign products results in the curtailment of imports of these products by the importers as they become costly. This can lead to the offsetting of the balance of payments deficit.

(8) Creation of external economies: The policy of protection to industries in the developing countries create external economics like expansion of demand for factor inputs, growth of allied industries, improvement in the quality of the products etc. These external economics resulting from the policy of protection helps in the overall growth of the economy.

The policy of protection can thus play a vital role in the industrial development of the developing countries. From the point of view of the developing countries, the restricted international trade is certainly better than the unrestricted trade.



CHECK YOUR PROGRESS

Q 5: State three arguments in support of protection of home industries in the developing countries.

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6.10 FORMS AND METHODS OF PROTECTION

The protection can be in the form of higher tariffs or quotas or in other forms such as domestic subsidies etc. When a particular country resorts to the commercial policy of protection, it adopts various alternative devices or their combinations. Some important methods of protection are

1. Tariffs
2. Import Quotas
3. Exchange control
4. State trading
5. Dumping or price discrimination
6. Subsidies
7. International cartels
8. International commodity agreements

6.10.1 Tariffs

A tariff is a kind of duty or levy imposed by the government of a country upon the traded commodity as it crosses the national boundaries. Tariff can be levied both upon exports and imports. However, a tariff, is generally levied by a country's government on her imports. The import duties or import tariffs are levied on the goods originating abroad and are scheduled for import to the duty-levying country. On the contrary the tariffs or duties imposed upon the goods originating in the duty-levying country and scheduled for abroad are called the export duties. A country may also resort to what is known as a transit duty. A transit duty is imposed upon the

goods originating in the foreign country and scheduled for a third country crossing the borders of the duty levying country.

A tariff is a type of protection which restricts the consumer's freedom of choice in the country. It forces the consumer's to curtail their consumption of those goods which they prefer. Imposition of import tariff leads to a relative change in prices of products and factors. This results in a significant change in the structure of international trade. A high tariff reduces the volume of international trade while on the other hand a low rate of tariff increases the volume of international trade. A negative tariff or subsidy results in an expansion of international trade.

Classification of Tariffs

Tariffs are of different types. We can classify tariffs into different groups or sub groups as follows :

(i) Classification on the basis of criterion for imposition : In this group we have (a) specific tariff (b) Ad valorem tariff (c) compound tariff and (d) sliding scale tariff

(a) Specific tariff: When a fixed sum of money is charged by the government per physical unit or according to the weight or measurement of the commodity imported or exported it is called specific tariff. Specific duties are levied on goods like rice, wheat, cement, sugar, cloth and so on. They are very easy to administer as they are not involved with the problem of determining the value of the exports and imports.

(b) Ad valorem tariff: 'Ad valorem' is a Latin word and its meaning is 'on the value'. Ad valorem tariff refers to the duty which is levied as a fixed percentage of the value of the traded commodity. The basis of this tariff is the price or value of the commodity rather than its physical dimensions.

(c) Compound tariff: It is a combination of specific and Ad valorem tariff. Compound tariff includes specific duty on

each unit of the commodity besides a percentage of Ad valorem duty. Compound tariff provides greater elasticity to revenues and is also an ideal system to provide effective protection to the home industries.

(d) Sliding scale tariff : Sliding scale tariff refers to those import duties which vary with prices of the commodities. Although sliding scale tariff may either be on specific or Ad valorem basis, in practice, these are generally on a specific basis.

(ii) Classification on the basis of purpose for which tariff is imposed : In this group we have the (a) revenue tariff and (b) protective tariff.

(a) Revenue Tariff : This tariff has been designed to generate more revenue for the government. Although in the advanced countries because of the introduction and diversification of direct taxes the significance of tariff as a source of government revenues has been reduced still in the less developed countries revenue tariff plays an important role as a source of revenue to the government. The imposition of tariff as a source of revenue also has protective effect as it leads to the shift of demand of the domestic consumers from the imported goods to home-produced goods.

(b) Protective Tariff : The protective tariff is levied by the government in order to protect the home industries from the cut-throat competition from the foreign produced goods. Higher the rate of protective tariff, greater will be the protective effect. A perfect protective tariff prohibits completely the import from abroad and thereby yields no revenue to the government. However, in practice, the perfect protective tariff may not exist. If there is strong domestic demand for imports then there is high possibility of smuggling of the imported goods. The imposition of a

high rate of protective tariff can make the domestic producers more lethargic and inefficient.

(iii) Classification on the basis of discrimination : Here we have two types of tariffs- (a) non-discriminatory tariff and (b) discriminatory tariff.

(a) Non-discriminatory tariff - In this case a uniform tariff rate is applicable to all the commodities irrespective of the country of origin. Low rates of tariffs on certain commodities may exist because of commercial agreements with some countries but when the tariff imposing home country extends the same low tariff rates to the commodities of all the countries it is known as non-discriminatory tariff or single column tariff. Though this system of tariff is very easy and simple to administer, it is not elastic enough to adjust itself according to the changing needs of the industries of the concerned country.

(b) Discriminatory tariff : In this case varying tariff rates exist for different commodities. The products originating from the favoured countries have a lower tariff rate as compared to the products imported from the other countries. Discriminatory tariffs may be double column tariff or multiple column tariff. Double column tariff provides two rates of import duty on all or some commodities. Both the rates may be declared either by the government from the very beginning or one rate may be declared in the beginning and the other rate may be declared after some commercial treaties are signed with other countries. A country adopting this system believed in the commercial treaties and bargaining. A new rate of tariff may be declared after entering into commercial treaties which serve the purpose of the country concerned. The double column tariff may either be a

general and conventional tariff or a maximum and minimum tariff.

General and conventional tariff: Here there are two separate tariff schedules. The general tariff schedule is determined by the state legislature with the declaration that it would be adjusted if and when needed as a result of commercial treaties. The conventional tariff schedule is the result of commercial treaties entered into by the tariff-imposing country with the other countries. In this system changes in tariff rates according to the changes in domestic condition or requirements is not permitted. The changes are possible only after negotiations and agreements are reached between the concerned countries or after the expiry of the existing agreement. Compared to the general tariff schedule which is flexible, the conventional tariff schedule is rigid.

Maximum and Minimum Tariff: Under this system two rates of tariff- maximum and minimum tariff rates are fixed for every commodity by the legislature and the government is authorised to apply specific rates of tariff to the goods imported from the different countries. The minimum tariff rates are applied on the imports of those countries which are entitled for concessions either under the 'most favoured nation clause' or on consideration of cordial relations with the tariff- levying country. The maximum tariff rates are applied for the purpose of improving the bargaining position of the home country vis-a-vis the foreign countries.

Multiple column tariff: The multiple tariff consists of three different rates of tariff- a general rate, an international rate and a preferential rate. The general and international rates can be considered same as the

maximum and minimum tariff as discussed above. The preferential tariff is generally applied by a subject country to the products originating from the colonizer country. The preferential tariff is kept lower than the general tariff.

(iv) Classification on the basis of products : In this case tariffs can be (a) import duties and (b) export duties.

(a) Import duties : When the home country levies tariff upon the products of the foreign countries as they enter its territory, tariff is called import duty or import tariff.

(b) Export duties : When tax is levied on the products of the home country as they leave its territory to be sold in the foreign market then the tax or duty is called export duty or export tariff.

(v) Classification on the basis of retaliation : Here tariffs are of two types (a) retaliatory tariffs and (b) countervailing tariffs.

(a) Retaliatory tariffs : When a foreign country imposes tariffs upon the exports from the home country and the latter levies tariffs against the products of the former, the tariffs resorted to by home country is called the retaliatory tariffs. While imposing this tariff the home country does not have any objective of either raising revenues or protecting home industries but to act in retaliation.

(b) Countervailing tariffs : When the foreign country exports large quantities of its products in the market of the home country on the strength of export subsidies then the duties imposed upon them as they enter the territory of the home country in order to neutralise the unfair advantage enjoyed by these foreign products, is called countervailing tariffs.



CHECK YOUR PROGRESS

Q 6: Mention some important methods of protection.

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Q 7: What is 'Ad valorem' tariff ?

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6.10.2 Quotas

Import quotas like tariffs are an important protectionist device and an old from of trade restriction.

An import quota refers to a fixed quantity or value of a commodity that has been allowed to be imported from foreign countries in the country during a given period of time, usually one year. Import quotas may be fixed either in terms of the physical volume or monetary value of imports or a combination of the two. The time period to which quota apply differs from country to country, the shortest being a month and the longest a year. Quotas which are assigned in quantitative terms are called direct quotas and those which are expressed in value units are referred to as indirect quotas.The broad objectives of an import quota are as follows :

(i) To regulate imports in an efficient and effective manner.

(ii) To check imports with the intension to correct an adverse balance of payments.

(iii) To protect the home industries for foreign competition.

(iv) To maintain and stabilise domestic price level by restricting import inflows.

(v) To retaliate against the restrictive trade policies adopted by some of the foreign countries.

(vi) To strengthen a country's bargaining power by limiting import demands

(vii) To check the speculative imports in anticipation of changes in exchange rates, tariff rates and internal money and credit policies.

Types of Import Quotas

Import quotas may be classified into five major groups – (a) tariff or custom quota (b) unilateral quota (c) bilateral quota (d) mixing quota and (e) licensing of imports.

(a) Tariff or custom quota : Under this system, a certain specified quantity of a commodity is allowed to be imported by the government of the importing country either duty free or at a special low rate of import duty. But imports in excess of this fixed limit are charged a higher rate of duty. A tariff quota is either an autonomous quota or an agreed quota. The autonomous tariff quota is fixed by decree or law. On the contrary, the agreed tariff quota is the result of some agreement between the quota imposing country and one or more foreign countries. Flexibility is an important advantage of this system. However the system has some drawbacks. Since the imports upto a specified limit are allowed duty free or at low rates of tariffs, the entire gain from low rates is enjoyed by the exporting country. Again the rush of imports at low rates of tariff is likely to have disturbing effect upon the domestic price level of the importing country.

(b) Unilateral Quota : Under the unilateral quota system, an absolute limit is placed by a country upon the quantity of a commodity to be imported during a specified period. This limit is imposed without prior negotiation with the foreign governments. The unilateral quota so fixed are of two types– global quota and allocated quota. Under a global quota, it is possible to import the commodity from any country upto the full amount of the quota. On the contrary under an allocated quota system the total of the quota is distributed among the different exporting countries on the basis of certain criteria.

The global quota system tends to favour nearby exporting countries as against the distant ones and as such it cannot be considered a very satisfactory device. Besides it also operates against the smaller and less organised exporters. As the quota is announced by the government, the importers rush to make imports which results in over-supply and greater price fluctuations. The global quota system also does not provide sufficient protection to the domestic producers.

The system of allocated quota tries to overcome these defects of the global quota system. But even the allocated quota system is not free from defects. It imposes an undesirable rigidity to the sources of supply. This system is also not cost and quality efficient. Here the exporting countries are assured of their share in the import quota and therefore there is the possibility of foreign firms being indulged in monopoly practices.

(c) Bilateral quota : Under the bilateral quota system, quotas are fixed through negotiation between the importing country and the exporting country or foreign export groups. This system has a number of merits. In case of the bilateral quota system the quotas are decided by mutual agreements and it minimises the suspicion of discrimination. In this system excessive fluctuations are avoided and also export monopolies are excluded through agreements. The bilateral quota system is less arbitrary and thus arouses less or no opposition from the exporting countries and provokes no retaliation activity.

However this system also has got certain drawbacks. It promotes the formation of international cartels and opens the way to corruption on a large scale. The exporting countries, after securing the desired quota, may raise prices of their products to the disadvantage of the importing countries. This system intensifies competition to a great extent.

(d) Mixing quota or indirect quota : This quota system requires producers to utilise a certain proportion of domestic raw

materials along with imported parts to produce finished goods domestically. The mixing quota therefore sets limits on the proportion of foreign made raw materials to be (imported and) used in domestic production.

The system of import quota has two basic objectives– to help the domestic producers of raw materials and to save the valuable and scare foreign exchange.

Mixing quota system is also subjected to certain criticisms. In case the domestic materials, which are used in fixed proportion along with imported materials are of poor quality there is a chance of deterioration of the quality of production in the quota enforcing country. Besides this system leads to a deviation from the principle of comparative cost and thereby results in inefficiency and higher cost structure.

(e) Licensing of import : The mechanism of licensing of imports has been evolved as a system devised to administer quota regulations. In this system, the prospective importers are to obtain a license from the proper authorities for importing any quantity within the specified quota.

The system of issuing licenses for the regulation of imports has a number of advantages. The licensing authority can have a control over the volume of imports. The system also tends to minimise speculative activity. Besides, it does not permit wide fluctuations in prices, has a great deal of flexibility and is adaptable to changing situations and also ensures the economical use of foreign exchange of the country.

The system, however, has certain shortcomings. It favours only the established and prevents the entry of new importers and thereby encourages the growth of monopolies in the import trade. This system may lead to bureaucratic administration, nepotism and corruption. Besides it may also lead to concentration of economic power in the hands of small and privileged groups of established importers.



CHECK YOUR PROGRESS

Q 8: What is an import quota ?

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6.10.3 Exchange Control

Exchange control implies governmental intervention in the matter of foreign exchange and the exchange rates. It refers to those restrictions which are imposed by the government on foreign exchange business.

Objectives of Exchange Control

(i) The government of a particular country may sometimes desire to fix the exchange rate of its country's currency at a level above the rate established in the free market. This desire for over-valuation of the country's currency may be because of two major reasons First, if any developing country wishes to import from foreign countries raw materials, machinery etc. on a large scale for its industrial development, it usually fixes a high rate of exchange for its currency. Second, a high rate of exchange for its currency will be advantageous for any country in repaying its debt to the other country.

(ii) Inorder to correct the deficit in the balance of payments, the country needs to encourage exports and discourage imports. For this the use of foreign exchange earnings by the exporters for importing goods must be checked through appropriate exchange control. Exchange control is very essential in implementing an import policy. Exchange control may be used to protect the country's balance of payments.

(iii) Exchange control may be resorted to by the government of a country to check the violent fluctuations in its rate of exchange. Exchange control may be adopted to maintain exchange rates at an arbitrarily chosen fixed point by the government of a country.

(iv) Under the free exchange system there is the danger of flight of capital for various reasons. This sudden outflow of capital can have dangerous consequences for the economy of the country. Thus the government of that particular country may resort to exchange control in order to check this outflow of capital.

(v) Inorder to remove the chronic imbalance in foreign trade the government sometimes uses exchange control.

(vi) Exchange control may sometimes be used to give protection to the domestic producers. Through exchange control, the government may restrict the imports into the country and hence provide an opportunity to the domestic industries to develop without any fear of foreign competition.

(vii) Exchange control may be used by a developing country in order to restrict or eliminate the import of non-essential goods.

(viii) Through exchange control it is possible for the government to prohibit the imports of certain commodities by not allotting any foreign exchange for their import.

(ix) Exchange control may also be used by the government of a country to strengthen its trade relationships with certain countries. The government may fix favourable rates of exchange for trade with such countries.

Methods of Exchange Control

The method of exchange control are of two types – unilateral methods and bilateral or multilateral methods.

The unilateral methods are those which may be adopted by the government of a country without any understanding with other countries. The unilateral methods are as follows :

(i) Regulation of Bank Rate : When the Central Bank of a country raises the bank rate, all other interest rates automatically follow the bank rate. As a result, foreign capital is attracted to that country. The demand for the currency of the country goes up in the exchange market of the foreign countries and consequently the rate of exchange goes up in relation to other

currencies. The opposite happens when the central bank of the country lowers the bank rate.

(ii) Regulation of foreign trade : When a particular country faces an unfavourable balance of payments its government controls the rate of exchange by regulating the imports of the country.

(iii) Rationing of foreign exchange : Under this system, there is no free sale and purchase of foreign currencies in the country. The exporters have to surrender their foreign exchange earnings to the Central Bank in exchange for domestic currency. There is rationing of scarce foreign currencies in the country by the government.

(iv) Exchange pegging : Exchange pegging refers to the fixing of the rate of exchange by the government either above or below the normal rate reached in the market. When the rate of exchange is fixed above the normal rate by the government it is called 'pegging up' and when it is fixed below the normal market rate it is known as 'pegging down'. Today the system of exchange pegging is considered as the main instrument of the policy of exchange control.

(v) Exchange equilization fund or exchange stabilisation fund : The primary objective of this fund is to check the fluctuations in the rate of exchange.

(vi) Multiple exchange rates : Sometimes a country may fix different exchange rates for import and export of different commodities which is referred to as multiple exchange rates. The exchange rates are different for exports, imports. capital inflow and outflows. The main objective of the multiple exchange rate is to maximise the foreign exchange earnings of a country by increasing its exports and reducing its imports.

Bilateral or multilateral methods of exchange control prevails when two or more than two countries agree to adopt certain measures to control the rate of exchange. The main bilateral or multilateral methods of exchange control are as follows :

(i) **Payment agreements :** The payment agreement is made between two countries where one is the creditor and the other is the debtor country. As per agreement, provision is made for the repayment of the principal and the interest by the debtor country to the creditor country. The creditor country is not free to impose any restrictions on the imports from the debtor country but the debtor country can try its best to restrict the volume of its imports from the creditor country.

(ii) **Exchange clearing agreement :** Under this system, two countries engaged in international trade pay to their respective central banks the amounts payable to their respective foreign creditors. The central banks on their part use the money to offset the corresponding claims after fixing the value of the currencies by mutual agreement. The importers have to deposit their payments with the central bank in the respective accounts. For a country which has little or no foreign exchange reserves and which is more interested in selling than buying, exchange clearing device becomes helpful. This system aims at offsetting each other's payments and the basic assumption is that countries entering into such an agreement should try to equalise their imports and exports in order that there will be no necessity for either making or receiving payments from the other countries.

(iii) **Transfer moratoria :** Under the system of transfer moratoria, the payment for imported goods or the interest on foreign capital is made not immediately but after the lapse of a certain predetermined period provided in the agreement between the two countries. The importers and the debtors deposit the amounts which they owed to the foreigners in domestic currency in some authorised bank. The banks make the payment to the exporters and the foreign creditors in foreign currencies after the fixed internal

(iv) Compensation agreements : Compensation agreement is a type of barter agreement. Here the question of making payment in foreign exchange does not arise. The imports and exports of the two countries exactly balance each other and as such the payments of the two countries cancel each other and there is no problem of foreign exchange.



CHECK YOUR PROGRESS

Q 9: What is meant by exchange control?

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6.10.4 State Trading

The term state trading refers to government participation in the foreign trade. Under state trading the government carries on some or all of a country's foreign trade. Thus state trading means partial or complete state monopoly in international trade.

The major factors responsible for the growth of state participation in world trade are as follows :

(i) Spread of economic socialism : Socialist blocs embrace state trading in accordance with their socialist ideal, viz. as production is state controlled, distribution too should be government managed. In order to have controlled capitalism with some socialistic motives capitalistic nations too favour state trading. In order to achieve certain socialistic objectives developing nations too have state participation in foreign trade.

(ii) Economic planning : For nations which have embraced economic planning state intervention in foreign trade is very essential for them to have regulation and check over imports and exports conductive to planning.

(iii) Problem of shortage of foreign exchange : Countries facing persistent disequilibrium in the balance of payments and foreign exchange shortages favours state trading activity.

Forms of state trading

(i) The state may involve itself in buying and selling operations in the would markets.

(ii) The state may establish autonomous agencies for carrying out the foreign trade of the country.

(iii) The state may under government regulations grant rights to private traders to carry out exports and imports.

Objectives of state trading

(i) To improve the country's terms of trade. The success of state trading in improving a country's terms of trade is conditioned by the type of markets to be faced in the foreign countries, the degree of competition, the nature of the product dealt with and the country's foreign trade policy.

(ii) To attain development targets in a planned economy by controlling and regulating imports and exports.

(iii) To obtain revenue for the state treasury.

(iv) To attain optimum allocation of scarce foreign exchange resources and to safeguard the balance of payments position of the country.

(v) To ensure a higher price to producers.

(vi) To promote exports. When private traders do not come forward for exporting certain items, state trading may open up new vistas.

(vii) To achieve military strength. Purchase of defense materials are transacted by state agencies only. No private traders are permitted today by most of the nations to deal in war materials.

Advantages of state trading

The advantages of state trading are as follows :

(i) As the state trading agency controls both the internal and external exchange rates, the state trading economy can bargain with great freedom in the world market.

(ii) State trading helps in enhancing the commercial bargaining position of a country in the international market.

(iii) State trading can have wide discriminatory powers in the foreign trade.

(iv) The imports in the country may be rationed by state trading. State trading may subsidise the consumption of certain imports and may also penalise the import of undesirable, conspicuous imported materials.

(v) State trading may also be used as an instrument of protection and a means of securing political and economic welfare of the country.

(vi) State trading works as an effective instrument of export promotion.

(vii) State trading serves as an effective import controlling measure.

(viii) Evils like tax evasion by importers and exporters, speculation, black marketing etc. may be controlled by state trading.

Disadvantages of state trading

The disadvantages of state trading are as follows :

(i) State trading favours bilateral trading and discourage multilateral trading.

(ii) The objectives of state trading of a country viz. improvements in the country's terms of trade etc. may not be realised when its counter parts also use state trading operations.

(iii) Competition is restrained under state trading which may lead to the growth of evils of public monopoly like corruption, red-tapism etc.

(iv) In a situation of dynamic international trade quick business decisions are very much important. However state trading lacks this essential requirement under its centralised bureaucratic administration.

(v) When compared to the private business organisation, business administration under state trading is generally uneconomical.

(vi) Very often state trading does not work in accordance with the accepted principles of international trade. It does not follow the rules of comparative cost advantage and relative specialisation.

In fact organization of specialisation is a difficult problem of state trading.

(vii) State trading may sometimes retard the foreign trade of a country. This may be because on account of long official procedures and formalities a private foreign trader may be unwilling to have economic relations with a foreign government.

6.10.5 Dumping or Price Discrimination

Dumping means discriminatory monopoly pricing in foreign trade. It refers to different pricing in foreign trade. It refers to different pricing in the domestic and foreign markets. As defined by Haberler dumping is "the sale of a good abroad at a price which is lower than the selling price of the same good at the same time and in the same circumstances at home, taking account of differences in transport costs". Dumping is followed when a producer possessing monopoly in the domestic market for his product charges a high domestic price and a low price in the foreign market. Likewise under reverse dumping a producer charges low domestic price and a high foreign price for the product.

Dumping is an interesting example of monopolistic practices in the domain of international trade. It essentially means selling the same good at different prices in the home and foreign markets. Dumping enables the exporter to compete in the foreign market and capture the market by selling at a low price. Sometimes the exporter may also sell the product below costs and in order to make up for the deficiency in sales revenue he charges a high price to the domestic buyers. Thus, the higher domestic price subsidises a segment of the foreign price and thereby help in promoting exports. The export earnings may then be made available to promote the growth of domestic industries, which otherwise would not have been possible. Again through dumping the producer may be able to widen the size of the foreign market for his product and thereby be able to minimise his investment risk.

Dumping implies price discrimination and its success depends on the following conditions :

(i) The producer must possess a degree of monopoly power at least in the home market.

(ii) There must be clearly defined separate markets.

(iii) There should be no possibility for the buyers to resell the goods from a cheaper market to a dearer market.

(iv) Price discrimination is possible only when two different markets have different elasticities of demand.

Kinds of dumping

(i) Sporadic Dumping : Sporadic dumping is motivated by the desire to get rid of the inventory stocks which are practically unsaleable in the home market at the end of the season.

(ii) Predatory Dumping : This refers to selling at a loss abroad as measured by the average cost and not by the marginal cost of production. Predatory dumping aims at getting a footing in the foreign market by surpassing the rival firms. It is subsequently followed by an increase in prices after the market is firmly captured and competition from the rivals have been overcome.

(iii) Persistent Dumping : When a producer keeps on selling his goods at lower prices in one market than in the other it is referred to as persistent dumping. Its scope arises because of the differences in the demand curve for a particular commodity in different markets. As for example, if the domestic demand for the commodity is inelastic while the foreign demand for the product is highly elastic then the producer can sell a larger quantity of the product in the foreign market at a lower price and a smaller quantity in the domestic market at a higher price.

Dumping by a foreign country is condemned by the domestic producers of a country and as such as an anti-dumping measure, a tariff wall has to be erected by the concerned country.

6.10.6 Subsidies

The government by providing subsidies to the domestic producers grants the policy of protection to the home industries. Subsidies may be in the form of tax exemption, development rebate or tax remittance. Sometimes the state may also bear a segment of the cost of production. Subsidies are provided to the domestic producers when the cost of production is high and they are not capable of either competing with foreign goods or selling goods at a cheaper rate.

The government further may also provide export bounties to the exporters in order to encourage them. Export bonuses or bounties artificially bring down the domestic price of goods to be exported and as such the exporters can sell them off at low prices in the foreign market and increase exports. Very often the subsidies and bounties tend to reduce imports and increase exports and as a consequence cause diversion of resources from more efficient uses to less efficient uses.

In order to counteract the export subsidies of a foreign government, the importing country may impose duties and thereby convert the subsidies of the exporting country into customs revenue for the importing country.

6.10.7 International Cartels

An international cartel is formed by producers in the same line of production in two or more countries and who agree to regulate the production and sales for monopolistic ends. International cartels try to eliminate competition in the foreign markets. Through explicit agreements the members of a cartel form an organised association. This ensures them higher profits than would be possible otherwise.

The scope of cartels is very wide covering metals and minerals, manufactured goods like chemicals, dyestuffs, pharmaceutical products and electrical products.

Cartels are usually formed for fear of cut-throat competition and the desire for monopoly control.

The main objectives of cartels are as stated below :

(i) To achieve control over price. Cartels are often found to resort to price fixing above a competitive price and thereby earn high monopoly profits.

(ii) To impair the quality of product. With the formation of cartels buyers cannot safeguard themselves against low quality as they do not get any opportunity to choose between different varieties.

(iii) To allocate trade territories to each cartel member so that they acquire and maintain a monopolistic position in their respective allocated markets.

(iv) To restrict supply and thereby assign quotas to each cartel member.

(v) To retard technological change until the existing plants and productive facilities have been fully depreciated.

The advantages of international cartels are as follows :

(i) Because of business combines, large scale output has been possible and goods are being sold at cheaper rates through cartels.

