International Organization and Regional Cooperation in Trade

DEECO608

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LOVELY
PROFESSIONAL
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Unit 01: Theoretical Foundations of International Trade

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Objectives

After reading this Unit, students will be able to:

- understand the importance of international trade
- analyze the theoretical foundations of international trade

Introduction

The barter of goods or services among different peoples is an age-old practice, probably as old as human history. International trade, however, refers specifically to an exchange between members of other nations, and accounts and explanations of such trade begin (despite fragmentary earlier discussion) only with the rise of the modern nation-state at the close of the European Middle Ages. As political thinkers and philosophers began to examine the nature and function of the nation, trade with other countries became a particular topic of their inquiry. It is, accordingly, no surprise to find one of the earliest attempts to describe the function of international trade within that highly nationalistic body of thought now known as mercantilism.

1.1 International Trade

International trade is the exchange of capital, goods, and services across international borders or territories because there is a need or want. Such trade represents a significant share of gross domestic product (GDP) in most countries. International trade is the exchange of capital, goods, and services across international borders or territories. International trade has existed throughout history. Its economic, social, and political importance has risen in recent centuries. "The aim of international trade is to increase production and raise people's standard of living. International trade helps citizens of one nation to consume and enjoy the possession of goods produced in some other nations." Classification of International trade are

- Import Trade: The inflow of goods into a country is called the import trade.
- Export Trade: The outflow of goods from a country is called export trade.
- Entrepot Trade: Many times, goods are imported for the purpose of re-export after some processing operations. This is called the entrepot trade.

Types of IT

1. Direct Business: In direct business, the importer places an order with the manufacturer of the exporting country.
2. Consignment Business: Under the consignment business, the exporter sends the goods to an agent in the importing country.
3. Indent Firms: Indent firms charge a commission for their services. The indent firms are also called commission agents.
4. Merchant Shippers: This is a class of businessmen who buy goods on their own account and sell them in a foreign country at a profit.

1.2 Importance of International Trade

Make maximum use of raw materials

Some countries have natural raw materials, such as oil (Qatar), metals (Iceland), fish (Iceland), Congo (diamonds) and butter (New Zealand). Without trade, these countries would not benefit from the natural contributions of raw materials.

Eli Hawker and BertilOll developed the theoretical model. Countries known as the Hecksher-Ohlin Model (H-O Model) say they will pay special attention to producing and exporting goods that use several local component settlements. Countries with limited resources will import.

Comparative benefit

The principle of comparative achievement states that countries with special benefit costs must have particular expertise. Although a country can produce two goods at a low price, it should not make manufacturing). Therefore, exports of these services and goods will be efficient for India. Economies like the UK may benefit relatively from education and video game development. Trade allows countries to specialize. More details on how comparative gain can enhance financial well-being. The theory of relative gain has limitations, but it explains at least some aspects of international trade.

Great choice for users

The new commercial theory does not emphasize comparative advantage and relative input costs. In real business, the new business theory states that a driving force behind trade is giving consumers a choice of different products. We import BMW cars from Germany, not because they are affordable, but because of the quality and brand image. The business enables a wide selection of music and film to appeal to different tastes when it comes to music and film. When the Beatles toured the US in the 1960s, it was exporting British music – relative labor costs were not significant.

Probably the best example is things like clothing. Some textiles (eg, value-added garments from Primark) are very important and are likely to be imported from low-cost countries such as Bangladesh, however, we also import fashion labels from Gucci (Italy), where customers are charged lower prices. Are benefited. The argument is that international trade often fits the pattern of monopoly competition.

Specialization and Economy – More Efficiency

Another aspect of the new business theory is that no matter which countries are experts, the main thing is to advance expertise, which enables companies to benefit from an economy of scale that is influenced by other factors. Improves the Many times, countries may specialize in specific industries for no particular reason – this can be a historical risk. But that expertise provides better efficiency. Multinationals divide the manufacturing process into a global production system for high value-added products. For example, Apple designs its computers in the US but reduces production in Asian factories. Trade enables a product with multiple country sources. The manufacturing process is often global in car production, with engines, tires, design, and marketing coming from various countries.

Business in service sector

Import of physical goods, trade in bananas and export cars. However, the growth of the services sector economy means that more business is invisible –insurance, IT services and banking. In creating this website, I sometimes source our IT services for developers from other countries. This

can be for small jobs up to $ 50. In addition, I can export a review guide for countries around the world on 49 7.49. A global economy with modern communications enables many micro-trades, which would not be possible in the pre-Internet era.

Global Development and Economic Development

International trade is an essential factor in promoting economic growth. This increase has led to a reduction in poverty – particularly in Southeast Asia, the highest growth rate since the 1980s.

1.3 Benefits Of International Trade

Comparative Advantage

It allows countries to gain specialized expertise in producing only those goods and services, which is good.

Economies of Scale

If a country wants to sell its goods in a foreign market, it needs to produce more than meet domestic demand. Therefore, the production of high quantities of energy moves the economy on a scale; that is, the cost of production of each item decreases.

Competition

Selling goods and services in foreign markets also increases competition in that market. In a way, it is suitable for local suppliers and customers. Suppliers need to ensure that their price and quality are sufficient to withstand foreign competition.

Transfer of technology

International trade often leads to the transfer of technology from a developed country to a developing country. Government regulations are often applied to foreign companies developing local production capacity in developing countries.The increase in international trade is creating employment in both countries. This is why big business countries like America, Japan, and South Korea have lower unemployment rates.

1.4 Disadvantages of International Trade

More job creation and Excessive dependence

Countries or companies engaged in foreign trade are the victims of global events. An adverse event can affect product demand and job losses. For example, the recent US-China trade war has adversely affected the Chinese export industry.

Unsuitable for new companies

New companies or startups do not have a lot of resources, and experience can make it difficult to compete with large foreign companies.

Threat to national security

If a country relies on imports for strategic industries, exporters may be forced to make decisions that are not in the national interest.

Stress on natural resources

A country has only natural resources. But if it opens its doors to foreign companies, those natural resources can be depleted much faster.While international trade has pros and cons, the pros far outweigh the disadvantages. Now, international trade has become necessary, but a country must maintain a fair balance between imports and exports to ensure that the economy continues at a growth rate.

1.5 The Theories of International Trade

Mercantilism

This theory was popular in the 16th and 18th Centuries. During that time, the nation's wealth only consisted of gold or other kinds of precious metals, so the theorists suggested that the countries

should start accumulating gold and different types of metals more and more. The European Nations began to doing so. Mercantilists, during this period, stated that all these precious stones denoted the wealth of a nation; they believed that a country would strengthen only if the government imports less and exports more. They said that this is the favorable balance of trade and that this will help a nation to progress more

Mercantilism thrived during the 1500's because there was a rise in new nation-states and the rulers of these states wanted to strengthen their nations. The only way to do so was by increasing exports and trade, because of which these rulers were able to collect more capital for their nations. These rulers encouraged exports by putting limitations on imports. This approach is called protectionism Though, Mercantilism is one the most old-fashioned theory, it still remains a part of contemporary thinking. Countries like China, Taiwan, Japan, etcetera still favor Protectionism. Almost every country has implemented protectionist policy to protect their economy in one way or another. Countries that are export oriented prefer protectionist policies as it favors them. Import restrictions lead to higher prices of goods and services. Free-trade benefits everyone, whereas, mercantilism's protectionist policies only profit select industries.

Theory of Absolute Cost Advantage

Adam Smith, the father of economics, thought that the basis of international trade was absolute cost advantage. According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first.

In other words , the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources. Adam Smith first described the principle of absolute advantage in the context of international trade, using labor as the only input. Since absolute advantage is determined by a simple comparison of labor productiveness, it is possible for a party to have no absolute advantage in anything; in that case, according to the theory of absolute advantage, no trade will occur with the other party. It can be contrasted with the concept of comparative advantage which refers to the ability to produce specific goods at a lower opportunity cost.

Origin of the theory

The main concept of absolute advantage is generally attributed to Adam Smith for his 1776 publication An Inquiry into the Nature and Causes of the Wealth of Nations in which he countered mercantilist ideas. Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation's import and instead stated that all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage. Smith also stated that the wealth of nations depends upon the goods and services available to their citizens, rather than their gold reserves. While there are possible gains from trade with absolute advantage, the gains may not be mutually beneficial. Comparative advantage focuses on the range of possible mutually beneficial exchanges.

Assumptions of the Absolute Advantage Theory:

- Trade between the two countries.
- He took into consideration a two-country and two-commodity framework for his analysis.
- There is no transportation cost.
- Smith assumed that the costs of the commodities were computed by the relative amounts of labour required in their respective production processes.
- He assumed that labour was mobile within a country but immobile between countries.
- He implicitly assumed that any trade between the two countries would take place if each of the two countries has an absolutely lower cost in producing one of the commodities.

Table 1.1 Hours of work necessary to produce one Unit

Country	Cloth	Wine

England	80	100
Portugal	120	90

Table 1.2 Hours of work commit after specialization

Country	Cloth	Wine
England	80+100	0
Portugal	0	90+120

According to Table 1, England commits 80 hours of labour to produce one Unit of cloth, which is fewer than Portugal's hours of work necessary to produce one. England is able to produce one Unit of cloth with fewer hours of labour; therefore England has an absolute advantage in the production of cloth. On the other hand, Portugal commits 90 hours to produce one Unit of wine, which are fewer than England's hours of work necessary to produce one Unit of wine. Therefore, Portugal has an absolute advantage in the production of wine.

If the two countries specialize in producing the good for which they have the absolute advantage, and if they exchange part of the good with each other, both of the two countries can end up with more of each good than they would have in the absence of trade. In the absence of trade, each country produces one Unit of cloth and one Unit of wine. Here, if England commits all of its labour (80+100) for the production of cloth for which England has the absolute advantage, England produces (80+100)÷80=2.25 units of cloth. On the other hand, if Portugal commits all of its labour (90+120) for the production of wine, Portugal produces (90+120)÷90=2.33 Units of wine. By exchanging the 2.25 units of cloth and the 2.33 Units of wine, both of the two countries can end up with more of each good than they would have in the absence of trade.

Achieving an Absolute Advantage

An absolute advantage is achieved through low-cost production. In other words, an absolute advantage refers to an individual, company, or country that can produce at a lower marginal cost. An absolute advantage is established when (compared to competitors):

Fewer materials are used to produce a product

Cheaper materials (thus a lower cost) are used to produce a product

Fewer hours are needed to produce a product

Cheaper workers are (in terms of hourly wage) used to produce a product Advantages of Absolute Advantage

Absolute Cost Advantage

Absolute cost advantage results from the specialization of labor proposed by Smith in his theory. Specialization of labor, or division of labor, results in a significantly higher productivity per Unit of labor, and in turn, a lower cost of production. Smith also used the concept of "Economies of Scale" to explain the lowering of production costs, as a higher output due to labor diversification would significantly reduce production cost.

Criticisms:

Firstly, this theory assumes that each exporting country has an absolute cast advantage in the production of a specific commodity. This assumption may not hold true, when a country has no specific line of production in which it has an absolute superiority. In this context Ellsworth says "Smith's argument is not very convincing as it assumed without argument that international trade required a producer of exports to have an absolute advantage, that is, an exporting country must be able to produce with a given amount of capital and labour a larger output than any rival. But what if a country has no line of production in which it was clearly superior."

Most of the backward countries with inefficient labour and machinery may not be enjoying absolute advantage in any line of activity. So the principle of absolute cost advantage cannot

provide a complete and satisfactory explanation of the basis of trade proceeds among different countries.

Secondly, Adam Smith simply indicated the fundamental basis on which international trade rests. The absolute cost advantage had failed to explore in any comprehensive manner the factors influencing trade between two or more countries.

Thirdly, the 'Vent for Surplus' doctrine of Adam Smith is not completely satisfactory. This doctrine can have serious adverse repercussions on the growth process of the backward countries. These countries do not sell their surplus produce in foreign markets but are constrained to export despite domestic shortages to neutralize their balance of payments deficit.

Comparative Advantage Model

Prior to Adam Smith's Wealth of Nations (1776) publication, mercantilism was the dominant doctrine of foreign commerce. This concept advocated for a country to maximize exports while limiting imports in order to accumulate 'treasure.' Adam Smith objected to this view. He contended that prohibitions on foreign commerce reduced market forces' benefits.

In essence, the case for free trade is one for large-scale marketplaces. If comprehensive free trade were implemented, the market would encompass the entire globe, providing consumers with a diverse array of commodities. Additionally, international competition would compel domestic enterprises to maintain competitive pricing. Innovations in manufacturing processes and product design would spread faster, benefiting customers.

Smith maintained that commerce should be conducted based on absolute advantage. This term describes the position when one country is absolutely more efficient at producing good A, whilst another country is absolutely 'better' at producing good B. Both countries would benefit from specialisation in the goods they excel and then exchange their wares.

Thus, Britain has an absolute edge over Jamaica in terms of automobile manufacture, whereas Jamaica has an absolute advantage in terms of tropical fruit output. Both countries will benefit from specialization and trade. Absolute advantage is a specific instance of the benefits of specialization and labor division.

David Ricardo extended and developed Smith's thesis on absolute benefit in 1817. Ricardo, improving upon Adam Smith's exposition, developed the theory of international trade based on what is known as the Principle of Comparative Advantage (Cost). International trade involves the extension of the principle of specialization or division labor to the sphere of international exchange.

As an individual specializes in the trade in which he excels, a country likewise specializes in the production of the item in which it excels naturally. A country may produce many things at a time, but it may have comparative advantages in the production of some commodities (say, tea or jute as in India) over others and it will specialize in those goods.

Similarly, another country would produce those goods (say, machineries and engineering goods as in Germany or Japan) in which it has comparative advantage. If these two countries produce goods according to their respective areas of comparative advantage, each country would be able to produce the goods at the lowest cost; and both these countries will gain from trading with each other. This is the substance of the principle of comparative advantage (cost).

The principle of comparative cost states that (a) international trade takes place between two countries when the ratios of comparative cost of producing goods differ, and (b) each country would specialize in producing that commodity in which it has a comparative advantage. We may illustrate this principle after stating its assumptions first.

The classical version of the principle of comparative cost is based on several assumptions:

(a) Trade takes place between two countries only, say A and B.

(b) They are trading with only two commodities, say, jute and cotton, (c) The cost of production of these two goods in both the countries is expressed in terms of labor only, (d) The production of these two goods in both the countries taken place at constant costs, (e) There is no transport cost, or the transport cost, if any, is so small a part of product prices that it is ignored.

Illustration: Ricardo was concerned about the position where a country was able to produce every commodity at an absolutely lower real cost than another country. He suggested that in this case each country should specialize in the production of those goods where its comparative advantage was greatest.

This can be explained by using the division of labor as an example. If A is ten times more efficient than B as a surgeon and twice as efficient as a road sweeper, then A should devote all his efforts to surgery and leave all the roads sweeping to B.

Ricardo developed his theory by comparing two countries, England and Portugal, and two commodities, wine and cloth. Table 1 shows that Portugal was more efficient in the production of both goods, but Ricardo argued that both countries could benefit if they specialized where their advantage was comparatively high and then traded.

Portugal's labor costs were lower than England's in both cloth and wine, but the comparative advantage was greater in wine. The cost ratios were 9:10 for cloth and 8:12 for wine. Thus, it cost England roughly 1.1 times as much labor to produce cloth as it did Portugal, but 1.5 times as much to produce wine.

Ricardo showed that both countries would benefit if England specialized in cloth and Portugal in wine and; if after specialization, a unit of wine is exchanged for a unit of cloth. England would gain 20 hours since it costs her 100 hours to produce cloth but 120 to produce wine.

Portugal would also benefit because she would trade a unit of wine which took 80 hours to produce and receive a unit of cloth which would have taken her 90 hours to produce. Hence, Portugal gains 10 hours.

In Ricardo's own words (referring to Portugal): "It would be advantageous for her to export wine in exchange for cloth. She would obtain more cloth from England than she could produce by diverting a portion of her capital from the cultivation of wines to the manufacture of cloth".

In the above example, Portugal has an absolute advantage in the production of both the commodities since the input requirements for both the commodities are less than those of England. But Portugal has a comparative cost advantage in wine. However, a situation of equal advantage, where one country is superior to another in the same ratio in all products, rules out the possibility of gainful trade.

Ricardo's theory is a simple one. It ignores factors such as transport costs and assumes that goods are homogeneous. It also ignores intra-firm trade, such as that between subsidiaries of a multinational firm. Nevertheless, its conclusion is clear. Countries should specialise where their advantage is comparatively greatest (or, comparative disadvantage is least) and then trade.

Criticisms of the Theory

As with many other economic ideas there are criticisms to be levelled at this theory:

i. It is much more complicated in the real world in deciding in which goods countries have a comparative cost advantage. This is so because there are a large number of goods and many countries.

ii. In reality we find changing pattern of comparative advantage. A country may gain comparative advantage by raising its factor (labour) productivity or by imposing restrictions on trade such as an import tariff. So, comparative advantage is dynamic concept, and not a static one, as Ricardo thought.

iii. The theory ignores the effects of transport costs. England might specialise in cloth and Portugal in wine. However, once transport costs are added any comparative advantage may be lost.

iv. The theory assumes that if Portugal wants to specialise introducing more wine it can do so easily by transferring factors of production into wine production. However, it may be not easy to transfer these factors from cloth to wine production easily. In addition, textile workers might not know how to produce wine.

v. Modern theories, no longer based on Ricardo's labour theory, have established that the only necessary condition for the possibility of gains from trade is that price ratios should differ between countries.

vi. Ricardo ignored the role of demand completely and explained trade from supply side. The post-trade exchange rate between the commodities, whose determination Ricardo could

not explain, is established by the Law of Reciprocal Demand, i.e., one country's demand for another country's product and vice versa.

vii. Ricardo's analysis is based on the labour theory of value as costs are expressed in terms of labour hours. However, the classical labour theory itself has lost its relevance.

viii. Riocardo's theory assumes the operation of the law of constant cost. Hence, it cannot be applied in the case of increasing or decreasing costs.

ix. The classical writers have applied their principle in case of trade with two countries only and with two commodities only. So, the principle has a limited scope of application in practice. It cannot explain multi-lateral trade.

x. Increasing returns or decreasing cost are a second great factor — in addition to differences in comparative costs — in explaining the basis of trade. Writes Paul Samuelson, "If economies of mass production are overwhelmingly important, costs may decrease as output expands. This would strengthen the case for international exchange of goods."

xi. Trade may also occur due to a third factor, viz., difference in tastes between countries. America produces motor cars. It also imports cars from Japan because it has a special liking for Japanese cars. Here, trade occurs due to consumption bias.

xii. Finally, the theory assumes that costs remain constant at all levels of output. But, in reality, we find that costs rise after a certain stage due to the operation of the law of diminishing returns. Thus, at some point, after each country has expanded the production of its specialty far enough the cost ratios may become equal.

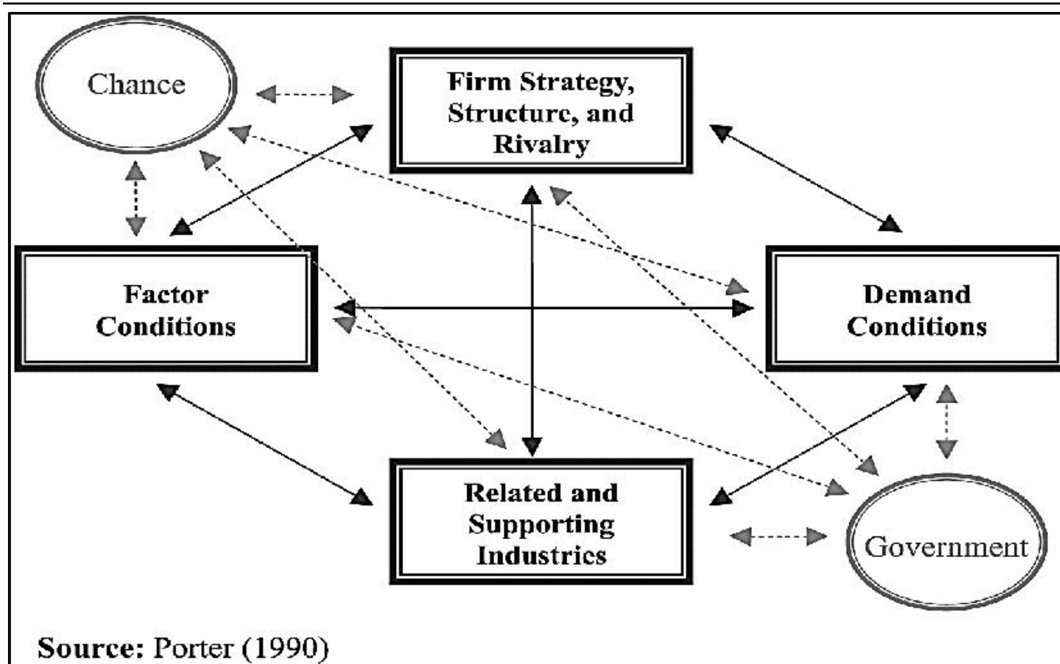
Porter's Diamond Theory

While Porter (1990) never focused exclusively on the causes affecting trade patterns, his theory of national competitive advantage does explain why one country is more competitive in a given industry. If Italy retains a competitive edge in the manufacturing of ceramic tiles and Switzerland retains a competitive edge in the production of watches, the former will export ceramic tiles and the latter will export watches, while both will import commodities in which their own industry is uncompetitive.

Why is there a distinction? Porter identifies four reasons that contribute to this variety. He refers to these characteristics collectively as the "diamond of national advantage." Porters' diamond model consists of the following:

- Contextual factors
- Conditions of demand
- Related and ancillary industries
- Firm strategy, organization, and competition

Figure1: Porter’s Model



Source: Porter (1990)

Earlier economists took these issues into account to a greater or lesser extent. What is critical in Porter's idea of national competitive advantage is that the interaction between these components shapes the competitive advantage.

Factor conditions indicate the extent to which a country's factor of production may be successfully employed in a given industry. This notion extends beyond the factor proportions theory by demonstrating that while the availability of factors of production is not critical for competitive advantage, their contribution to the creation and improvement of products is critical. If one asserts that Japan has a competitive edge in the vehicle manufacturing industry, it is not merely because the country has easy access to iron ore, but also because the country has a skilled labor force capable of sustaining this industry's competitiveness.

Second, demand for the product must exist in the home market from the start. Porter believes that it is not the size of the market that matters for competitive advantage, but the intensity and sophistication of the demand. If consumers are sophisticated, they will place a premium on complex items, which will aid in their manufacture. Gradually, the country will develop a competitive edge in this sector of industry.

Thirdly, the firm that operates alongside competitors and complementary firms benefits from close collaboration in the form of competition or backward and forward linkages. When competition is fierce, every business will strive to provide higher-quality goods at a lower cost in order to remain competitive. Again, if complimentary units congregate in a single region, powerful backward and forward links may exist. All of this will contribute to the nation's competitive advantage.

Fourthly, the firm's own strategy contributes to export growth. There is no hard and fast rule for implementing a particular method. It is determined by a variety of circumstances in the home country or the importing country and varies over time. Nonetheless, the firm's strategic choices have a long-term impact on its future competitiveness. Again, the industry structure and competitiveness of individual enterprises are critical. The stronger the competition, the bigger the industry's competitive power.

Along with the four factors, Porter weights a few more, including government policy and the role of chance in occurrences. Government policy has an effect on all four criteria via a variety of regulatory/deregulatory methods. It can exert control over the availability of various resources and alter the demand pattern through taxes and other mechanisms. It can incentivize/disincentivize supportive industries via a variety of incentives/disincentives. Similarly, random occurrences like as war or unforeseeable events such as inventions/innovations; interruptions in the supply of inputs; and so forth might destroy competitors' advantages.

However, there are various criticisms put forth against Porter's national competitive advantage theory. To begin, there are circumstances in which the lack of any of the characteristics represented by Porter's diamond has no effect on the competitive advantage. For example, when a firm is exporting its entire output, the intensity of demand at home does not matter. Secondly, if the

domestic suppliers of inputs are not available, the backward linkage will be meaningless. Thirdly, Porter's national competitive advantage theory is based on empirical findings covering 10 countries and four industries. A majority of the countries in the sample have different economic backgrounds and do not necessarily support the finding. Fourthly, availability of natural resources, according to Porter, is not the only condition for attaining competitive advantage and there must be other factors too for it. But the study of Rugman and McIlveen (1985) shows that some Canadian industries emerged on the global map only on the basis of natural resource availability. Fifthly, Porter feels that sizeable domestic demand must be present for attaining competitive advantage. But there are industries that have flourished because of demand from foreign consumers. For example, a lion's share of Nestle's earnings comes from foreign sales. Nevertheless, these limitations do not undermine the significance of Porter's national competitive advantage theory. For competitive advantage, see Porter's Diamond Theory.

H-O Theory of International Trade

The classical comparative cost theory failed to explain why the comparative costs of producing particular commodities vary between countries. Heckscher and Ohlin's novel approach delved deeper into the fundamental mechanisms that produce disparities in comparative costs. They argued that the variation in comparative costs is due to variances in countries' factor endowments and the varying factor proportions required to produce different commodities. As a result, this new theory is dubbed the Heckscher-Ohlin theory of international trade. Due to widespread agreement among contemporary economists about Heckscher and Ohlin's explanation of international trade, this theory is also known as modern theory of international trade. Additionally, because this theory is founded on a general equilibrium study of price determination, it is sometimes referred to as the General Equilibrium Theory of International Trade. It is worth noting that, contrary to classical economists, Ohlin maintains that there is no fundamental distinction between domestic (inter-regional) and international commerce. Indeed, he maintains that international commerce is really a subset of inter-regional trade. Thus, Ohlin maintains that it is not the cost of transportation that distinguishes international trade from domestic trade, as transportation costs are involved in intra-regional domestic trade. Trade occurs because the currencies of many countries are linked via foreign exchange rates, which define the value or purchasing power of various currencies. Thus, Ohlin considers different nations as merely regions separated by national frontiers, distinct languages and cultures, and so forth. However, these distinctions do not preclude nations from trading with one another. As a result, he contends that the general theory of value, which can be used to explain interregional trade, can also be used to explain worldwide commerce equally effectively. The general equilibrium theory of value states that the relative prices of commodities are determined by their demand and supply. In the long run, under perfect competition, relative prices of commodities are equal to the average cost of production. The cost of production of a commodity, as is well-known, depends upon the prices paid for the factors of production employed in the production of that commodity. Factor prices, in turn, determine the factor owners' revenues and, thus, the demand for goods. Thus, trade is mutual inter-dependence between prices of commodities and prices of factors, and the ex-change of goods and factors between demand for commodities and demand for factors. This is how the general equilibrium theory of value accounts for the pricing of goods and variables among different individuals within a region or country. However, according to Ohlin, the classical analysis presumes it to apply to a single market in a country and ignores the space factor whose introduction is crucial for explanation of trade between regions. The same factors that explain commerce between regions also explain trade between states or countries. The Heckscher-Ohlin Theorem: International trade, according to Ricardo and other classical economists, is based on differences in comparative costs. It is critical to note that Heckscher and Ohlin agreed on this fundamental thesis and simply expounded on it by describing the reasons that contribute to variances in commodity comparative costs across regions or countries. Ricardo and his successors interpreted variations in comparative costs as originating only from differences in labour ability and efficiency.

This does not account for the disparities in comparative cots. Ohlin identified other fundamental elements, notably disparities in nations' factor endowments and differences in the proportion of factors used to produce various commodities, which account for differences in comparative costs and hence the ultimate basis of interregional or international trade.

Thus, Heckscher-Ohlin theory does not contradict or supersede comparative cost theory, but rather complements it by providing a sufficiently good explanation for why comparative costs differ.

According to Ohlin, there are two processes at work behind disparities in comparative costs:

1. Different locations or countries have varying endowments of various factors.

2. The manufacture of various items necessitates varying factor-proportions.

It is a well-known fact that different countries (regions) have varying levels of productive components required for products production. Certain countries have a relative advantage in terms of capital, whereas others have a relative advantage in terms of labour and land. In general, factors that are more abundant in a country will have a lower price, whereas factors that are relatively scarce would have a higher price. Thus, Ohlin asserts that factor endowments and factor prices are inextricably linked. Assume that K represents the availability or supply of capital in a country, L represents the supply of labour, and PK represents the price of capital and PL represents the price of labour. Furthermore, consider two countries A and B; in country A, capital is abundant while labour is limited. The reverse is the case in country B. Given these factor endowments, capital in country A will be relatively inexpensive. In figurative terms:

Because (K/L)A > (K/L)B

Since (PK/PL)A < (PK/PL)B

Thus, disparities in factor endowments result in disparities in factor prices, which account for disparities in the comparative costs of producing various commodities. Along with differences in factor endowments, differences in the quantities of factors required to produce various commodities also play a significant role in explaining discrepancies in comparative costs between countries. Certain commodities are designed in such a way that their manufacturing takes significantly more capital than other factors; as a result, they are referred to as capital-intensive commodities. Other goods require a greater proportion of land than capital or labour and are hence referred to as land-intensive commodities. These disparities in factor productions (or, alternatively, differences in factor intensities) required to produce distinct commodities account for differences in the comparative costs of production. The disparities in the comparative costs of producing various commodities result in disparities in the market pricing of various commodities in various nations. It follows from above that some countries have a comparative advantage in the production of a commodity for which the required factors are found in abundance and comparative disadvantage in the production of a commodity for which the required factors are not available in sufficient quantities. Thus, a country A which has a relative abundance of capital and relative scarcity of labour will have a comparative advantage in specializing in the production of capital-intensive commodities and in return will import labor-intensive goods. This is because (PK/PL)A < (PK/PL)B. On the other hand, a labour-abundant country B with a scarcity of capital will have a comparative advantage in specialising in the production of labor-intensive commodities and export some quantities of them and in exchange for import capital-intensive commodities. This is because in this country (PL/PK)B < (PL/PK)A. If the two countries have identical factor endowments and the factor-productions used to produce different commodities are identical, there will be no differences in relative factor prices [i.e. (PK/PL)A (PK/PL)B], implying that differences in the comparative costs of producing commodities in the two countries will be non-existent. In this arrangement, countries will gain nothing by trading with one another.

Summary

- The dynamic potential afforded by IT that was pointed out by the classics [Smith (1776)] was disregarded by the 'marginalist revolution'. This was due to the fact that the 'marginalist revolution' studies temporarily left out the lines of the long-term evolution of the economy. As we know, after 1870 the EG was no longer viewed as a great issue for economists due, as it seems, to the perspectives opened by IR. Nevertheless, as exceptions to the rule, authors like Marshall, Young and Schumpeter still dealt with the importance of IT to EG. On the other hand, for instance, the main development in what concerns the scope of the IT theory (the Heckscher-Ohlin-Samuelson model) came to the conclusion that countries benefited from the opening to IT; however, it did no more than identify static gains. But existing studies — for example, Baldwin (1984) — conclude that the static effects (gains only for the increase in the level of per capita income) are very modest.
- It was in this context that, namely after WWII, occurred some reactions to the classical and neoclassical theories which ended up being put to practice in the experiments with introverted and protectionist growth, specially in Latin America. In short, the defenders of

these theses maintain that the relevant products as regards IT were produced in keeping with the appeals of the DCs markets and their technologies. Thus, the LDCs were in a disadvantageous situation due to their reduced dimension and sophistication of their markets, as well as to the weak capacity for technological innovation and to the commercial intervention in what concerns the DCs consumers.

- The interest for the EG reawakened, however, with the works of Solow (1956 and 1957). From then on there was a real concern in analyzing the questions belonging to growth in a quantified and systematized way (with a clear distinction between questions belonging to growth and questions belonging to development).
- It should be noted, however, that Solow's (and Swan's) neoclassical growth model assumed technological progress to be exogenous, not because this was a realistic assumption, but because it was the only tractable one. This suggests that interaction with other countries may have no effect on an economy's long term rate of growth. Nevertheless, there may be some interesting effects of openness in the long term level of welfare, and in the transition to the steady state. In the open economy version of the neoclassical model, international flows of capital raise the rate of convergence to the steady state.
- In the late 1950s, the seminal paper by Solow (1957) attempted to account for economic growth in the US, finding it to be not fully explained by the increase in productive inputs such as labour and capital alone. The largest part of growth was thus attributed to a residual. In subsequent research, much effort was devoted to trying to better understand the origin of productivity increases by squeezing down the residual, by introducing other variables such as accumulation of human capital, economies of scale, a better allocation of resources and new generations of more productive machines. However, even with the introduction of new variables an unexplained residual remained.
- Therefore, on the one hand, the attempt to determine sources of growth in their entirety and, on the other hand, the failure of introverted growth experiences and the association of fast EG to the opening of IT and to the resulting international specialisation in several countries led to the undertaking of research on trade and growth (which adopted the neoclassical framework). We mentioned some theoretical studies — structuralist syntheses, analyses that underscore economic integration, the models of Findlay (1980 and 1984) and Feder (1982) —, empirical applications— among others, structuralist studies, Feder (1982) and Ram (1987) — and studies and/or recommendations about the external commercial policy — among others, UN recommendations, Balassa (1978, 1986 and 1987), Krueger (1985) and WB (1987) — whose defining characteristic is to view IT (above all the exporting component) as an explanatory variable of EG.
- Generally, they associate that situation with a better allocation of resources (according to the comparative advantages), with a greater utilisation of the productive capacity (which makes it possible to obtain economies of scale), with the greater propensity to implement technological improvement (in answering to the greater competition that they face) and with the higher level of employment created in comparison with introverted strategies.
- Although this body of literature enlarged the original framework, technology was still treated as a public good.
- However, on the one hand, in view of the neoclassical theory's limitations (mainly because the technological progress is exogenous but also because, in open economies, this suggests that, in practice, the increase of the convergence among countries is not verifiable) and, on the other hand, in view of the many developments and suggestions which are afforded by Smith, Schumpeter, Knight, Arrow, Kaldor and Uzawa, among others, economists have

recently started to model the process of knowledge accumulation, and the resulting literature is known as endogenous growth theory. This allows us to develop tractable and flexible models that embody the vision of economics life as an endless succession of innovation and change wrought by competition. • These growth models allow for an economy to be able to reach a balanced growth path through endogenous forces and underscore the microeconomic foundations of the growth process, identifying in detail the driving force of growth (which is knowledge, generally under the form of technological innovation), its respective dynamics as well as the driving forces which influence its accumulation. Thus, in most new models the determining factor of economic growth is endogenous innovation, and this innovation is still influenced by IT. Consequently, the modelling which these new models afford brought with it a more exact approach to the relation between EG and IT. So we can say that the dynamic potential created by IT was decisively recovered more recently with the advent of the models of endogenous growth.

- Furthermore, the endogenous approach, bringing increasing returns and non-competitive market structures into the core of growth analysis, made it so that perfect competition would no longer be a sine qua non condition for optimal trajectories of growth to exist. The growth path may not be optimal. So, the governmental intervention may be useful in order to move the growth path towards the optimal one.
- Regarding the contribution of IT to EG, in light of the new approach, we alluded to Romer's work (1990), which viewed IT as a motivating factor of growth, when integrating economies with different levels of human capital. We also saw that the assumptions as to differences among countries condition trade patterns and their effect on growth. With respect to this, Lucas (1988) and Grossman and Helpman (1991a) assume that the only differences among countries have to do with initial provision of factors, whereas Grossman and Helpman (1990) point to differences in respect to the countries' technological capacities.
- The works of Grossman and Helpman (1991b and 1991c) and Rivera-Batiz and Romer (1991a) have also helped clarify why a country's participation in an integrated world economy can speed up its growth : among other reasons, it allows access to a wider base of technological knowledge, it makes technological diffusion easier, it motivates research and avoids redundancies in research. We also presented Romer's work (1993), which recommended that the LDCs open to the foreign investment with more advanced technology so that they could register increases in the rate of innovation and in the economy's rate of growth.
- In this context, the abundant empirical evidence, specifically, suggests that trade openness tends to be beneficial for growth. Especially for the DCs, because they affect the domestic rates of innovation. And for the LDCs (which hardly invest in R&D) because of the dynamic effects of the economic integration with DCs, the catch-up of the convergence, the importation of capital goods and the capacity for adaptation and implementation of innovations. Finally, let us mention that the intensity of dynamic effects depends simultaneously on the geographic structure of international trade (i.e., on the level of development of trade partners).

Keywords

1. Neoclassical theory: An economic theory that outlines how a steady economic growth rate will be accomplished with the proper amounts of the three driving forces: labor capital and technology. The theory states that by varying the amounts of labor and capital in the

production function, an equilibrium state can be accomplished. When a new technology becomes available, the labor and capital need to be adjusted to maintain growth equilibrium.

2. Endogenous growth theory: This theory holds that economic growth is primarily the result of endogenous and not external forces. Endogenous growth theory holds that investment in human capital, innovation, and knowledge are significant contributors to economic growth. The theory also focuses on positive externalities and spillover effects of a knowledge-based economy which will lead to economic development. The endogenous growth theory also holds that policy measures can have an impact on the long-run growth rate of an economy. For example, subsidies for research and development or education increase the growth rate in some endogenous growth models by increasing the incentive for innovation.

Self Assessment

1. The international monetary system can be defined as the institutional framework within which
A. International payments are made
B. Movement of capital is accommodated.
C. Exchange rates among currencies are determined.
D. All of above

2. Gresham's Law in economics relates to
A. Supply and Demand
B. Circulation of currency
C. Consumption and supply
D. Distribution of goods and services

3. The international monetary system went through several distinct stages of evolution. These stages are summarized, in alphabetic order, as follows:
   i. Bimetallism
   ii. Bretton woods system
   iii. Classical gold standard
   iv. Flexible exchange rate regime
   v. Interwar period
A. (iii), (i), (iv), (ii), (v)
B. (i), (iii), (v), (ii), (iv)
C. (v), (i), (iii), (ii), (iv)
D. (v), (iii), (iv), (ii), (i)

4. What are the requirements of good international monetary system (IMS)
A. A good system must be able to adjust imbalances in balance of payments quickly and at a relatively lower cost
B. the system must be able to keep exchange rates relatively fixed and people must have confidence in the stability of the system
C. The system must be able to provide enough reserve assets for a nation to correct its balance of payments deficits without making the nation run into deflation or inflation
D. All of the above

5. During the period of the classical gold standard (1875-1914) there were
A. Highly volatile exchange rates.
B. Volatile exchange rates.
C. Moderately volatile exchange rates.
D. Stable exchange rates.

6. Which of the following is not the goal of the Bretton Woods conference?
A. Intended to govern currency regulations and establish legal obligations
B. Promote investment of capital

C. Set a standard for exchange rates
D. Establish international monetary cooperation

7. What was the desire behind the Bretton Woods Agreement?
A. A desire to put an end to the Second World War
B. A desire to eradicate the causes that led to the Second World War
C. A desire for creating a system of fluctuating currencies
D. A desire for the abolition of different currencies

8. What was the agreement for Bretton Woods System?
A. Fixed Exchange Rate
B. US Dollar as reserve currency
C. US dollar was pegged to gold at $35 an ounce
D. All of the above

9. Which were the two institutions that were instituted during the Bretton Woods System era?
A. World Trade Organization and World Bank
B. International Monetary Fund and World Bank
C. World Trade Organization and United Nations
D. International Monetary Fund and World Trade Organization

10. When Bretton Woods System was created?
A. 1955
B. 1944
C. 1956
D. 1942

11. Choose the false statement among the following statements:
A. The Bretton Woods Conference was held in 1944 in Canada
B. Silver supplemented gold introducing 'bimetallism'
C. Gold standard was the epitome of the fixed exchange rate system
D. The Gold Standard: 1870 to the outbreak of the First World War in 1914

12. The Smithsonian Agreement of 1971 is related to?
A. Moving from fixed to floating exchange rate
B. Widening the permissible band of the exchange rates to 2.5 per cent above or below the new 'central rates'
C. Tackle shortage of liquidity during the Great Depression
D. Bop crisis faced by countries after fall of the Bretton Woods System

13. With reference to SDR, consider the following statement:
    i. 'Reserve asset' created under the control of the IMF
    ii. At present, it is calculated daily as the weighted sum of the values in dollars of four currencies (euro, dollar, Japanese yen, and pound sterling)
    iii. Special Drawing Rights (SDRs) also known as 'paper gold'

Which of the statements given above is/are correct?

A. and (ii) only
B. only
C. and (ii) and (iii)
D. and (iii) only

14. In the formation of the European Monetary System, an attempt was made to allow for the problems of particular countries by allowing:
A. Members freely to choose to join in the broad band of the system
B. Marginal intervention in support of currencies
C. Some member currencies to float
D. Some members to join in the broad band

15. In which year Slovenia was admitted in the European Monetary System?
A. 2005
B. 2007
C. 2002

D. 2000

Answer to Self Assessment

1.	D	2.	B	3.	B	4.	D	5.	D
6.	B	7.	B	8.	D	9.	B	10.	B
11.	A	12.	B	13.	C	14.	D	15.	B

Review Questions

1. Describe the concept of international trade and explain its analysis.
2. What is the importance of international trade?
3. Distinguish between the domestic trade and foreign trade.
4. What are the reasons for phenomenon international growth in recent years?
5. Highlight the advantages of international trade.
6. Discuss Mercantilism
7. What is absolute advantage? Discuss.
8. Write a short note on the Porter theory ?

Further Readings

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Unit 02: Direct Investment

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Objectives

After reading this Unit students will be able to:

- Understand the importance of Foreign Direct Investment
- Identify the economic rationale that underlies foreign direct investment
- Examine the cost-benefit analysis of FDI
- Analyze the theoretical foundations in FDI Policy Framework

Introduction

Foreign Direct Investment is when a business invests directly in the facilities necessary to manufacture and promote a product in another country. For instance, in the early 1980s, Honda, a Japanese vehicle manufacturer, established a manufacturing facility in Ohio and began producing automobiles for the North American market. These automobiles were alternatives for Japanese imports. Once a business accepts FDI, it is classified as a Multinational Enterprise (the term "multinational" refers to "more than one country").

FDI is classified into two types. The first is a greenfield investment, which entails the formation of completely new enterprise in another country. The second method entails acquiring or combining an established business in another country. Acquisitions can be the minority (where the foreign firm accepts 10% to 49% of the company's share capital and voting rights), a majority (where the foreign firm acquires 10% to 99% of the company's share capital and voting rights), or outright (where the foreign firm acquires 100% of the company's share capital and voting rights) (foreign interest of 100 percent).

There is a critical contrast between foreign direct investment and foreign portfolio investment (FPI). Foreign portfolio investment is the purchase of foreign financial instruments by individuals,

businesses, or public organizations (e.g., national and municipal governments) (e.g., Government bonds, foreign stocks). FDI does not need the acquisition of a substantial equity share in a foreign business company. FPI is calculated using a different set of facts than FDI. FPI enables businesses and individuals to establish a truly diversified portfolio of foreign financial assets, thereby reducing risk.

2.1 Overview of Foreign Direct Investment

FDI refers to investment in a foreign country in which the investor retains control. FDI means that the investor has a sizable influence over the firm's management in the destination country. It is typically accomplished by establishing a subsidiary, acquiring an interest in an existing corporation, or establishing a joint venture in a foreign country. Foreign Direct Investment is an investment made into a country by an individual or business located in a foreign country.

- FDI occurs when a foreign entity obtains a majority or controlling position in a firm's shares in another country or starts operations in that country.
- It is distinct from foreign portfolio investment, in which a foreign firm only acquires a company's equity shares.
- In FDI, the foreign entity has a say in the company's day-to-day operations.
- FDI encompasses financial inflows and inflows of technology, knowledge, skills, and expertise/know-how.
- It is a significant source of non-debt financial resources for economic development.
- FDI often occurs in economies with growth potential and a trained workforce.
- Since the previous several years, FDI has grown dramatically as a significant mode The benefits of FDI are not dispersed equitably. It is dependent on the systems and infrastructure of the host country.

2.2 Factors of FDI

- Framework for policymaking
- Entry and operation/functioning rules (mergers/acquisitions and competition)
- Stability in the political, economic, and social spheres
- Foreign affiliates' treatment criteria
- International conventions
- Trade policy (tariff and non-tariff barriers)
- Privatization policy

Since FDIs cannot be readily liquidated, these are governed by long-term considerations. So the FDI decisions are affected by the following factors:

- Political stability,
- Government policy,
- State of economic development,
- Industrial prospects, etc.

2.3 Foreign Direct Investment in the World Economy

The term "FDI flow" refers to the total amount of FDI conducted during a specified period (usually a year). The stock of FDI is the overall accumulation of foreign-owned assets at a particular time. Additionally, we discuss FDI outflows, which refer to the flow of FDI out of a country, and FDI inflows, which refer to the flow of FDI into a country.

The international economy has seen significant growth in both the flow and stock of FDI during the last two decades. The average FDI outflow surged from approximately $25 billion in 1975 to a

record $1.3 trillion in 2000. Not only has the flow of FDI surged in the last quarter, but the country load has also accelerated faster than global trade growth. For example, between 1990 and 2000, global FDI surged around fivefold, while international commerce climbed by approximately 82 percent and global outflows increased by roughly 23 percent. By 2000, the global stock of FDI had surpassed $5.7 trillion due to the significant FDI flow. Sixty-three thousand parent businesses controlled 6,90,000 affiliates in foreign markets, generating an estimated $14 trillion in global sales, over twice the global exports.

2.4 Types of FDI

FDI By Direction

- *Inward FDI* occurs when a foreign entity invests in or purchases the goods of a domestic company.
- *Outward FDI* is a business strategy in which a domestic company expands its activities into a foreign country, either by acquiring or extending an existing foreign facility.

FDI By Motive

- **Resource seeking**: - looking for resources at a lower absolute cost.
- **Market seeking: -** secure market share and sales growth in target foreign market.
- **Efficiency seeking: -** seeks to establish efficient structure through useful factors, cultures, policies or markets.
- **Strategic asset seeking: -** seeks to acquire foreign firms' assets that promote long-term corporate objectives.

FDI By Target

- **Horizontal FDI**: The company carries out the same activities abroad as at home (for example, Toyota assembling cars in both Japan and UK).
- **Vertical FDI:** When additional storage of activities is added abroad.
    - The FDI that takes the firm nearer to the market is called Forward vertical FDI. (for example Toyota acquiring a car distributorship in America).
    - Where international integration moves back towards raw materials is called Backward vertical FDI. (for example Toyota acquiring a tyre manufacturer).

FDI By Entry Modes

- **Greenfield investment:** Greenfield Investment is manufacturing, office, etc. It is the idea of building a facility on a greenfield such as farmland or a forest.
- **Merger and Acquisition:** A merger combines two companies to form a new company. An acquisition is the purchase of one company by another company in which a new company is formed.

Horizontal FDI

Horizontal FDI is an investment in the same industry as the parent company. FDI is expensive, other things being equal because the firm must face the costs of building manufacturing facilities in a foreign country or acquiring a foreign enterprise. FDI is dangerous because of the difficulties inherent in conducting business in another culture where the "rules of the game" may be significantly different. When a business exports, it avoids the costs of FDI and mitigates the risks associated with international sales by utilizing a native sales agent. Similarly, when a corporation licenses its know-how, it avoids the expenses and dangers of FDI. Firms prefer FDI to any of the two.

Exporting or licensing because of the following factors that alter the relative attractiveness of exporting, licensing, and FDI:

1. Transportation costs,
2. Market imperfections,
3. Following competitors,
4. Strategic behavior, and
5. Location advantages.

Transportation Costs

When transportation costs are added to production costs, shipping some products over a long distance becomes unprofitable, particularly those with a low value-to-weight ratio and can be manufactured in practically any place (e.g., cement, soft drinks, etc.). Exporting becomes less lucrative for such products when compared to FDI or licensing. Thus, transportation costs alone can account for Cemex's decision to invest in FDI rather than export. Transport expenses are typically a negligible portion of total landed prices for products with a high value-to-weight ratio (e.g., electronic components, personal computers, medical equipment, computer software, etc.). Transportation costs have a negligible effect on the relative attractiveness of exporting, licensing, and FDI in these instances.

Caution* **Low-value-to-weight products incur higher transportation costs, resulting in unprofitable transactions.

Market Imperfections

Market imperfections are issues that prevent markets from operating at their optimal level of efficiency. Internationalization theory is frequently used in the international business literature to refer to the marketing imperfection approach to FDI. Concerning horizontal FDI, market imperfections occur in two situations: when there are impediments to the sale of know-how and when there are no impediments to know-how (licensing is a mechanism for selling know-how). Impediments to the free movement of goods between countries reduce the likelihood of exporting compared to FDI and licencing. Impediments to know-how transfer improve the profitability of FDI in comparison to licencing. Thus, the explanation based on market imperfections predicts that FDI will be favored if there are hurdles to exporting and selling complex and expensive know-how.

Impediments to Exporting: Governments are the primary source of barriers to the free flow of goods between states. By imposing taxes on imported goods, the government raises the Cost of exporting compared to foreign direct investment and licensing. Similarly, by imposing limitations on imports, governments enhance the attractiveness of FDI and licensing. For example, throughout the 1980s, the flow of FDI by Japanese automakers into the United States was influenced in part by protectionist threats from Congress and import bans on Japanese cars. These factors have reduced the profitability of exporting and raised the profitability of FDI for Japanese automakers.

Impediments to sale know-how: According to economic theory, there are three reasons why the market does not always operate well: a mechanism for selling know-how, or why licensing is not as appealing as it appears at first glance. To begin, licensing may imply the transfer of a firm's know-how to a possible overseas competitor. Second, licensing does not ensure the firm's tight control over manufacturing, marketing, and operations in a foreign country, which may be necessary to leverage its know-how advantage profitably. Licensing grants a licensee authority over production, marketing, and strategy for a royalty fee. However, a corporation may wish to retain control over specific services for strategic and operational reasons.

Example:A firm might want its foreign subsidiary to price and market very aggressively, but the licensee may be unable to do this.

Thirdly, a firm's know-how may not be licensable. This is especially true for management and marketing expertise, where the needed skills are difficult to define and cannot be captured in a straightforward license contract. They apply to the entire organization and have been developed through time. They are not embodied in a single individual but are widely distributed throughout the organization.

Product Life Cycle

According to the product life cycle, each product or line of business undergoes four stages: development, growth, maturity, and decline. Sales growth is rapid and entry is simple throughout the first two stages. Individual firms gain experience and growth slows in the latter two stages, making entry more difficult due to incumbents' cost advantages. Sales and prices decrease during the decline phase of a product line (as substitutes arise), and enterprises who have not acquired a favourable position on the experience curve become unprofitable and either merge or depart the industry.

Strategic Behavior

Another explanation for FDI is that it manifests strategic competitiveness between enterprises operating in the global market environment. F. T. Knickerbocker advanced an early variation of this theory by examining the relationship between FDI and rivalry in oligopolistic industries. Oligopoly is a term that refers to an industry that is dominated by a small number of large enterprises (e.g., an industry in which four firms control 80 percent of a domestic market may be defined as an oligopoly). The interdependence of the big players is a fundamental competitive element of these sectors. What one company does can directly affect its larger competitors, compelling them to respond in kind.

Knickerbocker's idea can be extended to include multipoint competition. Multipoint rivalry occurs when two or more firms confront one other's actions in distinct markets in an attempt to restrain one another. The objective is to prevent a competitor from establishing a dominant position in one market and then use the revenues earned to support competitive attacks in other markets. Kodak and Fuji Photo Film Co, for example, compete against one another on a global scale. Fuji will not be far behind if Kodak joins a particular overseas market.

Location Advantages

John Dunning, a British economist, claimed that locational advantage could assist explain the kind and direction of FDI. Dunning refers to location-specific benefits resulting from the use of resource endowments or assets associated with a particular foreign site that firm values when combined with its unique assets (such as technological, marketing, or management know-how). Dunning supports the internalization thesis that market failures make licensing a firm's distinctive assets problematic (know-how). As a result, he says, integrating location-specific assets or natural resource endowments with a firm's distinct advantages frequently necessitates FDI. It entails establishing manufacturing facilities in the countries where these foreign assets or resource endowments are located.

Vertical FDI

Vertical FDI takes two forms, and there is backward vertical FDI into an industry abroad that provides inputs for a firm's domestic production processes. Historically, most backward vertical FDI has been in extractive industries

Example: Oil extraction, bauxite mining, tin mining, and copper mining. The objective has been to provide inputs into a firm's downstream operations.

Firms such as Royal Dutch/Shell, British Petroleum (BP), RTZ, and Consolidated Gold Field are classic examples of such vertically integrated multinationals.

The second form of vertical FDI is forward vertical FDI, in which an industry abroad sells the outputs of a firm's domestic production processes. Forward vertical FDI is less common than backward vertical FDI.

Example: Volkswagen entered the US market, it acquired a large number of dealers rather than distribute its cars through independent US dealers.

The question may arise as to why firms go to all the trouble and expense of setting up operations in a foreign country. There are two basic answers–the first is a strategic behavior argument, and the second draws on the market imperfections approach.

Strategic Behavior Argument

According to economic theory, a corporation can raise entry barriers and keep new competitors out of an industry by vertically integrating backward to establish control over the source of raw material. This strategic conduct entails vertical FDI if the raw material is located abroad.

Another interpretation of vertical FDI is based on strategic behavior views such as investment to avoid existing entry barriers set by corporations already conducting business in a country. This may account for Volkswagen's choice to develop its dealer network upon entering the North American automobile market.

Market Imperfections Approach

The approach based on market imperfections provides two explanations for vertical FDI. The first explanation is based on the premise that there are barriers to the market mechanism's sale of know-how. The second rationale is based on the notion that investing in specialized assets exposes the investing firm to risks that vertical FDI can only mitigate.

Impediments to the Sale of Know-how

In the early decades of this century, when neither Great Britain nor the Netherlands had domestic oil resources, oil refining corporations like British Petroleum and Royal Dutch/Shell pursued backward vertical FDI to supply crude oil to their British and Dutch oil refining facilities.

By extrapolating from this scenario, it is predicted that backward vertical FDI will occur when a firm possesses the expertise and capability to extract raw resources in another country but lacks an efficient producer capable of supplying raw materials to the firm.

2. Investments in Specialized Assets

A specialized asset is one that is created to execute a particular activity and whose value is greatly diminished when used in its next-best usage. Consider the instance of an aluminum refinery that is tasked with the task of refining bauxite ore and producing aluminum. Bauxite ores are found in various geological settings and have a diverse chemical composition. Each mineral kind requires a unique refinery. Running one type of bauxite through a refinery designed for another type increases production costs by 20 to 100 percent. Thus, the value of an aluminum refinery investment is contingent upon the availability of the required type of bauxite ore.

The consequences of horizontal and vertical FDI theories for business practice are self-evident. First, John Dunning's thesis about location-specific advantages helps explain the direction of FDI, both horizontal and vertical. The most helpful theory, both explanatory and business-wise, is the market imperfections approach. In terms of horizontal FDI, this technique identifies with some precision how the relative rates of return associated with horizontal FDI, exporting, and licensing vary depending on the circumstances. According to the hypothesis, shipping is preferable to approve, and horizontal FDI is more expensive and hazardous, as long as transportation costs are low and minimal tariff barriers. As transport cost and tariff barriers increase, exporting becomes unprofitable, and the choice is between horizontal FDI and licensing. Since horizontal FDI is more costly and riskier than licensing, other things being equal, the theory argues that licensing is preferable to horizontal FDI. While licensing may work in some circumstances, it is not an attractive choice when one or more of the following requirements exists:

1. the firm has valuable know-how that cannot be adequately protected by a licensing contract

2. the firm needs tight control over a foreign entity to maximize its market share and earnings
in that country, and
3. a firm's skills and know-how are not amenable to licensing.

2.5 Implications of FDI

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries where protecting firm-specific expertise is of paramount
2. importance and licensing are hazardous.
3. Global oligopolies, where competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they can launch coordinated attacks against their international competitors (as Kodak has done with Fuji).
4. Industries where intense cost pressures require that multinational firms maintain tight control over foreign operations (so they can disperse manufacturing to locations around the globe where factor costs are most favorable to minimize costs).

The majority of the limited evidence seems to support these conjectures. In addition, licensing is not a good option if the competitive advantage is based upon managerial or marketing knowledge embedded in the firm's routines and the skills of its managers and is difficult to codify in a "book of blueprints." This would seem to be the case for firms based in a fairly wide range of industries.

Firms for which licensing is a good option tend to be in industries whose conditions are opposite to those specified above. Licensing tends to be more common (and more profitable) in fragmented, low-technology industries were globally dispersed manufacturing is not an option. Licensing is also more straightforward if the knowledge to be transferred is relatively easy to codify. An excellent example of an industry where these conditions seem to exist is the fast-food industry. McDonald's has expanded globally by using a franchising strategy. Franchising is essentially the service industry version of licensing-although it usually involves many longer-term commitments than licensing. With franchising, the firm licenses its brand name to a foreign firm in return for a percentage of the franchisee's profits. The franchising contract specifies the conditions that the franchisee must fulfill to use the franchisor's brand name. Thus, McDonald's allows foreign firms to use its brand name as long as they agree to run their restaurants on precisely the same lines as McDonald's restaurants elsewhere in the world. This strategy makes sense for McDonald's because:

1. Like many services, fast food cannot be exported,
2. Franchising economizes the costs and risks associated with opening foreign markets,
3. Unlike technological, brand names are easy to protect using a contract,
4. There is no compelling reason for McDonald's to have tight control over franchisees, and
5. McDonald's know-how, in terms of how to run a fast-food restaurant, is amenable to being specified in a written contract (e.g. the contract specifies the details of how to run a McDonald's restaurant).

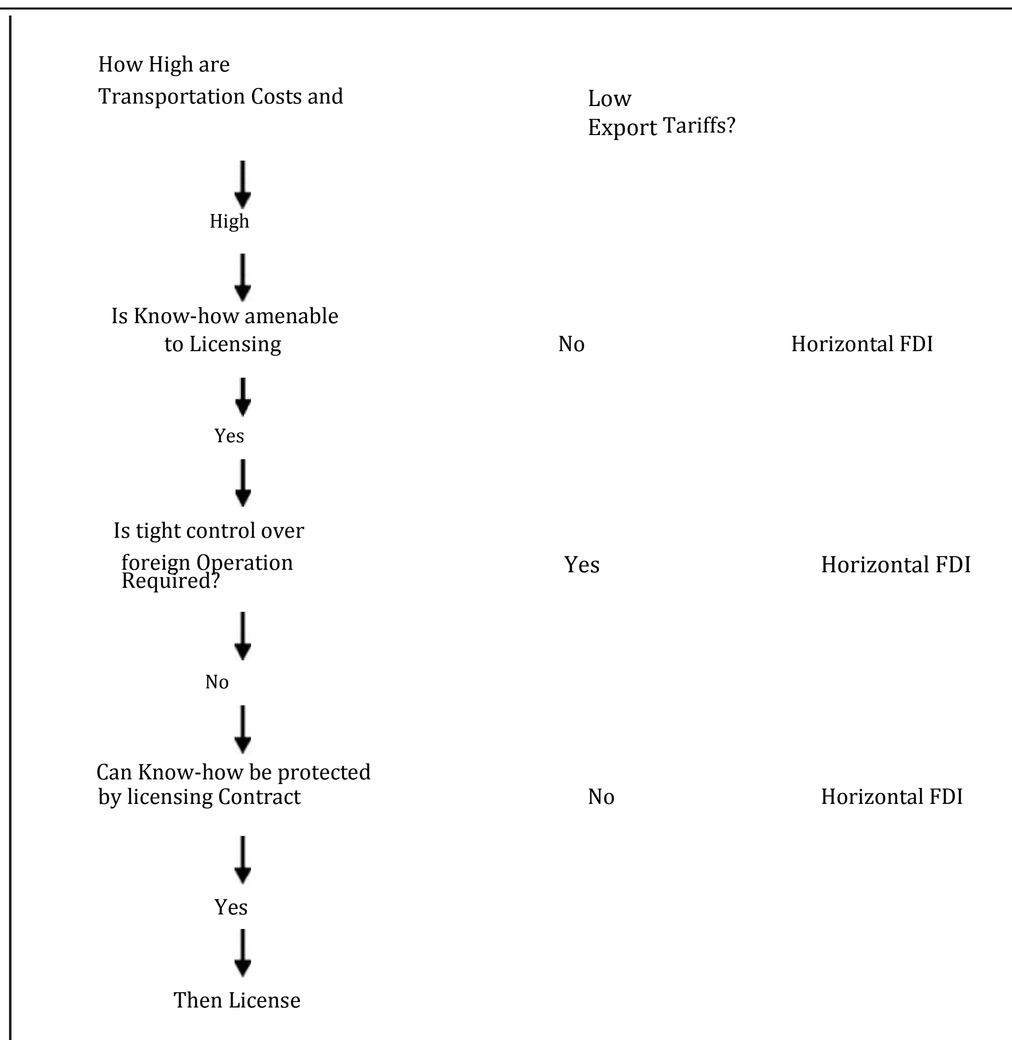
It may be noted that McDonald's does undertake some FDI to establish" master franchisors" in each country in which it does business. These master franchisors usually are joint ventures with local companies and their task is to manage McDonald's franchisees within a particular country.

In contrast to the market imperfections approach, the product life-cycle theory and Knickerbocker's theory of horizontal FDI tend to be less valuable from a business perspective. These two theories are descriptive rather than analytical. They do an excellent job of describing the historical pattern of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing and exporting. Both these theories ignore the issue of licensing as an alternative to FDI.

Finally, concerning vertical FDI, both the market imperfections and the strategic behavior approaches have valuable implications for business practice. The strategic behaviour approach points out that vertical FDI may be a way of building barriers to entry into an industry. The strength of the market imperfections approach is that it points the conditions under which vertical

FDI might be preferable to the alternatives. Most importantly, the market imperfections approach points to the importance of investments in specialized assets and imperfections in the market for know-how as factors that increase the relative attractiveness of vertical FDI.

Figure 2.2: A Decision Framework



2.6 Reasons for FDI

There are strong reasons why MNCs are welcome to invest in foreign countries. Some of the prominent reasons are explained below:

1. To fill the gap between available domestic resources and the desired level of resources: Traditionally, foreign investment is seen as a way of filling the gap between the domestically available supplies of savings, foreign exchange, government revenue, and human capital skills and the desired level of these resources necessary to achieve growth and development targets. If domestic savings are inadequate to generate enough investments, foreign capital is expected to fill the gap between targeted or desired investment and locally mobilized savings.

The foreign exchange earnings generated from exports and foreign aid often fall short of the targeted requirements. This is typically called a trade deficit or gap. An inflow of FDI can not only alleviate part or all of the deficit on the balance of payments current account. Still, it can also remove that deficit over time if the MNCs can generate a net positive inflow of export earnings. There can be a gap between targeted government tax revenues and locally raised taxes. By taxing the MNC's profits and participating financially in their local operations, governments of developing countries are expected to mobilize public financial resources for development projects.

2. To fill the gap in management, entrepreneurship, and technology: Additionally, there is a management, entrepreneurial, technology, and talent deficit that is thought to be partially or entirely supplied by MNCs' local operations. Not only do multinational corporations provide poor countries with financial resources and factories, but they also provide a 'package' of necessary resources, such as managerial experience, entrepreneurial abilities, and technological skills, which can then be transferred to their local counterparts through training programs and 'learning by doing. Additionally, MNCs train local managers on how to develop relationships with foreign

institutions, identify alternate sources of supply, diversify market outlets, and gain a better understanding of international marketing methods. Additionally, MNCs provide extensive technological expertise about manufacturing processes, as well as modern gear and equipment, to capital-strapped developing countries. It is expected that some of this information percolates into the larger economy as engineers and managers depart to found their own businesses. Transfers of knowledge, skills, and technology are thought to be beneficial and productive for the recipient countries.

3. Promotion of domestic investment: MNC-established factories serve as a growth nucleus. A foreign corporation that establishes an industrial enterprise generates multiple additional enterprises that supply inputs to the parent company. It is not as though only a few nearby businesses benefit; an entire industry may benefit. Each dollar of FDI is anticipated to raise domestic investment by 80 percent of the amount of FDI.

4. Healthy competition in host countries: FDI can generate healthy competition in the recipient countries. When FDI assumes the form of greenfield projects, the result is the creation of new enterprises, adding to the number of players in the market. By implication, this can increase competition in the host country. Intense competition enhances consumer choice, tends to bring down prices and boosts the economic welfare of the consumers. Increased competition tends to stimulate capital investments by firms in the plant, equipment And R&D to gain a competitive advantage over their rivals. All these tend to result, in the long run, in increased productivity, innovations, and greater economic growth.

5. To take benefit of locational advantage: FDI is frequently attracted by locational advantages. The location-specific advantages, in particular, include natural resources such as oil and other minerals, which are, by nature, specific to certain locations. To capitalise on such endowments, a corporation must engage in FDI. This explains why many of the world's oil firms invested in FDI, as they needed to invest where the oil was located. Another example is a valuable human resource, such as a relatively inexpensive highly skilled labour force. Labor costs and skill levels vary by country. One significant advantage of putting facilities in Mexico is the availability of highly skilled labour at relatively low wage rates. Additionally, Mexican manufacturing enterprises report excellent rates of productivity growth and outstanding quality performance. France has been the focus of a great deal of MNC activity. Daimler- Chrysler has recently built a new factory in France because of its faith in the workers' productivity and work ethics. Additionally, France's recent economic success has delighted a number of multinational corporations.

Example: Hyundai, the automobile giant from South Korea, has chosen Chennai in India for its new car manufacturing plant. Skilled labour at low wages, location of auto parts manufacturers (such as Wheels India, Brakes India, Sundaram Fasteners, Sundaram Brakes, Bimetal Bearings, Tafe, and India Pistons in and around Chennai), guaranteed power supply, cheap land and proximity to sea port have attracted the plant to the capital city of Tamil Nadu. The argument that location-specific advantages attract FDI is propounded by the British economist John Dunning. Dunning believes that market imperfections make licensing and exporting difficult and thereby render FDI an obvious choice for globalization.

6. To reduce security risks: FDI is frequently contingent on a country's political efforts to mitigate security issues. For instance, Chinese state-owned petroleum corporations have started investing abroad in order to reduce their reliance on foreign oil suppliers. China may potentially benefit from the move by lowering the price of petroleum it receives. There is another political motivation for FDI. Throughout the early 1980s, the US administration implemented a variety of incentives designed to boost the profitability of US investments in Caribbean countries hostile to Cuba's Castro dictatorship. The US wanted to strengthen the economies of those friendly nations through the growth of the FDI and make it difficult for unfriendly leftist governments to gain control. But with the end of the Civil war, the US ended investment incentives in the Caribbean region, and much investment was diverted to Mexico because of NAFTA.

7. For economic growth in developing countries: Aid from international organisations and wealthy countries might be a temporary strategy to alleviate poverty. Economic growth facilitated by increasing investment has the potential to be a long-term solution. Jeffrey Sachs, Special Adviser to

the then Secretary General, Kofi Annan, on the Millennium Development Goals, told a press briefing on Sept 22, 2004, "Many of the poorest countries are simply being bypassed by globalization, and the promises of the rich countries are not being fulfilled. Not less globalisation, but more globalisation that reaches poor countries. Globalization is causing brain drain in the world's poorest countries. They do not perceive an increase in foreign investment." Sachs continued by stating that FDI would be the primary driver of growth in the developing nations.

Given the limitations of domestic savings, many developing countries will have to rely on foreign investment to accelerate economic growth. It may be noted that china has been able to maintain a high GDP growth rate for a long time because of a high savings rate and huge inflow of FDI.

2.7 Benefits of FDI

FDI Benefits to Host Countries

The four main benefits of FDI to host country are:

1. Resource-transfer effects,
2. Employment effects,
3. The balance-of-payments effect, and
4. Effect on competition and economic growth.

Resource-transfer Effects

FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate.

Many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company resources, or because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would.

Technology can stimulate economic development and industrialization. It can take two forms; both are valuable. Technology can be incorporated in a production process or it can be incorporated in a product.

Foreign managers trained in the latest management techniques can often help to improve the efficiency of operations in the host country, whether those operations are acquired or greenfield developments. Beneficial spin-offs effects may also arise when local personnel who are trained to occupy managerial, financial, and technical posts in the subsidiary of a foreign MNE leave the firm and help to establish indigenous firms. Similar benefits may arise if the superior management skills of a foreign MNE stimulate local suppliers, distributors, and competitors to improve their own management skills.

Employment Effects

The effects of FDI on employment are both direct and indirect. Direct efforts arise when a foreign MNE employs a number of host-country citizens. Indirect effects arise when jobs are created in local suppliers as a result of investment and when jobs are created because of increased local spending by employees of the MNE. The indirect employment effects are often as large as the direct effects, if not more significant than.

Example: When Toyota opened a new auto plant in France in 1997, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.

3. Balance-of-Payments Effect

Given the concern about current account deficits, the balance-of-payments effects of FDI can be an important consideration for a host government. There are three potential balance-of-payments consequences of FDI. First, when an MNE establishes a foreign subsidiary, the capital account of the host country benefits from the initial capital inflow (A debit will be recorded in the capital account of the MNEs home country since capital is flowing out of the home country).

Second, if the FDI is a substitute for imports of goods or services, it can improve the current account of the host country's balance of payments. Much of the FDI by Japanese automobile companies in the United States and United Kingdom, for example can be seen as substituting for imports from Japan.

A third potential benefit to the host country's balance-of-payments position arises when the MNE uses a foreign subsidiary to export goods and services to other countries.

4. Effect on Competition and Economic Growth

When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase competition in a national market and thus consumer choice. In turn, this can increase competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations and greater economic growth.

FDI's impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services where exporting is often not an option because the service has to be produced where it is delivered.

2.8 Trends of FDI in India

Indian has been attracting foreign direct investment for a long period. The sectors like telecommunication, construction activities and computer software and hardware have been the major sectors for FDI inflows in India. From April to August 2020, total Foreign Direct Investment inflow of USD 35.73 billion was received. It is the highest ever for the first 5 months of a financial year. FDI inflow has increased despite Gross Domestic Product (GDP) growth contracted 23.9% in the first quarter (April-June 2020). FDI received in the first 5 months of 2020-21 (USD 35.73 billion) is 13% higher as compared to the first five months of 2019-20 (USD 31.60 billion).

- Foreign direct investment in India has played an important role in the development of the Indian economy.
- FDI in India has in a lot of ways enabled India to achieve a certain degree of financial stability, growth and development.
- The investment climate in India has improved tremendously since 1991 when the government opened up the economy and initiated the LPG strategies.
- This money has allowed India to focus on the areas that needed a boost and economic attention, and address the various problems that continue to challenge the country.
- The improvement in this regard is commonly attributed to the easing of FDI norms.
- Many sectors have opened up for foreign investment partially or wholly since the economic liberalization of the country.
- Currently, India ranks in the list of the top 100 countries in ease of doing business.
- In 2019, India was among the top ten receivers of FDI, totaling **$49 billion inflows**, as per a UN report. This is a 16% increase from 2018.
- In February 2020, the DPIIT notifies policy to allow 100% FDI in insurance intermediaries.
- In April 2020, the DPIIT came out with a new rule, which stated that the entity of nay company that shares a land border with India or where the beneficial owner of investment into India is situated in or is a citizen of such a country can invest only under

the Government route. In other words, such entities can only invest following the approval of the Government of India.

Government Measures to increase FDI in India

- Government schemes like production-linked incentive (PLI) scheme in 2020 for electronics manufacturing, have been notified to attract foreign investments.
- In 2019, the amendment of FDI Policy 2017 by the government, to permit 100% FDI under automatic route in coal mining activities enhanced FDI inflow.
- FDI in manufacturing was already under the 100% automatic route, however, in 2019, the government clarified that investments in Indian entities engaged in contract manufacturing is also permitted under the 100% automatic route provided it is undertaken through a legitimate contract.

2.9 Foreign Direct Investment in World Economies

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. Yet, the benefits of FDI do not accrue automatically and evenly across countries, sectors and local communities. National policies and the international investment architecture matter for attracting FDI to a larger number of developing countries and for reaping the full benefits of FDI for development. The challenges primarily address host countries, which need to establish a transparent, broad and effective enabling policy environment for investment and to build the human and institutional capacities to implement them. With most FDI flows originating from Organization for Economic Co-operation and Development (OECD) countries, developed countries can contribute to advancing this agenda. Developed countries can facilitate developing countries' access to international markets and technology, and ensure policy coherence for development more generally; use overseas development assistance (ODA) to leverage public/private investment projects; encourage non-OECD countries to integrate further into rules-based international frameworks for investment; actively promote the OECD Guidelines for Multinational Enterprises, together with other elements of the OECD Declaration on International Investment; and share with non-members the OECD peer review-based approach to building investment capacity.

Political Ideology and Foreign Direct Investment: Radical View and Free market View

Radical view

Has Marxist roots; views Multi-National Enterprise (MNE) as an instrument of imperialist domination. Prohibits FDI; nationalize subsidiaries of foreign-owned MNE's

Free market view

Classical economic roots (Adam Smith); views the MNE as an instrument for allocating production to most efficient locations
No restrictions on FDI

Pragmatic nationalism

Views FDI as having both benefits and costs restricts FDI where costs outweigh benefits; Bargain for greater benefits and fewer costs; aggressively court beneficial FDI by offering incentives.

2.10 Cost Benefit Analysis of FDI

Foreign Direct Investment is an investment in the form of a controlling ownership (10%or more) in a business in one country by an Business entity based in another country. Businesses that make foreign direct investments are often called multinational corporations (MNCs) or multinational enterprises (MNEs). A cost-benefit analysis is a process by which business decisions are analyzed. The benefits of a given situation or business related action are summed, and then the costs

associated with taking that action are subtracted. Prior to erecting a new plant or taking on a new project, prudent managers conduct a cost-benefit analysis as a means of evaluating all the potential costs and revenues that may be generated if the project is completed. The outcome of the analysis will determine whether the project is financially feasible or if another project should be pursued. Cost Benefits of FDI can be classified as two

I. Cost and Benefits of the Country

a.) Benefits of the Host Country

- Improving the balance of payments - inward investment will usually help a country's balance of payments situation. The investment itself will be a direct flow of capital into the country and the investment is also likely to result in import substitution and export promotion. Export promotion comes due to the multinational using their production facility as a basis for exporting, while import substitution means that products previously imported may now be bought domestically.
- Providing employment - FDI will usually result in employment benefits for the host country as most employees will be locally recruited. These benefits may be relatively greater given that governments will usually try to attract firms to areas where there is relatively high unemployment or a good labor supply.
- Source of tax revenue - profits of multinationals will be subject to local taxes in most cases, which will provide a valuable source of revenue for the domestic government.
- Technology transfer - multinationals will bring with them technology and production methods that are probably new to the host country and a lot can therefore be learnt from these techniques. Workers will be trained to use the new technology and production techniques and domestic firms will see the benefits of the new technology. This process is known as technology transfer.
- Building of economic and social infrastructure.
- Strengthening of the government budget.
- Stimulation of national economy
- The presence of one multinational may improve the reputation of the host country and other large corporations may follow suite and locate as well.

b.) Cost of the host country

- Cultural and political interference.
- Unhealthy competition to Domestic players
- Over utilization of local resources (both natural and human resources)
- Violation of human rights (child labor eg. the case of NIKE in Vietnam, APPLE in China etc).
- Threat to indigenous technology.
- Threat to local products.

