MCM-506

अन्तर्राष्ट्रीय व्यापार व वित्तीय परिचालन

INTERNATIONAL BUSINESS AND FINANCE OPERATIONS

वाणिज्य विभाग

प्रबन्ध अध्ययन एवं वाणिज्य विद्याशाखा

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INTERNATIONAL BUSINESS AND FINANCE OPERATIONS

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MCM-506 INTERNATIONAL BUSINESS AND FINANCE OPERATIONS

इकाई-22 पर्यावरण अवलोकन, निगरानी और अंतरराष्ट्रीय प्रबंधन सूचना प्रणाली (Environmental Scanning, Monitoring and International Management Information System)

इकाई-23 अंतर्राष्ट्रीय परिचालन का संगठन व नियंत्रण पहलू (Organization and Control Aspects of International Operations)

इकाई-24 अंतर्राष्ट्रीय सहयोगात्मक व्यवस्था की प्रक्रिया, कौशल और प्रबंधन (Process, Skills and Management of International Collaborative Arrangements)

UNIT-1 Importance, Nature, Scope and Modes of Entry into International Business

Structure

Objectives

After studying this unit you will be able to -

- To understand the concept of international business
- To know the benefits, barriers, and characteristics of international business
- To understand different modes of entering into international markets
- To understand the advantages and limitations of these different modes of entry

1.1 Introduction

The study of international business aims at understanding the business operations, as they operate in an international context. According to Wikipedia, International business is a term used to collectively describe all commercial transactions (private and governmental, sales, investments, logistics, and transportation) that take place between two or more regions, countries and nations beyond their political boundary. Usually, private companies undertake such transactions for profit; governments undertake them for profit and for political reasons. It refers to all those business activities which involve cross border transactions of goods, services, resources between two or more nations. Transaction of economic resources include capital, skills, people etc. for international production of physical goods and services such as finance, banking, insurance, construction etc.

Although the same principles apply to the marketing of goods and services in domestic and foreign markets, there are some special considerations which must be borne in mind while preparing a marketing strategy for penetrating markets abroad. Even advanced countries like USA and the UK have highly developed markets faced with severe competition in international markets from other countries like Japan and Germany.

1.2 International Business - Conceptual Framework

Some of the definitions of international business can be stated as under:

- Exchange of goods and services between individuals and businesses in many countries.
- A specific organization such as a multinational corporation or international business company that engages in business between many country

- International business comprises of the business activities necessary for creating, shipping and selling goods and services across the national boundaries. (Nuka)

This broad definition includes the very small firm that exports (or imports) a small quantity to only one country, as well as the very large global firm with integrated operations and strategic alliances around the world. Within this broad array, distinctions are often made among different types of international firms, and these distinctions are helpful in understanding a firm's strategy, organization, and functional decisions (for example, its financial, administrative, marketing, human resource, or operations decisions). One distinction that can be helpful is the distinction between multi-domestic operations, with independent subsidiaries which act essentially as domestic firms, and global operations, with integrated subsidiaries which are closely related and interconnected. These may be thought of as the two ends of a continuum, with many possibilities in between. Firms are unlikely to be at one end of the continuum, though, as they often combine aspects of multi-domestic operations with aspects of global operations. Though international business is in essence export marketing. It has a broader connotation in marketing literature. It is not the same thing as international trade, however the principle of comparative cost governs both international trade as well as international marketing. This principle/theory is the foundation for understanding the working of trade among nations. Although its ramifications become quite complicated, the essence of the theory is very simple.

1.2.1 Growth of International Business

International business grew over the last half of the twentieth century partly because of liberalization of both trade and investment, and partly because doing business internationally had become easier. In terms of liberalization, the General Agreement on Tariffs and Trade (GATT) negotiation rounds resulted in trade liberalization, and this was continued with the formation same time, worldwide capital movements were liberalized by most governments, particularly with the advent of electronic funds transfers. In addition, the introduction of a new European monetary unit, the euro, into circulation in January 2002 has impacted international business economically. The euro is the currency of the European Union, membership in March 2005 of 25 countries, and the euro replaced each country's previous currency. As of early 2005, the United States dollar continues to struggle against the euro and the impacts are being felt across industries worldwide. In terms of ease of doing business internationally, two major forces are important:

a) Technological developments which make global communication and transportation relatively quick and convenient; and
b) The disappearance of a substantial part of the communist world, opening many of the world's economies to private business.

1.2.2 Characteristics of International Business

Some of the salient characteristics of international business are:

Large scale operations:

In international business, all the operations are conducted on a very huge scale. Production and marketing activities are conducted on a large scale. It first sells its goods in the local market. Then the surplus goods are exported.