(ii) Due to cartels wasteful competition has been eliminated.

(iii) The problem of excess capacity has also been solved through cartels.

The disadvantages of cartels are :

(i) Cartels tend to reduce the volume of international trade because of restricted output and high price policy.

(ii) International cartels may also mean underutilisation of the world's resources and manpower because of the lack of competition and the system of production quotas followed by the cartel members.

6.10.8 International Commodity Agreements

International commodity agreements refer to government-sponsored international cartels. They are infact inter-governmental arrangements that relates to the production and trade of certain basic raw materials and agricultural goods like coffee, sugar, wheat etc. Contrary to the private cartels, under the international commodity agreements, arrangements are made by the governments to bring together a large number of independent producers who otherwise would not have been able to unite with one another in order to carry out the restrictive practices. Besides, unlike cartels the international commodity agreements takes into consideration the consumer's interest in determining supply and price policies. Here there is no restriction on output, nor incidence of high price and low quality.

International commodity agreements are mostly inter-governmental agreements between leading producer countries which arises as an outcome of deliberate governmental policy.

International commodity agreements have been often opposed on the ground that they form an obstacle to the effective operation of free market forces.

However Professor Krause expresses some hope for the commodity agreements if they conform to certain standards like recognition of consumer interests, elimination of excess capacity and increase of income and consumption through economic prosperity.

6.11 EFFECTS OF PROTECTION

Trade protectionism has certain effects to a country's macro-economy and often the global economy. The effects of protection are discussed below :

(i) The imposition of a tariff duty leads to a rise in the price of the imported good by the amount of the duty. This provides an opportunity to the indigenous industry to increase its output. This increase in the output

of the domestic industry due to the imposition of the tariff duty is called the protective effect.

(ii) When a tariff duty is imposed it results in a decline in the total consumption of the commodity. With the rise in the price of the imported good, as well as domestic good due to higher production cost, the total consumption of the good concerned will be less than before. This fall in consumption due to the imposition of tariff duty is called the consumption effect.

(iii) The imposition of tariff duty may result in increased revenue of the government so long as the duty is not so high so as to stop imports altogether. This increased revenue of the government resulting from the imposition of tariff duty is termed as revenue effect.

(iv) Again the imposition of tariff duty may raise the price not only of the imported good but also of the domestic product. In this case the consumers have to pay more for the commodity which might lead to a transfer of income from the consuming class to the producing class. If the rise in the price continues for a long time the new wealth with the producers may get transferred to the owners of scarce factors resulting in them getting a higher remuneration for their services. This is known as the redistributive effect.

(v) The tariff duties usually make the terms of trade for the tariff imposing country. However if the other countries retaliate by imposing counter-duties on the goods of the country in question, the favourable effect on the terms of trade will cease to exist.

(vi) When tariff duties are imposed it usually results in a decreased demand for imported goods by raising their prices. The money saved by the domestic consumers is now spent on the indigenous commodities. Hence to increase the production of the indigenous goods, idle resources and idle manpower are mobilised which results in increased income and employment in the country. This may be referred to as the income effect of protective tariffs.

(vii) At least in the initial stages the imposition of tariff duties results in a favourable effect on the balance of payments of a country because of

the reduction of imports of the concerned country. However, this favourable effect might be nullified in the long run if the other countries retaliate by imposing counter- duties on the exports of the concerned country.

(viii) An important effect of protection is that consumers, due to the imposition of import quotas, will have a limited choice of products and goods. Because of these quotas, consumers will have a very limited choice as to the quality, quantity and type of product that would otherwise be available to them without trade protection. Another problem that consumers will face is that they will have to pay more for the limited quantity of goods and products.

(ix) A nation can use the policy of protecting its infant industry, but for how long is an important concern. The protection of an infant industry may actually cost a government significant amount of money and financial resources.

(x) Nations will take reciprocal action if there are trade protection policies put into effect. Nations will retaliate if they cannot sell their goods and products in markets where they normally could. Even if those nations are political and military allies, they will impose countervailing tariffs, quotas, subsidies, exchange controls and other protection methods, inorder to deal with another nation's actions. A trade war will ultimately mean increased import costs as manufacturers and producers must pay more for equipment, commodities and intermediate products from foreign markets. This will also affect a nation's real GDP growth. This trade protection should be very carefully considered as it could have dangerous repercussions on a domestic economy and even globally.



CHECK YOUR PROGRESS

Q 10: Mention four effects of protective tariff duties.

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6.12 LET US SUM UP

In this unit we have discussed the following points :

- A trade policy of no restrictions on the movement of goods between countries is known as the policy of free trade.
- Protection refers to the commercial policy of the government under which a number of restrictions are imposed on import trade with a view to protect home industries from foreign competition.
- A tariff is a kind of duty or levy imposed by the government of a country upon the traded commodity as it crosses the national boundaries.
- An import quota refers to a fixed quantity or value of a commodity that has been allowed to be imported from foreign countries in the country during a given period of time, usually one year.
- State trading refers to government participation in the foreign trade.
- Dumping means discriminatory monopoly pricing in foreign trade. It refers to different pricing in foreign trade.
- International commodity agreements refer to government-sponsored international cartels.



6.13 FURTHER READING

1) Manner, H. G. (2015). International Economics, Vikas Publishing House Pvt. Ltd., New Delhi, India.

2) Methani, D. M. (2015), International Economies, Hemalaya Publishing House, Mubmbai, India.

3) Verma, K. N. (2015), International Trade : Theory & Practice, Vishal Publishing Co., Jalandhar, India.g

6.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A trade policy of no restrictions on the movement of goods between countries is known as the policy of free trade.

Ans to Q No 2: Arguments for free trade-

- Proper utilisation of resources
- Large factor incomes
- Optimisation of consumption
- Educative effect
- Check on monopolies
- Scope for factor specialisation
- Extensive markets.

Agreement against free trade–

- Absence of pre requisites of free trade
- Harmful to economically underdeveloped countries
- Leads to dumping
- Import of harmful products
- Rise of monopolies
- Foreign dependence
- Harmful for economic interest
- Need to protect infant industries.

Ans to Q No 3: Protection refers to the commercial policy of the government under which a number of restrictions are imposed on import trade with a view to protect home industries from foreign competition.

Ans to Q No 4: Arguments for protection-

- Infant industry argument
- Diversification of industries argument
- Home market argument
- Basic industries argument
- Employment argument
- Proper utilization of natural resources argument

- Idle resources argument
- Wage argument
- National defense argument
- Improvement in the balance of payments argument
- Dumping argument.

Arguments against protection-

- Low economic utilisation of natural resources
- Encouragement to inefficient industries
- Establishment of monopoly
- Loss to consumers
- Violation of consumer's freedom of choice
- Inequalities in the distribution of national income
- Reduction in foreign trade
- Political corruption
- Misdirection of resources.

Ans to Q No 5: Three arguments in support of protection of home industries in the developing countries are -

- Growth of infant industries
- Diversification of industries
- Greater domestic capital formation.

Ans to Q No 6: Some important methods of protection are -

- Tariffs
- Import quotas
- Exchange control
- State trading
- Dumping or price discrimination
- Subsidies
- International cartels
- International commodity agreements.

Ans to Q No 7: 'Ad valorem' tariff refers to the duty which is levied as a fixed percentage of the value of the traded commodity. The basis of this tariff is the value or price of the commodity rather than its physical dimensions.

Ans to Q No 8: An import quota refers to a fixed quantity or value of a commodity that has been allowed to be imported from foreign countries in the country during a given period of time, usually one year.

Ans to Q No 9: Exchange control implies governmental intervention in the matter of foreign exchange and the exchange rates. It refers to those restrictions which are imposed by the government on foreign exchange business.

Ans to Q No 10: Four effects of protective tariff duties are -

- Consumption effect
- Revenue effect
- Redistributive effect
- Income effect.



6.15 MODEL QUESTIONS

Q 1: Briefly justify the policy of free trade.

Q 2: What are the main classifications of tariff ?

Q 3: Discuss the objectives of an import quota.

Q 4: Discuss the advantages and disadvantages of State Trading.

Q 5: Discuss the advantages and disadvantages of International Cartels.

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UNIT 7 : BALANCE OF PAYMENTS

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Balance of Payments and Balance of Trade

7.3.1 Current Account and Capital Account

7.4 Balance of Payments: Types, Causes and Remedial Measures

7.4.1 Types of Balance of Payments Disequilibrium

7.4.2 Causes of Balance of Payments Disequilibrium

7.4.3 Remedial Measures to Remove Balance of Payments Disequilibrium

7.5 Let Us Sum Up

7.6 Further Reading

7.7 Answers to Check Your Progress

7.8 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to–

- define the concept of balance of payments and balance of trade
- distinguish between balance of payments and balance of trade
- lay out the structure of balance of payments
- discuss disequilibrium in the balance of payments and
- identify the causes for disequilibrium in the balance of payments and suggest corrective measures.

7.2 INTRODUCTION

In the previous unit, we have already discussed international trade. We have so far discussed why and how trade occurs between countries. This unit discusses two important aspects of reporting the international transactions of a country viz., balance of payments and balance of trade. After going through this unit you will be able to define the terms balance of

payments and balance of trade; differentiate between the two as well as discuss their structures. Apart from these the unit will also enable you to gain an idea about the disequilibrium in balance of payments and put forward certain remedial measures for correcting the disequilibrium.

7.3 BALANCE OF PAYMENTS AND BALANCE OF TRADE

- **Balance of Payment:** International Monetary Fund (IMF) has defined the balance of payment as a systematic record of the economic transactions between the reporting country and the rest of the world during a specific period of time, i.e., one year.

  Thus, when India's balance of payments is prepared, India becomes the reporting country and the rest of the world will refer to India's trading partners. Harvey and M. Johnson define the balance of payment in the following words, "The balance of payments account for a country set out, in summary form, all the current and capital transactions which have taken place between the residents of that country and the rest of the world in a given period of time". It is to be noted that the word residents in the definition does not only mean the citizens of the country but also the firms, industries, government, business houses and international agencies operating in the country.

- **Balance of trade:** The term balance of trade is often misunderstood and confused. This is because different economists have interpreted the term in different senses. At least two different concepts of balance of trade are prominent. Traditionally, the term has been used to define the difference between the value of merchandise (or goods) exports and the value of merchandise (or goods) imports. This is also known as merchandise trade balance. Thus, in this sense, the terms balance of trade or merchandise trade balance are synonymous. Later economists like J.E. Meade and W.M. Scammel have however used the term in a wider sense. According to this line of thinking, balance of trade also includes services. Thus, in this sense, the balance of trade is the difference between a nation's exports and imports of both goods

and services. This has an important implication. For example, a country may enjoy a favourable balance of payments position (i.e., value of exports greater than value of imports) when it comes to merchandise trade balance. But, if she has to heavily rely on the import of various kinds of technical services, balance of services put it in an unfavourable position (i.e., value of exports less than value of imports).

This ultimately makes the balance of trade unfavourable for the country.

In the following Table 8.1, a hypothetical schedule is presented which shows the various components of a balance of payment schedule.

Table 7.1 : A Hypothetical Balance of Payments Schedule

Sl	Major Accounts	Credit (Receipts) (in Rs. Crores)	Debits (Payments) (in Rs. Crores)	Net Surplus (+) or Deficit (-) (in Rs. Crores)
(1)	(2)	(3)	(4)	(5)
1	Goods Account	200	175	+25
2	Services Account	150	250	-100
A)	BALANCE OF TRADE (1+2)	(350)	(425)	(-75)
3	Unilateral Transfers Account	275	140	+ 135
B)	BALANCE OF PAYMENTS ON CURRENT ACCOUNT (1+2+3)	(625)	(565)	(+60)
4	Long-term Capital Account	180	160	+20
C)	BASIC BALANCE (1+2+3+4)	(805)	(725)	(+80)
5	Short-term Capital Account	75	50	+25
D)	BALANCE OF PAYMENTS ON CAPITAL ACCOUNT (4+5)	(255)	(210)	(+45)
E)	OVERALL BALANCE OF PAYMENTS (B+D)	(880)	(775)	(+105)
6	International Liquidity Account Net Changes in External Reserves		105	
F)	BALANCE OF PAYMENTS	(880)	(880)	(0)

From the above hypothetical table 8.1 it can be seen that balance of trade consists of the goods account (merchandise goods) and the service account. Thebalance of paymentsis a much broader concept and gives a complete summary of all economic transactions that involve money flowing into or from a country.

7.3.1 Current Account and Capital Account

It can be seen from the above that the balance of payments is separated into two main accounts:

- **Current account:** records transactions that involve the export or import of goods and services and interest paymentsas well as unilateral transfers to and from abroad. All the flow components are contained in this account.
- **Capital account:** records transactions that involve the purchase or sale of assets or investments, like companies, stocks, bonds, bank accounts, real estate and factories.

We shall now discuss the different components of both these accounts in some detail.

- **Current Account:** The current account consists of four sub accounts:
  - Merchandise trade consists of all raw materials and manufactured goods bought, sold, or given away. Since early 1990s, the merchandise trade account has been combined with services to determine the "balance of trade." Thus, the term balance of trade today includes both these accounts.
  - Services include tourism, transportation, engineering, and business services, such as law, management consulting, and accounting. Fees from patents and copyrights on new technology, software, books, and movies are also recorded in the service category.
  - Income receipts record investment incomes made up of interest and dividend payments and earnings of domestic owned firms operating abroad.

- Unilateral transfers are payments that do not correspond to the purchase of any good, service or asset. These usually take the form of international aid, gifts, or worker remittances from abroad.

➢ **Capital Account:** The capital account measures the difference between sales of assets to foreigners and purchases of assets located abroad.

- Assets owned abroadare divided into official reserve assets, government assets, and private assets. These assets include gold, foreign currencies, foreign securities, reserve position in the International Monetary Fund, other long-term assets and direct foreign investment (direct foreign investment is also called foreign direct investment (FDI).
- Foreign-owned assets in the country are divided into foreign official assets and other foreign securities.
- Borrowings and lendings to and from abroad: It includes two major components, viz.,
  (a) All transactions relating to borrowings from abroad by private sector, government, etc. Receipts of such loans and repayment of loans by foreigners are recorded on the positive (credit) side.
  (b) All transactions of lending to abroad by private sector and government. Lending abroad and repayment of loans to abroad is recorded as negative or debit item.
- Investments to and from abroad: It includes two major components, viz.,
  (a) Investments by rest of the world in shares of home companies, say, Indian companies, real estate in India, etc. Such investments from abroad are recorded on the positive (credit) side as they bring in foreign exchange.

(b) Investments by residents of the home country, say, Indian residents in shares of foreign companies, real estate abroad, etc. Such investments to abroad be recorded on the negative (debit) side as they lead to outflow of foreign exchange.

- Change in Foreign Exchange Reserves: The foreign exchange reserves are the financial assets of the government held in the central bank. A change in reserves serves as the financing item in India's BOP. So, any withdrawal from the reserves is recorded on the positive (credit) side and any addition to these reserves is recorded on the negative (debit) side. It must be noted that 'change in reserves' is recorded in the BOP account and not 'reserves'.
- Balance on Capital Account: The transactions, which lead to inflow of foreign exchange (like receipt of loan from abroad, sale of assets or shares in foreign countries, etc.), are recorded on the credit or positive side of capital account. Similarly, transactions, which lead to outflow of foreign exchange (like repayment of loans, purchase of assets or shares in foreign countries, etc.), are recorded on the debit or negative side. The net value of credit and debit balances is the balance on capital account.



LET US KNOW

- Surplus in capital account arises when credit items are more than debit items. It indicates net inflow of capital.
- Deficit in capital account arises when debit items are more than credit items. It indicates net outflow of capital.
- In addition to current account and capital account, there is one more element in BOP, known as 'Errors and Omissions'. It is the balancing item, which reflects the inability to record all international transactions accurately.



CHECK YOUR PROGRESS

Q 1: State whether the following statement is True or False. The word balance in balance of payments does notnecessarily mean equilibrium. (T/F)

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Q 2: Mention the four sub-accounts that comprise the current account of the balance payments. (Answer in about 20 words)

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Q 3: Which sub-account of balance of payments includes the item foreign direct investment?

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7.4 BALANCE OF PAYMENTS: TYPES, CAUSES AND REMEDIAL MEASURES

The balance of payment is said to be in equilibrium if the total value of the credits side is equal to the total value of the debit side. However, it is important to remember that the word balance in balance of payments does not necessarily mean equilibrium; a balance of payments may also be in disequilibrium (if the money value of the payments side exceeds the money value of the receipt side the BOP is unfavourable) or in surplus (the money value of the receipt side being more than the money value of the payments side, the BOP is favourable). The word balance only means that it is a balance sheet of receipt and payments.

A "favorable" balance of trade or trade surplus occurs when exports exceed imports. A "negative" balance, or trade deficit occurs when the imports surpass exports. When the total value of the credit items is less than the total value of the debit items, the balance of payments is in disequilibrium or unfavourable. The home country remains indebted to the rest of the world.

A disequilibrium in the balance of payments may be caused by factors like rising development expenditure (leading to the increasing import of raw materials, machines, technology etc.), trade cycle (propensity raises imports), structural changes (development of substitutes), political uncertainty (outflow of capital) etc.

In theory, the current account should be balanced with the capital account. The sum of the balance of payments statements should be zero. Therefore, when a country buys more goods and services than it sells (a current account deficit), it must finance the difference by borrowing, or by selling more capital assets than it buys (a capital account surplus). A persistent current account deficit amounts to exchanging capital assets for goods and services. Large trade deficits mean that a country is borrowing from abroad and it appears as an inflow of foreign capital in the balance of payments.

7.4.1 Types of Disequilibrium in Balance of Payments

There are three broad types of disequilibrium in the balance of payments. They are:

- Cyclical disequilibrium,
- Secular disequilibrium, and
- Structural disequilibrium
- **Cyclical disequilibrium:** in the balance of payments may occur because of the following:
  - Trade cycles follow different phases in different countries. Thus, the economic prosperity or downturn differs in different countries. This may adversely affect the balance of payments of certain countries.
  - Different governments in different countries adopt different sets of policy measures to promote/regulate trade and commerce. This also affects the disequilibrium of balance of payments.
  - Income elasticity of demand for imports also varies among countries. Some countries may have weaknesses

for imported commodities and hence can spend more on such commodities. This in turn, affects the disequilibrium of the balance of payments of a country.

- **Secular disequilibrium:** in the balance of payments may occur because of the factors like ***capital formation***, population growth, technological advancement, innovations etc.

Capital formation has an important role to play in international trade volume of a country. Higher the capital formation, higher can be the volume of exports. Again, if the capital formation in a country is low, it has to import high cost capital from foreign countries. This may adversely affect the balance of payments of a country.

Population growth may also adversely affect the balance of payment because, higher population growth results in higher levels of domestic consumption. This reduces the export potential while increases the import potential at the same time.



Capital formation: It is the process of adding to the stock of real productive assets (machineries etc.) of an enterprise. This is done either by in-house research and development activities or through procurement from outside.

7.4.2 Causes of Balance of Payment's Disequilibrium

Disequilibrium in balance of payments may be attributed to the following important causes:

- **Cyclical fluctuations:** As we have already said, cyclical fluctuations in the economy may affect the balance of payments of a country adversely.
- **Steep increase in imports:** Rapid economic development of a country may result in steep rise in imports. Again, rapid economic development may also propel domestic consumptions. Thus, the payments made for imports may be more than payments received from exports. This adversely affects the balance of payments of a country.
- **Rapid population growth:** As we have already said, population growth may also adversely affect the balance of payments. Because, higher population growth results in higher levels of

domestic consumption, thus reduces the exports potential while increases the import potential at the same time.

- **Low level of infrastructural technologies:** A country may have to heavily import technologies and machineries if its level of technological infrastructure is low. This often happens in case of developing countries. These countries have to pay huge amount in import of technologies and machineries. This cause huge inflow of foreign exchange from its exchequer.
- **International borrowing and investment:** Developing countries often have to undertake huge international borrowing in an attempt to develop its infrastructure and to meet its requirements of funds. On the other hand, a developed country may engage itself in huge lending of funds to other countries. These activities adversely affect the balance of payments of both the countries.

7.4.3 Remedial Measures to Remove Balance of Paymentes Disequilibrium

There are a large number of measures to remove disequilibrium in the balance of payments. Some of the important measures are mentioned in brief below.

- The market forces of demand and supply can restore equilibrium. A deficit in the BOP increases the demand for foreign currency and raises the exchange rate causing a fall in the external value of the domestic currency. This will make export cheaper and import dearer. Exports will rise and imports will fall. The balance of payment disequilibrium will be removed.
- Devaluation of the domestic currency can correct the disequilibrium in BOP. Devaluation is the fall in the external value of a country's domestic currency in terms of foreign currencies and gold. Devaluation of the currency will ultimately make export cheaper and import dearer. Exports will rise and imports will fall. The balance of payment disequilibrium will be removed.

- Exchange control measures can restore equilibrium. By regulating the demand for imports, e.g., the govt. may reduce the volume of imports.
- Export promotion measures through various incentives like tax concession; rebates etc. to the exporters will raise exports and reduce the disequilibrium.
- Import restriction policies like import substitution, imposition of import duties and physical quantity restrictions can lower the volume of imports.
- Help may be sought from the IMF to tide over the temporary disequilibrium in the balance of payment.

- Export promotion measures through various incentives like tax concession, rebates, etc. to the exporters will raise exports and reduce the disequilibrium.
- Import restriction policies like import substitution, imposition of import duties and physical quantity restrictions can lower the volume of imports.
- Help may be sought from the IMF to tide over the temporary disequilibrium in the balance of payment.



ACTIVITY 7.1

We have said that factors like technological advancement and innovation affect the balance of payments of a country. Put forward your own arguments as to how these factors affect the balance of payments of a country. (You can take the help of the arguments put forward in capital formation in this case)

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CHECK YOUR PROGRESS

Q 4: State whether the following statements are Trueor False.

(i) Exchange control measures can restore balanceof payments equilibrium. (T/F)

(ii) Large trade deficits mean that a country is lending heavily toabroad and it appears as an inflow of foreign capital in thebalance of payments. (T/F)

Q 5: What do you mean by capital formation and how does it affect the balance of payments of country? (Answer in about 50 words)

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Q 6: How does foreign borrowing affect the balance of payment of a developing country? (Answer in about 50 words)

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7.5 LET US SUM UP

In this unit we have discuss the following points-

- The balance of payments consist of two main accounts:
  - Current account-records transactions that involve the export or import of goods and services and interest payments. as well as unilateral transfers to and from abroad.

All the flow components are contained in this account.

- Capital account-records transactions that involveborrowings from and lending to abroad,the purchase or sale of assets or investments, like companies, stocks, bonds, bank accounts, real estate and factoriesetc,

- Balance of trade is the difference between a nation's exports and imports of both goods and services.
- Balance of payments give a complete summary of all economic transactions that involve money flowing into or from a country.
- The balance of payments is separated into two main accounts: Current account and Capital account.
- The balance of payment is said to be in equilibrium if the total value of the credits side is equal to the total value of the debit side.
- The balance of payments may be in disequilibrium or in surplus.
- There are three broad types of disequilibrium in the balance of payments. They are:
  - Cyclical disequilibrium,
  - Secular disequilibrium, and
  - Structural disequilibrium.
- Important causes of balance of payments disequilibrium include:
  - Steep increase in imports,
  - Cyclical fluctuations,
  - Rapid population growth,
  - Low level of infrastructural technologies, and
  - International borrowing and investment.
- Measures to remove balance of payments disequilibrium include:
  - Working of the market forces of demand and supply,
  - Devaluation of the domestic currency,
  - Exchange control measures,
  - Export promotion and import restriction policies, and
  - Help from agencies like IMF for correcting temporary disequilibrium.



7.6 FURTHER READING

1) Mannur, H. G. (1995). *International Economics*. Noida: Vikash Publishing House Pvt. Ltd.

2) Paul, R.R. (2006). *Money, Banking and International Trade*. Jalandhar: Kalyani Publisher

3) Rana, K. C. &Verma, K. N. (1998). *Macroeconomic Analysis*. Jalandhar: Vishal Publications.



7.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: True

Ans to Q No 2: Current account of balance of payments consist of the following sub-accounts:

- Merchandise trade,
- Services,
- Income receipts from domestic firms/individuals operating in abroad, and
- Unilateral transfers.

Ans to Q No 3: Capital account includes the item foreign direct investment (FDI).

Ans to Q No 4: (i) True (ii) False

Ans to Q No 5: Capital formation means the process of adding to the stock of real productive assets (machineries etc.) of an enterprise. It requires huge funds. An enterprise may invest in in-house research and development and acquire such capital formation. The other way is to import from other countries. When the enterprise decides to import, it adversely affects the balance of payment of the country.

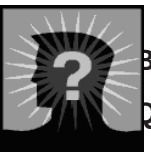
Ans to Q No 6: Developing countries often have to undertake huge international borrowing in an attempt to develop its infrastructure and to meet its requirements of funds. Such foreign borrowing increases the inflow of funds. But, the borrower has to pay interest on such borrowing which is essentially an outflow of resources apart from repaying the principal amount. Thus, the developing countries have to undergo huge outflow of funds. This adversely affects the balance of payments of the developing countries.

7.8 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: Write a short note on balance of trade.

Q 2: Discuss the structures of current account and capital account.



B) Long Questions (Answer each question in about 300-500 words)

Q 1: What do you mean by balance of payments? How does it differ from balance of trade? Does a country's balance of payments always balance? Explain

Q 2: What are the different types of balance of payments disequilibrium? What are the causes for such disequilibrium? Suggest some remedial measures.

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UNIT 8 : FOREIGN EXCHANGE

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning and Instruments of Foreign Exchange

8.4 Functions of Foreign Exchange Market

- 8.4.1 Transfer Functions
- 8.4.2 Credit Functions
- 8.4.3 Hedging Functions

8.5 Foreign Exchange Rate or Rate of Exchange

8.6 Determination of Equilibrium Exchange Rate

- 8.6.1 Purchasing Power Parity Theory
- 8.6.2 The Balance of Payment Theory

8.7 Let Us Sum Up

8.8 Further Reading

8.9 Answers to Check Your Progress

8.10 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to–

- derive the meaning of exchange rate and instruments
- discuss the concepts of foreign exchange market and its functions
- discuss the process of determination of equilibrium rate of exchanges.