II. Cost and Benefits of Investing MNCs

a.) Benefits of Investing MNCs

- Access to markets: FDI can be an effective way for you to enter into a foreign market. Some countries may extremely limit foreign company access to their domestic markets. Acquiring or starting a business in the market is a means for you to gain access.
- Access to resources: FDI is also an effective way for you to acquire important natural resources, such as precious metals and fossil fuels. Oil companies, for example, often make tremendous FDIs to develop oil fields.
- Reduces Cost of production: FDI is a means for you to reduce your Cost of production if the labor market is cheaper and the regulations are less restrictive in the target foreign market. For example, it's a well-known fact that the shoe and clothing industries have been able to drastically reduce their costs of production by moving operations to developing countries. Its also likely that Investors may get investment incentives, promotion, social amenities.

b.) Cost of Investing MNCs

- Risk from Political Changes. Because political issues in other countries can instantly change, foreign direct investment is very risky. Plus, most of the risk factors that you are going to experience are extremely high.
- Hindrance to Domestic Investment: As it focuses its resources elsewhere other than the investor's home country, foreign direct investment can sometimes hinder domestic investment
- Economic Non-Viability: Considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.
- Expropriation: Remember that political changes can also lead to expropriation, which is a scenario where the government will have control over your property and assets. Investment abroad takes away employment opportunities of the people in the Home country.

Summary

This unit attempts to give an overview of the functions in as simple manner as possible. Foreign direct investment occurs when a firm invests directly in facilities to produce a product in a foreign country. It also occurs when a firm buys an existing enterprise in a foreign country. Horizontal FDI is FDI in the same industry abroad as a firm operates at home. Vertical FDI is FDI in an industry abroad that provides inputs into or sells output from a firm's domestic operations. Several factors characterized FDI trends over the past 20 years; (a) there has been a rapid increase in the total volume of FDI undertaken, (b) there has been some decline in the relative importance of the United States as a source for FDI, while several other countries have increased their share of total FDI outflows, (c) an increasing share of FDI seems to be directed at the developing nations of Asia and Eastern Europe, while the United States has become a major recipient of FDI, and (d) there has been an increase in the amount of FDI undertaken by firms based in developing nations. High transportation costs and/or tariffs imposed on imports help explain why many firms prefer horizontal FDI or licensing over exporting. Impediments to the sale of know-how explain why firms prefer horizontal FDI to licensing These impediments arise when (a) a firm has valuable know-how that cannot be adequately protected by a licensing contract, (b) a firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (c) a firm's skills and know-how are not amenable to licensing. Knickerbocker's theory suggests that much FDI is explained by imitative strategic behaviour by rival firms in an oligopolistic industry. Vermon's product life cycle theory suggests that firm's undertake FDI at particular stages in the life cycle of products they have pioneered. Dunning has argued that location-specific advantages are of considerable importance in explaining the nature and direction of FDI. According to Dunning, firms undertake FDI to exploit resource endowments or assets that are location-specific. Backward vertical FDI may be explained as an attempt to create barriers to entry by gaining control over the source of material inputs into the down stream stage of a production process. Forward vertical FDI may be seen as an attempt to circumvent entry barriers and gain access to national market. The market imperfections approach suggests that vertical FDI is a way of reducing a firm's exposure to the risks that arise from investments in specialized assets. From a business prescriptive, the most useful theory is probably the market imperfections approach, because it identifies how the relative profit rates associated with horizontal FDI, exporting, and licensing vary with circumstances. The benefits of FDI to a host country arise from resource-transfer effects, employmenteffects, balance of payments effects, and its ability to promote competition. The costs of FDI to a host country include adverse effects on competition and balance of payments and a perceived loss of national sovereignty. The benefits of FDI to the home (source) country include improvement in the balance of payments as a result of the inward flow of foreign earnings, positive employment effects when the foreign subsidiary creates demand for home country exports and benefits from a reverse resource-transfer effect. A reverse resource-transfer effect arises when the foreign subsidiary learns valuable skills abroad that can be transferred back to the home country. The costs of FDI to the home country include adverse balance-of-payments effects that arise from the initial capital outflow and from the export substitution effects of FDI. Costs also arise when FDI exports jobs abroad.

Keywords

Backward Vertical FDI: It is an attempt to create barriers to entry by gaining control over the source of material inputs into the down stream stage of a production process.

Foreign Direct Investment (FDI): Direct investment in business operations in foreign country.

Forward Vertical FDI: It is an attempt to circumvent entry barriers and gain access to national market.

Horizontal Foreign Direct Investment: Foreign direct investment in the same industry abroad as a firm operates in at home.

Market Imperfections: These are factors that restrain markets from working perfectly.

Vertical Foreign Direct Investment: Foreign direct investment in an industry abroad that provides input into a firm's domestic operations, or foreign direct investment into an industry abroad that sells the outputs of a firm's domestic operations.

Self Assessment

1. The foreign direct investment includes
A. Intellectual Property
B. Human Resource
C. Tangible Good
D. Intangible Goods

2. The disputes of FDI are over
A. Concern
B. Interest
C. Regard
D. Hobby

3. Treaty of Rome was signed in the year
A. 1959
B. 1957
C. 1956
D. 1955

4. When did Austria join European Union?
A. 1997
B. 1993
C. 1995
D. 1999

5. For spreading information the foreign policy decision-makers rely on
A. Bureaucrats
B. Politicians
C. Media
D. Public

6. ___ is not an advantage of international business.

A. Low-cost production
B. Market forces
C. Large customer base
D. Diversified risk

7. Trade occurs as a result of:
A. Choice differential.
B. Habit differential.
C. Taste differential.
D. Resource differential

8. Which of the following best defines a multinational corporation?
A. A company that exports to many countries
B. A large company that imports from many countries
C. A company that operates in many different countries
D. A company that produces goods and services for a large market

9. Which one of the following is not a feature of a Multi-National Company?
A. It owns/controls production in more than one nation.
B. It sets up factories where it is close to the markets.
C. It organizes production in complex ways.
D. It employs labour only from its own country.

10. What is the main motive behind the investments of MNCs?
A. The main motive is to increase their assets and earn profits.
B. The main motive is the welfare of the poor people.
C. The main motive of an MNCs is to offer financial support to the government of their country.
D. The main motive is to benefit foreign countries.

11. MNCs keep in mind certain factors before setting up production". Identify the incorrect option from the choices given below
A. Availability of cheap skilled and unskilled labour
B. Proximity to markets
C. Presence of a large number of local competitors
D. Favorable government policies

12. The foreign direct investment includes
A. Intellectual Property
B. Human Resource
C. Tangible Good
D. Intangible Goods

13. The disputes of FDI are over
A. Concern

B. Interest
C. Regard
D. Hobby

14. More expansion of foreign direct investment can boost __________ .
A. Money circulation
B. Demand
C. Employment
D. Unemployment

15. The foreign direct investment DOES NOT include
A. Intellectual Property
B. Human Resource
C. Tangible Good
D. None of the above

Answer for Self Assessment

1.	C	2.	B	3.	B	4.	C	5.	C
6.	B	7.	D	8.	A	9.	D	10.	A
11.	C	12.	C	13.	B	14.	C	15.	D

Review Questions

1. What is international investment or foreign investment? What are the basic facts which help in distinguishing foreign direct investment and foreign portfolio investment (FPI)?
2. Discuss the benefits of FDI to the home court and to the host country.
3. What are the factors affecting international investment? Discuss four E's of international investment.
4. What is FDI? State and explain the factors that influence FDI.
5. Why do countries want FDI?
6. Explain Eclectic Theory and internationalization theory of international trade.
7. Discuss the global trends of FDI. What are new developments in FDI policies?
8. Explain Indian foreign investment policy. What measures have been adopted to attract FDI?
9. What are the major incentives for developed countries to invest in developing countries?
10. What are the advantages and disadvantages of FDI as compared to a licensing agreement with a foreign partner?
11. Recently, many foreign firms from both developed and developing countries acquired high tech US firms. What might have motivated these firms to acquire US firms?
12. Japanese MNCs such as Toyota, Toshiba and Matsushita made extensive investment in South East Asian countries like Thailand, Malaysia, Indonesia and India. In your opinion, what forces are driving Japanese investments in these regions?

13. Inward FDI is bad for

(a) A developing economy and

(b) A developed economy and shouldbe subjected to strict controls! Discuss.

14. Compare and contrast these explanations of horizontal FDI: the market imperfections approach, Vermon's product life-cycle theory, and Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of horizontal FDI? Why?

15. Compare and contrast these explanations of vertical FDI: the strategic behaviour approach the market imperfections approach. Which theory do you think offers the best explanation of the historical pattern of vertical FDI? Why?

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Unit 03: Instruments of Commercial Policy

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Objectives

After this lecture, you will be able to understand

- understand the importance of tariff and non-tariff barriers
- identify the Instruments of Commercial Policy
- understand the dynamics of protectionism in international trade
- evaluate the WTO Trade Regulations
- study the trade scenario of developing nations
- review different trade policies of developing nations
- find out the remedies for developing nation problems
- examine the effects of international capital flow
- analyze the theoretical foundations of foreign investment

Introduction

Import duties are levied on products and services. Tariffs are used to stifle trade by increasing the cost of imported products and services, hence increasing their cost to consumers. They are one of a number of instruments available for influencing trade policy. Tariffs may be imposed by governments to generate money or to protect home businesses from international competition, as customers will generally purchase cheaper foreign-produced items. Tariffs can lead to less efficient domestic industries and trade wars as exporting countries reciprocate their tariffs on imported goods. The WTO and similar organisations exist to combat the use of outrageous tariffs. Non-tariff barriers are another means by which an economy might limit the amount of commerce it conducts

with another economy, whether for selfish or charitable reasons. Any trade barrier results in economic loss because it prevents markets from functioning properly. Financial loss can be used to describe the revenue lost as a result of the trade barrier. In international commerce, a quota is a government-imposed restriction on the quantity, or in extreme situations, the value, of products or services that may be exported or imported during a given period of time. Quotas are more effective in restricting trade than tariffs, mainly if domestic demand for a commodity is not sensitive to increases in price. Due to the fact that the consequences of quotas cannot be countered by currency depreciation or export subsidies, they may be more disruptive to the international trade mechanism than tariffs. Quotas can also be used as a coercive economic weapon, selectively applied to specific countries. Tariff quotas should not be confused with import quotas. A tariff quota permits importing a certain quantity of a commodity duty-free or at a lower duty rate. In comparison, amounts exceeding the quota are subject to a higher duty rate.

government engagement in economic activity. They are implemented with two overt economic

3.1 Definition

Tariffs, or tariffs on commodities imported into a country or region, are one of the first examples of objectives in mind. First and foremost, they provide income for the government. Second, they increase economic returns to enterprises and resource suppliers to local industry that are subject to international import competition. Tariffs are frequently employed to safeguard the incomes of domestic producers from international competition. This protection comes at a cost to domestic consumers, who pay higher prices for import-competing goods, and to the economy, which suffers from inefficient resource allocation to the import-competing domestic industry. Thus, since 1948, when most developed economies' average tariffs on manufactured products exceeded 30%, those economies have tried to cut tariffs on manufactured goods through numerous rounds of negotiations under the General Agreement on Tariffs and Trade (GATT). Agriculture-related trade and tariff limitations were addressed only during the most recent Uruguay Round of discussions. Historically, and even during the GATT period, several countries imposed extremely high tariffs on certain agricultural commodities. When combined with other trade restrictions, they frequently posed substantial impediments to foreign producers' market access. Tariffs that are set too high can effectively shut down all trade and operate as import bans.

3.2 Types of Tariffs

Tariffs can be expressed in absolute or relative terms; they may be discriminatory or non-discriminatory, imposed on imports or on exports, and prompted by considerations of revenue or protection to domestic industries. They are expressed in absolute terms of dollars and cents per unit e.g. per tonne, or per pound of weight of the imported (or exported) quantity. Specific duties can be levied on goods like wheat or rice or sugar, but they can not be adopted for all goods and services, predominantly in the case of valuable goods. For instance, specific tariffs can not be levied in the case of, say, diamonds, modern art paintings, transistors, television sets, etc. We cannot estimate duties on the articles by weighing them physically. The task has to be calculated based on the value of these products rather than their physical weight. When, therefore, duty is levied based on the value of the product measured by their money price, we have ad valorem tariffs (ad valorem is a Latin word that means "on the value"). Ad valorem tariff is a percentage tax.

There may also be a compound tariff which combines a specific duty with an ad valorem duty. The distinction between the two types of tariffs is of some significance. As the prices of imported goods rise, the ad valorem tariff based on a given fixed percentage brings greater revenue to the tariff imposing country, whereas specific tariffs lack such revenue elasticity with respect to import price changes.

A discriminatory tariff calls for different rates of duties depending on the country of origin or the product's destination. For example, a country can impose higher rates of duty on goods coming into the country from, say, Australia and lower rates of duty on goods coming from Thailand. On the other hand, a non-discriminatory tariff imposes a uniform rate of duty regardless of their source of origin. Tariffs are said to be single columns when non-discriminatory, and double columns when they are discriminatory. Revenue tariffs are imposed primarily to produce revenue for the

government. With the introduction and expansion of income taxes and other direct taxes, the importance of tariffs as a source of revenue has considerably gone down, especially in developed countries. However, the less developed countries still rely on tariffs as a substantial source of government revenues. In Malaysia, for example, the import and export duties together amount for well over 40 percent of the total government revenues. In commercial policy, it is the protective tariffs that dominate the scene. When the tariffs are imposed primarily to protect the domestic industries from foreign competition, the country is said to have protective tariffs. The motive, here, is not revenue but protection of the domestic economy from foreign competition. It is impossible to classify revenue tariffs and protective tariffs and put them into watertight compartments because tariffs imposed for revenue will produce some protective effects and the protective tariffs yield some revenue. The difference between the two basically concerns their primary motive as such. Finally, there are retaliatory tariffs and countervailing tariffs. When Country A imposes (or increases) duties against the products from Country B, it is possible that country B will retaliate and levy duties on goods imported from Country A. Country B's tariffs are then described as retaliatory tariffs. Their motive is neither to raise revenue nor to accord protection to domestic industries but to act in retaliation. Tariffs are said to be countervailing when a country imposes (or increases) import duties with a view to offset export subsidy in the country of origin. For example, if Country B, the government of country B may think that country A is subsidizing its export to Country B, the government of country B may think that country A's products entering into Country B are enjoying "unfair advantage" over the country's domestic import replacement products. Country B is justified in imposing countervailing duties on the products imported from Country A. The countervailing duties aim to offset such an unfair advantage given by export subsidies in foreign countries. Import duties have received most of the analytical and policy attention and they are far more widespread than the export duties. In some countries like the United States, export duties are prohibited by law. In other countries where export duties are in vogue, their sole aim appears to be revenue collection. Import duties, however, are motivated by two other considerations, besides revenue viz. reviews of protection and balance of payments adjustment. Therefore, in what follows, we will concentrate our tariff study only concerning the import tariffs.

The Effective Rate of Protection:

The impact of a tariff is often different from its stated amount. Compared to free trade, the effective tariff rate measures the total increase in domestic production that the tariff makes possible. When tariff rates are low on raw materials and components, but high on finished goods, the effective tariff rate on finished goods is much higher than the nominal rate. This is referred to as tariff escalation

Avoiding and postponing tariffs

- Production sharing and special treatment for foreign assembly
- Bonded warehouses A bonded warehouse, or bond, is a building or other secured area in which dutiable goods may be stored, manipulated, or undergo manufacturing operations without payment of duty.
- Foreign trade zones

3.3 Effects of Imposing Tariffs

Consumer surplus is the difference between what consumers would be willing to pay and what they produce. The imposition of a tariff reduces consumer surplus.

An increase in producer surplus, or rent, is the payment that need not be made in the long run to induce domestic producers to supply additional goods with the tariff—also called ***the subsidy effect of tariff.***

Tariffs are a boon to domestic producers who now face reduced competition in their home market. The reduced competition causes prices to rise. The sales of domestic producers should also rise, all else being equal. The increased production and price causes domestic producers to hire more workers which causes consumer spending to rise. The tariffs also increase government revenues that can be used to benefit the economy. There are costs to tariffs; however, now the price of the good with the tariff has increased, the consumer is forced to either buy less of this good or less of some other good. The price increase can be thought of as a reduction in consumer income. Since consumers are purchasing less, domestic producers in other industries are selling less, causing a decline in the economy. Generally, the benefit generated by increased domestic production in the tariff-protected sector and increased government revenues does not offset the increased prices' losses caused by consumers and the costs of imposing and collecting the tariff. We haven't even

considered the possibility that other countries might put tariffs on our goods in retaliation, which we know would be costly to us. Even if they do not, the tariff is still expensive to the economy. In my article The Effect of Taxes on Economic Growth, we saw that increased taxes cause consumers to alter their behavior which in turn causes the economy to be less efficient. Adam Smith's The Wealth of Nations showed how international trade increases the wealth of an economy. Any mechanism designed to slow global trade will have the effect of reducing economic growth. For these reasons, economic theory teaches us that tariffs will be harmful to the country imposing them. That's how it should work in theory. How does it work in practice?

Stolper-Samulelson Theorem

An increase in the relative price of a commodity (for example, as the result of a tariff) raises the return of the factor used intensively in production of commodity.Thus, the actual return to the nation's scarce aspect of production will rise with the imposition of a tariff. Scare factor (which a country is imported) will raise the return of products with the imposition of tariff. For E.g. N-2 (scare of labor) impose a tariff on X. commodity (labor-intensive), so prices of X (px/py) will rise and so labor wages (w/r) will rise. Because the increase in wages will lead the prices higher. The share of labor in N2 increase in wages (income of labor) decreases the national income (reduced by tariff). Thus demand of capital decreases and the k price. I-e interest decrease.

Non -Tariff Barriers

Non-tariff barriers (NTBs) are trade barriers that restrict imports but are not in the usual form of a tariff. Non-tariff barriers are another way for an economy to control the amount of trade it conducts with another economy, either for selfish or charitable purposes. Any barrier to employment will create an economic loss, as it does not allow markets to function properly. The lost revenues resulting from the barrier to trade can be called a financial loss. Non-tariff barriers to trade (NTBs) are trade barriers that restrict imports but are not in the usual form of a tariff. Some common examples of NTBs are anti-dumping measures and countervailing duties, which, although called non-tariff barriers, affect taxes once they are enacted. Their use has risen sharply after the WTO rules led to a significant reduction in tariff use. Some non-tariff trade barriers are expressly permitted in minimal circumstances when they are deemed necessary to protect the health, safety, sanitation, or depletable natural resources. In other forms, they are criticized as a means to evade free trade rules such as those of the World Trade Organization (WTO), the European Union (EU), or the North American Free Trade Agreement (NAFTA) that restrict the use of tariffs. Some of the non-tariff barriers are not directly related to foreign economic regulations but significantly impact foreign-economic activity and foreign trade between countries. Trade between countries is referred to as trade in goods, services, and factors of production. Non-tariff barriers to trade include import quotas, special licenses, unreasonable standards for the quality of goods, bureaucratic delays at customs, export restrictions, limiting the activities of state trading, export subsidies, countervailing duties, technical barriers to trade, sanitary and phytosanitary measures, rules of origin, etc. Sometimes in this list, they include macroeconomic actions affecting trade.

Non-tariff Restrictions

Quota

Quota has significant restrictions on trade. It is a direct quantitative restriction on the amount of a commodity allowed to be imported or exported. Western nations used quotas to protect agriculture and stimulate the export of manufactured products

Comparison of Quota and Tariffs

- Quota increase domestic price
- increase domestic production with improvement in demand.
- Tariff leaves price and output but increases imports and consumption.
- Import quotas limit import to a specialized level while import doesn't specify the import and is uncertain.
- Govt distributes import levels on official judgment and action to avoid the monopoly.
- In essence, foreign exporter increases their efficiency (price) or accepts lower profit that falls import.
- But they can't reduce the export quota, which is less than anticipated.

Other Nontariff Barriers and Non-Protectionism

Voluntary export

It is the most crucial trade barrier. In this case, the importing countries induce (under threat of higher around trade restriction) the exporter country to limit their export to that country. US negotiated with Japan in 1980 to restrict their export, which the US saved 44000 jobs in the auto industry. But the total cost of the consumer was $15.7bn. The cost of one job was more than $100,000

The non-tariff barriers can include a wide variety of restrictions to trade.

Licenses: The most common instruments of direct regulation of imports (and sometimes export) are licenses and quotas. Almost all industrialized countries apply these non-tariff methods. The license system requires that a state (through a specially authorized office) issue permits for foreign trade transactions of import and export commodities included in the lists of licensed merchandise. Product licensing can take many forms and procedures. The main types of licenses are generally licenses that permit unrestricted importation or exportation of goods included in the lists for a certain period of time, and a one-time license for a particular product importer (exporter) to import (or export). The one-time license indicates a quantity of goods, its cost, its country of origin (or destination), and in some cases also customs point through which import (or export) of goods should be carried out. The use of licensing systems as an instrument for foreign trade regulation is based on several international level standards agreements. In particular, these agreements include some provisions of the General Agreement on Tariffs and Trade and the Agreement on Import Licensing Procedures, concluded under the GATT (GATT). Licensing of foreign trade is closely related to quantitative restrictions—quotas - on imports and exports of certain goods. A quota is a limitation in value or in physical terms, imposed on the import and export of certain goods for a certain period. This category includes global quotas regarding specific countries, seasonal quotas, and so-called "voluntary" export restraints. Quantitative controls on foreign trade transactions are carried out through a one-time license. Quantitative restriction on imports and exports is a direct administrative form of government regulation of foreign trade. Licenses and quotas limit the independence of enterprises with regard to entering foreign markets, narrowing the range of countries, which may be entered into the transaction for certain commodities, regulate the number and range of goods permitted for import and export. However, the system of licensing and quota imports and exports, establishing firm control over foreign trade in certain goods, in many cases, turns out to be more flexible and effective than economic instruments of foreign trade regulation. The fact can explain that licensing and quota systems are an essential instrument of trade regulation of the vast majority of the world. This trade barrier is usually reflected in the consumers' loss because of higher prices and limited selection of goods and in the companies, that employ the imported materials in the production process, increasing their costs. An import quota can be unilateral, levied by the country without negotiations with exporting country, and bilateral or multilateral, when it is imposed after negotiations and agreement with exporting country. An export quota is a limited amount of goods that can leave the country. There are different reasons for the setting of export quota by the government, which can be the guarantee of the supply of the products that are in shortage in the domestic market, manipulation of the prices on the international level, and the control of goods strategically crucial for the country. In some cases, the importing countries request exporting countries to impose voluntary export restraints.

Standards: Standards take a special place among non-tariff barriers. Countries usually impose standards on classification, labeling and testing of products to be able to sell domestic products and to block sales of products of foreign manufacture. These standards are sometimes entered under the pretext of protecting the safety and health of local populations. Administrative and bureaucratic delays at the entrance Among the methods of non-tariff regulation should be mentioned administrative and bureaucratic delays at the entrance, which increase uncertainty and the cost of maintaining inventory. Import deposits Another example of foreign trade regulations is import deposits. Import deposits are a form of deposit. The importer must pay the bank for a definite period (non-interest-bearing deposit) equal to all or part of the cost of imported goods.At the national level, administrative regulation of capital movements is carried out mainly within a framework of bilateral agreements, including a clear definition of the legal regime and procedure, for the admission of investments and investors. It is determined by mode (fair and equitable, national, most-favored-nation), order of nationalization and compensation, transfer profits and capital repatriation, and dispute resolution. Foreign exchange restrictions and foreign exchange control Foreign exchange restrictions and foreign exchange controls occupy a special place among the non-tariff regulatory instruments of foreign economic activity. Foreign exchange restrictions constitute the regulation of transactions of residents and nonresidents with currency and other currency values. Also, an essential part of the mechanism of control of foreign economic activity is establishing the national currency against foreign currencies.

3.4 Protectionism

Any measure designed to give local producers of goods or services an advantage over foreign competitors.

Arguments for Protection

There are many arguments for protecting local producers and industries. These include:

Protecting Domestic Employment: At any given time in an economy, some industries will be in decline (sunset industries) because they can not compete with foreign competition. If the sectors are relatively large, this will lead to high levels of structural unemployment, and governments often attempt to protect the industries to avoid unemployment. The negative externalities of a rapidly declining primary industry may be so significant the government feels obligated to provide some protection.

a) Counter Argument for Free Trade: The industry will continue to decline and protection will simply prolong the process. Although there will be short-run social costs, it could be better to let the resources employed in the industry go into another, expanding area of the economy.

Saving the economy from low-cost labor: The main reason for declining domestic industries is the low cost of labor in exporting countries. The economy should be protected from imports produced in countries where the cost of labor is very low. For Example – US clothing Industry, there have been demands in the US to protect the domestic clothing industry from cheap imports from Asia, where wages are much lower. Manufacturing Industries: While trade may create many benefits for the economy, the cost in terms of job losses may be concentrated in particular industries. There is much greater job insecurity among manufacturing workers in developed countries who fear they will lose their jobs to workers in emerging markets such as China and India. Workers and their trade unions may lobby vigorously for protection against imported goods.South Korea – Shipbuilding Industry • In 1998, the hourly wage for shipbuilding in the US was $19.19, but in South Korea, it was $9.27. While cheaper labor is available in other Asian countries, South Korean workers are well educated and can achieve high productivity levels.Not surprisingly, South Korea is now the largest shipbuilder in the world.In 2004, South Korea produced 14,768 large commercial ships, whereas the US had only 289.

a) **Counter Argument for Free Trade:** If we protect the economy from low-cost labour, consumers will pay higher prices than they should.Production in a protected economy would take place at an inefficient level.The countries wishing to export would lose trade and their economy would suffer.

- It should be realized that comparative advantages change over time and that a country with a comparative advantage in producing a good at present may not have that in the future. For example, the US did likely have a comparative advantage in shipbuilding. As relative factor costs change in different countries, resources must move as freely as possible from industries where comparative advantage is waning into sectors where it is growing.

b) Counter Argument Government supports workers who lose jobs: Governments have some responsibility to help workers who have lost their jobs due to increasing competition, from low-cost foreign labor. These supply-side policies could include additional education and training, so retrenched workers can enter new industries.

Protecting an Infant (sunrise) industry: Many governments argue that an industry that is just developing may not have the economies of scale advantages that more prominentsectors in other countries may enjoy. The domestic industry will not be competitive against imports until it can gain the cost advantages of economies of scale. Because of this, it is argued that industry needs to be protected against imports until it achieves a size where it can compete on an equal footing.

Counter Argument for Free Trade: Most developed countries have highly efficient capital markets (well, at least before the GFC!), which allows them access to large amounts of financial capital, even more so since the advent of globalization. Due to this fact, it can be argued that there is no basis for the idea that industries in developed countries will be set up in a relatively minor way. They could benefit from economies of scale in a relatively short period. Example: The Saudi Arabian government has been diversifying into petrochemical production in recent years.

It has undertaken several projects in partnership with large multinationals such as Chevron, BP, and Exxon Mobil.The plants constructed have been among some of the largest globally, gaining

almost immediately from economies of scale. Developing countries without access to sophisticated capital markets can likely use the infant industry argument to justify protectionist policies. However, it is debatable whether they have the global political power to impose protectionist policies without complaints and action from developed countries.

To avoid the risks of over-specialization: Governments may want to limit overspecialization if it means the country could become over-dependent on the export sales of one or two products. Any change in the world markets for these products might have severe consequences for the country's economy. For example, technological changes could severely reduce the demand for a commodity, as the development of quartz crystal watches did for the Swiss wristwatch industry, harming the economy. The introduction of new products or changes in the patterns of demand and supply can seriously affect the economies of developing countries, which tend to over-specialize in the production of primary products without choice. For example, the over-supply of coffee on the world market caused a fall in prices and severely impacted countries like Ethiopia.

a) Counter Argument for Free Trade: There are no real arguments against this view. It does not promote protectionism; it simply points out the problems that countries may face if they specialize to a great extent.

Strategic Reasons: It is sometimes argued that specific industries need to be protected if needed in times of war. For example, agriculture, steel, and power generation. Steel is required for many defense items, such as planes and tanks. The steel industry would argue that it must be protected to stay competitive. This argument may be a valid one to a certain extent, although it is often overstated. In many cases, it is unlikely that countries will go to war. It is also unlikely that they will be cut off from all supplies if they do. Most probably, this argument is being used as an excuse for protectionism.

To Prevent Dumping: Dumping is the selling by a country of large quantities of a commodity, at a price lower than its production cost, in another country.For example, the EU may have a surplus of butter and sell this at a meager cost to a small developing country. Where countries can prove that their industries have been severely damaged by dumping, their governments are allowed to impose anti-dumping measures to reduce the damage under international trade rules. However, it is challenging to prove whether or not a foreign industry is guilty of dumping.

- ***Counter Argument For Free Trade:*** A government that subsidizes a domestic industry may actually support dumping. For example, developing countries argue that when the EU exports invested sugar, it is a form of disposal because the price doesn't reflect the actual cost of the EU sugar producers. Therefore, if dumping does occur, it is more likely that there will be a need for talks between governments rather than any form of protection. There is always a danger that protectionism will invite retaliatory actions by foreign governments, reducing the benefits that can be gained by all consumers and producers in all countries.
- ***To Protect Product Standards:*** A country might have to impose safety, health or environmental standards on goods imported into its domestic market to ensure that the imports match the criteria of domestic producers. This is a valid argument, as long as the concerns are valid. For example, the EU has previously banned the import of American beef because it has been treated with hormones. Many of the reasons given for bans when standards are simply subtle means of protection. Where there is a dispute over product standards, a response by the exporting country might be to use retaliatory policies. In the EU-US beef dispute, the US retaliated against the EU in May 1999 by imposing trade sanctions on $117 million worth of imports from Europe.
- ***To raise government revenue:*** In many developing countries, it is difficult to collect taxes, so governments impose import taxes (tariffs) on products to raise revenue. The International Monetary Fund (IMF) estimated that, on average, import duties accounted for approximately 15% of total government revenue for developing countries in 2002.
- ***To correct a balance of payments deficit:*** Governments sometimes impose protectionist measures to reduce import expenditure and thus improve the current

account deficit. A current account deficit occurs when a country spends more on its imports of goods and services than it is earning on its exports of goods and services. This will only work in the short run. It does not address the current problem because it does not rectify the actual causes of the deficit. Also, if countries do this, then it is likely that other countries will retaliate with protectionist measures of their own. All the counter-arguments previously covered are great arguments for free trade. As previously studied, the arguments against protection are related to why countries work.

- ***Prices:*** Protection may raise prices for consumers and producers of their imports.
- ***Choice:*** Protection would lead to less choice for consumers.
- ***Competition:*** Competition would diminish if foreign firms were kept out of a country, so domestic firms may become inefficient without the incentive to minimize costs. Innovation may also be reduced for the same reason.
- ***Comparative Advantage:*** Protectionism distorts comparative advantages, leading to the inefficient use of the world's resources. Specialization is reduced, which would reduce the potential level of the world's output.

3.5 WTO Trade Regulation

The WTO intends to supervise and liberalize international trade.The organization officially commenced on January 1, 1995, replacing the GATT (General Agreement on Tariffs and Trade).The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. It tries to provide market access to countries for their products and services and promotes friendly investment policies by eliminating:

- Trade distortions between countries.
- Trimming down tariff and non-tariff barriers.
- Removing quotas.
- Abolishing subsidies in a phased manner.

WTO has rules to address quality issues, labor standards, environmental aspects, government regulation, and legal frameworks.The need for an institution to promote rule-based trade was felt when in the 1930s, the world suffered through the Great Depression and World War II. The WTO came into existence on 1 January 1995 as successor to the General Agreements on Tariffs and Trade (GATT). Its genesis goes back to the post-Second-World-War period in the late 1940s when economies of most European countries and the US were greatly disrupted following the war and the great depression of the 1930s. Consequently, a United Nations Conference on Trade and Employment was convened at Havana in November 1947. It led to an international agreement called Havana Charter to create an International Trade Organization (ITO), a specialized agency of the United Nations to handle the trade side of international economic cooperation. The draft ITO charter was ambitious and extended beyond world trade discipline to rules on employment, commodity agreements, restrictive business practices, international investment, and services.

However, the attempt to create the ITO was aborted as the US did not ratify it and other countries found it difficult to make it operational without US support. The combined package of trade rules and tariff concessions negotiated and agreed by 23 countries out of 50 participating countries became known as General Agreement on Tariffs and Trade (GATT): an effort to salvage from the aborted attempt to create the ITO. India was also a founder member of GATT, a multilateral treaty aimed at trade liberalization. GATT provided a multilateral forum during 1948-94 to discuss the trade problems and reduction of trade barriers. As shown in Exhibit its membership increased from 23 countries in 1947 to 123 countries by 1994. GATT remained a provisional agreement and organization throughout these 47 years and facilitated considerably, tariff reduction. During its existence from 1948 to 1994, average tariffs on manufactured goods in developed countries declined from about 40 per cent to a mere 4 per cent. It was only during the Kennedy round of negotiations in 1964-67, that an anti-dumping agreement and a section of development under the GATT were introduced. The first major attempt to tackle non-tariff barriers was made during the Tokyo round. The eighth round of negotiations known as the Uruguay Round of 1986-94 was the most comprehensive of all and led to the creation of the WTO with a new set up of agreements.

Why WTO required

- This economic issue started with the 1929 Stock Market Crash, wiping out people's savings and creating unemployment at the highest level in the Western World. That great Depression further resulted in WWII and destroyed many European countries.In January 1948, 23 nations organized the GATT in Geneva, providing an opportunity to start tariff negotiations.This first round resulted in 45,000 tariff concessions affecting $10 billion (about 1/5th of the world trade).The WTO replaced GATT as the world's global trading body in 1995.GATT trading regulations established between 1947 and 1994 remain the primary rule book for multilateral trade in goods.
- **Organizational Structure of the WTO**
- The organizational structure of WTO as summarized in Figure l, consists of the Ministerial Conference, General Council, council for each broad area, and subsidiary bodies.
- First level : The Ministerial Conference The Ministerial Conference is the topmost decision-making body of the WTO, which has to meet at least once every two years.
- Second level : General Council Day-to-day work in between the Ministerial Conferences is handled by the following three bodies:
- • The General Council
- • The Dispute Settlement Body
- • The Trade Policy Review Body In fact, all these three bodies consist of all WTO members and report to the Ministerial Conference, although they meet under different terms of reference.
- Third level : Councils for each broad area of trade There are three more councils, each handling a different broad area of trade, reporting to the General Council.

  • The Council for Trade in Goods (Goods Council)

  • The Council for Trade in Services (Services Council)

  • The Council for Trade Related Aspects of Intellectual Property Rights (TRIPS Council)

Each of these councils consists of all WTO members and is responsible for the working of the WTO agreements dealing with their respective areas of trade. These three also have subsidiary bodies. Six other committees also report to the General Council since their scope is more minor. They cover issues, such as trade and development, the environment, regional trading arrangements, and administrative issues. The Singapore Ministerial Conference in December 1996 decided to create new working groups to look at investment and competition policy, transparency in government procurement, and trade facilitation.

Fourth level: Subsidiary bodies Each of the higher councils has subsidiary bodies that consist of all member countries.

Goods Council: It has 11 committees dealing with specific subjects, such as agriculture, market access, subsidies, anti-dumping measures, etc.

Services Council: The subsidiary bodies of the Services Council deal with financial services, domestic services, GATS rules, and specific commitments.

Dispute settlement body: It has two subsidiaries, i.e., the dispute settlement 'panels' of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals at the General Council level. Formally all of these councils and committees consist of the full membership of the WTO.

But that does not mean they are the same, or that the distinctions are purely bureaucratic. In practice, the people participating in the various councils and committees are different because different levels of seniority and different areas of expertise are needed. Heads of missions in Geneva (usually ambassadors) normally represent their countries at the General Council level. Some of the committees can be highly specialized and sometimes governments send expert officials from their countries to participate in these meetings. Even at the level of the Goods, Services, and TRIPS councils, many delegations assign different officials to cover different meetings. All WTO members may participate in all councils, etc., except the Appellate Body, dispute settlement panels, textile monitoring body, and plurilateral committees. The WTO has a permanent Secretariat based in Geneva,

with a staff of around 560 and is headed by the Director-General. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the Secretariat does not have the decision-making role that other international bureaucracies are given. The Secretariat's main duties are to extend technical support for the various councils and committees and the Ministerial Conferences, provide technical assistance for developing countries, analyse world trade, and explain WTO affairs to the public and media. The Secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

Principles of the Multilateral Trading System Under the WTO for an international business manager, it is difficult to go through the whole of the WTO agreements which are lengthy and complex being legal texts covering a wide range of activities. The agreements deal with a wide range of subjects related to international trade, such as agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, and intellectual property. However, a manager dealing in international markets needs to have an understanding of the basic principles of WTO which form the foundation of the multilateral trading system. These principles are discussed below. Trade without discrimination Under the WTO principles, a country cannot discriminate between its trading partners and products and services of its own and foreign origin.

Most-favoured nation treatment: Under WTO agreements, countries cannot normally discriminate between their trading partners. If a country grants someone a special favour (such as a lower rate of customs for one of their products), it has to do the same for all other WTO members. The principle is known as Most-favoured nation (MFN) treatment. This clause is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS, Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS, Article 4), although in each agreement, the principle is handled slightly differently. Together, these three agreements cover all three main areas of trade handled by the WTO. Some exceptions to the MFN principle are allowed as under:

- Countries can set up a free trade agreement that applies only to goods traded within the group —discriminating against goods from outside.
- Countries can provide developing countries special access to their markets.
- A country can raise barriers against products that are considered to be traded unfairly from specific countries.
- In services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners—whether rich or poor, weak or strong.

National treatment: The WTO agreements stipulate that imported and locally-produced goods should be treated equally—at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of 'national treatment' (giving others the same treatment as one's own nationals) is also found in all the three main WTO agreements, i.e., Article 3 of GATT, Article 17 of GATS, and Article 3 of TRIPS. However, the principle is handled slightly differently in each of these agreements. National treatment only applies once a product, service, or an item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

Gradual move towards freer markets through negotiations: Lowering trade barriers is one of the most obvious means of encouraging international trade. Such barriers include customs duties (or tariffs) and measures, such as import bans or quotas that selectively restrict quantities. Since GATT's creation in 1947-48, there have been eight rounds of trade negotiations. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the mid-1990s industrial countries' tariff rates on industrial goods had fallen steadily to less than 4 per cent. But by the 1980s, the

negotiations had expanded to cover nontariff barriers on goods and new areas, such as services and intellectual property. The WTO agreements allow countries to introduce changes gradually through 'progressive liberalization'. Developing countries are usually given longer period to fulfil their obligations.

Increased predictability of international business environment: Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future market opportunities. With stability and predictability, investment is encouraged, jobs are created, and consumers can fully enjoy the benefits of competition—choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In the WTO, when countries agree to open their markets for goods or services, they 'bind' their commitments. For goods, these bindings amount to ceiling on customs tariff rates. A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. In agriculture, 100 per cent of products now have bound tariffs. The result of this is a substantially higher degree of market security for traders and investors. The trading system under the WTO attempts to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports as administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries' trade rules as clear and public (transparent) as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

Promoting fair competition: The WTO is sometimes described as a 'free trade' institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair, and undistorted competition.

3.6 Objectives of WTO

- Raising standards of living.
- Ensuring full employment.
- Expanding production of goods and services.
- Sustainable development.
- Securing share in trade of developing and least developed countries.
- Designing a reciprocal and mutually advantageous arrangement directed to substantially reducing discriminatory treatment in international trade relations.

General Agreement on Tariffs and Trade

The General Agreement on Tariffs and Trade (GATT) has significantly widened the access to international markets, besides providing legal and institutional framework. Under the WTO regime, countries can break the commitment (i.e., raise the tariff above the bound rate), but only with difficulty. To do so, a member country is required to negotiate with the countries most concerned and that could result in compensation for trading partners' loss of trade. Opening Up of the Industrial Sector Market access schedules under GATT include commitments of member countries to reduce the tariffs and not increase the tariffs above the listed rates, which means the rates are bound. For developed countries, bound rates are the rates generally charged. Most developing countries have bound the rates somewhat higher than actual rates charged, so the bound rates can serve as a ceiling. Reduction in tariffs : Individual member countries have listed their commitments to reduce the tariff rates in schedules annexed to the Marrakesh Protocol to the General Agreement on Tariffs and Trade, 1994, which is a legally binding agreement. Under these commitments, developed countries were to cut the average tariff levels on industrial products by 40 per cent in five equal instalments from 1 January 1995. However, the percentage of tariff reduction on some products of export interest to developing countries, such as textiles and clothing and leather and leather products is much lower than the average, as they are considered sensitive. Several developing countries and economiesin-transition agreed to reduce their tariffs by nearly

two-thirds of the percentage achieved by developedcountries. As a result, the weighted average levels of tariffs applicable to industrial products were expected to fall in a period of five years from • 6.3 per cent to 3.8 per cent in developed countries • 15.3 per cent to 12.3 per cent in developing countries • 8.6 per cent to 6 per cent in the transition economies Additional commitments were made under the Information Technology Agreement in 1997 wherein 40 countries accounting for more than 92 per cent of trade in information technology products, agreed to eliminate import duties and other charges on most of these products by 2000 and on a handful of the products by 2005. As with other tariff commitments, each participating country is applying its commitments equally to exports from all WTO members, i.e. on a most-favoured nation basis, even from members that did not make the commitments. Tariff bindings : Besides the commitments to reduce tariffs, market access schedules represent commitments on the part of member countries not to increase the tariffs above the listed rates known as 'bound' rates. Binding of tariff lines has substantially increased the degree of market security for traders and investors.

Opening Up International Business Opportunities in Textiles: World trade in textiles and clothing had been subject to a large number of bilateral quota arrangements over the past four decades. The range of products covered by quotas expanded from cotton textiles under the short-term and long-term arrangements of the 1960s and early 1970s to an ever-increasing list of textile products made from natural and man-made fibers under five expansions of the multifiber agreement. From 1974 until the end of the Uruguay Round, the international trade in textiles was governed by the Multi-fiber Arrangement (MFA). This was a framework for bilateral agreements or unilateral actions that established quotas limiting imports into countries whose domestic industries were facing serious damage from rapidly increasing imports. The quota system under MFA conflicted with GATT's general preference for customs tariffs instead of measures that restricted quantities. The quotas were also exceptions to the GATT principle of treating all trading partners equally because they specified how much the importing country was going to accept from individual exporting countries. Since 1995, the WTO's Agreement on Textiles and Clothing (ATC) took over from the MFA and had been the WTO's significant agreement. A Textiles Monitoring Body (TMB) supervised the implementation of the agreement. It monitored actions taken under the agreement to ensure that they are consistent, and reports to the Council on Trade in Goods and reviews the operation of the agreement. The TMB also dealt with disputes under the ATC. If they remain unresolved, the disputes could be brought to the WTO's regular Dispute Settlement Body.

General Agreement on Trade in Services

The General Agreement on Trade in Services (GATS) is the first and only set of multilateral rules governing international trade in services. Negotiated in the Uruguay Round, it was developed in response to the strong growth of the services economy over the past three decades and the greater potential for marketing services internationally brought about by the communications revolution. The GATS has three elements:

1. The main text containing general obligations and disciplines
2. Annexes dealing with rules for specific sectors
3. Individual countries' specific commitments to provide access to their markets, including indications where countries are temporarily not applying the most-favored nation principle of non-discrimination.

General obligations and disciplines: The agreement covers all internationally-traded services, e.g., banking, telecommunications, tourism, professional services, etc. It also defines four ways (or 'modes') of trading services internationally.

Commitments on market access and national treatment: Individual countries' commitments to open markets in specific sectors and the extent of their openness has been the outcome of the Uruguay Round negotiations. The commitments appear in 'schedules' that list the sectors being opened, the extent of market access being given in those sectors (e.g., whether there are any restrictions on foreign ownership), and any limitation on national treatment (whether some rights granted to local companies will not be granted to foreign companies). For instance, if a government commits itself to allow foreign banks to operate in its domestic market, that is a market-access commitment. And if the government limits the number of licences it will issue, then that is a market-access limitation. If it also says foreign banks are only allowed one branch while domestic banks are allowed numerous branches, that is an exception to the national treatment principle. These clearly defined commitments are 'bound'—like bound tariffs for trade in goods, and they can only be modified after negotiations with affected countries. Because 'unbinding' is difficult, the commitments are virtually guaranteed conditions for foreign exporters and importers of services

and investors in the service sector. Governmental services are explicitly carved out of the agreement and there is nothing in GATS that forces a government to privatize service industries. The carve-out is an explicit commitment by WTO governments to allow publicly funded services in core areas of their responsibility. Governmental services are defined in the agreements as those that are not supplied commercially and do not compete with other suppliers. These services are not subject to any GATS discipline, are not covered by the negotiations, and the commitments on market access and national treatment do not apply to them.

Transparency: GATS stipulates that governments must publish all relevant laws and regulations, as set-up enquiry points within their bureaucracies. Foreign companies and governments can then use these inquiry points to obtain information about regulations in any service sector. Further, the member countries' governments have to notify the WTO of any change in regulations that apply to the services that fall under specific commitments.

Objectivity and reasonability of regulations: Since domestic regulations are the most significant means of exercising influence or control over services trade, the agreement says governments should regulate services reasonably, objectively, and impartially. When a government makes an administrative decision that affects a service, it should also provide an impartial means for reviewing the decision (e.g., a tribunal). GATS does not require any service to be deregulated. Commitments to liberalize do not affect governments' right to set levels of quality, safety, or price, or to introduce regulations to pursue any other policy objective. A commitment to national treatment, e.g., would only mean that the same regulations would apply to foreign suppliers as to nationals. Governments naturally retain their right to set qualification requirements for doctors or lawyers, and to set standards to ensure consumer health and safety.

3.7 Rules of WTO

a) Protection to Domestic Industry through Tariffs: Member countries can protect their domestic industry/production through tariffs only. It prohibits quantitative restrictions, except in a limited number of situations.

b) Binding of Tariffs: The member countries are urged to eliminate the protection of domestic industry/production by reducing tariffs and removing other barriers to trade in multilateral trade negotiations.

c) Most Favored-Nation (MFN) Treatment: The rule lays down the principles of non-discrimination amongst member countries. Tariffs and other regulations should be applied to imported or exported goods without discrimination. Exceptions to the regulations are regional arrangements subjected to preferential or duty-free trade agreements and the Generalized System of Preferences (GSP), where developed countries apply preferential or duty-free rates to imports from developing countries.

d) National Treatment Rule: The rule prohibits member countries from discriminating between imported products and domestically produced goods in the matter of internal taxes and the application of internal regulations

3.8 WTO Agreements

- At the heart of the WTO are the WTO agreements, negotiated and signed by a large number of the world's trading nations and ratified by their parliaments.
- Agreement on trade related aspects of intellectual property rights. (TRIPS)
    - Intellectual property rights
    - Copyrights
    - Patent trade marks
    - Geographical names
    - Industrial designs
    - Trade secrets
- Agreement on agriculture. (AOA)
- Agreement on Sanitary and phytosanitary measures. (SPS)

    - Food safety through CAC.
    - Plant health standards.
    - Animal health standards specific towards;
    - Additives, contaminants and toxic substances in food.
    - Pesticides & drug residues and MRL compliance.
    - Food Certification (HACCP and GMP).
    - Labeling requirements.
    - Plant and animal quarantine requirements.
    - Disease and Pest control.
- Technical barriers to trade (TBT) agreement.
    - Inspection, testing and certification.
    - Custom procedures.
    - High custom duties.
    - Violation of intellectual property rights.
    - Investment restrictions.
    -

3.9 Developing Countries

Introduction

The term "developing countries" does not have a precise definition, but it is a name given to anylow and middle-income countries. Very dependent on the developed industrial countries asexport markets and source of imports. Exports are heavily weighted toward primary products (agricultural goods, raw materials) and labor-intensive manufactures. Share of manufactured exports is increasing, but mainly in a small number of newly industrialized nations (such as South Korea Hong Kong)

Developing Nations and Trade

Table3.1 Developing nations: dependence on primary products (2000)

Country	Major Export Product	% of Total Exports
Nigeria	**Oil**	**98**
Saudi Arabia	**Oil**	**86**
Burundi	**Coffee**	**80**
Ethiopia	**Coffee**	**70**
Venezuela	**Oil**	**69**
Mauritania	**Iron Ore**	**59**
Chad	**Cotton**	**54**
Zambia	**Copper**	**51**

Developing Nation Concern

Face problems of unstable export markets –

1. Concentration on one or a few primary-product exports combined with inelastic supply and demand conditions
2. Argue that they face worsening terms of trade as the relative value of primary products has fallen compared to manufactured goods they import.

Remedies for developing nation problems

1. **Stabilizing commodity prices - international commodity agreements**

– **Production and export controls**

– **Buffer stocks**

– **Multilateral contracts**

2. **Generalized system of preferences (GSP)**

3. **But experience with commodity agreements has been mixed, at best, and application of the GSP is spotty.**

Growth strategies for Developing Nation Concerns:

a) Import substitution

- Trade barriers protect emerging domestic industries
- Popular in the 1950s and 1960s

b) Export-led growth

- Focus on the export of manufactures as the engine of growth
- Became more common starting in the 1970s

Import substitution: Pros

- Risk of establishing home import-replacing industry is low because home market already exists.
- It is easier for developing nations to protect their own markets than to force industrial countries to open theirs.
- Gives foreign firms an incentive to locate production in a developing country, providing jobs.
- Trade restrictions shelter home industry from competition, giving no incentive for efficiency.
- Small size of most developing country markets makes it difficult to benefit from economies of scale.
- Protection of import-competing industries draws resources away from all other sectors, including potential exporters.

Export-led growth: Pros

- Encourages industries in which developing countries are likely to have a comparative advantage, such as labor-intensive manufactures.
- **Export markets allow domestic producers to utilize economies of scale**.
- Low level of trade restrictions forces domestic firms to remain competitive.
- Main disadvantage to export-led growth is that it depends on the ability and willingness of industrial nations to absorb large quantities of manufactures from developing countries

In other words, it is sensitive to economic cycles and protectionist pressures in the export markets

Foreign Trade Policy

"Trade policy refers to the complete framework of laws, regulations, international agreements, and, negotiating stances adopted by a government to achieve legally binding market access for domestic firms." - Walter Goode

- The Government has set a long-term vision of making India a significant player in world trade.
- Foreign Trade Policy (FTP) provides the basic policy framework of translating this vision into specific strategies, goals and targets.

Free Trade Policy

- It does not impose any restriction on exchanging goods and services between different countries. It involves the complete absence of tariffs, quotas, exchange restrictions, taxes and subsidies on production, factor use and consumption. A government pursues seeks to maintain a system of trade restrictions to protect the domestic economy from the competition of foreign products.

Protective Trade Policy

- A country pursues seeks to maintain a system of trade restrictions to protect the domestic economy from the competition of foreign products.

Inward looking trade policy(import substitution)

- It stresses the need for a country to evolve its development style and be the master of its own fate, with restrictions on the movement of goods, services, and people in and out of the country.
- An inward-looking trade policy encourages the development of indigenous technologies appropriate to a country's resource endowment.

Outward looking trade policy (export-led growth)

- It encourages free trade and the free movement of capital, workers, enterprises, and students, a welcome to the multinational enterprise, and an open system of communications.

3.10 International Capital Flow

International capital flows are the financial side of International Trade. When someone imports a good or service, the buyer (the importer) gives the seller (the exporter) a monetary payment, just as in domestic transactions. If total exports were equal to total imports, these monetary transactions would balance at net zero: people in the country would receive as much in financial flows as they paid out in financial flows. But generally the trade balance is not zero. The most general description of a country's balance of trade, covering its trade in goods and services, income receipts, and transfers, is called its current account balance. If the country has a surplus or deficit on its current account, there is an offsetting net financial flow consisting of currency, securities, or other real property ownership claims. This net financial flow is called its capital account balance.

When a country's imports exceed its exports, it has a current account deficit. Its foreign trading partners who hold net monetary claims can continue to hold their claims as economic deposits or currency, or they can use the money to buy other financial assets, real property, or equities (stocks) in the trade-deficit country. Net capital flows comprise the sum of these monetary, financial, real property, and equity claims. Capital flows move in the *opposite* direction to the goods and services trade claims that give rise to them. Thus, a country with a current account deficit necessarily has a capital account surplus. In balance of payment accounting terms, the current-account balance, which is the total balance of internationally traded goods and services, is just offset by the capital-account balance, which is the total balance of claims that domestic investors and foreign investors have acquired in newly invested financial, real property, and equity assets in each others' countries. While all the above statements are true by definition of the accounting terms, the data on international trade and financial flows are generally riddled with errors because of undercounting. Therefore, the global capital and trade data contain a balancing error term called "net errors and omissions."

Effects of International Capital Flow

a) Effect on Domestic Labour

- Capital flows to utilize cheaper labour.
- More employment opportunities.
- International capital flow increases labour productivity.
- It brings higher wages.

b) Effects on Consumers

- The foreign investment enables the country to produce at a lower cost.
- It leads to a fall in prices.

- It increases the consumer surplus.
- The recent fall in prices of various goods and services in India is an example of this (4G services).
- Foreign products may be made available to domestic consumers.

c) Effect on Government

- Government revenue increases since productivity are high.
- More income is generated; more revenue is collected.
- It shows a positive fiscal impact.

d) Effects on External Economies

- Foreign investment helps to improve infrastructure.
- It helps developing nations address capital shortages.
- Foreign debt may be dependent on highway construction, metro construction, etc.
- It creates more external benefits:

Input demand: labor, construction materials (cement, sand, steel, machines etc.), transportation of laborers and materials, input demand increase in all concerned sectors etc.

Output demand: demand by the beneficiaries of input demand for finished goods and services

e) Effect on BOP

- The inflow will be credited to the BOP of a country.
- The outflow will be debited to the BOP of a country.
- India gained surplus in BOP through inflow.
- India has one of the largest foreign exchange reserves in the world.

f) Effect on Growth

- The effect of foreign investment on economic growth
- Developing countries like India are capital-short countries.
- They need external assistance.
- Foreign capital helps to fill this capital shortage.
- It boosts the production sector of the economy.

g) Effect on needy sectors

- Foreign investors focus on profit making in non-priority sectors.

- Investment in priority sectors may be less.
- Needy sectors remain capital short.

h) Effect on Politics

- Foreign investors may interfere in international politics.
- Funding for the election.
- Foreign MNC's don't have any sincere interest in the welfare of the people.

i) Effect on Ethical Trade Practices

- Foreign investors may engage in unfair and unethical trade practices.
- They may try to drive small players out of the industry by following cheaper pricing policies.
- They may capture market share somehow.

i) Effects on Small Enterprise

- The entry of MNC's will affect the domestic economy.
- Small firms may not be able to survive the competition.
- Dumping may be followed by driving small domestic rivals out of the industry.

j) Effect on Competition

- Inward foreign investment promotes domestic competition.
- It reduces the monopoly power of domestic enterprises.

John Dunning and OLI

The OLI (Ownership, Location, Internalization) Paradigm or Eclectic Paradigm developed by John Dunning, provides a holistic framework to identify and evaluate the significant factors influencing foreign production by enterprises and the growth of foreign production. Prof. Dunning first conceived the idea of OLI after witnessing the US manufacturing industry's 2 to 5 times higher labor productivity in the UK, when the US affiliates in the UK were no better than their UK competitors and much poorer than their parent companies.

Ownership: A foreign multinational firm may have an ownership advantage, such as access to a patent, blueprint, or trade secret. This may be even intangible, like a reputation or famous trademark.

Location: Tariffs, quotas, and transportation costs or providing service close to the customer, hotels say.

Internalization: The multinational internalizes some firms' specific advantages by producing abroad, independent of the localization advantages of making abroad. If these were not present, the international could hire a domestic firm or foreign subsidiary to produce under license.

Ownership Advantages

- These emanate more from knowledge-based (R&D) firm-specific assets than physical capital-based ones. Compared to physical capital (plant and machinery), knowledge or a blueprint can easily travel between countries and locations. Also, there are economies of scale in multi-plant knowledge-based firms. One firm can do the R&D and produce in different countries/locations, rather than other firms engaging in independent, repetitive and competitive R&D in different places.

Ownership and Location combined

- Firm level activities such as R&D are joint inputs, which means they act like a fixed cost. The firm can benefit from R&D in one Location in multiple plants. But there are also plant-level economies of scale. There are also transportation costs between countries. There are also trade barriers. Multinationals will exist when firm-level fixed costs, tariffs and transport costs are large compared to plant level economies of scale. Multinationals are also likely to exist when both countries in question are large and have similar factor endowments.

Internalization

- It might be easier to transfer knowledge within the firm than at an arms-length distance to a foreign subsidiary. Recall that the activities of multinationals are often R & D based and technically advanced. Another reason is the presence of transaction costs. Examples of transaction costs include negotiation, re-negotiation, opportunistic behavior, and above all, problems with the agency.

FDI and Rivalry between firms under oligopoly. Smith (1987)

Usually, an import tariff encourages FDI. But here, an import tariff may encourage a domestic firm to enter and so it covers all its plants and firm-specific fixed costs. In which case, the multinational may not enter but simply export. Consumers are better off as now they have two sources of goods at lower prices—product cycle theories between the North and South. The North innovates new goods. Old goods can be produced more cheaply in the South. There is a rate of technological diffusion and sometimes this is achieved by FDI. Capital abundance in the North encourages more FDI to the South.

Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

The effect of tariff is to raise the cost of imported products and the consumers loose because they have to pay more for imports.

By lowering costs, subsidies help domestic producers to compete against low-cost foreign imports and to gain export markets.

An import quota is a direct restriction imposed by an importing country on the quantity of some good that may be imported. A voluntary export restraint is a quota on trade-imposed from the exporting country's side. A local content requirement calls for some specific fraction of a good to be produced domestically. An administrative policy is an informal instrument or bureaucratic rule that can be used to restrict imports and boost exports. There are two types of arguments for government intervention in international trade: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups, or with promoting goals with regard to foreign policy, human rights, consumer protection, and the like. Economic arguments for intervention are about boosting the overall wealth of a nation. The problems with strategic trade policy are two fold: (a) such a policy may invite retaliation, in which case all will loose, and (b) strategic trade policy may be captured by special interest groups, which will distort it to their own ends. The GATT was a product of the post-war free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move towards greater free trade under the GATT appeared to stimulate economic growth. The completion of the Uruguay Round of GATT talks and establishment of the World Trade Organization have strengthened the world trading system by extending GATT rules to services, increasing protection for intellectual property, reducing agricultural subsidies, and enhancing monitoring and enforcement mechanisms. The theory of economic integration refers to the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together

Keywords

Tariff: a tax that has to be paid on goods coming into a country

Protectionism: Any measure designed to give local producers of goods or services an advantage over foreign competitors.

WTO:World Trade Organization

Developing Countries: anylow and middle-income countries.

International Capital Flow: International capital flows are the financial side of International Trade. When someone imports a good or service, the buyer (the importer) gives the seller (the exporter) a monetary payment, just as in domestic transactions

Self Assessment

1. If a tariff and import quota lead to equivalent increases in the domestic price of steel, then?

A. the quota results in efficiency reductions but the tariff does not
B. The tariff results in efficiency reductions but the quota does not
C. They have different impacts on how much is produced and consumed
D. They have different impacts on how income is distributed

2. In a tariff and import quota lead to equivalent increase in the domestic price of steel, then?

A. The quota results in efficiency reductions but the tariff does not
B. The tariff results in efficiency reductions but the quota does not
C. They have identical impact on how much is produced and consumed
D. They have identical impact on how income is distributed

3. Antidumping duties are used to ?
A. offset the margin of dumping
B. punish domestic consumers for buying high-priced imported goods
C. discourage foreign governments from subsidizing their exporters
D. reduce the tariff revenue of the domestic government

4. Which of the following was created under the Bretton Woods system to manage the world economy?
A. the International Development Agency.
B. the General Agreement on Tariffs and Trade.
C. the European Union.
D. NATO

5. Specific tariffs are
A. import taxes stated in specific legal statutes.
B. import taxes calculated as a fixed charge for each unit of imported goods.
C. import taxes calculated as a fraction of the value of the imported goods.
D. the same as import quotas.

6. A Most Favored nation status doesn't necessarily refer to
A. Same and equal economic treatment
B. Non-discriminatory treatment
C. Same tariff rates applicable
D. Uniform civil code

7. Economic development refers to
A. Economic growth.
B. Economic growth plus changes in output distribution and economic structure.
C. Improvement in the well-being of the urban population.
D. Sustainable increases in Gross National Product

8. OPEC is the
A. Organization of Petroleum Exporting Country.
B. Organization of Pre- European Commission.
C. Oil Producing Economies Caucus.
D. Organization of Problematic Economies Committee

9. Which of the following are referred to as the developed economies?
A. Countries earning huge industrial profits
B. Countries proficient in trade and export
C. Countries having large per capita income
D. Countries advanced in technology

10. With ________________, prices rise in the first sector, remain the same in the second, and increase overall.
A. ratchet inflation.
B. inflationary expectations.
C. import substitution.
D. demand-pull inflation.

11. The Organization of Petroleum Exporting Countries (OPEC) is a ________ whose members have agreed to limit output and fix prices.
A. duopoly.
B. generalized system of tariff preferences.
C. multifiber arrangement.
D. cartel.

12. Identify the arguments for protecting local producers and industries.

A. To Avoid the Risks of Over-Specialization.
B. Strategic Reasons.
C. To Prevent Dumping.
D. All of the above

13. Along with the World Bank and ________________, WTO is the third economic pillar of worldwide dimensions.
A. International Economic Association (IEA)
B. International Monetary Funds (IMF)
C. International Funding Organisation (IFO)
D. International Development Bank (IDB)

14. Among the following options, which one is not the objective of the WTO?
A. To protect environment
B. To improve the balance of payment situation of the member countries
C. To improve the standard of living of people of the member countries
D. To enlarge production and trade of goods

15. TRIPS (Trade-Related Aspects of Intellectual Property Rights) agreement is administered by the _______ .
A. World Bank (WB)
B. United Nations Organization (UNO)
C. World Trade Organization (WTO)
D. United Nations Conference on Trade and Development (UNCTAD)

Answers for Self Assessment

1.	D	2.	C	3.	A	4.	B	5.	B
6.	D	7.	D	8.	A	9.	C	10	A
11.	D	12.	D	13.	B	14.	B	15	C

Review Questions

1. Define tariff. Discuss the types of tariff.
2. Explain Non-tariff barriers and its types.
3. 3. Distinguish between quotas and non-tariff barriers
4. What are the functions of WTO? Discuss
5. Discuss the Impact to the Economy of a Country with the Tariff Imposed on It.
6. What is the Empirical Evidence on the Effect of Tariffs? Discuss

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Unit 04: Factor Movements and International Trade in Services

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4.2 Theories of International Factor Movement

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4.6 The Prescriptions of Comparative-Cost Theory Apply to Services

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4.8 Is the Optimal-Tariff Argument Especially Applicable to the Services Sector?

Summary

Keywords

Self Assessment

Answer for Self Assessment

Review Questions

Further Readings

Objectives

After studying this chapter, you will be able to:

- examine the effects of international capital flow
- analyze the theoretical foundations of foreign investment
- grasp the definition and characteristics of international trade in services
- understand the classifications and features of international trade in service

Introduction

Trade in goods and services takes place across the border in order to achieve economic integration. This has been a key basis for the development of numerous international trade models. However, worldwide movements of factors of production in monetary terms, known as Factor Movement, are not the only kind of economic integration. Although commerce and factor activity are fundamentally identical in terms of economics, the political backdrop is vastly different. Global trade, on the other hand, tends to cause more political challenges than international factor movement. As a result, factor migration is subject to more limitations than goods commerce.

4.1 Classifications of Factors Movement

International factor movements are cross-national movements of labour, capital, and other production variables. Labor mobility (immigration and emigration); capital transfers (through international borrowing and lending); and Foreign Direct Investment (via multinational corporations' transactions involving direct ownership of foreign firms) are all examples of these movements. International labour migration is a critical component of our global economy, with the UN estimating that over 175 million individuals (about 3% of the world's population) live in a country other than their native country. International labour mobility is a sensitive political issue, especially when it comes to the unlawful movement of persons across international borders in

search of work. As a result, certain countries have waged strong anti-immigrant campaigns, as seen in France, Italy, Germany, and other countries in the 1990s.

According to classic international economic theory, lowering obstacles to labour mobility leads to wage parity between countries. Some economists argue that labour migration has had a greater impact on the salaries of low-skilled employees in developed countries than imports of commodities that rely heavily on unskilled labour.Immigration regulations, transportation costs, a lack of knowledge about work prospects, and language barriers all limit labour mobility. Unlike labour mobility, capital transfer is based on financial transactions rather than physical migration. Portfolio investment is another name for it, and it can be done by private, commercial banks as well as international public banks like multilateral development banks. Capital mobility can alternatively be defined as an inter-temporal trade in which resources are exchanged throughout time (i.e. a trade-off of goods today for goods tomorrow). Capital transfers necessitate the sacrifice of one economy for the benefit of another, which entails an opportunity cost, which is calculated as the difference between the present and future value of capital assets. A chargeable amount in interest rate payment compensates for this discrepancy. As a result, interest rates are a key factor of international capital mobility.Foreign Direct Investment (FDI) is the ownership of assets in a country by foreigners (typically corporations) with the purpose of exercising control. The main goal of FDI is not just to transfer resources between countries, but also to gain control over them. FDI primarily takes the form of multinational firms in which a foreign firm controls 10% or more of a local subsidiary's stock. Due to the nature and availability of intensive factors, transportation costs, and other trade restrictions, FDI is frequently required. Internalization occurs as a result of FDI, which leads to technological transfers, vertical integration, and other benefits.

4.2 Theories of International Factor Movement

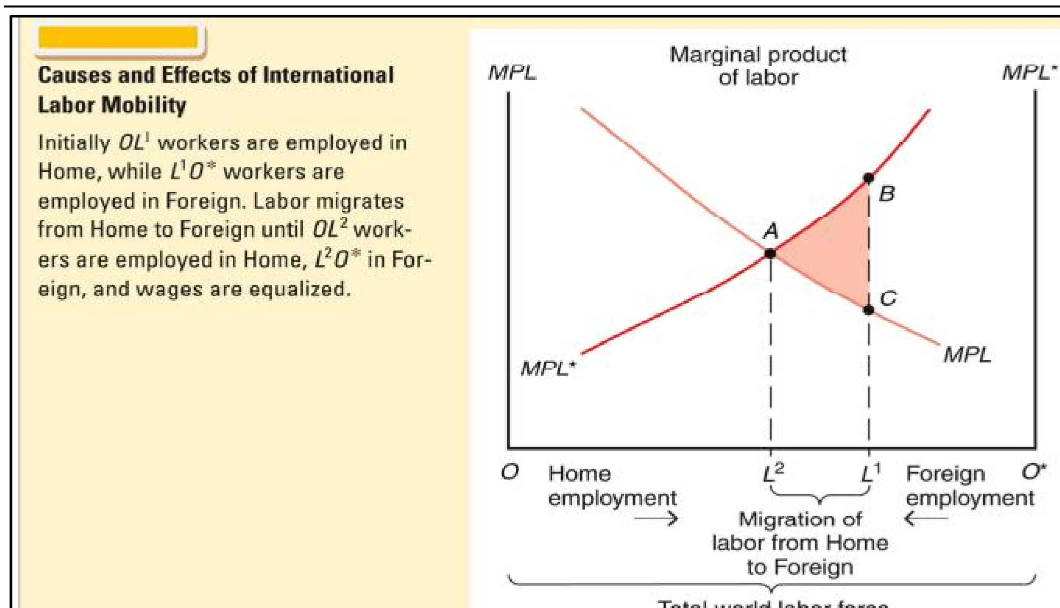
International Factor Movement is a substantial breach of the Heckscher – Ohlin trade model, which states that trade in commodities is based on differences in factor endowment, which leads to differences in factor pricing, which in turn leads to differences in commodity prices.

Labor Migration

The international movement of capital and labour can be understood as an arbitraging process comparable to that which occurs inside a country's regions. This movement lowers pay disparities by reducing labour supply in low-wage areas and increasing the number of persons looking for work in high-income places. We use a variation of the Heckscher–Ohlin model in which only one good is produced and one of the elements (labour) is mobile across countries to explain the influence of labour migration. On a fixed supply of land, when more employees are engaged, the marginal productivity of labour often drops, resulting in a convex marginal productivity curve.

The actual wage paid to workers equals their marginal product due to competition, as marginal product equals output and the value of wages and rental income paid to factors of production. Given the same level of technology, if the domestic country has a labour abundant economy and the foreign country has a land abundant economy, marginal productivity of workers in the home country will be lower than in the foreign country, causing domestic workers to migrate to the foreign country until real wages in both countries are equal.

Figure 1: International Labor Mobility



From OL1 to OL2, foreign output increases by the area under its MPL* curve. Domestic output decreases from OL2 to OL1 by the area under its MPL curve. When the marginal product of labour is the same in all nations, the value of global output is maximised. Goods trade, according to the Heckscher-Ohlin model, is a viable alternative to factor mobility. The value of commodities reflects the worth or productivity of the factors of production that generated them because services from factors of production are "embodied" in goods. Despite real pay discrepancies between nations, total factor price equalisation with labour mobility does not occur for reasons similar to those outlined in the Heckscher-Ohlin model. The concept is based on the assumption that trade countries manufacture the same commodities and use the same technology, which is not always the case.

4.3 Portfolio Investment/Capital Mobility

Portfolio theory in the modern era (MPT)

This was started by Harry Markowitz. Detailing mathematics of diversification, he proposed that investors focus on selecting portfolios based on those portfolios' overall risk reward characteristics instead of merely compiling portfolios from securities that each individually have attractive risk-reward characteristics. To summarize, inventors should choose portfolios rather than individual securities. Single-period returns for diverse securities are treated as random variables, with expected values, standard deviations, and correlations assigned. These can be used to calculate the expected return and volatility of any portfolio made up of those securities. Risk and reward are proxied by volatility and projected return. Certain ones will optimally balance risk and reward out of the entire universe of possible portfolios. These comprise what Markowitz called an efficient frontier of portfolios. An investor should select a portfolio on the efficient frontier.

International movements of capital are a prominent feature of the international economic landscape. Even in the absence of international capital movements, any economy faces a trade-off between present consumption and future consumption. Economies usually do not consume all of their current output; some of which takes the form of investment in machines, buildings, and other forms of productive capital. The more investment an economy undertakes now, the more it will be able to produce and consume in the future. However, to invest more, an economy must release resources by consuming less (unless there are unemployed resources, a possibility we temporarily disregard). Thus, there is a trade-off between current and future consumption. Let's imagine an economy that consumes only one good and will exist for only two periods, which we will call present and future. Then there will be a trade-off between present and future production of the consumption good, which we can summarize by drawing an intertemporal production possibility frontier.

It looks just like the production possibility frontiers we of two goods as a country can trade current consumption for future consumption in the same way that it can produce more of one good by producing less of another. Hence, a country may have comparative advantage in current consumption making its PPF biased toward current consumption implying a lower opportunity cost of spending current income.

When a country borrows, it gets the right to purchase some quantity of consumption in return for repayment of some larger quantity in the future. Specifically, the quantity of repayment in future will be (1 + r) times the quantity borrowed in present, where r is the real interest rate on borrowing. Since the trade-off is one unit of consumption in present for (1 + r) units in the future, future consumption's relative price is 1/(1 + r).

A country with a comparative advantage in future production of consumption goods is one that in the absence of international borrowing and lending would have a low relative price of future consumption, that is, a high real interest rate. This high real interest rate corresponds to a high return on investment, a high return to diverting resources from current production of consumption goods to production of capital goods, construction, and other activities that enhance the economy's future ability to produce. So, countries that borrow in the international market will be those where highly productive investment opportunities are available relative to current productive capacity, while countries that lend will be those where such opportunities are not available domestically.

4.4 Labor migration

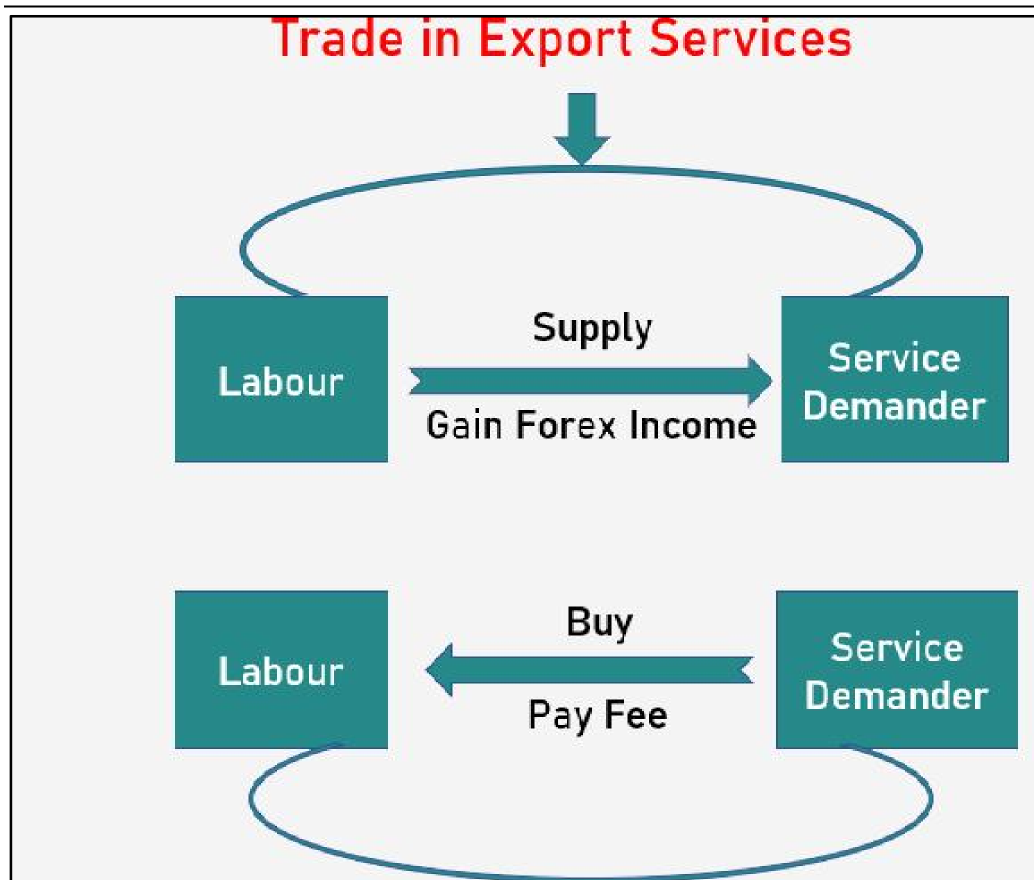
Net migration is the net total of migrants during the period, that is, the total number of immigrants less the annual number of emigrants, including both citizens and noncitizens. (World Bank Group, 2014). The theory of factor movement states that labor will move from relatively abundant to where it is relatively scarce. The motivating factor for this trend is to earn higher wages where labor is relatively scarce. Thus, the trend based on statistics is to see the movement of people from high populated countries and low-income economies to high income countries with relatively less population than the source country.