A) **Integration of economies**: International business integrates (combines) the economies of many countries. This is because it uses finance from one country, labour from another country, and infrastructure from another country. It designs the product in one country, produces its parts in many different countries and assembles the product in another country. It sells the product in many countries, i.e. in the international market.

B) **Benefits to participating countries**: International business gives benefits to all participating countries. However, the developed (rich) countries get the maximum benefits. The developing (poor) countries also get benefits. They get foreign capital and technology. They get rapid industrial development. They get more employment opportunities. All this results in economic development of the developing countries. Therefore, developing countries open up their economies through liberal economic policies.

C) **Competition:** International business has to face keen (too much) competition in the world market. The competition is between unequal partners i.e. developed and developing countries. In this keen competition, developed countries and their MNCs are in a favourable position because they produce superior quality goods and services at very low prices. Developed countries also have many contacts in the world market. So, developing countries find it very difficult to face competition from developed countries.

D) **Science and technology**: International business gives a lot of importance to science and technology. Science and Technology (S & T) help the business to have large-scale production. Developed countries use high-end technologies. Therefore, they dominate global business. International business helps them to transfer such top high-end technologies to the developing countries.

E) **International trade restrictions:** International business faces many restrictions on the inflow and outflow of capital, technology and goods. Many governments do not allow international businesses to enter their countries. They have many trade blocks, tariff barriers, foreign exchange restrictions, etc. All this hinders international business.

1.3 Domestic Vs International Business

Both in domestic as well as international business, the sole mantra for competitiveness is to satisfy the customers by delivering them higher value. It is also necessary to build goodwill both in local and in global markets. The striking difference between international and domestic business lies in the environment in which the two take place. The important points of differences are:

1.3.1 Independent Countries:

Each country is a sovereign political entity and therefore, several restrictions are imposed by them for importing and exporting the goods and services in order to safeguard their national interest. The traders in international marketing have to observe such restriction. There may be of the following categories:

i) Imposition of tariffs and customer duties on import and export of goods and services in order to make them costly in the importing country and ban their entry in the country completely. By the efforts of WTO there has been a significant reduction in tariff globally and on regional basis due to the emergence of regional economic groupings.

ii) Quantitative restrictions are also imposed with an intention to restrict trade in some specific commodities with the objective of protection of home industries from the competition of the foreign commodities.

iii) Exchange control is another restriction imposed by almost every sovereign state. The Government in some cases does not ban the entry of goods in the country but the importer is not allowed the necessary foreign exchange to make payment for the goods imported.

1.3.2 Diverse Legal Systems:

There are different legal systems in different countries which makes the task of business more difficult. As the goods move across national boundaries, they are confronted with different sets of laws, and the traders are not sure as to which particular system will apply to their transaction.

1.3.3 Different Monetary Systems:

Each Country has its own monetary system and the exchange rates for each country's currency are fixed under the rules framed by the international monetary fund, therefore they are more or less fixed

1.3.4 Lower mobility of factors of production:

Mobility of different factors of production is less between nations than in the home country itself. However, with the advent of air transport, the mobility of human resources has increased manifold.

1.3.5 Difference in market characteristics:

Market characteristics are different in each segment i.e. demand pattern, channels of distribution, methods of promotion etc. are quite different from market to market. If we take each country as a separate market, we can assume different market characteristics there. These differences are accentuated due to the existence of government controls and regulations. However, this is a difference of degree only.

1.3.6 Difference in procedures and documentation:

The laws of the country and customs of trade in each country demand different procedures and documentary requirements for the import and export of the goods and services. The traders residing in the territory have to comply with these regulations and customs if they want to import or export of goods and services. The above points of differences, we can say that the two types of business systems - international and domestic are quite different. As each country has to protect its own interest political and financial, it has to put certain restrictions on foreign trade import to a trader are quite different as compared to domestic marketing. Restrictions are also there in domestic marketing, but the procedures, systems and the rules and regulations are applied equally in all the parts of the country and these are well-known to the traders concerned.

1.4 Advantages of international business

In the present times, with high degree of globalization of business, no business can survive or grow without an international perspective. Some of the benefits of international business are:

Survival: International competition may not be a matter of choice when survival is at stake. Because most countries are not as fortunate as the limited states in terms of market size, resources and opportunities, they must trade with others to survive.

Growth of overseas markets: Developing countries in spite of economic and marketing problems are excellent markets. According to a report proposed for U.S. Trade Representatives, Latin America and Asia/Pacific are experiencing the strongest economic growth.

Sales and Profits: Foreign markets constitute a large share of the total business of many firms that have wisely cultivated markets abroad. Many large US companies are doing very well because of their overseas customers. IBM and Compaq sell more computers abroad than at home. The success of Coca Cola clearly emphasize the importance of overseas markets. Inflation and Price Moderation The benefits of exports are self-evident. Imports can also be highly beneficial to a country because they constitute reserve capacity for the local economy without imports (or with restricted imports) there is no incentive for domestic firms to moderate their prices. The lack of imported product alternatives forces consumers to pay more, resulting in inflation and excessive profits for local firms. This development usually acts as a prelude to worker's demand for higher wages, further accelerating the problem of inflation.