8.2 INTRODUCTION

In this unit, we shall discuss how the exchange rates of two currencies of two different countries are determined. We know that every country has its own currency. For example, India has Rupee, Bangladesh has Taka, Nepal also has Rupee, US has the Dollar, UK has the Pound. Now, the relative strength of these currencies (in terms of its value in the

international market) varies significantly. This relative strength of two currencies, say Indian Rupee and the US Dollar, would determine how much of one currency (say one Indian Rupee) would earn how much of the other currency (say US Dollar) is technically called the 'exchange rate'. For example, as on 8th of April, 2019, for obtaining a US Dollar, we have to forego approximately 70 Indian Rupees. Thus, US Dollar = 70 Indian Rupee is the exchange rate of the Indian Rupee in terms of US Dollar.

In this unit, we shall discuss the process of exchange rate determination. How a foreign exchange market functions, would also be discussed.

8.3 MEANING AND INSTRUMENTS OF FOREIGN EXCHANGE

Foreign exchange may be defined as the system or process of converting the currency of one country into the currency of another country. Foreign exchange is the mechanism that not only involves the conversion of currency but also includes all deposits, credit and balance payable in any foreign currency and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in one currency payable in any foreign currency. Thus, the foreign exchange is essential for smooth conduct of international transaction related to goods, services and capital among countries as the currency of each country is different. In general, foreign exchange can be defined in two forms -in narrow form and in a broad form. In the narrow sense, it simply means the foreign currency while in the broad form it represents whole mechanism of international transaction, payments, rules and regulations of payments, methods of payments and the institutional facilitate payments among currencies of different countries.

- Instruments of Foreign exchange:Foreign exchange is facilitated through the instruments like foreign bills of exchange, bank drafts, telephonic transfer, letter of credits.
  - **Foreign bills of exchange:** It is the customary instruments of foreign exchange. It is a written order or request to the drawee from the drawer to pay a certain among of money. Generally, it is

used with added formality of a letter of credit. The exporter or creditors of one country draw bills on the importers or debtors in other country and have them duly accepted by them. The bills are sold out to the debtors (imports) of their country who want to make payment abroad and the creditors (exporters) in the foreign countries collect their money from the debtors (imports) of their own country. Thus, the working of these bills is very simple.

- **Telephonic transfer:** Telephonic transfer is used when quick transfer of funds from one country to another country is needed. Thus, it is a quick mode of international payment system. In case of this instrument, an exporter receives payment in the form of deposits in favour of a bank in the country of importer. The bank exporter country sends a telegraphic order to the corresponding banks in the importer country for the transfer of certain amount of money deposited with the account of exporter in terms of the currency of exporter.
- **Bank Drafts:** A bank draft is an order of bank to pay money on demand. The importer or debtor can get bank draft from his own bank and it is transferred to the exporter or creditor. The creditor or exporter then collects the amount from the branch of bank of his own country.
- **Letter of Credit:** A letter of credit is an important instrument of foreign exchange. It authorises a person to draw a bill or cheque for a specific amount from the issuing banks at a stipulated time. The bank which issues the letter of credit takes the responsibility to pay the exporter. The travellers can avail the benefit of letter of credit. The letter of credit authorises the traveller to draw cheques or bill for the payment of the banks. The letter of credit can be revocable or irrevocable at the instance of the importers while for the exporters it is of irrevocable in nature.

8.4 FUNCTIONS OF FOREIGN EXCHANGE MARKET

Foreign exchange market performs three important functions, viz., transfer functions, credit functions and hedging functions.

8.4.1 Transfer Functions

The basic function of the exchange market is the transfer of purchasing power from one country to another i.e. facilitating the conversion of one currency into another. This function is affected through a variety of credit instruments. In performing the transfer functions, the foreign exchange market carries out payments internationally by clearing debts. Thus, the international clearing function performed by foreign exchange market plays a very important role in international trade.

8.4.2 Credit Functions

For the growth of international trade, the foreign exchange market performs the credit function. The growth of international trade dependsto a great extent on credit facilities. Credit facilities are available for both exports and imports. Exports get pre shipment and post shipment credit.

8.4.3 Hedging Functions

The third important function of foreign exchange market is to facilitate hedging function. Hedging function means avoidance of foreign exchange risks. It protects exporters and importers against losses arising from fluctuations in exchange rates. It reduces or avoids the exchange risks by providing services for helping the anticipated or actual claims liabilities in exchange for the ***forward contract***s.



forward contract: A forward contract is usually a three months contract to buy or sell the foreign exchange for another currency at a fixed date in the future at a price agreed upon today.

CHECK YOUR PROGRESS

Q 1: Describe the use of foreign bills of exchange as a tool of foreign exchange. (Answer in about 60 words)

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Q 2: Describe how forward contracts function. (Answer in about 40 words)

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8.5 FOREIGN EXCHANGE RATE OR RATE OF EXCHANGE

The rate of exchange or foreign exchange rate is related with the foreign exchange market. It is the rate at which currency of one country is exchanged with currency of another country. A rise in the exchange rate or reduction in the value of domestic currency with respect to the foreign currency is called depreciation of the domestic currency in relation to the foreign currency. A fall in exchange rate or an increase in the value of the domestic currency in terms of another currency is called appreciation of the domestic currency. For example, when exchange rate of rupee vis a vis US$ goes up from Rs.70 per 1$ to Rs.72 per 1$, it is depreciation of Indian rupee. Similarly a fall of exchange rate from Rs.70 per 1$ to Rs.68 per 1$ is appreciation of rupee.

Rate of exchange can be of following types:

- **Fixed exchange rate:** A fixed exchange rate is a regime in which the value of a country's currency is fixed by government or central bank against either the value of another single currency or to a basket of other currencies or to the price of gold. Fixed exchange rate is also known as pegged exchange rate. There are three types of fixed exchange rate (a) Rigid peg with a horizontal band: it is an exchange

rate regime under which exchange rate functions is maintained within a range (either specified or non-specified) by the central bank. The specific band may be one sided (17 per cent in Vietnam), a narrow range (2.25 per cent in Denmark) or broad range (77 per cent in Libya). (b) Crawling peg: The par value of domestic currency is fixed in terms of a selected foreign currency (or precious metal or currency basket) and is rest at intervals based on pre-set criterion such as change in inflation rate. (c) Crawling band: the domestic currency is on a crawling peg which is maintained within a range i.e. band.



LET US KNOW

The biggest advantage of the crawling peg is its responsiveness to the market made of domestic currency.

Floating Exchange Rate or Flexible Exchange Rate: It has two types (i) managed float or dirty float (ii) free float or clean float. A floating exchange rate or flexible exchange rate is the opposite of fixed exchange rate. In case of flexible exchange rate, market forces determine the value of the domestic currency against a selected foreign currency.

Managed float or dirty float: A managed float or dirty float is a flexible exchange rate in which the monetary authorities influence the exchange rate through direct or interact intervention without specifying the target exchange rate.

Free float or clean float: Free float or clean float is a floating exchange rate which is determined purely by the market forces (i.e. demand and supply of currency).



LET US KNOW

A de-facto exchange rate is the one that a country actually follows. A de-jure exchange rate system is the one that country claims to follow.



Note: if the absolute PPP hold the relative PPP would not hold and vice versa.

8.6 DETERMINATION OF EQUILIBRIUM EXCHANGE RATE

Equilibrium exchange rate is the rate at which demand for a currency is equal to supply of the currency in the economy.

There are two theories that explain the mechanism of determination of equilibrium exchange rate. These are- (a) Purchasing power parity theory and (b) Balance of payments theory.

8.6.1 Purchasing Power Parity Theory

The purchasing power parity (PPP) theory was introduced by a Swedish Professor Gustav Caser. According to this theory when the exchange rates are free to fluctuate, the rate of exchange between two countries depends upon the relative purchasing power of their respective currencies. The theory was originally developed as a theory of exchange rate determination. But now it is primarily used to compare living standards across countries.

- **There are two versions of PPP theory:** The absolute Purchasing Power Parity Theory: According to absolute purchasing power parity, theory the equilibrium exchange rate between two currencies is equal to the ratio of the price levels in the two countries. This is expressed as: $R = \frac{p}{p*}$ where R is exchange rate, p is the general price level in the home country. p* is the general price level in the foreign country.
- **Relative purchasing power parity theory:** According to the relative purchasing power parity theory, the change in the exchange rate over a period of time should be proportional to the relative change in the price level in the two countries over the same time period. This can be expressed as or symbolically,

$$R_1 = \frac{\frac{p_1}{p_0}}{\frac{p*_1}{p_0*}} \times R_0$$

Where R_1 is the exchange rate in period 1, R_0 is the exchange rate in base period. p_1 and p^*_1 are the general price levels in the current period in the home country and the foreign country respectively. p_0 and p_0^* are the general price levels in the base periods in the home country and the foreign country respectively.

If the general price level change in the foreign country form the base period to current period (i.e. $\frac{p_1^*}{p_0^*} = 1$), while the general price level in the home country increases by 50 per cent, the according to relative PPP, the exchange rate should be depreciated by 50 per cent) in current period as compared to the base period.

- **Criticisms of PPP theory:** The purchasing power parity theory is criticised on the following grounds:
  - Limitations of price index numbers: to measure the equilibrium exchange rate, the PPP theory uses the concept of price index numbers. As the price index number has many limitations the theory also suffers from these limitations.
  - The composition of national income: the composition of national income varies in different countries. Thus the goods and services included in the index number should be different in different countries. Thus, considering same composition of goods and services in different countries in calculating price index numbers is not relevant.
  - Goods have different quality: The quality of goods and services is not considered in calculating the equilibrium exchange rate. The goods and services poses different qualities in different countries.
  - Neglect the impact of change in exchange rate on prices: this theory does not take into account the impact of fluctuations in exchange rate on prices.

- Ignores international capital movements: International capital movements affect the equilibrium exchange rate. But this theory ignores the effect of international capital movements on the equilibrium exchange rate.
- Free from all barriers: the PPP theory assumes the free international trade while in real world the international trade is not free from barriers.
- No transportation cost: the PPP theory assumes that there is no transportation cost, but in reality this assumption is vague.
- Ignores the demand for and supply of foreign exchange: The determination of equilibrium exchange rate the demand for and supply of foreign exchange is essential. But the PPP theory does not consider the demand and supply conditions in determining equilibrium foreign exchange rate.
- Short run fluctuations: the explanation of short term changes in exchange rate is not satisfactory.
- Interpretation of elasticities of demand for exports and imports: the PPP theory assumes that the elasticity of demand for exports and imports is equal to unity. This assumption does not hold good.

Though the Purchasing Power Parity theory has several limitations; it provides some important aspects regarding exchange rate. These are-

- It portrays the relationship between the internal price level and the exchange rate.
- It explains both the state of trade and nature of Balance of Payments (BOP) at a particular time.
- To some extent this theory is applicable to all sorts of monetary standards.

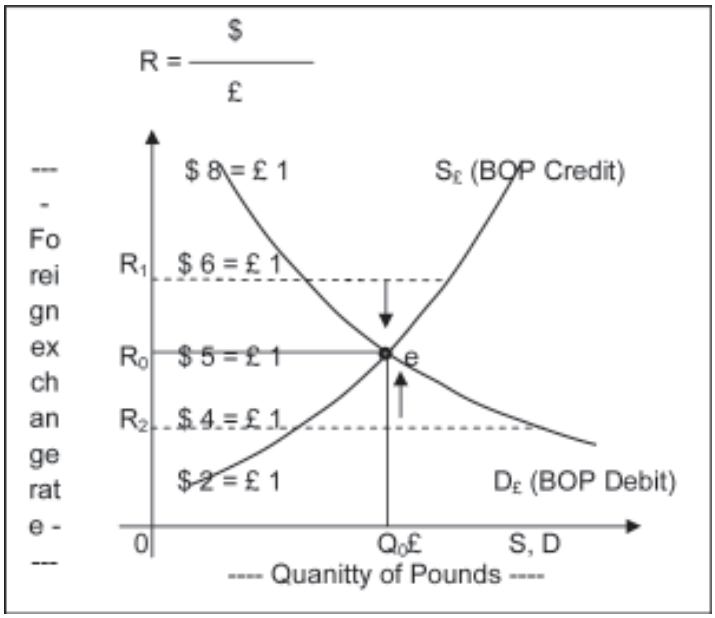
8.6.2The Balance of Payment Theory

The Balance of Payment (BOP) Theory is also known as the Demand and Supply Theory of Exchange Rate Determination and General Theory of Exchange Rate Determination. According to this theory, the exchange rate is determined by the free play of demand for and supply of foreign exchange.

The demand for foreign exchange is determined from the domestic demand for imports of foreign goods and services and capital outflow. Thus, the demand for foreign exchange comes from the debit transaction in the current and capital accounts of BOP.

The supply of foreign exchange is made up of the foreign capital obtained from exports of goods and services, receiving of unilateral transfer payments from abroad and short-term and long term capital imports or inflows of capital. Thus, the supply foreign exchange is derived from the credit transactions in the current and capital account of BOP in the home country.

Figure 9.1: Exchange rate determination



Supply of foreign exchange comprises of all the foreign receipts (both earning and borrowings) and the demand for foreign exchanges comprises of all the foreign payments (both spending

and lendings). The supply of foreign exchange is not always equal to the demand for foreign exchange. The rate of foreign exchange at which the demand for and the supply of foreign exchange is equal is known as equilibrium foreign exchange rate. In the equilibrium foreign exchange rate the BOP is also in equilibrium.

This can illustrated with the aid of Figure 9.1.

In Figure 9.1, the quantity of foreign exchange and the foreign exchange rate are measured along the horizontal and vertical axes respectively. $D_£$ is the demand curve for foreign exchange and takes into account all the automatic debit transactions in the BOP. $S_£$ is the supply curve of the foreign exchange and it comprises of all the automatic credit transaction in BOP. The demand curve i.e. $D_£E$ and the supply curve i.e. $S_£$ intersects at point "e" where the amount of foreign exchange demanded is equal to amount of foreign exchange supply i.e. OQ_0. R_0 is the rate of foreign exchange and OQ_0 is the quantity of foreign exchange corresponding to point "e" respectively. Thus, R_0 is the equilibrium foreign exchange rate where BOP is in equilibrium and OQ_0 is the equilibrium quantity of foreign exchange. Thus at R_0 the foreign exchange market is cleared. Which means that at R_0 the supply of foreign exchange is exactly equal to the demand for foreign exchange. Any other exchange rate is not equilibrium exchange rate as at these rates demand from and supply of foreign exchange do not match with each other. At R_1 there is excess supply of foreign exchange which results in reduction of exchange rate until it drops down to R_0. Again at R_2 there is excess demand for foreign exchange which results in increase of exchange rate until it reaches R_0. R_0 is the equilibrium exchange rate.



LET US KNOW

- If there are changes in demand for and supply of foreign exchanges, the equilibrium foreign exchanges rate will change.

- The rate of foreign exchange is also influenced by the foreign elasticity of demand for exports, the domestic elasticity of demand for imports, the domestic elasticity of supply of exports and the foreign elasticity of supply of imports.
- **Criticisms of BOP Theory:** The BOP theory is an important theory as it considers all the factors that affects the demand for and supply of foreign exchanges to determine the equilibrium exchange rate. It also tries to correct the BOP disequilibrium by adjusting equilibrium exchange rate. But this theory is not free from criticisms. Some of the serious limitations of the theory are as follows:
  (i) The assumption of perfect competition is not valid as in reality the existence of perfect competition is not found.
  (ii) This theory does not recognise the relationship between the internal price level and exchange rate. The changes in internal price level may have impact on BOP position of a country and ultimately it affects the exchange rate as the determination of equilibrium exchange rate is established at BOP equilibrium.



CHECK YOUR PROGRESS

Q 3: How is equilibrium exchange rate determined according to the absolute purchasing power parity theory? (Answer in about 60 words)

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Q 4: Mention the factors from which the demand for foreign exchange can be determined.(Answer in about 40 words)

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8.7 LET US SUM UP

In this unit we have discuss the following points-

- Foreign exchange may be defined as the system or process of converting the currency of one country into the currency of another country.
- Foreign exchange is the mechanism that not only involves the conversion of currency but also includes all deposits, credit and balance payable in any foreign currency and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in one currency payable in any foreign currency.
- The foreign exchange market (Forex, FX or currency market) is a global decentralised or over the counter (OTC) market for the trading of currencies.
- In general, foreign exchange market is a market in which national currencies are bought and sold against one another.
- The rate of exchange or foreign exchange rate is related with the foreign exchange market. It is the rate at which currency of one country is exchanged with currency of another country.
- A rise in the exchange rate or reduction in the value of domestic currency with respect to the foreign currency is called depreciation of the domestic currency in relation to the foreign currency. A fall in exchange rate or an increase in the value of the domestic currency in terms of another currency is called appreciation of the domestic currency.
- Equilibrium exchange rate is the rate at which demand for a currency is equal to supply of the currency in the economy.
- There are two theories that explain the mechanism of determination of equilibrium exchange rate. These are- (a) Purchasing power parity theory and (b) Balance of payments theory.



8.8 FURTHER READING

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2) Mannur, H. G. (1995). *International Economics*. New Delhi: Vikash Publishing House Pvt. Ltd.

3) Mithani, D. M. (2011). *International Economics*. Mumbai: Himalaya Publishing House,.

4) Rana, K. C. & Verma, K. N. (2004). *International Economics*. Jalandhar: Vishal Publishing Co.



8.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q No 1: Foreign bills of exchangeis used with added formality of a letter of credit. The exporter or creditors of one country draw bills on the importers or debtors in other country and have them duly accepted by them. The bills are sold out to the debtors (imports) of their country who want to make payment abroad and the creditors (exporters) in the foreign countries collect their money from the debtors (imports) of their own country.

Ans. to Q No 2: A forward contract is usually a three months contract to buy or sell the foreign exchange for another currency at a fixed date in the future at a price agreed upon today.

Ans. to Q No 3: According to absolute purchasing power parity, theory the equilibrium exchange rate between two currencies is equal to the ratio of the price levels in the two countries. This is expressed $as = \frac{p}{p*}$ where R is exchange rate, p is the general price level in the home country. p^* is the general price level in the foreign country.

Ans. to Q No 4: The demand for foreign exchange is determined from the domestic demand for imports of foreign goods and services and capital outflow. Thus, the demand for foreign exchange comes from the debit transaction in the current and capital accounts of BOP.

8.10 MODEL QUESTIONS

A) Short Questions (Answer each question in about 50 words)

Q 1: What is a foreign exchange market?

Q 2: What is the meaning of fixed or pegged exchange rates?

Q 3: What are the merits of fixed exchange rate?

Q 4: What is flexible or floating exchange rate? How is it determined?

Q 5: What is crawling peg system?

Q 6: What is managed float?

Q 7: What is foreign exchange market?

Q 8: What are the different types of functions of foreign exchange market?

Q 9: State the purchasing power parity theory of exchange rate determination..

Q 10: State the BOP theory of exchange rate determination.

B) Long Questions (Answer each question in about 300-350words)

Q 1: What is exchange rate? Discuss different types of exchange rates.

Q 2: Critically explain the Purchasing Power Parity Theory of exchange rate determination.

Q 3: Critically explain the Balance of Payments theory of exchange rate determination.

Q 4: What is foreign exchange market? Discuss different types of functions of foreign exchange market.

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UNIT 9 : INTERNATIONAL TRADE FINANCE

UNIT STRUCTURE

9.1 Learning Objective

9.2 Introduction

9.3 Meaning of Trade Finance

9.4 Sources of finance to International Trade

9.5 Mechanism of International Trade Finance

9.6 Role of EXIM Bank

- 9.6.1 Objectives of EXIM Bank
- 9.6.2 Operations of EXIM Bank
- 9.6.3 Organisation of EXIM Bank
- 9.6.4 Functions of EXIM Bank
- 9.6.5 Financing of EXIM Bank
  - 9.6.5.1 Pre-Shipment Finance
    - 9.6.5.1.1 Special mode of Pre-Shipment Finance
  - 9.6.5.2 Post-Shipment Finance
- 9.6.6 EXIM Bank-a catalyst for India's International Trade

9.7 Let Us Sum Up

9.8 Further Reading

9.9 Answers To Check Your Progress

9.10 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- know the meaning of trade finance
- identify various sources of trade finance
- know various instruments of trade finance
- explain the importance and functions of EXIM Bank.

9.2 INTRODUCTION

Financing international trade is a complex process, involving many variables, ranging from corporate policy and marketing strategy to exchange risk and general borrowing conditions. The reason behind this complexity is that trade involves two countries with different currencies and jurisdictions. In addition, payments must be made at a distance and across time, so the exporter, the importer or both need credit during part or all of the period from the initial manufacture of goods by the exporting firm to the time of the final sale and collection by the importer.

In this unit we will discuss the meaning of trade finance, sources of finance to international trade, mechanism of international trade finance and the role of EXIM Bank.

9.3 MEANING OF TRADE FINANCE

Trade finance is the financing of international trade flows. It is an umbrella term meaning it covers many financial products that banks and companies utilise to make trade transactions feasible. It makes import and export transactions possible for entities, ranging from a small business importing its first private-label product from overseas to multinational corporations importing or exporting large amounts of inventory around the globe each year. Trade finance can help reduce the risk associated with global trade by reconciling the divergent needs of an exporter and importer. Various intermediaries such as banks and financial institutions can facilitate these transactions by financing the trade.

There are two players in a trade transaction: (1) an exporter,who requires payment for their goods or services and (2) an importer who wants to make sure they are paying for the correct quality and quantity of goods.

9.4 SOURCES OF FINANCE TO INTERNATIONAL TRADE

Following are the sources of finance to international trade:

1. **Commercial Banks:** Globally, commercial banks provide foreign

currency loans for business purposes. They play a vital role in sourcing finance to non-trade international operations. They provide pre-export financing, help in the collection process, issue and confirm letter of credit, book acceptance and discounting drafts, offer fee based services, taking foreign exchange currency risks(spot, forward, swap, etc.). For instance, Standard Chartered has now been recognised as a major source of foreign currency loans to the Indian industry.

2. **International Agencies and Development Banks:** Numerous international agencies and development banks have evolved over the years to finance international trade and business.These bodies offer medium and long term loans and grants to elevate the development of economically backward areas in the world.These bodies were initiated by the Governments of developed countries of the world at national,regional and international levels for financial endowment of various projects.The most prominent among them include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.
3. **International Capital Markets:**Modern organisations as well as multinational companies depend upon sizeable borrowings in rupees and in foreign currency as well. Important financial instruments used for this purpose are:
   a. **Global Depository Receipts (GDRs)**The local currency shares of a company are given to the depository bank. The depository bank in turn, issues depository receipts against these shares. These depository receipts accounted in US Dollars are known as GDRs.In the Indian context, GDRs serve as an instrument issued abroad by an Indian company to raise funds in any foreign currency and can be listed and traded on a foreign stock exchange.Aholder of GDR can convert it into the number of shares it represents as and when it feels the need for it.
   b. **American Depository Receipts (ADRs)**Itis a negotiable instrument issued by a US bank representing a specified number of shares in a foreign stock that is traded on a US stock exchange.

c. **Foreign Currency Convertible Bonds (FCCBs)**Foreign Currency Convertible Bonds are equity linked debt securities that has to be converted into equity or depository receipts within the stipulated time period. Thus a holder of FCCB has the option of either converting them into equity shares at a predetermined price or exchange rate or retaining the bonds.The FCCBs are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertible debt instrument. FCCBs are listed and traded in foreign stock exchanges.

4. **Specialised House or Institutions:** Specialised house or other trading institutions may under forfeiting arrangement purchase from exporters receivable without recourse at a discounted rate to allow exporter access financing before maturity of the bill. The receivable becomes a tradable security.

9.5 MECHANISM OF INTERNATIONAL TRADE FINANCE

Trade finance offers several mechanisms to facilitate and assure timely, authorised and secure payment in the course of a transaction. There are a few basic financial mechanisms which form the foundation of international trade transactions. The most popular trade financing methods are the following:

Letter of Credit (L/C): Letter of credit is a bank's conditional promise to pay issued by a bank at the request of an importer (the applicant/buyer), in which the bank promises to pay an exporter (the beneficiary of the letter) upon presentation of documents specified in the L/C. An L/C reduces the risk of non-completion, because the bank agrees to pay against documents rather than actual merchandise.

Bankers' Acceptance: When a draft is accepted by a bank, it becomes a bankers' acceptance. As such it is the unconditional promise of the bank to make payment on the draft when it matures.

Bill of Lading: The bill of lading is a legal document issued to the exporter by a common carrier transporting the merchandise. It serves three purposes: a receipt, a contract and a document of title. As a receipt, it indicates that the carrier has received the merchandise described on the face of the document. As a contract, the bill of lading indicates the obligation of the carrier to provide certain transportation in return for certain charges. As a document of title, the bill of lading is used to obtain payment or a written promise of payment before the merchandise is released to the importer.

Factoring: Factoring is a financial transaction and a type of debtor finance in which a firm (client) sells its accounts receivable (i.e. invoices) to a third party (called a factor) at a discount. It is a financing technique, in which there is an outright selling of trade debts by a firm to a third party, i.e. factor, at discounted prices.

Forfaiting: Forfaiting refers to the purchase of financial obligations such as bills of exchange or promissory notes, without recourse to the original holder, usually the exporter. Thus it enables the exporters to receive immediate cash by selling their medium and long-term receivables; the amount an importer owes the exporter, at a discount through an intermediary.

Countertrade: It is a form of international trade where goods are exchanged for other goods, in place of hard currency. Countertrade is classified into three major categories-barter, counter purchase and compensation.

- Barter is the oldest countertrade process. It involves the direct receipt and offer of goods and services having an equivalent value.
- In a counter-purchase, the foreign seller contractually accepts to buy the goods or services obtained from the buyer's nation for a defined amount.
- In compensation, the delivery of goods to one party is compensated for by the seller's buying back a certain amount of product from that same party. The transaction is governed by one contract, and the value of the goods is expressed in monetary terms.



CHECK YOUR PROGRESS

Q 1: What is Bill of Lading?

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Q 2: What is Letter of Credit?

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Q 3: What is Countertrade?