India has the highest level of emigration in 2012 with net migration of 2,294,049 people. Bangladesh and Pakistan too have a high level of emigration. Both countries are characterized by high population and low per capita income. Thus, workers in these countries seek higher wages elsewhere by migrating out of the country. The top destinations for immigrants in 2012 are the United States, Russia, Canada and the United Kingdom. United States as a country has a more liberal policy pertaining to immigration. Hence, there is large influx of people into the country. Moreover, it is a high-income country and wages are averagely high as compared to what obtains in similar job profiles in developing countries. The same goes for the United Kingdom and Canada. Canada has a strategic policy to increase its population as it is characterized by an aging population with several resources being underemployed.

4.5 International Trade Services

When a labor in one nation supplies service to the service demander (natural person, legal person and other organization) of another nation to obtain foreign remittances subsequent a compensated and voluntary principle, which constitutes the service export”.

Figure2: Trade Services



The demanders of one country become the consumers of the services, supplied by the service producers of another country, and forms the service imports. The definition involves service suppliers (labor), nationality, national border, residents and non-residents. So, three fields should be clarified:

Extension of labor

Different Nationalities

Movement of National Person

Characteristics of Trade services

Intangibility: Target species of service trade is intangible.

Synchronism & Internationalism: Productions and consumptions simultaneously happen.

Flexibility & Elusiveness: The approach of non-tariff barriers is the way to protect service trade, which can make different regulations for different products, such as technical standard, accreditation The restriction to service trade means market permission and domestic legislation, which can not be negotiated among different countries.

4.6 The Prescriptions of Comparative-Cost Theory Apply to Services

Economists embarking on proofs of the proposition that the world as a whole gains from free trade do not normally specify the characteristics of the 'goods' (x , , x z, x . . .) which enter their analysis; and even the typical use of the word 'goods' is a matter of tradition, not deliberately designed to exclude services. Had Ricardo in his classic example specified wine and insurance policies instead of wine and cloth, his demonstration of the gains from trade would have still succeeded. It was dependent only on one country being able to produce insurance policies at a lower cost relative to wine than the other country. Nothing in the logical structure of his proof ipso facto excludes international transactions involving services from its scope. All of this notwithstanding, certain classes of both goods and services have characteristics that raise doubts about the applicability to them of the Ricardian proposition or other propositions from the body of comparative-cost theory.

First, many service industries are subject to fiduciary regulation and, in many others, sellers are required to possess appropriate licences and qualifications.

These ubiquitous facts could be interpreted as a challenge to the major premise of the Ricardian argument; as deriving from a belief that, without such restrictions, one party to a voluntary transaction may be wrong to regard himself as having gained from it. This issue is considered in the next sub-section. Secondly, the Ricardian argument is about trade. But in some industries, and notably in some service industries, foreign markets are most efficiently served by a permanent presence in the market - by establishing a local branch or subsidiary.

4.7 Foreign Direct Investment as a Substitute of Trade

In a review of eighteen service industries, the Department of Commerce in the United States identified eight industries in which investment is the dominant mode for international transactions (accounting, advertising, automobile and truck leasing, banking, employment agencies, equipment leasing, hotels and motels and legal services), eight industries in which both trade and investment flows are important (communications, computer services, construction and engineering, educational services, franchising, health services, insurance and motion pictures) and only two industries in which trade flows dominate (air and maritime transport). This raises the question of how foreign direct investment as a substitute for trade, or as a necessary condition for trade, should enter the analysis. From the observation that trade and foreign direct investment may be close substitutes in the case of some services (such as insurance) and that trade and mobility of labor may be close substitutes in other cases (such as management services), some people have concluded that there are problems in the application of standard trade theory, as developed for trade in goods, to the services sector. It is not at all clear why this should be so. Certainly, there is a particular problem for the positive theory, in that it may be hard to predict whether a comparative advantage will manifest itself as a trade flow, an investment flow or a labor flow. But from the viewpoint of the normative theory there is less of a problem. A country gains from importing services or allowing immigration of labor or receiving foreign direct investment if the terms on which these transactions take place are more favourable than the terms available on domestic transactions. The basic reasoning is the same in each case. To the extent that the three modes of commerce are close substitutes, the welfare effects of the three should also be almost the same.

Nevertheless, the view that there is a problem here is sufficiently widespread to deserve more detailed attention and we consider this point later in the section. Turning now to the other strands of the normative theory identified in the previous section, whether services deserve exceptional treatment can similarly be considered.

4.8 Is the Optimal-Tariff Argument Especially Applicable to the Services Sector?

It seems unlikely that there are many countries (or even many groupings of countries acting in concert) which have available to them in the services sector trade-restrictive policies that would have an appreciable effect in reducing the cost to the country of services purchased from abroad (unless that cost had previous been raised by poor policy, which is certainly possible). Indeed, it was argued above that, where countries have world market power to exploit, it is likely to be in their export markets rather than their import markets. Taxes on exports better exploit such power than by taxes on imports. And, in so far as trade policies are designed to exploit monopoly power in international markets, the difficulty of taxing imports at the border does not make a sound economic case for imposing alternative forms of restrictions on imports of services. This is a suitable point to deal with the possibility that the foreign country has monopoly power that it is exploiting. This is quite different from the optimum-tariff argument, for that argument is concerned with how the home country should exercise its monopoly power, if it has any. Therefore, let us suppose that we are concerned with policy choice in a country that does not have market power itself, but is faced by a monopolistic supplier that is offering goods or services at a price significantly above the marginal cost of production. In such a situation, there is an incentive for the country to promote (by protection or direct subsidy) the development of domestic suppliers, even if they are less efficient than the foreign monopolist, for their very existence will

i. reduce the foreign supplier's monopoly power
ii. lower the price faced by the country
iii. transfer some of the monopoly profits from the foreign supplier to the home country.

Of course, the application of this argument is strictly limited. It cannot be in a country's interest to produce at a cost greater than the marginal import cost at which supplies are obtainable from the foreign monopolist (although that marginal import cost will exceed the price charged by the monopolist which, in turn, will exceed the monopolist's cost of production). However, it has to be said that the scenario in which a foreign supplier has significant monopoly power seems, at least in the area of services, fairly implausible. The mark-up over marginal cost must surely incentivize potential competitors to enter the market and drive down the price. There may be barriers to entry in particular cases, so that one foreign supplier is in a privileged and protected position, perhaps due to past colonial links.

Then, there is a simple and powerful policy response: to remove the barriers to entry by other foreign suppliers and domestic firms. In general, the adoption of policies which facilitate entry, whether by domestic or foreign competitors, into allegedly monopolistic markets seems likely to be a socially less costly means of curbing monopoly power than the promotion of inefficient domestic firms.

The discussion now turns to the theory of optimal policy intervention in the presence of distortions. There are two major cases, or groups of cases, in which policy interventions affecting trade flows, but by means other than tariffs, can be defended on economic grounds. The first group of arguments was alluded to earlier, namely the presence of distortions in domestic factor markets. Factor markets may be badly distorted in many countries, especially developing countries, with the result that the services sector is larger or smaller than it would be if resources were efficiently allocated. But there is no a priori means of determining whether, in practice, the effect is likely to be that the services sector is too small or too large. Moreover, application of this set of ideas to the services sector seems to raise no special conceptual difficulties. The analysis appears to apply whether the industry is producing a 'service' or a 'good'. But one member of this group of arguments is the infant-industry argument. That argument is sufficiently important for special attention to be devoted to considering its specific relevance to the services sector (see below).

- Balance-of-payments arguments for protecting domestic service industries might also be included in this group. One of the authors has discussed that issue elsewhere in the context of insurance. There is little to add to that discussion for services in general.
- The second group of arguments for intervention also raises issues that are not, in principle, specific to service industries, although they may, in practice, have a more direct relevance to certain ones than to goods industries.
- These are arguments for intervention based on the existence of externalities in production or consumption. Appropriate policy in either case will typically entail subsidies to activities generating positive externalities and taxes on those activities generating negative externalities.
- Again, as with factor-market distortions, the analytical framework is as relevant to services as to goods. If a side-effect of a service activity is to 'pollute' the environment with, say, pornographic displays then it is desirable to discourage the activity, just as it is desirable to reduce the output of goods whose production pollutes the air with smoke. There is a case for a tax on imports only when it is imports that generate negative external effects.
- Particular service industries (cinema and video film, popular music and advertising) provide examples of such putative negative external effects attached to imports. Such imports are often said to have deleterious effects on local cultures (in both developed Economists working on demonstrations of the premise that free trade benefits the globe as a whole do not usually identify the features of the 'goods' (x,xy,xz,x….) etc.

Ricardo's illustration of the benefits of trade would have succeeded even if he had used wine and insurance policies instead of wine and fabric in his classic example. It was simply contingent on one country being able to produce insurance coverage at a cheaper cost than the other in relation to wine. Nothing in his evidence ipso facto logical structure prevents foreign service transactions from its scope. Despite this, certain types of products and services have characteristics that cast doubt on the Ricardian thesis or other propositions from the body of comparative-cost theory's applicability to them. For starters, many service businesses are regulated by fiduciary standards, while many others require sellers to have relevant licences and certifications. These commonplace facts could be read as a challenge to the Ricardian argument's central premise: that without such constraints, one person to a voluntary transaction might be mistaken to regard himself as having benefited from it. In the following section, we'll look at this topic in more detail. The Ricardian argument, on the other hand, is about trade. However, in some industries, particularly service industries, a permanent presence in the market - the establishment of a local branch or subsidiary - is the most efficient way to serve overseas markets. The US Department of Commerce identified eight industries in which investment is the dominant mode of international transactions (accounting,

advertising, automobile and truck leasing, banking, employment agencies, equipment leasing, hotels and motels, and legal services), and eight industries in which both trade and investment flows are important (communications, computer services, construction and engineering, et cetera), in a review of eighteen service industries (air and maritime transport).

This raises the question of how foreign direct investment should be included in the study as a substitute for trade or as a required condition for trade. Some people have concluded that there are problems in applying standard trade theory, as developed for trade in goods, to the services sector because trade and foreign direct investment may be close substitutes in some cases (such as insurance) and trade and labour mobility may be close substitutes in other cases (such as management services). It's not entirely clear why this is the case. There is certainly an issue with the positive theory in that predicting whether a comparative advantage would present itself as a trade flow, an investment flow, or a labour flow can be difficult. However, there is less of an issue from the standpoint of normative theory. If the terms on which these transactions take place are more favorable than the terms offered on domestic transactions, a country benefits from importing services, allowing labour immigration, or receiving foreign direct investment. In each situation, the basic logic is the same. The welfare impacts of the three kinds of commerce should be almost identical to the extent that they are close substitutes. Nonetheless, the belief that there is a problem here is prevalent enough to need more in-depth consideration, which we will do later in the section. Moving on to the various strands of normative theory discussed in the previous section, the question of whether services deserve special consideration can be explored as well. Is the optimal-tariff argument particularly relevant in the services industry? On the contrary, it appears improbable that many nations (or even groups of countries acting together) have trade-restrictive measures available to them in the services sector that would have a significant impact on lowering the cost of services obtained from outside (unless that cost had previous been raised by poor policy, which is certainly possible). Indeed, as previously stated, countries with global market strength are more likely to exploit their export markets rather than their import markets. Export taxes do a better job of exploiting this power than import taxes do. Furthermore, insofar as trade policies are intended to take advantage of monopolistic power in international markets, the difficulties of taxing imports at the border does not provide a compelling economic argument for putting alternative forms of limitations on service imports. This is a good place to bring up the potential that the foreign government is abusing its monopoly power. This is not the same as the optimum-tariff argument, which is concerned with how the home country should use its monopoly power, if it has any. Assume that we are considering policy options in a country that lacks market power but is confronted with a monopolistic provider supplying goods or services at a much higher price than the marginal cost of production. In such a situation, the country has an incentive to encourage the development of domestic suppliers, even if they are less efficient than the foreign monopolist, because their very existence will

i. reduce the foreign monopolist's monopoly power,
ii. lower the country's price,
iii. transfer some of the monopoly profits from the foreign supplier to the home country.

Of course, this reasoning has a very restricted application. It cannot be in a country's best interests to produce at a cost higher than the marginal import cost at which supplies can be obtained from a foreign monopolist (even if that marginal import cost will be higher than the monopolist's price, which will be higher than the monopolist's cost of production). However, it must be noted that, at least in the sphere of services, the situation in which a foreign supplier has major monopoly strength appears unrealistic. Potential competitors must undoubtedly be enticed to enter the market and drive down the price because of the mark-up over marginal cost. In other circumstances, there may be entrance hurdles, putting one foreign provider in a privileged and protected position, maybe as a result of past colonial ties. Then there's a straightforward and effective governmental response: removing obstacles to entrance for other overseas suppliers and domestic businesses. In general, policies that make it easier for domestic or foreign competitors to enter supposedly monopolistic markets appear to be a socially less expensive way of limiting monopoly power than promoting inefficient domestic enterprises. Now we'll look at the notion of optimal policy intervention in the face of distortions. On economic considerations, there are two key circumstances, or sets of cases, in which policy interventions impacting trade flows but not through tariffs can be justified. The first set of arguments, namely the existence of domestic factor market distortions, was mentioned before. Many countries, particularly developing countries, may have severely skewed factor markets, resulting in the services sector being larger or smaller than it would be if resources were more efficiently distributed. However, there is no way to predict whether the services sector would end up being too small or too large in practice. Furthermore, there appear to be no unique conceptual hurdles in extending these notions to the services business. The analysis appears to apply whether the industry is generating a 'service' or a 'product.'

However, one of these explanations is the infant-industry argument. That argument is substantial enough that its applicability in the services sector should be given special study. This group could also include motivations for supporting domestic service enterprises that are related to the balance of payments. This problem has already been discussed in the context of insurance by one of the authors. There isn't much else to say about services in general. The second set of intervention reasons also identifies challenges that are not specific to service sectors in principle, but may have a stronger direct influence on some of them in practice than on goods businesses. These are interventionist arguments based on externalities in production or consumption. Subsidies for activities that generate positive externalities and taxes on activities that generate negative externalities will almost certainly be appropriate policy in either case. The analytical paradigm can be used to both services and products, as well as factor market distortions. If a service activity's side effect is to 'pollute' the environment with, for example, pornographic displays, the activity should be discouraged, much as limiting the output of commodities that pollute the air with smoke should be discouraged. There is a case for an import tax only when imports have negative external effects. Specific service industries (movie and video movies, popular music, and advertising) are good examples of purported import-related negative externalities. This type of import is commonly cited as having a negative impact on local cultures (in both developed and developing countries). If this is the case, economic efficiency may be used to justify border controls or usage limits. This type of externality argument raises a number of issues that are not addressed in this article. For example, observers may dispute regarding the sign of the external effect. Because of the inherent subjective nature of conjectures regarding consumption externalities in general, it's difficult to distinguish supposed externalities from bigotry (others should have what I think they should have), basic conservatism, or the interests of domestic industry workers. As a result, three difficulties must be addressed in the application of the normative theory of comparative cost to service industries:

i. regulatory and licensing issues,
ii. foreign investment issues, and
iii. the infant-industry issue. and emerging countries.

If this is the case, border controls or usage limits may be justified on the basis of economic efficiency. This type of externality argument creates a lot of questions that aren't covered in this article. Observers may disagree about the sign of the external effect, for example. Because of the inherent subjective nature of conjectures regarding consumption externalities in general, it's difficult to distinguish supposed externalities from bigotry (others should have what I think they should have), basic conservatism, or the interests of domestic industry workers. As a result, there are three issues that need to be addressed in the application of the normative theory of comparative cost to service industries:

i. regulatory and licensing concerns,
ii. issues originating from foreign investment, and
iii. the infant-industry issue. Licensing and regulation,

It is remarkable that the services sector is the focus of government intervention and regulation of a form and degree different from that which non-service businesses are subjected to at the domestic level in almost all economies. The motivation and nature of this regulation merit close examination, first to see if it reveals a genuine need for interventions specifically targeted at services or at specific services, then to see if such interventions should affect international transactions to a greater or lesser extent than domestic transactions, and finally to see what impact the regulation has on international trade, for good or bad reasons. Any explanation of regulatory economics may simply demonstrate that the services sector is prone to more detailed government intervention than other sectors. The majority of the time, it is services that are regulated. It can take the following forms:

i. government ownership or control of telecommunications, broadcasting, cable television, and other media,
ii. government control of entry into and rates charged in various modes of transportation,
iii. government control of entry into and rates charged in many services such as law, accounting, medicine, hairdressing, and taxi driving,
iv. government ownership or control of telecommunications, broadcasting, cable television, and other media, and
v. detailed supervision of the structure It would be an exaggeration to imply that these examples of regulation follow a completely consistent pattern.

Nonetheless, two recurring and intertwined ideas emerge. The first is the threat of "destructive competition," and the second is the necessity to safeguard the interests of inexperienced customers. The argument that competition will be destructive is frequently made in the transportation industry, and is based on the alleged tendency for industries with high fixed costs and fluctuating

demand to be subjected to intense competition, which leads to frequent bankruptcy and constant changes in the services offered to consumers. As a result, cartels like the International Air Transport Association (IATA) and shipping conventions thrive thanks to government support and protection. Another criticism is that there will be 'cream-skimming,' in which some firms are only willing to offer the most profitable markets, causing service to deteriorate or disappear in the less profitable regions as a result of competition. It's undoubtedly true that economists, on the whole, find these arguments less convincing than people of the sector who are alleged to be affected by these issues. Arguments that competition will be damaging, for example, often need a steady inflow of new entrants into a market, even though their presence will result in negative profits in equilibrium. This would be unthinkable to most economists. More people may find it difficult to believe that a certain set of circumstances is likely to have practical significance. Similarly, the 'cream-skimming' argument suggests that protected enterprises should be willing to serve a market where they will lose money. The 'non-cream' markets are profitable, according to a different and more economically viable argument. On empirical matters, economists' intuitions are of no particular use. Fortunately, evidence of the effects of deregulation in the United States is now available. Domestic passenger air transport deregulation has resulted in much lower fares and a fair amount of both exit and entry into the business. Still, there has been very little evidence of competition of a degree that would harm consumer interests in the long run or of loss of service to marginal markets. Similarly, the relaxation of regulation of the New York Stock Exchange has brought about significant gains to the consumers of its services and no evidence of the destructive competition which the stock exchange itself had predicted based on the (scarcely credible) argument that its members had a high ratio of fixed to variable costs. (As any economist would have predicted, the most striking single effect of de-regulation was on the price of a 'seat' on the stock exchange, that price reflecting the value of the anticipated monopoly rents available from the limitation on entry and competition.) These, admittedly limited, examples give some grounds for adopting a skeptical approach to arguments of destructive competition, especially when they are offered by those with a clear self-interest in the restriction of competition. The second major argument for regulation rests on the imperfect information of buyers, a problem which seems to be greater when it is an intangible service rather than a tangible good that is being purchased. But imperfect information on the part of buyers does not ipsofacto make a case for regulation of suppliers. In principle, it would be possible to ensure that the relevant information was available so that buyers could make their own choice between alternative suppliers on the basis of it. However, this raises the problem that it might be expensive for buyers to interpret such information (the balance sheets of insurance companies, for example). Moreover, when the basic information required is the same for all buyers, the duplication involved in each buyer seeking and interpreting the same information for himself is wasteful. There is a case for just one agency or person to acquire and process the information and to disseminate it to all other potential buyers. This does not have to be a government agency, although 'free-rider' problems emerge when it is not. Nor, if it is a government agency, is it necessary on this ground that it should be equipped with powers to compel suppliers rather than powers to inform buyers. But a case for regulation starts to take shape when the information requirements of buyers are uniform, when all are likely to act in the same way on the basis of that information and when it is expensive to convey the information to them. Suppose that no fully-informed buyer would buy insurance, deposit money or fly in the aircraft of a company with characteristics below a certain level. If it is expensive to inform all potential buyers that a company's characteristics have fallen below the required level then there is a possible case for ruling that any company taking deposits, selling insurance or providing air passenger transport should display the appropriate characteristics. Companies unwilling or unable to attain the required level should be refused the opportunity to offer the service. It is worth emphasizing that this case rests

i. on the costs to buyers of acquiring information,
ii. on homogeneity of the information requirements of buyers and homogeneity of reactions to particular pieces of information
iii. on the high costs to an information-gathering and information-interpreting agency of disseminating information.

These conditions are quite restrictive. The argument is not exclusive to services. Many traded goods are subject to health, safety and technical standards, presumably on identical grounds. Indeed, this fact constitutes an increasingly important problem in trade policy (especially within the European Community where, as with trade in services, the possibility of affecting imports by tariffs is limited). In trade in goods, as in trade in services, the basic objectives of regulation are widely seen as legitimate. But there is an important difference between goods and services. A regulatory agency can forbid a supplier of goods to sell 'sub-standard' items while permitting it to continue to sell its other lines. Still, in many services the distinction between the standard of the product and the acceptability of the supplier does not exist. An unsatisfactory bank seems likely to default on all its

obligations, a doctor of dubious competence cannot be required to supply only competent medical care. Thus, when the case for regulation is accepted it becomes a case for regulating entry into the industry. The next step is to recognize that often the natural people to police standards of entry are the existing suppliers of the product, for who can judge the competence of a prospective lawyer, accountant or hairdresser better than a professional qualified in the field? Once the industry is given a key role in setting entry standards, or even advising on the appropriate standards of entry, the regulatory agency is in imminent danger of 'capture' by the industry, of being more concerned with protecting the interests of suppliers than those of consumers. Then the problem of equity arises if there is ever a proposal to de-regulate or relax entry standards. Those who entered the industry under regulated conditions will normally have paid some form of entry fee which reflects the value of the super-normal profits associated with the restriction. A proposal that cuts the resale value of a stock-exchange seat or a taxi license will be seen as inequitable by those who thought that they had purchased a permanent right to operate in a protected market. The implication is that market regulation will have a 'ratchet' effect, with de-regulation being rarer than increases in regulation. At the very least, all of this must lead one to suspect that even if there is a good case for some regulation in a regulated industry, there will be a systematic tendency for regulation to be taken too far. What is the relevance of all this to applying the theory of comparative cost to the services sector? Given a case for government intervention, the central question is whether international transactions should be treated differently from domestic transactions. On the face of it, there is no such case. If consumers need protection from over-optimistic, stupid or fraudulent suppliers, they need that protection independently of the nationality of the suppliers. The existence of a case for regulation in no sense invalidates prescriptions deriving from the theory of comparative advantage. To the extent that consumers benefit from competition, more competition seems better than less competition and foreign countries may be an important source of potential and actual competition. The established reputations of foreign suppliers may be an important source of assurance to customers. This is as true of services as of goods. Such considerations argue for regulation of service industries in neutral ways between domestic and foreign suppliers and that are specifically designed to avoid exclusion of foreign competition. This, it must be recognized, is a counsel of perfection. In practice, even a well-intentioned government will find it difficult to regulate service industries in ways that do not accidentally discriminate against foreign competitors.

For example, a common requirement in the banking and insurance industries is that a firm should have an adequate capital base relative to its level of operation. To require that a foreign subsidiary show evidence of such assets in the country of operation may be to under-estimate the possibilities of risk spreading and risk sharing among the different parts of a multinational enterprise and impose costly restrictions on the investment policy of the firm.

On the other hand, to allow the assets of the parent firm or other foreign-held assets to be used to meet solvency requirements exposes one to the danger that if the same assets are used to guarantee the solvency of several independent operations, they may be inadequate cover against the independent risks to which the multinational enterprise as a whole is subject.

No doubt there is much to be gained by the adoption of methods of protecting consumers which do not discriminate against foreign competitors, but it seems impossible to avoid all conflict between the objectives of free competition and the objectives of consumer protection. In addition, there is the problem that governments normally do not want to be even-handed between domestic and foreign firms and, in their attempts to protect domestic firms against foreign competition, will welcome the opportunity to design domestic policies whose ostensible purpose is to protect consumers, but which really serve to exclude, or hamper, foreign competition.

The problem of recognizing misuse of regulatory powers may be exaggerated. It should not be difficult to test whether a measure whose supposed intention is to protect consumer interests does in fact fulfil such an objective. Foreign Investment in Service Industries The point has already been briefly made that, in principle, foreign investment is susceptible to the same type of analysis as international trade. An international investment will be made when both investor and recipient see better opportunities than they see elsewhere. This transaction, apparently to the private mutual benefit of the parties involved, will fail to be socially beneficial under precisely the conditions discussed earlier in trade.

This will be as true of investment in the services sector as investment in the goods sector. The fact that investment flows may be of greater relative importance than trade flows in the services sector is of no particular significance. There is, however, the following issue which has not yet been considered in this article. If a government is following some non-optimal policies, might it not be the case that other policies should be adjusted to take account of the distortions created by the first set of policies? This issue is of some practical importance concerning the effects of trade policies on

investment flows. For example, if a multinational enterprise is induced to invest in a host country only by the need to get around the host's restrictions on imports of goods, will such a 'tariff-hopping' investment necessarily be beneficial to the host? In fact, it might not be so, precisely because of the existence of the trade restriction. An import restriction benefits the producers within a country of import-competing goods at the expense of consumers. Because they include a component that is merely a transfer from consumers, producer earnings are elevated above the social productivity of producers' inputs. Assume that foreign corporations invest in a country because the presence of an import restriction increases the investment's returns. In that circumstance, the investment's cost to the host country may well outweigh its benefit, because the investor's returns will surpass the investment's genuine social productivity. Another way to look at the possible loss in this scenario is as a decrease in tariff income as tariff-exempt imports are substituted with output connected with foreign investment. Another option is that foreign investment, while not damaging in and of itself, may worsen trade terms by increasing exporters' production and lowering prices paid to existing exporters. In the case of inward investment in the services sector, it is unlikely that either of these consequences would be negative. An unfavorable terms-of-trade effect in a country importing services would require the investment to boost the volume of exports by relocating any domestic factors displaced from the services sector to the manufacturing sector. Such an effect, if it occurs, is likely to be minor and, in any case, unlikely to influence the terms of trade in a way that offsets the investment's positive consequences. It is similarly unlikely that the impacts would be considerable in a country that exports services. As has already been said, many countries are unlikely to be able to modify their service trade arrangements. It does not appear that tariff-hopping investment will result in losses in the services sector. This is due to the fact that service imports are usually exempt from tariffs. There could be a variety of different trade barriers that lead to behaviorsimilar to tariff-hopping investment. Tariff revenue may be matched by'rents' generated by such barriers. Owners of import licenses, for example, receive rents from their capacity to buy cheaply overseas and sell expensively at home in countries with quotas rather than tariffs. In so far as the direct result of foreign investment in the services sector is a reduction in imports of the service that were previously not taxed at the border, there is less likely to be an adverse social effect, for the rents of importers are not likely to be as socially valuable as tax revenue received by the government. In this regard, inward investment in service sectors is more likely than inward investment in tariff-protected goods industries to benefit the host country (which, in practice, seems itself unlikely to give rise to losses, given taxation of profits). This conclusion holds true for investment in those businesses as well (which may only occur in the services sector). Overseas direct investment is the sole way for foreign providers to reach the market.

Finally, it is worth noting a range of general issues that arise concerning foreign direct investment and are extensively discussed in the vast literature on the multinational enterprise. Foreign investment in the services sector has the potential to generate positive externalities in the host country. In so far as many service industries rely on human skills and 'knowhow' for their comparative advantage and in so far as many service industries can be entered on a relatively small scale (compared with manufacturing industry), contact with multinational enterprises may provide the quickest route for local residents to acquire the relevant knowledge and skills and to create a locally based industry which does not have to rely on protection of one form or another for its existence. On the other hand, there are the concerns which many have about foreign direct investments: transfer of technology, interference in host-country politics, transfer pricing and so on. Perhaps only in the case of communications and computer services are there issues of particular relevance to the services sector, but these general issues are beyond the scope of the article. By contrast to the widespread feeling that foreign investment raises particular problems in the services sector, our general conclusion is that, from an economic point of view, inward investment in service industries seems more likely to give rise to economic gains to the host country than inward investment in goods industries (which, in practice, seems unlikely to give rise to losses, given sensible policy in the host country). Labor migration has also been suggested as a possible substitute for trade in services. This, however, is a form of international transaction which raises major issues which again go far beyond the scope of the article. Infant-industry Case in Services The essentials of the infant-industry case - and its difficulties - are the same for goods and services. Therefore, it is not necessary to differentiate between goods and services in setting out the issues. The infant-industry argument starts from the postulate that a country has an inherent comparative advantage in some activity. Nevertheless, the output of activity is imported. The inherent comparative advantage does not display itself in current production because the local industry cannot come into existence, or expand consistently with its inherent comparative advantage, because of competition from established firms abroad. Hence, it is said, there is a case for protection. Were the 'infant' allowed a competition-free space in which to grow, there would be a process of learning by doing and the comparative advantage would be revealed. At the end of the

process the local industry would be viable without protection and this, it is said, would give rise to a net gain to the country as a whole. Appropriate protection will expand the scale of the domestic activity and, therefore, will lead to more local residents possessing the requisite skills of the activity than would otherwise be the case. Were the argument for possession of the activity on national soil based on some externality - the needs of national defense, say - this would be sufficient. Local residents would then be bearing a cost for some specified purpose. But the attraction of the infant-industry case is exactly that it maintains that, in the aggregate, local residents will not bear a cost for supporting the activity. There will be social returns to the initial costs of protection which justify those costs in pure economic terms. Two statements are necessary for the infant-industry argument to arrive at its conclusion that protection is justified in economic terms: (a) Encouragement of the industry by protection is socially worthwhile. The expected social gains from protection outweigh the expected social losses when both are appropriately discounted. (b) Without protection it is not privately worthwhile for producers to enter the industry. The expected private gains from entering the industry are outweighed by the expected private losses when both are appropriately discounted. The problem for proponents of this argument is to explain how these two states of affairs can co-exist. The social gains from establishing the activity all accrue to local producers in the first instance. In the absence of protection, the social losses entailed in the establishment of the industry would also accrue to them as private losses (and, depending on the form of protection, they might be smaller than the social losses from protection). If it is socially worthwhile to establish the industry by protection, therefore, it seems that it must also be privately worthwhile. The question which advocates of the infant-industry case must answer is why private producers do not act on this incentive: why protection is necessary to establish the industry. Several answers might be given to this question. They include, for example, a social rate of discount that is lower than the private rate, different social and private attitudes towards risk and the blanket case of uninformed potential producers and well-informed members of governments. Perhaps the most important answer focusses on ' first-mover disbenefits' within the industry where the returns to the investments of those first entering the industry - for example, their investments in research and development - do not accrue to those who invested, but are spread over later entrants also, who, for example, acquire at low cost the knowledge which the early entrants acquired at a high cost. The optimal policy response to such problems will vary with the imperfection alleged; but the key point here is that none of the justifications for giving special assistance to infant industries is a justification for protection from foreign competition. There is always a policy response that is economically more efficient than a trade restriction. The first point to be borne in mind when applying the infant-industry argument to services is that the difficulties of applying a tariff to some service imports do not preclude efficient policy responses to infant-industry cases. Nor will it be an efficient response to any of the above conditions to prohibit or restrict foreign investment in the industry (which, it might be noted, will provide a possible solution to problems of first-mover disbenefits, since such disbenefits might then accrue to foreign investors to the benefit of local or potential local producers). Applying the infant-industry argument to service industries essentially calls for answers to two questions. The first is whether the valid conditions required for the argument are likely to apply to service industries. The second, if they do, is what policies are appropriate? The answer to the question of whether the circumstances of the infant-industry case apply to service industries is obviously empirical, not appropriately answered in a priori terms. Nevertheless, first, one might conjecture that since entry into many service industries can be made on a relatively small scale, attitudes towards risk are likely to be a less important determinant of entry and establishment than in the manufacturing industry. Second, it is difficult to think of reasons why government officials might have better sources of information on the potential of enterprises in service industries than potential entrants into those industries. Third, it is difficult to think of first-mover disbenefits that might affect service industries. Each of these points provides some ground for skepticism that the conditions of the infant-industry case will be met in service industries. Suppose this is incorrect, and those conditions do exist. In that case, however, neither differences between social and private rates of discount nor attitudes towards risk provide a good ground for policies specific to service industries. Both call for policies that correct the underlying problem - for goods and services. This might entail, for example, general policies towards capital markets or in the provision of capital for new firms. In the case of first-mover disbenefits, there will typically be some defect in the economic structure and an efficient policy will be to correct that defect so that those who invest in research or in training labor are appropriately rewarded. Only adherence to the position that government officials know best might suggest actions specific to the services sector (if what they know is that entry into their domestic services sector will yield profits for entrants). Even then, the appropriate policy is a subsidy to output of the domestic services sector. It does not entail discrimination against foreign firms supplying services, whether by trade or investment. Conclusion on the Normative Theory This section has addressed the question of the applicability of the normative theory of comparative cost to the services sector. It is concluded that

none of the potential difficulties in applying the normative theory of comparative cost to trade and investment in service industries appears to yield any prior reason to suppose that the theory does not apply. Or, to put it more positively, the theory of comparative cost does provide a useful framework in which to analyze the particular issues which arise in the services sector. Therefore, attention now turns to the positive issue of what actually determines comparative advantage in service industries.

Determines Comparative Advantage in Service Industries

The underlying stylized fact of service trade and investment in the current setting is that services and service-related investment tend to migrate from developed to developing countries. There are some exceptions to this rule. If the global civil aviation market is liberalized,

For example, it is extremely possible that certain developing-country airlines will expand at the expense of developed-country airlines.

However, it is generally true that developing countries import services while developed countries export them. Information and its utilization are crucial to service firms that engage in international transactions. This strongly implies that countries with a big skilled worker population will have a competitive edge in the service sector. Furthermore, the creation of some services (particularly transportation) necessitates a significant amount of money. Few internationally traded services necessitate a significant amount of labour. Where they do (shipping, building, and engineering), the firms are frequently able to combine their physical assets and abilities with labour from developing countries. With one exception, all of these reasons show that industrialized countries have a competitive advantage in the production of services, whereas emerging countries have a disadvantage. These hypotheses are simple to test in theory. In fact, however, there is a big problem with data availability, and only one daring attempt to break through that barrier has been undertaken, by AnderC. Sapir and Ernst Lutz in a World Bank research. "The study only looks at a few industries (freight transportation, passenger transportation, and insurance), and it usually only looks at a small number of nations. It occasionally uses created variables that are, at most, a shaky approximation of the data they're intended to represent. Finally, it focuses solely on trade flows, ignoring any interrelationships between trade and investment flows. All of these flaws (which the authors recognize and highlight) are attributable to a lack of data. Despite this issue, the econometric analysis' conclusions are in broad and sometimes considerable agreement with the above-mentioned hypotheses. Professor Sapir and Dr. Lutz argue that "the availability of physical and human capital is the most important factor shaping comparative advantage in services trade." Furthermore, developing economies that succeed in collecting capital have a good chance of exporting services. 'However, emphasizing service exports does not appear to be a realistic option for most emerging countries.' However, there are several areas of the services sector where the advancement of micro-electronic technology could provide considerable opportunities for developing countries. Micro-electronics is advanced technology, but the 'technological gap' between developed and developing countries may be of less importance here than in other areas. The rate of diffusion of technological knowledge between firms in micro-electronics is quite unprecedented, which means that one should also expect a rapid rate of international diffusion. The number of people in an electronically-based enterprise who are required to have advanced expertise will in some cases be a very small proportion of the labor force; and the levels of skill required from most of the labor force may be quite modest.

Further aspect of the micro-electronic revolution is that it greatly facilitates communication between different locations, to the extent that it is now possible for a worker in one country with access to a computer terminal to receive information, instructions and 'raw materials' electronically from another country, to perform the tasks assigned to him and then to deliver the 'product' back to the distant employer or customer. The following is a specific example. In recent years the typesetting stage of book production has been increasingly performed in developing countries in the Middle East and Asia. The source of this apparent comparative advantage is a simple one. Typesetting is labor intensive and wages of print workers in the developing countries are particularly high relative to skilled wages in developing countries. The comparative advantage of developing countries in this area can be expected to grow as electronic transmission of data reduces transport costs and delays and as more stages of the printing process are incorporated electronically into the typesetting stage.

(This example assumes that typesetting itself will remain a significant part of the printing process and is not supplanted by direct input from the material writer. However, the general point will apply to any process requiring keyboard input of a routinized kind.)

Summary

One of the most important characteristics of a service is its function as an intermediary good. Other manufacturers' services will usually complement their own production and commerce. Inappropriate policy that raises the price or lowers the quality of such services is a tax on production and marketing in service-using industries, as well as a tax on ultimate service consumers. Such taxation, on the other hand, frequently occurs without equivalent revenue to the national treasury. The 'tax revenue' will go straight to local producers of protected services, where it will be absorbed either in inefficient operations or in increased profits. Consumers and service users must be taxed in this way, and the justification must be compelling. We have presented several reasons for being skeptical of the existence of such an explanation in this post. Insofar as local service producers require protection or subsidies to survive (which, of course, is unlikely for all of them), insofar as there is no basis in infant-industry-type externalities to expect that protection will allow a sufficient rate of increase in their acquisition of comparative advantage to justify the costs of production, and insofar as the industry has no positive external effect (as surely there isn't), Similarly, domestic service industry regulation requires justification, and the pertinent question is whether the right balance is struck between the costs and benefits of regulation to service users. Although there may be a valid rationale for some regulation, it has been suggested that there is a systematic tendency for restrictions to take suboptimal forms and to go too far. Because of the magnitude of the services industry, it's possible that the costs of bad policy will be substantial. The nature of service sectors, as well as statistics about their operations that are already available - or will be available soon - From a conceptual standpoint, however, this study argues that applying the conventional toolkit of the international economist to the problems of trade and investment in services is not difficult. Although there are important differences between services and goods that merit careful consideration, the overwhelming logic of the idea of comparative advantage transcends these distinctions.

Keywords

Factor Movement: International **factor movements** are movements of labor, capital, and other factors of production between countries.

Capital Flow: Capital flows refer to the movement of money for the purpose of investment, trade, or business operations.

Foreign Investment: Foreign investment involves capital flows from one nation to another in exchange for significant ownership stakes in domestic companies or other assets.

Labor Migration: Labor migration is define**d** as the movement of persons from their home State to another State for the purpose of employment.

Services Relevance: The performance of any services of the type provided by the Company, its Affiliates and/or their predecessors at any time, past, present or future, including, but not limited to, consulting services, technology services, and/or outsourcing services.

Self Assessment

1. Investment in Plant & machinery is termed as-
A. FDI
B. FII
C. Portfolio Investment
D. Capital Investment

2. The traditional mode of entering into international business is-
A. Licensing
B. Exporting
C. Joint venture
D. Subsidiary

3. Bilateral aid
A. is technical aid given by IMF.
B. is given directly by one country to another.
C. is aid with repayment in inconvertible currency.
D. is a loan at bankers' standards.

4. The main reason behind MNCs investments are-
A. To benefit foreign countries
B. To provide financial support to the country's Government
C. For the welfare of underprivileged people
D. To increase assets & earn profits

5. Both foreign direct investment (FDI) and foreign institutional investment (FII) are related to investment in a country. Which of the following is incorrect regarding FDI and FII?
A. Both FII and FDI bring capital into the economy.
B. FII invests in technology-oriented enterprises, whereas FDI invests in traditional business set ups.
C. The restrictions on the entry of FDI are lower than that on FII.
D. FDI is considered to be more stable than FII. FII can be withdrawn even at a short notice

6. Which of the following statements is/are correct regarding FDI under automatic route?
1. FDI in India under the automatic route does not require prior approval either by the Government of India or the Reserve Bank of India.
2. Investors are only required to notify the concerned regional office of the RBI before receipt of inward remittances and file required documents with that office before the issue of shares to foreign investors.

Select the correct answer using the codes given below.
A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

7. Which of the following are the components of foreign capital?
1. Grants and loans
2. External commercial borrowings
3. Foreign direct investment
4. Deposits from non-residents

Select the correct answer using the codes given below.
A. 1, 2, 3, and 4
B. 1, 2, and 4 only
C. 1 and 2 only
D. 3 and 4 only

8. If the Balance of Payment of a country is adverse, then which institution will help that country?
A. World Bank
B. World Trade Organization
C. International Monetary Fund

D. Asian Development Bank

9. What was the first economic theory of international trade to be developed?
A. The theory of mercantilism
B. The theory of comparative advantage
C. The theory of absolute advantage
D. The Heckscher-Ohlin theory

10. Mercantilists believed that a country could increase the amount of wealth it had by _____.
A. Promoting exports and discouraging imports
B. Discouraging exports and promoting imports
C. Controlling imports and exports
D. Increasing both imports and exports

11. According to Adam Smith, the trade between countries should happen _____.
A. Naturally according to the market forces
B. Under government regulation
C. Using factors that are available
D. Only when a country has an absolute advantage

12. ....is the payment method most often used in International Trade which offers the exporter best assurance of being paid for the products sold internationally.
A. Bill of Lading
B. Letter of Credit
C. Open Account
D. Drafts

13. Key controllable factors in global marketing are:
A. Government policy and legislation
B. social and technical changes
C. marketing activities and plans
D. all of the above

14. Which of the following was created in an effort to promote free trade?
A. World Trade Organization
B. the Sarbanes-Oxley Act
C. multilateral development banks
D. the Organization for Economic Cooperation and Development

15. Removing barriers or restrictions set by the government is called:
A. Liberalization
B. Investment
C. Favorable trade
D. Free trade

Answer for Self Assessment

1.	D	2.	B	3.	B	4.	D	5.	B
6.	C	7.	A	8.	C	9.	A	10.	A
11.	D	12.	B	13.	C	14.	A	15.	A

Review Questions

1. What do you understand by Capital Flow Movement?
2. Does the perspective of comparative advantage apply to the trade services?
3. What is the role of the Labor migration in the trade services?

4. Explain the various types of barriers of trade investment?
5. Explain the theory of trade services?
6. Elaborate the HO- Theory of trade?
7. How the trade in services influences the global economy?

Further Readings

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Unit 05: Regional Economic Integration

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Objectives

After reading this Unit students will be able to:

- examine the effects of regional economic integration
- analyze the different levels of regional integration

Introduction

Regional economic integration is a process in which two or more countries agree to eliminate economic barriers, with the end goal of enhancing productivity and achieving greater economic interdependence. It can take different forms, from the simplest preferential trade area to the most advanced monetary or fiscal union. In Asia, integration has intensified since the 1990s as countries recognized the need to harness domestic sources of growth, as is evident from the various indicators of integration such as trade flows, foreign direct investment, tourism, financial links, and output correlation (Figure 1). A number of factors contributed to this growth in regionalism, including the rapid expansion of Asian markets and existence of various mechanisms for cooperation. The most well-known model of integration in Asia is the Association of Southeast Asian Nations (ASEAN) Economic Community (AEC), which was formally established in 2015. Asia's integration is basically market driven (influenced by policies), multispeed (different levels of integration) and multitracked (varies across sectors; ADB [2012]). To facilitate integration, policy frameworks have been established through various regional mechanisms and bodies (e.g., ASEAN and Asia-Pacific Economic Cooperation) and have resulted in varying integration results across sectors and subregions

5.1 Levels of Economic Integration

Economic integration can be classified into five additive levels,

Free trade. Tariffs (a tax imposed on imported goods) between member countries are significantly reduced, some abolished altogether. Each member country keeps its own tariffs regarding third countries, including its economic policy. The general goal of free trade agreements is to develop economies of scale and comparative advantages, promoting economic efficiency. A challenge concerns the resolution of disputes as free trade agreements tend to offer limited arrangements and dispute resolution mechanisms. Therefore, they are therefore prone to the respective influence and leverage of the involved nations that can lead to different outcomes depending on their economic size. A large and complex economy having a free trade agreement with smaller economies is better positioned to negotiate advantageous clauses.

Custom union. Sets common external tariffs among member countries, implying that the same tariffs are applied to third countries; a common trade regime is achieved. Custom unions are particularly useful to level the competitive playing field and address the problem of re-exports (using preferential tariffs in one country to enter another country). Movements of capital and labor remain restricted.

Common market. Services and capital are free to move within member countries, expanding scale economies and comparative advantages. However, each national market has its own regulations, such as product standards.

Economic union (single market). All tariffs are removed for trade between member countries, creating a uniform market. There are also free movements of labor, enabling workers in a member country to move and work in another member country. Monetary and fiscal policies between member countries are harmonized, which implies a level of political integration. A further step concerns a monetary union where a common currency is used, such as with the European Union (Euro).

Political union. Represents the potentially most advanced form of integration with a common government and where the sovereignty of a member country is significantly reduced. Only found within nation-states, such as federations where there are a central government and regions (provinces, states, etc.) having a level of autonomy over well-defined matters such as education.

As the level of economic integration increases, so does the complexity of its regulations. This involves a set of numerous regulations, enforcement, and arbitration mechanisms to ensure that importers and exporters comply. The complexity comes at a cost that may undermine the competitiveness of the areas under economic integration since it allows for less flexibility for national policies and a loss of autonomy. The devolution of economic integration could occur if the complexity and restrictions it creates, including the loss of sovereignty, are no longer judged to be acceptable by its members.

5.2 Free Trade Area (FTA)

A free trade area (FTA) refers to a specific region wherein a group of countries signs a trade agreement that seals the economic cooperation among them. The FTA's main goals are to bring down barriers in trading, specifically tariffs and import quotas, and encourage the free trade of goods and services among its member countries. Free trade agreements are entered into by two or more countries who want to seal the economic cooperation among themselves and agree on the terms of trading. In the agreement, member countries specifically identify the duties and tariffs that are to be imposed on member countries when it comes to imports and exports.

The key terms of free trade agreements and free trade areas include:

Import goods are products that were manufactured from a foreign land and are brought into another country and consumed by its domestic residents.

Export goods are the opposite of import goods – a manufacturer located in one country sells its products to buyers in a foreign country.

5.3 Free Trade Area vs. Customs Union vs. Single Market

Free trade area and customs union both deal with tariffs and trading. However, they are different in many ways. A free trade area is concerned with removing tariffs, and regulations that are applied to

member countries who trade with each other. Members establish a common set of policies that regulate trade terms, tariffs, and quotas. Another thing about a free trade area is that imports from outside the area do not confer the benefit of the free trade agreement. For example, two countries that are members of a free trade area, such as the U.S. and Mexico, refrain from imposing tariffs on each other. However, if a U.S. company imports bananas from South America, they would be subject to tariffs. A customs union, similar to an FTA, also removes tariffs between its members, but it also sets up a common external tariff to non-members on imported and exported goods. The main difference between an FTA and a customs union is that more compliance (bureaucracy) is involved under an FTA transaction. A single market runs deeper than a customs union because it promotes frictionless trading. Every member recognizes that every single product manufactured by the group's members is suitable for sale, for distribution to all members, and for consumption. A single market basically creates a level playing field for every member and not only encompasses tradable products and goods but also allows the citizens of each member country to work freely throughout the area.

5.4 Advantages of a Free Trade Area

A free trade area offers several advantages, including

Increased efficiency the good thing about a free trade area is that it encourages competition, which consequently increases a country's efficiency, in order to be on par with its competitors. Products and services then become of better quality at a lower cost.

Specialization of countries When there is intense competition, countries will tend to produce the products or goods that they are most efficient at. Efficient use of resources means maximizing profit.

No monopoly When there is free trade, and tariffs and quotas are eliminated, monopolies are also eliminated because more players can come in and join the market.

Lowered prices When there is competition, especially on a global level, prices will surely go down, allowing consumers to enjoy a higher purchasing power.

Increased variety with imports becoming available at a lower cost, consumers gain access to a variety of products that are inexpensive.

5.5 Disadvantages of Free Trade Area

Despite all the benefits brought about by a free trade area, there are also some corresponding disadvantages, including:

Threat to intellectual property When imports are freely traded, domestic producers are often able to copy the products and sell them as knock-offs without fear of any legal repercussions. Therefore, unless the FTA includes provisions for intellectual property laws and enforcement there are no protections for exporting companies.

Unhealthy working conditions Outsourcing jobs in developing countries can become a trend with a free trade area. Because many countries lack labor protection laws, workers may be forced to work in unhealthy and substandard work environments.

Less tax revenue Since member countries are no longer subject to import taxes, they need to think of ways to compensate for the reduced tax revenue.

5.6 The Trade Regimes

While the trade policy framework continues to be evolving and varies considerably among countries, the following main features characterize the trade regimes of CIS members: On the import side, most countries have so far avoided the establishment of quantitative restrictions or licensing. But protectionist pressures are rising and leading to the imposition of such controls in some countries (e.g., Uzbekistan) or sectors (alcoholic beverages-- in Russia).

In 1995 three countries, Belarus, Kazakstan and Russia established a customs unionwhich the Kyrgyz Republic agreed to join in 1996

The tariff regimes vary considerably, but on the whole countries have established few tariffs exceeding 30%. Some countries have low and uniform tariffs, e.g., Armenia's maximum tariff is 10% and the Kyrgyz Republic has a 10% uniform tariff); while in others the range goes up to 100% for a few items. In Russia, the average is about 13-14% with a range from 0 to 30% for most commodities, with some selected items considerably higher (see table 2 for details at a somewhat aggregated level).

On the export side, there has been significant dismantling of export controls in most countries; but controls of exports through state trading continues in some key exportable (cotton, oil and natural gas).

Trade with each other, is in principle free under the terms of the FTA. Imports are duty free, but it appears that export and foreign exchange controls in practice limit trade among some of the countries. Weaknesses in the payments systems continue to hamper trade, leading to continuing use of barter; but the previous state to state barter agreements have been by and large eliminated. Many countries have established a mixed VAT system: "origin" based for CIS trade and "destination" based with regard to the rest of the world. This means that with respect to CIS countries, imports are not taxed but domestic producers pay the VAT regardless of whether the good is exported or sold domestically. For the rest of the world, imports pay the VAT but exports are zero rated.

The Customs Union members negotiated a common external tariff based on the Russian tariff. But in the course of 1996, the three original members unilaterally introduced modifications to the external tariffs they applied to some commodities (Rietzler and Usmanova, 1996); also, as of the time of this writing, the Kyrgyz Republic had not taken any steps to introduce the common external tariff but instead continued to apply a uniform 10% tariff to imports from the rest of the world. All four countries are applying to the WTO on the basis of individual tariff schedules rather than as a custom union. Thus, at present, strictly speaking, there is no common external tariff for the Customs Union. But the agreements are still in place and the governments may pursue further steps towards their full implementation.

5.7 The Effects of Customs Union

There are two kinds of effects of customs unions, static and dynamic. The static effects relate to the impact of the establishment of the customs union on welfare. The analysis in this instance focuses on a comparison of the welfare of a country or groups of countries before and after the establishment of the customs union; thus, the analysis is one of comparative statics.

The dynamic effects focus on the impact the customs union on the rate of output growth of a country or countries in the medium term. Many analysts have noted (Winters 1996) that supporters of customs unions and other regional preferential arrangements frequently find that the static welfare effects are typically small and possibly negative. They then focus on the potential dynamic benefits, which however, are difficult to define and even more difficult to measure.

In the case of the CIS countries, there is already a FTA among all members as well as a Customs Union (CU) among some of them however modified by specific exceptions for variation from a common external tariff. Hence the analysis of both dynamic and static effects has to compare the advantages and disadvantages of joining this specific customs union not just any one, and assumes that in principle the alternative to joining, is continuation of the FTA among the CIS; but the implications of a different alternative, under which countries that do not join the CU are excluded from the FTA area, also briefly examined.

Static Welfare Effects

The principal impact of joining the customs union would be to replace the external tariff of each of the countries with the common external tariff of the customs union. In general, under these circumstances the benefits of joining the CU would depend to a considerable extent on the height and structure of each of the countries external tariff compared to that of the Customs Union external tariff. While in practice a Customs Union external tariff may not be in place at present, for purposes of analysis, the Russian tariff is a good proxy of the Customs Union external tariff that had been negotiated and will be used for the discussion in this unit. If a country such as Armenia or the KyrgyzRepublic with lower external tariffs were to substitute the Russian tariff for its own tariff structure, it would increase its unweighted average tariff to 13-14 percent (see table 2). More importantly, assuming that following accession of new members, the common external tariff is not changed, the Russian tariff exhibits considerably more dispersion compared with the tariff for some of the countries (typically between 0 and 30 percent),3 meaning that for selected

highly protected products in Russia, the tariff would increase significantly. For other countries, adopting the common external tariff would mean actually reducing their average tariff.

Starting with Jacob Viner (1950), international trade economists typically analyze preferential trade arrangements, whether members of a FTA or a CU, in terms of trade creation and trade diversion. Trade creation in a product occurs, when additional imports come from partner countries which displace sales of inefficient domestic producers and these imports are at least as cheap as imports from non-partner countries. Trade creation results in improved welfare for the importing country for much the same reasons as increased trade improves a country's welfare. On the other hand, trade diversion occurs when suppliers in the rest of the world (who continue to face tariffs) are more efficient than partner suppliers, but additional partner country imports displace the more efficient suppliers. Trade diversion is typically (but not necessarily) welfare reducing since the home country must pay more to import the product from the less efficient partner country suppliers.

Although the general theory of regional trading arrangements is quite ambiguous in its conclusions, we believe some definitive conclusions are possible with respect to the specific customs union under consideration, at least for some of the CIS countries. Since the partner countries in the potential customs union already have tariff free access to the other CIS markets under the Free Trade Agreement, prices in these countries' markets cannot fall as a result of the customs union, i.e., there will be little welfare gain from trade creation. Whatever trade creation would occur, would come from third country suppliers in those products where the current external tariff in the country is higher than that of the Customs Union external tariff. Since welfare costs from a tariff increase with the square of the tariff rate, net welfare effects are little impacted by reductions in tariffs by a few percentage points say, from ten to seven percent. Rather what is crucial to the welfare effects are the changes that involve significant tariff increases.

5.8 SAARC

Simultaneously, exporters in the countries of the region have to be helped financially to take care of resource constraints. As financing imports through export earnings alone has not been a possibility for SAARC countries, and generation of internal resources to fill the gap has been equally difficult, dependence on external assistance tied to the source has been a marked practice. What is required is a discreet use of clearing and payment arrangements and promotion of mutually advantageous counter trade. In this context the idea of having a common South Asian Currency would be of enormous value. We need to move towards much closer cooperation for this to happen, to guard against misuse, money laundering and other considerations. As the EU experience has shown, a common currency demands strict fiscal controls and extensive monetary cooperation, which the region is still far from having.

The SAFTA Agreement was signed on 6 January 2004 during Twelfth SAARC summit held in Islamabad Pakistan.

Quality-Upsurge and Intra-SAARC Trade

South Asia has to contend with another factor that is emerging. Due to the impact of globalization, consumer taste has developed and is growing further in favour of goods from outside the region. As our experience shows, the only way to meet this challenge is to improve the quality of our products for our consumers and make them competitive against imported goods rather than clamp down on imports and fight the rising tide of globalization. If this calls for structural changes, these must be undertaken and in concert with countries of the region. Non-availability of exportable surpluses of preferred specifications, sub-standard quality of goods and services, and lack of standardization are major constraints to regional trade and its movement towards forging a South Asian Community. Low production efficiencies and high export competitiveness of the region have been quite an obstacle to increased intra-SAARC trade. To achieve the latter, South Asian countries should pay more attention to reducing trade imbalances amongst themselves. As the largest member of SAARC, India has a special responsibility for this. It should strive harder to reduce its surpluses in trade with other regional

states by assisting them to produce more for the huge Indian market, reduce its protective mechanism vis-a-vis these countries and encourage more free trade arrangements with them as it has done with Nepal, Bhutan and recently Sri Lanka. Similarly, these countries should drop their inhibitions for developing closer and more open trade ties with India since in a climate of trust India's size and consumption capabilities will prove to be a boon to them rather than a bane. There is also the need to achieve greater standardization, and harmonization of documents such as letters of credit and complex customs procedures as the European Union has done, avoid delivery delays and enforce greater quality control. These steps are of crucial importance for a smooth flow of trade within the region.

Linkages and Transportation

To move towards a South Asian Community, the network of transport and transit facilities in the region has also to be considerably improved. Trade cannot move without its arteries being fluent. Lack of infrastructure is the enemy of development. It also comes in the way of fruitful regional cooperation. The absence of proper rail and road links among SAARC countries increases the cost of such cooperation, disturbs delivery schedules and inhibits mutually advantageous business enterprises to develop. The logistics of freight movement are fundamental for trade. SAARC's Technical Committee on Transport and Communication has deliberated on these issues, but on the ground progress has been slow and inconsistent with the needs of the moment. Moreover, these deliberations have remained largely in the official domain and the great potential of the private sector has not been provided the right impetus.

Governments can play a very useful role in improving transport service facilities like railways, roads, shipping and ports. The possibilities of undertaking regional projects in this vital sector through private sector involvement are immense. There is also scope for cooperation in specific areas like inland waterways and coastal shipping. India, the only member of SAARC sharing land/sea borders with all the South Asian countries, has to take initiatives in upgrading these links but other regional partners must also overcome their inhibitions and come forward, seeking inspiration from the successful examples of Europe and NAFTA in fostering regional cooperation in this field among countries irrespective of their size.

The region should work on developing SAARC transport infrastructure and develop trunk routes of trade and development. It is high time that SAARC moved forward to establish an Infrastructure Fund, took up a couple of major infrastructure projects and implemented them so well that these would inspire confidence in SAARC's capability to deliver. The fund should focus on the improvement of the intra-SAARC border transport links that merit the most immediate attention. While all the member states have to do their part to create such a fund, India as the largest of them and having borders with all of them has a very major responsibility in the matter and must give the lead. In this respect, attention should be given to the Indian proposal at the meeting of the Council of Ministers in July 2004 for setting up a SAARC Infrastructure Fund for financing large collaborative projects.

New Dimensions

South Asian trade must also move more vigorously into the manufacturing and services sectors. From primary commodities it should fan out more and more into manufacturing and services trade. In the last two decades industrial joint ventures and transfer of technology have played a critical role in the growth of trade in regions such as ASEAN, the EU and NAFTA. International trade in services has also become a significant source of foreign exchange earnings. Joint ventures and technology transfers in manufacturing and services sectors constitute a major form of cooperation between enterprises of both developed and developing nations. SAARC states would stand much to gain by promoting such cooperation among them. While the signing of agreements on investment promotion and protection, avoidance of double taxation, and establishment of an Arbitration Council are important, SAARC needs to move away from mere trade in goods, as contemplated under SAPTA, to a new dimension of cooperation, embracing trade in services, and enhanced investment flows and cooperation in fiscal and monetary matters.

Sectors in which Joint Ventures and technology transfers are feasible are huge. These range from local market-oriented ventures such as frozen food and fruit products to agro-based industries, textile and leather products, rubber and plastic products, mineral based industries, metal and metal products, chemicals, transport equipment, nonelectric machinery, electrical equipment, goods and machinery, and energy-based industries.

Towards an Economic Union

The South Asian region offers a high potential for cooperation in such services as tourism and the hotel industry, consultancy services, services for small industry development, computer software, joint ventures for research and development, development finance, construction industry and banking. Taking advantage of the current foreign exchange position of the region as a whole, it would be useful to create a SAARC Reserve Fund as a source of financing debit balances. SAARC states should also undertake focal programs in the form of SAARC Technology Missions (SAARCTEMs) to improve agriculture and dairy development, using biotechnology. Similarly Joint SAARC Resource Surveys could be undertaken with a selective use of space technology and informatics to support sustainable development. At the same time the South Asian countries should encourage joint eco-friendly use of the region's water and power resources by designing sub-regional projects for manufacturing, installing and maintaining energy systems including solar energy. These steps will take South Asia closer to the goal of becoming a community and hopefully, somewhat later, help it evolve into South Asian Union. Towards this end, SAARC should create a high-powered Economic Council comprising Finance/Planning Ministers of each Member State to promote initiatives for regional economic, commercial, financial and monetary integration so vital to the emergence of an Economic Union.

Poverty Alleviation

We cannot face the world with full pride and dignity unless we eliminate the hydra of poverty that stalks our region. Each of our countries has the responsibility to concentrate on this theme individually and in concert with regional partners. It is obvious that while there is no substitute for each of our nation's individual efforts, SAARC should take the lead in promoting collaborative efforts to achieve poverty alleviation. It should be possible for the member States of SAARC to spare a proportion of their national allocations to meet the challenge of poverty for SAARC's collaborative efforts to that end. A common pool in the form of a SAARC Poverty Alleviation Fund should form the basis for such an effort. In this context one must welcome India's offer of US $ 100 million to set the ball rolling on this. Given the dimensions of the problem this is not a big amount but with other Member Countries chipping in, it should be possible for the SAARC Poverty Alleviation Fund to finance specific projects for implementation. Member States should also set up National Committees to consult with each other to monitor progress on such collaborative projects as well as devise programmes to implement the goals of the SAARC Social Charter. The region has a grave need to meet challenges jointly especially in combating diseases such as tuberculosis and HIV/AIDS. Fresh initiatives in this direction are necessary.

The academics analyzing the successes and failures of SAARC have long felt that it is important to create a regional forum for people's representatives from each member country to interact with their counterparts from others to discuss issues facing them regionally and to help develop regional cooperation. Establishment of a South Asian Parliamentary Forum would help achieve that objective.

An Oracle

More than half a century ago, at the first Asian Conference Pandit Jawahar Lal Nehru expressed the hope that the event would stand out in history as a landmark and said, "*Strong winds are blowing all over Asia*". Let us not be afraid of them but rather welcome them for only with their help can we build the Asia of our dreams. Let us have faith in these great new forces and the dream which is taking shape. Let us above all, have faith in the human spirit which Asia has symbolized for those long age's past.

More than anyone else, South Asia is a party to that dream and that spirit. In this twenty first century the continent of Asia has set its sights quite high and we stand closer to the fulfillment of that dream. And yet we are not so close. Much of that hope now rests on the next SAARC Summit in Dhaka, the thirteenth since its establishment. It was in Dhaka that SAARC's odyssey began when Bangladesh put us all together to think and work as a region. Let the Dhaka summit be the harbinger of a new dawn for the people of this historic region by taking several leaps forward.

High on the heels of the Fifth EU-India Summit came the third ASEAN—INDIA Summit on November 11, 2004 at Vientiane, Laos.

It is a happy augury that India's regional relationships are developing a fresh thrust and a new momentum. In a world of shrinking distances, rising expectations and soaring new dreams, the

human family has to learn to sink its differences and maximize cooperation all around to carve a new destiny. In that historic journey, entities like the EU, ASEAN and increasingly SAARC standout as important milestones. Regional cooperation will be propelled as much by the historic force of globalization as by a new dynamism in bilateral equations. For Asia to add this momentum would be necessary to bury the hatchet of earlier conflicts and rivalries and move from the security of weapons to the firmer security of regional and global cooperation, from the worn-out concept of Mutually Assured Destruction to that of Mutually Assured Cooperation, from the battle for humanity's survival to that of growth for all. A brave new world beckons to us free of destitution, deprivation and discrimination if only we could heed its call and move towards it in one file, our steps in a harmonious blend.

5.9 North American Free Trade Agreement

The North American Free Trade Agreement (NAFTA) is an agreement signed by the governments of Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994. It superseded the Canada—United States Free Trade Agreement between the U.S. and Canada.

NAFTA has two supplements: the North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC).

Negotiation and U.S. Ratification

Following diplomatic negotiations dating back to 1986 among the three nations, the leaders met in San Antonio, Texas, on December 17, 1992, to sign NAFTA. U.S. President George H. W. Bush, Canadian Prime Minister Brian Mulroney and Mexican President Carlos Salinas, each responsible for spearheading and promoting the agreement, ceremonially signed it. The agreement then needed to be ratified by each nation's legislative or parliamentary branch.

Before the negotiations were finalized, Bill Clinton came into office in the U.S. and Kim Campbell in Canada, and before the agreement became law, Jean Chrétien had taken office in Canada.

The proposed Canada-U.S. trade agreement had been very controversial and divisive in Canada, and the 1988 Canadian election was fought almost exclusively on that issue. In that election, more Canadians voted for anti-free trade parties (the Liberals and the New Democrats) but the split caused more seats in parliament to be won by the pro-free trade Progressive Conservatives (PCs). Mulroney and the PCs had a parliamentary majority and were easily able to pass the Canada-US FTA and NAFTA bills. However, he was replaced as Conservative leader and prime minister by Kim Campbell. Campbell led the PC party into the 1993 election where they were decimated by the Liberal Party under Jean Chrétien, who had campaigned on a promise to renegotiate or abrogate NAFTA; however, Chrétien subsequently negotiated two supplemental agreements with the new US president. In the US, Bush, who had worked to "fast track" the signing prior to the end of his term, ran out of time and had to pass the required ratification and signing into law to incoming president Bill Clinton. Prior to sending it to the United States Senate, Clinton introduced clauses to protect American workers and allay the concerns of many House members. It also required US partners to adhere to environmental practices and regulations similar to its own.

With much consideration and emotional discussion, the House of Representatives approved NAFTA on November 17, 1993, 234-200. The agreement's supporters included 132 Republicans and 102 Democrats. NAFTA passed the Senate 61-38. Senate supporters were 34 Republicans and 27 Democrats. Clinton signed it into law on December 8, 1993; it went into effect on January 1, 1994. Clinton while signing the NAFTA bill stated that "NAFTA means jobs. American jobs, and good-paying American jobs. If I didn't believe that, I wouldn't support this agreement."

Provisions

The goal of NAFTA was to eliminate barriers to trade and investment between the US, Canada and Mexico. The implementation of NAFTA on January 1, 1994 brought the immediate elimination of tariffs on more than one-half of Mexico's exports to the U.S. and more than one-third of U.S. exports to Mexico. Within 10 years of the implementation of the agreement, all US-Mexico tariffs would be eliminated except for some U.S. agricultural exports to Mexico that were to be phased out within 15 years. Most U.S.-Canada trade was already duty free. NAFTA also seeks to eliminate non-tariff trade barriers and to protect the intellectual property right of the products.

In the area of intellectual property, the North American Free Trade Agreement Implementation Act made some changes to the Copyright law of the United States, foreshadowing the Uruguay Round

Agreements Act of 1994 by restoring copyright (within NAFTA) on certain motion pictures which had entered the public domain.

Mechanisms

NAFTA's effects, both positive and negative, have been quantified by several economists, whose findings have been reported in publications such as the World Bank's Lessons from NAFTA for Latin America and the Caribbean, NAFTA's Impact on North America, and NAFTA Revisited by the Institute for International Economics. Some argue that NAFTA has been positive for Mexico, which has seen its poverty rates fall and real income rise (in the form of lower prices, especially food), even after accounting for the 1994-95 economic crisis. Others argue that NAFTA has been beneficial to business owners and elites in all three countries, but has had negative impacts on farmers in Mexico who saw food prices fall based on cheap imports from US agribusiness, and negative impacts on US workers in manufacturing and assembly industries who lost jobs. Critics also argue that NAFTA has contributed to the rising levels of inequality in both the US and Mexico. Some economists believe that NAFTA has not been enough (or worked fast enough) to produce an economic convergence, nor to substantially reduce poverty rates. Some have suggested that in order to fully benefit from the agreement, Mexico must invest more in education and promote innovation in infrastructure and agriculture.

Investment

The US foreign direct investment (FDI) in NAFTA Countries (stock) was $357.7 billion in 2009 (latest data available), up 8.8% from 2008.

The US direct investment in NAFTA countries is in nonbank holding companies, and in the manufacturing, finance/insurance, and mining sectors. The foreign direct investment, of Canada and Mexico in the United States (stock) was $237.2 billion in 2009 (the latest data available), up 16.5% from 2008.

Industry

Maquiladoras (Mexican factories that take in imported raw materials and produce goods for export) have become the landmark of trade in Mexico. These are plants that moved to this region from the United States, hence the debate over the loss of American jobs. Hufbauer's (2005) book shows that income in the maquiladora sector has increased 15.5% since the implementation of NAFTA in 1994. Other sectors now benefit from the free trade agreement, and the share of exports from non-border states has increased in the last five years while the share of exports from maquiladora-border states has decreased. This has allowed for the rapid growth of non-border metropolitan areas, such as Toluca, León and Puebla; all three larger in population than Tijuana, Ciudad Juárez, and Reynosa.

Environment

For more details on this topic, see NAFTA's Impact on the Environment. Securing U.S. congressional approval for NAFTA would have been impossible without addressing public concerns about NAFTA's environmental impact. The Clinton administration negotiated a side agreement on the environment with Canada and Mexico, the North American Agreement on Environmental Cooperation (NAAEC), which led to the creation of the Commission for Environmental Cooperation (CEC) in 1994. To alleviate concerns that NAFTA, the first regional trade agreement between a developing country and two developed countries, would have negative environmental impacts, the CEC was given a mandate to conduct ongoing ex post environmental assessment of NAFTA.

In response to this mandate, the CEC created a framework for conducting environmental analysis of NAFTA, one of the first ex post frameworks for the environmental assessment of trade liberalization. The framework was designed to produce a focused and systematic body of evidence with respect to the initial hypotheses about NAFTA and the environment, such as the concern that NAFTA would create a "race to the bottom" in environmental regulation among the three countries, or the hope that NAFTA would pressure governments to increase their environmental protection mechanisms. The CEC has held four symposia using this framework to evaluate the environmental impacts of NAFTA and has commissioned 47 papers on this subject. In keeping with the CEC's overall strategy of transparency and public involvement, the CEC commissioned these papers from leading independent experts.

NAFTA-related environmental threats instead occurred in specific areas where government environmental policy, infrastructure, or mechanisms, were unprepared for the increasing scale of production under trade liberalization. In some cases, environmental policy was neglected in the wake of trade liberalization; and measures against non-tariff trade barriers, threatened to discourage more vigorous environmental policy. The most serious overall increases in pollution due to NAFTA were

found in the base metals sector, the Mexican petroleum sector, and the transportation equipment sector in the United States and Mexico, but not in Canada.

Agriculture

From the earliest negotiation, agriculture was (and still remains) a controversial topic within NAFTA, as it has been with almost all free trade agreements that have been signed within the WTO framework. Agriculture is the only section that was not negotiated trilaterally; instead, three separate agreements were signed between each pair of parties. The Canada-U.S. agreement contains significant restrictions and tariff quotas on agricultural products (mainly sugar, dairy, and poultry products), whereas the Mexico-U.S. pact allows for a wider liberalization within a framework of phase-out periods (it was the first North-South FTA on agriculture to be signed).

The overall effect of the Mexico-U.S. agricultural agreement is a matter of dispute. Mexico did not invest in the infrastructure necessary for competition, such as efficient railroads and highways, which resulted in more difficult living conditions for the country's poor. Mexico's agricultural exports increased 9.4 percent annually between 1994 and 2001, while imports increased by only 6.9 percent a year during the same period.

One of the most affected agricultural sectors is the meat industry. Mexico has gone from a small-key player in the pre-1994 U.S. export market to the 2nd largest importer of U.S. agricultural products in 2004, and NAFTA may be credited as a major catalyst for this change. The allowance of free trade removed the hurdles that impeded business between the two countries. As a result, Mexican farmers have provided a growing meat market for the U.S., leading to an increase in sales and profits for the

U.S. meat industry. This coincides with a noticeable increase in Mexican per capita GDP that has created large changes in meat consumption patterns, implying that Mexicans can now afford to buy more meat and thus per capita meat consumption has grown.

Mobility of persons

According to the Department of Homeland Security Yearbook of Immigration Statistics, during fiscal year 2006 (i.e., October 2005 through September 2006), 73,880 foreign professionals (64,633 Canadians and 9,247 Mexicans) were admitted into the United States for temporary employment under NAFTA (i.e., in the TN status). Additionally, 17,321 of their family members (13,136 Canadians, 2,904 Mexicans, as well as a number of third-country nationals married to Canadians and Mexicans) entered the U.S. in the treaty national's dependent (TD) status. Because DHS counts the number of the new 1-94 arrival records filled at the border, and the TN-1 admission is valid for three years, the number of non-immigrants in TN status present in the U.S. at the end of the fiscal year is approximately equal to the number of admissions during the year. (A discrepancy may be caused by some TN entrants leaving the country or changing status before their three-year admission period has expired, while other immigrants admitted earlier may change their status to TN or TD, or extend TN status granted earlier).

5.10 India and the European Union

The Summit

The European Union and India had held their first Summit in 2000. The progress made since then was so encouraging that by the middle of last year both sides agreed to establish a EU-India 'strategic partnership.' At the Fifth India-EU Summit on November 8, 2004 where India was represented by Prime Minister Dr. Manmohan Singh and EU by Dutch Prime Minister Dr. Jan Petar Balkenende, President of the European Council, both sides agreed to jointly workout a Comprehensive EU-India Action Plan for a Strategic Partnership and a new Joint Political Declaration, at the next Summit. They also agreed to hold regular, institutionalized parliamentary exchanges between the Indian Parliament and the European Parliament and to promote political interaction between the two sides by fostering cooperation between political parties and trade unions. Cooperation is also to be encouraged between business associations, universities and civil societies.

A new feature now will be the flow of students and scholars between the EU and India through an India specific scholarship programme under EU's project Erasmus Mundus. An Energy Panel will also be set up to coordinate joint efforts to ensure energy security in an increasingly volatile energy environment when the rising prices of the fuel are causing havoc particularly in developing societies. Both sides also agreed to organize EU-India Environment Forum and to exchange views and information on issues of mutual interest. Joint workshops on automotive engineering, genomic studies, life sciences and nano-technology will also be held with a view to meet the challenges of the

future in a spirit of cooperation. On the wider global plane the European Union and India agreed at the last - Summit to install a dialogue on disarmament and non-proliferation. An agreement was reached 'to consider regular exchange of views on possibilities for cooperation on themes like resolution of conflicts.' These agreements provide a new dimension to EU-India relations for these indicate an interest on the part of both of them to act as global players in concert with each other. This has happened at a time of the enlargement of the EU to 25 countries covering the broad span of Europe all the way from the Atlantic to the Ural and the Arctic to the Mediterranean and in the context of the Lisbon strategy to make Europe the world's most competitive economy by 2010. Europe has established a new constitution for itself taking the European Union to a much higher stage of integration than foreseen by the Maastricht Treaty. An expanded Europe and a growing India throw up an enormous potential for a partnership for mutual benefit that the summit document seeks to crystallize.