Increase in employment opportunities: Unrestricted trade improves the world's GNP and enhances employment generally for all nations. Importing products and foreign ownership can provide benefits to a nation. In a developing country like our's , the problem of employment can be solved to some extent by increasing the level of export. Moreover, new markets are surveyed for exporting the goods and many persons are engaged directly or indirectly in the export trade.

Increase in the Standard of Living: International business increases countries' and their citizen's higher standards of living that otherwise is not possible without trade. Product shortages force people to pay more for less. Exports increase the employment opportunities which in turn increase the purchasing power of the people by which they can purchase more for consumption. Similarly export enhances the industrialization of the country. Now items are produced for consumption which increases the level of standard of living.

International Collaboration: International business results in international collaboration. Developed countries fix their import quotas for different countries and for different commodities. A country can export to the extent of its quota. In order to settle certain common issues some countries form a group or common platform to discuss various issues concerning international trade. OPEC and EEC are such groups.

1.5 Methods of entering international markets

A firm aspiring to venture into international business can enter into it by a variety of methods. Some of the methods are explained in the following discussion.

1.5.1 Exporting

Exporting is the most traditional mode of an access to the foreign market. It is the most prevalent entry strategy for many companies. The majority of international trade is carried out by firms that sell domestically produced goods in foreign markets. Exporting is favored by small and large companies an initially entry strategy or it could be used on a continuing basis to serve foreign markets. It enables the firms to enter into offshore markets without substantial risk. Basically, the exporting firm employs existing domestic capacity for production, distribution and administration and earmarks a portion of the domestic production to markets abroad. Exporting is considered to be an appropriate strategy under the following conditions:

i) The market potential is not big enough to justify production in the foreign market (s).

ii) High cost of production in a foreign market.

iii) Prevalence of political and other risks associated with investment in the foreign country.

iv) Lack of infrastructural facilities in foreign market resulting in production bottlenecks.

v) Foreign direct investment may not be encouraged by the foreign country.

vi) The seller may not have a permanent interest in the foreign market.

vii) Home country government provides an array of export incentives.

viii) The exporter can realize economics of scale through increased sales, thereby realizing cost competitive advantages, both domestically and internationally.

ix) The exporter may prefer to get experience of operating in foreign markets. Such experience may help further expansion through other forms of foreign market involvement.

The procedure of exporting involves placement of an order by an overseas buyer, obtaining export license. (if applicable), securing reliable transportation and transit insurance, and fulfillment of requirements imposed by the importer's country. These requirements relate to payment of customs duties, declaration, documents and inspections.

Exporting takes two broad forms:

1.5.1.1 Indirect Exporting

1.5.1.2 Direct Exporting

Indirect Exporting It involves selling of domestically produced goods in foreign markets by delegating the activities related to exporting to outside agents and firms. There is no special expertise of heavy cash outlay require, The firm only abides by the instruction of an agent or firm which performs the marketing activities abroad.

Following alternative channels are available for effecting indirect exports.

(i) Buyer for Export

There are many merchant exports/export houses that buy goods from Indian manufacturers and sell them abroad.

(ii) Foreign buyers in the domestic market

The foreign firms buy products through their procurement offices in exporter's countries. These firms may be retailers or wholesalers buying products for resale in overseas e.g. large U.S. retailer, such as Sears and Macy's have foreign buying offices in other countries. Macy's has buying offices in 30 countries. Wal-Mart has many also. Some other companies regularly send buying teams for the same purpose. Substantial amount of business is conducted by such foreign buying teams for the same purpose. Substantial amount of business is conducted by such foreign buying operations. The foreign buyers usually assist the procedures in developing countries in adapting the products meeting the specification through counseling and training.

(iii) International Trading Companies/Overseas Import Houses:

Large import houses in countries like Japan provide an alternative form of entering such foreign markets. These companies have purchasing offices in many countries. These firms supply the foreign goods to the home markets in which they operate. Japanese International trading companies such as Mitsubishi, Mitsui and Sony account for about half of the Japanese imports. Selling through such trading companies automatically ensures that the goods will reach the important distributors and through them to the retailers/consumers

(iv) Export Management Company:

Such a company acts as agent or middleman for firms with relatively small international volume or for those companies who are not desirous of involving their own personnel in international marketing. It has no production of its own and acts only as an international marketing agent and charges commission from the producers on the basis of volume of goods handled by it. The Export Management Companies (EMCs) help the exporters to market their products more efficiently and more effectively EMCs act for several firms at the same time. An exporter works in close cooperation with an EMC and has sufficient control over deals made through it. The EMC often uses the letter head of the manufactures, negotiates of the firm's behalf and gets its approval on orders and quotations. Most EMC's accept foreign credit responsibility. Thus EMC approach enables the small firms to overcome limitation of size and knowledge while retaining sufficient control over export deal.