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9.6 EXPORT IMPORT BANK OF INDIA

The EXIM Bank of India is the premier export finance institution of the country, set up in 1982 under the EXIM Bank of India Act 1981.The Government of India launched the institution with a mandate, not just to enhance exports from India, but to integrate the country's foreign trade and investment with the overall economic growth. Since its inception, EXIM has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, EXIM has over the period, evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium enterprises,in their globalisation efforts, through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production ,export marketing, pre-shipment and post-shipment overseas investment.

The EXIM Bank provides financial assistance to exporters and importers and functions as the principal financial institution for coordinating the working of other institutions engaged in financing of exports and imports of goods and services. It provides refinance facilities also to the commercial institutions against their export-import financing activities.

The Bank also undertakes limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of companies engaged in exports or imports and providing technical, administrative and financial assistance to parties in connection with exports or imports.

The paid–up capital of the Bank is Rs.500 crores wholly subscribed by the Central Government. The Government also grants loans to the Bank. The Bank can raise resources from (a) the open market through the issue of bonds and debentures,(b) from RBI, from its National Industrial Credit(Long Term Operations) Fund and (c) can borrow foreign currency in or outside India.

Entire business of the Industrial Development Bank of India (IDBI) relating to export financing has been taken over by the EXIM Bank.

EXIM Bank operates three broad programmes of financing viz. loans, re-discounting and guarantees.It has been guided by expertise at the Board level, by senior policy makers, expert bankers, leading players in industry and international trade as well as professionals in exports, imports or financing.

The Head Office of EXIM is located at Mumbai with a network of 14 branches in India and overseas. The domestic offices are in Ahmedabad, Bangalore, Chennai, Guwahati, Hyderabad, Kolkata, Mumbai, New Delhi, and Pune. The overseas offices are in Budapest, Johannesburg, London, Singapore and Washington DC.

With offices spread across India and in select locations of the world, the bank aspires to boost the businesses of industries and SMEs.

9.6.1 Objectives of EXIM Bank

Within the framework of the basic aim of the Bank,the objectives of the Bank may be summarised as under:

i. Provision of financial, technical and administrative assistance in the export-import sectors;

ii. Planning, promotion, development and financing of export oriented concerns;

iii. Undertaking and financing research,surveys and techno-economic studies in connection with the promotion and development of foreign trade;

iv. Collection, compilation and dissemination of market and credit information in respect of international trade.

9.6.2 Operations of EXIM Bank

The operations of EXIM Bank are grouped as below:

A. Export Credits

- Bank provides exports of Indian machinery, manufactured goods, consultancy and technology services on deferred payment terms.
- Lines of credit/buyer's credits are extended to overseas entities i.e. governments, central banks, commercial banks for financing export of goods and services from India.

B. Export Capability Creation Programmes

- Export Product Development Programme
- Export Marketing Finance Programme
- Export Oriented Units
- European Community Investment Partners(ECIP)
- Asian Country Investment Partners(ACIP)
- Overseas Investment Finance Programme
- Export Facilitation Programmes
  1. Software Training Institutes
  2. Minor Ports Development

C. Export Services

In addition to finance, the bank provides a range of information and advisory services to Indian companies to supplement their efforts aimed at globalisation of Indian business.

9.6.3 Organisation of EXIM Bank

The operations of the Bank are governed by a Board of Directors. The Board of Directors consists of a chairman, a managing director, two deputy managing directors; one director each nominated by the Reserve Bank of India; IDBI Bank Ltd. and Export Credit Guarantee Corporation of India Ltd.; and not more than 12 directors nominated by the Central Government of, whom 5 directors are Central Government officials; not more than 3 directors are from commercial banks; and up to 4 directors are professionals with experience in export/import or financing.

9.6.4 Functions of EXIM Bank

The EXIM Bank provides two types of assistance:

A. Funded Assistance

B. Non-Funded Assistance

A. Funded Assistance: Funded assistance is provided to Indian exporters to enable them to operate in international markets .In particular it includes the following:

I. Loans to Indian Companies

a) Direct financial assistance to exporter in the form of medium term credit to enable them to extend deferred credit to overseas buyers;

b) Overseas investment finance to enable Indian promoters of overseas joint ventures to finance equity participation in the form of export of plant and machinery or cash remittances;

c) Technology and consultancy services;

d) Pre-shipment credit to finance export contracts for capital goods.

II. Loans to Foreign Governments, Companies and Financial Institutions

a) Overseas buyers credit directly to foreign importers for import of Indian capital goods and related services;

b) Lines of credit to foreign governments and financial institutions for import of Indian capital goods and related services;

c) Re-lending facilities to bank overseas to enable them to provide term finance for import of Indian capital goods.

III. Loans to Commercial Banks in India

a) Export Bills rediscounting facility;

b) Refinance of export credit

B. Non-Funded Assistance: Non-funded assistance is provided in the form of guarantee in association with Indian commercial banks on behalf of Indian exporters/contractors in favour of overseas importers/employers and banks. These guarantees are in the form of:

a) Bid bonds: Bid Bond is generally issued for a period of six months.

b) Advance Payments Guarantee: Exporters are expected to secure a mobilisation advance of 10-20% of the contract value which is normally released against bank guarantee and is generally recovered on a pro-rata basis from the progress payments during project execution.

c) Performance Guarantees: Performance Guarantee for 5-10% of contract is issued,valid up to completion of maintenance period,normally one year,after completion of contract period and/or grant of Final Acceptance Certificate (FAC) by the overseas employer. Format of guarantee is expected to be furnished by exporter, at least four weeks before actual issue to facilitate discussions and formal approval.

d) Retention money guarantees: This enables the exporters to obtain the release of retention money (normally 10% of contract value) before obtaining Final Acceptance Certificate (FAC) from client.

e) Guarantee for Raising Finance Abroad: Bridge finance may be needed at the earlier phases of the contracts to supplement

the mobilisation of advance. Bridge finance up to 25% of the contract value may be raised in foreign currency from an overseas bank against this guarantee issued by a bank in India. Request for overseas borrowings must be supported by currency-wise cash flows, also indicating the outstanding letters of credit and L/C drawal schedule.

f) **Other Guarantees:** Example: in lieu of custom duty or security deposit for expatriate labour.

g) **Guarantee Commission:** It is charged at rates stipulated by the Foreign Exchange Dealers Association of India (FEDAI) or as stipulated by guarantee issuing bank. Margin requirement for issue of guarantee is generally waived by banks for Export Performance Guarantee.

9.6.5 Financing of EXIM Bank

EXIM Bank offers a range of financing programmes at various stages of the export cycle covering: Export Product-Export Product Development-Import Finance-Advisory Services-Investing Abroad-Post Shipment –Pre Shipment –Export Marketing

Exim Bank extends pre-shipment/post-shipment credit either directly or in participation with commercial banks.

Pre-Shipment Finance: It refers to the credit extended to exporters prior to the shipment of goods for the execution of export order. It is issued by a financial institution when the seller wants the payment of the goods before shipment. Thus it is provided to the exporters for the purposes like purchase of raw materials, their processing and converting into finished goods and packaging them.

The main objectives behind pre-shipment finance:

- Procure raw materials
- Carry out manufacturing process
- Provide a secure warehouse for goods and raw materials
- Ship the goods to the buyers
- Meet other financial cost of the business.

The following are the types of Pre-Shipment Finance:

a) **Packing Credit:** It is a loan or advance granted to the exporter for purchase of raw materials/processing/packing based on Letter of Credit (L/C) opened in his favour by the importer. The L/C confirmed order will be retained by the bank and will be endorsed accordingly indicating that packing credit has been availed by the exporter. The advance is provided to purchase raw materials, process, manufacture, pack, market and transport the required goods and services.

b) Advance against incentives receivable from Government covered by ECGC guarantee:

c) Advance against cheques/draft etc. representing advance payment.

Special mode of Pre-Shipment Finance:

Pre-Shipment Credit in Foreign Currency (PCFC): Authorised dealers are permitted to extend Pre-Shipment Credit in Foreign Currency (PCFC) with an objective of making the credit available to the exporters at internationally competitive price. This is considered as an added advantage under which credit is provided in foreign currency in order to facilitate the purchase of raw material after fulfilling the basic export orders.The rate of interest of PCFC is linked to London Interbank Offered Rate (LIBOR).The exporter has freedom to avail PCFC in convertible currencies like USD,Pound,Sterling,Euro,Yen,etc.However the risk associated with the cross currency transaction is that of the exporter.

Post-Shipment Finance: It refers to the credit extended to the exporters after the shipment of goods for meeting working capital requirement. It serves as a bridge loan for the period between shipment of goods and the realization of proceeds.

Post-shipment finance can be extended up to 100% of the invoice value of the goods. However, banks are free to stipulate margin requirements as per their lending norms.

It can be availed of either in Indian rupees or by using the rediscounting of export bills abroad scheme. Even though post-shipment finance is working capital finance, it may be offered on short-term basis or on a long-term basis depending upon the payment terms offered by the exporter to the overseas buyer.

Post-shipment finance (short-term) is extended to the exporters after the shipment of goods for meeting working capital requirement. Post-shipment credit (medium and long-term) is granted to the exporters for exports on deferred payment terms for a period of over one year. Post-shipment finance (short-term) is generally granted for the following purposes:

a) To provide working capital so as to fill up the gap between the shipment of goods and realisation of sales proceeds.
b) To pay insurance charges for insuring goods against perils of sea.
c) To pay ECGC premium for insuring commercial and political risks.
d) To pay commission and brokerage to overseas agents and distributors.
e) To undertake export promotion activities and advertising.
f) To pay custom duties, port charges and export duty, if any.
g) To pay marine freight and other shipping charges.
h) To pay for participation in international trade fairs and exhibitions.
i) To undertake market survey abroad and send trade delegations.

9.6.6 EXIM Bank-a catalyst for India's International Trade

The EXIM Bank an apex financial institution in the country tofinance, facilitate and promote India's international trade, has constantly strived to contribute towards India's globalisation efforts. With strong business fundamentals and in line with the increasingly competitive global trading environment, the Bank proactively seeks

to enhance the competitive edge of Indian companies through a comprehensive range of financing programmes and advisory and support services which encompass all stages of the export business cycle. Towards facilitating inclusive globalisation, the Bank is also involved in creating export capability in small and medium enterprises, grassroots business enterprises and agro industries.

With India amongst leading global services exporters, the Bank has played a pivotal and pioneering role in catalysing India's software exports since the mid-1980s, while the Bank's support to Indian engineering and consultancy services has added to the momentum in the significant growth in India's overall services exports witnessed in recent years.

It plays a four-pronged role with regard to India's foreign trade, those of a coordinator, a source of finance, consultant and promoter.

Exim Bank offers a diverse range of financing services for the Indian exporter, including a variety of Export Credit Facilities and Finance for Export Oriented Companies. Exim Bank's mission is to facilitate globalisation of Indian business.

The Bank offers a range of financing programmes that match the menu of Exim Banks of the industrialised countries. However, the Bank is a typical in the universe of Exim Banks in that it has over the years evolved,so as to anticipate and meet the special needs of a developing country.The Bank provides competitive finance at various stages of the export cycle.

The Bank finances export of Indian machinery,manufactured goods,consultancy and technology services on deferred payment terms. It also seeks to co-finance projects with global and regional development agencies to assist Indian exporters in their efforts to participate in such overseas projects.

The Bank is involved in promotion of two-way technology transfer through the outward flow of investment in Indian joint ventures overseas and foreign direct investment flow into India. It is also a partner institution with European Union and operates for facilitating

promotion of joint ventures in India through technical and financial collaboration with medium-sized firms of the European Union.



CHECK YOUR PROGRESS

Q 4: Where is the head office of Exim Bank and when it was set up?

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Q 5: Who governs the operations of the Exim Bank?

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Q 6: What is meant by Funded Assistance?

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9.7 LET US SUM UP

In this unit we have discuss the following points-

- Trade finance represents the financial instruments and products that are used by companies to facilitate international trade and commerce.
- Trade finance makes it possible and easier for importers and exporters to transact business through trade.
- There are four sources of finance to International Trade-.Commercial Banks,International Agencies and Development Bank, International capital market and specialised house or institutions.
- Trade finance offers several mechanisms to facilitate and assure timely, authorised and secure payment in the course of a transaction.
- EXIM has been both a catalyst and a key player in the promotion of cross border trade and investment.
- The operations of EXIM Bank are grouped asExport Credits, Export Capability Creation Programmes and Export Services.

- The operations of the Bank are governed by a Board of Directors.
- The Exim Bank provides two types of assistance:Funded assistance and Non-funded assistance.
- EXIM Bank offers a range of financing programmes at various stages of the export cycle.
- Pre-Shipment finance refers to the credit extended to exporters prior to the shipment of goods for the execution of export order.
- Post-Shipment financeIt refers to the credit extended to the exporters after the shipment of goods serving as a bridge loan for the period between shipment of goods and the realization of proceeds.
- The EXIM Bank has constantly strived to contribute towards India's globalisation efforts proactively seeking to enhance the competitive edge of Indian companies through a comprehensive range of financing programmes and advisory and support services which encompass all stages of the export business cycle.



9.8 FURTHER READING

1) International Business by V.K. Bhalla
2) International Trade by Vishal Kumar.



9.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The bill of lading is a legal document issued to the exporter by a common carrier transporting the merchandise.

Ans to Q No 2: A letter of Credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount.

Ans to Q No 3: It is a form of international trade where goods are exchanged for other goods, in place of hard currency.

Ans to Q No 4: Mumbai, 1982

Ans to Q No 5: The operations of the Bank are governed by a Board of Directors.

Ans to Q No 6: Funded assistance is provided to Indian exporters to enable them to operate in international markets.

9.10 MODEL QUESTIONS

Q 1: What is meant by Trade Finance? What are the various sources to international trade?

Q 2: Discuss the objectives and functions of EXIM Bank.

Q 3: Write a short note on: Mechanism of International Trade Finance.

Q 4: Enumerate the role of EXIM Bank in promoting international trade.

Q 5: Discuss the Pre-shipment and Post-shipment financing of EXIM Bank.



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UNIT 10 : FINANCING FOREIGN TRADE

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Export Finance

10.4 Per shipment credit

10.5 Pre-Shipment Finance

10.6 Post-Shipment Finance

10.6.1 Negotiation of Bills Under Letter of Credit

10.7 Sources of Short-Term Export Finance

10.8 Medium and Long-Term Finance

10.9 Forfaiting

10.10 Importance of Export Finance

10.11 Let Us Sum Up

10.12 Further Reading

10.13 Answer to Check Your Progress

10.14 Model Question

10.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain pre-shipment finance
- explain post-shipment finance
- discuss the sources of short term export finance
- know the importance of export finance

10.2 INTRODUCTION

Foreign trade or international trade refers to the exchange of goods and services between different countries or trade across the political boundaries. It is to be distinguished from domestic trade which is conducted within the country. The basic task of financing foreign trade is similar to that of home trade. However, there are complexities in financing foreign trade

arise out of difference in currencies, differences in practices, differences in regulations, lack of personal contact between buyers and sellers etc.

In this unit we will discuss the procedure of financing foreign trade, specially export financing.

10.3 EXPORT FINANCE

Finance is the basic requirement of all business activities. It is treated as the life blood of any business activity. The need for export finance arises as soon as the exporter received export order. Exporters should plan in advance is arranging export finance from the beginning and to the end of the export trade for sanctioning export finance. Export financing is a complicated lending transaction because is involved traders of two countries and foreign exchange transactions. The credit required by an exporter from a banker is broadly divided into two categories, viz (i) Pre-shipment credit, and (ii) Post-shipment credit.

According to RBI pre-shipment credit means “any loan to an exporter for financing the purchase, processing, manufacturing or packing of goods.”

On the other hand Post- shipment Credit means any loan or advance granted or any other credit provided by a bank to an exporter of goods from India after the shipment of goods to the realization of the export proceeds. Thus the dividing line between the two types of export credits is the date of shipment.

10.4 PER SHIPMENT CREDIT

When an exporter receives an export order, the goods to be exported may not be readily available with him for shipment. The exporter needs to produce or procure the goods. For the purpose, he has to purchase the raw materials, semi-finished goods, process/manufacture the same, or may procure the goods from their suppliers, pack them and dispatch them to the port town. The funds required for all these purposes are called pre-shipment credit.

Pre shipment credit is given by the commercial banks for purchasing and processing of materials, manufacturing of exportable commodities and packing of such commodities. Pre-shipmen credit is granted by the commercial banks for a period of 180 days from the date of sanctioning the credit. Further extension will be given for a period of 90 days, provided adequate reasons are given by the exporters for such extension.

Exporters should give an undertaking that the advance will be used exclusively for the purpose of procuring /manufacturing/ shipping of commodities means for export as given in export order of Letter of Credit. Banks will sanction the pre-shipment credit after verifying all the documents required for it. The credit worthiness of the exporter, their capacity to produce exportable commodities and the reputation of the organisation are also assessed by the banks before sanctioning pre-shipment credit. Exporters are advised to get appropriate insurance policy for export credit form the Export Credit Guarantee Corporation (ECGC).

Bank provide credit on the following basis

(i) A letter of credit opened by the importer in favour of the exporter, or

(ii) A confirmed and irrevocable order for the export of goods from India, or any other evidence of such an order.

10.5 PRE-SHIPMENT FINANCE

Pre-shipment means any loan or advance granted or any other credit provided by a bank to an exporter for financing the purchase, processing, manufacturing or packing of goods prior to shipment, on the basis of letter of credit opened in his favor or in favor of some other person, by an overseas buyer or a confirmed and irrevocable order for the export of goods from India or any other evidence of an order with the exporter. The maximum period for which any loan on advance may be granted or any other credit facility may be provided does not usually exceed 180 days, on such extended period as the central bank of the exporting country may allow. Normally, there are two ways open to an exporter to obtain license as the pre-shipment stage. They are anticipatory letters of credit and packaging credits.

Pre-shipment Finance in Foreign Currency

Exporters can get pre-shipment finance in foreign currency from commercial banks. Exporters can use the foreign currency for the purpose of importing necessary raw materials and other inputs for manufacturing exportable commodities. Pre-shipment finance in foreign currency is made available to the exporters who have a fire export order or a letter of credit. This type of financial arrangement is provided by banks for a maximum period of 180 days. Pre-shipment finance in foreign currency can be obtained any authorised dealers in foreign exchange. Commercial banks provide pre-shipment finance to the exporters against the security of (i) Pledge,(ii) Hypothecation(iii) Export Trust Receipt, (iv) Incentives Receivables, (v) Red Clause Letter and (vi) Back-to-Back Letter of Credit Banks will insist exporters to take appropriate export credit, insurance policy from the export credit guarantee corporation of India limited, for providing pre-shipment finance. The following documents are required for getting pre-shipment finance from banks;(i) Confirmed export order,(ii) letter of credit,(iii) policy of export credit guarantee corporation,(iv) copy of audited financial statement and income tax assessment, v) copy of the CNO exporter code number and (vi) copy of the registration –cum membership certificate issued by an exporter promotion council.

Anticipatory Letters of Credit

Anticipatory letters of credit is also known as red clause letters of credit. It is a normal letter of credit, which contains a special clause (usually typed in red) authorizing the negotiating or confirming bank. The red clause of letter of credit is generally opened to enable the exporter to procure material and executed the foreign buyer's order without looking up to much of his own funds. The advance made to the exporter is of course as the risk of the opening bank and in restricted to the amount authorised in the red clause letter of credit. The bank must ensure that there are proper instructions on the red clause letter of credit as regards reimbursement of the amount to be advanced to the exporter. Generally, the reimbursement of the amount to be advanced to the exporter under a red clause letter of credit is provided by the negotiation of clear draft under the letter of credit, in which case the

invoice submitted as the time of the negotiation of the documents should show a deduction to the extent of the drawings already made. Before advancing against a red clause letter of credit, it is advisable to ensure that the bank will be is a position to negotiate the bills drawn under the letter of credit.

Packing Credit

Packing credit is essentially a loan or advance granted a bank to an exporter to assist him in buying, packing and shipping the goods. These advances are generally made by commercial banks in different forms.

Forms of Advances

The main form of financing the exports as the pre-shipment stage is:

(1) Loans

(2) Overdrafts, and

(3) Cash credit

(1) Loans

Under loan account, the entire amount is paid to the borrowed either in case or by transfer to his current as one time. Generally, its repayment is stipulated by installments. The main advantage of the loan system is that the loans are for predetermined short periods and have a built-in-programme of repayment. They are automatically reviewed by banks on the due dates. The main disadvantage of the system is in its inflexibility and the need for borrowers to negotiate fresh loans every time. Verification of the ultimate use of funds in difficult in this system compared to the case credit system.

(ii) Overdrafts

An overdraft is a fluctuating account and its balance is sometimes in credit and sometimes in debit. Cheques drawn on a current overdraft arrangement enabled a customer to draw over and above his own balance up to the extent of the limit stipulated. Drawings and repayments are permitted as needed by the customer, provided the total amount overdrawn does not exceed the agree limit.

(iii) Cash Credit

Cash credits are ordinarily allowed against pledge or hypothecation of goods against personal security. If there is a good turnover in the account

and quick movements of goods, a cash credit limit is renewed periodically. The cash credit system has the advantage of flexibility. It enables the borrower as to route all their cash earnings through the account and keep drawings as the minimum level, thereby minimizing interest charges. The main disadvantage of the system is that the banks may find is difficult to ensure the end-use of funds due to its emphasis or the security aspect and the roll-over nature of credits.



CHECK YOUR PROGRESS

Q 1: What are the types of credit required by an exporter?

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Q 2: What is mean by Packing credit?

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10.6 POST-SHIPMENT FINANCE

Post-shipment finance is defined as any loan of advance granted or any other credit provided by an institution to an exporter of goods from India from the date of extending the credit after shipment of goods to the date of realization of export proceeds, in consideration or on the security of any drawback on any case payment by way of incentive from the market development assistance or any other relevant source. Need for post-shipment credit arises after the exporter has shipped the goods and has secured the shipping documents, such as bill of lading, etc. Now, the concern of the exporter is to realize his dues from the foreign importer. This is invariably done by drawing a bill of exchange on the importer. Thus post-shipment finance is given against-

1. Export bills drawn on foreign buyers, and
2. Export case incentives to be received by the exporter.

10.6.1 Negotiation of Bills Under Letter of Credit

The risk of uncertainty about receiving payment in foreign trade is largely mitigated by securing a letter of undertaking from the banker of the importer. Such letter is called, Letter of Credit (L/C) which plays a very important role in financing the foreign trade. A Letter of Credit is defined as a letter issued by the banker of the buyer, at the latter's request, in favour of the seller (exporter) informing him that the issuing banker undertakes to accept the bills drawn in respect of exports made to the buyer specified therein. It is thus, a written intimation from the banker issuing it, that they have been instructed to open a credit for a certain amount of goods to be exported under certain terms and conditions. The importer at whose request the L/C is issued is called the applicant, the exporter is called the beneficiary and the banker issuing it is called the issuing banker.

When a bill of exchange is drawn under a letter of credit, it may be negotiated with any banker in the exporter's country. But if the L/C mentions the name of any. Particular bank for the purpose of negotiation, it must be negotiated only with that banker.

By negotiation we mean that the negotiating banker (i.e. the banker through whom the. Export bills are sent to the importer), pays to the drawer the value of the bill on the basis of the undertaking given by the opening banker.

Bills of exchange either in Indian rupees of foreign currencies under a letter of credit of otherwise are offered to banks for negotiation such as sale of discount. Normally, the bills drawn against a letter of credit are accepted without any difficulty due to the fact that banks do not have any risk depends, the negotiation of bill depends upon the following factors:

i. **Credit Rating**: Status report on both drawee and drawer in terms of both financial and moral standing in the prime consideration in accepting a bill for negotiation.

ii. **Product characteristics**: The nature, quality and price of the export product also influence the banker's decision in accepting a bill. for instance, banks will accept the bill if the product is of international standard and quality and offered as most competitive rates and bas good demand abroad.

iii. **Documentary requirements**: In case of documentary bill, the banks will examine the documents like bill of lading and invoice or various aspects such as whether the bill is supported by all the documents mentioned in the letter of credit.

iv. **Rate of Negotiation**: The rate of negotiation mainly depends upon the currency in which the bill is drawn, the banking organization in the country concerned period of maturity etc. the banker treats the negotiation of until the final remittance is received. The banks consider the following factors are calculating such a rate:

   a. Prevailing rate of interest,
   b. The period which the bill has to run before maturity,
   c. Stamp duty to which the bill is liable in the foreign centre,
   d. Charges for collection which the foreign banks may make,
   e. An appropriate allowance for possible delays of mails or other contingencies and the banker's own profit over the transaction.

v. **Collection of bills**: the Sight Documents against payment as well as usance bills documents against acceptance can be offered to the banks of collection basis. Banks send such bills to their foreign branch for collection of payment. Banks may give advance against such bills and is may take the following forms:

   a. Cent percent advance: Bank may discount the bill of exchange by advancing to the drawer the full face value of the bills if a rupee bill of exchange has been drawn and received by the bank for discount with instructions

from the drawees that in addition to face amount of the bill, the drawee is to pay interest, collection charges and foreign bill stamps.

b. Percentage of advance: the usual procedure is that the bank will advance up to a certain percentage of the amount of cash bill of exchange depending upon the integrity and financial standing of the drawer. Besides, the collection charges are made on the full value of the bill.

c. Percentage advance against pending collection: under this system the drawer limit is calculated as a percentage times of outstanding amount and the customer can draw, if he needs, up to the amount indicated by the drawing limit.

10.7 SOURCES OF SHORT-TERM EXPORT FINANCE

The mail sources of short-term export finance are discussed below;

1. **Foreign Trade Financed by Exporter :** This is one of the sources of export credit buy very few exporters will employ their capital to finance to finance for export. Exporter will employ this method when he is financially sound and he may consider supplying goods to the importer on the basis of credit. In this situation, exporter will provide credit to the importer on the following terms:

   i. **Open Current Account**: Generally, this method will operate between the exporter and importer who have long-term dealings. Exporter sends the letter of rights to the importer. Importer makes payment within appointed time on the basis of the exporter's letter of rights. Interest is charged as certain rates if the importer delays the payment beyond the agreed time limit.

   ii. **Open Account**: Exporter ships the goods without financial documents to his advantage except commercial invoice. Sales on open account are settled through agreed periodic remittances. Considerable risk is involved in the open account

method as seller carries no documentary evidences of transaction with him. Hence, this method is generally confined to interrelated companies.

iii. **Payment by return mail**: Under payment to return mail method, the seller ships the goods and a shipment advice is sent to the importer. The importer must make the remittance immediately of receipt of shipment advice.

iv. **Payment against bills of exchange:** under this method, the exporter ships the goods to the importer on the basis of bills of exchange drawn or importer's name. In addition to documentary bill of exchange, invoice, shipping bill and insurance are enclosed. The exporter sends the bills of exchange directly or through the bank for collection of payment.