Technology and Economic Cooperation

One of the highlights of the November 8, 2004 Joint India-EU statement is the decision to speed up the conclusion of an agreement for India joining the European Union's Galileo Global Positioning System as part of their strategic partnership. This satellite navigation project with its network of 30 satellites will become operational by 2008 and will provide a real alternative to the Global Positioning System being run by the US military that the US has the power to turn off selectively. It will guarantee the availability of highest quality signals over the Indian territory. India has agreed to invest money in this project appropriate to its participation in Galileo space, ground and user segments possibly to the tune of US $200 million. In terms of a strategic partnership India's participation under the Galileo satellite navigation project will stand on the same footing as its cooperation with the EU in the International Thermonuclear Experimental Reactor (ITER) project on fusion energy. The European Union and India already have a history of cooperation in the peaceful exploration and use of outer space. It has been moving forward on a regular basis through the European Space Agency and the Indian Space Research Organization. At the Fifth Summit, while India showed interest in EU's Galileo project, EU flagged its interest in India's Chandrayaan-I unmanned lunar exploration mission. It will include a payload of 55 kg of onboard instruments plus a 10 kg impactor for soft landing.

There is also a continuing strategic dialogue between India and the EU on the Information Society. In order to facilitate linkages in the area of research and technological developments, both sides agreed at the Fifth Summit to work towards a mutually acceptable mechanism to connect their information networks. EU and India have signed a MOU for a partnership programme providing for cooperation in sectors of education, health and environment. Agreement has also been reached on developing a Disaster Management Prepareness Programme and a Trade and Investment Development Programme. The trade between the EU and India now stands at some 30 billion US dollars. The two sides have agreed to intensify their trade cooperation in order to expand bilateral trade and investment flows several times over. It is important that both India and the European Union create an enabling economic environment and increasing access to their growing markets to reap mutual benefits. Europe's investment in India stands now at around US $5.5 billion whereas in the realm of infrastructure alone there is scope for investment up to US $150 billion.

Other Areas of Strategic Partnership

Dr. Romano Prodi, President of the European Commission, showed a great deal of interest at the Summit in EU collaborating with India in the energy sector. He recognized that supply and demand in this sector were not in equilibrium looking at its worldwide dimension and called the situation 'dramatic'. He noted that Asia was waking up and the energy needs of counties like India and China, as of the rest of Asia, would grow phenomenally in the years to come. Their development must not get stopped, he said, due to lack of energy and EU should come forward to help bridge the gap. India's Prime Minister on his part pointed out that apart from energy, there were opportunities for the EU for investment in other infrastructure development sectors such as roads, rail, sea ports and airports. Europe could also take advantage of the new drive in India for productivity growth, its world-class institutes of science and technology and management education, and the boom in agriculture, biotechnology and pharmaceutical industry. Dr. Manmohan Singh said that India could be used as a research and development laboratory by the EU to its great advantage while enhancing job opportunities for Indian scientists and engineers. The Prime Minister also drew EU's attention to the vast network of India's banking system and large financial markets. He invited the European Union to look at India as an investment destination of promise and great potential. Citing India and EU as natural partners Dr. Manmohan Singh underlined shared values between the two of democracy, pluralism, rule of law, a free press and an independent judiciary. The strategic

partnership between India and EU was vital, he said, for managing the challenges of global inter-dependence.

The European Union and India have also agreed to cooperate intensively on countering terrorism that is proving to be a menace to all their societies and to humankind at large. They will also push forward the Doha Development Agenda and the Framework Convention on Climate Change. They will take steps, too, for the promotion of tourism, enhancement of cooperation in the field of film production and distribution, conservation and restoration of works of art and monuments, scholarly exchanges between them, establishment of chairs on both sides for civilization studies and study of contemporary politico-economic systems under the Cultural Agreement signed at the fifth summit.

A Turning Point

The EU-India Fifth Summit thus marks a turning point in their relationship. While taking note of the ancient bonds between them as important cradles of civilization, the two sides manifested a strong will to meet the challenges of a new world facing them hand in hand as two poles of stability and as strong bastions of liberal democracy and market economy. India now greatly looks forward to a new level of cooperation with Europe from mere trade and investment, which remain very important, to a multiplicity of other areas impinging on human destiny such as space, science and technology, environment, peace and disarmament. Together India and Europe constitute more than a fourth of mankind and a vast chunk of this planet's natural resource. By putting their hearts, minds and resources together they can explore their potential to the fullest limit.

5.11 ASEAN—INDIA

India's emphasis on the resurgence of Asia and cooperation with Asian nations in the post-colonial era goes back to the days of the Asia Conference organized by Pandit Jawaharlal Nehru on the eve of India's independence, and the Bandung Conference later where the Indian leader offered Panchsheel as an alternative to the policy of deterrence that was shaping the cold war world. The countries of the South East Asian region and India have shared for thousands of years a priceless heritage of civilization and culture and of a very peaceful religious, social and economic interaction with each other. In this millennial relationship, all the societies extending from Myanmar to Indonesia along the Indian Ocean and from there to the Philippines in the Asia Pacific have had by dint of history and geography a close kinship and affinity with India. Today, like India again, they are pluralistic, multi ethnic societies. There also exists among them a multifaceted partnership through bilateral and multilateral links encompassing political, cultural, social, economic, scientific, technological, and security dimensions. These links constitute a solid foundation for taking ASEAN—INDIA partnership to greater heights and into new areas of growth and development.

Phnom Penh Summit

Since the First ASEAN—INDIA Summit held in Phnom Penh on November 2002 a number of agreements and understandings have already been reached between the two sides including the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India signed in Bali in October 2003 for realizing the full potential of ASEAN—INDIA Regional Trade and Investment Area (RTIA) and economic cooperation. At the Laos Summit in November last year the two sides committed themselves to promote a long term cooperative partnership, impart synergies to their complementarities and cooperate in a coordinated manner to accelerate and mutually reinforce sustainable growth and development, taking full advantage of their geographical contiguity. Both agreed to give high priority to development of regional infrastructure and road, rail, sea and air transportation links to increase physical connectivity that would facilitate greater movement of goods and people. In this connection they also agreed to facilitate travel and tourism between ASEAN and India by linking their tourist centres and to enhance synergies of tourist destinations. In addition, they agreed to promote cooperation in the fields of science and technology, and committed themselves to work through both conventional and innovative trade and economic arrangements to achieve freer movement of goods, services and investment.

The ASEAN Century

ASEAN and India agreed at the Laos summit to cooperate in human resource development, through capacity building, strengthening of institutions, training and entrepreneurship development focusing on small and medium enterprises. Apart from fostering cooperation to preserve their common cultural heritage, they agreed to promote people to people exchanges involving parliamentarians, the youth, artists, sport persons and representatives from business, industry, the media, and academic and think-tank institutions. The document on Partnership for Peace, Progress

and Shared Prosperity signed on November 11, 2004 at the Third ASEAN—INDIA Summit also provides for strengthening cooperation at the United Nations and other multilateral fora, in particular WTO. It expresses support for early reforms of the United Nations and the Breton Woods institutions to make them more democratic and responsive to the priorities of the developing countries. The ASEAN—India Partnership document manifests a new urge on the part of ASEAN and India to jointly address the common challenges confronting the world, especially those relating to security such as the menace of international terrorism, other transnational crimes like trafficking in drugs, human trafficking, cyber crimes, international economic crimes and environmental crimes, sea piracy and money laundering, through effective institutional linkages and programmes of cooperation. As partners ASEAN and INDIA have also agreed to collaborate on the global plane in areas of general and complete disarmament and the non-proliferation of weapons of mass destruction under strict and effective international control. India sees its growing interaction with ASEAN as 'critical to fulfilling the promise of the 21st century being an Asian century' to use the words of Prime Minister Manmohan Singh. While launching the INDIA—ASEAN car rally at Guwahati on the eve of the third ASEAN—INDIA Summit, the Prime Minister called it 'a journey in to the future demonstrating the possibilities in trade, tourism and people to people contact by bringing all these countries together'. He was equally conscious however of the enormous benefits likely to accrue to India's north eastern region through an intensification of ties with ASEAN and its member countries and of which the sub- regional cooperation under BIMSTC is a part.

Milestones Covered

To give practical shape to the objectives of this newly envisaged partnership, the Laos document is accompanied by an Action Plan for the implementation of specific activities and projects that will be periodically reviewed in the light of the dynamic developments in the region and the world. With the signing of this document India joins the array of ASEAN partners such as China, Japan and South Korea. Our relationship with ASEAN has come a long way from the year 1991 when the first steps were taken to move towards a constructive relationship with ASEAN. I had the good fortune of being Secretary (East) in the Ministry of External Affairs at that time and visited several ASEAN countries with that intent. As a result India became a sectoral dialogue partner of ASEAN in 1992. India's trade with ASEAN countries has multiplied a few times since then and now stands at US $13 billion. It is targeted to reach US $30 billion by 2007. This is a far cry from the mid-1960's when India declined the offer to be a full member of ASEAN. The Partnership Agreement reached at Laos with ASEAN makes it possible for India to interact with the South East Asia community of 500 million people with a combined GDP of US $750 billion as a collectivity. ASEAN's integrative mechanisms and the success it has achieved as a regional body should also inspire greater confidence in SAARC (the South Asian Association for Regional Cooperation), as an instrument of change in the South Asian region.

Summary

- SAARC commenced the process of liberalization eight years ago when in 1995 the Organization established the South Asian Preferential Trade Arrangement (SAPTA). During the last eight years four rounds of negotiations have been held among the member countries, exchanging lists of items for tariff concessions. So far more than 5000 items have been liberalized.
- South Asia has to contend with another factor that is emerging. Due to the impact of globalization, consumer taste has developed and is growing further in favour of goods from outside the region. As our experience shows, the only way to meet this challenge is to improve the quality of our products for our consumers and make them competitive against imported goods rather than clamp down on imports and fight the rising tide of globalization.
- It is a happy augury that India's regional relationships are developing a fresh thrust and a new momentum. In a world of shrinking distances, rising expectations and soaring new dreams, the human family has to learn to sink its differences and maximise cooperation all around to carve a new destiny. In that historic journey, entities like the EU, ASEAN and increasingly SAARC standout as important milestones. Regional cooperation will be propelled as much by the historic force of globalisation as by a new dynamism in bilateral equations.
- For Asia to add this momentum would be necessary to bury the hatchet of earlier conflicts and rivalries and move from the security of weapons to the firmer security of regional and global cooperation, from the worn out concept of Mutually Assured Destruction to that of Mutually Assured Cooperation, from the battle for humanity's survival to that of growth

for all. A brave new world beckons to us free of destitution, deprivation and discrimination if only we could heed its call and move towards it in one file, our steps in a harmonious blend.

- NAFTA was established in 1989 in Washington DC through trade agreement between Canada and the United States, which was attended by representatives of each. This agreement resulted in an agreement to eliminate or reduce tariffs between the two countries. In December 1992, NAFTA was signed by the presidents of the three countries, namely Brian Mulroney (Canada), Carlos Salinas de Gortari (Mexico), and George H. W. Bush (United States). The signing of NAFTA should be followed by a legislative ratification of the three countries. However, the United States legislature apparently alarming environmental and labor issues. Therefore, added the two agreements, each devoted to labor issues and environmental issues. Just beginning to be implemented NAFTA on January 1, 1994 (www.fas.usda.gov, 2009).
- Canada and Mexico are the second export market and the third largest for the United States. Commencing in 1992-1998, the value of U.S. agricultural exports increased by 26%, while accounting for 1997-1998, exports of food and food United States to Mexico increased from 881 million to 5.9 billion Dollars Dollars. This is the biggest level for 5 years in NAFTA. Mexico itself is a major target of U.S. food exports, and the United States have a supply of 75% of Mexican food imports. While Canada has been a stable market for U.S. food trade by increasing food exports by 10% every year from 1990 to 1998. Food in question is fruits, vegetables, snacksand other food consumption.
- Canada and Mexico needs the United States as an aid donor and the economies of both countries are deteriorating. For Canada and Mexico, NAFTA is the arena of competition among members. Mexico especially, most look very dependence on the United States in the economic sector.
- NAFTA can be regarded as one of the simplest forms of regionalism in the form of free trade areas. The relationship between the extent of member states in free trade relations in which each member benefits. Interests of members of the three countries in NAFTA of course not only on the economic sector. These countries also have a political interest, such as Mexico and Canada that require the United States to increase its bargaining position in economic assistance. NAFTA itself was established in order to offset the power of the new European Union.

Keywords

Economic union: An economic union is a type of trade bloc which is composed of a common market with a customs union.

Upsurge: a sudden forceful flow.

Disarmament: Disarmament is the act of reducing, limiting, or abolishing weapons. Disarmament generally refers to a country's military or specific type of weaponry. Disarmament is often taken to mean total elimination of weapons of mass destruction, such as nuclear arms. General and Complete Disarmament refers to the removal of all weaponry, including conventional arms.

Multilateral institutions: The international institutions which set the rules of international behaviour, for example the World Trade Organization.

Self Assessment

1. Which of the following types of regional economic integration focuses only on eliminating internal tariffs?

A. customs union
B. common market
C. complete economic integration
D. Free trade area

2. Anything that a Government might do to affect a Multinational adversely is known as_____.

A. Exchange rate risk
B. Business risk
C. Sales risk
D. Political risk

3. Which of the following is an example of a producer cartel?
A. ASEAN
B. EU
C. MERCUSOR
D. OPEC

4. Which of the following is not an example of political risk?
A. Change in Government
B. Civil unrest
C. War
D. Cost of production

5. If the Balance of Payment of a country is adverse, then which institution will help that country?
A. World Bank
B. International Monetary Fund
C. World Trade Organization
D. Asian Development Bank

6. NAFTA is an example of _______.
A. Common Market
B. Customers Union
C. Economic Community
D. Free Trade Area

7. A trade-creating customs union is one where:
A. lower-cost imports from outside the customs union are replaced by higher-cost imports from a union member
B. some domestic production in a member nation is replaced by lower-cost imports from another member nation
C. trade among members increases but trade with non members decreases
D. trade among members decreases while trade with nonmembers increases

8. A trade-diverting customs union:
A. increases trade among union members and with non member nations
B. reduces trade among union members and with non member nations
C. increases trade among members but reduces trade with non-members
D. reduces trade among union members but increases it with non members

9. A customs union that allows for the free movement of labor and capital among its member nations is called a:
A. preferential trade arrangement
B. free-trade area
C. common market
D. all of the above

10. Which year was IMF established?
A. 1945
B. 1995
C. 1940
D. 1947

11. Which of the following is not the objective of the IMF?
A. To promote international monetary cooperation
B. To provide loan to private sectors
C. To ensure exchange rate stability
D. To ensure balanced international trade

12. The European Union is an example of a/an ?
A. customs union
B. economic union
C. common market
D. free trade area

13. Members of the EU find that trade creation|| is fostered when their economies are ?
A. highly competitive
B. highly non competitive
C. small in economic importance
D. geographically distant

14. Which country is not a member of the European Union ?
A. Spain
B. Germany
C. France
D. Iceland

15. The Common Agricultural Policy of the European Union has ?
A. increase American farm exports to the EU
B. decrease American farm exports to the EU
C. lowered the price of American farm exports to the EU
D. not affected the price of American farm exports to the EU

16. When several countries jointly impose common external tariffs, eliminate tariffs on each other, and eliminate barriers to the movement of labor and capital among themselves, they have formed a/an ?
A. free trade area
B. customs union
C. common market
D. economic union

Answers for Self Assessment

1.	D	2.	D	3.	D	4.	D	5.	B
6.	D	7.	B	8.	C	9.	A	10.	B
11.	C	12.	A	13.	D	14.	B	15.	C
16.	A								

Review Questions

1. Write a short note on Phnom Penh Summit.
2. Discuss the role of SAARC and SAPTA.
3. What are the objectives of ASEAN union?
4. What is meant by regionalism? Discuss.
5. Discuss the role of NAFTA.
6. Write a short note on India and the European Union.

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Unit 06: Policy Framework and Promotional Measures

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Objectives

After reading this Unit students will be able to:

- analyse the direction of India's foreign trade and its policies
- analyse the direction of India's Investment policy
- measure the different levels of exporting promotion
- evaluate the Infrastructure Support of India's foreign trade
- discuss instruments of trade policy
- explicate policy measures for trade promotion
- analyze the functioning of different institutional arrangements for export promotion.
- organize the required documents for exports
- analyze the functioning of Special Economic Zones and Export Oriented Units
- compare the functioning of SEZ and EOU

Introduction

Advanced countries like Germany, U.S.A., Japan and others used their trade policy to (a) restrict their imports and provide a sheltered market for their own industries so that they could develop rapidly, and, (b) promote their exports so that their expanding industries could secure foreign markets. In other words, trade policy played a significant role in the development of the advanced countries. India, however, did not have a clear trade policy before Independence, though some type of import restriction—known as discriminating protection—was adopted since 1923 to protect a few domestic industries against foreign competition. It was only after Independence that a trade policy as part of the general economic policy of development was formulated by India.

6.1 Main Features of India's Trade Policy

India has been in a disadvantageous situation in terms of imports compared to sophisticated countries that are capable of producing and exporting nearly any commodity at affordable prices. As a result, India was unable to develop any industry without safeguarding it against international competition. Protecting native industries and promoting industrial development necessitated import restrictions, sometimes known as protection. Since independence, India's government has used a combination of import licensing, import quotas, import taxes, and, in certain circumstances, outright bans on the import of specific items to limit foreign competition. The Mahalanobis strategy of economic development through heavy industries, which India has followed since the Second Plan, called for prohibiting or limiting non-essential consumer goods imports, comprehensive import control of various items, liberal import of machinery, equipment, and other developmental goods to support heavy-industry-based economic growth, and a favorable climate for import substitution policy. On the export side, expanding exports was critical in order to pay for needed imports and reduce reliance on foreign countries. It was also realized that the domestic market for many items might not be sufficient to absorb the full domestic production, necessitating a search for markets elsewhere. To increase exports, the Indian government had to take a significant role through setting up trading institutions, and through fiscal and other incentives. Vigorous export promotion was emphasized after the Second Plan to earn foreign exchange to overcome the acute foreign exchange crisis. In the 1970's, importance of export promotion was again emphasized because of mounting debt service obligations and the goal of self-reliance (with zero net aid).

6.2 Phases of India's Trade Policy

The first phase covers the years 1947-48 to 1951-52, the second phase 1952-53 to 1956-57, and the third phase from 1956-57 to June 1966; the fourth phase began with the devaluation of the rupee in June 1966, and the last phase began in 1975-76.

During the first phase, from 1951 to 1952, India might have liberalised imports, but due to limits imposed by the United Kingdom on the use of sterling balances, she was forced to maintain wartime prohibitions. Because our balance of payments with the dollar area was severely negative, we made an effort to screen imports from hard currency areas and increase exports to this area in order to close the deficit. In 1949, India had to discount its currency as a result of this. During this time period, the import policy remained largely restrictive. Aside from that, due to domestic shortages, export limitations were imposed.

The purpose of trade policy during the second phase (1952-53 to 1956-57) was to liberalise foreign commerce. Import licences were granted in a liberal manner. Exports were also encouraged by loosening export rules, lowering export levies, eliminating export quotas, and offering export incentives. Liberalisation led to a tremendous increase in our imports but exports did not rise appreciably. As a result, our foreign exchange reserves were rapidly depleted. This necessitated a trade policy shift.

During the third phase which began in 1956-57, the trade policy was re-oriented to meet the requirements of planned economic development. A very restrictive import policy was adopted and the import controls further screened the list of imported goods. On the other hand, a vigorous export promotion drive was launched. The trade policy assumed that a lasting solution to the balance of payments problem lies in the promotion and diversification of our export trade. Not only should the export of traditional items be expanded, but export of newer items should also be encouraged. Similarly, import substitution industries should also be encouraged so that dependence on foreign countries be lessened. It was in this period that India's trade policy was thoroughly reviewed by the Mudaliar Committee (1962).

The fourth phase started after the devaluation of the rupee in June, 1966. During this period trade policy attempted to expand exports and strangely liberalised imports too. Actually, export promotion was given a big post through the acceptance and implementation of the commendations of the Mudaliar Committee (1962). The major recommendations included increased allocation of raw materials to export-oriented industries, income tax belief on export earnings, export promotion through import entitlement, removal of disincentives, and setting up of export Promotion Advisory Council, a Ministry of international Trade, etc. When these export promotion measures did not succeed and adverse balance of payments persisted, the Government of India undertook devaluation of the rupee in 1966 as a major step to check imports and boost exports. Initially devaluation was not successful and the adverse balance of payments worsened during the Annual

Plans. But during the Fourth Plan, the trade policy was quite successful in restricting imports and promoting exports. This period continued till 1975-76.

During the last phase (1975-76 onwards), the Government adopted a policy of import liberalisation, with a view to encourage export promotion. During Janata rule (1977-79) import liberalisation was also adopted to augment domestic supply of essential goods and to check rise in price level. Import- export policy of the Indian Government attempted to achieve such objectives as :

(i) to provide further impetus to exports;

(ii) to provide support to the growth of indigenous industry;

(iii) to provide for optimum utilisation of the country's resource endowments, especially in man-power and agriculture;

(iv) to facilitate technology up-gradation with special emphasis on export promotion and energy conservation;

(v) to provide a stimulus to those engaged in exports and in particular, to manufacturing units contributing substantially to the export efforts; and

(vi) to effect all possible savings in imports.

Thus, it is clear that the purpose of trade policy has been to stimulate economic growth and export promotion via import liberalisation. While framing the export-import policy (1985), the Government was guided by the recommendations of Abid Hussain Committee. Whereas the Committee emphasized the need for striking a balance between export promotion and import substitution, the Government in its wave of import liberalisation permitted a much greater quantum of imports in the name of export promotion and capital goods imports for technological upgradation. Thus, grave distortions appeared in the process of implementation of the recommendations of the Committee. The first major attempt at liberalisation was made by the Rajiv Gandhi government. As a result, in the four years from 1985-86 to 1989-90, exports surged forward and the period witnessed a record average annual growth of 17 per cent in dollar terms. Unfortunately, exports declined by 9 per cent in 1990-91.

6.3 India's Foreign Trade Policy

The commerce minister explained the rationale for the new policy, saying, "For decades, India's trade policy has been formed in a system of administrative restrictions and licensing." As a result, we now have a dizzying array of lists, appendices, and licenses. Delays, waste, inefficiency, and corruption have all resulted from this system. At every point, human intervention—described as discretion—has inhibited innovation and fostered arbitrariness.

As a result, the government decided that, while key critical imports such as POL, fertiliser, and edible oil should be protected, all other imports should be tied to exports through the expansion and liberalisation of the replenishment licence system. The following important reforms were announced to this end:

Major Trade Reforms

- Rep will become the principal instrument for export-related imports.
- For export-related imports, Rep will become the primary instrument.
- A consistent Rep rate of 30% of the f.o.b. value will now apply to all exports. This was a significant rise over the current Rep rates, which range from 5% to 20% of the f.o.b. value.
- Exporters with low import intensity benefited the most from the new Rep programme. Agricultural exports, for example, will see a significant increase in replenishment rates, which were previously as low as 5% or 10%.
- Except for the small-scale industry and makers of life-saving drugs/equipment, all extra licences will be removed.
- All additional licences given to export houses must be revoked.

- All items now listed in the Limited Permissible List OGL would be imported through the Rep route in the future.
- A category called as Unlisted OGL was included in the Exim policy. This category has been eliminated, and all things that fit within it can now only be imported through the Rep programme.
- For exporters, advance licencing was an alternative to the Rep route for acquiring imports. Many exporters were expected to find the Rep route more appealing now. However, exporters who choose to use advance licencing will still be able to do so.
- The government's goal was to decanalise all things save those that were absolutely necessary.
- In the light of the substantial liberalisation of the trade regime, and also the recent changes in exchange rates (after devaluation), Cash Compensatory Scheme (CCS) was abolished from July 3, 1991.

Assessment of the Trade Policy

The goal of Trade Policy (1991) was to reduce administrative regulations and barriers that impeded the free movement of exports and imports. The Exim scrip, which replaced Rep licences, was the Policy's foundational instrument. The goal of this device was to allow imports of up to 30% of export revenues when they were 100% realised. Clearly, the goal was to close the BOP gap. Various procedures for granting advance licences have been eased, and imports via exim scrips routes have been permitted. The country has been fed the motto of export promotion through import entitlement since the Mudaliar Committee in 1962. Following that, many instruments were fashioned, but a long-term perspective merely highlighted the fact that the government had failed to halt the faster increase of imports than exports during the previous three decades. The import widow was expanded even broader under various pretexts, and this persisted. Imports, particularly non-essential imports, have to be liberalised with considerable prudence. To summarise, India's trade strategy has been employed as part of overall economic policy to develop the country and diversify the economy since independence. At first, it took the form of limiting imports while increasing exports. It also took the form of coordinating international trade agreements, both bilateral and multilateral. Later, trade policy took the form of promoting exports through import liberalisation. India's trade policy, which was formulated by bureaucrats under the influence and guidance of Indian business houses and international conglomerates, had a significant impact on the country's rapid development, but it was primarily responsible for the country's entry into the traditional debt trap.

Let's look at the two aspects of India's trade policy: import and export policies.

6.4 Export-Import Policy

Import strategy in the post-independence period was directed by growth-oriented concerns that should eventually take us to the goal of self-sufficiency.

Policy on Exports and Imports in the First Decade of Planning

The Second Plan's major industrialization programme necessitated the establishment of a liberal import policy in the mid-1950s. Imports increased dramatically in both the private and public sectors. The private sector's modernisation, replacement, and expansion plans, as well as the government's heavy and basic industry development plans, resulted in an unprecedented increase in imports. Exports did not grow as expected. As a result, India lost all of its sterling holdings in order to pay off its negative balance. The country also faced a severe foreign exchange shortage—a true foreign exchange crisis. This forced a shift in import policy, with significant limits placed on imports.

It was believed throughout the Second Plan period that export revenues could not be greatly enhanced unless industrialization gained traction. This was expressed in the Second Plan as follows: "India's export revenues are derived from a few goods." Tea, jute, and cotton textiles, to name a few, make for roughly half of the quota. These primary exports are facing rising

international competition. This limits the potential for a significant growth in exports in the near future. While every effort should be made to promote the export of new commodities and to broaden and diversify the markets for the country's key exports, it must be recognized that greater domestic output will only be reflected in big export earnings after some degree of industrialization has occurred.

Mudaliar Committee Recommendations

The Government appointed the Import and Export policy Committee headed by Mr. Mudaliar in 1962 to review Government's trade policy. The Committee felt that developmental and maintenance imports were both essential for a growing economy and therefore, urged upon the government to provide facilities for the import of raw materials, components, etc., for all existing industries subject to higher priorities to new industries in

- power and transport which had proved a serious bottleneck;
- 'export-oriented' industries; and
- industries producing raw materials and components now imported.

Industries depending almost entirely on indigenous raw materials could arrange their own foreign exchange for the import of plant and machinery. The recommendations of the committee were accepted by the Government.

The import policy of restriction of non-essential goods on the one side and liberalization of imports of essential goods on the other was successful to a large extent—imports were controlled and exports were pushed up. This policy helped to reverse the persistent trade deficit.

Export-oriented Export-Import Policy

Since 1975-76, the Government of India has been following a liberalized import policy with the objective of increasing production, especially export production. There has been an increased emphasis on enhancing maintenance imports in order to promote capacity utilization. Since the principal purpose of the import policy was to encourage exports, it is characterized as export-oriented import policy.

Export-Import Policy (1985)

Mr. Vishwanath Pratap Singh, the then Commerce Minister, announced the Export-import Policy on the 12th April 1985. For the first time, the Government announced the policy on a three-year basis. The basic aim of the new policy was to facilitate production through easier and quicker access to imported inputs, impart continuity and stability of Exim Policy, strengthen the export production base, facilitate technological upgradation and effect all possible savings in imports.

Import-Export Policy (1990)

The government announced on April 30,1990 a new Import-Export Policy for a 3-year period. The Policy statement made it clear: "Improvement in our Balance of payments position can be achieved not so much through import curtailment as through promotion of exports. "The new policy has, therefore, provided further momentum to the ongoing process of liberalisation with emphasis on strengthening the impulses of industrial and export growth. The salient features of the new policy were:

1. List of items imported under Open General Licence (OGL) were expanded to facilitate easy access to import of items that are not available within the country.
2. The number of capital goods items permitted under OGL was increased from 1,261 to 1,343. This has been the major thrust of liberalisation.
3. Imports of certain raw materials such as petroleum products, fertilizers, oils/oilseeds, feature/ video films, newsprint, cereals, phosphoric acid, ammonia etc. were canalised through public sector agencies in view of the essential character of these imports from the

point of view of bulk consumption and the requirements of small Actual Users. However, trading houses/star trading houses were also permitted to import canalised items in order to promote exports.

4. A scheme of automatic licensing was introduced under which upto 10 per cent of the value of the previous year's licence can be imported.
5. For Registred Exporters, the concept of net foreign exchange earnings was made a guiding criterion for issue of licences thereunder.
   a) REP (Replenishment) licensing scheme was expanded and simplified.
   b) Export services like computer software, overseas management and consultancy service contracts as well as advertising jobs would qualify for import replenishments.
   c) Under the scheme of registration of Export Houses and Trading Houses, for determining eligibility, the annual average of net foreign exchange earnings in the base period should not be less than 5 crores for an Export House and 20 crores for a Trading House. These houses would be eligible for additional licences for import of raw materials, components. consumables and tools and capital goods allowed under OGL, besides other limited permissible items and canalisd items.
6. A scheme of Star Trading Houses was introduced for exporters with an average annual net foreign exchange earnings of 75 crores in the preceding three licensing years of the base period.
7. Under the Duty Exemption Scheme, Blanket Advance Licensing was introduced for manufacturer-exporters having a minimum net foreign exchange earnings of 10 crores during the preceding 3 years.
8. The Import-Export Passbook Scheme introduced in January 1986 was withdrawn.

Evaluation of India's Export-Import Policy

The 1985 import policy was broadly welcomed by various Chambers of Commerce and Industry, business and industrial houses and leading industrialists. The policy aimed at restricting unnecessary imports, but permitted imports for encouraging indigenous production and promoting exports. The policy also intended to pursue technological upgradation through imports. The policy was aware of the need to check dumping of goods by multinationals and, therefore, gave support to the indigenous industries by selective restrictions on imports. Another welcome feature of the import policy was the fillip it gave to the small-scale and cottage industries as well as to agricultural exports, all this would help to maximize utilization of our manpower and agricultural resources. As regards promotion of exports, the import policy contained clear cut measures to expand India's exports. The various measures were direct and positive and a general feeling was that India's import policy was clearly export-oriented.

However, critics noted some developments of a serious nature which would adversely affect our economy. They are:

1. Adverse effect on the growth of capital goods industry in India: The most serious liberalization has been attempted in the Exim Policy 1985-86 in the Capital Goods List bringing 208 items under the OGL list. Among the additions was microprocessor-based equipment, machine tools, spinning machines, jute machinery etc. The impact of this wave of liberalization is bound to be adverse. Given the limited size of the market and the problems of technology transfer and the procedural bottlenecks created by licensing, the development of capital goods industry which was never a very lucrative proposition for Indian industrialists, was made much more frightening in the wake of liberal imports of customs duty concessions.

2. Import policy likely to hit small-scale industries: Although the statement of objectives specifically mentioned encouragement of the small-scale sector, but the measures suggested do not match with the professed aims. Rather the Government in the name of modernization was helping big business to import labor-saving machinery. Economic and Political Weekly exposing double talk of the Government mentioned: "the government's pretensions of encouraging the handloom sector by controlling the textile industry are exposed by the fact that the latest in the labor-saving textile machinery, air jet and water jet looms (including shuttle-less looms), have been placed under OGL on the plea of modernization."
3. Adverse effect on indigenous industry: The new import policy was trying to over-reach its objectives of liberalization and under pressure from multi-nationals opened areas in which indigenous industry had adequate capacity. There was certainly far-reaching implications of such sweeping relaxations in imports. The Gujarat State Fertilizer Corporation (GSFC) and the Soda Ash Industry have been continuously pleading before the Government to restrict imports of caprolactam and soda ash since it would hit their interests adversely but the powerful multinationals forced the Government to dump these raw materials in India. This posed a problem of survival for the indigenous industry.
4. Technological dumping in the name of technology upgrading: According to RBI Report on Currency and Finance (1989-90), capital goods imports increased from 3,168 crores in 1984-85 to 8,831 crores in 1989-90 i.e., they have grown at an annual growth rate of 22.8 per cent during the 5-year period. There is, therefore, a relentless drive for unfettered import of capital. goods, design and drawings and technology. This is a dangerous trend from the country's point of view. Criticizing this approach, the Economic and Political Weekly mentioned: "What is missed in this line of reasoning is that production capacities once built on imported technologies and imported capital goods have to be sustained by imported raw materials, spares and parts. The so-called "inflexible imports" are, therefore, destined to grow constantly and relentlessly." Secondly, experience has also shown that the multinationals are hardly interested in technology transfer. Rather they in the name of technological upgradation, carry on 'technological dumping' of such technologies which have been superseded in the developed countries. This, the critics argue, is far more deleterious than dumping of goods—including capital goods.
5. From the foregoing analysis, it becomes evident that opening the door of imports much wider would result in increasing the trade gap. Such indiscriminate liberalization would create more dependence in terms of foreign exchange and widen the trade gap.

Export-Import Policy (2002-2007)

Union Commerce and Industry Minister Mr. Murasoli Maran announced the EXIM policy for the 5-year period (2002-07) on March 31,2002. The main thrust of the policy was to push India's exports aggressively by undertaking several measures aimed at augmenting exports of farm goods, the small-scale sector, textiles, gems and jewelry, electronic hardware etc. Besides these, the policy aimed to reduce transaction cost to trade through a number of measures to bring about procedural simplifications.

The salient features of Exim policy were as under:

1. Special Economic Zones: Indian banks were allowed to set up offshore banking units (OBUs) in special Economic zones. These units would act as magnets to attract foreign direct investments. These offshore banking units would be virtually foreign branches of Indian banks, but located

in India. OBUs would be exempt from cash reserve ratio (CRR), statutory liquidity ratio (SLR) and would give access to SEZ units and SEZ developers to international finance at international rates. This measure was aimed to make special Economic Zones internationally competitive.

2. Employment Oriented Measures: EXIM (2002-07) policy initiated a number of measures which would help employment orientation. Among them were the following:
   (i) Agriculture: Exim policy removed all quantitative restrictions on all agricultural products except a few sensitive items like jute and onions.
   (ii) Cottage sector and handicrafts :
   a) An amount of 5 crores under market access initiative (MAI) were earmarked for promoting cottage sector exports coming under KVIC. The units under handicrafts could also access funds under MAI. Under export promotion capital goods (EPCG) scheme, these units would not be required to maintain an average level of exports, while calculating export obligation. These units would be entitled to the benefit of Export House status on achieving lower average export performance of 5 crore as against 15 crores for others; and the units in handicraft sector would be entitled to duty-free imports of an enlarged list of items up to 3 per cent of f.o.b value of their exports.
   b) Small scale industry: With a view to encouraging further development of centres of economic and export excellence such as Tirpur for hosiery, woollen blankets in Panipat, woollen knitwear in Ludhiana, following benefits would be available to small-scale sector. Common service providers in these areas would be entitled to the facility of Export Promotion Capital Goods (EPCG) Scheme.
   c) Entitlement for Export House status at 5 crores instead of 15 crores for others.
3. Textiles: Duty entitlement passbook (DEPB) rates for all kinds of blended fabrics permitted. Such blended fabrics were to have lower rate as applicable to different constituent fabrics.
4. Gems and Jewellery: Rough diamonds import allowed on zero custom duty basis.

I. Growth-Oriented

Strategic package for status holders: The status holders would be eligible for the following facilities:

100 per cent retention of foreign exchange in exchange earners foreign currency (EEFC) account.

(a) Neutralizing high fuel cost: Fuel costs to be rebated for all export products. This would enhance the cost competitiveness of our export products.

(b) Diversification of markets: The following initiatives have been taken:

Focus LAC (Latin American Countries) was launched in November 1997 in order to accelerate trade with these countries. Our exports to these countries have increased by 40 per cent. To consolidate the gains of these programmes, this was extended upto March 2003.

Focus Africa was launched in April 2002. There is a tremendous potential for trade with sub-Saharan African region. During 2000-01, Indian exports to this region accounted for US $1.8 billion and imports were $1.5 billion.

II. Duty Neutralisation Instruments

(a) Advance licence : Duty Exemption Entitlement Certificate (DEEC) book was abolished. Redemption on the basis of shipping bills and band realisation certificates.

Withdrawal of advance licence for annual requirement (AAL) as problems were encountered in closure of AAL. The exporters could avail of advance licence for any value.

(b) Duty entitlement pass book (DEPB) : value cap exemption granted on 429 items to continue.

(c) Export promotion capital goods (EPCG) : licences of 100 crore or more to have 12 year export obligation period with 5 year moratorium period.

Assessment of EXIM Policy (2002-07)

Mr. Murasoli Maran, the then Minister for Commerce and Industry took a number of initiatives by providing tax concessions, streamlining certain procedures and removing quantitative restrictions.

Another positive feature of the policy was have 'Focus Africa' so that Indian exports to African countries can be developed. This initiative would help Indian exporters to explore this fast growing market which has been neglected earlier.

A big initiative to permit offshore banking units (OBUs) would help to develop foreign branches of Indian banks. The move was intended to provide international finance at international rates. This would lower the cost of credit to our exporters and thus make them more competitive. This initiative, specially directed at Special Economic Zones was another healthy feature of the Exim Policy.

However, critics raised several issues which need consideration. EXIM policy intended to boost the export of agriculture. In this effort, it intended to export wheat and thus reduce the mounting bufferstocks of foodgrains reaching the astonishingly high figure of 58 million tonnes in on January 1, 2002. There are two options before the government—(i) to export these foodgrains and earn foreign exchange and (ii) to use these foodgrains in 'food for work' programme and thus create employment in public works programme. It is really very disappointing that the Food Corporation of India is selling wheat in the international market as cattle feed at throw away prices. The question arises : Why is the quality of wheat procured by FCI poor when the Government continues to raise the support price of wheat for the farmers year after year ? It only speaks volumes about rampant corruption in FCI. The failure of the Central Government to persuade state governments to lift foodgrains from FCI is evident from the fact that as against an allocation of 28.55 million tonnes in 2000-01 in case of rice and wheat, the offtake was merely 11.72 million tonnes which is only 41 per cent of the allocation. This was mainly the consequence of an irrational policy fixing the issue price of foodgrains quite high. The result was that the public preferred to buy foodgrains from the open market. The Government, if it wants to increase the exports of agricultural products, should paymore attention toward improving the quality of rice and wheat procured so that it can fetch a good price in the international market.

EXIM Policy has laid great emphasis on Special Economic Zones (SEZs) which is a new incarnation of the Export Promotion Zones (EPZ) and Export-oriented Units (EOUs) promoted earlier. But the experience of the EPZ and EOUs has not been very happy. Together they account for only 12% of total exports. Too many procedural hurdles have prevented them from performing better. It would be very wise if the Special Economic Zones are not saddled with such excessive bureaucratic hurdles and are enabled to capture export markets. It may be noted the Special Economic Zones in China account for over 40 per cent of Chinese exports. India should learn to improve the performance of SEZs.

EXIM Policy made some concessions to help cottage and handicraft sector and small scale units which account for nearly 35 percent of the country's exports. But ironically, the policy did not pay adequate attention to the most important aspect of increasing bank credit to this sector.

Table 1 : Exports and Imports of Gems and Jewellery : India(US $ million)

	GrossExports(1)	Imports(2)	NetExports3= 1-2	3as% of1
1995-96	5,275	2106	3169	60.1
1999-00	7,550	5346	2114	28.0
2000-01	7384	4838	2546	34.9
2001-02	7306	4623	2683	36.7
2002-03	9030	6063	2967	32.9
2003-04	10,573	7129	3444	32.6
2004-05	13,761	9422	4339	31.5

2005-06	15529	9134	6395	41.2
2006-07	15977	7487	8490	53.1
2007-08	19657	7975	11682	59.4
2008-09	27,955	16,55 4	11,40 1	40.8
2009-10	29,000	16,16 4	13,83 6	47.7
2010-11	40,791	31,26 2	9,529	23.4

Source : Computed from the data provided in Economic survey (2003-04) and (2005-06), RBI, Handbook of Statistics on the Indian Economy 2009-10. Economic Survey 2009-10.

The programme allowed for duty-free imports of raw diamonds. However, when we look at the percentage of net diamond exports in total gems and jewellery exports, we can see that it has decreased from 60.1 percent in 1995-96 to 28 percent in 1999-2000, but then improved to 59.4 percent in 2007-08. It was 47.7% in 2009-10, but it dropped to 23.4 percent in 2010-11. We see a decrease in this proportion of net gem and jewellery exports, which could be related to the global recession. This emphasises the reality that simply lowering import duties does not provide the elasticity that exports require.

To summarise, the Commerce and Industry Ministry alone cannot create an atmosphere conducive to increased exports. It must coordinate with the Ministry of Power and Transportation for this purpose in order to avoid delays in the handling of products for export. Similarly, the Ministry of Commerce must persuade the Ministry of Finance to increase funding for infrastructure development. Not only that, but the federal and state governments must work together to achieve the goal of increased exports. This can be accomplished through increasing the competitiveness of our exports. This necessitates advancements in export technology as well as the creation of efficient infrastructure.

6.5 Foreign Trade Policy

Mr. Kamal Nath, Union Commerce and Industry Minister, launched the Foreign Trade Policy for the five-year term (2004-09) on August 31, 2004, with the goal of doubling India's share of world goods trade from 0.7 percent in 2003 to 1.5 percent in 2009. India's merchandise exports was $ 61.8 billion in 2003-04, accounting for around 0.7 percent of global exports. If this percentage were to double, the country's exports would have to reach $ 195 billion by 2009, assuming a 10% compound annual growth rate in global commerce. India's exports should expand at a 26 percent annual average growth rate to achieve this goal. Aside from that, the service sector is forecast to grow its share of invisibles exports to more than $ 100 billion. By 2009, the two industries are expected to attain a combined target of $300 billion.

The objective of the Foreign Trade Policy is two-fold :

(i) To double India's percentage share of global merchandise trade from 0.7 per cent in 2003 to 1.5 per cent in 2009; and

(ii) To act as an effective instrument of economic growth by giving a thrust to employment generation, especially in semi-urban and rural areas.

Key strategies to achieve the these objectives are :

1. Unshackling of controls;
2. Creating an atmosphere of trust and transparency;
3. Simplifying procedures and bringing down transaction costs;
4. Adopting fundamental principle that duties and levies should not be exported; and
5. Identifying and nurturing special focus areas to facilitate development of India as a global hub for manufacturing, trading and services.

Special Focus Initiatives : Sectors with significant export prospects coupled with potential for employment generation in semi-urban and rural areas have been identified as thrust sectors. These include agriculture, handicrafts, handlooms, gems and jewellery and leather and footwear sectors.

The threshold limit of designated "Towns of Export Excellence" is reduced from 1,000 crores to 250 crores in these thrust sectors.

Package for Agriculture : A new scheme called Vishesh Krishi Upaj Yojana (Special Agricultural Produce Scheme) was introduced to boost the exports of fruits, vegetables, flowers, minor forest produce and their value added products. Export of these products shall qualify for duty free credit entitlement equivalent to 5% of FOB value of exports.

Handlooms and Handicrafts : Duty free import of handlooms and handicrafts sector was increased to 5% of FOB value of exports.

Gems and Jewellery : Imports of gold of 18 carat and above shall be allowed under the replenishment scheme.

Export Promotion Scheme : A new scheme to accelerate growth of exports called "Target Plus" has been introduced. Exporters would be entitled to duty free credit based on incremental exports substantially higher than the general export target. For incremental growths of over 20 per cent, 25 per cent and 100 per cent, the duty free credit would be 5 percent, 10 per cent and 15 per cent respectively, of FOB value of incremental exports.

Service Exports : For services export, a "Served from India" scheme as a brand instantly recognized abroad, under which individual service providers earning foreign exchange of 10 lakh would be eligible for duty free credit entitlement of 10 per cent of total foreign exchange earned by them.

Duty free Import under EPCG : Duty free import of capital goods under EPCG (Export Promotion Capital Goods) Scheme. Capital good imported under EPCG for agriculture would be permitted to be installed any where in agri export zone.

EOUs : Export Oriented Units (EOUs) shall be exempted from service tax in proportion to their exported goods and services.

Notes: New Status Holder Categorization : A new rationalized scheme of categorization of status holders in Star Export houses has been introduced :

One Star Export House	25 crores
Two Star Export House	100 crores
Three Star Export House	500 crores
Four Star Export House	1,500 crores
Five Star Export House	5, 000 crores

Star Export Houses would be entitled to a number of privileges including fast-track clearance procedures, exemption from furnishing bank guarantees, eligibility for consideration under target plus scheme etc.

Free Trade and Warehousing Zone

1. A new scheme to establish Free Trade and Warehousing Zone (FTWZs) was introduced to create trade related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transaction in free currency. This was aimed at making India into a global trading hub.
2. FDI would be permitted up to 100% in the development and establishment of the zones and their infrastructure facilities.
3. Each zone would have minimum outlay of 100 crores and five lakh sq.mt. built up area.
4. Units in FTWZs would qualify for all other benefits as applicable for SEZ units.

Import of Second-hand Capital Goods

Import of second-hand capital goods would be permitted without any age restriction.

Bio-technology Parks : Bio-technology parks to be set up which would be granted all facilities of 100

% EOUs.

6.6 Assessment of Foreign Trade Policy (2004-09)

By establishing the new Foreign Trade Policy (2004-09), Commerce Minister Kamal Nath aimed to achieve two goals at once: to increase India's share of global exports from 0.7 percent in 2003-04 to 1.5 percent in 2008-09, and to boost job creation, particularly in semi-urban and rural areas. In this way, the Foreign Trade Policy is in line with the Common Minimum Programme's aims. The FTP's main feature is that it moved away from stressing simply the removal of quantitative constraints and instead focused on implementing actions to increase exports in thrust areas specified by it. Agriculture, handicrafts, handlooms, gems and jewellery, and leather and footwear were the key thrust areas. Because small and medium firms (SMEs) dominated these sectors, the boost granted to SMEs was likely to promote exports and create more jobs. In that regard, the policy orientation was extremely significant since it reached out to a considerably larger number of smaller company units and business houses rather than focusing just on giant five-star export firms.

It aimed to "bestow status on a huge number of hitherto unidentified small exporters" by streamlining star export firms from one to five stars. Furthermore, it will give an incentive for small exporters to advance from the lowest category of star export house to a higher category of star export house. The incentives will help the smaller entities to rise up on the ladder. This diversification and broadening of outreach to a wider number of units is a positive step forward.

Similarly, the reduction in the barrier for designated towns of excellence from 1,000 crores to 500 crores could be considered as part of this commendable endeavour to promote exports to a broader number of cities. In this regard, Mr. Gopal K. Pillai, Director General of Foreign Trade, correctly stated: "Reducing the cost of creating towns of excellence from 1,000 crores to 250 crores, as recommended in the strategy, is sufficient for enhancing the facilities in a town engaged solely in exports, such as Tirpur." The major goal is to increase the number of export centres.

A lot of positive ideas have been offered in light of the FTP's goal of tripling service exports. To build a brand equity “Served from India” is a unique step to push forward India’s image in foreign markets. Second, if pushed forward with zest and vigour, the establishment of a Services Export Promotion Council to address the difficulties of services in increasing market access as well as brand creation can go a long way.

The 'Target Plus Scheme' gives rewards based on the exporter's success. The simple rule is that the better the performance, the more duty-free credit is available. This type of incentive fosters a competitive spirit among Indian exporters, allowing them to increase their performance.

Another important initiative was to exclude all goods and services from service tax when they were exported. This is consistent with the core idea of not exporting charges and levies. In other words, it strengthens the Indian exporter's competitiveness in the worldwide market.

The establishment of a Free Commerce and Warehousing Zone (FTWZ) to boost infrastructure in the international trade industry was another move adopted. The strategy allowed for 100% FDI (Foreign Direct Investment) in the creation and establishment of zones, as well as their infrastructure. Some critics claim that FDI accounts for approximately half of China's manufacturing exports, whereas it accounts for only 8% in India. It may be argued that FDI can assist us in developing world-class infrastructure; nevertheless, if significant FDI flows are not available, India should invest in infrastructure on its own. More FDI inflows will begin until India has proven its credentials in overseas trade.

Another issue that needed to be addressed was lowering transaction costs, especially when the goal is to entice SMEs with low profit margins. The exemption from furnishing bank guarantee by exporters with minimum turnover of 5 crores, raising the validity of all licences and entitlements to a uniform 24 months and removal of service tax on all goods and services exports are all intended to reduce transaction cost.

Last, but not the least, it may be said that while the policy initiatives are designed with good intentions and are steps in the right direction, the pace of success of FTP will depend on the quality of implementation. Bureaucracy is known for putting spokes in the wheel of implementation the major task of the government is to facilitate the SMEs and other major exporters to achieve the challenging goal set by the new FTP to achieve merchandise export target of $ 195 billion and together with service sector, to earn $ 300 billion in terms of foreign exchange by 2009. It really very courageous of the Commerce and Industry Minister to fix such a high target which requires more than 25 per cent annual average growth rate in exports. Since export growth is also conditioned by exogenous factors operating in the world trade, the achievement of the target may be made more difficult despite our best intentions. But all honour to those who try.

During 2007-08, out exports reached a level of US $ 155 billion which is a creditable achievement. However, correspondingly our imports reached a level of $ 236 billion, widening the trade deficit to an improcedented high level of $ 81 billion which cannot be wiped out by surplus on the invisibles. Consequently, current account balance will become negative with a larger magnitude. Obviously, our foreign trade policy is one-legged since it emphasizes expansion of exports only, but remains oblivious of the tend of imports. Ultimately, India must, reach the stage of positive trade balance, rather than develop an economy with burgeoning trade deficit. The assistance extended to the Indian exporters are asunder :

Import Facilities For Exporters

- Duty Free Replenishment Certificate (DFRC) :- DFRC is issued to a merchant exporter or manufacturer exporter for the duty free import of inputs such as raw materials, components, intermediates, consumables, spare parts, including packing materials to be used for export production. Such licence is given subject of the Julfi1ment of time bound export obligation.
- Duty Entitlement Passbook Scheme (DEPB) :- Under the DEPB scheme, an exporter may apply for credit as a specified percentage of FOB value of exports, made in freely convertible currency. The credit shall be available against such export products and at such rates as may be specified by the Director General of Foreign Trade (DGFT) by way of public notice issued in this behalf, for import of raw materials, intermediates, components, parts, packaging materials, etc.

- Export Promotion Capital Goods Scheme (EPCG) :- EPCG scheme was introduced by the EXIM policy of 1992-97 in order to enable manufacturer exporter to import machinery and other capital goods for export production at concessional or no customs duties at all. This facility is subject to export obligation, i.e., the exporter is required to guarantee exports of certain minimum value, which is in multiple of tl;1e value of capital goods imported.

Duty Exemption Schemes

Duty Drawback (DBK):- The Duty Drawback Scheme is administered by the Directorate of Drawback, Ministry of Finance. Under this scheme, an

Exporter is entitled to claim :- .

Customs duty paid on the import of raw materials, components and consumables. Central excise duty paid on indigenous raw materials, components and Consumables utilized in the manufacture of goods meant for export.

Excise Duty Refund: - Excise duty is a tax imposed by the central government on goods manufactured in India. This duty is collected at source, i.e., before removal of goods from the factory premises. Export goods are totally exempted from central excise duty. However, necessary clearance has to be obtained in one of the following ways.

- **Export under rebate.**
- **Export under bond:**

Octroi Exemption: - Octroi is a duty paid on manufactured goods, when they enter the municipal limits of a city or a town. However, export goods are exempted from octroi.

Exemption from Income Tax :- In order to enable exporters to plough back their earnings and promote exports, the Government of India has given tax exemption to exporters on export earnings under section 80 HHC provision of the Income Tax Act. For example, for the A.Y. 2002-03, 60% of the export income is exempted from tax. At the same time, a ten year tax holiday is provided to 100% EOUs and units in EPZs.

Sales Tax Exemption :- Sales tax is a tax imposed by the State government on goods sold in or outside India. However, exportable goods are exempted from sales tax, provided the exporter or his firm is registered with the Sales Tax Authorities. This exemption is given on the following categories of goods :

Goods exported.

Goods purchased from the local market from export purpose.

Marketing Assistance

Market Development Assistance (MDA):- The government of India has set up a separate fund under the head Marketing Development Assistance (MDA) for developing marketing abilities of Indian exporters. It is granted by the Ministry of Commerce for export market development and research abroad. The amount granted under MDA varies from 25% to 60% of the actual expenditure incurred.

Market Access Initiative (MAI):- Under this scheme, financial assistance is available to the export promotion councils, C industry and trade associations and other eligible entities on the basis of the competitive merits of proposals received in this regard for undertaking marketing studies, setting up of common showrooms, warehousing facility, participation in sales promotion campaigns, publicity campaigns, international trade fairs, seminars, buyers- sellers meet, etc.

Supply of Raw Materials

a) Industrial Raw Material Assistance Centres (IRMAC) Scheme: .IRMAC is established by the government of India as,,-{i subsidiary of STC. Such centres import raw materials in bulk and supply them to the registered exporters against a valid import licence. This enables exporters to get timely supply of raw materials at reasonable prices, I~MAC has' been further simplified- by removing the actual user clause.

b) Back to-Back Inland Letter of Credit :- The facility of Back-to-Back Inland letter of credit was announced by the EXIM policy 1992-97 and came into effect from 1st April 1995. 13ack.to-back L/C is one, which can be opened In favour of local suppliers of raw materials or goods so as to enable exporters to got raw materials or goods for export on credit basis. It is a kind of pre-shipment finance procured by the exporter for the processing of export order.

Institutional Measures

The Government of India (GOI) has established a number of organisations to promote and expand export trade. These organizations are :-

Indian Institute of Foreign Trade (11FT) to provide training facilities. Indian Institute of Packaging (IIP) to upgrade, packaging standards.

Export Promotion Councils (EPCs) to undertake export promotion activities. Export Inspection Council (EIC) to upgrade quality standards.

Export Credit Guarantee.-Corporation (ECGC) to protect exporters against payment rises. Indian Council of Arbitration (ICA) to settle and solve disputes between importers and exporters. Apart from the above institutions, there are a number of other organisations such as Federation of Indian Export Organisation (FlEO), EXIM Bank, etc.

6.7 Expansion of Production Base for Exports

The first prerequisite of export promotion policy is to ensure larger exportable surpluses. In. other words, if a country wants to exports more, it must have more to export. It will have more to export only if more and more is produced for export. Hence, it calls for increasing flow of production and investment resources into the export sector.

Relaxation in Industrial Licensing Policy/MRTP/FERA/Foreign Collaborations With a view to facilitate relatively easier creation/expansion of production capacities for increasing export potential of Indian economic, necessary relaxations have been provided for in the policies for industrial licensing, MRTP (Monopolies and Restrictive Trade practices Act) and Foreign Exchange Regulations, etc. The Foreign Exchange Regulation Act has been liberalised and Foreign Exchange Management (FEMA) Act, 1999 has been operationalised. The rupee has been made fully convertible for all approved external transactions. As a result, exporters of goods and services and those who are in receipt of remittances are able to sell their foreign exchange at market determined rates. The importers and foreign travellers are also able to buy foreign exchange at market determined rates. Exporters have also been allowed to maintain foreign currency accounts. There is general liberalisation of remittance of foreign exchange for visits abroad, agency commission; export claims, reduction in export value, reimbursement of expenses incurred on dishonoured export bills, consular fees, etc. Consequently, creation of additions of production capacities for export is liberally allowed, both in the large-scale as well as small-scale sectors. Foreign collaboration and foreign capital investment is also liberally permitted for the export sector. 100% foreign equity has been permitted to the units in EPZ/EOU/EHTP/STP. All these policy measures are envisaged to go long way in facilitating easy expansion as Well as technological up gradation of export base in India through attracting larger flows of investment and other resources.

6.8 Liberal Import of Capital Goods

Import policy of India has made specially liberal provisions for easy import of capital goods of all types. Accordingly, imports of machinery and equipment are allowed without import licence. In addition special provisions have been made for import of capital-goods at a concessional rate of import duty. Export Promotion Capital Goods (EPCG) Scheme has been introduced for liberal import of capital goods.

Export Promotion Capital Goods Scheme: New Capital goods including computer software systems may be imported under the Export Promotion Capital Goods (EPCG) scheme. Under this provision, capital goods including jigs, fixtures, dies, moulds and spares upto 20% of the CIF value of the capital goods may be imported at 5% customs duty: This import is subject to an export obligation equivalent to 5 times CIF value of capital goods on FOB basis or 4 times the CIF value of capital goods on NFE basis to be filled over a period of 8 years. This period is reckoned from the date of issuance of licence. Import of capital goods shall be, subject to Actual User condition till the export obligation is completed.

Export Processing Zones (EPZ), Export-Oriented Units (EOU), Special Economic Zones (SEZs), Electronic Hardware Technology Parks (EHTP) and Software Technology Park Units (STP)

Units undertaking to export their production 'of goods may be set up under Export Processing Zones (EPZ) scheme, Export Oriented Units (EOU) scheme, Special Economic Zones (SEZs) scheme, Electronic Hardware Technology park (EHTP) scheme or Software Technology Park (STP) scheme. Such units may be engaged in manufacture, services, trading, development of software, agriculture including agro-processing, aquaculture, animal husbandry, bio- technology, floriculture, horticulture, pisciculture, viticulture, poultry, sericulture, and granites may I export all products except prohibited items of exports.

Summary

- India, however, did not have a clear trade policy before Independence, though some type of import restriction—known as discriminating protection—was adopted since 1923 to protect a few domestic industries against foreign competition. It was only after Independence that a trade policy as part of the general economic policy of development was formulated by India.

- On the import side, India has been in a disadvantageous position vis-a-vis advanced countries which are capable of producing and selling almost every commodity at low prices. This meant that India could not develop any industry without protecting it from foreign competition. Import restriction—commonly known as protection—was thus essential to protect domestic industries and to promote industrial development. Since Independence, the Government of India has broadly restricted foreign competition through a judicious use of import licensing, import quotas, import duties and, in extreme cases, even banning import of specific goods. The Mahalanobis strategy of economic development through heavy industries, which India adopted since the Second Plan, called for (a) banning or keeping to the minimum the import of non-essential consumer goods, (b) comprehensive control of various items of imports, (c) liberal import of machinery, equipment and other developmental goods to support heavy-industries based economic growth, and (d) favourable climate for the policy of import substitution.
- During the first phase up to 1951-52, India could have liberalised imports but on account of the restrictions placed by the U.K. on the utilisation of the sterling balances, she had to continue wartime controls. Since our balance of payments with the dollar area was heavily adverse, an effort was made to screen imports from hard currency areas and boost up exports to this area so as to bridge the gap. This also necessitated India to devalue her currency in 1949. By and large, the Import policy continued to be restrictive during this period. Besides this, restrictions were also placed on exports in view of the domestic shortages.
- Trade Policy (1991) aimed to cut down administrative controls and barriers which acted as obstacles to the free flow of exports and imports. The basic instrument developed by the Policy was the Exim scrip in place of Rep licences. The purpose of this instrument was to permit imports to the extent of 30% on 100 per cent realisation of export proceeds. Obviously, the purpose was to bridge the BOP gap. Trade policy has streamlined various procedures for the grant of advance licences as also permit imports through exim scrips routes.
- To conclude, India's trade policy since Independence has been used as part of general economic policy to develop the country and to diversify the economy. Initially it took the form of restricting imports and boosting exports. It also took the form of organising international trade and bilateral and multi-lateral trade agreements. In the later years, trade policy took the form of export promotion through import liberalisation. Formulated by bureaucrats under the influence and guidance of Indian business houses and multinational giants, India's trade policy did have an important influence on the rapid development of the country, but it was basically responsible for leading the country into the classical debt trap.

Keywords

- Foreign policy: A country's foreign policy, also called the foreign relations policy, consists of self-interest strategies chosen by the state to safeguard its national interests and to achieve its goals within international relations milieu. The approaches are strategically employed to interact with other countries. In recent times, due to the deepening level of globalization and transnational activities, the states will also have to interact with non-state actors
- Trade policy: Trade policy is a collection of rules and regulations which pertain to trade. Every nation has some form of trade policy in place, with public officials formulating the policy which they think would be most appropriate for their country. The purpose of trade policy is to help a nation's international trade run more smoothly, by setting clear standards and goals which can be understood by potential trading partners. In many regions, groups of nations work together to create mutually beneficial trade policies.

Self Assessment:

1. Amalgamation and rapid unification between countries can be identified as

A. Globalization

B. Liberalization

C. Socialization

D. Privatization

2. Which organizations strain on the liberalization of foreign investment and foreign trade?
A. International Monetary Fund
B. World Health Organization
C. World Trade Organization
D. International Labour Organization

3. The main reason behind MNCs investments are
A. To benefit foreign countries
B. To provide financial support to the country's government
C. For the welfare of underprivileged people.
D. To increase the assets and earn profits.

4. When did the government remove the barriers for investment and investment in India?
A. 1990
B. 1991
C. 1992
D. 1993

5. Which institute supports investments and foreign trade in India?

A. International Monetary Fund (IMF)
B. World Trade Organization (WTO)
C. World Bank
D. International Labour Organization (ILO)

6. Which of the following statements is/are correct about India Trade Promotion Organization(ITPO)?
a. India Trade Promotion Organization (ITPO) is the nodal agency of the Government of India under aegis of Ministry of Commerce and Industry for promoting country's external trade.
b. ITPO is a Mini-Ratna Category-1 Central Public Sector Enterprise (CPSE) with 100 percent shareholding of Government of India.
A. Only a
B. Only b
C. Both a & b
D. None

7. Indian Institute of Foreign Trade (IIFT) is situated in?

A. Dehradun
B. Lucknow
C. New Delhi
D. Mumbai

8. Which of the following statement is/ are correct about Federation of Indian Export Organizations (FIEO)?

i. FIEO represents the Indian entrepreneur's spirit of enterprise in the global market
ii. It is an apex body of the export promotion councils, community boards and development authorities in India

iii. Provides the crucial interface between international trading community of India and its government

A. only 1 and 2

B. only 2 and 3

C. only 1 and 3

D. All of the above

9. Export Inspection Council of India (EIC) is a certification body of India which ensures

A. Quality products exported within India

B. Quality and Safety of products imported outside India

C. Safe products exported within India

D. Quality and safety of products exported from India

10. Exporter's export risk is covered under which Scheme

A. Credit Guarantee scheme

B. Reserve Bank of India

C. Export Development Authorities

D. Export Credit and Guarantee Corporation

11. The major functions of Export Promotion Council (EPC) are to:

A. Provide commercial information, organize trade fairs, exhibitions, promote interaction between trade and government

B. Provide commercial information, organize trade fairs, exhibitions, Bail out exporters in case of losses

C. None of the above

D. Can't say

12. Excise duty exemption on exports is available for duty paid on
A. finished products only
B. components only
C. finished products and components
D. imported items

13. DEPB (Duty Entitled Passbook) scheme which ended in September 2011 was related to-
A. Foreign Direct Investment
B. Foreign Institutional Investment
C. Export Promotion
D. Import Substitution

14. Special Economic Zones (SEZ)are ____________.
A. the places where industries get certain tax advantage
B. the places wherein any person can start new industries
C. the places where industries can operate without any control
D. the places wherein the national labor laws don't apply

15. Star Export Houses are
A. Export Marketing Houses
B. Export house owned by Celebrity.
C. Export house advertised by Celebrity.
D. None of the above.

16. Deemed exports is beneficial to Indian buyers because: -

A. It reduces costs in supply chain management, Saves foreign exchange
B. It reduces costs in supply chain management, after sales service is easier, Saves foreign exchange
C. None of the above
D. Can't say

Answers for Self Assessment

1.	A	2.	C	3.	D	4.	B	5.	B
6.	C	7.	C	8.	D	9.	D	10.	D
11.	B	12.	C	13.	C	14.	A	15.	A
16.	B								

Review Questions

1. What do you mean by Trade Policy? Discuss the main features of India's trade policy.
2. Write a short note on the Export-Import policy.
3. Discuss foreign policy.
4. Discuss the role of SEZs and 100 % EOUs

Further Readings

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Unit 07: International Organization

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Objectives

After studying this chapter, you will be able to:

- Understand the role of International Organizations
- Understand the background of International Organizations
- Determine the historical significance of International Organizations.
- Analyze the functioning of International Organizations
- Understand the background of International Monetary Fund
- Determine the significance of International Monetary Fund
- Analyse the role of International Monetary Fund (IMF)
- Evaluate the operations of International Monetary Fund (IMF)

Introduction

International organizations are entities established by formal political agreements between their members that have the status of international treaties; their existence is recognized by law in their member nations; they are not treated as resident institutional units of the nations in which they are located. By use of a system, norms, and bureaucracy, international organizations assist nations in cooperating to improve living circumstances on a global scale and provide a common forum for discussing controversial topics and finding peaceful resolutions. International organizations play a significant role in assisting nations in achieving multiple noble goals, such as increasing economic prosperity, fostering social development, enhancing levels of well-being, preserving human rights, providing humanitarian aid, safeguarding the environment, and preserving peace.

7.1 Types of International Organizations

There are two types of international organizations:

- Governmental
- Non-governmental

Scope of International Organizations

- Its origin is based on multilateral international agreement.
- The institution has a personality of its own, which is distinct from that of its individual members.
- It has permanent organs which carry out common aims.

Some International Organizations

1. **IMF (International Monetary Fund)**
   - At the international level, overseas financial institutions and regulations.
   - It consists of 180 members. Out of them, G-8 members enjoy more powers i.e., the US, Japan, Germany, France, the UK, Italy, Canada and Russia except China and Saudi Arabia.
   - The US alone enjoys 16.75% voting rights.
2. **World Bank**
   - It was created in 1944.
   - It works for human development, agriculture and rural development, environmental protection, infrastructure and governance and provides loans and grants to developing countries.
   - It is criticized for setting the economic agenda of poorer nations, attaching stringent conditions to its loans and forcing free market reforms.

3. WTO (World Trade Organization)

- An international organization to set the rules for global trade which was set up in 1995 as a successor to General Agreement on Trade and Tariffs (GATT) and has 157 members, (as on 1 September 2012)
- Major economic powers such as the US, EU and Japan have managed to use the WTO to frame rules of trade to advance their own interests.
- The developing countries often complain of non-transparent procedure and being pushed around by big powers.

4. UNICEF (The United Nations International Children's Emergency Fund)

- UNICEF is created by resolution 57(I) of the United Nations General Assembly on 11 December 1946 to provide supplies and assistance to children after World War II.
- To help children and young people whose lives and futures were at risk – no matter what role their country had played in the war.
- UNICEF works in 191 countries and territories through 157 country programmes

7.2 InternationalMonetaryFund(IMF)

Background

The establishment of the International Monetary Fund, abbreviated IMF, is a watershed in the history of global economic cooperation. The creation of the International Monetary Fund was the

result of a 1944 meeting held in Bretton Woods (United States). The conference gave rise to the IMF and IBRD organizations. The IMF was established in December 1945, and in March 1947 it proclaimed its preparedness to begin foreign exchange transactions. Presently, 187 countries are members of the IMF. The IMF is a pool of central bank reserves and national currencies that its members have access to under specific conditions. It might be viewed as an expansion of the central bank reserves of member nations.

The principal purposes setting up of IMF are:

1. **Creation of global money related co-activity**: The above all else objective of the asset is to advance worldwide financial collaboration through an extremely durable foundation.
2. **Promotion of adjusted development of International Trade:** The second significant target of the asset is to work with the extension and adjusted development of global exchange and to contribute along these lines to the advancement and upkeep of elevated degrees of work of the part nations.
3. **Stability in conversion standard:** One of the principal goals of IMF is to advance trade steadiness, to keep up with methodical trade plans among individuals and to stay away from serious trade deterioration.
4. **Multilateral Payments Arrangement:** This goal is to aid the foundation of a multilateral arrangement of installment in regard of current record exchanges among individuals and in the end of unfamiliar trade limitations, which hamper the development of world exchange.
5. **To right maladjustments yet to be determined of installments:** The significant goal is to give certainty to individuals by making the asset's assets accessible to them under satisfactory protections. In this way, it gives them a valuable chance to address maladjustments in their equilibrium of installments without turning to measures disastrous of public and global success. The IMF doesn't meddle in the interior economy of the part nations to reestablish harmony in their equilibrium of installments.
6. **To abbreviate the span and reduce the level of disequilibrium:** The goal is to abbreviate the term and decrease the level of disequilibrium in the worldwide equilibrium of installments of individuals.
7. **Abolition of trade limitations:** The asset will attempt to eliminate a wide range of limitations and controls on unfamiliar trade forced by the part nations.
8. **Help in global installments:** The asset will loan or offer to its part countries monetarystandards of different nations. This works with unfamiliar trade exchanges among the individuals.
9. **Aid to part nations during crisis:** The asset targets giving momentary money related help to part countries during crisis.

7.3 MembershipofIMF

Therearetwotypesofmembersofthefund:

1. **Original Members:** All those countries whose representatives took part in Bretton WoodsConferenceandwhoagreedtobethememberoftheFundpriorto31stDecember,1945,arecalledtheoriginalmembersoftheFund.
2. **Ordinary Members:** All those who became its member subsequently are called ordinarymembers.

Any country may withdraw its membership by submitting a written withdrawal notification. Fund may terminate a country's membership if it violates its regulations. From forty in 1947 to 187 in 2010, the number of member states has increased from forty.

7.4 OrganizationandManagement

Inordertomanagethefund,thefollowingadministrativeboardshavebeensetup:

- ***Board of Governors:*** It consists of one Governor and an Alternate Governor for eachmember country. It meets once a year. The board of governors frames the policies of theFund.
- ***BoardofDirectors:***Itconductsday-to-dayaffairsoftheFund.Itconsistsof21directors,7of whom are permanent and others being temporary directors. Permanent directors belongto those countries that have the largest quotas in the Fund. Currently, these countries areUnitedStates,Japan,Germany,France,China,ItalyandSaudiArabia.Fourteenotherdirectors are elected by other member countries. India is one of the elected directors. Themanagingdirectormayappointthreedeputymanagingdirectorsinsteadofone,w.e.f.June,19 94.

7.5 CapitalResourcesoftheFund and Organizational Strategy of the Fund

Capital Resources of the fund

The capital resource of the fund are bought in by the different part nations via their separate shares. Every part's still up in the air before its enrolment as a part. The standard of every part is fixed concerning SDRs. Every nation needs to give 25% of its share sum with regards to save resources, as SDRs or some other usable cash and 75 percent concerning its own money. A country's relations with the not entirely set in stone by how much its standard.

Example:

(a) Voting powers of a part country relies on how much its standard. Every nation has 250 least votes. In addition, on every lakh of SDRs, one vote is expanded.

(b) The most extreme restriction of the monetary help from the Fund to the part country to address its equilibrium of installments relies upon how much its quantity.

(c) Share of a country in the portion of SDRs relies upon how much its share.

Changes in how much standard of Fund are made after like clockwork. The asset has made changes in the quantities of part nations at various times. In 2010, the portion raised by the Fund was around 238.4 billion SDRs.7.6.2. OperationalStrategyoftheFund

BorrowingStrategyoftheFund

The Fund is a significant financial institution in addition to conducting regulatory and advisory roles. The majority of the Fund's financial resources come from quota subscriptions from member countries. In addition, it can borrow from the governments, central banks, and private institutions of industrialised nations, the Bank for International Settlements, and even OPEC nations such as Saudi Arabia.

GeneralArrangementstoBorrow(GAB)

The Fund can borrow from its 20 industrialized members under GAB and NAB (New ArrangementstoBorrow)TheGABandNABarecreditarrangementsbetweentheIMFandagroupof membersand institutions to provide supplementary resources of up to SDR 34 billion (about US$50 billion)to the IMF to forestall or cope with an impairment of the international monetary system or to dealwithanexceptional situationthatposes athreat tothestability ofthatsystem

LendingStrategyoftheFund

Members may utilise the reserve tranche, the four credit tranches, and the three permanent facilities for particular reasons, per tranche policy. The members have access to the facility for compensatory financing of export fluctuations (established in 1963 and liberalised in 1975 and 1979), the Buffer stock financing facility (established in 1969), the Extended Fund 'facility (established in 1974), and the Structural Adjustment Facility (SAF) established in March of 1986. Fund lending is made to members momentarily out of balance in their current account balance of payments. If a member country's currency falls below its quota, the shortfall is known as a reserve tranche. It can automatically withdraw up to 25 percent of its reserve tranche upon notifying the Fund of its balance-of-payments needs. The Fund charges no interest on such withdrawals. The borrowing country is required to repay the loan within three to five years.

CreditStrategyoftheFund

CreditTranches

In addition, a member country may withdraw up to 100 percent of its outstanding limit from credit tranches in instalments. The borrowing member must demonstrate to the Fund that a feasible financial stability programme is being implemented. It indicates that credit tranche withdrawals are subject to conditions. To address the severe balance of payment issues, the Fund has gradually boosted the borrowing limit for members. A member can now borrow up to 300 percent of their new quotas on the Fund's overall net usage of resources. Withdrawals made under the CCFF, BSAF, SAF, STF, and ESAF are exempt from this 300 percent cap.

OtherCreditFacilities

The Fund has established several new loan facilities since 1960. These credit facilities exclude borrowings made through credit tranches, and these loans are available for an extended term. These are the credit facilities:

1. **BufferStockFinancingFacility(BSFF):**It was established in 1969. It was developed so that member nations may finance the commodities buffer stock. A member may use up to 30% of its quota under this heading. The member is required to collaborate with the Fund in establishing domestic commodity pricing. Repurchases occur between three and a half and five years.
2. **Extended Fund Facility (EFF):** The building was constructed in 1974. The EFF credit is offered to cover imbalances in the balance of payments. The quantities supplied by EFF are greater than the member's credit limit under conventional credit facilities. This facility is available for a maximum of ten years. The maximum loan amount permitted under EFF is 300 percent of the member's quota. The punishment is based on performance standards and instalment payments.
3. ***SupplementaryFinancingFacility(SFF):***In 1977, the Supplemental Finance Facility (SFF) was established to offer additional financing for extended or standby arrangements. The primary objective of the SFF was to provide member nations with funding to cover substantial balance of payments deficits relative to their economies and quotas. This facility was expanded to include developing member nations with modest incomes. In 1980, the Fund established a Subsidy Account to minimise the cost of SFF borrowing for low-income developing nations. Subsidy Account refers to the account through which the Fund pays out subsidies to borrower nations.
4. ***StructuralAdjustmentFacility(SAF):***It was founded in March of 1986. The primary objective of SAF was to give concessions to implement macroeconomic and structural reform plans over the medium term. Additionally, the loans are granted to them to address their balance of payments issues. The loans are made accessible to the weaker nations on extremely favourable terms. The interest rate levied on these loans ranges from 0.5 to 1%, and the

repayment duration varies from 5 12 to 10 years with a 5-year grace period. Annual payments are contingent on the acceptance of annual agreements, with members getting 15 percent of their quota under the first annual arrangement, 20 percent under the second annual arrangement, and 15 percent under the third annual arrangement. The SAF was established with a budget of 2,7 billion SDR. The majority of the funds come from loan repayments to the Trust Fund.

5. ***Enhanced Structural Adjustment Facility (ESAF):*** The ESAF was established in December 1987 with a budget of 6 billion SDR. It was established to satisfy the medium-term funding requirements of low-income nations. The ESAF has the same aims, eligibility requirements, and fundamental programmes as the SAF. The only difference between the two is the level of aid provided. The members can receive up to one hundred percent of their Quota throughout the course of a three-year programme, with a provision for up to two hundred fifty percent in extraordinary situations. The ESAF disburses funds biannually instead of annually.
6. ***CompensatoryandContingencyFinancingFacility(CCFF):***The CCFF was established in August of 1988. Its primary objective was to offer timely compensation for temporary shortages or increases in cereal import costs caused by external factors. This facility was offered to a member in order to continue the momentum of adjustment programmes financed by the Fund. In 1990, the Fund temporarily incorporated a significant element to assist members in recovering from the Gulf War Crisis. This was within 95 percent of the CCFF quota. Additionally, it was determined to increase the scope of CCFF. Now, for the calculation of export shortfalls, workers' remittances, and trip receipts, shortfalls in other services such as revenues from pipelines, canals, shipping, transportation, construction, and insurance, etc. are also factored into compensating finance. .
7. ***Transformation Facility (STF):*** In April, 1993, STF was established with $6billiontohelpRussiaandotherCentralAsianRepublicstofacebalanceofpaymentscrisis.
8. ***Emergency Structural Adjustment Loans (ESAL):*** The ESAL facility was established by the Fund at the beginning of 1999 to assist Asian and Latin American countries in financial difficulty. The Fund's short-term loan rates were 3 to 5 percentage points higher than its typical lending rates. The ESAL facility was established by the Fund at the beginning of 1999 to assist Asian and Latin American countries in financial difficulty. The Fund's short-term loan rates were 3 to 5 percentage points higher than its typical lending rates.
9. ***Contingency Credit Line (CCL):*** CCL was established in April 1999 to shield fundamentally sound countries from the contagion of other countries' financial crises. Those countries were deemed qualified which could finance BOP comfortably over the medium term, had a robust financial sector, and strong debtor-creditor relations. No nation has borrowed through this facility.

7.6 StrategyRegardingExchangeRatesPolicy

As stated in Article I of the Articles of Agreement, members are required to engage with the Fund and other members to ensure orderly exchange arrangements and create a stable system of exchange rates. In accordance with New Article IV of the second amendment to the Articles, the following exchange rate policies must be implemented: Endeavor to direct its economic and financial policies toward the objective of promoting orderly economic growth with reasonable price stability, taking into account its circumstances;

1. Seek to maintain stability by promoting orderly underlying economic and financial circumstances and a monetary system with a low propensity for irregular disruptions.

2. Avoid manipulating the exchange rate or the international monetary system to impede the adjustment of the balance of payments or obtain an unfair competitive advantage over other members.
3. In addition to ensuring the compliance of each member with these commitments, these three principles ensure the efficient operation of the international monetary system. According to the Second Amendment, these precise principles must be implemented in order to guide members' exchange rate strategies. These are described below:
4. A member is prohibited from manipulating exchange rates or the international monetary system to thwart effective balance of payments adjustments or gain an undue competitive advantage over other members.
5. A member should, if necessary, intervene in the foreign exchange market to address chaotic situations that may be characterised, in part, by disruptive short-term fluctuations in the value of its currency.
6. Members' intervention policies should take into account the interests of other members, especially those of nations in whose currencies they intervene.

The initial Fund Agreement stipulated that the par value of each member nation would be stated in terms of gold of a specified weight and quality or U.S. dollars. The objective was to establish a stable exchange rate system with ordered cross rates. Later, the Fund agreed to exchange rate adjustments that did not exceed 1% of the initial par value. A further modification of 1% is permitted, but only with the Fund's approval. In 1971, these provisions were modified from fixed to flexible exchange rates. Currently, the Fund has little influence over the exchange rate adjustment policies of its members. The member states are not compelled to maintain and establish gold or dollar parities.

Notifying the Fund, any nation can now adjust the par value of its currency by 10 percent. If a country wishes to alter its par value by 20%, it must obtain the Fund's prior consent. In such a scenario, the Fund must communicate its decision within seventy-two hours. If the change exceeds 20%, the Fund requires further time to make a decision. This decision is made by two-thirds of the members. By majority vote, the Fund can also alter the par values of all countries by a set proportion. If a member-nation disagrees with this modification, it must tell the Fund within 72 hours. A country may only alter its par value if it faces the challenge of resolving "fundamental disequilibrium" in its balance of payments position.

OtherFacilities

The balance of payments, exchange rate problems and monetary and fiscal issues are the otherissues on which the IMF advises its member countries. The Fund has set up three departments tosolvebankingandfiscalproblemsofmembercountries.Thesedepartmentsare:

1. **Central Banking Service Department:** This department helps member countries with theservices of its experts to manage and run their central banks. These services are especiallyprovidedtodevelopingcountriesformakingreformsintheirbankingsystem.
2. **FiscalAffairsDepartment:**Thisdepartmentisestablishedtoprovideadviceonfiscal mattersofthemembercountries.
3. **IMF Institute:** It conducts short-term training courses on the fiscal, monetary, banking andBOPpoliciesfortheofficersofthemembercountries.

In addition to these, the Fund’s research department publishes many reports in a year containingmaterial relating to different policy measures. The major publications are IMF Annual ReportandIMFstaffpapers,FinanceandDevelopmentJournal,etc.

7.7 MainFunctionsoftheFund

Based on the summary of the Fund provided above, it is clear that the Fund serves multiple important purposes. Fund exclusively deals with a country's central bank or government. It has no authority to intervene in the economies of member states. The Fund's primary functions are listed below. Nevertheless, the following functionalities are being modified:

1. **Determination of the rate of exchange by every country:** When a country becomes memberofthe Fund,ithastodeclareparvalueofitscurrencyintermsofdollarorgold.Thisfacilitatesmultilateralc onvertibilityofthatcurrency.
2. **Loanofforeigncurrency:**If a country has a adverse balance of payments, the Fund will lend the country the foreign currency it needs at a predetermined exchange rate. It allows the nation to discharge its international obligations. These loans have a brief duration.
3. **Restriction on foreign currency:** The Fund purchases and sells the currencies of its members. Whenever a country purchases the currency of another country from the Fund, the Fund makes it available by purchasing the currency from the country whose currency it is. A member country may acquire foreign currency from the Fund up to a maximum of 15% of its quota in any one year.
4. **Bankofcentralbanks:**The Fund is referred to as the Bank of the Central Banks of Various Countries. Similar to how a central bank holds the cash reserves of a country's commercial banks, the IMF mobilizes the resources of the central banks of its member nations.

1. **Technical assistance:** The Fund also provides its members with technical help. The Fund deputises its specialists to member nations in order to advise them on subjects such as currency control, foreign payments, credit money, central banking, and economic policy, etc. Additionally, the Fund publishes numerous technical journals and periodicals. coursestotherepresentativesofmember-countries. This training is imparted to the senior officers of the central banks and FinanceDepartments.In1975,atrainingcentrewassetup.
2. **Facilities during emergency:** Despite the fact that the IMF opposes any form of limitations on foreign exchange or foreign trade, member nations have been given the authority to implement such controls in times of emergency in the hope that they will be lifted as soon as the situation permits.
3. **Itservesasashort-termcreditinstitution:**The Fund eliminates the temporary burden of a member's unfavorable BOP. It is an additional layer of defense. It indicates that the member country will maintain its own foreign exchange reserves and that payments will be made first from these reserves, with the remainder being provided by the Fund.
4. **The fund provides a mechanism for improving short-term BOP position:** Its rules provide for the orderly modification of exchange rates for this purpose. A country can adjust its exchange rate if it determines that it is inconsistent with its economy. However, this modification may be made after proper consultation with Fund officials.
5. **The fund provides machinery for international consultations:** The Fund has presented the key countries with a good opportunity to resolve their competing claims.
6. **Thefundpromotesexchangestability**bypromotingorderlyadjustmentsofexchange rates.

Thus,theFundperformsfinancial,supervisoryandcontrollingfunctions.

Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- International payments are connected with the concept of international liquidity. These payments are made as a result of international trade in products and services as well as international capital flows. International liquidity refers to the generally accepted formal means of resolving international payments imbalances.
- IMF established a system of Special Drawing Rights on January 1, 1970 in an effort to increase international liquidity (SDRs). SDRs are intended to supplement gold and reserve currencies such as the pound and the dollar. The SDRs represent a completely new type of paper money that will serve as effectively as gold or the U.S. dollar.
- The defining characteristic of the IFC is that all of its loans and investments are provided in partnership with private businesses. In addition to IFC contributions, local and international investors also contribute to the same initiatives.

Keywords

Budget: An amount of money set aside to cover the total cost of a communication campaign or other marketing activity.

Foreign Exchange: Facilities' business across national boundaries, usually expressed in foreign currency bought or sold on the foreign exchange market.

GAB: General Arrangements to Borrow

Joint Ventures: An enterprise in which two or more investors share ownership and control over property rights and operations.

NAB: New Arrangements to Borrow

SAF: Structural Adjustment Facility

Self Assessment

1. Which of the following is the best explanation of a nongovernmental organization?

A. A for-profit organization with a goal of advancing the public good
B. An organization formed through a government, or group of governments, to advance the public good
C. A non-profit advocacy group regarding advancing the public good
D. A non-profit private organization relatively independent from government whose purpose is to advance the public good

2. Which of the following is an NGO that focuses its efforts on advocacy for human rights?

A. The United Nations
B. Greenpeace
C. Amnesty International
D. Wikileaks

3. Greater efficiency in small states with control of greater resource and corporate are internationally

A. MNCs
B. NGOs
C. INGOs
D. OPEC

4. The most important actor in International Relations (IR)

A. National Government

B. Government
C. National
D. Semi Government

5. Who gives financial support to NGIOs to conduct research?
A. International Organizations
B. Regional NGO's
C. Local Organizations
D. None of the above

6. Which is an example of the failure of League of Nations in the 1930s?
A. China's invasion of Japan
B. The Abyssinian Crisis
C. China's invasion of Manchuria
D. The Italian Crisis

7. Which of the following is a true statement about American involvement in the League of Nations?
A. President Woodrow Wilson refused to allow the U.S. to join the League of Nations
B. The Supreme Court ruled that joining the League of Nations would violate the U.S. Constitution
C. Congress voted to keep the U.S. out of the League of Nations
D. In the election of 1920, American voters voted to keep the U.S. out of the League of Nations

8. Which United Nations Body releases 'Annual overview of future needs'?
A. OCHA
B. UNICEF
C. UNFPA
D. UNHCR

9. When is the 'United Nations (UN) Day' observed every year?
A. October 21
B. October 24
C. October 25
D. October 27

10. Where is the headquarters of the 'United Nations Conference on Trade and Development' located?
A. Geneva
B. Washington
C. Paris
D. Brussels

11. The headquarter of International Monetary Fund is located at ……….
A. Geneva
B. London
C. USA
D. Washington D.C.

12. The International Monetary Fund (IMF) was established by an international treaty in
A. 1942
B. 1943
C. 1944
D. 1945

13. In December 1945, the IMF came into existence with the following number of countries signed its Articles of Agreement.
A. 29
B. 30
C. 31
D. 32

14. The purpose of IMF is to
A. To promote international monetary cooperation
B. To facilitate the expansion and balanced growth of international trade
C. To promote exchange stability
D. All of the above

15. The IMF focuses mainly on a country's ___ policies.
A. Macroeconomic
B. Microeconomic
C. Both (A) And (B)
D. None of the above

16. Member's quota delineates basic aspects of its financial and organizational relationship with the IMF, including:
A. Voting power
B. Access to financing
C. SDR allocations
D. All of the above

17. As US dollar, which of the following currency has largest weightage in the determining the value of SDR?
A. British Pound
B. Yen
C. Euro
D. Chinese yuan

18. How much money a member can borrow from the IMF?
A. 20 percent
B. 35 percent
C. 27.6 percent
D. 25 percent

19. How does the IMF serve its member countries?
A. Monitoring national, global, and regional economic and financial developments and advising member countries on their economic policies ("surveillance").
B. Lending members hard currencies to support policy programs designed to correct balance of payments problems.
C. Offering technical assistance in its areas of expertise, as well as training for government and central bank officials.
D. All of the above

20. IMF looks at the performance of the economy as a
A. microeconomics
B. macroeconomics
C. Both of the above
D. None of these

Answers for SelfAssessment

1.	D	2.	C	3.	A	4.	A	5.	A
6.	B	7.	C	8.	A	9.	B	10.	A
11.	D	12.	D	13.	A	14.	B	15.	A
16.	D	17.	C	18.	D	19.	D	20.	A

Review Questions

1. What are the objectives of IMF?
2. Enumerate the various strategies of the IMF.
3. Write short note on IMF membership and its capital structure.
4. Write a short note on the background of IMF.
5. Name the functions of IMF.
6. Evaluate the relationship of India with IMF

Future Readings

1. International Business Environments and Operations, John D Daniels, University of Miami, Lee H Radebaugh, Brigham Young university and Daniel P Sullivan , University of Selaware, Pearson, 2007

2. International Business – Competing in the Global Marketplace, Charles W L Hill, University of Washington and Arun Kumar Jain , Heilbronn Business School (Germany), on leave from IIM Lucknow, The Tata McGraw Hill publishing Company Ltd.

Unit 08: Regional Monetary Funds

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Objectives

After studying this chapter, you will be able to:

- examine the effects of international capital flow
- analyze the theoretical foundations of foreign investment
- grasp the definition and characteristics of international trade in services
- understand the classifications and features of international trade in service

Introduction

Our review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin in showed that, in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products that they can make most efficiently, while importing products that they can produce less efficiently. In this unit, we look at the political reality of international trade. The political reality is that which many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups. In this unit, we explore the political and economic reasons that governments have for intervening in international trade. When governments intervene, they often do so by restricting imports of goods and services into their nation, while adopting policies that promote exports. Normally, their moves are to protect domestic producers and jobs from foreign competition while increasing the foreign market for products of domestic producers.

8.1 World Bank

The World Bank Group is an international financial agency that was created in 1944 to aid in the reconstruction and development of member nations. The group is essential to multinational enterprises because it provides most of the planning and finance for economic development projects requiring billions of dollars for which private companies can serve as contractors, suppliers, and engineering-related service providers.

Origin: The IBRD, also known as the World Bank, was conceived in July 1944 at the UN Monetary and Financial Conference in Bretton Woods (New Hampshire, United States) and began operations in June 1946. Its purpose was to provide funds, policy guidance, and technical assistance to its poorer member countries in order to facilitate economic development. The alliance consists of four further organizations.

Activities: The bank derives its funds through capital contributed by member nations, sales of its own securities, sales of portions of its loans, repayments, and net income. A Board of Governors resolution dated April 27, 1988 stipulates that 3 percent of the authorized shares to be subscribed for would be paid in. The bank lends approximately $22 billion per year. It had lent a total of US$ 106 billion to member nations as of 30 June 1997. 89 percent of borrowers utilized the new single-currency loans, which were available in June 1996 to give borrowers the choice to choose IBRD loan terms that are compatible with their debt-management strategy and fit to their debt service capability. The Bank has created consortia or consultation groups of aid-providing nations for a number of countries in order to minimize excessive duplication of development assistance and to guarantee that the available monies are used most effectively. This includes Bangladesh, Belarus, Bolivia, Bulgaria, Egypt, Ethiopia, Jordan, Kazakhstan, Kenya, Kyrgyzstan, Macedonia, Malawi, Mauritania, Moldova, Mozambique, Nicaragua, Pakistan, Peru, Romania, Sierra Leone, Tanzania, the "Palestinian" West Bank and Gaza Strip, Zambia, and Zimbabwe. In 1996, for purposes of its analytical and operational activity.

The IBRD classified economies as low-income (average annual per capita GNP of $785 or less), middle-income (between $786 and $9,635), and high-income (more than $9,635). IBRD's efforts are centered on a vast array of technical support. It serves as the implementing agency for a variety of UN Development Programme-funded pre-investment studies. In 64 developing member countries, resident missions have been created, and regional offices for East and West Africa, the Baltic States, and South-East Asia assist in the design and implementation of initiatives. Economic Development Institute is a staff college maintained by the Bank for top officials of member countries. As part of IBRD's initiative to combat corruption, workshops on anti-corruption measures and public integrity were organized in more than ten countries in 1997.

The Strategic Compact: In March 1997, the Executive Board unanimously endorsed the Strategic Compact, which outlined a plan for fundamental reform to increase the Bank's effectiveness in implementing its regional programme and achieving its primary objective of decreasing poverty. Reforms Centre on decentralizing the Bank's interactions with borrowing nations. The success of delegated country administration, as well as the bank's support of good governance and anti-corruption measures in developing nations, are likely to be central policies of the new approach.

Organization: As of July 1997, the Bank has 180 members, each having voting power based on shareholding, which is in turn based on economic development. The Bank's president is selected by the Board of Executive Directors. The Articles of Agreement do not mention the nationality of the president, but by custom, the US Executive Director nominates a candidate, and by a longstanding, informal agreement, the president is a citizen of the United States (while the managing director of the IMF is European). The initial term is for 5 years, with a second term of no more than 5 years.

The World Bank’s mandate.

The World Bank promotes long-term economic development and poverty reduction by providing technical and financial support to help countries reform certain sectors or implement specific projects—such as building schools and health centers, providing water and electricity, fighting disease, and protecting the environment. World Bank assistance is generally long term and is funded both by member country contributions and through bond issuance. World Bank staff are often specialists on particular issues, sectors, or techniques.

Framework for cooperation

The IMF and World Bank collaborate on a routine basis and at many levels to assist member countries, including joint participation in several initiatives. The terms for their cooperation were set out in the 1989 concordat and subsequent frameworks to ensure effective collaboration in areas of shared responsibility.

High-level coordination.

During the Annual Meetings of the Boards of Governors of the IMF and the World Bank, Governors consult and present their countries' views on current issues in international economics and finance. The Boards of Governors decide how to address international economic and financial issues and set priorities for the organizations. A group of IMF and World Bank Governors also meet as part of the Development Committee, whose meetings coincide with the Spring and Annual Meetings of the IMF and the World Bank. This committee was established in 1974 to advise the two institutions on critical development issues and on the financial resources required to promote economic development in low-income countries.

Management consultation.

The Managing Director of the IMF and the President of the World Bank meet regularly to consult on major issues. They also issue joint statements, occasionally write joint articles, and have visited several regions and countries together. The First Deputy Managing Director of the IMF and the World Bank Managing Director of Operations also hold regular meetings to discuss country and policy issues

Collaboration.

IMF and Bank staffs collaborate closely on country assistance and policy issues that are relevant for both institutions. The two institutions often conduct country missions in parallel and staff participate in each other's missions. IMF assessments of a country's general economic situation and policies informs the Bank's assessments of potential development projects or reforms. Similarly, Bank advice on structural and sectoral reforms informs IMF policy advice. The staffs of the two institutions also cooperate in specifying the policy components in their respective lending programs. The 2007 external review of Bank-Fund collaboration led to a Joint Management Action Plan on World Bank-IMF Collaboration (JMAP) to further enhance the way the two institutions work together. Under the plan, Fund and Bank country teams discuss their country-level work programs, which identify macroeconomic and sectoral issues, the division of labor, and the work needed in the coming year. A review of Bank-Fund Collaboration underscored the importance of these joint country team consultations in enhancing collaboration. To strengthen IMF-WB collaboration at the Board level, joint meetings of Executive Directors of the two institutions are held once or twice a year to exchange views and capitalize on the strong complementarities in the two institutions' work.

Reducing debt burdens.

The IMF and World Bank have worked together to reduce the external debt burdens of the most heavily indebted poor countries under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). To date, debt reduction packages under the HIPC Initiative have been approved for 36 countries out of 39 eligible countries providing $76 billion in debt-service relief over time. The IMF and World Bank continue to collaborate in assisting low-income countries achieve their development goals without creating future debt problems. IMF and Bank staff jointly prepare country debt sustainability analyses under the Debt Sustainability Framework (DSF)developed by the two institutions. In April 2020, the G20 endorsed the Debt Service Suspension Initiative (DSSI) in response to a call by the IMF and the World Bank and the IMF to grant debt service suspension to the poorest countries to help them manage the severe impact of the COVID-19 pandemic. Since then, the initiative has delivered about $5 billion in relief to more than 40 eligible countries. The suspension period, originally set to end on December 31, 2020, has been extended through June 2021. The IMF and the World Bank are supporting implementation of the DSSI by monitoring spending, enhancing public debt transparency, and ensuring prudent borrowing. Climate Change. To help countries adapt and build resilience to climate change, the IMF and the World Bank introduced on a pilot basis in 2017 joint IMF-World Bank Climate Change Policy Assessments (CCPA) that provided overarching assessments of preparedness, macroeconomic impact, mitigation, adaptation, and financing strategies for small, vulnerable, and capacity-constrained countries. Setting the stage for the 2030 development agenda. In 2015, with the replacement of the Millennium Development Goals (MDGs) with the Sustainable Development Goals (SDGs) under the 2030 Global Development Agenda, the IMF and the Bank engaged in the global effort to support the Development Agenda. Each institution has committed to new initiatives, within their respective remits, to support member countries in reaching their SDGs. They are also working together to better assist the joint membership, including through enhanced

support of stronger tax systems in developing countries and support of the G-20 Compact with Africa to promote private investment in Africa. Assessing financial stability. The IMF and the World Bank are also working together to make financial sectors in member countries resilient and well regulated. The Financial SectorAssessment Program (FSAP) was introduced in 1999 to identify the strengths and vulnerabilities of a country's financial system and recommend appropriate policy responses.

Purpose for the setting up of the World Bank:

The purpose for the setting up of the Bank are:

- To aid in the reconstruction and development of member territories by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs, and the promotion of the development of productive facilities and resources in less developed nations.
- To promote private foreign investment through guarantees or participation in loans and other investments made by private investors; and when private capital is unavailable on reasonable terms, to supplement private investment by providing, on suitable terms, finance for productive purposes from its own capital, funds it has raised, and other resources.
- To promote private foreign investment through guarantees or participation in loans and other investments made by private investors; and to supplement private investment when private capital is unavailable on reasonable terms by providing, on suitable terms, finance for productive purposes from its own capital, funds it has raised, and other resources.
- To organize the loans made or guaranteed by it in connection to international loans through other channels so that the most beneficial and urgent projects, whether large or little, can be addressed first.
- To execute its operations with proper attention for the impact of foreign investment on business conditions in the territories of its members and, in the immediate postwar years, to aid in the transition from a wartime economy to a peacetime economy.
- The World Bank consists of the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) (IDA). IBRD is affiliated with the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) (MIGA). Sometimes, the Bank, the IFC, and the MIGA are referred to collectively as the "World Bank Group."

What does the World Bank do?

The World Bank is the world's largest source of development aid, lending its client countries over $30 billion annually. The Bank employs its financial resources, highly skilled personnel, and wide knowledge base to help each developing nation achieve stable, sustainable, and equitable economic growth. For all its clients, the Bank emphasizes the importance of: investing in people, particularly through basic health and education; protecting the environment; supporting and encouraging private business development; enhancing the capacity of governments to deliver quality services efficiently and transparently; and promoting reforms to create a stable macroeconomic environment that is conducive to investment. Additionally, the Bank is assisting nations in enhancing and sustaining the underlying conditions that help attract and maintain private investment. Governments are modernizing their economies and bolstering their banking institutions with support from the Bank in the form of both loans and guidance. They are investing in human capital, infrastructure, and environmental protection in order to increase the attractiveness and productivity of private investment. Through World Bank guarantees, MICA's political risk insurance, and partnerships with IFC's equity investments, investors are minimizing their risks and gaining the confidence to participate in developing and transitioning economies.

Where does the World Bank get its money?

The World Bank raises funds for its development programmes through the world's capital markets and, in the case of the International Development Association (IDA), from donations from wealthier member governments. IBRD, which accounts for almost three-quarters of the Bank's annual lending, obtains nearly all of its funds from financial markets. IBRD provides AAA-rated bonds and other debt securities to pension funds, insurance companies, enterprises, banks, and individuals worldwide. The IBRD charges its debtors interest rates that reflect the cost of borrowing. Loans must be repaid within 15 to 20 years, with a three- to five-year grace period before principal repayment commences. Similar to the IBRD, the IDA promotes growth and reduces poverty through interest-free loans (known as IDA "credits"), technical assistance, and policy advice. About one-fourth of all bank loans are comprised of IDA loans. Administrative costs are covered by a fee of less than 1 percent of the loan amount paid by the borrower. Repayment is due in 35 to 40 years, with a grace period of 10 years. Every three years, nearly 40 countries contribute to IDA's financing, which is restored. IDA funds are administered with the same prudence, conservatism, and caution as IBRD funds. As with the IBRD, an IDA credit has never defaulted. 15.3.7 Who is in charge of the World Bank? More than 180 member countries control the World Bank, and their views and interests are represented by a board of governors and a board of directors based in Washington. Member countries are World Bank stockholders with ultimate decision-making authority. To carry out these obligations, each member nation picks a governor and an alternate governor. In the fall, the Bank's governors, who are often ministers of finance or planning, convene for its annual meetings. They assess major Bank policy problems, admit or suspend nation membership, approve changes to the authorized capital stock, establish the IBRD's net income distribution, and approve financial accounts and budgets.

8.2 Role of International Institution

International organizations play an important role in the international arena, with power in mediation, dispute resolution, peacekeeping, applying sanctions, global governance etc. They also help in tackling key areas of international concern or global issues such as global health policy, monetary policies around the world, climate change, resource depletion and management of "global commons". International organizations today play an important role in almost all the political and economic challenges of the 21st century. The most important attribute of international organizations is their neutrality, impartiality and independence.

International Bank for Reconstruction and Development

Together with the IMF, the IBRD was established in 1945 to help reconstruct the global economy. It is owned by the governments of 151 nations, who also subscribe to its capital; it distributes funds to borrowers by borrowing on the world's capital markets, using loan repayment proceeds and retained revenues. At its inception, the bank's primary purpose was to act as an international rehabilitation and development lending facility. With the Marshall Plan providing the impetus for the reconstruction of Europe, the Bank was able to shift its focus to developing nations. Typically, the IBRD lends money to a government in order to construct that nation's economic infrastructure, such as highways and power plants. Funds are allocated to developing nations with more advanced economic and social development.

In addition, funds are only lent to IMF members when private financing is unavailable on fair conditions. Loans often include a five-year grace period and are repayable within fifteen or fewer years. Typically, IBRD-supported projects necessitate the importation of heavy industrial equipment, which creates an export market for numerous U.S. items. In general, bank loans are restricted to import needs denominated in foreign currency convertibles and must be repaid in those currencies at long-term interest rates.

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The importance of improving human capital and improving the welfare of families is perceived as a key aspect of development. The WID initiative was established in 1988 and it is oriented to increasing women's productivity and income. Bank lending for women's issues is most pronounced in education, population, health and nutrition and agriculture.

International Development Associations (IDA)

A financing institution created in 1960 and supervised by the IBRD to give concessional assistance to the poorest developing nations. Its resources include subscriptions, ordinary replenishments, special contributions, and transfers from IBRD's net earnings. Officers and personnel of the IBRD also serve as officers and staff of the IDA at the headquarters of the World Bank. Examining the performance of the IMF and the World Bank in poor nations reveals that, far from being the solution to global economic instability and poverty, these two international institutions constitute a significant problem. In the first place, their lending practises inhibit progress since the money they loan eliminates incentives for governments to advance economic freedom and fosters corruption. After more than four decades of reliance on these institutions, the vast majority of recipient countries have been unable to develop to their full potential. The International Development Association (IDA) is the World Bank Group department that lends money to the world's poorest nations. Despite receiving $28.8 billion since 1961, India remains poor. According to the Index, that money accomplished nothing to open India's economy, which remains "largely unfree." In 1989, the IDA provided a $8.3 million loan to Tanzania to implement the initial phase of a longer-term plan to rehabilitate the country's agricultural research infrastructure. FM-Financing is anticipated from multiple nations and international multilateral lending agencies. Although the IDA has independent resources from the IBRD, it does not have separate personnel. Loans are provided for projects similar to those carried out by IBRD, but with more lenient and advantageous credit terms. As indicated previously, World Bank/IDA aid has typically focused on infrastructure development. Helping the masses of poor people in emerging countries become more productive and participate actively in the development process appears to be the current priority. Greater emphasis is placed on enhancing urban living conditions and boosting the productivity of small businesses. Co-financing is anticipated from other nations and multilateral lending agencies. Although the IDA has independent resources from the IBRD, it does not have separate personnel. Loans are provided for projects similar to those carried out by IBRD, but with more lenient and advantageous credit terms. As indicated previously, World Bank/IDA aid has typically focused on infrastructure development. Helping the masses of poor people in emerging countries become more productive and participate actively in the development process appears to be the current priority. Greater emphasis is placed on enhancing urban living conditions and boosting the productivity of small businesses.

Multilateral Investment Guarantee Agency (MIGA)

MIGA is the World Bank's insurance arm, established in 1998 to promote the flow of foreign direct investment to and among developing member nations. It provides investors with investment guarantees against non-commercial risks, such as expropriation and conflict, and advises governments on how to improve the investment climate abroad. It may insure up to 90 percent of an investment, with a current maximum per project of $50 million. In March 1999, the Council of Governors approved a resolution for an estimated $850 million capital expansion for the Agency. In addition, the World Bank transferred $150 million to MIGA as operating capital. In 1999, it had 151 members and 15 nations that were in the process of meeting membership requirements.

8.3 International Finance Corporation Origin

It was founded in July 1956 to bolster the private sector in developing nations by providing long-term loans, equity investments, guarantees, standby financing, risk management, and quasi-equity instruments such as subordinated loans, preferred shares, and income notes. It contributes to the financing of new subordinated loans, preferred stock, and income notes. It helps finance new projects, aids established businesses in expanding, improving, or diversifying, and offers a variety of advisory services to clients in the public and private sectors. Approximately 80% of its finances are borrowed from international financial markets via public bond issues or private placements, while 20% are borrowed by the IBRD.

Activities: IFC promotes sustainable economic development in developing nations by financing private sector investment, mobilizing resources on international financial markets, and offering advice services to businesses and governments. Finance and Foreign Exchange IFC assists enterprises and financial institutions in emerging countries in creating jobs, generating tax revenue, enhancing corporate governance and environmental performance, and contributing to their local

communities. The objective is to improve life, particularly for those who require the advantages of growth the most.

Strategic compact: IFC emphasizes five strategic priorities for maximizing its sustainable development impact:

- Strengthening its focus on frontier markets, particularly the SME sector;
- Building long-term partnerships with emerging global players in developing countries;
- Addressing climate change, and environment and social sustainability activities;
- Addressing constraints to private sector investment in infrastructure, health, and education; and
- Developing domestic financial markets through institution building and the use of innovative financial products.

For all new investments, IFC articulates the expected impact on sustainable development, and, as the projects mature, IFC assesses the quality of the development benefits realized.

Organisation: IFC promotes sustainable economic development in developing nations by financing private sector investment, mobilizing resources on international financial markets, and offering advice services to businesses and governments. Finance and Foreign Exchange IFC assists enterprises and financial institutions in emerging countries in creating jobs, generating tax revenue, enhancing corporate governance and environmental performance, and contributing to their local communities. The objective is to improve life, particularly for those who require the advantages of growth the most.

8.4 Organization for Economic Cooperation and Development (OECD)

Origin: Founded in 1961 to replace the Organization for European Economic Cooperation (OEEC), which was linked to the Marshall Plan and was established in 1948.

Members: Australia, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, the Republic of Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, the United Kingdom, and the United States. Activities: In 1999, the OECD's primary programming areas were as follows: economic policy; statistics; energy; development cooperation; sustainable development; public management; international trade; financial fiscal and enterprise affairs; food, agriculture and fisheries; territorial development; environment; science; technology and industry; biotechnology and biodiversity; electronic commerce; initiative to combat corruption; regulatory reform; ageing society; education; employment, labour adolescence; and employment, labour adolescence. Relationships with non-member nations: The Centre for Co-operation with Non-Members (CCNM) facilitates policy communication between the OECD and non-member countries. This discussion is managed by CNNM through multi-national thematic, regional, and country programmes. The Emerging Market Economy Forum (EMEF), the Transition Economy Programme (TEP), and the Emerging Asia Programme target distinct groups of nations with similar issues. Key nation projects for China, Russia, Slovakia, and Brazil are tailored to each country's specific need. The Baltic States have a well-established regional programme, and there are further programmes in development for South-East Europe and Latin America. Relations with developing countries: The OECD's Development Assistance Committee (DAC) is the primary body through which the Organization addresses issues related to cooperation with developing countries and is one of the key forums in which the major bilateral donors collaborate to increase the effectiveness of their joint effort to support sustainable development. The DAC's objective is to promote coordinated, integrated, effective, and sufficiently funded international activities in support of sustainable economic and social development, guided by the "development partnership strategy" (OECD, 1996). In addition, the Development Centre conducts research on social and economic concerns in developing nations, while the club du Sahel serves as a forum for West African nations and OECD aid agencies. Relations with other international groups: Under a treaty adopted concurrently with the OECD Convention, the European Commission normally participates in the ORCD's activities. EFTA delegates may also attend OECD meetings. Several additional international organisations, including the ILO, FAO, IMF, IBRD, UNCTAD, IAEA, and the Council of Europe, have formal ties with the European Union. A few non-governmental organisations, including the Business and Industry Advisory Committee to the OECD (BIAC) and the Trade Union Advisory Committee, have been granted consultative status, allowing them to discuss issues of common interest and be consulted in a particular field by the relevant ORCD Committee or its officers (TUAC).

Organizations: The governing body of OECD is the Council, on which each member country is represented. It meets from time to time (usually once a year) at the level of government ministers, with the chairmanship at ministerial level being rotated among member governments. The council also meets regularly at official level, when it comprises the Secretary-General (chairman) and the Permanent Representatives to OECD (ambassadors who head resident diplomatic missions). It is responsible for all questions of general policy and may establish subsidiary bodies as required to achieve the aims of the organization. Decisions and recommendations of the Council are adopted by agreement of all its members.

8.5 International Cooperation

ICT has shown that cooperation is possible and can emerge spontaneously, both the theory and the record of international politics demonstrate that cooperation is difficult to initiate and fragile once created. By identifying the prerequisites for cooperation, however, ICT thereby also identifies what is missing from or obstructing cooperation where it does not arise. Rational actors can then use institutions, or design new ones, to overcome these obstacles and promote international cooperation.

The definition of international cooperation is general in terms of both actors and issues. Cooperation occurs not only among individuals but also among collective entities, including firms, political parties, ethnic organizations, terrorist groups, and nation-states. Although ICT often defines international cooperation in terms of states, it can also involve other actors, especially intergovernmental organizations (IGOs) and nongovernmental organizations (NGOs). These diverse actors cooperate for different objectives across a wide range of issue areas: IGOs work with states to combat global environmental problems, firms collude to monopolize markets, NGOs campaign to save the whales, and so on. Finally, international cooperation is not always a good thing, at least from the perspective of those excluded or targeted. For example, international sanctions involve cooperation against target countries, and commodity cartels often harm consumer states.

Summary

The Fund's goal is "to promote international monetary cooperation, exchange stability to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment."

World Bank began operations in June 1946, with its purpose being to provide funds, policy guidance and technical assistance to facilitate economic development in its poorer member countries. The Group comprises other organizations like IDA, MIGA and IFC.

IFC was established to help strengthen the private sector in developing counties, through the provision of long-term loans, equity investments, guarantees, standby financing, risk management and quasi equity instruments such as subordinated loans, preferred stock and income notes

In OECD, the aims of the organization are to promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy

Keywords

Foreign exchange: The system by which one currency is exchanged for another.

International Finance Corporation: United Nations agency that invests directly in companies and guarantees loans to private investors

International Monetary Fund: A United Nations agency to promote trade by increasing the exchange stability of the major currencies

Options: They are contracts that give the buyer the right but not the obligation to buy or sell a specified amount of foreign exchange at a set price for an agreed upon period

Organization for Economic Cooperation and Development: An organization that acts as a meeting ground for 30 countries which believe strongly in the free market system

World Bank: An organization whose focus is on foreign exchange reserves and the balance of trade

Self Assessment

1. What is the main role of the World Bank?
A. To be a forum for trade and liberalization.
B. To assist countries in development.
C. To facilitate private investment around the world.
D. All of the options given are correct.

2. Which of the following statement is correct?
A. World bank has established 73 years ago
B. Headquarter of World Bank is in Washington D.C.
C. Adam smith is the founding father of the World Bank
D. Only a. and b.

3. Which of the following is not the function of World bank?
A. To provide the long-term loans to the members countries
B. To provide the loans to the private investor belonging to the member countries
C. To ensure the exchange rate stability
D. To provide the loan for the productive activities

4. What is the main mission of the World Bank?
A. Reduce poverty in the globe
B. Improve the living standard
C. Reduce hunger and morbidity
D. Only a and b

5. Which of the following is/ are Functions of World Bank?
A. Granting developmental loans to underdeveloped countries.
B. Providing loans to governments for agriculture, irrigation, power, transport, water supply, education, health, etc.
C. Providing loans to private concerns for specified projects
D. All of the above

6. Organization for Economic Cooperation and Development (OECD) was established with the main objective of seeking sustains ____________?
A. economic growth among its member countries
B. cooperation in Defense of its member countries
C. economic and army cooperation
D. None of them

7. OECD was established in ____________?
A. 1963
B. 1961
C. 1962
D. 1960

8. The Organization for European Economic Cooperation (OEEC) was founded in 1948 to help administer the Marshall Plan for the reconstruction of Europe after World War II. It was renamed as _________?
A. European Union (EU)
B. Organization for Economic Cooperation and Development (OECD)
C. Council of the European Union (CEU)
D. General Agreement on Tariffs and Trade (GATT)

9. Where is the Secretariat of the Organization for Economic Co-operation and Development (OECD)?
A. Tokyo, Japan
B. London, UK
C. Paris, France
D. New York, USA.

10. Which of the following countries have been blacklisted by the Organization for Economic Co-operation and Development (OECD) on refusing to adopt new rules for openness and serving as Tax Havens?
A. Costa Rica, Switzerland, Austria and Andorra
B. Costa Rica, Malaysia, Philippines and Uruguay
C. France, Japan, Laos and Libya
D. the Philippines, Latvia, Lesotho and Ireland

11. IBRD provides
A. Loans
B. Grants
C. Analytic and Advisory Services
D. All of the above

12. The Headquarter of World Bank is in
A. Geneva
B. Paris
C. New York
D. Washington DC

13. Following is the soft loan section of the World Bank
A. International Development Association (IDA)
B. International Finance Corporation (IFC)
C. Multilateral Investment Guarantee Agency (MIGA)
D. all of the above

14. Headquarter of Asian Development Bank (ADB) is in
A. Bangkok
B. Singapore
C. Beijing
D. Manila

15. Asian Development Bank (ADB) has the following objective(s)
A. Environmental Protection
B. Economic Growth
C. Human Development
D. All of the above

Answer for Self Assessment

1.	B	2.	D	3.	C	4.	D	5.	D
6.	D	7.	B	8.	B	9.	C	10.	B
11.	D	12.	D	13.	A	14.	D	15.	D

Review Questions

1. Discuss the reason for establishment of World Bank. How does it operate?
2. Discuss the major areas of work of the organizations under the World Bank.
3. State the main aim of establishing the International Finance Corporation. What are its priorities?
4. Differentiate between fundamental and technical forecasting.
5. Why there was a need to replace Organization for European Economic Cooperation?
6. Explain OECD relation with other major international organizations.

Further Readings

- International Business Environments and Operations, John D Daniels, University of Miami, Lee H Radebaugh, Brigham Young university and Daniel P Sullivan , University of Selaware, Pearson, 2007

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Unit 09 : The Charter of United Nations

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Objectives

After reading this Unit students will be able to:

- Understand the concept of the United Nations General Assembly.
- Understand the role and functioning of United Nations Security Council
- Understand the functioning of the United Nations Human Rights Convention
- Discuss different articles of the Universal Declaration of Human Rights (UDHR)

Introduction

The world up until now has witnessed two World Wars, one Cold War and several other disputes among nations. The differences which lead to such destructive ends have been varied, from the fight over limited resources to the dispute over beliefs and ideologies and a lot of times a pure thirst for power and expansion. Whatever be the reason, our world can never afford to bear wars be it a small or a large level. The destruction of lives, properties and resources can never be fully recompensed with. And this is why it is important that the nations of the world with the different interests learn to peacefully coexist. The organizations set up on the worldwide level have some agreed upon objectives to ensure that the situation doesn't escalate to the level of war. In this unit, we will learn about the League Covenant, the United Nations; the purposes and principles of the UNO, UN Charter, Principal Organs of the UNO and the different international organizations such as the SAARC, OPEC, WTO and IMF.

9.1 The League Covenant and The United Nations Charter

In this section, we will have a look at the two prominent worldwide organizations: The League Covenant and The United Nations Charter.

The League Covenant

League of Nations was the first stable worldwide security organization whose major aim was to uphold world peace. It was an intergovernmental association. It was established as a result of the

Paris Peace Conference. The League of Nations had its maximum extent from 28 September 1934 to 23 February 1935. It comprised fifty-eight members.

Origin

The 20th century provided the world two main power blocs through alliances between powerful European countries. These coalitions came into power in 1914, i.e. at the beginning of the World War I, drawing all the main European countries into the war. When the war ended in November 1918, it had had a profound impact, endangering the social, political and economic fabrics of Europe and inflicting psychological and physical harm on the continent. Anti-war feeling rose across the world sovereign states to enter into war for their own advantage.

The Paris Peace Conference was summoned to build a permanent peace after World War I. The Covenant of the League of Nations was prepared by a particular commission, and the League was set up by Part I of the Treaty of Versailles. On 28 June 1919, fourty-four countries signed the Covenant, including thirty-one countries that participated in the war on the side of the Triple Entente or joined when the war was going on.

Goals

Its primary goals, as mentioned in its Covenant, included the Preventing war by combined security and disarmament, Settling global disputes by negotiation and arbitration. Other goals in this and pertaining treaties were as; labour conditions, just treatment of native inhabitants, Trafficking in persons and drugs, Arms trade, Global health, Prisoners of war, Safeguard of minorities in Europe. The diplomatic philosophy behind the League reflected a basic shift in thought from the preceding hundred years.

Principal organs

The following were the constitutional organs of the league:

- The assembly
- The council
- The permanent secretariat (headed by the general secretary and based in Geneva)

It had two important wings in the permanent court of International Justice and the International Labour Organization.

The covenant implied the setup of auxiliary bodies for a variety of questions of a relatively technical character. Thus, the League had many agencies and commissions.

Concord was needed for the decisions of both — the assembly and the council, apart from the matters of procedure and some other precise cases, for example, the admission of new members. This general regulation concerning agreement was the gratitude of national sovereignty.

Secretariat

The Permanent Secretariat, set up at the seat of the League at Geneva consisted of a body of experts in several spheres under the direction of the General Secretary. The major sections of the secretariat were: Political, Financial, Economics, Transit, Minorities, Administration, Mandates, Disarmament, Health, Social

Staff

The Staff of the League's secretariat was accountable for readying the agenda for the council and assembly and printing reports of the meetings and other scheduled matters, efficiently acting as the civil service for the League.

Assembly

The assembly comprised representatives of all associates of the League. Each state was permitted up to three representatives and one vote. The exceptional functions of the Assembly involved:

- The admission of new Members
- The periodical election on non-permanent Members of the council
- The election with the council of the judges of the permanent court
- The control of the budget.

In a way, the Assembly had become the general directing force of League's activities.

Permanent Court of International Justice

The Covenant provided the Permanent Court of International Justice, but it was not established by it. The Council and Assembly framed its constitution. Its judges were appointed by the Council and Assembly, and its budget was approved by the Assembly. The Court included eleven judges and four deputy-judges, who were elected for nine years.

International Labour Organization

The International Labour Organization (ILO) was set up in 1919 on the basis of part XIII of the Treaty of Versailles and thus became the part of the League's operations.

Health Organization

The League's health organization included the following three bodies:

1 A Health Bureau, containing permanent officials of the League, an executive section

2 The General Advisory Council or Conference consisting of medical experts

3 A Health Committee

Committee on Intellectual Cooperation

The League of Nations had focused on the question of international intellectual cooperation right from the time of its creation. The work of the Committee involved enquiry into the states of intellectual life, help to countries whose intellectual life was scarce, formation of national committees for intellectual cooperation, collaboration with global intellectual organizations and security of intellectual property.

Slavery commission

The Slavery Commission was made to eliminate slavery and slave trading across the globe and fought forced prostitution

Committee for the study of the legal status of women

The committee for the study of the legal status of women was made to conduct an inquiry into the status of women across the world.

Members

Among the League's fourty-two founding members, twenty-three (or twenty-four, counting Free France) did not leave the League until it was dissolved in 1946. In the beginning year, six other countries joined, only two of which remained as its members till it got dissolved. An additional fifteen countries joined in later years.

Resolving Territorial Disputes

The consequences of World War I left a lot of issues to be settled between nations, including the precise position of national boundaries and which country in the particular regions would like to join. Most of these questions were taken care by the triumphant allied powers in bodies for example the allied supreme council.

9.2 The United Nations Organization

The United Nations was founded in 1945 after World War II to substitute the League of Nations, to end wars between nations and to offer a platform for dialogue. It contains manifold subsidiary organizations to complete its missions. The name 'United Nations' was planned by US President Franklin D. Roosevelt and was first applied in the 'Declaration by United Nations' of 1 January 1942, during the World War II, when envoys of twenty-six nations vowed their governments to carry on fighting together against the Axis Powers.

The Idea

The idea for the future United Nations as a global organization came up in declarations signed at the time of the World War II at the wartime Allied conferences: the Moscow Conference and the Tehran Conference in 1943. From August to October 1944, envoys of France, the Republic of China, the United Kingdom, the United States, and the USSR met to discuss plans at the Dumbarton Oaks Conference in Washington, D.C. Those and later talks led to the proposals outlining the functions of the United Nations Organization, its membership and organs, as well as arrangements to keep international peace and security and global economic and social cooperation. Governments and private citizens, all-inclusive, discussed and debated these suggestions.

The Origin

The United Nations Charter was drafted by the envoys of fifty countries at the United Nations Conference on International Organization, which met at San Francisco from 25 April to 26 June 1945. The members deliberated the aims worked out by the envoys of — China, the Soviet Union, the United Kingdom and the United States at Dumbarton Oaks in August-October 1944. The Charter was signed on 26 June 1945 by the envoys of the fifty nations. Poland, which was not present at the Conference, signed it later and became one of the original fifty-one Member States. The United Nations formally came into subsistence on 24 October 1945, when the Charter had been ratified by China, France, the Soviet Union, the United Kingdom and the United States and by a majority of other signatories. On 24 October each year, the United Nations Day is celebrated.

Establishment

On April 25, 1945, the United Nations conference on global organization started in San Francisco. In addition to governments, many non-governmental organizations, including Rotary International and Lions Clubs International were invited to help in the drafting of a charter. After a hard work of two months, the fifty countries represented at the conference signed the Charter of the United Nations on June 26. Poland, which was incapable of sending a representative to the conference because of political instability, signed the charter on 15 October 1945. The charter noted thatbefore it would be implemented, it must be ratified by the governments of the Republic of China, France, the USSR, the United Kingdom and the United States, and by a majority of the other fourty-six signatories. That happened on 24 October 1945 and the United Nations was officially established.

The League of Nations officially dissolved itself on 18 April 1946 and handed over its mission to the United Nations.

The High Hopes

The UN leaders had high hopes that it would take action to stop conflicts between nations and make future wars impossible. Those hopes have clearly not completely come to pass. From about 1947 until 1991, the splitting up of the world into hostile camps during the Cold War made accord on peacekeeping matters very hard. After the end of the Cold War, renewed calls arose for the UN to turn out to be the agency for attaining world peace and collaboration, as several dozen active military disagreements continued to rage across the globe. The disintegration of the Soviet Union has also left the United States in a sole position of international dominance, creating a number of new problems for the UN.

The Aim

The United Nations is a global organization whose declared aims are as follows:

- Facilitating cooperation in international law
- International security
- Economic development

- Social progress
- Human rights
- Achievement of world peace

It has its offices all across the world. The UN and its specialized agencies decide on substantive and secretarial issues in regular meetings held throughout the year.

Six principal organs

The organization has the following six principal organs:

- The General Assembly (the main deliberative assembly)
- The Security Council (for deciding certain resolutions for peace and security)
- The Economic and Social Council (for assisting in promoting international economic and social cooperation and development)
- The Secretariat (for providing studies, information and facilities needed by the UN)
- The International Court of Justice (the primary judicial organ)
- The United Nations Trusteeship Council (which is currently inactive)

Other famous UN System agencies include the World Health Organization (WHO), the World Food Programme (WFP) and United Nations Children's Fund (UNICEF).

Legal basis of establishment

Just after its setting up, the UN sought identification as an international legal person. Therefore, the court has come to the conclusion that the organization is a global person. That is not the similar as saying that it is a State, which it surely is not, or that its legal personality and rights and duties are the same as those of a State ... What it does mean is that it is a subject of international law and competent of possessing international rights and duties, and that it has ability to maintain its rights by bringing global claims.

The General Assembly

The General Assembly is the major deliberative assembly of the United Nations. It comprises of all the United Nations' member states. The assembly meets in regular annual sessions under a president elected from among the member nations. Over a two-week period at the beginning of each session, all members have the chance to address the assembly. Usually, the Secretary-General makes the initial statement, followed by the president of the assembly. The first session was convened on 10 January 1946 in the Westminster Central Hall in London and incorporated representatives of fifty-one nations. When the General Assembly votes on significant questions, a two-thirds majority of those present and voting is needed.

UN Headquarters in New York City

In December 1945, the US Senate and the US House of Representatives, by agreed votes, requested that the UN establish its headquarters in the United States. The UN accepted this proposal and, after considering sites in the Black Hills, The UN headquarters formally opened on 9 January 1951. Although the main headquarters of the UN remain in New York City, chief agencies base themselves in Geneva, The Hague, Vienna (Figure 4.3), Nairobi and elsewhere.

9.3 Purposes And Principles of The Uno, Un Charter, Principal Organs of The Uno

The United Nations Organization (UNO), as we have learnt is better known as the United Nations (UN), is an international organization. It was founded on 24 October 1945 after the Second World War, replacing the League of Nations, to prevent any further wars between countries and provide a platform for dialogue. It contains multiple subsidiary organizations to carry out its missions.

There are currently 192 member states, including nearly every sovereign state in the world. From its offices around the world, the UN and its specialized agencies decide on substantive and administrative issues in regular meetings held throughout the year

Objectives of United Nations

The objectives of United Nations are enshrined in the Preamble of the UN Charter. It has been given in the following four objectives, which are mentioned as follows:

i. To save the succeeding generations from the scourge of war
ii. To reaffirm faith in fundamental human rights, in the work and dignity of human person and equal rights of men, women and nations large and small
iii. To establish conditions under which justice and respect for the obligations arising from treaties and other sources of international law can be maintained
iv. To promote social progress and better standard of life in large freedom.
v. Objectives, purpose and principles of united nations
vi. The constitution of the United Nations is the Charter of the UN. It has nineteen chapters which is divided into 111 articles that explain the purposes, principles and operating methods of the organization.

(i) Objectives

The objectives of the UN are enshrined in the preamble to the Charter of UN. It has the four objectives as mentioned below:

(a) To save the succeeding generations from the scourge of war
(b) To reaffirm faith in fundamental human rights, in the work and dignity of the human person and equal rights of men, women and nations large and small.
(c) To establish conditions under which justice and respect for the obligations arising from treaties and other sources of international law can be maintained, and
(d) To promote social progress and better standard of life in larger freedom.

(ii) Purpose

The purpose of the UN has been set forth in Article 1 of the Charter. These are mentioned as follows:

(a) Maintenance of international peace and security
(b) Development of friendly relations among nations
(c) International cooperation in solving problems of economic, social, cultural and humanitarian nature; promotion and encouragement of respect for human rights and fundamental freedoms; and
(d) To be a center of harmonizing the actions of nations to achieve the above ends.

(iii) Principles

To fulfill the purposes of the UN, the following principles are envisaged in Article 2 of the Charter. It has been mentioned as follows:

(a) The organization is based on the principle of the sovereign equality of all its members.
(b) All members shall fulfill in good faith the obligations they have assumed under the Charter.
(c) The members shall settle their international disputes by peaceful means.
(d) The members shall refrain in their international relations from the threat or use of force in any manner inconsistent with the purpose of the UN.

Principal organ of United Nations

The United Nations has six official languages: Arabic, Chinese, English, French, Russian, and Spanish. As we have discussed in the previous section, the six principle organs of the UN are:

(a) The General Assembly

(b) The Security Council

(c) The Economic and Social Council

(d) The Secretariat

(e) The International Court of Justice and

(f) The United Nations Trusteeship Council

General Assembly

The General Assembly is the only major organ in which all members are presented. It is the apex body of the United Nations. It has been described as 'the town meeting of the world' since all members are ipso facto members of the General Assembly. It is the main deliberative assembly of the United Nations and also one of the most important of the six principal organs. As it is the forum in which all member states are represented and in which each member has an equal vote irrespective of its size or population. The importance of the General Assembly has grown through the expansion of UN membership.

Composition of General Assembly

According to the Article 4 of Chapter 2 of the United Nations Charter, the membership of United Nations is open to all peace-loving states which accept the obligations as well as the judgment of the Organization that is contained in the present Charter and are able and willing to carry out these obligations. The admission of any such state to membership in the United Nations will be effected by a decision of the General Assembly upon the recommendation of the Security Council.

Beginning with fifty-one nations at the end of the Second World War, the membership of the General Assembly has grown to 192 members at present. All the members of the General Assembly are the member states of United Nations.

The General Assembly meets in regular yearly sessions under a president, who is elected from among the member states. The first session was convened on 10 January 1946 in the Westminster Central Hall in London and included representatives of fifty-one nations. Traditionally, the Secretary-General makes the first statement, followed by the president of the assembly. Over a two-week period at the start of each session, all members have the opportunity to address the assembly.

Each member country has one vote. Apart from approval of budgetary matters, resolutions are not binding on the members. The Assembly may make recommendations on any matters within the scope of the UN, except matters of peace and security that are under Security Council consideration. When the General Assembly votes on important questions, a two-thirds majority of those present and voting is required. All other questions are decided by majority vote. The examples of important questions include:

- Recommendations on peace and security;
- Election of members to organs;
- Admission of new members,
- Suspension, and expulsion of members; and,
- Budgetary matters

Committee of General Assembly

The General Assembly is quite a large body and therefore for an effective deliberation, it works through various Committees. The matters are allocated to the various committees on the advice of the General Committee. The main committees of the General Assembly in addition to the General Committee, are as follows:

(i) First Committee (Disarmament and related International Security Matters

(ii) Special Political Committee

(iii) Second Committee (Economic and Financial matters)

(iv) Third Committee (Social, Humanitarian and Cultural matters)

(v) Fourth Committee (Decolonization matters)

(vi) Fifth Committee (Administrative and Budgetary matters)

(vii) Sixth Committee (Legal matters)

Functions and powers of General Assembly

The General Assembly performs varied and extensive functions which can be studied under the following heads:

(i) Deliberative functions

The General Assembly can discuss any question or matter within the scope of the UN Charter and relating to any organ of the United Nations. It can invite the attentionof the Security Council to the situation which is likely to endanger international peace and security. It can also recommend measures for the peaceful adjustment of situation which is likely to disturb the friendly relations amongst nations.

The General Assembly can also initiate studies and make recommendations for the following:

(a) Promoting international co-operation in political arena and encourage progress of international law and its codification

(b) Promoting international co-operation in the economic, social, cultural, education and health fields

(c) Assisting in realizing human rights and fundamental freedom for all without discrimination as to race, sex, language or religion.

However, the recommendations of the General Assembly do not possess any legal sanction and are merely an expression of opinion or advice of the Assembly which is not binding on the member states.

(ii) Legislative functions

The General Assembly has also performed legislative functions even though the UN Charter did not assign any legislative functions to the Assembly. This occurs whenever there can not be an agreement between any countries, they would refer the matter to the General Assembly for its recommendations on the issues, with the understanding that the recommendations of the General Assembly would be binding on the parties; as it had happened in the case of US, Great Britain, France and Soviet Union in relation to the disposal of their Italian colonies.

(iii) Supervisory functions

The supervisory functions of the General Assembly include the power to exert control and regulate working of other organs and agencies of the United Nations. It receives and considers annual and special reports from other organs of the United Nations. Thus, the Security Council reports to the General Assembly the measures decided upon or taken for the maintenances of international peace and security.

(iv) Financial functions

The General Assembly enjoys important financial powers as it appoints expenses among the member states and approves the budget of the United Nations. It has to also review the working of the other organs of the United Nation as the responsibility for the financial and budgetary arrangements of the specialized agencies of the organization also rests with the General Assembly. The control over finances gives the General Assembly the power to supervise and control the activities of other organs and agencies of the organization.

(v) Electoral functions

The Electoral Functions of the General Assembly include the admission of new members and selection of members of other organs. It admits new members to the UN on the recommendation of the Security Council but no new members can be admitted without an affirmative vote of the General Assembly.

The General Assembly can also suspend a member on the basis of recommendations of the Security Council on the ground of violating the principles of the UN Charter continuously.

The General Assembly also elects members of several other organs such as the ten non-permanent members of the Security Council, the judges of the International Court of Justice for a period of nine years in concurrence with the Security Council. It also appoints the Secretary General on the recommendation of the Security Council.

(vi) Constituent functions

The General Assembly enjoys important power with regard to the amendments of the Charter. The amendments to the UN Charter can be carried out by the General Assembly by two thirds majority of its members. However, this member has to be ratified by two thirds of the members of the United Nations, including all permanent members of the Security Council, in accordance with their constitutional processes.

The General Assembly can also convene a General Conference in concurrence with the Security Council to review the original Charter. For the discharge of these duties, the General Assembly can establish various committees and subsidiary organs. Some of the Committees which have been set up by the General Assembly in this regard include the Political and Security Committee, Economic and Financial Committee, Social Humanitarian and Cultural Committee, Trusteeship Committee, Administrative and Budgetary Committee, Legal Committee, General Committee and the Credential Committee.

Security Council

The Security Council is often described as the enforcement wing of the United Nations. Its primary responsibility is to maintain international peace and security among countries. In other words, the services can be requisitioned any time; the Security Council has to work continuously so that it can take quick action in the event of threat to international peace and security.

While the other organs of the United Nations can only make 'recommendations' to member governments, the Security Council has the power to make binding decisions that the member governments have agreed to carry out, under the terms of Charter Article 25. The decisions of the Council are known as United Nations Security Council resolutions.

Composition of the Security Council

The Security Council is made up of fifteen member states, consisting of five permanent members- namely; China, France, Russia, the United Kingdom and the United States– and ten non-permanent members. The five permanent members hold veto power over substantive but not procedural resolutions allowing a permanent member to block adoption but not to block the debate of a resolution unacceptable to it.

The Economic and Social Council

The framers of the UN Charter were fully aware of the importance that the social and economic conditions for preserving world peace. Therefore, the Economic and Social Council (ECOSOC) has been established to coordinate the economic and social work of the United Nations along with the specialized agencies and institutions to assist the General Assembly in promoting international economic and social cooperation and development.

The ECOSOC is one of the six principal organs of the United Nations that operate under the authority of the General Assembly in accordance to the Article 55 of the UN Charter. The article also enjoins the United Nations to create conditions of stability and well being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of the people by:

(i) Promoting higher standards of living, full employment and conditions of economic and social progress and development

(ii) Solutions of international economic, social, health and related problems and in international cultural and educational cooperation

(iii) Universal respect for and observance of human rights and fundamental freedoms for all without distinction as to race, sex, language or religion.

Composition of Economic and Social Council

The Economic and Social Council (ECOSOC) has fifty-four members. Each year the General Assembly elects eighteen members for a period of three-year term but the retiring members are eligible for immediate re-election. Originally, the Council comprised of twenty-seven members which was raised to fifty-four in 1974. The Council's fifty-four member Governments are elected by the General Assembly for overlapping three-year terms. The seats on the Council are based on geographical representation with fourteen of the seats allocated to African States, eleven to Asian States, six to Eastern European States, ten to Latin American and Caribbean States, and thirteen to Western European and other States.

The president is elected for a one-year term and chosen amongst the small or middle powers represented on ECOSOC. All the decisions are taken by a simple majority with each member enjoying one vote.

The Economic and Social Council (ECOSOC) meets once a year in July for a four-week session. One session is held at New York and the other is held at Geneva. It has also held another meeting each April with the finance ministers who head key committees of the World Bank and the International Monetary Fund (IMF) since 1998. During the remaining part of the year, the Council carries on its work through its subsidiary bodies-commission and committees, which meet at regular intervals and report back to the Council.

Functions of Economic and Social Council

The functions of the ECOSOC include information gathering, advising member nations, and making recommendations. Besides, providing policy coherence and coordinating the overlapping functions of the UN's subsidiary bodies. There are many UN organizations and agencies that functions to work on the particular issues.

Subsidiary Bodies of the Council

The Subsidiary bodies of the Economic and Social Council include five regional commissions, six functional commissions, six standing committees and other standing expert bodies.

1. Regional Commission
2. Functional Commission
3. Standing Committees

4. Expert Bodies

Trusteeship Council

The Trusteeship Council has been one of the principal organs of the United Nations in the UN Charter. It works as an auxiliary organ of the General Assembly in so far as it supervises the administration of the non-strategic trust territories and an auxiliary organ of the Security Council with regard to strategic areas.

Composition of Trusteeship Council

The UN Charter did not prescribe the size of the Council and merely provided that the Trusteeship Council must reflect a balance between members that administers Trust Territories and the members that do not. In order to ensure this balance, it was provided that the General Assembly may elect for three years as many members as may be necessary in order to ensure that the total membership may of the Trusteeship Council is equally divided between those members of the United Nations which administer Trust Territories and those which do not .

Objectives of the Trusteeship System

According to the UN Charter, the Trusteeship System has the following objectives as mentioned below:

(a) To promote international peace and security

To promote the political, economic, social and educational advancement of the inhabitants of the trust territories and their progressive developments towards self-government or independence as may be appropriate to the particular circumstances of each territory and its people and the freely expressed wishes of the people concerned, and as may be approved by the terms of each trusteeship agreement.

(b) To encourage respect for all without distinction as to race, sex or religion and to encourage recognition of the interdependence of the people of the world

(c) To ensure equal treatment in social, economic and commercial matters for all members of the United Nations and also equal treatment of the latter in the administration of justice without prejudice to the attainment of the foregoing objectives.

Functions and Powers of Trusteeship Council

The functions and powers of the Trusteeship Council have been outlined in Article 87 of the UN Charter. Its functions include the following:

(a) Consideration of reports submitted by the administering authority

(b) Acceptance of petitions and their examinations in consultation with the administering authority

(c) To arrange periodic visits to the respective trust territories at times agreed upon with the administering authority

To take over other actions in conformity with the terms of the trusteeship agreements.

The functions can be studied under the following heads as follows:

(i) Consideration of reports from Administering Authority According to the UN Charter, each of the administering authority is expected to submit an annual report for the territories under its control. In the report, it should provide information regarding the political,

economic, social and educational advancement of the inhabitants of the territory under its control.

The council also studies reports with the help of the specialized agencies and make necessary suggestions. It is on this basis of the examination that the reports that the Council drafts and incorporate the annual report as given to the General Assembly in the case of non-strategic territories and areas and to the Security Council in the case of the strategic areas.

(ii) Receipt and examination of petitions

The Trusteeship Council reviews and examines the petitions from individuals as well as Organization in the Trust Territories. On receipt of petitions, the same are sent to the administering authority for comments before these are examined by the Council. These petitions can cover a wide range of subjects such as property claims and titles, denial of civil and human rights, racial discrimination, poor educational services and appeals for greater participation in local administration.

(iii) Visit to trust territories

The Trusteeship Council can also arrange periodic visits to the Trust territories, at times agreed upon with the Administering Authority in order to acquire first hand information about the conditions and problems of the Trust territories. Usually such missions are sent to each trust territory every two years.

In addition to the above function, the Trusteeship Council can take any other action in conformity with the terms of the Trusteeship Agreements.

9.4 International Court of Justice

The International Court of Justice (ICJ) is the principal judicial organ of the United Nations. It has been established in 1945 according to the Statute of the International Court of Justice which forms an integral part of the UN Charter. The Statute of the International Court of Justice, similar to that of its predecessor, is the main constitutional document constituting and regulating the Court. It is based on the Permanent Court of International Justice which was prepared by the League Council and has been unanimously approved by the League Council in 1920.

It is located in The Hague, Netherlands and is based in the Peace Palace in The Hague, Netherlands, sharing the building with the Hague Academy of International Law, a private centre for the study of international law. The Court began work in 1946 as the successor to the Permanent Court of International Justice. Its purpose is to adjudicate disputes among states. The court has heard cases related to war crimes, illegal state interference and ethnic cleansing, among others, and continues to hear cases.

Composition of International Court of Justice

The International Court of Justice consists of fifteen judges elected by the General Assembly and the Security Council, voting independently. The Judges are elected on the basis of their merit and their high moral character and not on the basis of their nationality. It carefully elects the judges so that no two judges can be nationals of the same state. This has been done in order to ensure that no country or group dominate the courts.

t its head is the Secretary-General, who is appointed by the General Assembly on the recommendation of the Security Council for a five-year, renewable term.

The duties carried out by the Secretariat are as varied as the problems dealt with by the United Nations. These range from administering peacekeeping operations to mediating international disputes, from surveying economic and social trends and problems to preparing studies on human rights and sustainable development. Secretariat staff also informs the world's communications media about the work of the United Nations; organize international conferences on issues of worldwide concern; and interpret speeches and translate documents into the Organization's official languages.

The Secretariat has offices located at the headquarters of the United Nations in New York. It also has branch offices at Geneva, Vienna and Nairobi. The Secretariat also includes the regional commission's secretariat at Addis Ababa, Baghdad, Bangkok, Geneva and Santiago and has offices all over the world

The staff members and the Secretary-General are answer to the United Nations alone for their activities, and take an oath not to seek or receive instructions from any Government or outside authority, as international civil servants. Under the Charter, each Member State undertakes to respect the exclusively international character of the responsibilities of the Secretary-General and the staff and to refrain from seeking to influence them improperly in the discharge of their duties.

Composition of the Secretariat

The United Nations Secretariat is headed by the Secretary-General who is assisted by a staff of international civil servants worldwide. It provides studies, information, and facilities needed by United Nations bodies for their meetings. It also carries out tasks as directed by the UN Security Council, the UN General Assembly, the UN Economic and Social Council, and other UN bodies. The United Nations Charter provides that the staff be chosen by application of the 'highest standards of efficiency, competence, and integrity,' with due regard for the importance of recruiting on a wide geographical basis.

The UN Charter provides that the staff shall not seek or receive instructions from any authority other than the UN. Each UN member country is enjoined to respect the international character of the Secretariat and not seek to influence its staff. The Secretary-General alone is responsible for staff selection.

The Secretary-General's duties include helping resolve international disputes, administering peacekeeping operations, organizing international conferences, gatheringinformation on the implementation of Security Council decisions, and consulting with member governments regarding various initiatives. The key Secretariat offices in this area include the Office of the Coordinator of Humanitarian Affairs and the Department of Peacekeeping Operations. The Secretary-General may bring to the attention of the Security Council any matter that, in his or her opinion, may threaten international peace and security. At present the Secretary General is António Guterres from Portugal.

Functions of the Secretariat

The main functions of the Secretariat are as follows:

(i) Production of reports and other documents containing information, analysis, historical background, research findings, policy suggestions etc. to facilitate deliberations and decision making by other organs and their subsidiary bodies.

(ii) Provision of secretarial services to legislative organs in accordance with the policies adopted by the General Assembly

(iii) Provision of meeting services to the legislative organs in accordance with the policies adopted by the General Assembly

(iv) Provision of editorial, translation and documents reproduction services for the issuance of UN documents in different languages

(v) Conduct of studies and provision of information that answers to the priority needs of the governments of member countries in meeting challenges in various fields.

(vi) Production of statistical publications, information bulletins and analytical work which the General Assembly has decided.

(vii) Organization of conference, expert groups meetings and seminars on topics of concern to the international community

(viii) Provision of technical assistance to developing countries

(ix) Undertaking of services missions to countries, areas or locations as authorized by the General Assembly or the Security Council

(x) To arrange for dissemination of information on United Nations activities and decisions among the public

(xi) Provision of programme planning, financial, personal, legal, management and general services which are essential for rational selection of work items and allocations of resources among them for effective, economic and efficient performance of the services and functions of the Secretariat.

Secretary-General

The Secretariat is headed by the Secretary-General, who acts as the de facto spokesperson and leader of the UN. The Secretary-General is the chief administrative officer of the Secretariat. He is appointed by the General Assembly on the recommendations of the Security Council. The current Secretary-General is António Guterres, who took over from Ban ki Moon in 2017 and will be eligible for reappointment when his first term expires in 2021.

Envisioned by Franklin D. Roosevelt as a 'world moderator', the position is defined in the UN Charter as the organization's 'chief administrative officer', but the Charter also states that the Secretary-General can bring to the Security Council's attention 'any matter which in his opinion may threaten the maintenance of international peace and security', giving the position greater scope for action on the world stage. The position has evolved into a dual role of an administrator of the UN organization, and a diplomat and mediator addressing disputes between member states and finding consensus to global issues.

The Secretary-General is appointed by the General Assembly, after being recommended by the Security Council, any member of which can veto, and the General Assembly can theoretically override the Security Council's recommendation if a majority vote is not achieved, although this has not happened so far. There are no specific criteria for the post, but over the years, it has become accepted that the post shall be held for one or two terms of five years, that the post shall be appointed on the basis of geographical rotation, and that the Secretary-General shall not originate from one of the five permanent Security Council member states.

Powers and function of the Secretary-General

The UN Secretary General has been given more powers than he enjoyed under the League of Nations. These can be conveniently studied under the following heads:

(i) Administrative and service functions

The Secretary-General is responsible for the organization and direction of the activities of the UN. The staff of all the UN organs excluding the International Court of Justice falls under his purview.

It is his responsibility to ensure that the various organs of the UN and their committees and conferences work properly. It is for this purpose that he draws the provisional agenda, notifies about the meetings to various members, provides staff and facilities for the holdings of meetings, examines the credentials or representatives and submits reports to the concerned organ.

He also assists in the drafting of documents, resolutions and reports and provides legal and technical advice. He also takes necessary action on the resolutions passed by the General Assembly viz communicates these resolutions to the member governments and ascertain the steps taken to implement these resolutions or recommendations.

According to Article 102 of the UN Charter 'every treaty and every international agreements entered into by any member of the United Nations shall, as soon as possible be registered with the Secretariat and published by it'.

(ii) Financial functions

The Secretary-General has also been entrusted with important financial responsibilities, subject to the authority of the General Assembly; he prepares the budget of the United Nations. He allocates funds, control expenditure, collects the contributions from members and acts as custodian of all the funds.

He tries to develop common fiscal controls and financial practices in consultation with specialized agencies and undertakings.

(iii) Representational functions

The Secretary-General represents United Nation in negotiations with other agencies and governments as the chief representative of UN. He also occupies a central position in the working of the various organs of the UN because the staff of these organizations and agencies is not only recruited but also controlled by the Secretary-General.

(iv) Political functions

The Secretary-General has also been assigned important political functions. It is through these political functions he exercises profound influence on the formulation of the policy. This power emanates from Article 99 of the UN Charter which stipulates that 'the Secretary General may bring to the attention of the Security Council any matters of which in his opinion may threaten international peace and security.'

Critical Evaluation of United Nations

Unlike other intergovernmental organization, United Nations (UN) is unique in its scope. Nearly all the nations of the world are members of the UN. This arrangement provides an unprecedented legitimacy and an opportunistic forum in which all the nations are heard, but if any member nation tries to ignore the voice of another the status and efficiency of the system becomes intimidated.

The basis of the UN is the concept of collective security. This concept originally gained importance with the persistence of President Wilson of the USA. After the end of World War I, after recognizing the 'failures' of the typical balance of power system, Wilson disputed that a joint power would be the most competent way to limit the future destructiveness of any nation who wanted decisive power and conquest.

The basis of this system was that no nation should become powerful enough so as to be capable of overpowering the others. Through this arrangement, an uneven equality was kept by two camps of states in the system. Basically, this arrangement occurred due to the fear of empire that so often troubled Europe.

The United Nations came up in October of 1945, with the major objective of maintaining international peace and security in the hope of evading another world war. The UN has an array of mechanisms that it uses for achieving its aims.

The Security Council first determines whether there is a 'threat to the peace, breach of the peace or act of aggression and makes recommendations, or decide what steps should be taken in accordance with Articles 41 and 42, for maintaining or restoring international peace and security.' If such a determination is made, the Security Council then has the ability to determine whether or not to give sanctions, first to non-military (Article 41), and then to military (Article 42) only after it has been decided that measures provided for under Article 41 were insufficient.

9.5 Human Rights Declarations

Human Rights Under UN Charter- At the San Francisco Conference it was expressed by several delegates that the United Nations should establish an international Bill of Rights. Although that could not be done the promotion and respect for human rights which at present constitute so important and so conspicuous be an integrated part of the U.N. Charter.

The result was that the Charter contained a number of provisions for the promotion of human rights and fundamental freedoms in the Preamble and in Article1,13(I}(b)55,56,62(2),68and76(c)which areas follows:

1 The Preamble of the Charter in its first substantive paragraph laid down that...we the people soft he Charter in its first substantive paragraph laid down that...we the people soft he United Nations determined toreaf firm faith in fundamental human rights. In the dignity and worth of the human person in the equal rights of men and women and of nations large and small.