2. **Foreign Trade Financed by the Exporter with the Assistance of his Bank :** Under this category, exported obtains bill of exchange from the importer which will remain with his for a certain period of time. After the expiry period the exporter accepts payment from the importer. Besides, the exporter can discount the bill from any commercial bank for finance if he needs finance before the expiry period of the bill.

3. **Foreign Trade Financed by the Importer :** The following are the main types of short-term credit given to the exporter by the importer.

(i) **Payment of placing orders**: The importer makes full payment in advance of placing fire orders with the exporter

(ii) **Cable transfers**: Under this system, a cable message will be send to the importer by the exporter once the goods are ready for dispatch. On the receipt of the cable message, payments are made to the exporter

(iii) **Payments through confirming houses**: Resident Buyer or a Forwarding Agent may be confirming houses. The payment will be made by the confirming houses to the exporter on the basis of fire order by the importer. However, exporter will be prepared to accept payment on the basis of credit worthiness of confirming houses.

4. **Foreign Trade Financed by Importer with Bank Assistance :** The exporter can get import finance through a bank by any of the following two methods:

   (i) Bills of Exchange: Documentary bill of documentary draft is one of the main methods of payment in export trade. Under this system, the exporter has to draw a bill of exchange on the buyer, payable as sight when no trade credit is being extended or payment as some future date to take care of inherent credit terms. The exporter is supposed to submit the bill with documents of title namely, commercial and custom invoices marine insurance policy. The sets of document are to be surrendered to the importer of the payment of the bill in respect to sigh bill the amount is realized and remitted back to the exporter's bank account. But, in time bill, after the bill in accepted by the importer is returned to the exporter's bank to be presented again to the buyer for payment on the date of maturity.

   (ii) Letter of credit Under letter of credit method, the exporter why desired to get an assurance of payment against documents usually stipulated in his contract with the overseas imported by means of banker's letter of credit which enables the exporter to obtain immediate payment of his invoice against shipping documents. The two main kind (i) irrevocable letter of credit and (ii) Revocable letter of credit, at Irrevocable letter of credit in one which after issuance cannot be cancelled without the consent of parties concerned- A Revocable letter of credit can be altered or cancelled as any time without any consent or reference to the beneficiary or seller or exporter

5. **Foreign Trade Financed by Banks :** Under this category, on the basic of the request of the importer, the bank opens documentary credit and makes payment to the exporter by obtaining the documents. The bank accepts the bills drawn by the exporter and the exporter gets the accepted bills discounted and gets the short-term finance

6. **Foreign Trade Financed by Accepting Houses :** The main function of an accepting house is to accept the bills drawn by the exporters. Normally, the imported and Accepting house will have a written agreement is which the house accepts the bill drawn by an exporter. Accepting house accepts commission for its work from the importer. After sending the acceptance from Acceptance house, the exporter gets such bills discounted and gets Payments.
7. **Foreign Trade Financed by Discount Houses :** Discount houses are trading houses engaged in discounting of bills. The Discount houses discount the bill if it is accepted by any accepting house. Further, the Discount house discounts the bill on the basis of credit worthiness and financial soundness of the exporter as well as importer even if the bill is non-accepted by an Accepting house.

10.8 MEDIUM AND LONG-TERM FINANCE

Long-term finance refers to the credit facility extended up to a period from five to twenty years. It is provided for long-term development activities such as purchase of capitalized heavy items such as ship-building purchase of electric machines, heavy engineering goods, etc. Long-term finance generally involved higher levels of risk that short term finance. Hence the interest rate for long term finance is more that other forms of credit. The World Bank International Monetary Fund, international Development Association and Asian Development Bank are some of the international financial institutions granting long term credit. The main purposes of long-term credit for both exporter and the importer are presented below:

(1) To import and export of capital goods.
(2) To provide credit facility on liberal terms to the importer.
(3) To execute the export promotion programme.
(4) To establish new enterprise and
(5) To make capital investment in other countries.

The medium and long term credit can be divided into two. They are:

(1) Supplier's Credit.

(2) Buyer's Credit

Suppliers Credit: Under this system the Indian exporter will offer credits to the overseas buyer. The exporter can on the other hand secure reciprocal credits from the commercial banks which in turn can get refinance from the EXIM Bank.

Buyer's credit: It is a means of financing an export transaction involving capital goods and equipment of large value or complete turnkey projects on long term credit. Loan is extended by a bank or other financial institutions in the supplier's country to the overseas buyer why in thus in a position to pay case for the supplier received. The loan is guaranteed by the buyer's bank or often extended to the buyer's bank itself for the specific purpose in view. The main two points to be made in this connection are: (i) supplies get his money if he fulfils his responsibility, and (ii) there is no involvement of transfer of funds from one country to another.

10.9 FORFAITING

The term Forfait is derived from the French meaning the surrender of rights. Forfaiting is non-recourse discounting of export bills. Forfaiting is one of the forms of financing to the exporters. The export-import bank of India is authorised by RBI to undertake forfeiting for export financing. Alan C Shapiro in his book "Multinational Financial Management" has defined Forfaiting as "the discounting as a fixed rate without recourse of medium term export receivables denominated in fully convertible currencies." Example, ABC Co Ltd has exported to a buyer in London and ABC Co Ltd will get export payment after 5 months. In this situation, under forfeiting, ABC Co Ltd can get export bill discounted with a forfaiting agency, through EXIM Bank. The forfaiting agency will pay the amount after deducting a few commitment fee, discount fee and documentation fee prescribed for forfeiting.



CHECK YOUR PROGRESS

Q 3: Define Letter of Credit.

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.....

Q 4: What is mean by negotiation?

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.....

10.10 IMPORTANCE OF EXPORT FINANCE

The importance of export finance is present below

1) **It enhances exports in the competitive market**; export finance paves the way to increase exports. Increasing exports are essentials for a developing as well as developed country. But export market is operating in the competitive environment. Hence, the government or banking institutions usually extend concessional credit to its exporters, who are need of such credits to fulfill their export obligations.

2) **Technological Development**: the degree of technical know-how is very low in less developed and developing countries. So, less developed countries hire the services from other developed countries but their charges are very high. Huge finance is needed to the less developed countries to repay service charges. Export finance is needed to pay such charges.

3) **Easier terms and conditions**: if the credit is available on easier terms, exporters will be in a position to sell the goods to the importer on easier payment terms.

4) It is a source for the economic development of nation. Developing countries are having deficiency of foreign exchange reserve to copy with their development needs. Exporters obtain long-term export credit from specialized financial institutions to meet import commitments. Thus, export finance does not create pressure over foreign exchange position and help for economic development.

5) **Balanced growth**: The deficiency of finance is one of the main constraints for economic development of developing countries. In this context, export finance contributed to economic development and helps to establish balanced industrial development of different nations

6) It reduces adverse balance of payments. Adverse balance payment creates serious consequences on development activities of any nation. With sufficient export finance, the manufacturers of a country may produce more and export more to different markets in the world. Increase in export earnings will help to solve balance of payment of crisis.

7) It helps for sales promotion. The various sales promotion programme like advertising, publicity, trade fairs and exhibitions, etc., need adequate fiance. Export finance can be used for undertaking aggressive export promotion measured to increase export market.

8) It enhances customer service. Export finance is needed for product adaptation, improvement of quality, adding new uses to the product and to use an appropriate pricing method to increase export performance.

9) Export finance fulfils short, medium and long-term financial needs. Exporters need short-term medium-term and long term finance to meet their production and distribution requirements. Banks provide short-term credit extending to a period up to one year, and other terms of financial needs are met from other national and international financial institutions. Long-term credit helps to bring modernization and adoption of latest technology.



10.11 LET US SUM UP

In this unit we have discuss the following points-

- The need for export finance arises as soon as the exporter received export order.

- The credit required by an exporter from a banker is broadly divided into two categories, viz (i) Pre-shipment credit, and (ii) Post-shipment credit.
- Exporters can get pre-shipment finance in foreign currency from commercial banks.
- Long-term finance refers to the credit facility extended up to a period from five to twenty years.
- Forfaiting is non-recourse discounting of export bills.



10.12 FURTHER READING

1) International Business by V.K. Bhalla
2) International Trade by Vishal Kumar.



10.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The credit required by an exporter from a banker is broadly divided into two categories, viz (i) Pre-shipment credit, and (ii) Post-shipment credit.

Ans to Q No 2: Packing credit is essentially a loan or advance granted a bank to an exporter to assist him in buying, packing and shipping the goods.

Ans to Q No 3: A Letter of Credit is defined as a letter issued by the banker of the buyer, at the latter's request, in favour of the seller (exporter) informing him that the issuing banker undertakes to accept the bills drawn in respect of exports made to the buyer specified therein.

Ans to Q No 4: By negotiation we mean that the negotiating banker (i.e. the banker through whom the. Export bills are sent to the importer), pays to the drawer the value of the bill on the basis of the undertaking given by the opening banker.



10.14 MODEL QUESTIONS

Q 1: Discuss the mail sources of short-term export finance.

Q 2: Discuss the importance of export finance.

Q 3: Discuss the factors on which negotiation of bill depends.

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UNIT 11 : INTERNATIONAL MONETARY FUND

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Bretton Woods System-Pre History

11.4 Bretton Woods System

11.5 Objectives of IMF

11.6 Organizational Structure and quota

11.7 Role and Functions of IMF

11.8 Credit Facilities

11.9 Let Us Sum Up

11.10 Further Reading

11.11 Answers To Check Your Progress

11.12 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- know the Bretton Woods system
- explain the Objectives of IMF
- know the Organizational Structure and quota of IMF
- discuss the Functions of IMF

11.2 INTRODUCTION

After the First World War (1919-1931), the world faced the Great Depression of thirties between 1929-1936. Price, profit, employment, production and income of the leading countries fell very low. World War II (1939-1935) further disrupts the pattern of international trade and dislocates the economies of the world. Therefore, the monetary authorities of the world felt the need for international cooperation to establish a stable international monetary order. As a result International Monetary Fund was established.

In this unit we will discuss the objectives and functioning of International Monetary Fund.

11.3 BRETTON WOODS SYSTEM-PRE HISTORY

The International Monetary Fund (IMF) is an international monetary institution created in July 1944 at the United Nations Bretton Woods Conference in New Hampshire, United States. Total 44 countries of the world attend the conference and sought to build a framework for international economic cooperation and avoid repeating the competitive currency devaluations that contributed to the Great Depression of the 1930s. The primary objective of IMF is to ensure exchange rate stability and increasing liquidity for promoting balanced multilateral trade among the member nations.

In the 1930s several conferences held dealing with the world monetary problems caused by the Great Depression and First World War. But all these conferences fail to bring stability in the world economy. But after dislocating the economies of the world by World War II, the need for a stabilizing system became evident. Plans were made for an innovative monetary system and a supervising institution to monitor all actions. First negotiations took place under wartime conditions.

In 1944 an international conference took place in Bretton Woods, New Hampshire United States. 44 countries attended this conference in order to restructure international finance and currency relationships. The participants of this conference created the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD/World Bank). The Bretton Woods System provided a compromise between fixed and floating exchange rate system and they agreed on implementing a system of fixed exchange rates with the U.S. dollar as the key currency. The U.S. undertook to exchange gold for dollars with foreign central banks at a fixed rate. The new system aimed at- (a) establishing international harmony and exchange rate stability associated with the gold standard; (b) allowing individual countries the freedom to pursue their own macroeconomic policy.

The IMF was officially established on December 27, 1945, when the 29 participating countries at the conference of Bretton Woods signed its Articles of Agreement. It commenced its financial operations on March 1, 1947. The IMF is an international organisation, which today consists of 189 member countries. With its **Headquarters at** Washington, D.C.

11.4 BRETTON WOODS SYSTEM

The Bretton Woods System permitted their member countries some degree of flexibility within a limited band (or range) of exchange rate fluctuations. So the Bretton Woods System may also be called as band system. Under this system, the currency is allowed to fluctuate between an upper limit and a lower limit of exchange rate around the established par value. But it was not allowed to move outside this band. So long as the exchange rate moves within the band the monetary authority does not intervene. It is only when the exchange rate hits the ceiling or the floor of the band the monetary authority will intervene.

The Bretton Woods system that the IMF was to supervise rested on two main things, viz., the maintenance of stable exchange rate system and a multilateral credit system.

The IMF would organize the system, consult with member countries about exchange rate changes and create international liquidity when needed. The problem faced in the attempt to return to gold standard had made it evident that an attempt to maintain a fixed exchange rate through it was not a correct way.

Members of IMF came to a compromise that the members should keep their exchange rate within 1 percent of agreed par values, but that member could propose a change in the par value of its currency if it had a fundamental dis-equilibrium in its balance of payment.

The procedure used to maintain a currency within the agreed range, was that, the government was to buy or sell its domestic currency on the foreign exchange market as appropriate.

If the proposed change in the par value of a currency was less than 10 per cent then the IMF (monetary authority) could not object. But if it was

more than that then the member countries had to seek the Funds permission. Salient features of the system were:

- **Gold exchange standard:** Countries pegged their currencies to US dollar and US dollar was pegged to gold. Like this the dollar became the medium for the intervention in the foreign exchange market and the countries held a good portion of their reserves in dollars.
- The IMF made the arrangement for creating international liquidity. So each member had a right to borrow from the Fund in order to help it maintain its exchange rate within the specified range in the face of a temporary external deficit. The funds for such burrowing were provided by each member country was the quota of 25 per cent of gold and remainder in its own currency. This quota is strongly related with the country's economic and monetary importance affecting the value of its international trade.

The Bretton Woods System collapsed on 15th August, 1971 when President Nixon announced non convertibility of $ into gold. This was followed by the realization of an 'inverted triangle' pattern where base (gold) was very narrow while claims ($ in circulation) were vast.

11.5 OBJECTIVES OF IMF

International monetary fund (IMF) is an autonomous organization. Its Headquarters is in Washington. At present the IMF has 116 member countries. Former Soviet Block nations are not members of IMF. The governing body of IMF is a Board of Governors consisting of one representative and one alternate representative appointed by each member nation. The board of meets once a year and exercises its power in such important matters as joining of new members, revision on quotas, election of directors, etc., but it has delegated working authority to the board of executive directors. The board consists of 20 executive directors of whom 5 are nominated, one each by the five largest quota holding countries, USA, UK, Germany, France and India, of the remaining 15, three are elected by Africa, 3 by Latin America, 5 by the Far east and Pacific area and 4 by Continental Europe. The chairman of the Board of Executive Directors is

the Managing Director of the IMF.

There are three general objectives of IMF

- The elimination or reduction of existing exchange control.
- The establishment and maintenance of currency convertibility with stable exchange rate.
- The widest extension of multilateral trade and payments.

The objectives of the IMF as stated in Article of the IMF agreements as follows:

- To promote international monetary cooperation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems.
- To facilitate the expansion of balanced growth of international trade and to contribute there by, to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as the primary objectives of economic policy.
- To promote exchange stability, to maintain orderly exchange arrangement among members and to avoid competitive exchange depreciation.
- To assist in the establishment of a multilateral system of payment in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- To give confidence to members by making the funds available to them under adequate safeguard and, thus, providing them with opportunity to correct disequilibrium in their balance of payments without resorting to measures destructive of national or international prosperity.

  In accordance with above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.



CHECK YOUR PROGRESS

Q 1: In which year the IMF was established?

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Q 2: Mention one objective of IMF.

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11.6 ORGANIZATIONAL STRUCTURE AND QUOTA

The IMF's governing document, the Articles of Agreement, provides for a three-tiered governance structure with a board of governors, an executive board, and a managing director. The board of governors is the highest policymaking authority of the IMF. All countries are represented on the board of governors, usually at the finance minister or central bank governor level. Day-to-day authority over operational policy, lending, and other matters is vested in the board of executive directors, a 24-member body that meets three or more times a week to oversee and supervise the activities of the IMF. As the largest shareholder, the United States has its own seat on the executive board. The executive board or board of governors of the IMF can approve loans, policy decisions, and many other matters by a simple majority vote; however, a supermajority vote is required to approve major IMF decisions. The supermajority may require a 70% or 85% vote, depending on the issue. At 16.52% of total voting power, the United States has unique veto power over major policy decisions.

The primary source of IMF lending resources is the financial contributions or quota subscriptions of its member nations. A country's proportion of quota, or quota share, broadly reflects its weight in the global economy; larger economies have larger quotas. A member's quota also impacts the country's voting power at the IMF. Countries with larger quotas, and thus larger financial commitments to the institution, have a greater say in how the IMF is run. The United States contributes$117billion to the IMF quota (17.46%). Quotas are denominated in Special Drawing Rights (SDRs),

the IMF's unit of account. In addition, the United States has contributed$44 billion to funds at the IMF that supplement quota resources. India's current quota in the IMF is SDR (Special Drawing Rights) 5,821.5 million, making it the 13th largest quota holding country at IMF and giving it shareholdings of 2.44%. However, based on voting share, India (together with its constituency countries Viz. Bangladesh, Bhutan and Sri Lanka) is ranked 17th in the list of 24 constituencies at the Executive Board.

11.7 ROLE AND FUNCTIONS OF IMF

The IMF primarily plays the following roles-

- Promoting research in various areas of international economics and monetary economics.
- Providing a forum for discussion and consultation among member countries.
- Focusing on its core macroeconomic and financial areas of responsibility.
- Working in a complementary fashion with other institution established.

The functions of the IMF can be discussed as below:

1. **Exchange Stability:** The first important function of IMF is to maintain exchange stability and thereby to discourage any fluctuations in the rate of exchange. The Found ensures such stability by making necessary arrangements like—enforcing declaration of par value of currency of all members in terms of gold or US dollar, enforcing devaluation criteria, up to 10 per cent or more by more information or by taking permission from IMF respectively, forbidding members to go in for multiple exchange rates and also to buy or sell gold at prices other than declared par value.
2. **Eliminating BOP Disequilibrium:** The Fund is helping the member countries in eliminating or minimizing the short-period dis-equilibrium of balance of payments either by selling or lending foreign currencies to the members. The Fund also helps its members towards removing the long period disequilibrium in their balance of payments. In case of

fundamental changes in the economies of its members, the Fund can advise its members to change the par values of its currencies.

3. **Determination of Par Value:** IMF enforces the system of determination of par values of the currencies of the members countries. As per the Original Articles of Agreement of the IMF every member country must declare the par value of its currency in terms of gold or US dollars. Under the revised Articles, the members are given autonomy to float or change exchange rates as per demand supply conditions in the exchange market and also at par with internal price levels.

   IMF is exercising surveillance to ensure proper working and balance in the international monetary system, i.e., by avoiding manipulation in the exchange rates and by adopting intervention policy to counter short-term movements in the exchange value of the currency.

4. **Stabilize Economies**: The IMF has an important function to advise the member countries on various economic and monetary matters and thereby to help stabilize their economies.

5. **Credit Facilities**: IMF is maintaining various borrowing and credit facilities so as to help the member countries in correcting disequilibrium in their balance of payments. These credit facilities include-basic credit facility, extended fund facility for a period of 3 years, compensatory financing facility, buffer stock facility for helping the primary producing countries, supplementary financing facility, special oil facility, trust fund, structural adjustment facility etc. The Fund also charges interest from the borrowing countries on their credit. A brief discussion is made on various credit facilities of IMF in the last part of this unit.

6. **Maintaining Balance between Demand and Supply of Currencies**: IMF is also entrusted with important function to maintain balance between demand and supply of various currencies. Accordingly the fund can declare a currency as scarce currency which is in great demand and can increase its supply by borrowing it from the country concerned or by purchasing the same currency in exchange of gold.

7. **Maintenance of Liquidity:** To maintain liquidity of its resources is another important function of IMF. Accordingly, there is provision for the member countries to borrow from IMF by surrendering their own currencies in exchange. Again for according accumulation of less demand currencies with the Fund, the borrowing countries are directed to repurchase their own currencies by repaying its loans in convertible currencies.

8. **Technical Assistance:** The IMF is also performing a useful function to provide technical assistance to the member countries. Such technical assistance in given in two ways, i.e., firstly by granting the members countries the services of its specialists and experts and secondly by sending the outside experts.

   The IMF provides technical assistance in areas within its core mandate such as macroeconomic policy, monetary and foreign exchange policy and fiscal policy and management external debt and macroeconomic statistic.

   - The objective of IMF technical assistance is to contribute to the development of the productive resources of the member countries by adopting its economic policy and financial policy. IMF helps countries strengthen their human and institutional capacity.
   - The IMF provides technical assistance in three areas - (i) Designing and implementing fiscal and monetary policies (ii) drafting and receiving economic and financial legislation, regulation and procedures and (iii) Institution and capacity building such as in central banks, treasury, tax and customs departments and statistical services.

9. **Reducing Tariffs:** The Fund also aims at reducing tariffs and other restrictions imposed on international trade by the member countries so as to cease restrictions of remittance of funds or to avoid discriminating practices.

10. **General Watch**: The IMF is also keeping a general watch on the monetary and fiscal policies followed by the member countries to ensure no flouting of the provisions of the charter.

11. **Surveillance of the global economy:** The IMF is mandated to oversee the international monetary and financial system and monitor the economy and financial policies of its member countries. This activity is known as surveillance and facilitate international co-operation since the demise of the Bretton Woods system. Surveillance has evolved largely by way of changes in procedures rather than through the adoption of new obligations. The responsibilities changed from those of guardian to those of overseer of members' policies.

The IMF analyses the appropriateness of each member country's economic and financial policies for achieving orderly economic growth and assesses the consequences of these policies for other countries and for the global economy.

11.8 CREDIT FACILITIES

Members can access the IMF's resources through a number of special facilities or policies that the IMF has set up to accommodate the specific balance of payments needs and circumstances of the membership. These have eligibility requirements beyond a mere general balance of payments need. Following are the some credit facilities through which Members can access the IMF's resources-

i) **Basic Credit facility:** The IMF provides financial assistance to its member nations to overcome their temporary difficulties relating to balance of payments. A member nation can purchase from the fund other currencies of SDRs in exchange for its own currency, to finance payment deficits. The loan is repaid when the member repurchases its own currency with other currencies or SDRs. A member can unconditionally borrow from the fund in a year equal to 25% of its quota. This unconditional borrowing right is called the reserve tranche. It addition, four tranches (each equal to 25% of the quota) are available to a country. Thus, a member country has the basic credit facility of 5 tranches (i.e.,125% of its quota) from the Fund. In other words, the borrowings from the IMF should not increase the currency of a member country with the Fund more than 200% of its quota.

ii) **Extended Fund Facility:** In September 1974, the IMF started extended fund facility to assist the member countries with sever balance of payment problem for long periods. Under this arrangement, the IMF provides additional borrowings facility unto 140% of the member's quota, Over and above the basic credit facility. The extended facility is limited for a period up to 3 years and the rate of interest is low, i.e., from 4% to 6.5%.

iii) **Compensatory Financing Facility:** In 1963, IMF established compensatory financing facility to provide additional financial assistance to the member countries, particularly primary producing countries facing shortfall in export earnings. In 1981, the coverage of the compensatory financing facility was extended to payment problem caused by the fluctuations in the cost of cereal inputs.

iv) **Buffer Stock Facility:** The buffer stock financing facility was started in 1969. The purpose of this scheme was to help the primary producing countries to finance contributions to buffer stock arrangements for the stabilisation of primary product prices.

v) **Supplementary Financing Facility**: Under the supplementary financing facility, the IMF makes temporary arrangements to provide supplementary financial assistance to member countries facing payments problems relating to their present quota sizes. The IMF has borrowing agreements with 14 lenders to provide different currencies for supplementary financing.

vi) **Special Oil Facility's:** In 1974, the IMF established a temporary credit facility called Special Facility to extend credit to countries with payments difficulties caused by oil price hikes. The facility was terminated in 1976.

vii) **Trust Fund**: The IMF has sold gold in public auctions at prices much above the price prevailing in the market. Part of the profit so earned has been used to establish a Trust Fund in 1976 for making conditional loans to the less-developed countries with payments problems.

viii) **Structural Adjustment Facility:** The IMF established in March 1986 Structural Adjustment Facility (SAF) to provide additional balance of

payments assistance on concessional terms to the poorer member countries. In December 1987, the Enhanced Structural Adjustment Facility (ESAF) was set up to augment the availability of concessional resources to low income countries. In 1999, the ESAF was re-named the Poverty Reduction and Growth Facility (PRGF), and the facility's objective was broadened to include an explicit focus on poverty reduction in the context of a comprehensive growth-oriented strategy. The purpose of SAF and ESAF is to help the poor countries to undertake strong macroeconomic and structural programmes to improve their balance of payments positions and promote economic growth.

ix) **Exogenous Shocks Facility:** The IMF approved the establishment of the Exogenous Shocks Facility (ESF) to become effective in January 2006. It strengthens the IMF's capacity to provide policy support to low-income countries and in recognition that exogenous shocks can have a significant adverse impact on poverty and growth.72 The ESF is directed at PRGF-eligible members that do not have in place a PRGF arrangement and experience a sudden and exogenous shock. Countries with a PRGF arrangement would qualify for augmentation of access under that arrangement.

x) **Trade Integration Mechanism:** The IMF is a strong advocate of multilateral trade liberalization, and has pressed for the completion of the Doha Round, as well as of earlier rounds of multilateral trade negotiations. To help advance the Doha Round discussions, in April 2004 the Executive Board approved the establishment of a Trade Integration Mechanism (TIM) to address balance of payments difficulties that may result from implementation of trade liberalization measures undertaken by other countries.



CHECK YOUR PROGRESS

Q 3: In which year IMF established Structural Adjustment Facility?

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Q 4: Mention one function of IMF.

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11.9 LET US SUM UP

In this unit we have discuss the following points-

- The International Monetary Fund (IMF) is an international monetary institution created in July 1944 at the United Nations Bretton Woods Conference in New Hampshire, United States.
- The Bretton Woods System permitted their member countries some degree of flexibility within a limited band (or range) of exchange rate fluctuations.
- The Bretton Woods System collapsed on 15th August, 1971 when President Nixon announced non convertibility of $ into gold.
- The primary source of IMF lending resources is the financial contributions or quota subscriptions of its member nations.
- Members can access the IMF's resources through a number of special facilities or policies that the IMF has set up to accommodate the specific balance of payments needs and circumstances of the membership.



11.10 FURTHER READING

1) Money Banking & International Trade by R.R. Paul, Kalyani Publication.

11.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The IMF was officially established on December 27, 1945.

Ans to Q No 2: One objectives of IMF is to promote international monetary cooperation through a permanent institution this provides the machinery for consultation and collaboration on international monetary problems.

Ans to Q No 3: In March 1986.

Ans to Q No 4: One important function of IMF is to maintain exchange stability..



11.12 MODEL QUESTIONS

Q 1: Explain the functions of IMF.

Q 2: List the objectives of IMF.

Q 3: Discuss the credit facilities extended by IMF to its member countries.

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UNIT 12 : WORLD TRADE ORGANISATION (WTO)

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Evolution of the WTO

12.4 Benefits of the WTO

12.5 Objectives and Functions of the WTO

12.6 The WTO: A Critical Appraisal

12.7 Let Us Sum Up

12.8 Further Reading

12.9 Answers to Check Your Progress

12.10 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to–

- differentiate between GATT and WTO
- outline the objectives and functions of WTO
- discuss the evolution of WTO
- make a critical assessment of the activities of the WTO.

12.2 INTRODUCTION

The WTO officially commenced on 1 January 1995 under the Marrokesh agreement signed by 124 nations on 15 April 1994, replacing the General Agreement on tariffs and trade (GATT) which commenced in 1948. It is the largest international economic organisation in the world.

In this unit, we shall discuss the WTO. Its evolution, objectives and functions are the main subject matter of this unit. Towards the end, a critical appraisal of WTO has been made.

12.3 EVOLUTION OF THE WTO

The WTO deals with regulation of trade in goods, services and intellectual property between participating countries by providing a frame work for negotiating trade agreements and dispute resolution process aimed at enforcing participant's adherence to WTO agreements, which are signed by representatives of member governments and ratified by their parliament. The WTO prohibits discrimination between trading partners, but provides exceptions for environmental protection, national security and other important goals. Trade related disputes are resolve by independent judges at the WTO through a dispute resolution process.

The WTO's current Director General is Roberto Azevedo, who leads a staff of over 600 people in Geneva, Switzerland.

The WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), was established by a multilateral treaty of 23 countries in 1947 after World War II in the wake of other new multilateral institutions dedicated to international economic cooperation- such as the World Bank and International monetary fund. A comparable international institution for trade, named the international trade organization never started as the US and other signatories did not ratify the establishment treaty and so GATT slowly became a de facto international organization.

- **Differences between the GATT and WTO:** The WTO is not an extension of GATT but successor to the GATT and has different features:
  - The WTO is an international organization with a large legalentity secretariat, head quartered in Geneva, Switzerland, the GATT was basically a provisional treaty serviced by an ad hoc secretariat.
  - GATT allowed the contracting parties to retain their domestic laws in certain sensitive areas (for example, agriculture and textiles). But, WTO reverses such policies of protection.
  - WTO has members, while GATT had only contracting parties.
  - The GATT was applied only on a 'provisional basis'. The WTO

commitments are permanent and binding to the member countries. As such the WTO approach is rule based and time bound.

- The WTO has a wider scope than the GATT, bringing into the multilateral trading system, trade in services, intellectual property and investment. But the GATT rules applied only to trade in merchandise goods. Thus the WTO is wider in its coverage deeper in its penetrating and more effective in implementation of agreement.
- Unlike the GATT, the WTO dispute settlement mechanism is not dilatory but automatic. Thus, it is much quicker.

- **Structure of the WTO:** The organizational structure of the WTO is as follows:
  - The Ministerial Conference (MC) is the supreme governing body which takes ultimate decisions on all matters. It is constituted by representative of all the member countries.
  - The General Council is the real engine of the WTO, composed of the representative of all members. It acts on behalf of the MC. It also acts as the Dispute Settlement body as well as the Trade Policy Review Body.
  - The General Council has the following subsidiary bodies which oversee committees in different areas:
  - Council for Trade in Goods: There are 11 committees under the jurisdiction of Goods Council each with a specific task. All members of the WTO participate in the committees. The Textiles monitoring body is separate from the other committees, but still under the jurisdiction of Goods Council. The body has its own Chairman and only 10 members.
  - Council for Trade-Related Aspects of Intellectual Property Rights- Information on intellectual property in the WTO, news and official records of the activities of the TRIPS council and details of the WTO's work with other international organization in the field.

- Council for Trade in Services: The Council for Trade in Services operates under the guidance of General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It is open to all WTO members and can create subsidiary bodies as required.

  The Services Council has three subsidiary bodies; financial services, domestic regulations, GATS rules and specific commitments. The Council has several different committees, working groups and working parties. There are committees on the following: Trade and Environment, Trade and Development Regional Trade Agreements, Balance of Payments;Restrictions and Budget Finance and Administration. There are working groups on the following; Trade, Debt and Finance, and Trade and Technology transfer.
- The secretariat conducts the administration of WTO, which is headed by the Director General (DG) who is appointed by the MC for the tenure of four years. He is assisted by the four Deputy Directors from different membercountries.
- The annual budget estimates and financial statement of the WTO are presented by the DG to the CBFA for review and recommendations for the final approval by the GC.

12.4 BENEFITS OF THE WTO

- The liberalization of trade and investment has resulted in increase in completion, efficiency of resources utilization, improvement in quantity and productivity and fall in prices and acceleration of economic development.
- WTO provides a forum for multi-lateral discussion of economic relations between nations. The most important of these relate to anti-dumping subsidies and countervailing measures, safeguard disputes settlements. This is likely to ensure greater security and predictability of the international trading system and thus create a more favourable environment for India in the new world economic order.

- WTO has a mechanism to deal with violation of trade agreement and it has a system in place to settle trade disputes between nations. WTO does considerable research related to global trade and disseminates a wealth of information.
  - With special reference to India, the following points are important:
  - India's market share in world export has improved and has been able to take advantage of the opportunities available.
  - India expects improved prospects for agricultural exports as a result of likely increase in the world prices of agricultural products due to reduction in domestic subsidies and barriers to trade.
  - India has ensured that all major programmes for the development of agriculture will be exempted from the disciplines in the agricultural agreement.
- **The WTO Agreements:** The WTO agreements are intended to ensure that the members operate a non discriminatory trading system that spells out their rights and their obligations. Each country promises to do the same for imports into its own market. This system also gives developing countries some flexibility in implementing their commitments. Various WTO agreements can be discussed under the following major heads:
  - **Goods:** From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers, the text of the General Agreement spelt out important rules about non-discrimination. Since1995 the GATT has become the WTO's umbrella agreement for trade in goods. It also has specific dealing with sectors such as agriculture and textiles and with specific issues such as state trading product standards, subsidies and actions taken against dumping.
  - **Services:** Services firms such as banks, insurance firm telecommunications companies' tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of free and fair trade that applied to trade goods.

These principles were in new GATS. WTO members have also made individual commitments under GATS stating which of their services sectors they are willing to open to foreign competition. The GATS provides multilateral framework of rules and regulations which should govern trade in services under conditions of transparency and progressive liberalization.

- **Intellectual property:** The WTO's intellectual property agreement amount to rules for trade and investment in ideas and creativity. The rules state how copyrights patent, trademarks geographical names to identify products, industrial designed integrated circuit, layout designs and under closed information such as trade secrets "intellectual property"- should be protected when trade is involved.
- **Agreement on Agriculture:** The agreement on agriculture is mainly concerned with domestic subsidies, minimum market access commitment, domestic support and food aid operations. These agreements aims at supporting domestic and export subsidies on agricultural goods.
- **Agreement on trade in textiles and clothing (multi-fiber agreement):** This agreement provides for phasing out the import quotas on textiles and clothing in force under the multi-fiber agreement since 1947, by the end of January 2005, quotas on textiles and clothing have been abolished.
- **Agreement on market access:** The member nations will cut tariffs on industrial and farm products by an overage of about 37% The USA and the European Union will cut tariff between by one half.
- **Agreement on Trade related Investment Matters (TRIMs):** This agreement calls for introducing national treatment of foreign investments and removal of quantitative restrictions. It also prevents the imposition of any performance clauses on foreign investors in respect of earnings on foreign exchange, foreign equity participation and transfer of technology. It requires foreign

investment companies to be treated at par with national companies.

- **Agreement on Trade related Intellectually Property Rights (TRIPs):** This agreement is concerned with protection of seven categories of intellectual property rights: (i) Copy right (ii) trade marks (iii) geographical indications (iv)industrial design (v) patents, (vi) integrated circuits and (vii) trade secrets.

  Regarding copyrights it is specified that the Berne convention should be complied with the protection of liberally artistic works including computer programming.

  The owner of the registered trademark possess exclusive rights for its use. The geographical indication related to the identification of a product originating in the territory of the member state and it should be legally protected. Industrial designs are to be protected for atleast 10 years and patents for 20 years. Topographic of integrated circuits to be protected for 10 years. Trade secrets and know-how of commercial value to be protected against breach of trust.

- **Policy Review:** The trade policy review mechanism's purpose is to improve transparency, to create a greater understanding of the policies that countries are adopting and to assess their impact.

- **Development and Trade:** All WTO agreements has provision for their members to implement agreements and commitments measures to increase their trading opportunities and support to help them build the infrastructure for WTO work handle dispute, and implement technical standard.

- **Technical Assistance and Training:** The WTO organizes around 100 technical cooperation missions in developing countries annually. The WTO set up Reference Centers in over 100 trade ministries and regional organization in capitals of developing and least developed countries, providing computers and internet access to enable ministry officials to keep abreast

of event in the WTO in Geneva through online access to the WTO's immense database of official documents and other materials.

- **Dispute Settlement:** The WTO's procedure for resolving trade quarrels under the dispute, settlement understanding is vital for enforcing the rules and therefore for ensuring the trade flow smoothly. The system encourages countries to settle their differences through consultation. To make it more effective they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of a ruling by panel of experts.
- **Plurilateral trade agreements:** This agreement consists of (i) Agreement on trade in civil aircraft (ii) Agreement on Government procurement (iii) International Bovine Meat Agreement (iv) International Dairy Agreement.



CHECK YOUR PROGRESS

Choose the correct answer:

Q 1: The head quarter of world trade organization is located in

(a) New York (b) Tokyo (c) Geneva (d) Berlin

Q 2: Which of the following is not the agreement under the of the WTO?

(a) Multi Fiber Agreement (MFA)

(b) Agreement on Agriculture (AOA)

(c) Convention on the International Trade in Endangered Species (CITES)

(d) Agreement of Textile and Clothing (ATC)

12.5 OBJECTIVES AND FUNCTIONS OF THE WTO

- **Objectives of the WTO are as given in the preamble to the Marrakesh agreement:**
  - To ensure the reduction of tariffs and other barriers to trade.

- To eliminate discriminatory treatment in international trade relations.
- To facilitate higher standards of living, full employment, a growing volume of real income and effective demand and an increase in production and trade is goods and services of the member nations.
- To make positive effect, which ensures developing countries, especially the least developedones to secure a level of share in the growth of international trade that reflects the needs of their economic development.
- To facilitate the optimal use of the world's resources for sustainable development.
- To promote an integrated, more viable and durable trading system incorporating all the resolutions of the Uruguay rounds multilateral trade negotiations.

- **Functions of the WTO:** The major functions of the WTO are as follows:-
  - To lay down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.
  - To provide the institutional framework for the administration of the substantive code which encompasses a spectrum of norms governing the conduct of member countries in the arena of global trade.
  - To provide an integrated structure of the administration, thereby to facilitate the implementation, administration and fulfillment of the objectives of the WTO agreement and other multilateral trade agreements.
  - To ensure the implementation of the substantive code.
  - To act as a forum for the negotiation of further trade liberalization.
  - To cooperate with the IMF and WB and its associates for establishing a coherence in trade policymaking.
  - To settle the trade related disputes.

12.6 THE WTO: A CRITICAL APPRAISAL

The WTO has been subjected to a number of criticisms. It is observed by the developing countries that the negotiations and decision making in the WTO are dominated by the developed countries.

- There is extreme inequality within the structure of WTO and it is this inequality that drives the outcomes. Though the developed countries have reduced the tariff rates and opened up their economies but still they follow certain ways of protection in their countries.
- The developed countries are heavily subsidizing their farmers. Farmers from the developing countries can never hope to get subsidies from their governments so they were in a disadvantageous position so far as export is concerned.
- WTO's ministerial conferences have discussed various issues such as free movement of capital, goods and services and technology. This is very important for them as the developed block needs the markets of the third world countries. But when it comes to the labour movement, it was not allowed.
- The process of free trade is not what was promised. The third world was led to believe that it would make access to foreign territories through global export. But only few countries gained at cost of developing countries.
- WTO has been granted powers to enact international jurisdiction.But critics observe that the developed countries have succeeded in building up a new international economic order that fully serves their interest at the cost of developing countries
- WTO agreements mandate the member nations to implement the clauses and conditions favourable to advanced economies. The USA has not accepted Kyoto protocol. WTO committee on trade and environment should amend the TRIPs agreement in order to facilitate the access to and the use of environmentally sound technologies.



CHECK YOUR PROGRESS

Choose the correct answer:

Q 3: WTO came into force on:

(a) 01.01.1995 (b) 01.01.1994

(c) 01.01.1996 (d) 01.01.1999

Q 4: WTO is said to take care of:

(a) Balance of payments problem (b) Trade related issues

(c) Border of the countries (d) Politics of the countries

Q 5: WTO agreement on agriculture consists of:

(A) Domestic support (B) Export subsidies

(C) Market access (D) Input subsidies

(a) A and D are correct (b) B and D are correct

(c) AB and C are correct (d) AB and D are correct

Q 6: Which of the following IPRs is to be covered by WTO?

(a) Copy rights (b) Trade marks

(c) Trade secrets (d) Agriculture exports



12.7 LET US SUM UP

In this unit we have discuss the following points-

- WTO officially defined as the legal and institutional foundation of multi-lateral trading system.
- Presently 125 countries are member of it.
- The WTO has framed various agreements concerning trade investment and settlement of trade disputes.
- The principles and agreements of WTO have very significant impact on national economies and globalization.
- The WTO also faces growing pressures for protectionism among legislator and workers in the major industrial powers, and especially the USA, who say "free trade" and "globalization" of the world economy mean jobs, will be stolen by developing countries with cheaper labour.

- WTO's objectives is to help trade flow smoothly, freely, fairly and predictable.



12.8 FURTHER READING

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12.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (c)

Ans to Q No 2: (c)

Ans to Q No 3: (a)

Ans to Q No 4: (b)

Ans to Q No 5: (b)

Ans to Q No 6: (d)



12.10 MODEL QUESTIONS

Q 1: Bring out the difference between the GATT and WTO

Q 2: What are the objectives of WTO?

Q 3: Critically examine the role of WTO in global economies.

Q 4: Discuss the functions of WTO.

Q 5: Examine the functional structure of WTO.

Q 6: Discuss the major WTO agreements.

Q 7: Write notes on the following:

(a) TRIPs (b) Trade in Services (c) Patents (d) TRIMS

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UNIT 13 : WORLD BANK, ADB AND UNCTAD

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 The World Bank: Its Objectives, Functions and Role

13.4 Asian Development Bank

- 13.4.1 Aims & objectives of ADB
- 13.4.2 Focus Areas of ADB
- 13.4.3 India and ADB

13.5 UNCTAD

- 13.5.1 Competition and Consumer Policies Programme - mandate and key functions

13.6 Let Us Sum Up

13.7 Further Reading

13.8 Answer to Check Your Progress

13.9 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- outline the functions and role of international financial institutions
- discuss the objectives, functions and role of the World Bank
- describe the aims and objectives of the international regional development banks, particularly the Asian Development Bank
- get an idea of UNCTAD.

13.2 INTRODUCTION

This unit primarily reflects upon a few international financial institutions. We all know that the developing countries often lacks financial capital for different developmental projects. As a result a number of international financial institutions have emerged to provide financial asistance

to these countries. Some of these institutions are truely international in character, as these institutions fulfill the financial needs of most of the countries of the world. For example, International Monetary Fund, World Bank etc. On the other hand, there are also a few International Financial Institutions with certain geographical boundaries. For example, the Asian Development Bank. The Asian Development Bank caters to the financial needs of the Asian region only.

In this unit we shall besically discuss objectives, functions and roles of two major financial institutions of the world, viz., The International Monetary Fund and The World Bank. The aims and objectives of Asian Development Bank has also been discussed. Towards the end of the unit, the role of Asin Development Bank in offering developmental assistance to India has been discussed.

13.3 THE WORLD BANK: ITS FUNCTIONS AND ROLE

The World Bankis also known as the international bank for reconstruction and development (IBRD). It was established on Dec 25 1944. Its purpose was to reconstruct the war-damaged economies. The objective of granting loans to developing countries came much later.

- **Organisational Structure of the World Bank:** The World Bank has a three tier organizational structure, viz., a Board of Governess, Executive Directors and a President. The Board of Governors is the supreme governing authority. It consists of one governor and one alternate governor, appointed for five years by each member. The Board is required to meet once every year. It reserves to itself the power to decide important matters such as new admissions, change in Bank's stock of capital, ways and means of distributing the net income.

  For all technical purpose the Board delegates it powers to the Executive Director.

  The Executive Directors elect a President who becomes their ex-officio chairman holding office during their pleasure. He is chief of the

operating staff of the bank and is responsible for the conduct of the ordinary business of the bank.

- **Objectives of the World Bank:** The objects of the bank as laid down in its agreement are:
  - To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purpose and the encouragement of productive facilities and resources in less developed countries.
  - To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when private capital is not available on reasonable term, to make loans for productive purpose out of its own resources or from borrowed found.
  - To promote the long term balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources to assist in raising productivity and the standard of living of workers in their areas.
  - To arrange loans for more useful and urgent small and large projects.
- **Functions of the World Bank:** On the basis of the Articles of agreement the World Bank has the following functions:
  - The bank should properly assess the economic position of the borrowing country and its loan repayment prospects.
  - The bank should lend only for specific projects which are economically and technically superior and of a high priority nature.
  - The bank lends only the foreign exchange content of any project and expects the borrowing country to mobilizes its domestic resources.
  - The bank ensures the power of supervision and control to ascertain that the funds are used only for the purpose for which it is granted. The bank provides medium or long term loans, the

term being related to the estimated useful life of the equipment or plant being financed.

- The bank insists the borrowing country to procure its requirements in the cheapest possible market without sacrificing quality.
- The bank indirectly attaches special significance to the promotion of private sector.

- **Role of the World Bank:**
  - **World Bank's role in lending operations:** The World Bank offers loans to its members in the following ways:
    - By granting or participating in the direct loans out of its own funds.
    - By granting loans out of the funds raised in the market or otherwise borrowed by the bank.
    - By guaranteeing in whole or part loans made by investors through the investment channels.
    - The total outstanding amount of loans made by the bank is not to exceed 100 per cent of its total unimpaired subscribed capital resources and surplus. The interest rate charged by the bank is uniform among all its members and is based on market cost. In addition to the rate of interest, the bank charges on all loans a commission of 1 per cent for the purpose of creating a special reserve against loans and 1/2 per cent for administrative expenses. The bank's lending is primarily confined to infrastructure projects like roads, railways, power, the communication and part development recently, the bank has evinced interest in energy development, and oil and gas explorations.

- **World Bank's role in Technical and Advisory Assistance:** The World Bank Provides the financial assistance rendered to member countries. It also provides technical and advisory assistance to assess their total economic resources and to setup priorities to be followed in their development programmes. It also provides training for senior officials

of members of developing countries and provides a helping hand in economic and social research.

The World Bank Group consists of 5 main institutions. These institutions play distinct role in fighting poverty and impressing living standards for people in the Developing world. (i) The International Bank for Reconstruction and Development (IBRD), (ii) The International Development Association (IDA), (iii) The International Finance Corporation (IFC), (iv) The Multilateral Investment Guarantee Agency (MIGA) and (v) The International Centre for Settlement of Investment Disputes (ICSID). India as one of the founder members of the IBRD and IMF, is one of the largest beneficiaries of the IBRD-IDA assistance.



CHECK YOUR PROGRESS

Q 1: The international bank for reconstruction and development or the world bank was established on-

(a) 20 Dec 1940 (b) 25 Dec 1947

(c) 25 Dec 1944 (d) 23 Dec 1945

Q 2: The president of World Bank is elected by-

(a) Bank's executive directors (b) Board of governors

(c) Members of the bank (d) Selected members of bank

13.4 ASIAN DEVELOPMENT BANKS

The Asian development bank (ADB) was set up in 19 December 1966 under the United Nations Economic Commission for Asia and Far East (ECAFE) for the economic development of Asian countries. Its headquarters is the Ortigas Center at Manila, Philippines.

In the beginning, ADB had 31 members but now it has 67 members, of which 48 are from within Asia and the pacific and 19 from outside, ADB has similar weighted voting system as of World Bank.

Organisational Structure: The highest policy making body of the ADB is the board of governors composed of one representative from each member state. The board of governors, in turn, elect among themselves

the 12 members of the board of directors and their deputies 8 of the 12 members come from regional members while the others come from non-regional members. The board of governors also elects the bank's president who is also the chairperson of the board of directors and manages ADB. The tenure of president is of 5 years.

13.4.1 Aims & Objectives of ADB

The ADB defines itself as a social development organization its goal is to reduce poverty in Asia and the pacific. It helps to improve the quality of people lives by providing loans and technical assistance for a broad range of development activities. ADB is a non-profit, multilateral development finance institution that engages in mostly public sector lending for development purposes in its member countries.

The main objectives of ADB are:

- To promote investment in the ESCAP region of public and private capital for development.
- To utilize the available resources for financing development with a priority to those regional, sub regional as well as national projects and programes which contribute more effectively to the harmonious economic growth of the region as a whole.
- To help regional member countries in the coordination of their plans and policies for development with a view to achieving better utilization of resources.
- To provide technical assistance for preparation, financing and execution of development projects and programmes.
- To cooperate with the United Nations and other international, regional and local organization for mobilizing funds for financing development programmes and plans in the member countries.
- To undertake and provide such other activities and service that may advance its purpose.

13.4.2 Focus Areas of ADB

The focus area of ADB includes:

- Education: Most developing countries in Asia and pacific have improved their educational status but still facing economic and social colleges.
- Environment: Environment, climate changes and disaster risk management environmental sustainability is a prerequisite for economic growth and poverty reduction in Asia & the Pacific
- Infrastructure, including transport, communication energy, water supply and sanitation and urban development.
- Financial sector development creates prosperity that can be shared throughout the society, particularly to benefit the poor. Financial sector and capital market development including microfinance, small and medium sized enterprises, and regulatory reforms is vital to decreasing poverty in Asia and the Pacific.
- Regional cooperation and integration (RCI): RCI was seen as a long standing priority of the Japanese government as a process by which national economies become more regionally connected. It plays significant role in accelerating economic growth reducing poverty and economic disparity, raising productivity and employment and strengthening institution.

13.4.3 India and ADB

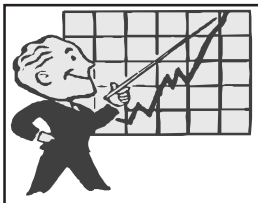
The ADB commenced lending to India in 1986, though it had been a founder member of the bank. The bank has provided funds for infrastructure development, hydro power projects, health and nutrition and housing finance. India is holding 6.33 per cent of shares, totaling 672,030 shares in the ADB on September 22, 2012. India has 5.4 per cent voting rights. India is the fourth largest shareholder. The ADB and the Government of India have agreed to a new country partnership strategy for 2013-2017 which supports the country's 12th

Five Year Plan. The strategy comes with a financial envelope of around $10 billion. Since launching its tending operations in 1986, the ADB has approved 168 sovereign loans amounting to $27.2 billion. As of December 2012, the portfolio included 78 ongoing sovereign loans amounting to $11.2 billion.

ADB has also sought to assist state government directly helping to deepen the spread the reform process across the country.

Reform-oriented Gujrat was the first state to negotiate a loan directly from ADB. Other states are Karnataka, Rajasthan, Utter Pradesh and Assam.

- Assam Integrated flood and river bank Erosion Risk management investment program.
- ADB sign $26 million loan agreement for Assam to improve drainage infrastructure of Dibrugarh.
- Government of India and ADB have signed a loan agreement of $60 million for renovation, protection and community based flood risk management activities along the Brahmaputra River in Assam.
- The Assam Urban infrastructure investment program funded by ADB and aims to improve the urban environment and quality of life in the cities of Guwahati and Dibrugarh.



CHECK YOUR PROGRESS

Choose the correct answer

Q 3: The Asian development bank was established on-

(a) 19 Dec 1960 (b) 16 Dec 1965

(c) 16 Dec 1961 (d) 19 Dec 1966

Q 4: Number of member countries of ADB at present are:

(a) 31 (b) 67 (c) 48 (d) 61

Q 5: The headquarter of ADB is

(a) Manila (b) New Delhi

(c) Islamabad (d) Kathmandu

13.5 UNCTAD

In the early 1960s, growing concerns about the place of developing countries in international trade led many of these countries to call for the convening of a full-fledged conference specifically devoted to tackling these problems and identifying appropriate international actions.

The first United Nations Conference on Trade and Development (UNCTAD) was held in Geneva in 1964. Given the magnitude of the problems at stake and the need to address them, the conference was institutionalized to meet every four years, with intergovernmental bodies meeting between sessions and a permanent secretariat providing the necessary substantive and logistical support.

The United Nations Conference on Trade and Development – UNCTAD – reaches its fiftieth anniversary in June 2014, and member States felt it to be appropriate to mark this milestone by the publication of a short history of the organization. From the very begriming UNCTAD's basic philosophy, in its political and ethical content, has been one of compromise and co-operation, not one of confrontation and conflict—to promote economic development and trade through inter-national co-operation within the universal United Nations framework. The international economic institutions set up at the end of World War II under United States leadership were mainly designed to avert the recurrence of the disastrous events of the 1930s and to promote free trade and payments by dismantling restrictions and allowing market forces to bring about the optimum inter-national division of labour and maximum welfare of all countries.