2 Para3 of Article 1of the Charter provided that the achievement of international cooperation in promoting and encouraging respect for human rights and for fundamental freedoms for all without distinction as to race sex, language or religion shall be one for the purpose so the United Nations. However, despite the differences as to what rights and freedoms are the achievement of the maximum freedom and dignity of the human beings was the primary aim of the United Nations.

3 The General Assembly and the Economic and Social Council were given the task for there alienation of the promotion of human rights and fundamental freedoms. Most of the it

relating to human rights are considered by the Assembly's Third Committee(Social, Humanitarian and Cultural Committee) ,but others may be refer red to other Committees such as the Sixth Committee (Legal) or the First Committee (Political and Security)or the Special Political Committee).

4 Article 55 provided that the United Nations shall promote,

(a) higher standard so filling full employment and conditions of economic and social progress and development;

(b) solution so international cultural and educational cooperation; and

(c) universal respect for and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language or religion. Universalized and internationalized the concept of human rights which hitherto was adopted in some countries since last 200 years. It was the first international document which recognized there spect for human rights and fundamental freedoms as a principle of International Law. Their recognition and their further realization was deemed necessary as they were regarded as one of the methods of achieving greater unity between he States and also because they are indispensable for the maintenance of international peace and security.

Promotion and Protection of Human Rights by the United Nations

. The term promotion of human rights may mean setting of international standard of human rights, education and dissemination. The prime responsibility for the promotion of human rights under U.N.Charter rests in the General Assembly, in the Economic and Social Council and its subsidiary body-Human Rights Council. The term 'protection of human rights 'which may mean implementation and enforcement action doesnot find place in the U.N Chapter. Among the United Nations agencies only the Security Council and the International Court of Justice can engage in enforcement action; only they have a competence to pass a binding resolution or issue a binding judgement. The Security Council can threaten or vote sanctions

a. Human Rights Council

The World leaders- Heads of State and Government met at United Nations Head quarters in New York from September 14 to 16,2005 and adopted a document at the end of the Summit known as 2005 World Summit Outcome. The Outcome document contained a number of globalize issues on which the leaders agreed to take action. They agreed to create a U.N Human Rights Council which shall be responsible for the protection of all human rights and fundamental freedoms for all without distinction of any kind and in a fair and equal manner. The Council as an Inter-governmental body responsible for strengthening the promotion and protection of human rights around the globe and for addressing situations of human rights violations and make recommendations on them. It may discuss all the Matic human right issues and situations that require its attention. The Council is as judiciary organ of the General Assembly. Composition of the Human Rights Council the Human Rights Council consists of 47 members who are elected directly and individually by secret ballot by the majority of the members of the General Assembly. The membership is based on equitable geographical distribution i.e, 13 from African Group,13 from Asian Group, 6 from the Eastern European Group.

From the Western European and other States Group. The Assembly, by a two-thirds majority of members present and voting could suspend the rights of membership of a Council member who commits gross and system at violations of human rights. The process of suspension requires a two-third majority vote by the General Assembly. The members of the Council service for a period of three years and are not eligible for immediate re- election. The Council holds regular sessions three times a year i.e, in March, June and September. The Council can decide at any time to hold a special session to address human rights violations and in emergencies at the request of one third of the member States.

b. Functions of the Human Rights Council

c. The Council performs the following functions:-

a) It shall promote human rights education and learning as well as advisory services technical assistance and capacity building to be provided in consultation with and with the consent of Member States concerned.
b) It shall serve as a forum for dialogue on the matic issues on all human rights;
c) It shall make recommendations to the General Assembly for the further development of International Law in the field of human rights;
d) It shall promote the full implementation of human rights obligations undertaken by States and follow upto the goals and commitments related to the promotion and protection of human rights emanating from United Nations Conferences and Summits;
e) It shall undertake a universal periodic review, based on objective and reliable information of the fulfillment by each State of its human rights obligations and commitments in a manner which ensures universality of coverage and equal treatment with respect to all States;
f) It shall contribute, through dialogue and cooperation towards the prevention of human rights violations and respond promptly to human rights emergencies;
g) It shall work in close cooperation in the field of human rights with Governments, regional organizations national human rights instructions and civil society.
h) It shall make recommendations with regard to the promotion and protection of human rights.
i) (i)The Council shall submit an annual report to the General Assembly.
j) The Council shall assume the role and responsibilities of the Commission on Human Rights relating to the work of the Office of the United Nations High Commission for Human Rights.
k) The Council held its first meeting on June 19 ,2006.The Council established the following bodies which are called subsidiary bodies of the Human Rights Council and which reports to the Council directly.
l) Universal Periodic Review (UPR} The Council adopted a Resolution 5/1 on June 18, 2007 by consensus for a package reform which included the-establishment of UPR. The UPR is a unique process which involves are view of the human rights records of all 192 members of the United Nations once in every four years. Thus 48 States will be reviewed each year.
m) Complaint Procedure - Human Rights Council on June 18, 2007 adopted Resolution 5/1to establish complaint procedure whose, purpose is to address consistent patterns of gross violation of all human rights and fundamental freedoms occurring in any part of the world and under any circumstances. Functions of the Complaint Procedure are carried on by two Working Groups; the Working Group on Communications(WGC)consisting of five independent and qualified expert and the Working Group on Situations (WGS) consisting of five members. They examine written communications and bring them to the Human Rights Council.
n) Special Procedures - Special Procedures with the support of the Office of the United Nations High Commissioner for Human Right(OHCHR)undertake country visits; action individual cases and concerns of a broader structural nature by sending communications to States concerned; conduct thematic studies and convene expert consultations. Special Procedure report annually to the Human Rights Council. Persons performing functions within the scope of Special Procedure are called Special Rapporteur Special Representative of the Secretary-General of Independent Experts.

o) Advisory Committee - In September 2007, the Council decided to create an Advisory Committee by adopting Resolution 5/1 to provide expert advice at its direction. The Advisory Committee replaced the former Sub-Commission on the Promotion and Protection of Human Rights. The Committee held its first meeting in August 2008. The Committee is composed of eighteen independent experts representing the various regions of the World. Experts are elected by Governments and the Council. They are elected for a period of three years and may be re-elected once.

Summary

- League of Nations was the first stable worldwide security organization whose major aim was to uphold world peace. It was an intergovernmental association. It was established as a result of the Paris Peace Conference. The League of Nations had its maximum extent from 28 September 1934 to 23 February 1935. It comprised 58 members.
- The principle constitutional organs of the league were : The assembly, the council and the permanent secretariat.
- Other institutions like the Permanent Court of International Justice, International Labour Organization, Health Organization, Committee on Intellectual Cooperation, Slavery Commission and the Committee for the study of the legal status of women were constituted under the League.
- The United Nations was founded in 1945 after World War II to substitute the League of Nations, to end wars between nations and to offer a platform for dialogue. It contains manifold subsidiary organizations to complete its missions.
- The aims of the United Nations are: Facilitating cooperation in international law, international security, economic development, social progress, human rights and achievement of world peace.
- The six principle organs of the United Nations are the General Assembly, the Security Council, the Economic and Social Council, the Secretariat, the International Court of Justice and the United Nations Trusteeship Council.
- The security Council is often described as the enforcement wing of the United Nations, its primary responsibility is to maintain international peace and security among countries.
- The Economic and Social Council has been established to coordinate the economic and social work of the United Nations along with the specialized agencies and institutions to assist the General Assembly in promoting international economic and social cooperation and development.
- The Trusteeship Council works as an auxiliary organ of the General Assembly in so far as it supervises the administration of the non-strategic trust territories and an auxiliary organ of the Security Council with regard to strategic areas.
- The International Court of Justice's purpose is to adjudicate disputes among states. The court has heard cases related to war crimes, illegal state interference and ethnic cleansing, among others, and continues to hear cases.
- The Secretariat comprises of the Secretary General and such other staff as the organization may require. It provides services to the other organs of the United Nations.

- The South Asian Association for Regional Cooperation (SAARC) is an organization of the South Asian nations. It was founded in 1985 dedicating to the economic, technological, social and cultural development and emphasizing of collective self-reliance.
- The General Agreement on Tariffs and Trade is a multilateral agreement regulating trade among 153 nations. It was set up after the World War I. In 1995, it was replaced by the World Trade Organization.
- International Monetary Fund is an international organization set up for standardizing global financial relations and exchange rates.

Keywords

- The League of Nations: It was the first stable worldwide intergovernmental association whose major aim was to uphold world peace.
- SAARC: South Asian Association for Regional Cooperation is an organization of the South Asian nations dedicated to the economic, technological, social and cultural development and emphasizing of collective self-reliance.
- GATT: The General Agreements on Tariffs and Trade (GATT) is a multilateral agreement regulating trade among 153 nations. It was set up after World War II to promote economic cooperation of nations. It was replaced by WTO in the year 1995.
- Special Drawing Rights: It is an international reserve asset created by IMF. It is a potential claim on the freely usable currencies of the IMF's member countries.
- OPEC : It is an association of oil and petroleum exporting countries in order to co- ordinate and unify petroleum policies, prices , returns etc. among member countries.

Self Assessment

1. Who are the permanent members of the UN Security Council?

A. Japan, Germany, France, Britain, Canada, United States.
B. France, Russia, USA, Britain, China.
C. USA, Germany, Britain, Brazil, China, Nigeria.
D. USA, China, Britain, Germany, India.

2. Which of the following is not the purpose of the UN?

A. To maintain international peace and security
B. To develop friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples
C. They are to settle their international disputes by peaceful means and without endangering international peace, security and justice
D. It is based on the sovereign and inequality of all members

3. Which is/are the official language of the UN

A. English
B. French
C. Arabic
D. All of the above

4. Which one of the following is not the main committee of the UN Council

A. Economic and Financial Committee
B. Social, Humanitarian and Cultural Committee
C. Special Political and Decolonization Committee
D. Planning and Executive Committee

5. Why will further UN reform be necessary?

A. Because the UN will never work democratically as long as it has vetoes in the Security Council.
B. Because of the heightened concern over terrorism, the pervasiveness of inequality and injustice around the world, and the predominance of United States military power, and the need for regional representation in the UN Security Council.
C. Because after the Iraq war of 2003 no one believes in the UN any more.
D. All of the options given are correct.

6. What can be defined as human rights?

A. Those benefits granted to any adult person.
B. Those entitlements for those lawfully residing in a given country.
C. Those rights inherent to all human beings.
D. Sets common standards on human rights protection.

7. Which of the following Articles of the Universal Declaration of Human Rights states that “Everyone has the right to recognition every whereas a person before the law”?

A. Article 4
B. Article 6
C. Article 5
D. Article 7

8. UDHR are adopted by:

A. General Assembly
B. Security Council
C. The General Assembly on the recommendation of Security Council
D. ECOSOC

9. Right to work, free choice of employment and protection against employment is contained in Universal Declaration of Human Rights in:

A. Article 21
B. Article 22
C. Article 23
D. Article 27

10. UDHR consists of how many articles:

A. 24 articles
B. 30 articles
C. 35 articles
D. 48 articles

11. Who are the permanent members of the UN Security Council?

A. Japan, Germany, France, Britain, Canada, United States.
B. France, Russia, USA, Britain, China.
C. USA, Germany, Britain, Brazil, China, Nigeria.
D. USA, China, Britain, Germany, India.

12. UN Council has ------------- permanent members

A. Five
B. Ten
C. Fifteen
D. Twenty

13. The number of non-permanent members of UN Security Council is

A. Eight
B. Ten
C. Twelve
D. Fourteen

14. Which of the following is / are the function of the UN Council?

A. to call upon the parties concerned to comply with such provisional measures as it deems necessary or desirable to prevent an aggravation of the situation
B. to call on members of the United Nations to take measures not involving the use of armed force — such as sanctions — to give effect to the Council's decisions
C. To recommend methods of adjusting such disputes or the terms of settlement
D. All of the above

15. Which of the following is not function of United Nations Development Programme?

A. Protect refugees worldwide
B. Poverty reduction
C. Crisis prevention and recovery
D. Energy and environment

Answers for Self Assessment

1.	A	2.	D	3.	D	4.	D	5.	B
6.	C	7.	B	8.	A	9.	C	10.	B

11. B 12. A 13. B 14. D 15. A

Review Questions

1. What were the goals of the League Covenant?
2. Write a short note on the establishment of the United Nations conference.
3. What are the deliberative functions of the Security Council?
4. Explain the composition, functions and powers of the General Assembly.
5. Discuss the functions of the Economic and Social Council.
6. What kind of powers and functions does the International Court of Justice enjoy?
7. Critically evaluate the functioning of the United Nations

Further Reading

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Unit 10: International Monetary System

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Objectives

After reading this Unit students will be able to:

- Know the Meaning of International Monetary System.
- Discuss the Bretton Woods System.
- Explain the Present International Monetary System.

Introduction

The period 1870 to 1914 are regarded as the classical gold standard period. London was the center of international trade and finance, and the major currencies, led by the British pound, were convertible into gold at specified parities. During this time, there were no major currency crises, and no major currencies had to be discounted or revalued. International trade and finance proceeded without incident; goods and factors moved freely across national borders. Although trade restrictions were not unheard of, they were not typically utilized for the sake of balance of payments adjustments. Deficits and surpluses were to be addressed by deflation and inflation within the economy.

During this time, international liquidity consisted of gold, and the British pound served as the reserve currency. The British pound was a significant contributor to international liquidity, and it was regularly utilized to meet balance of payments commitments. The time was marked by currency rates that were largely stable. On the eve of World War I, this was the condition of the global monetary system. World War I ended all of this.

The interwar years were marked by worldwide monetary and exchange rate disorder. The gold standard was abandoned, trade and tariff limitations gained significance, exchange rates ceased to be stable, and competitive exchange rate movements and beggar-my-neighbor policies became the norm. It was deemed necessary to put an end to all of this and establish a system of international monetary arrangements in which countries could pursue full employment and stable prices without causing issues for others.

The Bretton Woods System was supported by two pillars: the preservation of stable currency rates and an IMF-instituted global credit system. In order to ensure orderly exchange rate adjustments, the framers of the Bretton Woods Agreement required IMF clearance for exchange rate changes above 10 percent. The Fund would only authorize modifications more than 10 percent if it was convinced that a "fundamental imbalance" existed in the balance of payments of the member country. The second pillar of the system was the international liquidity arrangement.

There was to be a pool of member countries' currencies, donated on the basis of the fixed quota system for member countries, allowing the Fund to function as a "lender of last resort."

The Bretton Woods System never operated as anticipated by its creators. Specifically, the Bretton Woods System was threatened by two changes: (a) the increased role of the U.S. dollar as a worldwide currency and a widely acknowledged asset, and (b) the exchange rate rigidity that grew over time. Please explain briefly these two problem areas.

At the end of World War II, the United States possessed more than three-quarters of the world's monetary gold and fifty percent of the world's gross national product. For these reasons, the US dollar became the international currency. The world's countries began to retain their official reserves in US dollars. Dollar holdings (as reserves) earned interest, whereas gold holdings (as reserves) did not. Therefore, the US dollar was superior to gold. After 1958, the US balance of payments deficits kept the global monetary system liquid. The increasing accumulation of US dollars by foreign nations, particularly Europe, constituted a danger to the dollar's status as the international reserve currency.

The second threat to the Bretton Woods System's stability was the reality-based rigidity of exchange rates. Despite initial exchange rate changes in the early 1950s, by the 1960s the global monetary system had established a system defined by continuous deficits and surpluses. The Bretton Woods System failed to achieve exchange rate stability in equilibrium.

The accumulation of US dollars by foreign central banks was directly attributable to the large and chronic US payments deficits. Even as early as 1964, the foreign countries' dollar holdings were equal to the United States' total gold reserves. This excessive buildup of US dollars in foreign countries resulted in foreign central banks' reluctance to maintain US dollars as currency reserves. After 1968, the dollars’ worth began to decline, and the price of gold began to skyrocket. In March 1968, at the request of the United States, the United States and European nations agreed to establish the so-called Two-tier Gold Market. This measure isolated the private gold market from the official gold market on which central banks traded gold. On the private market, the price of gold may climb above $35 per ounce, but the central banks continued to trade gold at a fixed price of $35 per ounce. Since the passage of the Gold Reserve Act in 1934, the U.S. government has committed to buying or selling limitless quantities of gold at a set price of $35 per ounce. The European nations decided not to exert pressure on the United States to exchange its dollar reserves into gold. In 1968, the US currency became nearly unconvertible to gold.

10.1 Meaning of International Monetary System

The international monetary system is the mechanism prevalent on global foreign currency markets that finances international trade and capital flows and determines exchange rates. Following is a discussion of the worldwide financial system since the end of World War II.

10.2 The Bretton Woods System

During the years preceding World War I, nearly all major national currencies were pegged to the international gold standard with fixed exchange values. During World War I, this technique was discontinued. From the end of the war till 1925, there were shifting exchange rates. In 1925, efforts were made to return to the gold standard. However, it fell as a result of the Great Depression. Numerous nations resorted to protectionism and competitive devaluations, so reducing international trade by virtually half. However, depression eliminated entirely during World War II.

In July 1944, the allies gathered at Bretton Woods, in the United States, to escape the rigidity of the gold standard and the instability of the 1930s in international trade and finance, and to promote free trade. The current International Monetary Fund (IMF) devised an adjustable peg system as the new system.

Under the Bretton Woods system, exchange rates between nations were established or tied at $ 35 per ounce of gold or the US dollar. This referred to a fixed exchange rate system with fluctuations in the exchange rate within a band or range of 1% above to 1% below par. But these modifications were unavailable to the United States, which was required to maintain the dollar's gold value. If the exchange rate reached either band, the monetary authorities were required to buy or sell dollars against their respective currencies. Where there was "fundamental disequilibrium" (i.e. persistent and huge deficits or surpluses) in BOP, large adjustments might be made with the permission of the IMF and other countries. With the exception of a transitional period, member states were prohibited

from imposing limitations on payments and commerce. They were permitted to store a portion of their foreign reserves in gold and the remainder in dollars. These reserves were intended to allow member nations to incur short deficits or surpluses while maintaining stable exchange rates. In the event of a BOP deficit, dollar sales resulted in a reserve outflow, while dollar purchases resulted in a reserve inflow.

Under the Bretton Woods arrangement, reserve outflows were a source of concern. To fix the BOP deficit, the IMF insisted on expenditure reduction strategies and devaluation. In addition, temporary BOP deficits were covered by borrowing from the Fund for a period of three to five years. A country's ability to borrow from the Fund would depend on the size of its quota. The IMF loans were issued in convertible currencies.

The first 25% of its allotment was automatically allocated to the gold tranche, while the remaining 75% was allocated to credit tranches with high interest rates. The World Bank (or IBRD) was established in 1946 to provide long-term loans, followed by the International Finance Corporation (IFC) in 1956 and the International Development Association (IDA) in 1960. In January 1948, the General Agreement on Tariffs and Trade (GATT) went into effect to eliminate trade restrictions. In order to supplement its resources and meet the objectives of the International monetary system, the and began borrowing from the eleven industrialized countries under General Agreements to Borrow (GAB) in October 1962. In addition, it established Special Drawing Rights (SDRs) in January 1970 to bolster foreign reserves and meet its members' liquidity needs. From the 1950s to the mid-1960s, the Bretton Woods system ran smoothly. During this time period, global output increased, and with the GATT's decrease of tariffs, global commerce also increased.

The Breakdown of the Bretton Woods System

The following are the principal causes and sequences of the breakdown of the Bretton Woods system.

1. Built-in Instability: The Bretton Woods System had a built-in instability that led to its eventual collapse. It had an adjustable peg system that was within plus or minus 1% of $35 par value. In the event of fundamental disequilibrium, a nation may discount its currency with IMF agreement. However, nations were hesitant to weaken their currencies since they needed to sell more goods to pay for more expensive imports from other nations. This prompted nations to rely on deflation to remedy BOP imbalances via expenditure-cutting monetary-fiscal policies. The United Kingdom frequently returned to deflation, as in 1949, 1957, and 1967.
2. The Triffin Dilemma : Since the dollar operated as a means of exchange, a unit of account, and a store of value within the IMF system, every country desired to raise its dollar reserves, resulting in an excess of dollar holdings. As a result, the U.S. gold stock and balance of payments continued to decrease. In 1960, Robert Triffin cautioned that the demand for global liquidity was outpacing the supply since the incremental supply of gold was growing slowly. As a result of the dollar's convertibility into gold, the supply of US dollars would fall short of countries' liquidity requirements. This would compel the United States to forsake its pledge to convert currencies to gold. This is the Triffin Dilemma, which precipitated the breakdown of the Bretton Woods System in August 1971.
3. Lack of International Liquidity : There was a growing lack of international liquidity due to increasing demand for the dollar in world monetary markets. With the expansion of world trade, BOP deficits (and surpluses) of countries increased. This required the availability of gold and the dollar. However, gold production in Africa was barely increasing. This increased the dollar's demand and holdings. Additionally, countries desired to store more dollars because they earned interest. As the dollar supply was insufficient relative to the liquidity requirements of countries, the United States produced extra dollars to pay for its deficits, which other nations took as reserves.
4. Mistakes in US Policies : In the 1960s, the BOP deficits of the United States grew substantially worse. The policies adopted by the U.S. administration in response to global

crises eventually contributed to their escalation. In the 1960s, rising US government spending on the Vietnam War, the US space programme, and the "Great Society" (social welfare) programme resulted in a significant cash outflow from the country. However, the Federal Reserve did not devalue the currency. Instead, monetary and fiscal measures were implemented to reduce the BOP deficit.

5. Destabilizing Speculation : Since countries with "fundamental disequilibrium" in BOP were unwilling to lower their currencies and need time to obtain IMF permission, speculators were able to engage in dollar speculation. When devaluations were implemented, they occurred in greater quantities than had been anticipated. This was attributable to destabilizing speculation, which rendered monetary-fiscal measures ineffective for controlling capital flows. This was the direct cause for the 1967 devaluation of the British pound.
6. Crisis of Confidence and Collapse : The immediate cause of the breakdown of the Bretton Woods System was the emergence of a dollar confidence crisis. The British pound was devalued in November 1967. With the emergence of a separate price on the open market, the global gold market was no longer under control. The direct cause of the breakdown of the Bretton Woods System was the March 1971 rumour that the United States would devalue the dollar. This caused a massive capital flight from the United States. When certain small European central banks attempted to convert their dollar holdings into gold at the US on August 15, 1971, the US blocked the conversion of dollars into gold. It refused to intervene in foreign exchange markets to ensure stable exchange rates and imposed a 10 percent import surcharge. Thus, the breakdown of the Bretton Woods System was mostly due to liquidity, adjustment, and confidence issues. The increase in liquidity (foreign reserves) resulted from the United States' BOP deficits. As a result of the United States' inability to reduce its deficits and the accumulation of superfluous dollars in foreign nations, there was a crisis of trust in the dollar, and the Bretton Woods System collapsed.

Thus, the main points of the post-war system evolving from the Bretton Woods Conference were as follows:

1. A new institution, the International Monetary Fund (IMF), would be established in Washington DC. Its purpose would be to lend foreign exchange to any member whose supply of foreign exchange had become scarce. This lending would not be automatic but would be conditional on the member's pursuit of economic policies consistent with the other points of the agreement, a determination that would be made by IMF.
2. The US dollar (and, de facto, the British pound) would be designated as reserve currencies, and other nations would maintain their foreign exchange reserves principally in the form of dollars or pounds.
3. Each Fund member would establish a par value for its currency and maintain the exchange rate for its currency within one per cent of par value. In practice, since the principle reserve currency would be the US dollar, this meant that other countries would peg their currencies to the US dollar, and, once convertibility was restored, would buy and sell US dollars to keep market exchange rates within the 1 per cent band around par value. The United States, meanwhile, separately agreed to buy gold from or sell gold to foreign official monetary authorities at $35 per ounce settlement of international financial transactions. The US dollar was thus pegged to gold and any other currency pegged to the dollar was indirectly pegged to gold at a price determined by its par value.

4. A Fund member could change its par value only with Fund approval and only if the country's balance of payments was in "fundamental disequilibrium." The meaning of fundamental disequilibrium was left unspecified but everyone understood that par value changes were not to be used as a matter of course to adjust economic imbalances.
5. After a post-war transition period, currencies were to become convertible. That meant, to anyone who was not a lawyer, that currencies could be freely bought and sold for other foreign currencies. Restrictions were to be removed and, hopefully, eliminated. So, in order to keep market exchange rates within 1 per cent of par value, central banks and exchange authorities would have to build up a stock of dollar reserves with which to intervene in the foreign exchange market
6. The Fund would get gold and currencies to lend through "subscription." That is, countries would have to make a payment (subscription) of gold and currency to the IMF in order to become a member. Subscription quotas were assigned according to a member's size and resources. Payment of the quota normally was 25 per cent in gold and 75 per cent in the member's own currency. Those with bigger quotas had to pay more but also got more voting rights regarding Fund decisions.

The Bretton Woods System worked without major changes from 1947 till 1971. During this period, the fixed exchange rates were maintained by official intervention in the foreign exchange markets. International trade expanded in real terms at a faster rate than world output and currencies of many nations, particularly those of developed countries, became convertible. The stability of exchange rates removed a great deal of uncertainty from international trade and business transactions thus helping the countries to grow. Also, the working of the system imposed a degree of discipline on the economic and financial policies of the participating nations. During the 1950s and 1960s, the IMF also expanded and improved its operation to preserve the Bretton Woods System. The system, however, suffered from a number of inherent structural problems. In the first place, there was much imbalance in the roles and responsibilities of the surplus and deficits nations. Countries with persistent deficits in their balance of payments had to undergo tight and stringent economic policy measures if they wanted to take help from the IMF and stop the drain on their reserves. However, countries with surplus positions in their balance of payments were not bound by such immediate compulsions. Although sustained increases in their international resources meant that they might have to put up with some inflationary consequences, these options were much more reasonable than those for the deficit nations. The basic problem here was the rigid approach adopted by the IMF to the balance of payments disequilibria situation. The controversy mainly centres around the 'conditionality issue,' which refers to a set of rules and policies that a member country is required to pursue as a prerequisite to using the IMF's resources. These policies mainly try and ensure that the use of resources by concerned members is appropriate and temporary. The IMF distinguishes between two levels of conditionality – low conditionality where a member needs funds only for a short period and high conditionality where the member country wants a large access to the Fund's resources. This involves the formulation of a formal financial programme containing specific measures designed to eliminate the country's balance of payments disequilibrium. Use of IMF resources, under these circumstances, requires IMF's willingness that the stabilization programme is adequate for the achievement of its objectives and an understanding by the member to implement it.

10.3 The Present International Monetary System

Beginning in March 1973, India, Canada, Japan, Switzerland, the United Kingdom, and a number of smaller nations utilized floating exchange rates. However, the "joint float" of the EEC countries remained after March 1973 and was now known as the "snake in the lake" due to the absence of a band within which EEC currencies might fluctuate relative to other currencies. In March 1979, the European Monetary System (EMS) was established, resulting in the creation of the European Currency Unit (ECU), a "basket" currency comprised of the major European currencies. The EMS restricts the internal exchange rate fluctuations of its member nations to no more than 2.25 percent from the "central rates," with the exception of Italy, whose lira is permitted to fluctuate up to 6 percent.

In the meantime, the Jamaica Agreement of January 1976 (ratified in April 1978) formalized the regime of floating exchange rates under the auspices of the IMF. A number of factors forced the majority of member countries of the IMF to float their currencies. There were large short-term capital movements and central banks failed to stop speculation in currencies during the regime of adjustable pegs. The oil crisis in 1973 and the increase in oil prices in 1974 led to the great recession of 1974-75 in the industrial countries of the world. As a result, "the dollar saw a precipitous depreciation that, by late 1978, had reached such dangerous proportions that the United States government adopted a strategy of major intervention to keep the dollar's value from falling further" By 1978, the managed floating exchange rate arrangement had become permanent. By 1978's Second Amendment to the IMF Charter, members are no longer required to maintain and establish par values with gold or the dollar. The Fund has no control over the member countries' exchange rate adjustment programmes. However, it conducts international "monitoring" of its members' exchange rate policy. .

The Second Amendment has diminished gold's role in the global monetary system by (a) abolishing the official price of gold; (b) delinking it from the dollar in exchange arrangements; (c) eliminating the Fund's and its members' obligations to transfer or receive gold; and (d) selling a portion of the Fund's gold holdings.

The Second Amendment has also made SDRs as the chief reserve assets of the global monetary system whose value is expressed in currencies and not gold. It is now a unit of account, a currency peg and medium of transactions.

The current international monetary system of floating exchange rates is one of "controlled floating" rather than freely flexible exchange rates. It has seldom operated independently of government involvement. Periodic government interference has led to the system being referred to as a "managed" or "dirty" floating system. In 1977, when the intervention was extremely weighty, it was referred to as a "filthy" float. When governments do not intervene, the float is "clean." However, the likelihood of a clean float is quite low. Thus, a system of managed floating exchange rates is forming in which central banks attempt to limit variations of exchange rates around "normal" rates, despite the fact that the Fund's Second Amendment makes no reference of normal rates.

"The current international monetary system has also evolved in a number of significant ways, including the new allocation of SDRs, the increased nations' quota in the IMF, the renewal of the General Agreements to Borrow (GAB), the elimination of the official gold price, and the formation of the European Monetary System (EMS) and the Euro Currency."

The United States is the most influential nation on the global monetary system. It has let the dollar to float relative to other currencies, with sporadic interventions when the currency has reached extreme highs or lows. By the September 1985 Plaza Accord, the G-5 (United States, United Kingdom, Germany, Japan, and France) agreed to intervene to lower the dollar when it was extremely high (appreciating). Subsequently, the dollar declined significantly against the yen, by more than 50 percent. By early 1987, the dollar had become undervalued, and in accordance with the Louvre Accord, the G-7 (G-5 plus Canada and Italy) countries committed to cooperate in maintaining their currency rates close to their then-current levels. The Louvre Accord stabilized exchange rates for the remainder of the year. Since then, there appears to be a consensus that exchange rates should be mostly stabilized, but there is little overt collaboration between nations."

Its Problems

The present international monetary system is faced with excessive fluctuations and large disequilibria in exchange rates. Often countries, both developed and developing, have been faced with either excessive appreciation or depreciation of their currencies in relation to the dollar which continues to dominate the world monetary system. Even the newly created Euro of the EU which was supposed to be a strong currency has been depreciating considerably since its inception against the dollar. This has adversely affected the world trade.

Reform of the Present International Monetary System

Economists have suggested a number of measures in order to avoid the excessive fluctuations and large disequilibria in exchange rates for reforming the present world monetary system.

Coordination and Cooperation of Policies: A few economists, and McKinnon in particular, suggested international co-operation and co-ordination of policies among the leading developed countries for exchange rate stability. According to McKinnon, the US, Germany and Japan should have the optimal degree of exchange rate stability by fixing the exchange rates among their

currencies at the equilibrium level based on the purchasing power parity. Thus, they would co-ordinate their monetary policies for exchange rate stability.

Establishing Target Zones: Williamson advocated for the establishment of goal zones within which volatility in the exchange rates of major currencies may be tolerated. According to him, the equilibrium exchange rate should be determined by the forces of demand and supply. The top target zone should be 10 percent above the equilibrium exchange rate, while the lower target zone should be 10 percent below the equilibrium exchange rate. Through state intervention, the currency rate should not be permitted to fluctuate outside of the two goal zones. In February 1987, the five largest developed nations agreed, under the Louvre Agreement, to establish target zones for the stability of their currencies' exchange rates. Despite official action by these nations, exchange rates continued to fluctuate within wider ranges than those agreed upon at the Louvre. Since then, Williamson's concept has been dismissed as impractical. .

Improving Global Liquidity: The reform package of the present world monetary system should improve global liquidity. As a first step, both BOP deficit and surplus countries should take steps to reduce a persistent imbalance through exchange rate changes via internal policy measures. Second, they should also cooperate in curbing large flows of "hot money" that destabilise their currencies. Third, they should be willing to settle their BOP imbalances through SDRs rather than through gold or dollar as reserve assets. Fourth, there should be increasing flow of resources to the developing countries.

Leaning Against the Wind: To reduce the fluctuations in exchange rates, the IMF Guidelines for the Management of Floating Exchange Rates, 1974 suggested the idea of leaning against the wind. It means that the central banks should intervene to reduce short-term fluctuations in exchange rates but leave the long-term fluctuations to be adjusted by the market forces. Richard Cooper proposes a worldwide central bank with a global currency that would function as a global lender of last resort. Jaffrey Sachs suggests the establishment of an international bankruptcy court with jurisdiction over nations. George Soros believes that the IMF should establish external financial ceilings for each country, above which private capital access need not be guaranteed. However, mandated insurance should be provided by an international credit insurance business. Paul Krugman advocates the reinstatement of capital controls as the "least terrible solution" to a global economic crisis.

Objective Indicators: To iron out exchange rate fluctuations, the IMF Interim Committee suggested the adoption of such objective indicators as inflation-unemployment, growth of money supply, growth of GNP, fiscal balance, balance of trade and international reserves. The variations in these indicators require the adoption of restrictive monetary-fiscal measures to bring stability in exchange rates.

Summary

As opposed to developmental capital, international liquidity is the total of official foreign reserves held by the world's governments and the IMF. International liquidity is a notion related to countries' balance of payments, but not their economic development. However, there will be an indirect relationship between international liquidity and economic development, as the latter is directly tied to the balance of payments position of the countries, particularly the so-called Third World's undeveloped nations.

It is vital to maintain a particular level of international liquidity for international trade and monetary transactions to flow smoothly. A lack of international liquidity impedes the progress of international trade, whereas an excess of international liquidity would result in monetary expansion and a global inflationary wave. Today's globe is defined by insufficiency rather than excess of international liquidity.

The international liquidity crisis can be resolved by increasing international reserves such as gold and reserve assets, especially SDRs, through international agreements. This has its own limitations, which are typically related to supply constraints. The only long-term solution to the international liquidity problem, especially for Third World countries with enormous balance of payments deficits, lies in the willingness of surplus countries in the developed world to implement policy steps to lower their balance of payments surpluses. Additionally, this will make the world less protectionist.

The period, 1870-1914, was one of international gold standard, relatively free trade and factor movements, and of stable exchange rates. The inter- war period was characterized by international monetary and exchange rates, international cooperation and trade and tariff negotiations 1971

marked the end of the fixed exchange rate regime when the Bretton Woods System collapsed. Today we are living in a world of flexible exchange rates. As a measure of international reserves and exchange rates, the SDR is increasingly replacing gold, the US dollar, and other reserve assets. The Bretton Woods System no longer exists, and no replacement has been established.

SDRs are a new source of international liquidity, comparable to the discovery of new gold mines. The IMF remains the primary source of international money.

Changes in the International Monetary System have been driven largely by the rapid growth of private international capital flows, which first overwhelmed the Bretton Woods fixed exchange rate system, and, since the 1980s, have had especially strong effects on the emerging market countries.

Increasingly the discretion of national policymakers is constrained by international capital markets, which magnify the rewards for good policies and the penalties for bad policies. But markets may, on occasion, overreact by responding late and excessively to change in underlying conditions.

The International Monetary System has had to adapt to the increasing role of private capital flows. That process was evident in the shift towards flexible exchange rates among the major currencies three decades ago, and it continues today, as we absorb and react to the lessons of the emerging market crises of the last decade.

The gold standard worked well until World War I interrupted trade flows and disturbed the stability of exchange rate for currencies. The inter-war years from 1914-1944 were characterized by political instabilities and financial crisis.

The Bretton Woods System, which played a major emphasis on the stability of exchange rates, worked from 1945–1972. However, it came under mounting pressure as the post-war growth of international trade was complemented by an even more dramatic expansion of cross-border capital flows. These starkly revealed the difficulty of fixed exchange rate, an open capital account, and a monetary policy dedicated to domestic economic goals. With the leading countries unwilling to subordinate domestic policies to maintenance of the exchange rate, the fixed exchange rate regime among the major economies gave way.

Keywords

Monetary System : Medium of exchange: anything that is generally accepted as a standard of value and a measure of wealth in a particular country or region

Bretton Wood System : The Bretton Woods system of monetary management established the

rules for commercial and financial relations among the world's major industrial states in the mid-20th century. The Bretton Woods system was the first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states.

Self Assessment

1. The international monetary system can be defined as the institutional framework within which

A. International payments are made
B. Movement of capital is accommodated.
C. Exchange rates among currencies are determined.
D. All of above

2. Gresham’s Law in economics relates to

A. Supply and Demand
B. Circulation of currency
C. Consumption and supply
D. Distribution of goods and services

3. The international monetary system went through several distinct stages of evolution. These stages are summarized, in alphabetic order, as follows:

i. Bimetallism

ii. Bretton woods system
iii. Classical gold standard
iv. Flexible exchange rate regime
v. Interwar period
A. (iii), (i), (iv), (ii), (v)
B. (i), (iii), (v), (ii), (iv)
C. (v), (i), (iii), (ii), (iv)
D. (v), (iii), (iv), (ii), (i)

4. What are the requirements of good international monetary system (IMS)
A. A good system must be able to adjust imbalances in balance of payments quickly and at a relatively lower cost
B. the system must be able to keep exchange rates relatively fixed and people must have confidence in the stability of the system
C. The system must be able to provide enough reserve assets for a nation to correct its balance of payments deficits without making the nation run into deflation or inflation
D. All of the above

5. During the period of the classical gold standard (1875-1914) there were
A. Highly volatile exchange rates.
B. Volatile exchange rates.
C. Moderately volatile exchange rates.
D. Stable exchange rates.

6. Which of the following is not the goal of the Bretton Woods conference?
A. Intended to govern currency regulations and establish legal obligations
B. Promote investment of capital
C. Set a standard for exchange rates
D. Establish international monetary cooperation

7. What was the desire behind the Bretton Woods Agreement?
A. A desire to put an end to the Second World War
B. A desire to eradicate the causes that led to the Second World War
C. A desire for creating a system of fluctuating currencies
D. A desire for the abolition of different currencies

8. What was the agreement for Bretton Woods System?
A. Fixed Exchange Rate
B. US Dollar as reserve currency
C. US dollar was pegged to gold at $35 an ounce
D. All of the above

9. Which were the two institutions that were instituted during the Bretton Woods System era?
A. World Trade Organization and World Bank
B. International Monetary Fund and World Bank
C. World Trade Organization and United Nations
D. International Monetary Fund and World Trade Organization

10. When Bretton Woods System was created?
A. 1955
B. 1944
C. 1956
D. 1942

11. Choose the false statement among the following statements:
A. The Bretton Woods Conference was held in 1944 in Canada
B. Silver supplemented gold introducing ‘bimetallism’
C. Gold standard was the epitome of the fixed exchange rate system
D. The Gold Standard: 1870 to the outbreak of the First World War in 1914

12. The Smithsonian Agreement of 1971 is related to?
A. Moving from fixed to floating exchange rate
B. Widening the permissible band of the exchange rates to 2.5 per cent above or below the new 'central rates'
C. Tackle shortage of liquidity during the Great Depression
D. Bop crisis faced by countries after fall of the Bretton Woods System

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C. Tackle shortage of liquidity during the Great Depression
D. Bop crisis faced by countries after fall of the Bretton Woods System

15. In the formation of the European Monetary System, an attempt was made to allow for the problems of particular countries by allowing:
A. Members freely to choose to join in the broad band of the system
B. Marginal intervention in support of currencies
C. Some member currencies to float
D. Some members to join in the broad band

Answer for Self Assessment

1.	D	2.	D	3.	B	4.	D	5.	D
6.	B	7.	B	8.	D	9.	B	10.	B
11.	A	12.	B	13.	A	14.	B	15.	D

Review Questions

1. What do you mean by the monetary system? Discuss the international monetary system.
2. Write a short note on Bretton Wood System.
3. What are the causes of the breakdown of the Bretton Wood System? Discuss.
4. What are the components of the international monetary system?
5. Why do nations need international monetary systems?

Further Readings

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Unit 11: International Macroeconomic Policy

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Objectives

After reading this Unit students will be able to:

- Understand the concept of exchange rate
- Compare and contrast the fixed versus flexible exchange rates.
- Understand International Monetary Systems
- Identify the key features of the financial crisis.
- Describe the causes and consequences of the global financial crisis of 2007-2009.

Introduction

In the vast majority of contemporary economies, money (i.e. currency) is created and managed by a central authority. In most situations, individual nations generate their own currencies, but this is not always the case. (The Euro, which is the official currency of much of Europe, is a significant exception.) Because governments purchase goods and services from other countries (and sell goods and services to other countries), it is essential to consider how national currencies can be exchanged for those of other nations. Foreign-exchange markets, like all markets, are governed by the dynamics of supply and demand. In such marketplaces, the "price" of a currency unit is the amount of another currency required to acquire it. At the time of writing, the price of one Euro is around 1.25 US dollars since currency markets will swap one Euro for 1.25 US dollars. These monetary values are known as exchange rates. These are, more particularly, nominal exchange rates (not to be confused with real exchange rates). A currency's exchange rate can be expressed relative to any other currency, just as the price of a good or service can be expressed in dollars, euros, or any other currency. You can view a variety of these exchange rates by visiting a number of finance-related websites. A US Dollar/Euro (USD/EUR) exchange rate, for instance, indicates how many US

dollars can be purchased with one Euro, or the number of US dollars per Euro. Thus, exchange rates have a numerator and a denominator, and the exchange rate represents the amount of numerator currency that can be exchanged for one unit of the denominator currency. Due to the fact that currency prices are expressed relative to another currency, economists assert that currencies appreciate and devalue relative to other currencies. Appreciation and depreciation can be inferred directly from exchange rates. For example, If the USD / EUR If the exchange rate increased from 1.25 to 1.5, the Euro would purchase more U.S. dollars than previously. Consequently, the Euro would appreciate against the U.S. dollar. If the exchange rate rises, the currency in the denominator (bottom) of the rate appreciates relative to the currency in the numerator (top).

Similarly, if a currency exchange rate declines, the denominator currency depreciates relative to the numerator currency. This concept can be a bit confusing because it's easy to get it backwards, but it makes sense: for instance, if the USD/EUR exchange rate were to shift from 2 to 1.5, a Euro would purchase 1.5 US dollars instead of 2 US dollars. As a result, the Euro depreciates against the U.S. dollar, since one Euro is no longer worth as many U.S. dollars as it once was.

11.1 Meaning of Exchange Rate

The foreign exchange rate or exchange rate is the exchange rate between two currencies. It is the price of one currency expressed in terms of another. Customarily, the exchange rate is defined as the price of one unit of the foreign currency in domestic currency. The exchange rate between the dollar and the pound indicates how many dollars are necessary to purchase one pound. From the perspective of the United States, the exchange rate between the dollar and the pound is thus $ 2.50 = £ 1. The British would represent it as the number of pounds needed to purchase one dollar, with £ 0.40 = $1.

Arbitrage will maintain the exchange rate of $ 2.50 = £ 1 or £ 0.40 = $ 1 on the global foreign currency market. Arbitrage is the practise of purchasing a foreign currency on a market with a low price and selling it on a market with a high price. Arbitrage has the effect of eliminating variations in currency exchange rates so that there is a single exchange rate on the global foreign exchange market. If the exchange rate in London is $2.48 and in New York it is $2.50, foreign exchange speculators, also known as arbitrageurs, will buy pounds in London and sell them in New York for a profit of 2 cents per pound. As a result, the value of the pound relative to the dollar increases on the London market and decreases on the New York market. Eventually, it will equalise on both markets, and arbitrage will cease to exist. If the exchange rate between the dollar and the pound increases to $ 2.60 = £ 1 over time, the dollar is said to depreciate against the pound, since more dollars are required to purchase one pound. When the exchange rate between the dollar and the pound falls to $ 2.40 = £ 1, the dollar's value increases since fewer dollars are required to purchase one pound. If the first currency depreciates, the second currency appreciates, and vice versa. Thus a depreciation of the dollar against the pound is the same thing as the appreciation of the pound against the dollar, and vice versa.

11.2 Fixed Exchange Rates

In a system of fixed exchange rates, the exchange rate is predetermined and official. The central bank functions as a market maker and steps in to correct any demand-supply imbalance. This approach offers two key benefits. The first is that stable exchange rates eliminate uncertainty, which aids in lowering the costs of international commerce operations. The second advantage is that fixed exchange rates provide monetary authorities with discipline, prohibiting them from pursuing inflationary policies. When Brazil and Argentina implemented fixed-exchange-rate regimes in the 1990s, this point was highlighted. Excessive expansion of the money supply causes inflation, which in turn provides agents with an incentive to migrate into currencies with stable purchasing power. Such changes compel the central bank to act and purchase currency in order to preserve the exchange rate, thereby lowering the money supply. In this manner, fixed exchange rates constitute an automated mechanism that precludes central banks from engaging in excessive money supply expansion, and central banks are compelled to limit the money supply anytime inflation begins to rise to levels that will cause currency flight. This method is known as a nominal anchor, with the exchange rate functioning as a price anchor. In nations with a history of severe inflation and where central banks have lost trust with financial markets, it has been argued that implementing a fixed-exchange-rate nominal anchor is an effective strategy for regaining credibility. In addition, the costs

of such a commitment are minimal if monetary policy is deemed incapable of consistently influencing equilibrium real interest rates and equilibrium real economic activity.Several negatives counterbalance these advantages. First, by subscribing to a fixed exchange rate, a nation foregoes the exchange rate's role as a shock absorber that serves to shield the economy from external shocks. Second, the fixed exchange rate restricts the ability to utilise domestic monetary policy to stabilise the economy, however, as stated previously, this loss can be advantageous in circumstances when monetary authorities have a credibility problem due to significant inflation in the past.

Third, the nature of the adjustment process under fixed exchange rates may be markedly deflationary. Nations with trade surpluses will experience an excess demand for their currencies, whilst countries with trade deficits would experience an excess supply. If a deficit country is compelled to continue buying its currency to defend the exchange rate, this results in domestic monetary contraction in the deficit country and an increase in the money supply of the surplus country due to the deficit country's sale of foreign reserves. According to the conventional macroeconomic assumption, reductions in the money supply result in falling prices but have no effect on output. This is the "neutrality of money argument," according to which output and employment are controlled by real economic factors (tastes, resources, and productive technologies) and not by the quantity of currency in circulation (i.e., money). These changes in money supply, when applied to a global economy with fixed exchange rates, lead prices to fall in the deficit country and rise in the surplus one, so modifying relative competitiveness and reducing the trade deficit. In contrast, Keynesian analysis contends that monetary contraction generates real production contraction, which is exacerbated by price deflation due to debt effects. In the end, the adjustment process under fixed exchange rates leads to a domestic output contraction that reverberates throughout the international economy, as falling domestic income leads to fewer imports, which in turn reduces aggregate demand and income in other nations.

Instead than requiring the deficit country to protect its currency and prevent its appreciation, it may be possible to avoid this contractionary outcome by requiring the surplus country to defend its currency and prevent its appreciation. In this instance, the system is susceptible to an expansionary bias, as the surplus nation raises its money supply to prevent appreciation. However, this approach frees central banks from the restraint of fixed exchange rates. Periodic discrete adjustments to the fixed exchange rate in an effort to alleviate basic trade imbalances is a second method for eliminating contractionary bias. This was the approach of Bretton Woods. However, it eliminates (or severely weakens) the discipline of fixed exchange rates imposed on central banks. Additionally, it does away with the certainty of fixed exchange rates and invites market speculation aimed at anticipating or forcing a devaluation.

One claimed advantage of fixed exchange rates is that they reduce price uncertainty, which is good for international trade. However, introducing international capital mobility into a system of fixed exchange rates dramatically changes this conclusion. As noted earlier, capital mobility introduces portfolio and wealth allocation concerns that impact currency markets. Most importantly, capital mobility introduces financial market behaviors of speculation and herding into currency markets. These behaviors can render a fixed exchange-rate system financially fragile. If a country has a persistent

In the event of a trade deficit, the central bank will be required to safeguard the exchange rate by intervening. Market players will know, given the central bank's finite foreign reserve holdings, that it will eventually run out of foreign reserves to fund this defence. At this point, market participants may begin selling to exit the market before the central bank exhausts its reserves and is compelled to devalue. Therefore, the collapse can be brought forward in time, even if a central bank still has substantial reserve reserves. Moreover, speculators may speculate against any currency they perceive to be "subjectively" weak. On contemporary financial markets, speculators can get large levels of leverage that dwarf the central bank's foreign reserves. Therefore, they can wage a battle of attrition that they can win so long as the central bank with the weaker currency must defend the exchange rate. Fixed exchange rates provide speculators with a type of "one-way option." If they are successful in their speculation, they will reap the enormous rewards of devaluation. If the central bank is able to fend off the speculative attack, the only costs they will incur are the short-term transaction fees and interest, which are becoming increasingly small due to technological advances in electronic commerce. In a world with international capital mobility, fixed exchange rates are therefore vulnerable. This means that there is always a possibility of a speculatively-induced collapse, and mitigating this risk requires countries to retain substantial amounts of expensive foreign reserves.

A third disadvantage of fixed exchange rates is their influence on private-sector borrowing decisions, especially in developing nations. Fixed exchange rates produce a moral hazard in which agents believe that foreign currency borrowing carries no currency risk. Therefore, agents overborrow foreign currency, and abrupt drops in the exchange rate might leave them stranded with enormous local currency debt loads. As in East Asia and Argentina, a country can enter a cycle of debt deflation and economic contraction at this point.

11.3 Flexible Exchange Rates

The exchange rate in a flexible system is set by the market forces of demand and supply for a currency. There is a presumption among economists that markets are stable, that the actions of agents as represented by demand and supply are based on rational decisions based on "economic fundamentals," and that market economies (i.e., the entire network of individual markets that comprise the economy) have a tendency to adjust smoothly and swiftly to full employment equilibrium in the absence of market impediments (i.e., inappropriate regulations and restrictions on price adjustment). This basic assumption predisposes economists to see flexible exchange rates favourably.

The primary benefit of flexible exchange rates is their capacity to cushion and stabilise economic activity. Regarding external shocks, the exchange rate can adapt to preserve trade equilibrium. Therefore, if export demand decreases, the exchange rate can fall in order to reduce export prices and revive demand. Effectively, the external sector may be balanced by altering one price (the exchange rate) as opposed to adjusting thousands of prices, as would be required if restoring balance by downward aggregate price and nominal wage adjustment. In addition, a flexible currency rate can facilitate the adjustment to shocks in domestic demand. Consequently, a domestic expansion will tend to increase domestic interest rates, luring financial inflows and elevating the exchange rate. This appreciation will tend to diminish export demand and shift consumption away from locally produced items and toward imports, reducing aggregate demand and tempering the expansion.

The second key benefit of flexible exchange rates is that they increase the effectiveness of monetary policy, which may be employed to maintain domestic economic equilibrium. In a recession, the monetary authority can therefore reduce interest rates, leading financial capital to flee, which depreciates the currency rate and boosts net exports.Some negatives counterbalance these advantages. First, flexible exchange rates imply exchange-rate volatility, which increases the cost of international commerce to the extent that firms hedge this volatility. The greater the exchange rate volatility, the greater the uncertainty and cost. Perhaps even more important is that exchange-rate uncertainty may cause firms to diversify sources of production internationally to protect against exchange-rate changes that can adversely affect their costs and competitive positions. This hedge-driven diversification is inefficient, being driven by

uncertainty rather than concerns about production efficiency. Moreover, firms may end up with overall excess capacity that they are willing to carry as a hedge against exchange-rate exposure. This increases prices. Additionally, to the extent that internationally diversified production increases firms' bargaining power with labor, the distribution of income may be tilted away from wages to profits. Thus, volatile flexible exchange rates may have contributed to the negative effects of globalisation on income dispersion.

The issue of capital mobility constitutes a second difficulty with flexible exchange rates. In the absence of capital mobility, exchange market demand and supply will reflect the trade balance. Countries running surpluses will experience excess demand for their currency, as their trading partners seek to obtain currency to pay for imports, and this will cause the surplus country currency to appreciate. In contrast, currencies of deficit countries tend to decline when they sell their currency to acquire currency from surplus countries. This is the market exchange's double-entry logic. Every purchase is accompanied with an exchange offer. In currency markets, one currency is exchanged for another. If the Marshall- Lerner elasticity conditions are met, the depreciation of the deficit country's exchange rate will tend, over time (after J-curve effects have worked through), to restore trade balance, which will then cause its currency to stop depreciating. Such characteristics render the foreign exchange market stable.

Given the mobility of capital, however, demand and supply on currency markets will reflect more than merely trade balance concerns. They will also reflect asset portfolio considerations and decisions to hold wealth across different national financial markets. This brings an asset market

dimension to foreign exchange markets that can be highly problematic. In particular, currency markets will take on the character of asset markets. As such, they may be volatile and subject to speculative manias and herd behaviors. This opens the way for asset market volatility to impact exchange rates and, thereby, impact output and employment. Thus, as financial investors move money into a country, they will appreciate the exchange rate. This can make industries uncompetitive, resulting in plant closures and job losses despite the absence of any change in factory floor productivity. Capital inflows will also drive-up asset prices and lower interest rates, thereby promoting asset-centered booms and distorting the allocation of resources. In the event that the inflows reverse, the result can be a collapse in asset prices and a rise in interest rates, as happened in East Asia in 1997. Flexible exchange rates plus unrestricted capital mobility can, therefore, make a volatile cocktail.

11.4 Merits and Demerits of Fixed Exchange Rate

Under fixed or pegged exchange rates, all foreign exchange transactions occur at a rate specified by the central bank. It may fix the exchange rate through legislation or market action. According to the needs of the country, the central bank may purchase or sell foreign currency or make a policy decision to appreciate or depreciate the native currency. The following reasons are typically used in favour of and against the fixed exchange rate system:

Merits of Fixed Exchange Rates

Economic Advantages of a Fixed Exchange Rate : Similarly to a hard peg, a fixed exchange rate promotes international trade and investment by reducing exchange rate risk. As market players may see the structure as less permanent than a currency board, it may produce less trade and investment. Similar to a hard peg, a fixed exchange rate limits the government's capacity to employ monetary and fiscal policy to maintain domestic economic stability. Thus, it leaves countries vulnerable to shocks that are not shared by the country whose currency they have pegged. This is less of an issue than with a hard peg, as imperfect capital mobility allows for some deviation from the policy of the country or countries with which you have ties. However, the shock would have to be short because a major departure could not be sustained. The scope for the pursuit of domestic goals is greater for countries that fix their exchange rate to a basket of currencies — unlike a hard peg, the country is no longer placed at the mercy of the uniqueand the peculiar policies and shocks of each foreign nation. One method for creating a currency basket is to compose it of the currencies of the country's primary trading partners, particularly if the partner has a hard currency, with shares set in proportion to each country's proportion of trade. If the correlation of the business cycle with each trading partner is proportional to the share of trade with that country, then the potential for idiosyncratic shocks to harm the economy should be considerably reduced when pegged to a basket of currencies. As a result of the reintroduction of bilateral exchange rate risk with each trading partner, baskets do not attract as much bilateral commerce and investment as a peg to a single currency.

Political Advantages of a Fixed Exchange Rate In previous decades, it was considered that emerging nations with a history of profligacy may strengthen a new commitment to macroeconomic credibility by employing a fixed exchange rate for two reasons. First, the continuation of fixed exchange rates in nations with historically high inflation rates would communicate to market players that inflation is now under control. For instance, inflation reduces the number of dollars that can be purchased with a peso, just as it reduces the number of apples that can be purchased with a peso. In order to maintain a stable exchange rate, substantial inflation differentials must be eliminated. Second, it was believed that a fixed exchange rate would anchor inflationary expectations by stabilising import prices. It is believed that, for a given change in monetary policy, inflation will drop more rapidly if consumers anticipate reduced inflation.

After the numerous crises affecting fixed exchange rate regimes in the 1980s and 1990s, the persuasiveness of this argument has diminished. A fixed exchange rate regime, unlike a currency board, does nothing substantial to restrict policymakers and avoid a return to poor macroeconomic policy. Resisting the temptation to finance budget deficits through inflation ultimately depends on political will; if the political will is lacking, then the exchange rate regime will be abandoned, as was the case in many 1980s exchange rate crises. As a result of prior disappointments, investors may no longer view a stable exchange rate as a trustworthy government commitment to macroeconomic stability, hence diminishing the benefits of a fixed exchange rate. Moreover, some proponents of currency boards assert that investors will "test" the government's commitment to

maintaining a soft peg in ways that are detrimental to the economy. In contrast, they assert that investors will not test a currency board because they are confident in the government's resolve.

In recent years, many economists who had previously advocated fixed exchange rates based on their political advantages have moved their support to a hard peg. This is referred to as the "bipolar perspective" of exchange rate regimes: increasing international capital mobility has caused the global economy to operate more similarly to what models predict. As capital flows become more sensitive to interest rate differentials, it has proven impossible for "soft peg" fixed exchange rate regimes to concurrently pursue domestic policy objectives and maintain the exchange rate. As a result, countries are being pushed toward floating exchange rates (the pursuit of domestic goals) or “hard pegs” (policy directed solely toward maintaining the exchange rate). In this view, while “soft pegs” may have been successful in the past, any attempt by a country open to international capital to maintain a soft peg today is likely to end in an exchange rate crisis, as happened to Mexico, the countries of Southeast Asia, Brazil, and Turkey. Empirically, the trend does appear to be moving in this direction. In 1991, 65% of the world’s 55 largest economies used “soft peg” exchange rate arrangements; in 1999, the number had fallen to 27%.

Although the international trend has been towards greater capital mobility and openness, it should be pointed out that there are still developing countries that are not open to capital flows. The “bipolar view” argument may not hold for these countries : without capital flows reacting to changes in interest rates, these countries may be capable of maintaining a soft peg and an independent monetary policy. This has been the case for China.

Fixed exchange rates have the following merits :

1. The case for fixed exchange rate between different countries is based on the case for a common currency within a country. A country having a common currency with a fixed value facilities trade increases production and leads to faster growth of the economy. Similarly, a country would benefit if it has a fixed value of its currency in relation to other countries. Thus fixedexchange rates encourage international trade by making prices of goods involved in trade more predictable. They promote economic integration. As pointed out by Johnson, “The case for fixed rates is part of a more general argument for national economic policies conducive to international economic integration.”
2. The second argument for a system of fixed exchange rates is that it encourages long-term capital flows in an orderly and smooth manner. There is no uncertainty and risk resulting from a regime of fixed exchange rates.
3. There is no fear of currency depreciation or appreciation under a system of fixed exchange rates. For instance, it removes fear that holding large quantities of foreign currency might lead to losses, if a currency’s value drops. Thus it creates confidence in the strength of the domestic currency.
4. There is no fear of any adverse effect of speculation on the exchange rate, as speculative activities are controlled and prevented by the monetary authorities under a regime of fixed exchange rates.
5. Another advantage claimed by a system of fixed exchange rates is that it serves as an ‘anchor’ and imposes a discipline on monetary authorities to follow responsible financial policies with countries. “Inflation will cause balance of payments deficits and reserve loss. Hence the authorities will have to take counter-measures to stop inflation. Fixed exchange rates should, therefore, impose ‘discipline’ on governments and stop them from pursuing inflationary policies which are out of tune with the rest of the world.”
6. Johnson favours fixed exchange rates in the ‘banana republics’ where foreign trade plays a dominant role. Flexible exchange rates in them lead to inflation and depreciation when the exchange rate falls.

Demerits of Fixed Exchange Rates

The following arguments are advanced against a system of fixed exchange rates :

1. The principle defect in the operation of a system of fixed exchange rates is the sacrifice of the objectives of full employment and stable prices at the alter of stable exchange rates. For example, balance of payments adjustment under fixed exchange rates of a surplus country can take place through a rise in prices. This is bound to impose large social costs within the country.
2. Again, under this system, the effects of unexpected disturbances in the domestic economy are transmuted abroad. "While a country may be protected by fixed exchange rates from the full consequences of domestic disturbances and policy mistakes, it has to bear a share of the burden of the disturbances and mistakes of others. For to the extent that excess demand 'leaks out' of the country where it was originally created, it 'leaks in' (via a balance of payments surplus) to that country's trading partner."
3. Under it, large reserves of foreign currencies are required to be maintained. Countries with balance of payments deficits must have large reserves if they want to avoid devaluation. If countries wish to remain on the fixed exchange rate system, they must hold large reserves of foreign currencies. This also imposes a heavy burden on the monetary authorities for managing foreign exchange reserves.
4. This system requires complicated exchange control measures which lead to malallocation of the economy's resources.
5. Another problem relates to the stability of the exchange rate. The exchange rate of a country vis-a-vis another country cannot remain fixed for sufficiently long period. Balance of payments problems and fluctuations in international commodity prices often compel countries to bring changes in exchange rates. Thus it is not possible to have rigidly fixed exchange rates.

In fact, a regime of fixed exchange rates presupposes uniformity of domestic policy objectives and response of prices to fluctuations in demand. Such a system would undoubtedly run into severe difficulties in the present-day world. This is because there is a reluctance to be committed to theharmonisation of domestic policy objectives; prices respond only in a limited fashion of fluctuationsin the pressures of demand, and elasticities of demand in international trade have in general turned out to be quite low, at least in the short run. For these reasons, a rigidly fixed exchange rate regime has never been advanced as serious possibility in any of the recent discussions of reform of the international monetary system.

11.5 Merits and Demerits of Flexible Exchange Rate

Flexible, floating or fluctuating exchange rates are determined by market forces. The monetary authority does not intervene for the purpose of influencing the exchange rate. Under a regime of freely fluctuating exchange rates, if there is an excess supply of a currency, the value of that currency in foreign exchange markets will fall. It will lead to depreciation of the exchange rate. Consequently, equilibrium will be restored in the exchange market. On the other hand, shortage of a currency will lead to appreciation of exchange rate thereby leading to restoration of equilibrium in the exchange market. These market forces operate automatically without any intervention on the part of monetary authorities. We study below the case for and against flexible exchange rates.

Merits of Flexible Exchange Rates

The following merits are claimed for a system of flexible exchange rates :

1. A system of flexible exchange rates is simple in the operative mechanism. The exchange rate moves automatically and freely to equate supply and demand, thereby clearing the

foreign exchange market. It does not allow a deficit or surplus to build up and eliminates the problem of scarcity or surplus of any one currency. It also avoids the need to induce changes in prices and incomes to maintain or restore equilibrium in the balance of payments.

2. Under it, the adjustment is continual. The adjustment in the balance of payments are smoother and painless as compared with the fixed exchange rate adjustments. In fact, flexible exchange rates avoid the aggravation of pressures on the balance of payments and the periodic crises that follow disequilibrium in the balance of payments under a system of fixed exchange rates. There is an escape from the various corrective measures that are adopted by the governments whenever the exchange rate depreciates or appreciates.
3. Under this system, autonomy of the domestic economic policies is preserved. Modern governments are committed to maintain full employment and promote stability with growth. They are not required to sacrifice these objectives of full employment and economic growth in order to remove balance of payments disequilibrium under a regime of flexible exchange rates. As pointed out by Johnson, " The fundamental argument for flexible exchange rates is that they allow countries autonomy with respect to their use of monetary, fiscal and other policy instruments, by automatically ensuring the preservation of external equilibrium."
4. Since under a system of flexible exchange rates disequilibrium in the balance of payments is automatically corrected, there is no need to accommodate gold movements and capital flows in and out of countries.
5. There is no need for foreign exchange reserves where exchange rates are moving freely. A deficit country will simply allow its currency to depreciate in relation to foreign currency instead of intervening by supplying foreign exchange reserves to the other country to maintain a stable exchange rate. According to Sohmen, a system of flexible exchange rates removes the problem of international liquidity. The shortage of international liquidity is the result of pegged exchange rates and intervention by monetary authorities to prevent fluctuations beyond narrow limits. When exchange rates are flexible, speculators will supply foreign exchange to satisfy private liquidity needs. Individuals, traders, banks, governments, and others would, of course, continue to hold liquid assets in the form of gold or foreign exchange, but these holdings would be working reserves for purposes other than the maintenance of a fixed external value of the country's currency.
6. As a corollary to the above, when foreign exchange rates move freely, there is no need to have international institutional arrangements like the IMF for borrowing the lending short-term funds to remove disequilibrium in the balance of payments.
7. Again, according to Sohmen, the system of flexible exchange rates re-inforces the effectiveness of monetary policy. If a country wants to increase output, it will lower interest rates under a regime of flexible exchange rates, the lowering of interest rates will result in an outflow of capital, a rise in the spot rate for the currency which will, in turn, cause exports to rise and imports to fall. The increased exports will tend to rise domestic prices, or income or both. Thus a favourable trade balance will reinforce the expansionary effects of lower interest rates on domestic spending, thereby making monetary policy more effective. The above process will be reversed if the country wants to fight inflation by raising interest rates.

8. A system of flexible exchange rates does not require the introduction of complicated and expansive trade restrictions and exchange controls. Thus the cost of foreign exchange restrictions is removed.
9. Again, as a corollary to the above, the world can get rid of competitive exchange rate depreciation and tariff warfare among nations and there shall be no need of forming custom unions and currency areas which are the concomitant results of the system of fixed exchange rates.

Demerits of Flexible Exchange Rates

The advocates of fixed exchange rates advance the following arguments against a system of flexible exchange rates :

1. Critics of flexible exchange rates point out that market mechanism may fail to bring about an appropriate exchange rate. The equilibrium exchange rate in the foreign exchange market at a point of time may not give correct signals to concerned parties in the country. This may lead to wrong decisions and malallocation of resources with the country.
2. It is difficult to define a freely flexible exchange rate. It is not possible to have an exchange rate where there is absolutely no official intervention. Government may not intervene directly in the foreign exchange market, but domestic monetary and fiscal measures do influence foreign exchange rates. For instance, if domestic saving is more than domestic investment, it means that the country is a net investor abroad. The outflow of capital will bring down the exchange rate. All this may be due to the indirect impact of government policies. Further, in the absence of any understanding among governments about exchange rate manipulation, the system of flexible exchange rates might lapse into anarchy, for every country would try to establish favourable exchange rates with other countries. This may lead to retaliation among nations and result in war of exchange rates with disruptive effects on trade and capital movements. Thus some sort of understanding or agreement concerning exchange rates is implied in a regime of flexible exchange rates.
3. Another disadvantage of this system is that frequent variations in exchange rates, create exchange risks, breed uncertainty and impede international trade and capital movements. For instance, an Indian who imports from Japan and promises to pay in yen runs the risk that the rupee price of yen will rise above expected levels. And the Japanese exporter who sells for rupees runs the risk that the yen price of rupees will fall below expected levels. Similarly, exchange risks may be even more serious for long-term capital movements. This is because under a system of flexible exchange rates borrowers and lenders will be discouraged to enter into long-term contacts and the possibility of varying burden for servicing and repayment may be prohibitive.

Bo Sodersten has shown how flexible exchange rates increase uncertainty for traders and have a dampening effect on the volume of foreign trade. Assume that a country is under a regime of flexible exchange rates, the general price level is stable and the balance of trade is in equilibrium. Suppose the demand for the country's exports decreases, this leads to depreciation of the country's currency which, in turn, raises import prices and brings a fall in imports. Consequently, importers will be adversely affected. At the same time, exporters will gain with the increase in the prices of export goods. But the volume of exports will decline whereby they will also be losers. Opposite will be the consequences when currency appreciates. Suppose there is an abnormal inflow of short-term capital to country A which tends to raise its exchange rate. This will, in turn, increase the cost of A's exports in terms of foreign currencies, thereby lowering thelevels of output, employment and income in its export industries. The rise of exchange rate will also lower the cost of imports, thus discouraging output and employment in A's import competing industries. Thus importers and exporters will be at a disadvantage and the volume of trade will decline. This is illustrated in terms

of Sodersten's diagram, shown as Figure 1. The horizontal line S shows stable or fixed exchange rate, and the zig-zag line F shows flexible exchange rate. At time t0 the exchange rate is the same E, under both flexible and fixed rate systems. At t1, the currency depreciates, and the flexible exchange rate moves to D while thefixed exchange rate is at the same level D 1(= E). Since import prices have risen, imports will bediscouraged, and exports will be encouraged. At time t2 the currency appreciates and the flexible rate moves to A whereas the fixed rate remains at the same level A 1 (= E).

At A import prices fall. Imports are encouraged and exports are discouraged. So, exports will be at a disadvantage at A than at A1 and importers will gain at A than at A1. Similar will be at time t3 with fixed exchange rate at C 1 and the flexible exchange rate at C level. Thus, fluctuations ofthe exchange rate around a trend value will increase risks for exports and imports that willadversely affect the volume of foreign trade.

Under this system, speculation adversely influences fluctuations in supply and demand for foreign exchange. Critics argue on the basis of empirical evidence that speculation is destabilising which means that it aggravates fluctuations in exchange rate. "It is often said that speculators see a decline in the exchange rate as a signal for further decline, and that their actions will cause the movement in the exchange rate to be larger than it would be in the absence of speculation. In such a case, speculation is destabilising. Sodersten points out that "the limited experience from the 1920s seem to show that speculation at that time was destabilising. Since floating rates became common in 1973, fluctuations in exchange rates have been large. It seems that some of the excessive fluctuations have been caused by destabilising speculation." Such fluctuations increase uncertainties in trade and reduce the volume of foreign trade further.

Another serious drawback of a flexible exchange rate system is its inflationary bias. Critics argue that under a system of flexible exchange rates, a depreciation of the exchange rate leads to a vicious circle of inflation. Depreciation leads to a rise in import prices thereby making import goods more expensive. This leads to cost-push inflation. At the same time, export prices rise. Consequently, with the rise in the cost of living, money wages rise which, in turn, intensify inflation. But an appreciation of currency is unlikely to lead to a reduction in wages and prices when imports prices fall. This is because wages and prices are sticky downwards. This leads to an asymmetry which produces that Triffin calls ratchet effect that imparts an inflationary bias to the economy.

The main case against the system of flexible exchange rates is that it breaks up the world market. There is no one money which serves as a medium of exchange, unit of account, store of value and a standard of deferred payment. Under it, the world market for goods and capital would be divided. Resources allocation would be vastly sub-optimal. In fact, such a system clearly would not last long, according to Kindle Berger.

11.6 Meaning of International Monetary System

International monetary system refers to the system prevailing in world foreign exchange markets through which international trade and capital movements are financed and exchange rates are determined. We discuss below the international monetary system since the end of the World War II.

11.7 Gold Standards

An international gold standard avoids the asymmetry inherent in a reserve currency standard by avoiding the "Nth currency" problem. Under a gold standard, each country fixes the price of its currency in terms of gold by standing ready to trade domestic currency for gold whenever necessary to defend the official price. Because there are N currencies and N prices of gold in terms of those currencies, no single country occupies a privileged position within the system. Each one is responsible for pegging its currency's price in terms of the official international reserve asset, gold. The Mechanics of a Gold Standard because countries tie their currencies to gold under a gold standard, official international reserves take the form of gold. Gold standard rules also require each country to allow unhindered imports and exports of gold across its borders. Under these arrangements, a gold standard, like a reserve currency system, results in fixed exchange rates between all currencies. For example, if the dollar price of gold is pegged at $35 per ounce by the Federal Reserve while the pound price of gold is pegged at £14.58 per ounce by Britain's central bank, the Bank of England, the dollar / pound exchange rate must be constant at ($35 per ounce) ÷

(£14.58 per ounce) = $2.40 per pound. The same arbitrage process that holds cross exchange rates fixed under a reserve currency system keeps exchange rates fixed under a gold standard as well.

Symmetric Monetary Adjustment Under a Gold Standard because of the inherent symmetry of a gold standard, no country in the system occupies a privileged position by being relieved of the commitment to intervene. By considering the international effects of a purchase of domestic assets by one central bank, we can see in more detail how monetary policy works under a gold standard.

Suppose the Bank of England decides to increase its money supply through a purchase of domestic assets. The initial increase in Britain's money supply will put downward pressure on British interest rates and make foreign currency assets more attractive than British assets. Holders of pound deposits will attempt to sell them for foreign deposits, but no private buyers will come forward. Under floating exchange rates, the pound would depreciate against foreign currencies until interest parity had been reestablished. This depreciation cannot occur when all currencies are tied to gold, however. What happens ? Because central banks are obliged to trade their currencies for gold at fixed rates, unhappy holders of pounds can sell these to the Bank of England for gold, sell the gold to other central banks for their currencies, and use these currencies to purchase deposits that offer interest rates higher than the interest rate on pounds. Britain therefore experiences a private financial outflow and foreign countries experience an inflow.

11.8 Financial Crisis Causes

Financial crisis of 2007–08, also called subprime mortgage crisis, severe contraction of liquidity in global financial markets that originated in the United States as a result of the collapse of the U.S. housing market. It threatened to destroy the international financial system; caused the failure (or near-failure) of several major investment and commercial banks, mortgage lenders, insurance companies, and savings and loan associations; and precipitated the Great Recession (2007–09), the worst economic downturn since the Great Depression (1929–c. 1939).

Causes of the Crisis

Although the exact causes of the financial crisis are a matter of dispute among economists, there is general agreement regarding the factors that played a role (experts disagree about their relative importance). First, the Federal Reserve (Fed), the central bank of the United States, having anticipated a mild recession that began in 2001, reduced the federal funds rate (the interest rate that banks charge each other for overnight loans of federal funds—i.e., balances held at a Federal Reserve bank) 11 times between May 2000 and December 2001, from 6.5 percent to 1.75 percent. That significant decrease enabled banks to extend consumer credit at a lower prime rate (the interest rate that banks charge to their "prime," or low-risk, customers, generally three percentage points above the federal funds rate) and encouraged them to lend even to "subprime," or high-risk, customers, though at higher interest rates (see subprime lending). Consumers took advantage of the cheap credit to purchase durable goods such as appliances, automobiles, and especially houses. The result was the creation in the late 1990s of a "housing bubble" (a rapid increase in home prices to levels well beyond their fundamental, or intrinsic, value, driven by excessive speculation).Second, owing to changes in banking laws beginning in the 1980s, banks were able to offer to subprime customers mortgage loans that were structured with balloon payments (unusually large payments that are due at or near the end of a loan period) or adjustable interest rates (rates that remain fixed at relatively low levels for an initial period and float, generally with the federal funds rate, thereafter). As long as home prices continued to increase, subprime borrowers could protect themselves against high mortgage payments by refinancing, borrowing against the increased value of their homes, or selling their homes at a profit and paying off their mortgages. In the case of default, banks could repossess the property and sell it for more than the amount of the original loan. Subprime lending thus represented a lucrative investment for many banks. Accordingly, many banks aggressively marketed subprime loans to customers with poor credit or few assets, knowing that those borrowers could not afford to repay the loans and often misleading them about the risks involved. As a result, the share of subprime mortgages among all home loans increased from about 2.5 percent to nearly 15 percent per year from the late 1990s to 2004–07.

Third, contributing to the growth of subprime lending was the widespread practice of securitization, whereby banks bundled together hundreds or even thousands of subprime

mortgages and other, less-risky forms of consumer debt and sold them (or pieces of them) in capital markets as securities (bonds) to other banks and investors, including hedge funds and pension funds. Bonds consisting primarily of mortgages became known as mortgage-backed securities, or MBSs, which entitled their purchasers to a share of the interest and principal payments on the underlying loans. Selling subprime mortgages as MBSs was considered a good way for banks to increase their liquidity and reduce their exposure to risky loans, while purchasing MBSs was viewed as a good way for banks and investors to diversify their portfolios and earn money. As home prices continued their meteoric rise through the early 2000s, MBSs became widely popular, and their prices in capital markets increased accordingly.

Fourth, in 1999 the Depression-era Glass-Steagall Act (1933) was partially repealed, allowing banks, securities firms, and insurance companies to enter each other's markets and to merge, resulting in the formation of banks that were "too big to fail" (i.e., so big that their failure would threaten to undermine the entire financial system). In addition, in 2004 the Securities and Exchange Commission (SEC) weakened the net-capital requirement (the ratio of capital, or assets, to debt, or liabilities, that banks are required to maintain as a safeguard against insolvency), which encouraged banks to invest even more money into MBSs. Although the SEC's decision resulted in enormous profits for banks, it also exposed their portfolios to significant risk, because the asset value of MBSs was implicitly premised on the continuation of the housing bubble.

Fifth, and finally, the long period of global economic stability and growth that immediately preceded the crisis, beginning in the mid- to late 1980s and since known as the "Great Moderation," had convinced many U.S. banking executives, government officials, and economists that extreme economic volatility was a thing of the past. That confident attitude—together with an ideological climate emphasizing deregulation and the ability of financial firms to police themselves—led almost all of them to ignore or discount clear signs of an impending crisis and, in the case of bankers, to continue reckless lending, borrowing, and securitization practices.

Key Events of the Crisis

Beginning in 2004 a series of developments portended the coming crisis, though very few economists anticipated its vast scale. Over a two-year period (June 2004 to June 2006) the Fed raised the federal funds rate from 1.25 to 5.25 percent, inevitably resulting in more defaults from subprime borrowers holding adjustable-rate mortgages (ARMs). Partly because of the rate increase, but also because the housing market had reached a saturation point, home sales, and thus home prices, began to fall in 2005. Many subprime mortgage holders were unable to rescue themselves by borrowing, refinancing, or selling their homes, because there were fewer buyers and because many mortgage holders now owed more on their loans than their homes were worth (they were "underwater")—an increasingly common phenomenon as the crisis developed. As more and more subprime borrowers defaulted and as home prices continued to slide, MBSs based on subprime mortgages lost value, with dire consequences for the portfolios of many banks and investment firms. Indeed, because MBSs generated from the U.S. housing market had also been bought and sold in other countries (notably in western Europe), many of which had experienced their own housing bubbles, it quickly became apparent that the trouble in the United States would have global implications, though most experts insisted that the problems were not as serious as they appeared and that damage to financial markets could be contained.

By 2007 the steep decline in the value of MBSs had caused major losses at many banks, hedge funds, and mortgage lenders and forced even some large and prominent firms to liquidate hedge funds that were invested in MBSs, to appeal to the government for loans, to seek mergers with healthier companies, or to declare bankruptcy. Even firms that were not immediately threatened sustained losses in the billions of dollars, as the MBSs in which they had invested so heavily were now downgraded by credit-rating agencies, becoming "toxic" (essentially worthless) assets. (Such agencies were later accused of a severe conflict of interest, because their services were paid for by the same banks whose debt securities they rated. That financial relationship initially created an incentive for agencies to assign deceptively high ratings to some MBSs, according to critics.) In April 2007 New Century Financial Corp., one of the largest subprime lenders, filed for bankruptcy, and soon afterward many other subprime lenders ceased operations. Because they could no longer fund subprime loans through the sale of MBSs, banks stopped lending to subprime customers, causing home sales and home prices to decline further, which discouraged home buying even among consumers with prime credit ratings, further depressing sales and prices. In August, France's largest bank, BNP Paribas, announced billions of dollars in losses, and another large U.S. firm, American Home Mortgage Investment Corp., declared bankruptcy. By the summer of 2008

Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation), the federally chartered corporations that dominated the secondary mortgage market (the market for buying and selling mortgage loans) were in serious trouble. Both institutions had been established to provide liquidity to mortgage lenders by buying mortgage loans and either holding them or selling them—with a guarantee of principal and interest payments—to other banks and investors. Both were authorized to sell mortgage loans as MBSs. As the share of subprime mortgages among all home loans began to increase in the early 2000s (partly because of policy changes designed to boost home ownership among low-income and minority groups), the portfolios of Fannie Mae and Freddie Mac became more risky, as their liabilities would be huge should large numbers of mortgage holders default on their loans. Once MBSs created from subprime loans lost value and eventually became toxic, Fannie Mae and Freddie Mac suffered enormous losses and faced bankruptcy. To prevent their collapse, the U.S. Treasury Department nationalized both corporations in September, replacing their directors and pledging to cover their debts, which then amounted to some $1.6 trillion.

By this time there was general agreement among economists and Treasury Department officials that a more forceful government response was necessary to prevent a complete breakdown of the financial system and lasting damage to the U.S. economy. In September the George W. Bush administration proposed legislation, the Emergency Economic Stabilization Act (EESA), which would establish a Troubled Asset Relief Program (TARP), under which the Secretary of the Treasury, Henry Paulson, would be authorized to purchase from U.S. banks up to $700 billion in MBSs and other "troubled assets." After the legislation was initially rejected by the House of Representatives, a majority of whose members perceived it as an unfair bailout of Wall Street banks, it was amended and passed in the Senate. As the country's financial system continued to deteriorate, several representatives changed their minds, and the House passed the legislation on October 3, 2008; President Bush signed it the same day.

It soon became apparent, however, that the government's purchase of MBSs would not provide sufficient liquidity in time to avert the failure of several more banks. Paulson was therefore authorized to use up to $250 billion in TARP funds to purchase preferred stock in troubled financial institutions, making the federal government a part-owner of more than 200 banks by the end of the year. The Fed thereafter undertook a variety of extraordinary quantitative-easing (QE) measures, under several overlapping but differently named programs, which were designed to use money created by the Fed to inject liquidity into capital markets and thereby to stimulate economic growth. Similar interventions were undertaken by central banks in other countries. The Fed's measures included the purchase of long-term U.S. Treasury bonds and MBSs for prime mortgage loans, loan facilities for holders of high-rated securities, and the purchase of MBSs and other debt held by Fannie Mae and Freddie Mac. By the time the QE programs were officially ended in 2014, the Fed had by such means pumped more than $4 trillion into the U.S. economy. Despite warnings from some economists that the creation of trillions of dollars of new money would lead to hyperinflation, the U.S. inflation rate remained below the Fed's target rate of 2 percent through the end of 2014. Later that month the 168-year-old investment bank Lehman Brothers, with $639 billion in assets, filed the largest bankruptcy in U.S. history. Its failure created lasting turmoil in financial markets worldwide, severely weakened the portfolios of the banks that had loaned it money, and fostered new distrust among banks, leading them to further reduce interbank lending. Although Lehman had tried to find partners or buyers and had hoped for government assistance to facilitate a deal, the Treasury Department refused to intervene, citing "moral hazard" (in this case, the risk that rescuing Lehman would encourage future reckless behaviour by other banks, which would assume that they could rely on government assistance as a last resort). Only one day later, however, the Fed agreed to loan American International Group (AIG), the country's largest insurance company, $85 billion to cover losses related to its sale of credit default swaps (CDSs), a financial contract that protects holders of various debt instruments, including MBSs, in the event of default on the underlying loans. Unlike Lehman, AIG was deemed "too big to fail," because its collapse would likely cause the failure of many banks that had bought CDSs to insure their purchases of MBSs, which were now worthless. Less than two weeks after Lehman's demise, Washington Mutual, the country's largest savings and loan, was seized by federal regulators and sold the next day to JPMorgan Chase.

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There is now general agreement that the measures taken by the Fed to protect the U.S. financial system and to spur economic growth helped to prevent a global economic catastrophe. In the United States, recovery from the worst effects of the Great Recession was also aided by the American Recovery and Reinvestment Act, a $787 billion stimulus and relief program proposed by the Barack Obama administration and adopted by Congress in February 2009. By the middle of that year, financial markets had begun to revive, and the economy had begun to grow after nearly two years of deep recession. In 2010 Congress adopted the Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which instituted banking regulations to prevent another financial crisis and created a Consumer Financial Protection Bureau, which was charged with regulating, among other things, subprime mortgage loans and other forms of consumer credit. After 2017, however, many provisions of the Dodd-Frank Act were rolled back or effectively neutered by a Republican-controlled Congress and the Donald J. Trump administration, both of which were hostile to the law's approach.

Financial Market in Emerging Markets

Stage -1 : Initial Phase

Path A: Credit Boom and Bust

- Weak supervision and lack of expertise leads to a lending boom.
- Domestic banks borrow from foreign banks.
- Fixed exchange rates give a sense of lower risk.
- Banks play a more important role in emerging market economies, since securities markets are not well developed yet.

Path B: Severe Fiscal Imbalances

- Governments in need of funds sometimes force banks to buy government debt.
- When government debt loses value, banks lose and their net worth decreases.
- Additional factors:
- Increase in interest rates (from abroad)
- Asset price decrease
- Uncertainty linked to unstable political systems

Stage-2 Financial Crisis

Deterioration of bank balance sheets triggers currency crises:

- Government cannot raise interest rates (doing so forces banks into insolvency and speculators expect a devaluation.
- Severe fiscal imbalances triggers currency crises:
- Foreign and domestic investors sell the domestic currency.

Stage-3 Full Fledged Financial Crisis

- The debt burden in terms of domestic currency increases (net worth decreases).
- Increase in expected and actual inflation reduces firms' cash flow.
- Banks are more likely to fail:
- Individuals are less able to pay off their debts (value of assets fall).
- Debt denominated in foreign currency increases (value of liabilities increase).

11.9 Effects and Aftermath of the Crisis

In 2012 the St. Louis Federal Reserve Bank estimated that during the financial crisis the net worth of American households had declined by about $17 trillion in inflation-adjusted terms, a loss of 26 percent. In a 2018 study, the Federal Reserve Bank of San Francisco found that, 10 years after the start of the financial crisis, the country's gross domestic product was approximately 7 percent lower than it would have been had the crisis not occurred, representing a loss of $70,000 in lifetime income for every American. Approximately 7.5 million jobs were lost between 2007 and 2009, representing a doubling of the unemployment rate, which stood at nearly 10 percent in 2010. Although the economy slowly added jobs after the start of the recovery in 2009, reducing the unemployment rate to 3.9 percent in 2018, many of the added jobs were lower paying and less secure than the ones that had been lost.

For most Americans, recovery from the financial crisis and the Great Recession was exceedingly slow. Those who had suffered the most—the millions of families who lost their homes, businesses, or savings; the millions of workers who lost their jobs and faced long-term unemployment; the millions of people who fell into poverty—continued to struggle years after the worst of the turmoil had passed. Their situation contrasted markedly with that of the bankers who had helped to create the crisis. Some of those executives lost their jobs when the extent of their mismanagement had become apparent to shareholders and the public, but those who resigned often did so with lavish bonuses ("golden parachutes"). Moreover, no American CEO or other senior executive went to jail or was even prosecuted on criminal charges—in stark contrast with earlier financial scandals, such as the savings and loan crisis of the 1980s and the bankruptcy of Enron in 2001. In general, the key leaders of financial firms, as well as other very wealthy Americans, had not lost as much in proportional terms as members of the lower and middle classes had, and by 2010 they had largely recovered their losses, while many ordinary Americans never did.

That visible disparity naturally engendered a great deal of public resentment, which coalesced in 2011 in the Occupy Wall Street movement. Taking aim at economic elites and at a political and economic system that seemed designed to serve the interests of the very wealthy—the "1 percent," as opposed to the "99 percent"—the movement raised awareness of economic inequality in the United States, a potent issue that soon became a theme of Democratic political rhetoric at both the federal and the state levels. However, in part because the movement had no organized leadership or any concrete goals, it did not result in any specific reforms, much less in the complete transformation of "the system" that some of its members had hoped for.

1. The central importance of banking : A large part of what made the Asian crisis so devastating was that it was not purely a currency crisis, but rather a currency crisis inextricably mixed with a banking and financial crisis. In the most immediate sense, governments were faced with the conflict between restricting the money supply to support the currency and the need to print large quantities of money to deal with bank runs. More broadly, the collapse of many banks disrupted the economy by cutting off channels of credit, making it difficult for even profitable companies to continue business. This should not have come as a surprise in Asia. Similar effects of banking fragility played

roles in the crises of Argentina, Chile, and Uruguay in the 1980s and of Mexico in 1994-1995, and even in those of industrial countries like Sweden during the 1992 attacks on the EMS. Unfortunately, Asia's spectacular economic performance prior to its crisis blinded people to its financial vulnerabilities. In the future, wise governments will devote a great deal of attention to shoring up their banking systems to minimize moral hazard, in the hope of becoming less vulnerable to financial catastrophes.

2. The proper sequence of reform measures : Economic reformers in developing countries have learned the hard way that the order in which liberalization measures are taken really does matter. That truth also follows from basic economic theory : The principle of the second best tells us that when an economy suffers from multiple distortions, the removal of only a few may make matters worse, not better. Developing countries generally suffer from many, many distortions, so the point is especially important for them. Consider the sequencing of financial accou nt liberalization and financial sector reform, for example. It is clearly a mistake to open up the financial account before sound safeguards and supervision are in place for domestic financial institutions. Otherwise, the ability to borrow abroad will simply encourage reckless lending by domestic banks. When the economy slows down, foreign capital will flee, leaving domestic banks insolvent. Thus, developing countries should delay opening the financial accou nt until the domestic financial system is strong enough to withstand the sometimes violent ebb and flow of world capital. Economists also argue that trade liberalization should precede financial accou nt liberalization. Financial accou nt liberalization may cause real exchange rate volatility and impede the movement of factors of production from nontraded into traded goods industries.

3. The importance of contagion : A final lesson of developing country experience is the vulnerability of even seemingly healthy economies to crises of confidence generated by events elsewhere in the world—a domino effect that has come to be known as contagion. Contagion was at work when the crisis in Thailand, a small economy in Southeast Asia, provoked another crisis in South Korea, a much larger economy some 7,000 miles away. An even more spectacular example emerged in August 1998, when a plunge in the Russian ruble sparked massive speculation against Brazil's real. The problem of contagion, and the concern that even the most careful economic management may not offer full immunity, has become central to the discussion of possible reforms of the international financial system, to which we now turn.

Summary

The present unit discusses the exchange rate adjustment policies that have been in vogue from time to time with the establishment of the IMF. Before we discuss them, it is instructive to have a theoretical interlude relating to fixed and fluctuating exchange rates.

As with a hard peg, the drawback of a fixed exchange rate is that it gives the government less scope to use monetary and fiscal policy to promote domestic economic stability. Thus, it leaves countries exposed to idiosyncratic shocks not shared by the country to which it has fixed its currency. As explained above, this is less of a problem than with a hard peg because imperfect capital mobility does allow for some deviation from the policy of the country or countries to which you are linked. But the shock would need to be temporary in nature because a significant deviation could not last.

In fact, a regime of fixed exchange rates presupposes uniformity of domestic policy objectives and response of prices to fluctuations in demand. Such a system would undoubtedly run into severe difficulties in the present-day world. This is because there is a reluctance to be committed to the harmonization of domestic policy objectives; prices respond only in a limited fashion of

fluctuations in the pressures of demand, and elasticities of demand in international trade have in general turned out to be quite low, at least in the short run.

Keywords

Fixed exchange rate: A fixed exchange rate, sometimes called a pegged exchange rate, is also referred to as the Tag of particular Rate, which is a type of exchange rate regime where a currency's value is fixed against the value of another single currency or to a basket of other currencies, or to another measure of value, such as gold. A fixed exchange rate is usually used to stabilize the value of a currency against the currency it is pegged to. This makes trade and investments between the two countries easier and more predictable and is especially useful for small economies in which external trade forms a large part of their GDP.

Flexible exchange rate: A flexible exchange-rate system is a monetary system that allows the exchange rate to be determined by supply and demand. Every currency area must decide what type of exchange rate arrangement to maintain. Between permanently fixed and completely flexible however, are heterogeneous approaches.

Financial crisis: The term financial crisis is applied broadly to a variety of situations in which some financial assets suddenly lose a large part of their nominal value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults.

Self Assessment

1. Floating exchange rates
A. tend to correct balance of payments imbalances
B. reduce the uncertainties and risks associated with international trade
C. increase the world's need for international monetary reserves
D. tend to expand the volume of world trade

2. If a nation has a current account deficit of 6 and a capital account surplus of 2
A. the nation gains 8 in international reserves
B. the nation loses 8 in international reserves
C. the nation gains 4 in international reserves
D. the nation loses 4 in international reserves

3. When the balance on Canada's official settlement account is positive
A. Canada's balance on current + capital accounts is negative, and we are gaining international reserves
B. Canada's balance on current + capital accounts is positive, an d we are gaining international reserves
C. Canada's balance on current + capital accounts is negative, and we are losing international reserves
D. Canada's balance on current + capital accounts is positive, and we are losing international reserves

4. Which of the following is a disadvantage of a flexible exchange rate system?
A. nations must keep large reserves of gold or foreign currencies
B. flexible rates usually tend to produce inflation
C. uncertainty that tends to inhibit trade
D. all of the above

5. Foreign exchange refers to-
A. the price of the currency in terms of gold in the domestic market
B. The price of a nation’s currency in terms of another currency
C. The price of the one currency is determined by the government of the other country
D. none of the above

6. Managed floating exchange rate is called managed because it is influenced by the steps taken by
A. State Government
B. Central Bank
C. IMF
D. World Bank

7. The rate which is not determined by the government is known as
A. Fixed
B. Floating
C. Managed Float
D. None of these

8. The exchange rate at which demand for the foreign currency is equal to its supply is called
A. Equilibrium exchange rate
B. Equal exchange rates
C. Mint parity
D. All of the above

9. When the exchange rate is rises due to managed floating, it is called
A. Devaluation
B. Appreciation
C. Depreciation
D. Revaluation

10. ………… have been a major force in the globalization process connecting distant regions of the world?
A. Traders
B. International companies
C. Multinational corporations
D. Businesses houses

11. Suppose the Indian government puts a tax on the import of toys from China, what would happen?
A. Toys will get cheaper, more purchase by a consumer
B. No effect
C. Toys will get expensive, less purchase by a consumer
D. Toys will get expensive, more purchase by a consumer

12. ……….. is one such organization whose aim is to liberalize international trade?
A. WTO
B. UNC
C. IMF
D. ITO

13. What has been one major factor that has stimulated the globalisation process?
A. Availability of cheap labour in developing countries
B. Availability of unexploited resources in developing countries
C. Some countries are good in the landscape for natural resources
D. Rapid improvement in technology

14. What is used to contact one another around the world, to access information instantly, and to communicate from remote areas?
A. Mail and telephone
B. Information technology
C. Telecommunication.
D. B & C

15. Due to depreciation of domestic currency
A. Export rises
B. Import rises
C. Exports falls

D. None of the above

Answer for Self Assessment

1.	B	2.	C	3.	C	4.	C	5.	B
6.	B	7.	B	8.	A	9.	C	10.	C
11.	C	12.	A	13.	D	14.	D	15.	A

Review Questions

1. What do mean by fixed exchange rate?
2. Explain the merits and demerits of fixed exchange rate.
3. Discuss Flexible and floating exchange rate.
4. Explain the causes and consequences of financial crisis in global economy

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Unit12: FormsofEconomicCooperation

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12.3 International Trade

12.4 Developing Country Debts

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12.6 The Effects of Customs Union

Summary

Keywords

Self Assessment

Answer for Self Assessment

Review Questions

Further Readings

Objectives

After reading this Unit, students will be able to

- Discuss the International Economic Cooperation and International Trade.
- Explain Coordination of Macroeconomic Policy and Exchange Rates.
- Understand the emergence of trading Blocs
- Examine the rationale of a Customs Union (CU),
- Evaluate the benefits are expected from economic integration,
- Analyze the Static and Dynamic effects of Custom Unions.

Introduction

Although some form of economic cooperation has been a part of international political relations during most of this century, American interest in international economic cooperation has increased substantially. This heightened desire to coordinate economic policies with the other major economic powers is a response to the special problems of the 1980s: the sharp fluctuations in exchange rates, the massive shifts in the trade balance, and the explosive growth of debt, among many of the developing countries.

The increased interest in international economic cooperation also reflects the more fundamental changes in the world economy that have been evolving. The world economy has become more interdependent: international trade has increased relative to production for domestic markets and global capital markets have become larger and more active. In addition, the United States has lost the dominant economic position that it enjoyed in the early postwar years. Japan and the European Economic Community (EEC) have become major economic powers that compete effectively in trade and finance.

How has policy coordination evolved in this changing environment?

How have the changes in the world economy altered the problems and possibilities of international economic cooperation?

What are the prospects and potential benefits and costs of increased cooperation in the future?

Cooperation in macroeconomic and exchange rate policies generally means redirecting and increasing the economic role of governments. In contrast, cooperation in international trade involves reducing the interference of governments in private markets. Experience with the global debt problem has shown little explicit intergovernmental cooperation except for the Paris Club negotiations that deal with debts to the governments themselves. Therefore, it is helpful to consider the macroeconomic and exchange rate coordination and then turn to cooperation in international trade and dealing with global debt. In the aftermath of the breakup of the Soviet Union, trade among the newly independent states collapsed. Estimates vary, but the drop in volume terms may have been as much as 50% between 1992 and 1995 (see table 1). We have discussed the reasons and the consequences of this drastic decline elsewhere (Michalopoulos and Tarr, 1994; 1996).

The three Baltic countries decided, early on, to reorient their trade to Europe and the rest of the world, and all three have signed association agreements with the European Union.

The other twelve countries (members of the Commonwealth of Independent States (CIS)) attempted, mostly unsuccessfully, to maintain trade with each other through a variety of policy interventions, including the establishment of a Free Trade Agreement (FTA).

This Unit aims to analyze the economic implications of a customs union among transition economies, such as those established by these four countries, for both existing and prospective members. The next section of the paper describes the current trade regimes of the CIS, including the arrangements that govern trade with each other. The third section analyses the economic effects of the customs union, in part through the use of a partial equilibrium model described in detail in the appendix. The focus is on the impact of joining the customs union for countries that have not done so. As most CIS members apply for accession to the WTO, this section also draws some implications of the customs union for WTO accession. The last section summarizes the policy conclusions and the importance of the analysis. While the study focuses on the CIS countries, some of the findings may be relevant to other countries in transition--for example, among the countries of the former Yugoslavia that are considering the establishment of similar arrangements.

12.1 International Economic Cooperation

The objective development of diverse economic, scientific, and technological ties among individual countries and groups of countries and between the socialist and capitalist socio-economic and political systems is based on independence, equality, and mutual advantage. Essentially the process represents the intensification of the international division of labor.

The scientific and technological revolution, which has accelerated the international division of labor, and the USSR's growing economic strength and the entire world socialist system have increased the importance of international economic cooperation. Only after the appearance of socialism did genuine economic cooperation become possible, based on sovereignty and equality between states and peoples. The forms of economic cooperation within the socialist community and those within the capitalist economic system, while superficially similar, reflect the fundamental differences between the two opposing economic and sociopolitical systems.

Did you Know?

Theworldsocialist economic systemaffects the nature of economic cooperationnotonly between capitalist and socialist countries but alsobetweenthedevelopedcapitalistcountriesandthedevelopingcountries.

As a result of the continuing scientific and technological revolution, no single country, not even the most developed, can efficiently produce the entire range of modern products. Therefore, individual countries or groups of countries attempt to limit the range of goods they produce and produce them in huge quantities to meet not only their own needs but also the needs of other countries in exchange for the commodities that the other countries produce export. In this way, trade expands and a single world economy develops, each country providing the goods primarily it produces better and more cheaply than others.

International economic cooperation among the capitalist countries developed from simple forms of trade and exchange. At the imperialist stage, a complex and diverse system of international industrial ties arose between monopolies and monopolistic associations (such as international cartels, syndicates, and concerns), and intergovernmental economic unions were formed. The capitalist division of labor arose and developed, closely linked with the world capitalist market. Within the capitalist system, international economic cooperation is accompanied by fierce competition among monopolies and countries, by the intensification of irreconcilable contradictions, by the growing effect of the law of uneven economic and political development of capitalist countries in the age of imperialism, and by the narrowing of imperialism's sphere of influence and the growth of the world socialist system.

International economic cooperation includes foreign trade, credit relations, cooperation between countries in extracting natural resources, compensation arrangements, and extensive scientific and technical cooperation—for example, trade in licenses to produce certain goods and to use certain technological methods, joint scientific studies, and collaboration on major technical projects, in the construction of plants and other enterprises, in geological exploration, and in training national personnel.

The development of international credit has stimulated the expansion of international trade and other economic ties. The USSR maintains credit agreements with many countries, primarily the socialist and the developing countries. Of the 2,765 plants and other enterprises being built with Soviet technical assistance, 1,898 are in socialist countries and 858 are in developing countries; 1,680 projects had been completed as of Jan. 1, 1973 (1,263 in socialist countries and 412 in developing countries). The Soviet Union offers credits to banks and businesses in the advanced capitalist countries. It is participating in constructing a major metallurgical complex in France, providing machinery and equipment on credit. The Soviet Union is also seeking extensive long-term credits from the advanced capitalist countries, particularly to draw more rapidly into the economy the natural resourcesof Siberia and the Soviet Far East and to modernize Soviet industry and agriculture. The capitalist countries also stand to gain from such arrangements. Their unused monetary reserves can be put to profitable use; their credits can be repaid in products they need, such as natural gas, petroleum, and metals; and they can raise their level of employment.

The Soviet Union has developed such cooperation on both a bilateral and a multilateral basis with socialist countries wishing to obtain Soviet fuel, mineral, and forest resources,and has attracted capital investments from these countries. It contributes its own capital to such projects both in other socialist countries and in developing countries. Industrial complexes have been built on Soviet territory under bilateral agreements with the FRG, Japan, France, Finland, and the United States.

International economic cooperation in the form of compensation arrangements is becoming increasingly common. After receiving credit and purchasing the necessary equipment and technology from another country, the USSR constructs enterprises to produce a commodity, repaying the credit with the commodity. The Soviet Union also participates in the construction of enterprises in other countries on the understanding that its credits and technical assistance will be repaid with the goods produced. It has concluded long-term compensation agreements (five, ten, or more years) for cooperation in extracting natural resources in countries to which it has extended credit.

Rapid scientific and technological progress, the increased scale of production, and the Soviet Union's economic goals require more rapid modernization of many enterprises and even entire industries, creating many opportunities for scientific and technical cooperation development. The Soviet Union is expanding its scientific and technical ties particularly with the COMECON countries, and it provides much technical assistance to developing countries. Hundreds of modern enterprises and other industrial units have been built abroad with the help of Soviet scientific and technological achievements, and tens of thousands of licenses, designs, and sets of technical data have been transferred. The sale and purchase of licenses to produce machines, instruments, or equipment or of licenses to employ technological processes for extracting or processing materials have become important in the USSR's economic relations with advanced capitalist countries. Companies in the United States, the FRG, Japan, France, and other countries seek to buy licenses in the USSR. The Soviet Union in turn is purchasing an increasing number of licenses from these countries. This attests to the high level of Soviet technology, which is aiding the advance of technical ideas throughout the world and which can make use of the most recent scientific and technological developments abroad.

The various forms of international economic cooperation enable the Soviet Union and the other countries of the socialist community to benefit economically from specialization and cooperation

within the scope of both the socialist and the world-wide division of labor, to bring natural resources into the economy more rapidly, and to accelerate the economic development of each country. A significant growth in the production of high-quality export goods allows the socialist countries to compete successfully on the world market with firms in the capitalist countries, to increase their sales and the influx of foreign currency, to raise the general quality of goods in the country, to increase output, and thereby to accomplish more effectively and rapidly their main task—that of raising the people's material and cultural living standard.

12.2 Coordination of Macroeconomic Policy and Exchange Rates

It is useful, however, to focus on the more explicit types of macro-economic and exchange rate coordination and, in this context, to consider two extreme positions. At one extreme is the idea that each country should manage its own domestic monetary and fiscal policies with a concern for its

own well-being only and without trying to consider the effect of its policies on the other countries of the world. A government may understand that its economy is affected by the policies adopted elsewhere and that its own policies affect other countries but still choose to make its policy decisions unilaterally. At the other extreme is the view that each (industrial) country should formulate its economic policies in explicit coordination with every other (industrial) country so that the policies are chosen to maximize world economic welfare as a whole, or at least to achieve a configuration of policies from which no country can be made better off without making some other country worse off.

Although this statement of the alternatives might suggest that international coordination is unambiguously better than the uncoordinated pursuit of national self-interest, it is essential to distinguish between the theoretical possibilities of idealized coordination and the realistic potential gains of practical coordination. In practice, despite its aspirations, international coordination may produce results that are not as satisfactory as those that result from each country's uncoordinated pursuit of national self-interest.

One reason why coordination may fail to achieve an improvement in world economic performance is that, as Stanley Fischer notes in his background paper, extensive statistical studies indicate that the monetary and fiscal policies of each country have only a relatively small effect on the level of economic activity and inflation in other countries. The potential gain from even perfect coordination is therefore likely to be small and easily overwhelmed in practice when the policies are less than ideal.

International policy coordination may fail to improve overall economic performance simply because the political officials who participate in these international negotiations choose policies that are politically convenient rather than economically sound. We know that this happens all too frequently at the domestic level.

The international negotiation process may also be counterproductive because it diverts attention and action from needed domestic policy changes. Governments may explicitly delay painful domestic policy changes as part of an international negotiating strategy designed to induce policy changes abroad that would make the domestic changes unnecessary. The emphasis on international negotiations may also rechanneled domestic political pressures away from needed reforms. Recent experience provides ample examples of both dangers. Germany and Japan have failed to stimulate domestic demand enough because of their reliance on continued exchange rate stability expectations. The U.S. Administration has diverted attention from the need for budget deficit reduction by emphasizing the favorable effects on U.S. exports of greater fiscal expansion abroad.

The ability of international macroeconomic coordination to permit countries to pursue more expansionary policies than would otherwise be possible is both a potential benefit and a potential danger. When a single country tries to expand by itself, it may soon fin d that rising imports create a balance of payments problem. A coordinated expansion by a group of trading partners can eliminate this balance of payments constraint and permit all of the countries to expand more than any of them could have done alone. When all economies are operating well below capacity, such coordinated expansion can provide gains for all. But the ability of coordination to circumvent the balance of payments constraint on expansionary policies also creates the temptation to overexpand. Without the automatic market check of a deteriorating balance of payments, governments may pursue inflationary policies that would otherwise be avoided. On balance, whether one regards the ability to achieve an expansion that would not be possible without

coordinated action as a reason to favor coordination or to oppose it depends on the likelihood that governments will use that ability to pursue inflationary policies.

There is a further problem that arises because it is generally far more difficult to alter budget and tax policies than to change monetary policy. Macroeconomic coordination may in practice be limited toa coordination of only monetary policies. This is particularly the case in the United States because fiscal policy is controlled by the Congress. Even when its majority is of the same party as the President, it may be reluctant to enact the tax changes, particularly tax increases, that a President wants. But the reliance on monetary rather than fiscal policy will also be true in other countries because of the greater political attention generated by changes in fiscal policy and the greater difficulty of reversing expansionary fiscal changes if they turn out to be inappropriate.

A monetary expansion or contraction is not generally an appropriate substitute for a fiscal change. For example, while tighter monetary policy in the United States could offset the aggregate demand effect of large budget deficits, it would not reduce real interest rates. More generally, monetary and fiscal policies that have equal expansionary effects at home can have opposite effects on the rest of the world. A fiscal expansion that raises real interest rates and appreciates the currency will unambiguously raise foreign exports and thereby stimulate the foreign economy. In contrast, a monetary expansion that temporarily reduces real interest rates will depreciate the currency and thereby reduce foreign exports.

The need to rely on monetary policy rather than fiscal policy is mainly a problem when the international coordination focuses on exchange rate stabilization. If the United States had been induced to stabilize the dollar in the early 1980s, it would have done so by increasing the money supply rather than by cutting the budget deficit. This in turn would have increased the rate of inflation in the United States. Moreover, although the rise in inflation and in the price level would be sufficient to reduce the nominal value of the dollar, the real exchange rate might soon be back to the level that would have prevailed without any change in monetary policy. A commitment to exchange rate stabilization that leaves real exchange rates unchanged but causes higher inflation must be regarded as counterproductive.

12.3 International Trade

Although the primary source of the unprecedented rise of the U.S. trade deficit between 1982 and 1986 was the increase in the value of the dollar and therefore indirectly the growth of the U.S. budget deficit, the political response to the trade deficit has been an increase in attention to the specific problems of foreign competition and international trade practices. Unfortunately, much of this response has been a harmful backsliding from free trade to various sorts of restrictions on the flow of goods to the United States. Recent years have witnessed the cartelization of key international markets, the introduction of so-called voluntary restraints on a wide range of exports to the United States, and the tightening of U.S. import quotas on textiles with the threat of much more protectionism to come as a result of the pending trade legislation.

Of course, not all of the political response to the trade deficit has been harmful. The concern about the

U.S. trade balance has spurred a more assiduous pursuit of policies aimed at reducing foreign import barriers, especially those of Japan and some of its East Asian neighbors. Although these policies cannot eliminate the massive U.S. trade deficit as long as the dollar remains overvalued, they can increase the opportunity for American firms and employees to do more in those areas where they have a comparative advantage.

Cooperation in international trade requires not active ecomanagement of the economic environment but a negotiated reduction in government interference with private trade and investment flows. The golden rule of international trade is the double negative injunction : "Do not unto others what you would not have them do unto you."

The major trade rounds of the past quarter century have been successful in achieving sharp reductions of tariffs and quotas. But now, as several of the conference participants noted, improving the international allocation of resources requires a reorientation of the trade negotiations.

Government subsidies to domestic industries engaged in international competition must be reduced. This is true of agricultural policies in every major industrial country. It is also increasingly true of a wide range of manufacturing industries in Europe as well as in many developing

countries. Progress in these areas will be difficult not only because such subsidies restrain powerful domestic political

interests but also because it will involve extending international trade negotiations outside traditional lines into subjects previously regarded as domestic concerns. A similar extension of international trade negotiations into domestic policies is required to reduce purchasing restrictions of government buyers in transportation and telecommunications and to improve the international allocation of investment, the production of services, and the protection of patents and other forms of intellectual property. The current Uruguay Round of trade negotiations has recognized the importance of these issues. Only time will tell whether the potential gains from a better international division of labor and the negotiating skills of the parties will together be powerful enough to overcome the powerful domestic interests that stand in their way.

12.4 Developing Country Debts

Despite the conference's overarching theme of international cooperation and coordination, a striking feature of the presentations and discussion about the less-developed countries' (LDC) debt problem was the virtual absence of explicit references to intergovernmental coordination. That aspect of the conference is of course just a reflection of the way the international debt problem has been handled in practice.

Despite the desire of some commercial bankers, academic economists, and others to get governments individually and collectively to play a larger part in the resolution of the debt problem, the governments have been understandably reluctant to assume such a role. When governments have acted, they have generally mainly acted independently. The United States provided several "bridge" loans at an early stage in the debt crisis until commercial bank and IMF funding could be arranged. The Japanese government is now proposing to provide longer term credits on a unilateral basis and through the IMF, the World Bank, and the regional development banks. Individual governments have modified domestic banking rules to strengthen their domestic banks and encourage them to continue lending to the debtor countries, with an informal, ad hoc coordination of these banking "reforms" through the regular meetings of central bankers at the Bank for International Settlements. The only explicit intergovernmental coordination of policy was through the Paris Club meetings at which the governments acted in their roles as creditors of the specific borrowing nations. The IMF was the only official participant that played an explicit major role in dealing with the debts to private creditors.

Despite the minimal official government coordination in this area, there has been extensive private coordination among the commercial banks worldwide. The coordination committees of representatives of the major commercial banks have negotiated with the in dividual debtor governments on behalf of all the creditor banks. The debt problem has been managed by private international cooperation rather than by government coordination.

Looking ahead, the key role for official international cooperation in dealing with the debt problem should be maintaining open markers for the exports of the debtor countries. To service their debts while maintaining politically acceptable economic growth, the debtor countries must export. An increase in their exports will require a reorientation of domestic policies by the debtor nations, but it will only be possible if the creditor nations keep their markets open. Since the open markets of each creditor nation help all other creditors, and since the creditor nations as a whole have strong financial, economic, and political interests in the successful evolution of the debt problem, there is a powerful case for a coordinated agreement to maintain open markets for the products of these countries.

12.5 The Trade Regimes

While the trade policy framework continues to evolve and varies considerably among countries, the following main features characterize the trade regimes of CIS members: On the import side, most countries have avoided the establishment of quantitative restrictions or licensing. But protectionist pressures are rising and leading to the imposition of such controls in some countries (e.g., Uzbekistan) or sectors (alcoholic beverages-- in Russia).

The tariff regimes vary considerably, but countries have established few tariffs exceeding 30% on the whole. Some countries have low and uniform tariffs, e.g., Armenia's maximum tariff is 10% and

the Kyrgyz Republic has a 10% uniform tariff); while the range goes up to 100% for a few items in others. In Russia, the average is about 13-14%, ranging from 0 to 30% for most commodities, with some selected items considerably higher (see table 2 for details at a somewhat aggregated level).

There has been the significant dismantling of export controls on the export side in most countries. Still, controls of exports through state trading continue in some key exportable (cotton, oil and natural gas).

Trade with each other, is in principle free under the terms of the FTA. Imports are duty-free, but it appears that practice export and foreign exchange controls limit trade among some countries. Weaknesses in the payments systems continue to hamper trade, leading to continued use of barter; but the previous state-to-state barter agreements have been eliminated. Many countries have established a mixed VAT system: "origin" based for CIS trade and "destination" based with regard to the rest of the world. This means that imports are not taxed with respect to CIS countries, but domestic producers pay the VAT regardless of whether the good is exported or sold domestically. For the rest of the world, imports pay the VAT but exports are zero rated.

The Customs Union members negotiated a common external tariff based on the Russian tariff. But in the course of 1996, the three original members unilaterally introduced modifications to the external tariffs they applied to some commodities (Rietzler and Usmanova, 1996); also, as of the time of this writing, the Kyrgyz Republic had not taken any steps to introduce the common external tariff but instead continued to apply a uniform 10% tariff to imports from the rest of the world. All four countries are applying to the WTO on the basis of individual tariff schedules rather than as a custom union. Thus, strictly speaking, there is no common external tariff for the Customs Union. But the agreements are still in place and the governments may pursue further steps towards their full implementation.

12.6 The Effects of Customs Union

There are two kinds of effects of customs unions, static and dynamic. The static effects relate to the establishment of the customs union on welfare. The analysis in this instance focuses on comparing the welfare of a country or groups of countries before and after the establishment of the customs union; thus, the analysis is one of comparative statics.

The dynamic effects focus on the impact of the customs union on the output growth rate of a country or countries in the medium term. Many analysts have noted (Winters 1996) that supporters of customs unions and other regional preferential arrangements frequently fin d that the static welfare effects are typically small and possibly harmful. They then focus on the potential dynamic benefits, which are difficult to define and even more challenging to measure.

In the case of the CIS countries, there is already an FTA among all members as well as a Customs Union (CU) among some of them however modified by specific exceptions for variation from a common external tariff. Hence the analysis of both dynamic and static effects has to compare the advantages and disadvantages of joining this specific customs union not just any one, and assumes that in principle the alternative to joining, is continuation of the FTA among the CIS; but the implications of a different choice, under which countries that do not join the CU are excluded from the FTA area, also briefly examined.

Static Welfare Effects

The principal impact of joining the customs union would be to replace the external tariff of each of the countries with the standard external tariff of the customs union. In general, under these

circumstances the benefits of joining the CU would depend to a considerable extent on the height and structure of each of the countries external tariff compared to that of the Customs Union external tariff. While in practice a Customs Union external tariff may not be in place at present, for purposes of analysis, the Russian tariff is a good proxy of the Customs Union external tariff that had been negotiated and will be used for the discussion in this Unit. If a country such as Armenia or the Kyrgyz Republic with lower external tariffs were to substitute the Russian tariff for its own tariff structure, it would increase its unweighted average tariff to 13-14 percent (see table 2). More importantly, assuming that following accession of new members, the common external tariff is not changed, the Russian tariff exhibits considerably more dispersion compared with the tariff for some of the countries (typically between 0 and 30 percent),3 meaning that for selected highly protected

products in Russia, the tariff would increase significantly. For other countries, adopting the common external tariff would mean actually reducing their average tariff.

Starting with Jacob Viner (1950), international trade economists typically analyze preferential trade arrangements, whether members of a FTA or a CU, in terms of trade creation and trade diversion. Trade creation in a product occurs, when additional imports come from partner countries which displace sales of inefficient domestic producers and these imports are at least as cheap as imports from non-partner countries. Trade creation results in improved welfare for the importing country for much the same reasons as increased trade improves a country's welfare. On the other hand, trade diversion occurs when suppliers in the rest of the world (who continue to face tariffs) are more efficient than partner suppliers, but additional partner country imports displace the more efficient suppliers. Trade diversion is typically (but not necessarily) welfare reducing since the home country must pay more to import the product from the less efficient partner country suppliers.

Although the general theory of regional trading arrangements is quite ambiguous in its conclusions, we believe some definitive conclusions are possible with respect to the specific customs union under consideration, at least for some of the CIS countries. Since the partner countries in the potential customs union already have tariff free access to the other CIS markets under the Free Trade Agreement, prices in these countries' markets cannot fall as a result of the customs union, i.e., there will be little welfare gain from trade creation. Whatever trade creation would occur, would come from third country suppliers in those products where the current external tariff in the country is higher than that of the Customs Union external tariff. Since welfare costs from a tariff increase with the square of the tariff rate, net welfare effects are little impacted by reductions in tariffs by a few percentage points say, from ten to seven percent. Instead, the changes that involve significant tariff increases are crucial to the welfare effects.

Countries with Lower Tariffs Than in the Customs Union

Prospective partner country suppliers will have the potential, under the higher tariffs of the customs union, to raise prices to consumers in other CIS countries by the amount of the tariff preference over rest of world imports. In the model we present in the appendix, we assume that they will do so. A principal reason we believe they will do so is our judgment that advocates of the customs union propose it to expand protection for inefficient domestic industries throughout the CIS. The customs union is an import substitution strategy for inefficient industries, where the tariff structure is high in those industries that exist in the customs union, especially in Russia. In the appendix, we elaborate some additional reasons why we believe they will do so. Thus, a key assumption of our model is that prospective members of the customs union face upward sloping supply curves from partner country suppliers who will raise prices by the extent of the tariff.

Moreover, since these countries have tariff free access to markets of the customs union members and Russia in particular, the exporters from a CIS country joining the CU will not obtain improved access to the Russian market, which is by far the dominant market in the customs union. Thus, for countries like the Kyrgyz Republic and Armenia with already liberal external tariffs or others like Georgia and Moldova which are also pursuing generally liberal trade policies and assuming the common external tariff is not changed following their accession, the usual tradeoffs that must be considered in the evaluation of a preferential trade arrangement (trade diversion versus improved access and trade creation) do not apply. Thus, the CU would virtually result in pure trade diversion.

High tariff protection for such small economies is generally very inefficient and costly. Protection prevents the transmission of world prices to the economy and thereby prevents market signals from inducing resource reallocation to areas of comparative advantage in the economy. Experience has shown that countries with high protection generally grow more slowly than those with low protection over time. Moreover, we show in the appendix that increasing an external tariff within the framework of a customs union with Russia and the other partners for a small CIS country, is much more costly than simply raising tariffs, without preferential treatment to the customs union members. In fact, in this example the customs union will be several times more inefficient and costly to the small country than simply raising tariffs to the rest of the world in a non-preferential manner.

Joining the customs union with a common external tariff such as that previously negotiated is so costly for several reasons: First, partner country suppliers can raise prices under the tariff

protection they receive from preferential protection. Then for the quantities previously purchased from partner country suppliers, consumers in member countries with a once lower external tariff will likely pay higher prices (excluding the tariffs) to partner country producers than they were paying before participation in the customs union, i.e., there is an adverse terms-of-trade effect on the initial quantities purchased from partner country suppliers. Second, since rest of world imports are subject to a higher tariff, there will be a diversion of sales away from rest of the world suppliers toward partner country suppliers.

This trade diversion entails two costs: (a) since the importing country does not collect any tariff revenue on imports from partner countries, there is a loss of the tariff revenue on these diverting trade imports; and (b) excluding the tariff, consumers will have to pay higher prices to partner country suppliers than they were paying to rest of world suppliers prior to participation in the customs union.

In their comprehensive theoretical treatment, Bhagwati and Panagariya (1996) describe a model in which partner country suppliers have perfectly elastic supply curves. This situation might be expected to apply if a country is forming a preferential trade area with a huge market, such as the European Union or NAFTA because competition among many suppliers in the large market results in flat supply curves to the prospective new member country. In this case, there is a much larger likelihood of the preferential trade area being welfare increasing since the new member will not suffer a terms-of-trade loss on its purchases from the suppliers from the large market.

Countries with Higher Average Tariffs Than in the Customs Union

For countries with a higher average external tariff than that of the CU, the results are more ambiguous. On the one hand, in converting to the common external tariff, since the average tariff is lower than in the home country, there will be a number of products where the external tariff will be reduced.

Then there will be a welfare gain on those products where the external tariff is lowered Because there will be some trade creation from additional imports from rest of the world Suppliers (partner country suppliers already have tariff free access due to the FTA so no Additional trade creation is possible from CIS partners). On the other hand, the negotiated

Tariff of the CU is not uniform; rather, it favors the production of those products already produced in the CU Even in countries with higher average tariffs than in the CU, their tariffs typically favor their home production. Substitution of the CU tariff will shift the tariff structure so that it favors the producers of the CU, i.e., tariffs will be high on the products produced in the CU and low on the products produced in the home country, and it is likely that even in countries with higher average tariffs, they will have to raise their external tariffs on many products produced in their partner countries. This will allow partner country producers to charge higher prices under the protection of higher tariffs on third-country producers, a significant welfare loss that is likely to dominate. A choice available to a country in these circumstances is to lower its tariff on third countries, without joining the CU This option offers the gains from the trade creation on the products where the external tariff is being lowered, without the losses of the trade diversion from having to pay higher prices to inefficient partner country suppliers.

Russia, Kazakstan and Belarus. Finally, briefly consider the welfare impact on Russia, Kazakstan and Belarus, the members of the Customs Union which had adopted the standard external tariff.

Since the tariff structure favors production in these countries, then as more countries join the Customs Union, in the short run producers in these countries will gain additional profits and exports from the additional protection they receive against rest of world imports in the new partner country markets. Since the costs of protecting home producers will be borne in part by consumers in partner countries, the strategy has an initial appeal in the countries whose producers receive the high protection. But, because the benefits of a liberal trade regime to consumers are dispersed widely (presenting a free- rider problem where it is not typically worth it to individual consumers to lobby their governments for liberal trade actions) while the benefits of trade protection are concentrated in the industry receiving protection (which provides an incentive for the industry to lobby its government for protection), the kinds of preferential trade areas that will typically arise are those which are trade diverting (see Grossman and Helpman (1995)). Thus, in order for the existing members of the Customs Union to convince additional members to join, or at least to remain members over time, it is likely that the tariff structure will have to change in a way that

offers protection to producers of other CIS countries, i.e., the existing members will have to offer protection in their markets to high priced products produced in non-member CIS states.

Caution: Acountrywillnotparticipate inaCustomsUnioniftheCustomsUnionoffersneitherenhancedprotectionforitsproducersnorw idespreadbenefitsforitsconsumers.

Suppose the external tariff is adjusted to accommodate the inefficient producers of new members, although some of the producers of the existing member countries may still gain from a wider Customs Union. In that case, the benefits to the countries as a whole are going to be reduced and countries could become net losers. That is, the short-run gains to existing producers mask potential longer term costs of not opening up trade to the rest of the world. It is likely that the entire CIS is not collectively large enough to approximate world market efficiency in most products. Thus, a strategy of widening the protection of domestic producers through a Customs Union of a set of the CIS countries, is really an import substitution policy through protection on a slightly larger scale, a strategy that has retarded growth in many countries .

Revenue Effects

Due to the potential impact on the fiscal deficit, macro stabilization and inflation, governments must also be cognizant of the impact of preferential trade arrangements on their revenues. In this section, we examine various aspects of this question for the CIS countries.

Tariffs

Joining the customs union is likely to have negative revenue implications on Individual new members. As there will continue to be no tariffs on trade within the customs union, to the extent that rest of world imports are displaced, tariff revenue will be lost to the customs union. In addition, despite the fact that the customs union agreements stipulate that the tariff revenue will go to the country to whom the imports are destined, one can not overlook the potential administrative problems associated with obtaining tariff revenues from the customs offices of other member countries, especially given the weakness in tax reserve collections in all these countries. And there are other reasons to believe that revenues of imports from the rest of the world will be diminished. There are central administrative institutions of a customs union that will have to receive funding. Funding for the administration of the customs union or any centralized programs is typically done out of tariff revenue collected by the customs union.

Excise Taxes: Accession to the customs union will increase pressure on members to harmonize excise tax rates. These rates are presently rather diverse both within the CU countries and potential members. The tax revenue implications of unified rates would have to be assessed in each case individually.

Value Added Taxes. The dominant practice among the CIS countries is to apply the value added tax (VAT) on a mixed basis. That is, for trade outside of the CIS, imports are taxed but exports are not, the

"destination" system. For trade within the CIS, exports are taxed but imports are not, the "origin system." Participation in the customs union will require a value added tax that is harmonized with the system applicable in the customs union, i.e., the current mixed system. Berglas (1981) has shown that under certain assumptions (including flexible exchange rates) the origin or destination systems are equivalent and do not tax the trade regime if designed properly. Since the VAT rates of most CIS are approximately equalized, the allocation of real resources and trade flows among the other CIS countries is not seriously affected, but it is important to harmonize these taxes within a mixed system to avoid arbitrage and distortions.

What is more likely to be a problem with a mixed VAT system is the allocation of tax revenues. Even if the VAT rates are harmonized, countries with a trade deficit within the customs union and a trade surplus outside the customs union will experience an adverse transfer of VAT tax revenues toward the partners in the customs union with the opposite trade pattern. To illustrate, suppose the trade of Azerbaijan is balanced overall, but it imports exclusively from, say Russia, and exports exclusively outside the customs union, and that Russia has the opposite trade balance.

Since the destination system applies on trade outside of the CIS, and the origin principle applies on trade within the CIS, Azerbaijan would collect no VAT tax revenues (neither on its imports nor its exports), and Russia would collect all the VAT revenue on trade (Russia collects VAT on both its

exports to Azerbaijan and its imports from the rest of the world). Thus, even though the mixed VAT system would not change relative prices and is therefore non-distortionary because there is no impact on the allocation of resources, in this example it would represent a transfer of VAT revenues from Azerbaijan to Russia.

Dynamic Effects

In general, there are two basic ways in which the rate of output growth can increase: First through a faster growth of factor inputs and second through increases in the growth of total factor productivity. Assuming no changes in population growth and in labor force participation rates, the growth of factor inputs essentially boils down to the rate of investment in human and physical capital. Total factor productivity on the other hand is thought to be dependent in the medium and long term on improvements in technology and knowhow.

More generally, access to a diverse mix of products including modern technology appears to be very important for the growth process. New and diverse technologies are constantly appearing and these new technologies allow an increase in the productivity of both capital and labor.

The question that needs to be addressed then is how a customs union among the CIS countries will affect output growth through its impact on access to technology that enhances productivity and through its effects on the rate of investment in human and physical capital.

There is some evidence that developing countries total factor productivity is positively related to the access of technology and knowledge embodied in imports from developed countries. In the case of CIS and other transition economies, access to diverse and modern intermediate products from world markets appears especially crucial as these economies attempt to transform themselves from an industrial structure that was inherited from the era of the former Soviet Union, i.e., that was outdated and frequently not based on comparative advantage. It is very important that these countries move away from reliance on technologies that are available only in the countries that were part of the former Soviet Union, since the most dynamic and modern technologies are found elsewhere. Yet, tariff protection for products that are produced in the customs union will discourage the introduction of new products and technologies from outside the customs union and free trade area, technologies that would boost the growth and development of the CIS members. Thus, on the question of enhancing growth through improvements in total factor productivity the effect of the customs union (and for that matter of the exisitng free trade area) on all its members is likely to be very negative.

There are several ways through which a customs union could affect the rate of investment in member countries: (a) through a change in tariffs and hence in the cost of imported capital equipment that changes the rate of return on investment and the rate of capital accumulation; (b) through affectingthe financial system and the overall stability and effectiveness of economic policies that improve the climate of investment; (c) by providing an incentive to foreign direct investment to locate and produce in the countries of the Union as opposed to exporting goods and services.

Unfortunately, it is difficult to make a credible case that these effects would be positive in the case of a customs union in the CIS. First, it is likely that the cost of imported capital would actually increase especially for some of the smaller members, as they could obtain capital goods more cheaply from third countries. Second, while there are plans for greater integration of the financial systems and economic policies of members, which may positively impact the climate of investment in the future, there is very little chance that any of this will happen in the immediate future. In fact, premature integration without adequate multilateral institutions may resurrect some of the problems of the recent past which contributed to instability. For example, the common ruble area of 1992-1993, without monetary coordination of the multiple central banks was a root cause of inflation and trade problems. The key challenge in all countries is improving the national environment for private sector development by establishing policies and institutions (for example, better enforcement of contractual obligations) that improve the investment climate--policies that may best be pursued unilaterally in the near term. Third, it is possible that as result of the establishment of the customs union, there may be a positive effect on foreign investment that comes in to "jump" the common external tariff. How big this effect will be is hard to predict simply because there are so many other factors that constrain the inflow of foreign direct investment which countries need to address first and which are likely to have a far greater impact on foreign direct investment than the stimulus provided by the establishment of a customs union. More

importantly, foreign direct investment which is in response to tariff jumping can cause the welfare and growth rate of the capital importing country to decline. The reason is tht foreign investment responds to the private return to capital, and the foreigners will repatriate profits based on their private returns; but when the sector is highly protected, the social return to investment in the sector is much lower than the private return.

In sum, while the dynamic effects of establishing or joining a customs union and of the exisiting Free Trade Area in the CIS are difficult to demonstrate, they are likely to be negative, especially because of the adverse effect of the preferential arrangements on technology and productivity improvements.

The Threat of the Loss of the Free Trade Agreement: In the event that a CIS country fails to join the customs union, there is some possibility that the members of the customs union would apply the common external tariff to the exports of that CIS country; that is, they may revoke their Free Trade Agreements. Although we must be cautious since the effects will vary from country to country and we do not have precise estimates, the net welfare impact of participation in the Free Trade Agreement is likely to be negative for most CIS countries; consequently, the threat of exposure to the common external tariff of the customs union is not an event that should be feared for most CIS countries.

The reasons are as follows: If Russia, Kazakstan and Belarus, withdraw from the Free Trade Agreements and apply the negotiated common external tariff of the customs union to exports from the other CIS countries, there would be economic impacts on both the imports and the exports of these CIS countries. Regarding imports, as explained in detail in the appendix, applying tariffs on imports from former partner countries in the CIS results in displacement of partner country imports by rest of world supply. This results in a gain in tariff revenue on these sales. Moreover, since partner country suppliers are likely, in many products, to lower their prices to the extent of reduction of the tariff on rest of world products (since marginally inefficient partner country suppliers will be forced out of the market as competition from rest of world producers becomes more intense), CIS consumers will be able to pay less to partner suppliers by the amount of the tariff, and this is a gain to their economic welfare. Moreover, permitting efficient imports from the rest of the world instead of preserving inefficient imports from partners in the former Soviet Union is very productive in breaking away from the outdated and inefficient technology of the Soviet past.

Weighed against this potential benefit from applying tariffs on imports in the CIS is the loss in welfare from lost preferential access to the markets of countries in the Customs Union. Exporters from the CIS countries outside the Customs Union would no longer be able to obtain higher prices than producers from the rest of the world on exports to the countries in the Customs Union, since like

exporters from the rest of the world, their exports would also be subject to the tariff. But since the negotiated tariff of the Customs Union is based on the Russian external tariff, it tends to be high in those items important to Russian producers. That is, products important to the exports of the CIS tend to be inputs into production in Russia and therefore have relatively low tariffs in the Customs Union.

Although we must again be cautious since this effect will vary from country to country and we do not have precise estimates, this implies that most CIS countries outside Russia, Belarus and Kazakstan likely derive little terms of trade gain on their exports to the Customs Union, from the fact that they are in the Free Trade Agreement. That is, most CIS countries perhaps with the exception of Ukraine, would likely be able to sell the vast majority on their products in the same markets with small losses losses that are considerably smaller than the losses suffered by their consumers from having to pay higher prices to the exporters from the Customs Union.

Moreover, the dynamic effects of the free trade area could also be negative for all its members. It would be desirable for CIS exporters to find alternate marketing channels outside of the CIS Customs Union countries. This would reduce dependence on a limited number of countries for markets and transportation facilities. Absent Free Trade Agreements, it will become even more imperative for exporters from the CIS to find alternate markets and marketing channels. Moreover, while finding new markets outside of the Customs Union countries may require a difficult adjustment period, the experience of the Baltic countries between 1992 and 1994 demonstrates that rapid adjustment is possible.

Converting the Free Trade Area to a Customs Union

Now consider the impact of imposing the common external tariff at the rate t', starting with the Free Trade Agreement. The supply curve, including the tariff of the rest of the world and the new equilibrium price increases to P.R. (1+t'), where the quantity demanded for imports declines to M1. Partner country suppliers also receive this higher price and then the quantity they supply increases to Q1. The quantity supplied from the rest of the world declines to M1 - Q1.

The welfare costs to country A are strongly negative, and may be decomposed into three parts. First, there are consumer deadweight losses because country A consumers are induced to reduce their consumption of total imports from Mo to M1 in favor of alternate goods available that were previously less preferred (this could include domestic substitutes in this product category or goods in other product categories). These were equal to the triangle ADL in the initial equilibrium, but they increase to BCL. The difference is the shaded area ABCD, representing the increase in consumers' deadweight loss due to the common external tariff. Second, there is an increase in the triangle of producers' deadweight losses, from NGH to NFE.

The difference is the shaded area FEHG, representing the increase in producers' deadweight loss due to the imposition of the common external tariff. Partner country producers are able to obtain higher prices in country A, which attracts less efficient higher cost supply. Absent a tariff, supplies from the rest of the world would have been available at the price P.R. Third, part of the higher prices received by partner country suppliers results in an increase in their profits or producers' surplus. The increase in partner country profits or producers surplus is HIJE; this is a transfer from country A consumers to producers in partner countries. Overall the loss of moving to the customs union, given that a Free Trade Agreement is already in place, is the sum of the three shaded areas in Figure 1: ABCD + FEHG + HIJE.

Given a Free Trade Agreement, the losses to the economy of increasing tariffs through the common external tariff of the customs union are considerably greater than non-preferential tariff increases from an average rate of t to t'. That is, if tariffs were applied in a non-preferential manner and were increased from t to t', the costs to the economy of the increase in the tariff would be the shaded area ABCD. The customs union imposes the additional costs equal to the areas FEHG and HIJE, representing inefficiency losses and transfers to partner country suppliers, respectively.

Combined Loss of the Customs Union and the Free Trade Agreement

The combined loss of the Free Trade Agreement and the customs union is larger than the loss of the customs union or the Free Trade Agreement alone and equals the triangle BCL plus the rectangle

MFEJ. A non-preferential tariff of rate t' would produce a welfare loss equal to the triangle BCL. The difference is equal to the area MFEJ which derives from the fact that consumers in country A pay higher prices to partner country producers than they would have to pay to rest of the world producers. The area MFEJ would be captured for country A as tariff revenue and not lost to the economy if the tariff were not preferential. Instead with a the combination Free Trade Agreement and customs union the area MFEJ is added to the losses of country A, thereby greatly magnifying the losses. The area MFEJ represents a combination of transfers to partner country suppliers (the area MNEJ) plus inefficiency (deadweight) losses of using marginally inefficient partner country suppliers (the triangle NFE). It is necessary to reduce this estimate of the losses by the increase in the terms of trade earned by exporters from country A on their sales within the PTA. Since the tariff primarily benefits existing Customs Union members, these gains may be expected to be small.

Summary

- For small CIS countries, with relatively open trade regimes, joining the Customs Union that several CIS members have established could be economically quite costly. These costs could be mitigated, but probably not fully offset, if as a consequence of the entry of new members, both the average level and the dispersion of the previously negotiated external tariff of the customs union were reduced. Maintaining an open trade regime without

preferences is the best policy for these countries that maximizes welfare and growth prospects. It will also facilitate entry into the WTO, a key objective for these countries' trade policies.

- Even for the existing customs union members and others with more restrictive trade regimes than existing members, preferential arrangements that provide strong incentives to orient trade towards partners in the former Soviet Union contain significant long-term risks. The main risks are that the preferences (through customs union or free trade arrangements) lock in traditional technologies and production structures, reduce innovation and competition, and hence result in inefficient industries that absorb scarce resources that could be better used elsewhere.
- The discussion has focused on preferences and a specific customs union arrangement among CIS countries. But it has relevance for preferential arrangements, including customs unions, that might be considered in the context of other country groupings in the CIS as well as in transition economies in Eastern Europe, e.g. former Yugoslavia. In this case as well, the main problems would arise from lack of competition and the absence of dynamic technology. The discussion is not intended to apply to countries in transition joining the E.U., where different circumstances prevail which improve the prospects for economic benefits.
- A tariff will induce inefficiency losses, but preferential trading areas with partners with upsloping supply curves greatly magnify the losses. This explains why preferential trade arrangements with small partner countries or with countries that may be expected to increase supply at higher protected prices can be expected to be very inefficient, more inefficient than non-preferential tariff protection at the same rate.
- The key difference between preferential arrangements among CIS members an d other preferential arrangements (NAFTA, the E.U.) is that in the latter the markets are large enough to promote competition and encourage the flow of new technology which increase the probability that distortions introduced through preferences are more than offset by new trade creation and the dynamic effects of investment embodying new technology.
- We had advocated preferential arrangements for CIS members as useful transitional devices to mitigate the severe disruption of trade among the new independent states in the aftermath of the breakup of the Soviet Union (Michalopoulos and Tarr, 1992; 1994). Although based on duration of unemployment measures, two years appears to be a sufficient period of adjustment in market economies,11 there is no standard period for adjustment or transition; and the breakup of the Soviet Union clearly created unprecedented disruption which may have warranted a greater adjustment period. The new independent states have had five years to adjust to international competition. Given the inherited burden of inefficiencies that plagues a sizable portion of CIS industry, there are serious costs of continuing preferential arrangements indefinitely, and integrating more closely through a customs union at this time appears ill advised.

Keywords

1. Trade Creation: When trade between custom union partners increases, this implies a shift in the Union to more efficient, competitive producers
2. Trade Diversion: When imports from the less expensive world market are replaced by imports from a higher cost / less efficient partner country within the customs union

3. Trade expansion: When lower market prices in one partner country stimulates total domestic demand which is satisfied by increased foreign trade with another partner country
4. Economic Integrations: It refers to trade unification between the different states by the partial and full abolishing of customs tariffs on the trade

Note: *The government obtains tariff revenue on the imports from the rest of the world, equal to the rectangle GHAD, but imports from partner countries enter without paying tariffs.

Self Assessment

1. Which one of the following sets of countries contains only members of the European Union (EU)?

A. France, Spain, Switzerland, UK
B. Germany, Italy, Portugal, Sweden
C. Denmark, Greece, the Netherlands, Poland
D. Belgium, Greece, Italy, Portugal

2. If good X of country C faces a 10% tariff in country A and a 20% tariff in country B, but if A and B have free trade between each other, then A and B are part of which one (and only one) of the following types of groupings?

A. Free trade area
B. Customs union
C. Common market
D. Economic union

3. If country A forms a customs union with country B, then

A. country B continues to get tariff revenue from country A's exports sent to B.
B. all new trade between A and B because of the union is known as "trade creation".
C. the welfare of A and B must necessarily be enhanced, especially if A and B begin to buy many items from each other that they used to buy from the :"outside world".
D. A and B may especially benefit from the union if substantial economies of scale exist in some of the A and B industries.

4. If two countries remove all tariffs on each other's products and establish a common set of tariffs against the rest of the world, but take no further steps toward economic integration, these two countries have formed .

A. a free trade area
B. a customs union
C. a common market
D. an economic union

5. Which of the following is considered to be a positive dynamic effect of integration?

A. economic-of-scale effects
B. reduced customs costs
C. trade division
D. the increased monopoly power of firms

6. A ____ is a regional trading bloc in Which member countries eliminate internal trade barriers but maintain existing barriers against countries that are not member?

A. free trade area
B. customs union
C. common market
D. monetary union

7. Which of the following is not the positive effect of the trade bloc?

A. Co-operative Spirit
B. Expansion of the market
C. Uniform Policies

D. Import Restrictions

8. When was ASEAN established?
A. 1996
B. 1967
C. 1963
D. None of the above

9. Which of the country is not the part of NAFTA?
A. Great Britain
B. Canada
C. México
D. The United States

10. Which of the following is / are the objectives of the trade Bloc?
A. Maintaining better relations
B. Imposing barriers on non-member countries
C. Promoting free transfer of labor, capital and other factors
D. All of the above

11. Trade diversion takes place when?
A. a country moves from autarky to free trade
B. a movement to a customs union reduces the costs of trade through standardization economic integration results in a
C. economic integration results in a movement in product origin to a lower cost member country
D. economic integration results in a shift in product origin from a lower-cost, nonmember country to a member country having higher costs

12. Trade creation will more likely outweigh trade diversion for Country X that forms a customs union if the level of tariffs in Country X prior to the customs union is ________ and the total number of countries forming the customs union is _________?
A. relatively high; relatively large
B. relatively high; relatively small
C. relatively low ; relatively large
D. relatively low ; relatively small

13. What of the following is/are the relevance of the Commercial Policy?
A. Contributes to functioning of CU and Single Market
B. EU laws and community right to conclude trade agreement
C. Strengthens the bargaining power of EU versus individual states
D. All of the above

14. Antidumping duties are used to?
A. offset the margin of dumping
B. punish domestic consumers for buying high-priced imported goods
C. discourage foreign governments from subsidizing their exporters
D. reduce the tariff revenue of the domestic government

15. If a tariff and import quota lead to equivalent increases in the domestic price of steel, then?
A. the quota results in efficiency reductions but the tariff does not
B. The tariff results in efficiency reductions but the quota does not
C. They have different impacts on how much is produced and consumed
D. They have different impacts on how income is distributed

Answer for Self Assessment

1.	D	2.	A	3.	D	4.	B	5.	A

6.	A	7.	D	8.	B	9.	C	10.	D
11.	D	12.	A	13.	D	14.	A	15.	D

Review Questions

1. What is meant by trade regimes?
2. Write a short note on the effects of Custom Union. Discuss.
3. Discuss the dynamic and static effects of custom union.
4. What are the reasons for economic reforms
5. What challenges are faced by economic reforms?

Further Readings

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Unit 13 : Multilateralism and WTO

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Objectives

After reading this Unit students will be able to:

- understand the genesis of WTO,
- overview of WTO – its principles & functions,
- evaluate the emergence of IMS with reference to developing and developed Countries.

Introduction

The World Trade Organization (WTO) is the sole international body that deals with international trade rules. It establishes a framework for international goods and services trade. In the set of multilateral agreements covered later in this chapter, it establishes governments' rights and obligations. It includes a wide variety of topics relating to international trade, such as intellectual property rights protection and dispute resolution, and sets disciplines for states in developing laws, procedures, and practises in these areas, in addition to goods and services. Furthermore, in particular sectors, such as export pricing at unusually low prices, it applies firm-level discipline.

The fundamental goal of the WTO's rule-based international trade system is to ensure that international markets remain open and that access to them is not hampered by the arbitrary imposition of import restrictions. Under the Uruguay Round, all member countries' national governments secured enhanced access to their markets, allowing businesses to turn trade concessions into new commercial prospects. Manufacturing industries and businesses profit not only from growing legal systems, but they also gain rights as a result of them. The WTO also covers areas of concern to foreign businesses, such as customs valuation, pre-shipment inspection services, and import licencing procedures, with an emphasis on transparency to prevent non-tariff obstacles from being erected. Exporters' rights and domestic processes for taking action against dumping of imported goods are also spelled out in the agreements. An international business manager must gain a solid awareness of the WTO's global trading system's new opportunities and challenges.

13.1 WTO (World Trade Organization

The World Trade Organization (WTO) was established on January 1, 1995, as the successor of the General Agreements on Tariffs and Trade (GATT). Its origins can be traced back to the late 1940s,

when the economy of most European countries and the United States were severely affected by the war and the Great Depression of the 1930s. As a result, in November 1947, a United Nations Conference on Trade and Employment was held in Havana. It resulted in the Havana Charter, an international accord to establish an International Commerce Organization (ITO), a United Nations specialized organization to handle the trade side of international economic cooperation. The draught ITO charter was ambitious, encompassing restrictions on employment, commodities agreements, restrictive business practices, international investment, and services in addition to world trade discipline. The attempt to establish the ITO, however, was thwarted because the United States refused to ratify it, and other countries found it difficult to implement it without US cooperation.

The combined package of trade rules and tariff concessions negotiated and agreed by 23 countries out of 50 participating countries became known as General Agreement on Tariffs and Trade (GATT): an effort to salvage from the aborted attempt to create the ITO. India was also a founding member of the General Agreement on Tariffs and Trade (GATT), a global pact aimed at trade liberalization. Between 1948 and 1994, the GATT provided an international platform for discussing trade issues and lowering trade barriers. Its membership grew from 23 nations in 1947 to 123 countries in 1994, as indicated in Exhibit. Throughout these 47 years, GATT remained a provisional agreement and organization that greatly aided tariff reduction. During the period of its operation, from 1948 to 1994, average tariffs on manufactured goods in developed countries fell from around 40% to around 4%. An anti-dumping agreement and a section of development within the GATT were only adopted during the Kennedy round of negotiations in 1964-67. During the Tokyo round, the first major attempt to address non-tariff barriers was made. The eighth round of negotiations, known as the Uruguay Round, took place from 1986 to 1994 and resulted in the establishment of the World Trade Organization (WTO) with a new set of accords.

WTO vs GATT

The distinguishing features of WTO vis-a-vis erstwhile GATT are as follows :

GATT remained a 'provisional' agreement and organization throughout 47 years during 1948 to 1994, whereas WTO commitments are permanent.

Exhibit:MultilateralTradeRoundsunderGATT/WTO			
Year	**Roundname**	**Subjectscovered**	**Countries**
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Dillon	Tariffs	26
1964-67	Kennedy	Tariffsand anti-dumpingmeasures	62
1973-79	Tokyo	Tariffs, non-tariffmeasures,framework	
		agreements	102
1986-94	Uruguay	Tariffs,non-tariffmeasures,rules,	
		services,intellectualproperty,dispute	
		settlement,textiles,agriculture,creation	
		ofWTO,etc.	123
2001-present	Doha	Tariffsongoods,Non-agriculturemarketaccess(NAMA),specialanddifferentialtreatment,tradefacilitation,etc.	150

Source : WTO.

- GATT rules mainly applied to trade in goods, whereas WTO covers other areas, such as services, intellectual property, etc.
- GATT had contracting parties, whereas WTO has members.
- GATT was essentially a set of rules of the multilateral treaty with no institutional foundation, whereas WTO is a permanent institution with its own Secretariat.
- A country could essentially follow domestic legislation even if it violated a provision of the GATT agreement which is not allowed by the WTO.
- In WTO, almost all the agreements are multilateral in nature involving commitment of the entire membership, whereas a number of GATT provisions by the 80s were plurilateral and therefore selective.
- The WTO also covers certain grey areas, such as agriculture, textiles and clothing, not covered under the GATT.
- The dispute settlement system under the WTO is much more efficient, speedy, and transparent unlike the GATT system which was highly susceptible to blockages.

Why Should a Country Join the WTO ?

Despite the disciplinary framework for conduct of international trade under the WTO, countries across the world including the developing countries were in a rush to join the pack. The WTO has nearly 153 members, accounting for over 97 per cent of world trade. Presently, 34 governments hold observer status, out of which 31 are actively seeking accession, including large trading nations, such as Russia and Taiwan. The major reasons for a country to join the WTO are

- Each country requires access to foreign markets because it needs to sell its goods and services in order to receive foreign exchange for necessary imports such as capital goods, technology, fuel, and occasionally even food. Countries, on the other hand, need permission to export their goods and services to other countries. As a result, bilateral agreements between countries are required. The necessity for individual bilateral agreements is eliminated when a country joins a multilateral framework like the WTO, as member countries are able to export and import products and services among themselves.
- Under bilateral accords, an individual country is unlikely to secure a better deal than it would in a multilateral system. It has been noticed that developing countries had to commit to developed countries in bilateral agreements to a higher extent than the WTO requires.
- Being a member of the community of countries allows a country to benefit from the experiences of others and influence the WTO decision-making process.
- The WTO's dispute settlement system, which functions as an in-built mechanism for enforcing member countries' rights and responsibilities, provides some protection against subjective actions by other countries.
- It would be strange to remain outside of the World Trade Organization's (WTO) framework for conducting international trade, which has been in place for nearly six decades and accounts for over 97 percent of global trade. Others could even think it's suspicious.

Functions of WTO

The major function of the WTO is to ensure the flow of international trade as smoothly, predictably, and freely as possible. This is a multilateral trade organization aimed at evolving a liberalized trade regime under a rule-based system. The basic functions of WTO are

- To make trade agreements' implementation, administration, and operation easier.

- To provide a venue for member countries to continue negotiations on problems covered by the accords as well as new subjects that come within its mission.
- Its member countries' conflicts and disputes are resolved.
- to conduct periodic evaluations of its member countries' trade policy
- Through technical aid and training programmes, assist developing nations with trade policy concerns.
- other international organizations to collaborate with

Decision Making

A majority vote is also possible but it has never been used in the WTO and was extremely rare in the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments. Unlike other international organizations, such as the World Bank and the IMF, in WTO, the power is not delegated to the board of directors or the organization's head.

Organizational Structure of the WTO

The organizational structure of WTO as summarized in Figure l, consists of the Ministerial Conference, General Council, council for each broad area, and subsidiary bodies.

First level : The Ministerial Conference

The Ministerial Conference is the topmost decision-making body of the WTO, which has to meet at least once every two years.