UNCTAD promotes the development-friendly integration of developing countries into the world economy. UNCTAD fulfils this mandate through three key functions:

1. Providing a forum for intergovernmental deliberations
2. Undertaking research, policy analysis and data collection to inform these deliberations
3. Providing technical assistance to developing countries

The mandate and functions of UNCTAD are reflected in the strategy of the Competition and Consumer Policies Programme.

13.5.1 Competition and Consumer Policies Programme - mandate and key functions

The purpose of the Competition and Consumer Policies Programme is to contribute to poverty reduction and the MDGs by strengthening markets through improved competition and consumer protection. The Competition and Consumer Policies Programme fulfils this mandate through its three key functions:

1. **Providing a forum for intergovernmental deliberations :** Government representatives discuss competition and consumer protection issues. The main forum is the annual meeting of the Intergovernmental Group of Experts on Competition Law and Policy (IGE). The IGE's discussions focus on five clusters of issues:
   a. The relationship between competition policy and development
   b. Effectiveness of competition agencies
   c. International cooperation
   d. The interface between consumer and competition policies
   e. Capacity building

   Guidelines, tools and lessons learnt are compiled following these discussions and are disseminated to partner countries, which use them to improve the effectiveness of their competition agencies. These include the UNCTAD Model law on competition and the Handbook on competition legislation.
2. **Undertaking research, policy analysis and data collection :** Competition and Consumer Policies Programme focuses its research on the four groups of issues considered by the IGE. The reports developed under the Research Partnership Platform work stream are circulated and feed into presented to the IGE and inform their discussions.
3. **Providing technical assistance to developing countries :** The Programme assists partner countries to implement the

recommendations and best practice identified in the previous two work streams. To date COMPAL has been the primary delivery programme for technical assistance, working with competition and consumer protection agencies in 12 Latin American countries. Findings and lessons from the technical assistance are then fed back and used to inform the research and intergovernmental deliberation components of the Programme's work.

The Programme aims to continue being the partner of choice for developing countries seeking high quality, development focused support for improving their competition and consumer protection systems. It achieves this objective through the following strategies:

- **Global delivery of in-depth technical assistance**. Currently countries in Latin American, African and Asian region receive comprehensive long-term technical assistance to strengthen their competition and consumer protection systems through the COMPAL and AFRICOMP programmes. The Programmes replicate best practices learned through the COMPAL approach in new geographies.

  A new COMPAL Global programme is planned for 2014, providing in-depth technical assistance to forty countries and their associated regional bodies. This will increase the number of countries with effective competition and consumer protection systems, expanding UNCTAD's impact. The lessons and best practice identified through technical assistance will continue to inform the Programme's intergovernmental forums and associated research.

- **Multiplying impact through regional leaders**. The experience gained so far through capacity building activitiesIn the Competition and Consumer Policies

Programmes found that by working with countries with strong competition and consumer protection agencies (Indonesia, Brazil,, South Africa, Zambia. Serbia, Colombia and Peru, etc..), these countries became regional leaders, attracting neighbouring countries to participate in project activities and providing them with ongoing assistance.

The Programmes replicate these approaches in other regions, focusing initially on countries that are willing to take on this leadership role and have the necessary economic clout and competition infrastructure. This includes building strong relationships with the UNCTAD, ICN (International Competition Network) and the OECD (Organization for Economic Cooperation and Development). This approach allows initial donor funding to act as a catalyst, with the efforts of the regional leaders delivering increased impact and value for money.

- **Strong field-based presence**. A strong presence in the countries and regions where CCPB works make in-country delivery more effective and responsive, and ensures a free flow of information between countries and UNCTAD in Geneva. It also increases operational efficiency. The Programme relies on Resident Advisers and National Coordinators to be based in the regions where UNCTAD works, and establish Regional Centers to support technical assistance activities.
- **World-class technical expertise**. The competition and consumer policies programme provides high quality advice to counterparts, to those in countries with young and more advanced enforcement agencies. CCPB has hired senior staff to the programme as well as highly experienced and respected resident advisers.



13.6 LET US SUM UP

In this unit we have discuss the following points-

- Purpose of IMF and IBRD was to reconstruct the war damaged economies and grant loans for the economic development of developing economics.
- It is an inter governmental corporations with its capital owned entirely by its members.
- The importance of the regional banks (ADB) is growing as they are becoming more responsive to the special needs of their own concern areas.
- The ADB commenced lending to India in 1986, though it had been a founder member of the bank.
- The first United Nations Conference on Trade and Development (UNCTAD) was held in Geneva in 1964.



13.7 FURTHER READING

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13.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (c)

Ans to Q No 2: (a)

Ans to Q No 3: (d)

Ans to Q No 4: (b)

Ans to Q No 5: (a).

13.9 MODEL QUESTIONS

Q 1: What are the objectives of World Bank?

Q 2: Specify the lending activities of World Bank.

Q 3: Critically examine the lending policy of operation of world banks.

Q 4: What are the objectives of ADB?

Q 5: Write a note on India and ADB.

Q 6: Discuss the function of ADB.

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UNIT 14 : REGIONAL ECONOMIC COOPERATION AMONG DEVELOPING COUNTRIES

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Types of Regional Economic Integration

14.4 Advantages of Regional Economic Integration

14.5 Asian Economic Cooperation

- 14.5.1 South Asian Association for Regional Cooperation (SAARC)
- 14.5.2 South Asian Preferential Trade Agreements (SAPTA)
- 14.5.3 South Asian Free Trade Area (SAFTA)

14.6 Let Us Sum Up

14.7 Further Reading

14.8 Answers to Check Your Progress

14.9 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to–

- put forward the meaning of regional economic integration.
- outline the need for having an economic cooperation at regional level
- acquire knowledge about the various forms of economic cooperation and state of their operation.
- discuss the types, goals and principles of economic cooperation of Asian countries.

14.2 INTRODUCTION

Regional Economic Integration is an arrangement or agreement between between groups ofcountries in a geographical region to reduce and ultimately eliminate the trade barriers (i.e. tariff and non-tariff barriers)

to achieve free flow of goods, services, factors of productionamong each other.Some of the examples of regional economic integration include: (a) NAFTA (North American Free Trade Agreement)-An agreement among the U.S.A., Canada, and Mexico, (b) EFTA : European Free Trade Association consisting of Iceland, Liechtenstein, Norway, and Switzerland, (c) LAFTA : Latin American Free Trade Area consisting of Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay, (d) EU : European Union consisting of 28 European countries, and (e) APEC (Asian Pacific Economic Cooperation Forum) - This includes NAFT A members, Japan, and China.

In this unit, we shall discuss different types of regional economic integration, the advantages of regional economic integration and a few examples from the Asian context.

14.3 TYPES OF REGIONAL ECONOMIC INTEGRATION

On the basis of degree of integration, the main types of Regional Economic Integration areas follows:

- **Preferential Trade Arrangements (PTAs):** Preferential Trade Arrangements provides lower barriers on trade among participating countries. Preferential Trade Arrangements is the loosest form of regional cooperation and it exists when countries within a region to agree reduce or eliminate trade barriers (i.e. tariffs) on selected goods. It can be bi-lateral (when it is made between two countries) or multi-lateral (when within many countries). Example: British Commonwealth PreferenceAgreement.
- **Free Trade Areas (FTAs):** Free Trade Areas involve agreements of eliminating barriers to trade on all goodsand services between two or more countries in a region.However, the member countries are allowed to maintain their individual restrictions on all non member countries. Example: NAFTA (North Atalntic Free TradeAgreement and EFIA (European Free Trade Association).
- **Customs Union:** A custom Union involves the removal of tariff or other barriers on trade among membersas well as a common tariff on

products from non member countries. Example:ZOLLVEREIN or German Customs Union founded in 1833 , European Union or European Common Market.

- **Common Market:** A Customs Union becomes a Common Market when free movement of factors of production i.e labour and capital are allowed among the member nations. Thus in a Common Market, there is no trade restrictions, a common tariff on non members, and free movement of factors. Example: The European Common Market that came into being in1993.
- **Economic Union:** An Economic Union is formed when two or more countries that are already a common market proceed to unify their fiscal, monetary, and socio economic policies. An early example of an economic union is Benelux which was formed by Belgium, the Netherlands, and Luxemberg in 1960. The European Union (EU) is the present day example of an economic union. The countries of the EU coordinate their respective economic policies, laws and regulations so they can work together to address economic and financial issues. The EU also has a common currency, the Euro, used by 19 EU members.

The above list is presented in an ascending order of degree of integration among the member countries. Starting from the loosest degree of integration in the form of Preferential Trading Arrangement we arrive at the last step in the integration process in the form of Economic Union.



LET US KNOW

Balassa (1969) draws a distinction between economic integration and cooperation. This difference is based on quantitative and qualitative. Economic cooperation entails the actions whose aim to decrease discrimination, whereas the economic integration incorporates measures that entail the suppression of some forms of discrimination, the main objective of economic integration is the abolition of discrimination within an area.

For example, international cooperation includes the international agreements on trade policies while the removal of trade restrictions is an act under economic integration.

14.4 ADVANTAGES OF REGIONAL ECONOMIC INTEGRATION

Gains in Trade: Gains from trade are one of the major advantages of regional economic integrationfor member states. The larger market size created by regional cooperation causes a high degree of competitiveness among the member states which promotes a high degree of sophistication and specialisation. Specialisation ultimately results in larger gains from trade (both internal and external). The economic integration removes the protection to domestic industries to some extent. Thus it helps to removal of imperfect market structures like monopoly or oligopoly. Competition among the producers increases the efficiency of resource utilisation as well as the efficiency of production of goods and services. Thus, the inefficient units are left out from the market but some writes oppose this and argue.

- **Economies of Sale:** The main constraint in achieving the economies of scale is the small size of the market. The integration of economies of scale provide scope for enlargement in market size and this it allows the utilisation of economic resources at the most efficient way. Therefore, the economies of scale can be obtained in a wider market structure. However, some proponents of economic integration leads to diseconomies of scale as increasing the scale of production don't necessarily increase the economies of scale. Economies of scale are associated with regional economic integration as it widens the market size.
- **External economies of scale:** There are also external economies of scale associated with economic integration. Balassa (1969) points out a distinction between external economies operating outside of the market mechanism and the external economies of operating through market mechanism. External economies comprises of both inter-industry and intra-industry relationships that reduces the cost condition.

The external economies operating outside the market mechanism comprises of development techniques, transfer of technological knowledge, transmission of managerial efficiency, betterment of labour quality, development of skill etc.while the external economies of scale via market mechanism includes cost reductions through inter industry repercussions and interdependence via income changes.

- **Increased volume of total trade:** Total volume of trade increases as tariff burdens are either reduced or eliminated in economic integration among members' states.
- **Technological change:** As the size of market increase which promotes competition among industries, there is a greater scope for research and development. There is also transfer of technological knowledge among the countries. This results in greater sophistication in the production of goods and services. According to Balasa, there is a positive relationship between the market size and scope of research and development activity. He postulated this relationship by postulating large scale economies in research and development over arguing that an enlargement of the market brings about a more than proportional increase in research expenditure.
- **Risk and uncertainty:** Economic integration reduces the risk and uncertainties of trade restrictions. Tariff and other restriction make the transaction of goods and services among countries complex and difficult. But economic integration negotiates the risks and uncertainties related to international exchange of goods and services which foster the economic development.
- **Higher degrees of sophistication:** As the market size increases the competitiveness among the producers of member states increase which enhance higher degree of sophistication in the production process.
- **Increase in efficiency:** The Regional Economic Integration facilitates optimum allocation of resources among member countries which results in efficiency in production.

- **General welfare:** As the market size increases more products of different qualities and low price are available to the consumers. Hence, more options are available to consumers which provide more satisfaction to them. Thus, economic integration enhances the general welfare of the people by increase in real purchasing power of the people.
- **Investment:** Economic integration facilitates more investment opportunities. This investment includes both domestic as well as foreign investment. As the economic integration increases the market size and the competitiveness among the industries, there is more investment scope for the investors to invest in new investment projects.
- **Increase in factor mobility:** As the tariff and other types of restrictions are either eliminated or reduced, there is easy movement of factors of production among the member countries which ultimately promotes employment opportunity, reduction in production costand more efficient production of goods and services. It also enhances the exchanges of skills among the factor which is essential for betterment of factor quality.
- **Consumption:** Formation of economic integration benefits the consumer as economic integration facilitates the availability of low priced goods and services to the consumer. Before the formation of economic integration same goods and services are available at high price to the consumers. Thus economic integration also increases the real income of the consumers the member countries. This also increases the availability of various qualities of goods and services open for consumption. Here, the consumers are opened to choose among a large number of goods and services. Therefore, economic integration has positive impact on consumers.
- **Production:** The economic integration increases the competitiveness and economic efficiency of production of goods and services. Thus, it promotes production with lower cost and with better technology.



CHECK YOUR PROGRESS

Q 1: Mention the different types of regional economic integration. Answer in about 20 words.

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Q 2: How does regional economic integration affect the pattern of consumption of the consumers? Answer in about 60 words.

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14.5 ASIAN ECONOMIC COOPERATION

Asian Economic Cooperation is a result of the search for Economic Cooperation among Developing Countries (ECDC). The idea of ECDC became very popular after the UN Sixth Special Session in 1974 which adopted the Programme of Action for establishing New International Economic Order highlighting the importance of ECDC. This leads to the establishment of a number of regional free trade associations in Latin America and Sub-Saharan Africa and Asia. In Asian countries, mention must be made to establishment of ASEAN and SAARC.

14.5.1 South Asian Association for Regional Cooperation (SAARC)

With a view to tap economic benefits of regional economic integration, the proposal for cooperation among the countries of South Asia began to draw considerable support since the early 1980's. SAARC was constituted as the recommendations of Dhaka conference on 7-8 December in 1985. Originally seven countries viz. India, Pakistan, Bangladesh, Nepal, Sri Lanka, Bhutan, Maldives

came under the umbrella of SAARC. Joining of Afghanistanin 2007 increased its strength to 8 members at present. SAARC's headquarter is situated at Kathmandu, Nepal. The fundamental goal of SAARC is to promote economic and social development through optimum allocation of the collective human and material resources.

- **Objectives of SAARC:**
  - To promote welfare of the people of South Asia and improve their quality of life.
  - To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and realise their full potential.
  - To promote and strengthen collective self-realisation among the countries of South Asia.
  - To contribute to mutual trust, understanding and appreciation of each other's problems.
  - To promote active collaboration and mutual assistance in the economic, social and cultural technical and scientific fields.
  - To strengthen cooperation with other developing countries
  - To strengthen cooperation among themselves in inter-regional forums in matters of common interest.
  - To cooperate with international and regional organisation with similar aims and purpose.
- **Principles of SAARC:** Article II of the charter lay down the following principles of SAARC:
  - Cooperation within the framework of the Association shall be based respect for the principles of sovereign, equality, territorial integrity, political interdependence, non-interference in the internal affairs of other states and reach mutual benefits.
  - Such cooperation shall not be substitutes for bilateral and multilateral cooperation but shall complement them.

- Such cooperation shall not be inconsistent with bilateral and multilateral obligations.

South refers to the developing countries which number about 160 and the North refers to developed countries. Geographically, most of the developing countries are in the Southern hemisphere while the developed countries with the exception of Australia and New Zealand are in the northern hemisphere.

- **Areas of Cooperation:** Deliberations at various SAARC summits have identified many areas of cooperation. Though SAARC started with cooperation in non-economic areas such as sports, arts and culture, the process of cooperation has moved to some important economic areas. Broad areas of cooperation are identified as follows:
  - Agriculture
  - Rural development
  - Meteorology
  - Telecommunications
  - Scientific and technological cooperation
  - Health and population activities
  - Transport
  - Postal services
  - Sport, arts and culture
  - Control of drug trafficking
  - Women in development.
- **Issues faced by SAARC:** Though these areas have been identified, implementation of projects that develop these areas has remained incomplete for several reasons. To make the idea of cooperation practical and useful, projects which are viable, feasible and beneficial should be given priority. In essence, SAARC has not been able to meet its goals for various reasons. Following is the description of some of the problems that confront the SAARC.

- There is mutual distrust among some members of SAARC mainly due to border disputes, ethnic issues, religious, political outlook and affiliation etc. This in turn has been affecting realisation of objectives of SAARC.
- One of the perquisites of success of economic integration is that economies must be dissimilar in its nature such that one economy works as complementary to other. But so far as SAARC is concerned, economies of member countries are similar in its structure and economic transition.
- Despite regional integration under the banner of SAARC, the member countries' hunch to promote exports to hard currency areas has largely affected inter-regional trade within the region.
- Though member countries talk of economic integration at the regional lever, they are competitors in the international market and work as rivals. For example, India and Bangladesh are competitors with respect to jute. Similarly, India and Sri Lanka are competitors with respect to tea. This spirit of competition poses a serious threat to the success of SAARC.
- Countries in South Asia is characterised by underdevelopment of transport, communications, payment and clearing arrangements, institutional inadequacies etc. which stand as stumbling block in expansion of economic relations.
- The success of SAARC requires members to become emotionally closer. As we have mentioned, India has dominant position in SAARC by virtue of its resource endowments and impressive development in many fields. Thus, India should be considered as asset in SAARC, but this is not always taken by some members of the

association. Border disputes, ethnic issues etc. often create problems.

India has a dominant position in the SAARC in terms of demography, geography and economy. As per data available India account for over 40 percent of the exports and over 20 percent of the imports of the intra-regional trade. Because of the very large volume of India's world trade in comparison with the total intra-regional trade, the share of India's intra-regional trade in its total world trade has been very low -about 2 percent of the exports and less than one percent of the imports (Cherunilam, 1999)

➢ **Different SAARC Summits:**

Table 15.1: SAARC Summit: When & Where?

Summit	Year	Place
I	Dec. 7-8, 1985	Dhaka (Bangladesh)
II	Nov. 16-17, 1986	Bangalore (India)
III	Nov. 2-4, 1987	Kathmandu (Nepal)
IV	Dec. 1988	Islamabad (Pakistan)
V	Nov. 1989	Male (Maldives)
VI	Dec. 1991	Colombo (Sri Lanka)
VII	April 10-11, 1993	Dhaka (Bangladesh)
VIII	May 2-4, 1995	New Delhi (India)
IX	May 12-14, 1997	Male (Maldives)
X	July, 29-31, 1998	Colombo (Sri Lanka)
XI	Jan. 5-6, 2002	Kathmandu (Nepal)
XII	Jan. 4-6, 2004	Islamabad (Pakistan)
XIII	Nov. 12-13, 2005	Dhaka (Bangladesh)
XIV	Jan. 2007	New Delhi (India)
XV	August 2-3, 2008	Colombo (Sri Lanka)
XVI	April 28-19, 2010	Thimpu (Bhutan)
XVII	November 10-11, 2011	Adu City (Maldives)
XVIII	November 2014	Kathmandu (Nepal)
XIX	September 2016	Cancelled
XX	2019	Proposed Sri Lanka

➢ **Some Important Themes:**

Table 15.2: SAARC Important Years

1990	Year for Girls
1991	Year for House
1992	Year for Environment
1993	Year for Handicapped
1995	Year for Poverty Removal
1996	Year for Literacy
1991-2000	Decade for Girls
2005	Year of South Asia Tourism
2008	Year of Good Governance
2016-17	Year of Cultural Heritage

14.5.2 South Asian Preferential Trade Agreements (SAPTA)

The most significant aspect of 6th SAARC summit held in Colombo in 1991 was to launch the idea of a SAARC Preferential Trading Area in the 7th SAARC summit at Dhaka, Bangladesh. The foreign ministers of all seven SAARC countries i.e. India, Pakistan, Maldives, Bangladesh, Nepal, Bhutan and Sri Lanka, signed a historic agreement on 11th April, 1993 during the Seventh SAARC summit in Dhaka. SAPTA cooperatives among SAARC members came into force from December 7, 1995. The objective of the SAPTA is to promote and sustain mutual trade and economic co-operation among the member countries through exchange of trade concessions. SAPTA therefore can be viewed as the first step towards higher levels of trade and economic co-operation in the South Asian region.

➢ **Basic Principles:** The basic principles of SAPTA are as follows:

- ❍ Overall reciprocity and mutuality of advantages.
- ❍ Step by step negotiation and extension of Preferential Trade Arrangements (FTAs) in stages.



Tariff barrier means a tax on imported goods to restrict imports **in the** country. A **tariff barrier** is a price based policy to restrict **trade** because it changes the price of import paid by the importer.

Non tariff barriers are the government policies and actions other than **tariff barriers** that restrict imports.

Para Tariff-An extra fee or tax imposed on a good in addition to the **tariff** stated on the

- Inclusion of all types of products- raw, semi-processed and processed.
- Special and favourable treatment of Least Developed Countries (LDCs).

➢ **Major Instruments of SAPTA:** The main components of SAPTA are tariff, para-tariff and non-tariff. A member country can negotiate with other members under the following means:

- Direct Trade Measures: SAPTA outlined four approaches through which it can negotiate with member countries viz. product by product basis, across the board tariff reduction, sectoral basis and direct trade measures. The SAPTA envisagesthat concessions on tariff, para-tariff and non-tariff measures be negotiated step -by- stepin successive stages.
- National Schedules of Concessions: The process of negotiation on the schedule of concessionwas commencedin 1993 based on recommendations of the Inter Governmental Group on Trade Liberalization (IGG). At the sixth meeting of IGG held in Katmandu on 20thand 21stApril 1995, there was intensive rounds of bilateral and multilateral negotiations and agreed on the National Schedule of concessions to be granted by individual member states to other member states under the SAPTA Agreement.
- Maintenance of SAPTA Concession: On the issue of maintaining SAPTA concessions for LDCs, the Committee agreed that once the Non-LDCs member states complete the Trade Liberalization Programme (TLP) for LDC member states, SAPTA concessions would cease for LDC member states. However, if any items, on which SAPTA concessions are available to LDC, appear in the sensitive lists of non-LDC, they shall maintain the same level of concession through derogation.

14.5.3 South Asian Free Trade Area (SAFTA)

SAFTA was signed by all the seven SAARC members in the 12th SAARC summit held at Islamabad, Pakistan in January 4-5, 2004. It was a historic agreement on free trade among Asian countries. SAFTA has come into force on January 1, 2006 replacing SAPTA.

As part of agreement, SAFTA requires that the less developing countries like India, Pakistan and Sri Lanka to bring their duties down to 20 percent in the first phase of the two-year period ending in 2007. In the final five-year phase ending 2012, this 20 percent duty should be reduced to zero in a series of annual cuts. The least developed nations in South Asia (Nepal, Bhutan, Bangladesh, Afghanistan and Maldives) have an additional three years to reduce tariffs to zero. India and Pakistan ratified the treaty in 2009, whereas Afghanistan as the 8th or youngest memberstate of the SAARC ratified the SAFTA protocol on 4thMay 2011. The seven foreign ministers of SAARC member countries signed framework agreement on SAFTA in order to reduce custom duties between (0-5) % by 2016.SAFTA presupposes abolition of tariff. It will result in the creating of common market with common currency. The main purpose of SAFTA is to encourage and extend common contract among the countries such as medium and long term contracts which involves trade operated by states and assurance in respect of specific products. It includes agreement on tariff concession like national duties concession and non-tariff concession.

- **Objectives of SAFTA:**
  - To promote good competition in the free trade area to provide equitable benefits to all the countries involved in the contracts.
  - To benefit the people of the countries by brining transparency and integrity among the countries.

- To increase the level of trade and economic integration among the SAARC nations by reducing the tariff and trade barriers and also for providing special preference to LDCs.

➢ **Instruments of SAFTA:**

- Trade Liberalisation Programme
- Rule of origin
- Institutional Arrangements
- Consultation and Dispute settlement Procedures.
- Safe guards measures
- Try other instruments that may be agreed upon.

CHECK YOUR PROGRESS

Q 3: Mention the different areas of cooperation under SAARC. Answer in about 40 words.

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Q 4: Mention the major objectives of SAFTA. Answer in about 60 words.

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14.6 LET US SUM UP

In this unit we have discuss the following points-

- Regional Economic Integration is an arrangement between groups of different countries in a region to reduce or eliminate the trade barriers

tofacilitate free flow of goods, services, factors of production etc. It has different forms based on degree of integration.

- The major forms of regional economic integration are PTA, FTA, Custom Union, Common Market, and Economic Union.
- In South Asia, SAARC, SAPTA and SAFTA are the examples of regional economic cooperation among South Asian countries.



14.7 FURTHER READING

1) Jhingan, M. L. (2001). *International Economics*. Vrinda Publications (P) Ltd.
2) Mannur, H. G. (1995). *International Economics*. New Delhi: Vikash Publishing House Pvt. Ltd.
3) Rana, K. C. &Verma, K. N. (2004). *International Economics*. Jalandhar: Vishal Publishing Co.
4) Salvatore, D. (2004). *International Economics*. New Delhi: Willey-India.
5) Vaish, M. C. & Singh, S. (2012). *International Economics*. New Delhi: Oxford and IBH Publishing Co. Pvt. Ltd.



14.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The different types of regional economic integration include:Preferential Trade Arrangements (PTAs), Free Trade Areas (FTAs), Customs Union, Common Market and Economic Union.

Ans to Q No 2: Formation of economic integration benefits the consumer as economic integration facilitates the availability of low priced goods and services to the consumer. Before the formation of economic

integration same goods and services are available at high price to the consumers. Thus, economic integration also increases the real income of the consumers the member countries. This also increases the availability of various qualities of goods and services open for consumption.

Ans to Q No 3: Thebroad areas of cooperation under SAARC include: (a) Agriculture, (b) Rural development, (c) Meteorology, (d) Telecommunications, (e) Scientific and technological cooperation, (f) Health and population activities, (g) Transport, (h) Postal services, (i) Sport, arts and culture, (j) Control of drug trafficking, and (k) Women in development.

Ans to Q No 4: The major objectives of SAFTA are:

To promote good competition in the free trade area to provide equitable benefits to all the countries involved in the contracts.

To benefit the people of the countries by brining transparency and integrity among the countries.

To increase the level of trade and economic integration among the SAARC nations by reducing the tariff and trade barriers and also for providing special preference to LDCs.

14.9 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: What do you mean by regional economic integration?

Q 2: What are the different types of regional economic integration?