Second level : General Council

Day-to-day work in between the Ministerial Conferences is handled by the following three bodies:

- The General Council
- The Dispute Settlement Body
- The Trade Policy Review Body

In fact, all these three bodies consist of all WTO members and report to the Ministerial Conference, although they meet under different terms of reference.

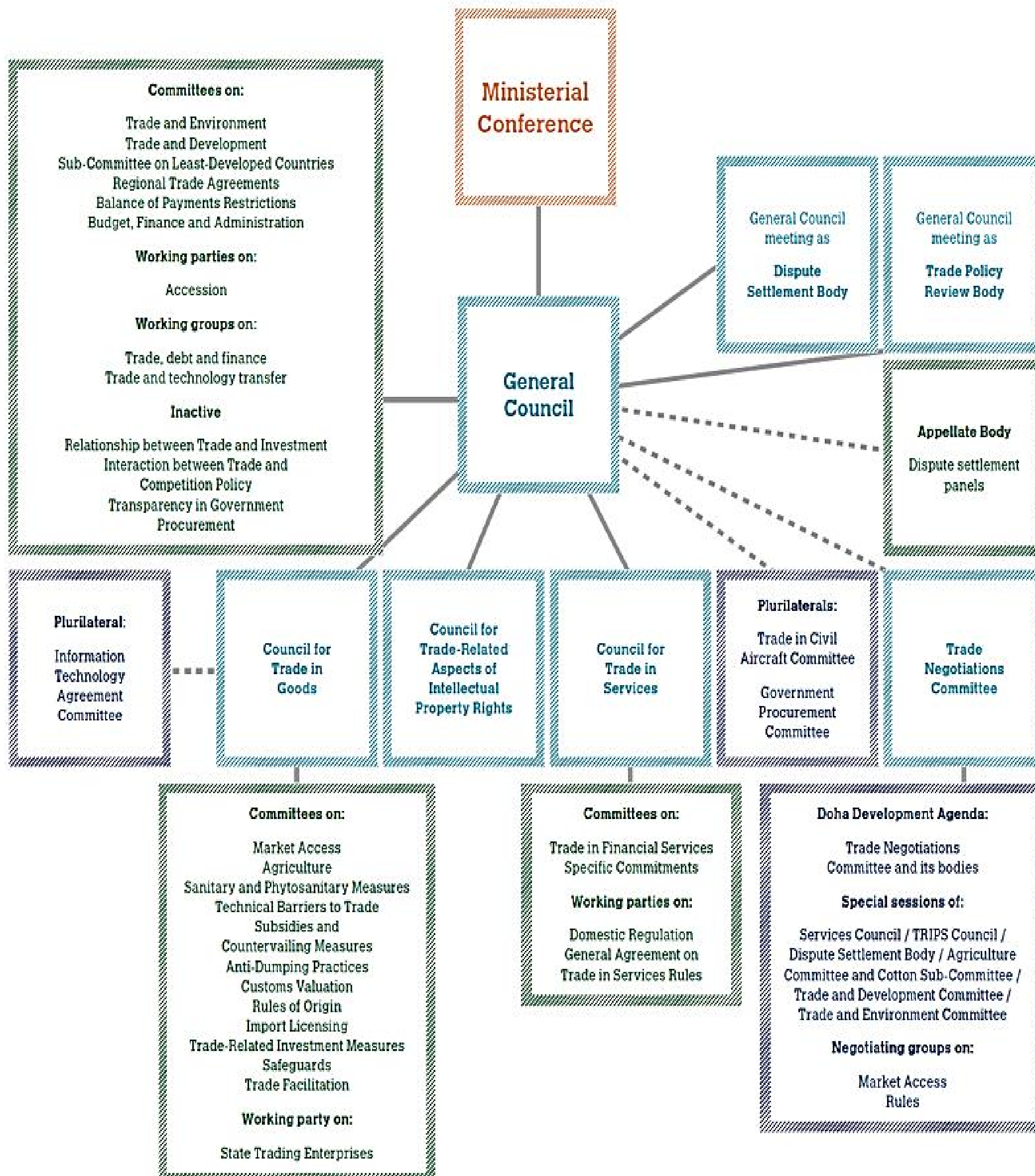
Third level : Councils for each broad area of trade

There are three more councils, each handling a different broad area of trade, reporting to the General Council.

- The Council for Trade in Goods (Goods Council)
- The Council for Trade in Services (Services Council)
- The Council for Trade Related Aspects of Intellectual Property Rights (TRIPS Council)

Each of these councils is made up of all WTO members and is in charge of implementing the WTO agreements that deal with their specific trade areas. There are also auxiliary bodies for these three. Six other entities, known as committees, also report to the General Council but have a narrower scope. They address topics like trade and development, the environment, regional trading agreements, and administrative difficulties. In December 1996, the Singapore Ministerial Conference voted to form new working groups to study investment and competition policies, government procurement openness, and trade facilitation.

Figure 13.1: WTO Structure



Fourth level : Subsidiary bodies

Each of the higher councils has subsidiary bodies that consist of all member countries.

Goods Council : It has 11 committees dealing with specific subjects, such as agriculture, market access, subsidies, anti-dumping measures, etc.

Services Council : The subsidiary bodies of the Services Council deal with financial services, domestic services, GATS rules, and specific commitments.

Dispute settlement body : It has two subsidiaries, i.e., the dispute settlement 'panels' of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals at the General Council level.

Formally all of these councils and committees consist of the full membership of the WTO. But that does not mean they are the same, or that the distinctions are purely bureaucratic. In practice, the people participating in the various councils and committees are different because different levels of seniority and different areas of expertise are needed. Heads of missions in Geneva (usually ambassadors) normally represent their countries at the General Council level. Some of the committees can be highly specialized and sometimes governments send expert officials from their countries to participate in these meetings. Even at the level of the Goods, Services, and TRIPS

councils, many delegations assign different officials to cover different meetings. All WTO members may participate in all councils, etc., except the Appellate Body, dispute settlement panels, textile monitoring body, and plurilateral committees.

The WTO has a permanent Secretariat based in Geneva, with a staff of around 560 and is headed by the Director-General. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the Secretariat does not have the decision-making role those other international bureaucracies are given. The Secretariat's main duties are to extend technical support for the various councils and committees and the Ministerial Conferences, to provide technical assistance for developing countries, to analyse world trade, and to explain WTO affairs to the public and media. The Secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

13.2 Principles of the Multilateral Trading System Under the WTO

For an international business manager, it is difficult to go through the whole of the WTO agreements which are lengthy and complex being legal texts covering a wide range of activities. The agreements deal with a wide range of subjects related to international trade, such as agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, and intellectual property. However, a manager dealing in international markets needs to have an understanding of the basic principles of WTO which form the foundation of the multilateral trading system. These principles are discussed below.

Trade without discrimination

Under the WTO principles, a country cannot discriminate between its trading partners and products and services of its own and foreign origin.

Most-favoured nation treatment : Countries are not allowed to discriminate amongst their trading partners under WTO rules. If a country gives a special favour to someone (such as a lower customs rate for one of their items), it must do the same for all other WTO members. Most-favoured-nation (MFN) treatment is the principle. This paragraph is so significant that it is the first item of the General Agreement on Tariffs and Trade (GATT), the international agreement that oversees goods trade. The idea of MFN is also a priority in the General Agreement on Trade in Services (GATS, Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS, Article 4), albeit the principles are treated differently in each agreement. These three accords, taken together, encompass the WTO's three primary areas of trade.

Some exceptions to the MFN principle are allowed as under :

- Countries can set up a free trade agreement that applies only to goods traded within the group

—discriminating against goods from outside.

- Countries can provide developing countries special access to their markets.
- A country can raise barriers against products that are considered to be traded unfairly from specific countries.
- In services, countries are allowed, in limited circumstances, to discriminate.

But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners—whether rich or poor, weak or strong.

National treatment: The World Trade Organization (WTO) stipulates that imported and domestically produced commodities should be treated equally—at least after the foreign goods have reached the market. Foreign and domestic services, as well as foreign and domestic trademarks, copyrights, and patents, should all be treated the same. All three major WTO agreements, namely, Article 3 of GATT, Article 17 of GATS, and Article 3 of TRIPS, contain the notion of "national treatment" (providing outsiders the same treatment as one's own citizens). The principle, however, is handled differently in each of these accords. Once a product, service, or piece of intellectual property has hit the market, it receives national treatment. As a result, levying a

customs duty on an import does not constitute a violation of national treatment, even if no corresponding tax is imposed on locally manufactured goods.

Gradual move towards freer markets through negotiations

One of the most obvious ways to encourage international trade is to lower trade barriers. Customs duties (or tariffs) and policies that restrict quantities selectively, such as import bans or quotas, are examples of such barriers. There have been eight rounds of trade negotiations since the GATT was established in 1947-48. Initially, they aimed to reduce tariffs (customs duties) on imported goods. By the mid-1990s, industrial countries' tariff rates on industrial goods had consistently declined to less than 4% as a result of the discussions. However, by the 1980s, the talks had broadened to include non-tariff barriers to commodities as well as new areas like services and intellectual property. The WTO agreements allow nations to gradually implement changes through a process known as "progressive liberalisation." Developing countries are typically granted more time to meet their responsibilities. .

Increased predictability of international business environment

Promises not to raise trade barriers are sometimes just as significant as promises to lower them since they provide firms a clearer picture of their future market potential. With stability and predictability, investment is encouraged, jobs are created, and consumers can fully enjoy the benefits of competition—choice and lower prices. Governments use the multilateral trading system to try to make the business environment more stable and predictable.

One of the Uruguay Round's accomplishments was to expand the volume of commerce that was subject to binding commitments. When countries agree to open their markets for products or services in the WTO, their pledges are 'bound.' These binders act as a ceiling on customs duty rates for commodities. A country's bindings can be changed, but only after negotiations with its trading partners, which may include compensating them for lost commerce. In agriculture, all products now have tariffs that are bound. As a result, traders and investors should expect a far higher level of market security.

In addition, the WTO's trading system aims to promote predictability and stability in other ways. One option is to discourage the use of quotas and other measures to put limitations on import volumes, as implementing quotas can result in more red tape and false allegations. Another is to make trade rules as plain and open (transparent) as feasible between countries. Many WTO accords compel nations to either publicly reveal their policies and practises inside their own country or to notify the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

Promoting Fair Competition

The WTO is sometimes described as a 'free trade' institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair, and undistorted competition.

The anti-discrimination rules—MFN and national treatment—are intended to ensure that trade conditions are fair. The WTO has also established regulations on dumping and subsidies that harm fair trade. The concerns are complicated, and the laws attempt to define what is fair and unfair trade, as well as how governments can respond, such as by levying additional import tariffs to compensate for the harm caused by unfair trade. Many other WTO accords, such as those in agriculture, intellectual property, and services, attempt to promote fair competition. The government procurement agreement (known as a 'plurilateral' agreement because only a few WTO members have signed it) extends competition laws to thousands of government bodies in numerous nations.

13.3 WTO Agreements : An Overview

WTO agreements are often referred to as 'trade rules' and hence the WTO is described as a 'rule-based' system. These rules are actually agreements negotiated by the member countries' governments. The WTO agreements fall in a broad structure of six main parts as under :

- An umbrella agreement (the agreement establishing WTO)
- Agreements for each of the three broad areas of trade covered by WTO

— Goods
— Services
— Intellectual property

- Dispute settlement
- Reviews of governments' trade policies

In addition to intellectual property, the WTO agreements cover two core areas: goods and services. Agriculture, health regulations for farm products (SPS), textiles and clothing, product standards, investment measures, anti-dumping measures, customs valuation methods, pre-shipment inspection, rules of origin, import licencing, subsidies and counter-measures, and safeguards are all covered by GATT agreements for goods. GATS addresses topics such as natural person mobility, air transport, financial services, shipping, and telecommunications. Furthermore, because these agreements are negotiated on a regular basis, they are dynamic rather than static. The new agreements can be incorporated into the overall bundle. The Doha Development Agenda, for example, is now being negotiated following the Doha Ministerial Conference.

General Agreement on Tariffs and Trade

The General Agreement on Tariffs and Trade (GATT) has significantly widened the access to international markets, besides providing legal and institutional framework. Under the WTO regime, countries can break the commitment (i.e., raise the tariff above the bound rate), but only with difficulty. To do so, a member country is required to negotiate with the countries most concerned and that could result in compensation for trading partners' loss of trade.

Opening Up of the Industrial Sector

GATT market access schedules contain pledges from member nations to cut tariffs and not to raise them above the indicated rates, implying that the rates are fixed. Bound rates are the rates that are often charged in industrialised countries. The bound rates in most developing nations are slightly higher than the actual rates paid, therefore they can operate as a ceiling.

Reduction in tariffs : In schedules appended to the Marrakesh Protocol to the General Accord on Tariffs and Trade, 1994, which is a legally binding agreement, individual member countries have listed their promises to reduce tariff rates. Developed countries were required to reduce average tariff levels on industrial products by 40% in five equal instalments beginning January 1, 1995, under these pledges. However, the percentage of tariff reduction on some products of export interest to developing countries, such as textiles and clothing and leather and leather products is much lower than the average, as they are considered sensitive. A number of developing countries and economies- in-transition agreed to reduce their tariffs by nearly two-thirds of the percentage achieved by developedcountries. As a result, the weighted average levels of tariffs applicable to industrial products were expected to fall in a period of five years from

- 6.3 per cent to 3.8 per cent in developed countries
- 15.3 per cent to 12.3 per cent in developing countries
- 8.6 per cent to 6 per cent in the transition economies

Additional commitments were made under the Information Technology Agreement in 1997, in which 40 countries representing more than 92 percent of global trade in information technology products agreed to eliminate import duties and other charges on most of these products by 2000, and on a small number of them by 2005. As with other tariff obligations, each participating country applies its commitments equally to exports from all WTO members, i.e. on a most-favoured-nation basis, including those from members who did not make the commitments.

Tariff bindings : Besides the commitments to reduce tariffs, market access schedules represent commitments on the part of member countries not to increase the tariffs above the listed rates known as 'bound' rates. Bin ding of tariff lines has substantially increased the degree of market security for traders and investors.

Opening Up International Business Opportunities in Textiles

Over the last four decades, a slew of bilateral quota agreements have governed global textile and garment commerce. Under five expansions of the multi-fiber agreement, the range of products covered by quotas grew from cotton textiles under the 1960s and early 1970s short-term and long-term arrangements to an ever-growing list of textile items derived from natural and man-made fibres. The Multi-fibre Arrangement governed global textile commerce from 1974 to the end of the Uruguay Round (MFA). This was a framework for bilateral or unilateral agreements that created import quotas for countries whose domestic sectors were being severely harmed by fast rising imports.

The MFA quota system ran counter to GATT's preference for customs taxes over quantity-restricting measures. Quotas were also deviations to the GATT concept of treating all trading partners equally because they stated how much the importing country would take from different exporting countries.

The WTO's Agreement on Textiles and Clothing (ATC) has been the WTO's significant agreement since 1995, taking over from the MFA.

The agreement's implementation was overseen by a Textile Monitoring Body (TMB). It kept track of the agreement's actions to make sure they were consistent, and it reported to the Council on Trade in Goods and reviewed how the agreement was working. Under the ATC, the TMB was also in charge of resolving disputes. The disagreements could be brought before the WTO's regular Dispute Settlement Body if they do not get resolved.

General Agreement on Trade in Services

The General Agreement on Trade in Services (GATS) is the first and only multilateral agreement that governs international services trade. It was designed in response to the substantial growth of the services industry over the last three decades and the increased potential for marketing services worldwide brought about by the communications revolution, and was negotiated in the Uruguay Round. The GATS has three elements :

1. The main text containing general obligations and disciplines
2. Annexes dealing with rules for specific sectors
3. Individual countries' specific commitments to provide access to their markets, including indications where countries are temporarily not applying the most-favoured nation principle of non-discrimination.

General obligations and disciplines : The agreement covers all internationally-traded services, e.g., banking, telecommunications, tourism, professional services, etc. It also defines four ways (or 'modes') of trading services internationally :

Mode 1 : Services supplied from one country to another (e.g., international telephone calls), officially known as 'cross-border supply'

Mode 2 : Consumers or firms making use of a service in another country (e.g. tourism), officially 'consumption abroad'

Mode 3 : A foreign company setting up subsidiaries or branches to provide services in another country (e.g., foreign banks setting up operations in a country), officially 'commercial presence'

Mode 4 : Individuals travelling from their own country to supply services in another (e.g., fashion models or consultants), officially 'presence of natural persons'

Most-favoured-nation treatment : MFN also applies to the service sector, where trading partners of a member country must be treated equally under the principle of non-discrimination. If a government authorises foreign competition in a sector, GATS requires that service providers from all other WTO members be offered equal opportunity in that sector. This is true even if the government has made no formal commitment under the WTO to allow foreign enterprises access to its markets. MFN applies to all services, however countries that currently have preferential service agreements with their trading partners have been granted exceptional temporary exemptions. Exemptions of this nature are expected to last no more than ten years.

Commitments on market access and national treatment : The Uruguay Round negotiations resulted in individual countries' commitments to open markets in specific areas and the amount of their openness. The obligations are listed in'schedules,' which detail the sectors that will be opened,

the level of market access that will be provided (for example, if there will be any limitations on foreign ownership), and any restrictions on national treatment (whether some rights granted to local companies will not be granted to foreign companies). A market-access pledge, for example, is when a government agrees to enable foreign banks to operate in its domestic market. And if the government sets a limit on how many licences it will give, it is a market-access restriction. If it also states that international banks are only permitted to open one branch while domestic banks are permitted to open many branches, this is an exception to the concept of national treatment.

These explicitly stated commitments are 'bound,' similar to bound tariffs for goods trade, and they can only be changed following talks with the countries impacted. Because 'unbinding' is difficult, the agreements are essentially guaranteed terms for foreign service exporters and importers, as well as service sector investors.

GATS expressly excludes government services, and there is nothing in the agreement that mandates a government to privatise service industries. The carve-out is an express commitment on the part of WTO states to enable publicly funded services in core areas of their jurisdiction. Governmental services are those that are not provided commercially and do not compete with other suppliers, according to the agreements. These services are not subject to any GATS discipline, are not subject to the discussions, and are not covered by the agreements on market access and national treatment.

Transparency: Governments are required to publish all applicable laws and regulations as well as establish inquiry points within their bureaucracies under the GATS. These inquiry points can then be used by foreign corporations and governments to learn about rules in any service industry. In addition, any change in legislation that relate to services that come under particular commitments must be reported to the WTO by member nations' governments.

Objectivity and reasonability of regulations : The agreement states that governments should regulate services in a reasonable, objective, and unbiased manner because domestic regulations are the most important way of exerting influence or control over services trade. When the government makes an administrative decision that affects a service, it should also establish an independent review mechanism (e.g., a tribunal). GATS does not mandate the deregulation of any service. Governments' rights to set quality, safety, and pricing levels, as well as to introduce restrictions to achieve any other policy goal, are unaffected by commitments to liberalise. A commitment to national treatment, for example, would simply mean that overseas suppliers would be subject to the same laws as domestic suppliers. Governments, of course, maintain the power to set qualifications for doctors and attorneys, as well as to establish norms to safeguard consumer health and safety.

Recognition : When two or more governments have agreements recognizing each other’s qualifications (e.g., the licensing or certification of service suppliers), GATS says other members must also be givena chance to negotiate comparable pacts. The recognition of other countries’ qualifications must not be discriminatory, and it must not amount to protectionism in disguise. These recognition agreements have to be notified to the WTO.

International payments and transfers : Once a government has agreed to open a service sector to global competition, it cannot typically impose restrictions on money being transferred out of the country as payment for services provided (current transactions). The sole exception is when there are balance-of-payments problems, and even then, the restrictions must be temporary and subject to other constraints.

Progressive liberalization : GATS required more discussions, which began in early 2000 as part of the Doha Development Agenda, because the Uruguay Round was merely the beginning. The purpose is to accelerate the liberalisation process by increasing the number of schedule commitments.

Complexity of International Trade in Services

International trade in goods is a relatively simple idea to grasp—a product is transported from one country to another. Trade in services is much more diverse. Telephone companies, banks, airlines, and accountancy firms provide their services in ways quite different from each other. The GATS annexes cover some of the diversity as discussed here.

Movement of natural persons : This annex deals with negotiations on individuals’ rights to stay temporarily in a country for the purpose of providing a service. It specifies that the agreement does not apply to people seeking permanent employment or to conditions for obtaining citizenship, permanent residence, or permanent employment.

Financial services : Instability in the banking system affects the whole economy. The financial services annex gives governments very wide latitude to take prudential measures, such as those for the protection of investors, depositors, and insurance policy holders, and to ensure the integrity and stability of the financial system. The annex also excludes from the agreement services provided when a government is exercising its authority over the financial system, e.g., central banks' services.

Telecommunications : The telecommunications sector has a dual role : it is a distinct sector of economic activity, and an underlying means of supplying other economic activities (such as, electronic money transfers). The annex says governments must ensure that foreign service suppliers are given access to the public telecommunications networks without discrimination.

Air transport services : Under this annex, traffic rights and directly related activities are excluded from GATS' coverage. They are handled by other bilateral agreements. However, the annex establishes that GATS will apply to aircraft repair and maintenance services, marketing of air transport services, and computer-reservation services.

The capabilities of services and areas of interest in industrialised and developing countries are substantially different. Developed countries have long sought to exert pressure on developing countries to gain access to their markets in their areas of special interest, such as financial and communications services, which were given priority in the negotiation process. On the other hand, industrialised countries have been reticent to expand their markets in Mode 4 and Mode 1 service sectors that are of interest to developing countries.

India's efforts have focused on obtaining legally enforceable pledges in the areas of cross-border service supply (Mode 1) and natural person movement (Mode 2). (Mode 4). The competence of India's service professionals drives Mode 4 objectives, while its significant competitive edge in IT and IT enabled services drives Mode 1 objectives (ITeS). India has pushed for the removal of the Economic Needs Test, a clear definition of the length of stay, and opportunities for extension, among other things. Some of these concerns have been addressed in the Hong-Kong Ministerial Declaration, which lays out a roadmap for domestic regulatory discipline development.

Agreements on Anti-dumping Practices

The WTO agreement on anti-dumping allows governments to act against dumping where there is genuine (material) injury to the competing domestic industry. A product is considered to be dumped if

- The export price is less than the price charged for the same product in the exporting country, or
- It is sold for less than its cost of production

To do so, the government must be able to demonstrate that dumping is occurring, quantify the extent of dumping (the difference between the export price and the exporter's home market price), and demonstrate that dumping is causing or threatens to cause injury. Anti-dumping action often entails levying an additional import tariff on a specific product from a certain exporting country in order to bring its price closer to its "normal value" or to alleviate injury to the importing country's domestic sector.

There are several methods for determining whether a product is being dropped heavily or gently. The agreement reduces the number of possibilities available. It offers three approaches for determining a product's 'normal value.' The most common way is to use the pricing in the exporter's home market. When this is not possible, the price charged by the exporter in another country or a computation based on the exporter's manufacturing costs, other expenses, and regular profit margins are the only options. The agreement also outlines how a fair comparison between the export price and a normal price can be made.

Anti-dumping actions can only be used if dumping is causing harm to the importing country's industry. As a result, a thorough inquiry must first be carried out in accordance with established procedures. All relevant economic factors that have an impact on the state of the industry in question must be evaluated as part of the study. If the inquiry reveals that dumping is occurring and that domestic industry is being harmed, the exporting company can agree to raise its price to an agreed-upon level in order to avoid paying anti-dumping duties.

The procedures for initiating anti-dumping complaints, conducting investigations, and ensuring that all interested parties are given the opportunity to present evidence are all spelled out in detail. Anti-dumping measures must be lifted five years after they were imposed unless an examination reveals that doing so would cause harm.

When authorities find that the margin of dumping is insignificantly tiny, anti-dumping investigations must be terminated promptly (defined as less than 2 per cent of the export price of the product.) Besides, the investigations also have to end if the volume of dumped imports is negligible, i.e., if the volume from one country is less than 3 per cent of total imports of that product, although investigations can proceed if several countries, each supplying less than 3 per cent of the imports, together account for 7 per cent or more of total imports.

All preliminary and final anti-dumping actions must be reported to the committee on anti-dumping practises promptly and in detail by member countries. Members can consult each other and use the WTO's dispute resolution system if they have disagreements.

India has been the leading user of anti-dumping measures in the world (Fig.2) followed by the US, the European Community, Argentina, South Africa, Australia, Canada, Brazil, China, and Turkey.

Emergency Protection from Imports

A WTO member may restrict import of a product temporarily (take 'safeguard' actions) if its domestic industry is seriously injured or threatened with injury caused by a surge in imports. Safeguard measures were always available under GATT (Article 19); however, they were infrequently used. A number of countries preferred to protect their domestic industries through 'grey area' measures—using bilateral negotiations outside GATT's auspices. They also persuaded exporting countries to restrain exports 'voluntarily' or to agree to other means of sharing markets. Agreements of this kind were reached at for a wide range of products among countries, e.g., automobiles, steel, and semiconductors.

The WTO's safeguards accords restrict "grey-area" measures and place time limits (sunset clauses) on all safeguard activities. On the export or import side, the agreement states that members must not seek, take, or maintain any Voluntary Export Restraints (VERs), Orderly Marketing Arrangements (OMAs), or any other similar measure. At the end of 1998, the bilateral measures that had not been adjusted to comply with the agreement were phased out. Only the European Union took advantage of this provision, which allowed countries to keep one of these policies in place for an additional year (until the end of 1999).

Governments may be asked to take precautionary measures by industries or businesses. The WTO agreement establishes requirements for national authorities to conduct safeguard investigations. Transparency and adhering to established standards and practises are emphasised, avoiding the use of arbitrary approaches. A safety measure should only be used to the amount necessary to prevent or cure serious injury, as well as to assist the affected industry in adapting. Quantitative restrictions (quotas) should typically not reduce import volumes below the yearly average for the last three representative years for which statistics are available, unless there is clear reason that a different level is required to prevent or rectify substantial injury.

In principle, safeguard measures cannot be targeted at a specific country's imports. A safeguard measure should not be in place for longer than four years, though it might be extended to eight years in exceptional situations. When a government limits imports to protect its own manufacturers, it must, in theory, give something in return. Exports from underdeveloped countries are partially protected from safeguard actions. An importing country can only impose a safeguard measure on a product from a developing country if the developing country supplies more than 3% of the product's imports, or if developing country members with less than 3% import share collectively account for more than 9% of the product's total imports.

The WTO's Safeguards Committee is in charge of overseeing the agreement's operations and monitoring members' commitment. Each aspect of a safeguard inquiry and related decision-making must be reported to the committee, and the committee reviews these reports.

Attempting to Reduce Non-tariff Barriers

Aside from import taxes, a multinational corporation must contend with a slew of bureaucratic and regulatory obstacles in the target nations, all of which obstruct the free flow of commerce. Such

barriers are commonly used to prevent market access and are frequently criticised as arbitrary due to their lack of transparency. The increasing use of non-tariff measures (NTMs) by developed countries, such as health and safety rules, technical restrictions, environmental controls, customs valuation procedures, and labour laws, has become a major obstacle to market access for developing-country exports. Agricultural products, textiles, leather products, and other products with lower value addition and technology content (agriculture products, textiles, leather products, and so on) are of particular importance to countries like India.

Import Licensing Procedures

Import licencing procedures are often regarded as difficult, opaque, and unpredictable, and have been utilised to prevent foreign items from entering the market. The Import Licensing Procedures Agreement aims to make import procedures easier and more transparent. The agreement mandates that governments make appropriate information available to foreign merchants so that they may understand how and why licences are given. It also explains how nations should notify the WTO when they implement new or amend existing import licencing procedures. The agreement outlines how countries should evaluate licence applications. The agreement establishes conditions for the automatic issuing of certain licences in order to ensure that the methods utilised do not impede commerce. The agreement aims to reduce the administrative burden on importers when applying for licences, so that administrative work does not impede or distort imports. According to the agreement, licencing authorities should not take more than 30 days to process an application. When all applications are considered at the same time, however, 60 days is allowed.

Customs valuation

The process of calculating the worth of a product at customs can be just as difficult for importers as the actual duty amount levied. The WTO agreement on customs valuation aspires for a fair, uniform, and neutral system for valuing products for customs purposes—a system that is based on business reality and prohibits the use of false or arbitrary customs values. The agreement establishes a set of valuation regulations that expands and clarifies the original GATT's provisions on customs valuation.

The agreement recognizes that the prices obtained by different importers for the same product may vary. The mere fact that the price obtained by a particular importer is lower than that at which other importers have imported the product, cannot be used as a ground for rejecting the transaction value. Customs can reject the transaction value in such situations only if it has reasons to doubt the truth or accuracy of the declared price of the imported goods. Even in such cases it has to give importers an opportunity to justify their price and if this justification is not accepted, customs has to provide importers in writing the reasons for rejecting the transaction value and for determining the dutiable value by using other methods. Further, by providing importers the right to be consulted throughout all stages of the determination of value, the agreement ensures that the discretion available to customs for scrutinizing declared value is used objectively.

The agreement also requires national legislation on the valuation of goods to prove the following rights to importers :

- Right to withdraw imported goods from customs, when there is likely to be a delay in the determination of customs value, by providing sufficient quantities, in the form of surety or a deposit, covering the payment of customs duties for which goods may be liable
- Right to expect that any information of a confidential nature that is made available to customs shall be treated as confidential
- Right to appeal, without fear of penalty, to an in dependent body within the customs administration and to judicial authority against decisions taken by customs

Pre-shipment inspection

Pre-shipment inspection is the practise of using specialised commercial companies (or 'independent entities') to inspect the shipping details—basically the price, quantity, and quality—of products ordered from another country. The primary goal of pre-shipment inspection is to protect national

financial interests (for example, by preventing capital flight, commercial fraud, and customs duty evasion) and to compensate for administrative infrastructure deficiencies.

Governments that use pre-shipment inspection are bound under the Pre-shipment Inspection Agreement. Nondiscrimination, transparency, the protection of confidential corporate information, the avoidance of undue delay, the adoption of particular rules for performing price verification, and the inspection agencies' avoidance of conflicts of interest are all examples of such requirements. Non-discrimination in the implementation of domestic laws and regulations, quick publishing of those laws and regulations, and, where requested, technical assistance are among the obligations of exporting members toward nations that use pre-shipment inspection.

The International Federation of Inspection Agencies (IFIA), which represents inspection agencies, and the International Chamber of Commerce (ICC), which represents exporters, have agreed to develop an independent review system. Its goal is to settle disagreements between an exporter and a government inspection agency.

Rules of origin

‘Rules of origin’ are used as the criteria to define where a product was made. They are an essential part of trade rules because a number of policies, such as quotas, preferential tariffs, anti-dumping actions, countervailing duty (charged to counter export subsidies), etc., discriminate between exporting countries. Rules of origin are also used to compile trade statistics, and for ‘made in...’ labels that areattached to products. This is complicated by globalization and the way a product can be processed in several countries before it is ready for the market.

WTO countries are required by the Rules of Origin Agreement to guarantee that their rules of origin are transparent and do not limit, distort, or disrupt international commerce. The Rules are applied consistently, uniformly, fairly, and in a reasonable manner. In the long run, the agreement aims for all WTO members to have common (harmonised) rules of origin, with the exception of certain types of preferential trade, such as countries establishing free trade zones being allowed to use different rules of origin for products traded under their free trade agreement.

Agreement on Trade Related Investment Measures

When foreign investors use investment to expand their businesses internationally, host governments frequently set conditions on them in order to encourage them to invest in accordance with particular national priorities. The Trade Related Investment Measures (TRIMs) Agreement acknowledges that certain policies might limit and distort investment. It states that no member may take any action that discriminates against foreigners or foreign products (i.e., violates GATT's principles of "national treatment"). It also prohibits investment measures that lead to quantity limitations (violating another GATT principle) and measures that mandate a specific level of local procurement by an enterprise (known as "local content requirements"). It also opposes restrictions that limit a company's imports or impose export targets (known as 'trade balance requirements').

Countries, on the other hand, are free to impose export performance standards as a condition of investment. They can also demand that a certain amount of ownership be held by local investors, that a foreign investor bring in the most up-to-date technology, or that a foreign investor do a certain quantity or type of R&D locally. All investment initiatives that do not comply with the agreement must be reported to fellow members through the WTO, according to the agreement.

Plurilateral Agreements

Except for four agreements negotiated at the Tokyo Round, all WTO agreements became multilateral agreements. The four exceptions are referred to as plurilateral accords because they only had a few signatories.

Fair trade in civil aircraft

The Civil Aviation Trade Agreement, which now has 30 signatories, went into effect on January 1, 1980. All aircraft, save military aircraft, and their parts and components, are exempt from import tariffs under the agreement. The agreement also establishes rules for government-directed civil

aircraft procurement and inducements to buy, as well as government financial assistance for the civil aircraft industry.

Opening up of competition in government procurement

The government and its agencies are the largest importers of goods of all kinds in most countries, ranging from basic commodities to high-tech equipment. Simultaneously, political pressure to favor domestic suppliers over overseas competitors can be considerable. In these countries, it creates significant impediments for foreign marketing organizations.

During the Tokyo Round, an agreement on government procurement was negotiated and put into force on January 1, 1981, with the goal of opening up as much of this business as possible to foreign competition. The agreement was created to make government procurement laws, regulations, procedures, and practices more transparent while also ensuring that they do not favor domestic products or suppliers while discriminating against foreign products or suppliers. Tendering procedures are covered by a considerable portion of the general rules and obligations.

The WTO Government Procurement Agreement went into force on January 1, 1996, and covers services (including construction services), sub-national procurement (e.g., states, provinces, departments, and prefectures), and public utility procurement. It also reinforces rules guaranteeing fair and non-discriminatory conditions of international competition.

For instance, governments are required to put in place domestic procedures by which aggrieved private bidders can challenge procurement decisions and obtain redress in the event such decisions were made inconsistently with the rules of the agreement. The agreement applies to contracts worth more than specified threshold values.

The International Dairy Agreement and International Bovine Meat Agreement, the two plurilateral agreements, were scrapped at the end of 1997. Countries that had signed the agreements decided that the sectors were better handled under the Agriculture and Sanitary and Phytosanitary agreements.

Ensuring Transparency in Trade Policy

An international marketing firm needs to know as much as possible the conditions of trade in the target market. The Trade Policy Review Mechanism (TPRM) aims to achieve transparency in regulations in the following ways :

a. Governments have to inform the WTO and fellow-members of specific measures, policies, or laws through regular 'notifications'.
b. The WTO conducts regular reviews of individual countries' trade policies, i.e., trade policy reviews. The objectives of trade policy review are :

- To increase the transparency and understanding of countries' trade policies and practices, through regular monitoring
- To improve the quality of public and inter-governmental debate on the issues
- To enable a multilateral assessment of the effects of policies on the world trading system

Members' own trade policies and practises are the focus of the evaluations. However, they also consider a country's broader economic and developmental needs, as well as its policies and ambitions, as well as the external economic environment in which it operates. Other WTO members' 'peer assessments' encourage nations to adhere more closely to WTO rules and standards, as well as to fulfil their promises. These assessments allow outsiders to gain a better understanding of a country's policies and situations, as well as provide input on the country's performance within the system.

Over a period of time, all WTO members were to come under scrutiny. The frequency of the reviews depends on the country's size.

- The four biggest traders—the European Union, the US, Japan, and Canada (the 'Quad')—are examined approximately once every two years.

- The next 16 countries (in terms of their share of world trade) are reviewed every four years.
- The remaining countries are reviewed every six years, with the possibility of a longer interim period for the least developed countries.

For each review, two documents are prepared—a policy statement by the government under review, and a detailed report written independently by the WTO Secretariat. These two reports, together with the proceedings of the Trade Policy Review Body's meetings are published; these publications which may be consulted while making strategic business decisions.

13.4 Ministerial Conferences and Emerging Issues

The highest decision-making body in the WTO is the Ministerial Conference (MC) that has to take place once in two years. Six ministerial conferences have taken place so far and have generated a lot of debate and controversies across the world, as discussed here.

Singapore Ministerial Conference

The first MC took place at Singapore during 9–13 December 1996 and reviewed the operations post-WTO. Major developed countries brought in proposals to start negotiations in some new areas, such as investment, competition policy, government procurement, trade facilitation, and labour standards. This evoked a lot of controversy. Significant pressure was built up by the developed countries for all members to accept their proposals; this was strongly opposed by developing nations. However, an agreement was finally reached to set up working groups to study the process of the relationship between investment and trade, competition and trade, and transparency in government procurement.

These are generally termed as Singapore issues. The subject of trade facilitation was to be studied in the Council for Trade in Goods.

Conclusion of Information Technology Agreement was an important decision made during the Singapore Ministerial Conference based on the proposal brought by developed countries to have an agreement on zero duty on import of information technology goods.

Geneva Ministerial Conference

The second MC, held at Geneva (Switzerland) during 18–20 May 1998, discussed implementational concerns of developing and least developing countries that led to establishment of a mechanism for evaluation of implementation of individual agreements.

The US-sponsored proposals for zero duty on electronic commerce were discussed and an agreement was reached to maintain status-quo on the market access conditions for electronic commerce for 18 months. The agreement on status-quo actually meant that there would be zero duty on e-commerce since no country had been imposing duty on this mode of trade. A declaration on global electronic commerce was also adopted.

Electronic commerce was defined as the mode of commerce in which all operations of trade would be conducted through the electronic medium; these operations include placing the order, supplying the product, and making the payment. They also include sale and transfer of goods through electronic medium, such as music and cinematographic products, architectural and machine drawings and designs, etc. However, the sale in which goods are physically transferred to the buyer would not be considered e-commerce.

Seattle Ministerial Conference

The third MC, held in Seattle (US) from November 30 to December 3, 1999, saw significant shifts in negotiations as poor countries made intensive preparations for the meeting, in contrast to previous MCs, which focused primarily on concerns brought in by rich countries. Developed countries attempted to push new concerns like as investment, competition policy, government procurement, trade facilitation, and labour standards forward in Seattle as well. However, poor countries asked that their recommendations be given top priority because they were relevant to the current agreement's operation, before any new issue could be addressed. No agreement on the topics could be reached, resulting in the MC's entire collapse, resulting in a lot of confusion and no decision.

Doha Ministerial Conference

The fourth MC, held in Doha, Qatar from November 9–14, 2001, widened the gap between developed and poor countries in the WTO. On the one hand, wealthy countries were eager to start a new round of multilateral trade talks, which would cover issues such as investment, competition policy, government procurement transparency, and trade facilitation. Developing countries, on the other hand, were adamant about not starting a new round because they believed they were still digesting the implications of the last round, the Uruguay Round, of multilateral trade discussions.

At the conclusion of Doha MC, a thorough work programme was adopted. Although the work programme was not explicitly referred to as a new round of negotiations, it possessed all of the characteristics of a new round of international trade discussions. Members agreed to draw up modalities for negotiations on the Singapore concerns and then begin negotiations using the modalities that were agreed upon by express consensus. It was also decided to improve the precision, effectiveness, and operationality of the Special and Differential (S&D) treatment for developing nations.

The main commitments of the Doha Declaration were.

- To continue the commitment for establishing a fair and market-oriented trading system through fundamental reform of support and protection of agricultural markets, specifically through
  - Substantial improvements in market access
  - Reductions of all forms of export subsidies, with a view of phasing them out
  - Substantial reductions in trade distorting domestic support
- To give developing countries Special and Differential Treatment in negotiations to enable them effectively to take into account their development needs
- To ensure negotiations on trade in services aimed at promoting the economic growth of all trading partners and the development of developing and least developed countries
- To reduce or eliminate tariffs and non-tariff barriers in non-agricultural markets, in particular on products of export interest to developing countries
- Doha Development Agenda (DDA) is a 'single undertaking' that means nothing is agreed until everything is agreed.
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Cancun Ministerial Conference

The fifth MC was held in Cancun (Mexico) during 10–14 September 2003 under heightened strain between the major developed and developing countries. Developing countries believed that heavy subsidies on production and exports of agriculture in developed countries had been grievously harming their agriculture which is means of livelihood of their major population unlike in developed countries. There was hardly any significant action perceived on the part of the developed countries in the areas of implementation of issues and Special and Differential Treatment. On the other hand, developed countries insisted upon starting the negotiations on the Singapore issues. Under this atmosphere of complete apprehension, anger, and mistrust, no agreement could be reached and the MC terminated without any comprehensive declaration.

The Hong Kong Ministerial Conference

- The sixth MC took place in Hong Kong during 13–18 December 2005. It called for conclusions in 2006 of negotiations launched at Doha in 2001 and establishment of targets and time frames in specific areas. The key outcomes of the Hong Kong Ministerial Conference included

- Amendment to TRIPS agreement reaffirmed to address public health concerns of developing countries.
- Duty free, quota free market access for all LDC products by all developed countries.
- Resolved complete Doha work programme and finalized negotiations in 2006.
- Elimination of export subsidies in cotton by developed countries in 2006; reduction of trade distorting domestic subsidies more ambitiously and over a shorter period.
- Elimination of export subsidies in agriculture by 2013 with substantial part in the first half of the implementation period. Developing countries, such as India will continue to have right to provide marketing and transport subsidies on agricultural exports for five years after the end date for elimination of all forms of export subsidies.
- The agreement that the three heaviest subsidizers, i.e., the European Union, the US, and Japan, were to attract the highest cut in their trade distortion domestic support. Developing countries like India with no Aggregate Measurement of Support (AMS) will be exempt from any cut on de minimus (entitlement to provide subsidies annually on product-specific as well as non-product specific basis each up to 10 per cent of the agricultural production value) as well as on overall levels of domestic trade distortion support (consists of the AMS, the Blue Box, and de minimus).
- Establishment of modalities in agriculture and Non-Agriculture Market Access (NAMA).
- The agreement that developing countries were to have flexibility to self-designate appropriate number of tariff lines as special products. In order to address situations of surge in imports and fall in international prices, both import quantity and price triggers have been agreed under the Special Safeguard Mechanism for developing countries.
- The agreement that in NAMA and Special and Differential Treatment (S&DT), elements such as flexibility and less-than-full reciprocity in reduction commitments for developing countries reassured.
- No sub-categorization of developing countries when addressing concerns of small, vulnerable economies.

Subsequently, at the General Council meeting held at Geneva on 31 July 2006, an agreement was reached on the framework in order to conduct the negotiations. Preliminary agreements were reached on broad approaches, especially in the areas of agriculture and industrial tariffs. It was decided to drop the three Singapore issues on investment, competition policy, and government procurement whereas negotiations on trade facilitation were to follow.

The Deadlock in WTO Negotiations

Despite rigorous talks, deadlines were missed, and negotiations on all aspects of the Doha work programme were postponed in July 2006, mostly due to a lack of convergence on important agricultural and NAMA concerns. Agriculture has remained the most divisive issue at subsequent Ministerial Conferences, deepening the gap between wealthy and developing countries. Subsidies to farmers continue to be generous in many wealthy countries. Surprisingly, while increasing the total amount of support, developed countries have met their technical responsibility of reducing reducible subsidy. Furthermore, both the EU and the US continue to provide export subsidies. Ironically, affluent countries are pressuring poor countries to significantly lower their tariffs. This poses a challenge to developing countries' domestic farming sectors, with major socioeconomic and political ramifications. As a result, agricultural discussions are incredibly difficult. Developed countries, on the other hand, are eager to get their industrial products onto the market.

Summary

- The World Trade Institution (WTO) is the sole international organisation dedicated to international trade regulations. It establishes a framework for the conduct of international goods and services trade. In the set of multilateral agreements covered later in this chapter, it lays forth the rights and obligations of states. It includes a wide variety of topics relating to international trade, such as intellectual property rights protection and dispute settlement, and sets disciplines for governments in the formation of rules, procedures, and practices in these areas, in addition to products and services. In addition, it imposes firm-level discipline in specific areas, such as export pricing at particularly low prices.
- WTO also includes areas of interest to international businesses, such as customs valuation, pre-shipment inspection services, and import licensing procedures, with an emphasis on transparency to prevent non-tariff obstacles from being erected. The agreements also stipulate rights of exporters and domestic procedures to initiate actions against dumping of foreign goods. An international business manager needs to develop a thorough understanding of the new opportunities and challenges of the multilateral trading system under the WTO.
- All of these councils and committees are made up of the WTO's full membership. However, this does not imply that they are the same or that the differences are largely administrative. In actuality, the people who serve on the various councils and committees vary according to the requirement for varying levels of seniority and areas of competence. At the General Council, heads of missions in Geneva (typically ambassadors) represent respective countries. Some of the committees are extremely specialised, and governments occasionally send experts from their nations to attend these meetings. Many delegations appoint various officials to cover different meetings, even at the level of the Goods, Services, and TRIPS councils. Except for the Appellate Body, dispute settlement panels, textile monitoring body, and plurilateral committees, all WTO members are welcome to participate in all councils and committees.
- The World Trade Organization (WTO) is commonly referred to as a "free trade" organisation, however this is not entirely correct. Tariffs and other forms of protection are permitted under the system, but only under limited circumstances. It is, more precisely, a set of norms designed to promote open, fair, and undistorted competition.
- In addition to intellectual property, the WTO agreements cover two core areas: goods and services. Agriculture, health regulations for farm products (SPS), textiles and clothing, product standards, investment measures, anti-dumping measures, customs valuation methods, pre-shipment inspection, rules of origin, import licencing, subsidies and counter-measures, and safeguards are all covered by GATT agreements for goods.

Keywords

GATT : General Agreement on Tariffs and Trade, an international treaty (1948-94) to promote trade **and economic development by reducing.**

WTO : The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.

Self Assessment

1. The sixth WTO ministerial conference was held in from 13 December - 18 December 2005.

A. Macau
B. Hong Kong
C. United States
D. Philippines

2. Designated name for the(commonly known as Taiwan)

A. Vietnam
B. Philippines
C. People's Republic of China
D. Republic of China

3. Which of the following languages is spoken in World Trade Organization?

A. Sardinian language
B. Spanish language
C. Italian language
D. Venetian language

4. What is the leader of World Trade Organization called?

A. Governor General of Tuvalu
B. Malaysian general election, 2008
C. List of Secretaries General of ASEAN
D. None of these

5. WTO stands for_______

A. World Tariff Organization
B. World Tax Organization
C. World Trade Organization
D. World Trademark Organization

6. __________ became the 164th member of World Trade Organization (WTO).

A. Kenya
B. Liberia
C. Pakistan
D. Afghanistan

7. The World Trade Organization (WTO) was established to implement the final act of __________round agreement of GATT.

A. Torquay
B. Uruguay

C. Geneva
D. Tokyo

8. Green Box contains:

A. fixed payments to producers for environmental programs
B. domestic subsidies that governments have agreed to reduce but not eliminate
C. subsidies which can be increased without limit
D. None of the above

9. Which topic was on agenda of the Doha Round of WTO trade negotiations?

A. More market accesses
B. Eliminating export subsidies
C. Reducing distorting domestic support
D. All of the above

10. In an open economy, policymakers try to maintain

A. Internal Balance
B. External Balance
C. Gold Standard
D. Both a and b

11. In which year the Great Depression was followed by bank failures throughout the world?

A. 1929
B. 1967
C. 2008
D. 1925

12. Asian Bond Markets Initiative in which of the following

A. ABMF
B. CGIF
C. Both of the above
D. None of the above

13. The Resumption Act (1819) marks

A. first adoption of the gold standard
B. unit of the account
C. financial account surplus
D. None of the above

14. Which of the economy is referred as laissez-faire economy?

A. Socialist

B. Capitalist
C. Imperialistic
D. None of the above

15.Meaning of development is different for

A. different people
B. alien people
C. same people
D. none of these

Answer for Self Assessment

l.	B	2.	D	3.	B	4.	D	5.	C
6.	D	7.	B	8.	A	9.	D	10.	D
11.	A	12.	A	13.	A	14.	B	15.	A

Review Questions

1. What is multilateralism? Discuss in detail.
2. What are the functions of WTO? Discuss.
3. Discuss the principles of the Multilateral trading system.
4. Explain in detail the ways to lower down the non-tariff barriers?
5. Write down the limitations of WTO in detail?

Further Readings

- Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement.
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Unit14: Global Cooperation on the Environment

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Objectives

After studying this unit, you should be able to:

- Realize the trends in the emerging global economy
- Identify the drivers of Globalization
- Describe the concept of 'Globalization of markets'
- Discuss the policy issues in Globalization
- Know the extent of Globalization in India

Introduction

A fundamental shift is occurring in the World economy. We are rapidly moving from a world in which national economies were relatively self-contained entities, isolated from each other by barriers to cross border trade and investment; by distance, time zones, and language and by national differences in Govt., regulation, culture and business systems –And we are moving towards a world in which barriers to cross- border trade and investment are tumbling, perceived distance is shrinking due to advances in transportation and telecommunication technology, material culture is starting to look similar the world over and national economies are merging into an inter dependent global economic system. The process by which this is happening is currently reported as Globalization.

International Monetary Fund defines Globalization as "the growing interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and widespread diffusion of technology".

Charles U.L. Hill defines Globalization as "The shift towards a more integrated and interdependent World Economy. Globalization has two main components-the Globalization of markets and Globalization of production."

Interdependence and integration of individual countries of the World may be called as Globalization. Thus, Globalization integrates not only economies but also societies.

14.1 Emerging Global Economy

The decades of the 1980s and 1990s brought transitions in the political, economic, technological, and environmental arenas. Some of these changes continue to reshape our work and non-work lives, much as the early Industrial Revolution did during the mid-1800s. This revolution is fueling increased Globalization.

Globalization has made a big world smaller. Globalization affects trade, finance, production, communications, and technological change. When we look at the world map, we need to think about how this global community of people and nations is being systematically drawn closer together.

Example: At Distributed Service Systems, a small full-service computer company located in Reading, Pennsylvania, a technical consultant sits at a terminal and solves assembly line production problems at Carpenter Technology steel plants in India, China, Mexico, and Taiwan. At the same time, a major U.S. global manufacturer in Green Bay, Wisconsin, has a small staff of foreign currency traders working twenty-four hours a day to manage the firm's global financial needs and resources.

Since 1980, world exports (goods leaving a country) have increased 194 percent, and U.S. imports (goods coming into the country) have more than tripled. In 1980, total U.S. trade equaled 9 percent of Gross Domestic Product (GDP), and Gross National Product (GNP), both of which measure the annual output of goods and services; in 2004, it amounted to 26 percent. Nations have found it cheaper and more efficient to trade more with each other than to produce all their products at home.

The last quarter of the century has seen rapid changes in the global economy. Barriers to the free flow of goods, services, and capital have been coming down. The volume of cross-border trade and investment has been growing more rapidly than global output, indicating that national economies are becoming more closely integrated into a single, interdependent, global economic system.

The move toward a global economy has been further strengthened by the widespread adoption of liberal economic policies by countries that for two generations or more were firmly opposed to them. Country after country, we are seeing state-owned businesses privatized, widespread deregulation, markets being opened to more competition, and increased commitment to removing barriers to cross-border trade and investment.

In short, current trends indicate that the world is moving rapidly toward an economic system that is more favorable for the practice of international business.

Greater Globalization brings with it risks of its own. This was starkly demonstrated in 1997 and 1998 when a financial crisis in Thailand spread first to other East Asian nations and then in 1998 to Russia and Brazil. Ultimately, the crisis threatened to plunge the economies of the developed world, including the United States into a recession.

14.2 BRICS

BRICS is the title of an association of leading emerging economies, arising out of the inclusion of South Africa into the BRIC group in 2010. As of 2012, the group's five members are Brazil, Russia, India, China, and South Africa. With the possible exception of Russia, the BRICS members are all developing or newly industrialized countries, but they are distinguished by their large, fast-growing economies and significant influence on regional and global affairs. As of 2012, the five BRICS countries represent almost 3 billion people, with a combined nominal GDP of US$13.7 trillion, and an estimated US$4 trillion in combined foreign reserves. Presently, India holds the chair of the BRICS group.

President of the People's Republic of China Hu Jintao has described the BRICS countries as defenders and promoters of developing countries and a force for world peace. However, some analysts have highlighted potential divisions and weaknesses in the grouping, such as India and China's disagreements over Tibetan and border issues, the failure of the BRICS to establish a World

Bank-analogue development agency, and disputes between the members of the UN Security Council reform.

The grouping has held annual summits since 2009, with member countries taking turns to host. Before South Africa's admission, two BRIC summits were held, in 2009 and 2010. The first five-member BRICS summit was held in 2011. The most recent summit took place in New Delhi, India, on March 29, 2012.

Table 14.1

Summit	Participants	Date	Host Country	Host Leader	Location
1st	BRIC	June 16, 2009	Russia	Dmitry Medvedev	Yekaterinburg
2nd	BRIC	April 16, 2010	Brazil	Luiz Inácio Lula da Silva	Brasília
3rd	BRICS	April 14, 2011	China	Hu Jintao	Sanya
4th	BRICS	March 29, 2012	India	Manmohan Singh	New Delhi
5th	BRICS	*2013*	South Africa	Jacob Zuma	*TBA*

14.3 Drivers of Globalization

Two macro factors seem to underlie the trend toward greater Globalization. The first is the decline in barriers to the free flow of goods, services, and capital that has occurred since the end of World War II. The second factor is technological change, particularly the dramatic developments in recent years in communication, information processing, and transportation technologies.

Declining trade and investment barriers: During the 1920s and 30s, many of the nation-states of the world erected formidable barriers to international trade and foreign direct investment. International trade occurs when a firm exports goods or services to consumers in another country. Foreign direct investment occurs when a firm invests resources in business activities outside its home country. Many of the barriers to international trade took the form of high tariffs on imports of manufactured goods. The typical aim of such tariffs was to protect domestic industries from foreign competition.

Having learned from this experience, the advanced industrial nations of the West committed themselves after World War II to removing barriers to the free flow of goods, services, and capital between nations. This goal was enshrined in the treaty known as the General Agreement on Tariffs and Trade (GATT). It started in 1947 as a set of rules to ensure non-discrimination, transparent procedures, the settlement of disputes, and the participation of lesser-developed countries in international trade.

The latest GATT negotiations, called the Uruguay Round, were initiated in 1987. Even though tariffs still were addressed in these negotiations, their importance has been greatly diminished due to the success of earlier agreements. The main thrust of negotiations had become the sharpening of dispute-settlement rules and the integration of the trade and investment areas that were outside of the GATT. After many years of often-contentious negotiations, a new accord was finally ratified in early 1995. The GATT was supplanted by a new institution, the World Trade Organisation (WTO), which now administers international trade and investment accords.

The role of technological change: Microprocessors and Telecommunications: Perhaps the single most important innovation has been the development of the microprocessor, which enabled the explosive growth of high-power, low-cost computing, vastly increasing the amount of information that can be processed by individuals and firms. The microprocessor also underlies many recent advances in telecommunications technology.

The Internet and the World Wide Web: The phenomenal growth of the Internet and the associated World Wide Web is the latest expression of this development.

Transportation technology: In addition to developments in communication technology, several major innovations in transportation technology have occurred since World War II. In economic terms, the most important is probably the development of commercial jet aircraft and super freighters and the introduction of containerization, which simplifies transshipment from one mode

of transport to another. The advent of commercial jet travel, by reducing the time needed to get from one location to another, has effectively shrunk the globe.

Globalization of Markets

Market globalisation is the process by which historically diverse and independent national markets are combined to form a single, enormous global market. Selling abroad has become simpler as a result of lowering trade restrictions. It has long been maintained that as customers' tastes and preferences in many countries start to align with some universal standard, a global market is being formed.

Example: Consumer products such as Citicorp credit cards, Coca-Cola soft drinks, Sony play station, and Mc Donald's hamburgers are frequently held up as a prototypical examples of this trend; they are also facilitators of it. By offering a standardized product worldwide, they help to create a global market.

Despite the fact that McDonald's hamburgers and Citicorp credit cards are widely available around the world, it is important to keep the idea that national markets are losing way to the global market in check. National marketplaces continue to differ significantly along many key parameters,

such as consumer preferences, distribution methods, culturally ingrained value systems, and similar things. For instance, automakers may advertise various car models based on a variety of variables such regional fuel prices, income levels, traffic congestion, and cultural values.

The most international markets are those for industrial goods and resources that meet a global need, not those for consumer goods, where national differences in likes and preferences are nevertheless frequently significant enough to slow globalisation. These include the markets for industrial goods like microprocessors, computer memory chips, and commercial jet aircraft as well as the markets for raw materials like aluminium, oil, and wheat.

In many global markets, the same firms frequently confront each other as competitors in nation after nation.

Transition from Domestic to International to Global Markets

After a company decides to go international, it must decide the degree of marketing involvement and commitment it is prepared to make. Generally, a domestic company enters emerge as an international company through the following stages:

1. **No direct foreign marketing:** A company in this stage does not actively cultivate customers outside national boundaries; however, this company's products may reach foreign marketing. Sales may be made to trading companies as well as foreign customers who come directly to the firm. Or products may reach foreign markets via domestic wholesalers or distributors who sell aboard without explicit encouragement or even knowledge of the producer. As companies develop websites on the Internet, many receive orders from international web surfers.

2. **Infrequent foreign marketing:** Temporary surpluses caused by variations in production levels or demand may result in infrequent marketing overseas. The surpluses are characterized by their temporary nature; therefore, sales to foreign markets are made as goods are available, with little or no intention of maintaining continuous market representation.

3. **Regular foreign marketing**: At this level, the firm has permanent productive capacity devoted to the production of goods to be marketed in foreign markets. A firm may employ foreign or domestic overseas middlemen to it may have its own sales force or sales subsidiaries in important foreign markets. The primary focus of operations and production is to service domestic market needs. However, as overseas demand grows, production is allocated for foreign markets.

4. **International marketing**: Companies in this stage are fully committed and involved in international marketing activities. Such companies seek markets all over the world andsell products that are a result of planned production for markets in various countries. This generally entails not only the marketing but also the production of goods outside the home market. At this point, a company becomes an international or multinational marketing firm.

5. **Global marketing**: At the global marketing level, the most profound change is the orientation of the company toward markets and associated planning activities. At this stage, companies treat the world, including their home market, as one market. Market segmentation decisions are no longer focused on national borders. Instead, market segments are defined by income levels, usage patterns, or other factors that often span countries and regions. Often, this transition from international marketing to global marketing is catalyzed by a company's crossing the threshold of more than half its sales revenues coming from aboard.

14.4 Policy Issues

Hegemon-led unilateralism and a lack of democracy in how these major institutions of global governance operate are their main flaws. Voting and representation are also strongly skewed in favour of the hegemons. Second, these institutions have kept promoting policies in the same manner and with the same techniques without considering the dynamising effects of the globalisation logic, which has implications for the compression of time and space as well as the mobility of capital and markets.

These factors have made income disparities more pronounced in the global north and further exacerbated poverty in the global south. In particular, there has been a great deal of arbitrary behaviour in the World Bank and IMF's operations, as well as a great deal of teleguiding of the UN and its agencies' actions, which has led to the Gulf crisis. All of these organisations and agencies need to update their charters and conventions to meet the needs of modern thought and the democratic movement currently sweeping the globe. Particularly with its section on the "Reciprocity" concept, the WTO has in many respects made it hard for smaller countries to have influence for their domestic growth. Since the Doha Rounds, over which the main economic powers have dragged their feet, it has made some of the most harmful statements on agricultural development and, in general, Third World Development.

Events on a national, regional, and international scale as well as the defining and evolving characteristics of globalisation have had a significant impact on the functions and responsibilities of international organisations over time. First, during the Second World War in the 1940s, and then again following the Cold War in the 1990s, their responsibilities in international politics have dramatically risen as globalisation and governance issues raise the bar for global problems and challenges. They however, would be best described at this time as anachronisms, organs that are more or less in danger of living out their relevance.

Presently, international organisations, particularly the multilateral organisation s, such as the United Nations Organisation, the World Bank, the International Monetary Fund and the World Trade Organisation, among others, carry with them fundamental structural deformities. They, thus face compelling operational challenges.

These challenges are essentially derived from some of the following:

- **At inauguration:** The global circumstances which gave birth to the constitutive rules and consequently gave international institutions their structure of operations have changed significantly particularly since the end of the Cold War. The extant structures, therefore cannot serve effectively the present global system of organisation. At the minimum, the structures would have to be reviewed and revised to take into cognizance, the present configurations of national and regional balances and imbalances.
- **Democratic Deficits**: Engagements within international organisations can hardly be described as democratic, as issues bordering on the transparency in the decision-making processes are constant. Developing countries are hard pressed to pursue their positions conclusively, as they lack the resources/capacity to do so at the expense of dominant states, which have the capacity. In the United Nations for example, the presence of a permanent Security Council with veto powers to vet decisions at the General Assembly, constitute a block of the "almighty" in an assembly of equal states. The UN operates like a huge

bureaucracy, affecting its response and carrying capacity, and ultimately its output. There is disproportionate structuring of the UN such that the carrying capacity of some of its agencies, groups and individuals is more than that of others. Indeed, some offices end up carrying out the responsibility and schedule of other agencies or departments. The efficiency of the UN system is measured more by paperwork than operation and real work. Proposed reforms of such should not be delayed but pursued to their logical conclusions.

- **Global response to regional problems**: The response of international organisations to developing regions like Africa and their most pressing problems has in many cases not been adequate, and most times, it is untimely. Early warning signals are either disregarded or totally ignored in a somewhat mindless manner. The way and manner international organisations such as the IMF, World Bank and even the United Nations address national or regional problems in some of the continents are more of a wait- for-something-to-happen-before-we-move engagement. International mechanisms for protecting basic human rights, or even preventing wide-scale atrocities, are weak and inadequate and used sometimes arbitrary (i.e. the haste to save Kuwaitis under Iraqi occupation and the lack of enthusiasm to prevent the Rwandan Genocide or the lukewarm approach to Darfur). Therefore, what is needed, are responsive global governance institutions that meet the needs of everyone in a balance between the rights of the citizens, sovereignty of states and legitimacy of mandate.
- **Legitimacy issues**: Legitimacy is mostly linked to perception, and the issue of legitimacy is at the heart of the challenge facing many international organisations. Their failure to rise to meet certain global challenges, particularly in distraught humanitarian cases (for example Rwanda and Darfur), leads to constant suspicion and calls, questioning the very basis of their existence and their corporate legitimacy.
- **Issues of accountability and transparency**: The case of accountability is worsened by the perceived lack of transparency in international organisations. This is made important as they assume more and more global tasks and responsibilities that go beyond the mission for which they were originally created. They thus have a greater impact on the lives of peoples and states, in ways that were not possible 20 years ago. They however, are hardly accountable to any independent institution acting on behalf of the generality of nations they represent or on whose behalf they act.
- **Enforcement of Mandates**: Enforcement powers of international organisations are severely limited, as their mandates are subject to the availability of resources to be provided by the patronizing or member states as well as their authorization. The concentration of powers in centralized distant bureaucracies with little sympathy for local cultural norms has the potential to counteract the concept of "division of powers" and the benefits of adapting methods of government to localities.

International organisations are generally prone to the duplication of projects and mission objectives. This can lead to an over concentration effort on a single subject or agenda, at the expense of other critical areas. Environment problems are an instance of this. Perhaps more important is the fact that the current relentless push for some form of uniformity under the rubric of an imposed single market. This in turn has created a situation wherein there is increasing political, social and cultural fragmentation. In essence the world is today witnessing fractionalization which in turn breeds complex frictions. From all indications, the Doha process of the WTO is more or less comatose, the IMF and the World Bank cannot be said to be at their imperial best and may become irrelevant once the Asian powers consolidate their growth and grip. Current prognosis suggests that only the United Nations might maintain any form of serious strategic relevance.

Globalization is not based on any ethical or moral guidelines. Most of the rules and regulations guiding the global processes have been made by the developed or the heavily developed countries. They have the resources as well as control the international institutions or mechanisms of

Globalization. Developing countries are therefore kowtowed into Globalization without choices. Globalisation's Free Trade and its concomitants as promoted through international organisations like the WTO, work to the disadvantage of developing market economies. Free Trade seeks the removal of protective measures and tariffs, put in place by developing economies to protect indigenous entrepreneurs, who are not likely to survive the influx of heavily subsidised products from developed nations if they remove protective measures. Globalisation's features have exposed inherent weaknesses by internationalizing crime and battlefields. Resources used to process globalisation may also be deployed to perpetrate crimes. Ideological conflict agendas are being reinterpreted to include anywhere and everywhere. For instance, terrorists battling America, have no compulsion bombing American Embassies in Kenya and Tanzania, developing countries without the resources to deal with global terrorism. Globalisation has facilitated an increasing growth trend for urbane centres. The attendant pressure on the existing inadequate recreational and development infrastructures adds to the environmental security and heightens the challenges to the provision of water and energy resources to the growing population. The consequence is a natural increase on violent crimes, conflicts hotspots and dysfunctional cities. These problems are magnified when the developed centres lure away professionals from poor nations to the richer nations. Globalisation facilitates this by the inequality that is accentuated in remunerations and incomes for professionals. Globalisation promotes competitions, sometimes violent competitions and conflicts, among nations, thereby putting in place motives for regional insecurities. It also promotes emergence of global oligopolies as typified by the rash of Mergers and Acquisitions (M&A) especially in banking and extractive industries.

Globalisation also facilitated the rise of international media houses, which monitor global events and transmit them live into people's living rooms. Much as they can use this power to drive international development processes, majority of the global media, however, chose to broadcast information that are stereotypical and tend to stigmatize peoples and their cultures. Globalisation has transformed many countries into cultural hybrids; typified by the McDonaldisation of the world. People, especially young people, are becoming more confused in terms of their identity. And the international media is fast creating illusions of better lives in other regions. Young people are encouraged by the visions they see, to live anywhere else but home. Most times, they are willing to disregard the humiliation, hostility and unsavouriness of their host country. The import is that, another round of slavery has begun. This time, the African is actually begging to be enslaved. Globalisation has also added to the "cultural confusion" identity crises by endorsing the superiority of one cultural origin over another. More people are seeking to have their children in Europe and America. These so-called global citizens will emerge in the world without any serious heritage, without any anchor.

14.5 Globalisation in India

The process of globalisation has been an integral part of the recent economic progress made by India. Globalisation has played a major role in export-led growth, leading to the enlargement of the job market in India.

One of the major forces of globalisation in India has been in the growth of outsourced IT and business process outsourcing (BPO) services. The last few years have seen an increase in the number of skilled professionals in India employed by both local and foreign companies to service customers in the US and Europe in particular. Taking advantage of India's lower cost but educated and English-speaking work force, and utilizing global communications technologies such as voice-over IP (VOIP), email and the internet, international enterprises have been able to lower their cost base by establishing outsourced knowledge-worker operations in India.

India opened up the economy in the early nineties following a major crisis that led by a foreign exchange crunch that dragged the economy close to defaulting on loans. The response was a slew of Domestic and external sector policy measures partly prompted by the immediate needs and partly by the demand of the multilateral organisations. The new policy regime radically pushed forward in favour of a more open and market-oriented economy.

Major measures initiated as a part of the liberalisation and globalisation strategy in the early nineties included scrapping of the industrial licensing regime, reduction in the number of areas reserved for the public sector, amendment of the monopolies and the restrictive trade practices act,

start of the privatisation programme, reduction in tariff rates and change over to market determined exchange rates.

Over the years there has been a steady liberalisation of the current account transactions, more and more sectors opened up for foreign direct investments and portfolio investments facilitating entry of foreign investors in telecom, roads, ports, airports, insurance and other major sectors.

As a new Indian middle class has developed around the wealth that the IT and BPO industries have brought to the country, a new consumer base has developed. International companies are also expanding their operations in India to service this massive growth opportunity.

Example: International companies that have done well in India in the recent years include Pepsi, Coca-Cola, McDonald's, and Kentucky Fried Chicken, whose products have been well accepted by Indians at large.

Globalisation in India has been advantageous for companies that have ventured in the Indian market. By simply increasing their base of operations, expanding their workforce with minimal investments, and providing services to a broad range of consumers, large companies entering the Indian market have opened up many profitable opportunities.

Indian companies are rapidly gaining confidence and are themselves now major players in globalisation through international expansion. From steel to movies, from cars to IT, Indian companies are setting themselves up as powerhouses of tomorrow's global economy.

14.6 International Cooperation in Environmental Protection

Protection of environmental resources, such as the global climate and biological diversity, is an international public good. It would be expected, therefore, that the pursuit of national self-interest would result in too little protection of resources. But the fact that all countries potentially could be better off if all cooperated to protect these resources equally suggests that countries have incentives to invent institutions that can facilitate cooperation. As discussed in the previous chapter, such institutions do exist; they are IEAs or treaties that establish rules for protecting international environmental resources. More than 140 IEAs have been negotiated, excluding bilateral agreements and European Community directives (Barrett, 1991). The most recent were agreements to protect the global climate and biological diversity signed in Rio de Janeiro in June 1992. An important question is whether such institutions really can be expected to improve environmental protection, given the incentives countries have to free ride. Both the climate change and biological diversity conventions were signed by about 150 countries - virtually all UN member countries. Does that mean that the agreements achieve the full cooperative outcomes, or do they instead merely codify the non-cooperative outcomes?

While both climate change and biological diversity concern shared environmental resources, they differ in one important respect. As noted in the introduction, climate change is a reciprocal externality: if one country emits more carbon, others may retaliate by emitting more too. Most of the other environmental problems discussed in the last section are similar. If one country eases its plant protection, others may respond by easing theirs. If one country increases its tuna harvest, others may do likewise. Biological diversity is more like a unidirectional externality; the costs of conservation fall primarily on tropical rain forest countries, while the benefits are received by the countries belonging to the Organization for Economic Cooperation and Development. For this reason, these types of environmental problems are treated separately below. It will be seen, however, that the qualitative results are remarkably similar. As indicated in the introduction, the reason is that the provision of compensation for the conservation of biological diversity itself involves a reciprocal externality.

Summary

In simple words, globalisation means moving towards an interdependent global economy.

- There are multiple reasons why companies go global like:
    - (i) Profit advantage,
    - (ii) domestic demand constraints,

(iii) competition,

(iv) government policies,

(v) availability of resources, etc.

- With technological developments and relaxation on rules and regulations on international business most of the companies are entering into global market.
- Globalisation of market and production has become major driving force behind globalisation.
- Corporations are today changing their strategies and are reorganizing their functions to cope up with the changed scenario. Whether, it is their production process or location, product strategy, marketing, finance, HR policies, etc.

Keywords

Globalisation: Growing interdependence of countries.

Globalisation of markets: It refers to the merging of historically distinct and separate national markets into one huge global marketplace.

Global Company: A company which takes the whole world as a single market and it standardises operations and its product worldwide in one or more of the firm's functional areas.

International marketing: It refers to marketing carried out by companies overseas or across national borderlines.

Mandate: An official order or commission to do something.

Outsourcing: Any task, operation, job or process that could be performed by employees within an organisation but is instead contracted to a third party for a significant period of time.

Principle of reciprocity: It states that favours, benefits, or penalties that are granted by one state to the citizens or legal entities of another, should be returned in kind.

World Wide Web: A widely used information system on the Internet that provides facilities for documents to be connected to other documents by hypertext links, enabling the user to search for information by moving from one document to another.

Self Assessment

1. If a German manufacturer of household appliances wants to take advantage of the cheaper labor available in the Czech Republic, which of the following actions will not serve that purpose?

A. build a manufacturing subsidiary there and employ Czech workers.

B. build a plant in the Czech Republic and send all German workers to operate it.

C. license a Czech firm to produce its products under its own label.

D. contract for a Czech firm to do some of the processing for it.

2. Which of the following was created in an effort to promote free trade?

A. World Trade Organization

B. the sarbanes-oxley act

C. multilateral development banks

D. the organization for economic cooperation and development

3. Removing barriers or restrictions set by the government is called:

A. Liberalization

B. Investment

C. Favorable Trade

D. Free Trade

4. Which is the right sequence of stages of Internationalization

A. domestic, transnational, global, international, multinational

B. domestic, international, multinational, global, transnational

C. domestic, multinational, international, transnational, global

D. domestic, international, transnational, multinational, global

5. Select example of Indian Multinational Company

A. Hindustan Unilever

B. Tesla

C. Cargill

D. Tesco

6. …………………corporation produces in the home country or in a single country and focuses on marketing these products globally or vice a versa.

A. Global

B. International

C. Transnational

D. None of The Above

7. Business across several countries with some decentralization of management decision making to subsidiaries is

A. Global Business.

B. Multinational Business.

C. Transnational Business.

D. Multi-Regional Business.

8. Immobility of labor among nations is

A. Absolute.

B. Relatively of a higher degree than among regions in the same country.

C. Relatively easier than movement within the country.

D. Of the same degree as within the country.

9. What is the role of IMF

A. It controls the budgets of national government

B. It acts as a forum for international economics

C. It Observes world exchange rates, balance of payments and multilateral payments

D. It seeks to promote free international trade

10. The world's four major trading currencies are all free to float against each other. They include all the following except.

A. The British Pound

B. The Japanese Yen

C. The Spanish Peso

D. The US Dollar

11. Nations that have major economic expansion attract

A. Imports

B. Foreign Direct Investment

C. Exports

D. Privatization

12. Which of the following resulted from the Great Depression?

A. Increased trade barriers and devalued currencies.

B. A stable exchange rate system.

C. Free international capital flows.

D. None of the options given is correct.

13. What is meant by the 'Washington Consensus'?

A. The consensus in Washington about matters of foreign policy.

B. The ten-point guideline to liberal economic reform for development around the world.

C. The ten-point guideline for economic growth in Europe.

D. The ten-point neo-liberal guideline for progress in the US.

14. Under what conditions will states create international institutions?

A. For mutual gains.

B. Only where position relative to other states is not affected.

C. They arise as reflections of identities and interest of states and groups which are themselves forged through interactions.

D. Depends on the school of thought

15. What is Dependency Theory?

A. Economic activity in the richer countries often leads to serious economic problems in the poorer countries.

B. Economic development of poorer countries is positively dependent on economic growth of richer countries.

C. Economic growth is beneficial to all.

D. None of the options given are correct.

Answers for SelfAssessment

l.	B	2.	A	3.	A	4.	B	5.	B
6.	A	7.	B	8.	B	9.	D	10.	C
11.	B	12.	A	13.	B	14.	D	15.	A

Review Questions

1. Explain the term 'Globalisation'. Why do companies engage in international business?
2. Discuss the forces driving companies towards international business.
3. Explain the concept of 'Globalisation of market'.
4. 'Think global, act local' how far this argument true? Explain.
5. 'The world is flat' - Friedman. Explain this concept in your own words.
6. Write briefly on 'Globalisation and India'.
7. Discuss the role of globalisation in development of Indian business.
8. Mention any four major trends in the changing scenario of Indian business.
9. Explain the policy issues involved in Globalization.

Further Readings

Bhagwati, Jagdish and Anne Krueger (1973), Exchange Control, Liberalization and Economic Development, American Economic Review, 63 (2), May, 419-427.

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