Q 3: State the difference between Preferential Trade Arrangements (PTAs) and Free Trade Areas (FTAs).

Q 4: Give examples of Free Trade Area.

Q 5: When did European Union achieve the status of common market?

Q 6: Give an appropriate example of Economic Union.

Q 7: When was SAARC established?

Q 8: Write the signatories of SAARC?

Q 9: Which country is the youngest as member of SAARC?

Q 10: Mentions two objectives of SAARC.

Q 11: State two principles of SAPTA.

Q 12: State the difference between SAPTA and SAFTA.

Q 13: What are the instruments of SAFTA.

B) Essay Type Questions (Answer each question in about 300-350 words)

Q 1: State arguments in favour of regional economic integration.

Q 2: Define Custom Union. How is it different from Free Trade Areas (FTAs)?

Q 3: Discuss the advantages of regional economic Integration.

Q 4: Write short notes on the following:

(a) SAARC

(b) SAPTA

(c) SAFTA.

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UNIT 15 : ISSUES IN INTERNATIONAL BUSINESS

UNIT STRUCTURE

15.1 Learning Objective

15.2 Introduction

15.3 Developments and Issues in International Business

15.4 Outsourcing and its potentials for India

- 15.4.1 Meaning of Outsourcing
- 15.4.2 Forms of outsourcing
- 15.4.3 Reason for outsourcing to India
- 15.4.4 Growing areas of outsourcing

15.5 Role of IT in International Business

15.6 International Business and Ecological Considerations

15.7 Let Us Sum Up

15.8 Further Reading

15.0 Answers To Check Your Progress

15.10 Model Questions

15.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- to identify the main issues affecting international businesses
- to identify the importance and potentiality of outsourcing for India
- to analyse the role of IT in international business.

15.2 INTRODUCTION

International Business refers to the trade of goods, services, technology, capital and/or knowledge across national borders and at the global or transnational level. It involves cross border transactions of goods and services between two or more countries. This helps to earn valuable foreign exchange which is used to pay for imports. Foreign exchange helps to make the business more profitable and to strengthen the economy of its country.

In today's interconnected society it is essential to understand the world in an international context.The globalisation of business and commerce has become an increasingly significant reality worldwide. The rise of globalisation poises a number of important challenges to a business seeking international presence. The complexity of playing at the global level presents companies with different conundrums and choices. Numerous strategic aspects must be taken into account prior to commitment at an international level and afterwards. Constant flexibility is required to adapt to changing patterns at local, regional and international level.

In this unit we will discuss some issues that closely associated with international business.

15.3 DEVELOPMENTS AND ISSUES IN INTERNATIONAL BUSINESS

Some of the issues in international business are as follows:

1. Social Issues
2. Ethical Issues
3. Labour Issues
4. Environmental Issues
5. Political Issues

1. Social Issues: With growing globalisation the concern about social issues has been increasing. The important social issues related to international trade is Social Responsibility.Social responsibility of business or corporate social responsibility (CSR) refers to what the business does, over and above the statutory requirement, for the benefit of the society. The word responsibility connotes that the business has some moral obligations to the society. The term corporate citizenship is also commonly used to refer to the moral obligations to the society. This implies that, just as individuals, corporates are also integral part of the society and that their behaviour shall be guided by certain social norms.

There has been a growing acceptance of the plea that business should be socially responsible in the sense that the business

enterprisewhich makes use of the resources of society and depends on society for its functioning should discharge its duties and responsibilities in enhancing the welfare of the society of which it is an integral part.

2. **Ethical Issues:** As political,legal,economic and cultural norms vary from nation to nation,various ethical issues rise with them.Business Ethics is a very intricate, controversial and perplexing issue because of, among other things, the varying ethical norms and social values. Multinational managers need to be sensitive to these varying differences and able to choose an ethical action accordingly.

In the sphere of international trade, we may consider the issue of ethics at two levels-the ethics of the trading nations and of the trading firms.

a) **Business Ethics and Trading Nations**: There is a feeling that the developed nations particularly, resort to a number of unethical practices in international trade. For example, certain sections of the Omnibus Trade and Competitiveness Act,1988,of the USA viz. Super 301 and Special 301,have become very controversial because of the way they have been used(or threatened to be used)against other countries for economic reprisals. The avowed objective of these sections of the Act is the expand global trade by opening markets. It is part of the strategy of reciprocal market access .In other words they aim at improving the United States' competitiveness by trade reprisals. The Section 301 of the Act deals with the steps the US government must take of if it perceives a threat to the trading interests of the US by the unjustifiable or unreasonable or discriminatory trade partners.

The major allegations are that the Section 301 has been used to humble successful trade rivals and those countries which do not toe the US political and economic lines. For instance, it was alleged that the major provocation for including India and Brazil in the watch list, in the long past, under this Section was the strong stand which they took in the Uruguay Round to uphold

the cause of the developing countries, opposing the stand of the US and other developed countries.

The US axe is often directed against countries with substantial trade surplus with the US like Japan and countries for which the US is the major export market (including developing countries like India).It is ironic that while the developed countries want the developing countries to open their economies more and more, they have been very keen to increase the protection of the vulnerable sectors of their own economies, like agriculture and labour intensive manufacturing. The trade regime of the developed countries is highly biased against the developing countries.

The developed countries using their might in the international organisations like WTO, IMF, World Bank, etc.to bend the policies and decisions to serve their vested interests to the detriment of the developing countries should also be regarded as unethical.

b) Business Ethics and Trading Firms: There are also large number of instances of firms engaged in international business resorting to unethical practices .An international marketer often finds that the norms of ethics vary from country to country. What is ethically wrong or condemned in one nation may not be so in another.

Bribery, pay-offs or kickbacks are common in business in many countries. However the extent and intensity of it vary from country to country. In some countries it is a common practice with government officials and other employees. The law in respect of such practices also varies among countries.

According to the regulation in some countries, while bribing is illegal within the country, bribing by the nation's firms in foreign markets to get or conduct business is not illegal because of the feeling that is inevitable in some markets.

Another issue is whether it is ethical to sell products which are banned in some countries because of their harmful effects

in other countries(often in developing countries).One issue is that if the government of a country permits the marketing of such a product or whether it should give up the sale of the product on its own.

3. **Labour Issues:** One of the important issues in the developed countries in respect of business with the developing countries pertains to ill-treatment of labour and children.

Child labour used in the manufacture of exports from the developing countries is widely criticised by people in the developed countries. There is protest against this in the developing countries too. For example, it is alleged that child labour is used by the carpet industry in India and some other countries and social activists in the developed nations demand ban on the import of goods employing child labour. Consumers are called upon to boycott such goods.

A similar issue is the sweat labour.The goods are manufactured by labour working in inhuman/unhealthy working conditions not getting fair wages should be banned or boycotted.Certain important developing country exports like garments are alleged to be suffering from such problem.

Some multinationals are criticised for outsourcing products from developing countries benefiting from the sweat labour.

It is a regrettable feature of many export processing zones that both male and female workers are trapped in low wage and low skill jobs. Labour relations and human resource department remain two of the most problematic aspects of zone functioning.The frequent absence of minimal standards and poor-labour management relations have predictable outcomes, such as high labour turnover, absenteeism, stress and fatigue, low rates of productivity, excessive wastage of materials and labour unrest which are very common.

Another important issue is trade union rights. Absence of trade union rights in some countries provides them a cost advantage and it has been seen that many multinationals are taking advantage of this.

4. Environmental Issues: There is a close association with the pattern of economic growth and environmental problems. Globalisation, by accelerating certain types of economic activities, causing unscrupulous exploitation of natural resources and using ecologically unfriendly technologies and operations, makes the problem more serious.

The trends of ecological damages associated with economic growth seem to tell us that if the present style of growth is pursued for long, economic growth will become 'self-defeating', and not self-sustaining. For, the seeds of destruction are present in the process of growth itself. Destruction of ecological balance seems to have become a concomitant of rapid growth. The environmental problems become more acute with increasing levels of industrialisation, urbanisation and intensification of agricultural activities with the modern pollution- prone technology.

Pollution explosion and modern technology are upsetting the ecological balance.The process of economic growth has been functioning as a double-edged weapon.With one edge it has been cutting open the way to human prosperity but at the same time with the other edge it has been choking off future prospects.The modern industrial technology,which enhances human welfare by the environmental destruction caused by it.The agro-chemicals,which helped revolutionise agriculture,besides poisoning the food crops and causing soil and water pollution, reduce the original productive capacity of land.

The fouling of water by industries and other sources cause destruction of fish, wealth, thus fouling the daily bread of tens of thousands of poor fishermen. The crop damages caused by water and air pollution are severe.

Environmental pollution has been regarded as the root cause of most of the diseases. If a realistic estimate of the cost of human health and life on account of pollution is made, including the loss of life, medical and public health expenditures, loss of production and productivity due

to ill health and other associated problems created by pollution. the figure found would be astounding.

One of the relationships between economic affluence and the destruction of environment is very well implied in the statement that the affluent society has becoming an "effluent" society. Napkins, towels, non-returnable containers,cans,toys,plastic packs,pastry tins,etc.create mounting solid disposal problems.In many developing countries there is no effective arrangement for their disposal and this causes a very serious damage to the ecology and poses an alarming threat for the future generations.

Globalisation increases these problems because of the indiscriminate increase in the consumption of such throw away categories of products in societies which are not environment conscious.

The problem of environmental degradation is thus assuming more and more serious proportions.

5. **Political Issues:** The political environment of countries is a critical concern for the international markets. International law recognises the sovereign right of a nation to allow or deny foreign firms to conduct.

The following are the political factors affecting International Business:

(a) **Political and legal differences**: The political and legal environment of foreign market is different from that of domestic market. The complexity generally increases in which a company does business increases

(b) **Political and legal forces**: The most important considerations for global business firms are the political and legal forces operative in the countries in which they plan to conduct business. Some foreign governments are unstable, that is there may be frequent, dramatic and unpredictable regime changes. When this occurs industries may be nationalised; private property may be seized or destroyed; normal business operations may be suspended, the workforce may go on strike.

(c) **Trade and investment restriction**: A government impose restriction on the free international exchange of goods or services. Trade barriers are generally classified as:

- Import policies reflected in tariffs and other import charges, quotas, import licensing, custom practices.
- Standards, testing, labelling and various types of certification.
- Lack of copyright protection.
- Restrictions on franchising, licensing, technology transfer.
- Restrictions on foreign direct investment, etc.

(d) **Restraining forces:** The factors which hamper globalisation:

- **External:** It includes government policies and controls which restrain cross-border business, social and political opposition against foreign business, etc.
- **Internal:** Organisation's internal factors

(e) **Government policies and regulation:**Government policies and regulation may also motivate internationalization. Many governments offer number of incentives and other positive support to domestic companies to export and to invest in foreign countries. Several countries give a lot of importance to import development and foreign investment. Some companies also move to foreign countries because of certain regulations like the environmental laws in advanced countries. Government policies which limit the scope of business in the home country may also provoke companies to move to other countries.

(f) **Political environment:** The political environment including the characteristics and policies of the political parties, the nature of the constitution and government system and environment .encompassing the economic and business policies. The most important policies are Industrial policy, Foreign trade policy, Fiscal policy, etc.



CHECK YOUR PROGRESS

Q 1: What is International Business?

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Q 2: State some of the issues in International Business.

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Q 3: What is meant by CSR?

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Q 4: Mention the political factors that affect the International Business.

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15.4 OUTSOURCING AND ITS POTENTIALS FOR INDIA

15.4.1 Meaning of Outsourcing

Outsourcing refers to the process in which companies entrust the processes of their business functions to external vendors. It is a business practice in which a company hires another company or an individual to perform tasks, handle operations or provide services that are either usually executed or had been previously been done by the company's own employees.The outside company,which is known as the service provider or a third-party provider,arranges for its own workers or computer systems to perform the tasks or services either on site at the hiring company's own facilities or at external locations.

Companies today can outsource a number of tasks or services. They often outsource information technology services, including programming and application development as well as technical support. They frequently outsource customer service and

call service functions. They can outsource other types of work as well, including manufacturing processes, human resources tasks and financial functions such as bookkeeping and payroll. Companies can outsource entire divisions, such as its entire IT department or just parts of a particular department.Generally, companies outsource functions that are non-core to their business. Call centre services, payroll, maintenance, order and inventory management, etc. are some of the kinds of work typically outsourced.

15.4.2 Forms of outsourcing

a. **Onshore Outsourcing:**It refers to procurement of services from someone outside the company but within the same country.

b. **Offshore Outsourcing:** It refers to procurement of services from abroad.

15.4.3 Reason for outsourcing to India

India has been a pioneer in providing outsourcing services and solutions to countries across the globe.India has a vast talent pool and it has become one of the most sought after destinations for global companies to outsource various office operations. Slowly it became one of the global leaders in the BPO sector and with India's additional edge in knowledge-based services; it also emerges as the new hub for outsourcing of knowledge processes too. The successful off-shoring of BPO sector led to the growth of KPO sector in India.

Outsourcing has boosted exports, increased national income, increased tax revenues, created employment opportunities and catered to the growth of other related industries like infrastructure, etc. Features making India the outsourcing hub are:

- **India has the largest technical and professional talent pool in the world:** India remains unmatched when it comes to its

pool of skilled and talented human resources. The country has a population of over 1.2 billion people and around 3.1 million graduates are added to the workforce each year. India also holds the distinction of being the largest English speaking nation in the world.

- **India offers flexible pricing options:** India remains a top outsourcing provider is due to the significant cost savings that companies can achieve. This is mainly because of the wide gap that exists between personnel costs in India and that of the developed countries.
- **India provides consistent high quality services:** While the cost factor plays a huge role in outsourcing, the consistently high quality provided by Indian outsourcing firms has also enabled India to remain as the top outsourcing destination.
- **India boasts of the best in infrastructure and technological capabilities**: In India, clients are offered the latest and best in software technology, including customised solutions for various applications such as e-commerce, business process re-engineering, system migration and such more.Outsourcing companies also maintain uninterrupted communication channels with clients by providing high-speed bandwidth via satellite connectivity, submarine cables and fibre optic networks.
- **The Indian government is stable and offers attractive IT policies:** The Indian outsourcing industry is supported by a stable pro-IT government whose policies on the economy, GDP growth, taxation, power, telecom, industrial parks and special zones have been helpful in improving infrastructure as well as communication system.IT is regarded as one of the top five priority industries in India, and the government has framed policies to obtain maximum benefit from outsourcing to India. The government has offered its support to the IT industry by providing various tax-related and other benefits and by enacting the Information Technology Act.

- **Indian companies provide the quickest time -to-market**: Indian outsourcing companies are able to provide the quickest time-to-market due to the advantages gained by time zone differences. The 12-hour differences between India and the USA provides companies with numerous opportunities for work to be completed earlier than expected, leading to greater efficiency, increased productivity and more time to focus on other crucial tasks. The time difference makes India an ideal option for clients who wish to outsource various service-related options, such as 24*7 Customer Support and Helpdesk services.
- **India is one of the world's fastest growing economies:** India has completed 60 years of democracy. The Indian service sector contributes 51% to India's GDP .Under this sector, software exports grew at an amazing rate of 40-50% during the 1990s.The infrastructure sector has been given a big boost by privatisation. The intertwining of the ISP, Telecoms, VSAT, Cellular and networking sectors is being done to create a convergent network for greater bandwidth availability.

15.4.4 Growing areas of outsourcing

Knowledge Process Outsourcing (KPO): With the evolution and maturity of companies, businesses are moving towards outsourcing high-end processes such as legal processes, market research and analytics, engineering processes, design and product development. Such off-shoring of high-end knowledge intensive work is termed as KPO.

The industry has also finally come of age, with the sector now providing a variety of services such as clinical trial management along with advanced research and analytics. Popular KPO services include services to the financial sector (such as insurance and actuarial services, corporate credit and projected finance services, equity research and investment banking) intellectual property

research, medical and legal research and research in biotechnology and pharmaceuticals.

Some of the Indian outsourcing companies are HCL Technologies, L&T InfoTech, Mind tree and Datamatics Global Services.

Thus India remains the preeminent destination for outsourcing services with excellence in IT, BPO and voice services.According to National Association of Software and services Companies (NASSCOM) the outsourcing sector today employs one million people and represents 25%of India's total exports. The IT service sector dominates the industry followed by BPO exports.

As such at the central level, the Department of Information Technology, Ministry of Communications and Information Technology are responsible for the overall development of outsourcing and IT industry. It is responsible for formulation implementation and review of national policies in the field of IT with the goal of making India a global IT superpower. At the State/Union Territory level, there are several organisations which handle matters relating to IT and outsourcing sectors; like Department of Information Technology, Delhi. Both at the Central and the State level, several policy initiatives and procedures are being undertaken to promote the sound growth of IT, BPOs and KPOs.

15.5 ROLE OF IT IN INTERNATIONAL BUSINESS

Information Technology is a terminology which is known to all educated people of the world at present times. Information Technology (IT), as defined by the Information Technology Association of America (ITAA), is "the study, design, development, implementation, support or management of computer-based information systems, particularly software applications and computer hardware". IT deals with the use of electronic computers and computer software to convert, store, protect, process, transmit and securely retrieve information.When computer and communication technologies are combined,the result is information technology, or "InfoTech".Information

technology is a general term that describes any technology that helps to produce, manipulate, store, communicate and/or disseminate information.

Business has always existed since the early times of man. Even though it only began with the simplistic barter system, business would not be the same as it is today without the advancements in technology. All the major industries would fall into a catastrophic collapse if one were to take away technology from business, since majority of business operations and transactions somehow involve the use of technology.

The role of technology in business caused a tremendous growth in trade and commerce. Business concepts and models were revolutionized as a result of the introduction of technology. This is because technology gave a new and better approach on how to go about with business. It provided a faster, more convenient and more efficient way of performing business transactions.

Globalisation has brought in many changes in the business scenario with the whole world inching towards one big market place. Communication between the buyers and sellers has become critical as each can opt to explore a greater number of alternatives than ever before. E-commerce through internet, e-mails, websites and other facilities enables a businessman to be linked with every corner of the world and thus opens up greater opportunities in the world market.

Another important factor is the time required for completing a business transaction. As markets are becoming competitive and information is more readily available, a quick, reliable and replicable transaction implies availing of prevailing opportunities. On the contrary, delays in processing a transaction might become synonymous to wasting an opportunity. Therefore, a fast and alternative mechanism of communication, contract and payment is an integral part of a globally competitive business organisation.

The information technology based business facilitates the very process of international transaction; this involves securing and finalizing a contract, delivery of the product and finally payment for performance of the contract. The movement of goods and services as well as the payment mechanism within a country are governed by regulatory and legal issues. Hence the regulatory environment is at the core of e-business development.

Many companies are changing the way they do business internationally by utilising the latest advancement in information and communication technology.New devices like smartphones and tablet computers,the latest software and media applications and the popularity of social networking sites make it easy for businesses to communicate with colleagues and customers around the world,evaluate product performance and sales and market and promote their products more effectively,all of which play an increasingly large role in international business.

International businesses face more competition as a company on the other side of the world may be producing a similar product.Information technology provides speed of communication that helps companies stay one step ahead of their competitors.Inaddition,more jobs are open to workers in an international business field. Many companies are allowing workers to perform their jobs from any location with internet connection a worker in New York can join a meeting in Tokyo via video conferencing or a worker in Seattle could sell products from Argentina online.

International technology in international business is presented in several ways. The internet is possibly the most important facet, as most information is stored and shared globally. Smartphones as well as tablet computers and laptops keep workers connected in any location making their jobs more flexible and giving them access to information instantly. Software and applications and finance productivity applications gives businesses a faster, easier way to connect with others and organise their information.

Thus technology in business is a growing necessity. As the years go by, the business world is leaning more towards it, making it almost impossible to separate the two from each other. Innovation breeds business, and since technology paves the way for it, it can be gathered here that business needs technology to be sustained.

15.6 INTERNATIONAL BUSINESS AND ECOLOGICAL CONSIDERATIONS

Ecology is the study of plants, animals, people and institutions in

relation to the environment. It thus refers to the interrelationship between people, the fauna (birds and animals), the flora(plants and forests) and their physical surroundings. Geographical and ecological factors such as natural resource endowments, weather and climatic conditions, topological factors, locational aspects in the global context, port facilities are all relevant to business. Ecological factors have recently assumed great importance.

In the globalisation era,many industries seek expansion andnot just limited to their own nation but go international and seek new market for their products and services. The environmental standards and norms play a significant role in determining the competitiveness of products and goods on the international market. Environmental responsibility is a vital component of a business strategy as it not only helps the environment, but it wins the trust of communities and gains the respect of the governments of the countries in which the business operates. All businesses impact on the environment and they emit pollution,produce waste and use resources. Businesses, however, are continually being encouraged to improve their approach to environmental issues.Companies of all sizes and sectors have come to recognisethat being a greener business can create new forms of business value,whether increased sales and reduces costs or forms of value that are indirect (increased quality, reduced risk, increased ability to attract and retain talent)or intangible(enhanced reputation or becoming a preferred trading partner).Every company do not derive such benefits, but many have found ways to turn the emerging environmental ethic into a business opportunity. Enormous economic and population growth worldwide in the second half of the twentieth century drove the impacts that threaten the health and the world-ozone depletion, climate change, depletion and fouling of natural resources and extensive loss of biodiversity and habitat.
Thus the depletion of natural resources, environmental pollution and the disturbance of the ecological balance has caused great concern. Government policies aimed at the preservation of environmental purity and ecological balance, conservation of non-replenish able resources, etc. has resulted in additional responsibilities and constraints for international business.Issues related to protection of the environment and ecology has received worldwide

attention not only in developed countries,but also in the developing countries.Increasing concern has been expressed about environmental degradation which can risk human life and existence.

No civilized government could afford to neglect the problems posed by environmental degradation. In most of the countries'legislations have been passed for conservation of natural resources and prevention and control of environmental pollution.International business firms have also been brought under such legislations and regulations.

As such ecological environment is a critical issue in international business. Modern industry and internationalization has provided people with a material prosperity unequalled in the history. It has also created unparalleled environmental threats to present generation and to future generations. The very technology that has enabled people to manipulate and control nature has also polluted the environment and rapidly depleted the natural resources. As the twenty-first century begins, several well established environmental trends are shaping the future of civilization. This includes population growth, rising temperature, falling water tables, shrinking cropland per person, collapsing fisheries, shrinking forests and the loss of plant and animal species.

In present scenario environmental issues raise large and complicated ethical and technological aspects for the international business society which are as follows:

1. The extent of the environmental damage produced by present and projected industrial technology.
2. Extent of largeness that threats pose to the people's welfare.
3. Values people must give up halting or slowing such damage.
4. Whose rights are violated by pollution and who should be given the responsibility of paying for the costs of polluting the environment?
5. The time interval of natural resources availability.
6. Obligations those firms have to future generations to preserve the environment and conserve the resources.



CHECK YOUR PROGRESS

Q 5: What do you mean by outsourcing?

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Q 6: What are the two forms of outsourcing?

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Q 7: What is KPO?

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Q 8: What is meant by ecology?

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Q 9: Do you agree that the role of technology in business caused a tremendous growth in trade and commerce?

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15.7 LET US SUM UP

In this unit we have discuss the following points-

- International Business refers to the trade of goods, services, technology, capital and/or knowledge across national borders and at the global or transnational level.
- Social Issues, Ethical Issues, Labour Issues, Environmental Issues and Political Issues are some of the issues of concern in the present day International Business.
- Outsourcing is a business practice in which a company hires another company or an individual to perform tasks, handle operations or provide services that are either usually executed or had been previously been done by the company's own employees.

- India remains the preeminent destination for outsourcing services with excellence in IT, BPO and voice services.
- The depletion of natural resources, environmental pollution and the disturbance of the ecological balance has caused great concern.As such ecological environment is a critical issue in international business.



15.8 FURTHER READING

1) International Economics by Francis Cherunilam

2) Indian Economy-Its Growing Dimensions by P.K.Dhar.



15.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: International Business refers to the trade of goods, services, technology, capital and/or knowledge across national borders and at the global or transnational level.

Ans to Q No 2: Some of the issues in International Business are Social Issues, Ethical Issues, Labour Issues, Environmental Issues and Political Issues.

Ans to Q No 3: Corporate social responsibility (CSR) refers to what the business does, over and above the statutory requirement, for the benefit of the society.

Ans to Q No 4: The political factors that affect International Business are: Political and legal differences, Political and legal forces, Trade and investment restriction, Restraining force, Government policies and regulation and Political environment.

Ans to Q No 5: Outsourcing refers to the process in which companies entrust the processes of their business functions to external vendors.

Ans to Q No 6: The two forms of outsourcing are:

(a) Onshore outsourcing and (b) Offshore outsourcing.

Ans to Q No 7: With the evolution and maturity of companies, businesses are moving towards outsourcing high-end processes such as legal processes, market research and analytics, engineering processes, design and product development. Such off-shoring of high-end knowledge intensive work is termed as Knowledge Process Outsourcing (KPO).

Ans to Q No 8: Ecology is the study of plants, animals, people and institutions in relation to the environment.

Ans to Q No 9: Yes, this is because technology gave a new and better approach on how to go about with business. It provided a faster, more convenient and more efficient way of performing business transactions.

15.10 MODEL QUESTIONS



Q 1: 'IT plays a vital role in International Business' Do you agree with the statement. Discuss.

Q 2: Give a brief account of the important issues related to International Business.

Q 3: Ecological environment is a critical issue in International Business. Elaborate.

Q 4: Write a note on outsourcing and its potentials for India.

*** ***** ***



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1) Government of India. *Economic Survey*. (Annual)
2) Reserve Bank of India. *RBI Report on Currency and Finance*. (Annual)
3) International Monetary Fund, *IMF Survey*. (Annual Reports)

Name of the Paper: Course Code:

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Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
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(E-mail id: ciqa@kkhsou.in)

1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my academic needs and expectations					
III.	The Unit writers have excellent knowledge about the course contents					
IV.	Language and contents of the units were presented at a level which I could readily understand					
V.	Ample opportunity for participation in the activities provided in the units					
VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII.	Quality of content is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *(Please feel free to provide your open comments)*

1. Which aspects of the SLM, according to you, worked well?

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2. What sort of changes/improvements do you feel KKHSOU could implement to improve the overall quality of the SLM?

Thank you for taking the time to complete this form.

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