Advantages and limitations of indirect exporting

Indirect exporting enable even a small company to enter into foreign market despite having limited managerial and financial resources. Manufactures of goods need not tie up their capital in goods for a long time because the export merchants usually pay them against purchase of their good. The small manufactures who cannot afford to spend huge sum of money on marketing research and contacting foreign customers get orders for export from merchant exporters or agents. The manufactures is free to concentrate on production. The manufacturing company, however, remains dependant on the export house/foreign buyers for its export business. Therefore, it cannot create its own brands. Further, the commission or profit that accrues to merchant exporter has the effect of reducing the return to the manufacturers.

1.5.1.2 Direct Exporting

In this method, the domestic manufacturing firm performs the export task itself instead of delegating the same to others. It requires greater involvement on the part of the firm in all functions of the sale and transmitting the merchandise. The firm can make a choice in terms of export markets and agents or distributes to represent the firm in those markets. It can motivate and control the distributors fix the price. Moreover, it can take decisions regarding products to be offered, promotional strategies to be pursued. Despite being more expensive and riskier than the indirect exporting, a large number of firms choose direct exporting. Apparently, direct exporting could result in higher sales than indirect exporting. It enables them better profit margin. The manufacturer exporter requires greater expertise in international marketing. Above all, the manufacturers can establish the brand and corporate image overseas. It also facilitates product adaptation meeting the requirements of the buyers effectively. For many companies, direct exporting evolves from indirect exporting. As knowledge about foreign markets and the sales made by an indirect export grows, the firm may decide to do its own direct.

Exporting may at times become costlier than other methods of overaeats investment. Further the host country may create impediments in exports by clamping by clamping new tariff barriers. In such a case the firm may resort to other methods of foreign market entry.

1.5.2 Licensing

Under international licensing, a firm in one country allows a firm in another country to use its intellectual property rights such as patents, trademarks, copyrights, technology, and marketing skills against the payment of royalty or fee. The supplier of such rights is called the licensor. The firm receiving the know-how and the right to manufacturer in the host country is called the license. The licensor avoids investing in production facilities and marketing activities in a foreign country. Therefore the licensor has very low level of involvement internationally.

The licensing agreements clearly specify the rights granted the responsibilities of each party, the markets to be served and the royalty amount. In many countries amount of royalties or fees are regulated by the government. Licensing agreements are subject to negotiations and tend to vary considerably in each case. A Licensing agreement may also be one of cross licensing. It involves mutual exchange of knowledge and or patents. In such a case, there may or may not be any monetary payments. Licenses are signed for a variety of time periods. The foreign license may ask for a longer licensing period to recover the initial capital investment made in machinery and other assets. The licensing agreements usually incorporate an option for renewal. Licensing agreements provide for a varying degree of control by a licensor. At times the agreement may require the license to purchase components or intermediate products from the licensor. The agreement may also specify the quality standards to be adhered to or put limits on marketing territory.

Advantages and Disadvantages of Licensing

Since licensing involves minimal commitment of resources. It is suitable for a firm which may not have the knowledge or the time to engage more actively in international marketing. For a company with limited resources, it can be beneficial to have a foreign partner market its products by signing a licensing contract. Licensing allows a firm to apply scare managerial resources on more lucrative markets. It is also an appropriatchoice when the market potential of the target market may be too small to support a manufacturing operation. Licensing reduces the risk of exposure to government intervention in that the license is a local firm in the host country. Licensing is a good entry method in a market where government regulation restricts the import of direct foreign investment. The licenses need not develop technology at his own. It reduces investment requirements for research and development and consequently the risk of its failure is reduced. Thus both commercial and political risks are minimized.

In industries of high national importance catering government order, local governments often prefer to purchase from local manufacturers. This may result in the formation of a "club" whereby foreign competitors find it difficult to gain any market share. In such a situation the foreign competitors can join such "clubs" via licensing to one of its members. A major disadvantage of licensing is that the license would develop as potential competitors after the expiry of the licensing agreement. The licensor receives royalties, usually paid as a percentage on sales volumes. The amount of royalties may be less than the expected levels in case the license's marketing skills are less developed. Further, the licensing fee in general are substantially lower than the profits that can be made by exporting or local manufacturing.

1.5.3 Franchising

Franchising is a special form of licensing in which the franchiser, that is the supplier of rights, grants another independent firm, called the franchise, the right to do business in a prescribed manner. The franchise agreement is more comprehensive than a regular licensing agreement in as much as the total operation of the franchise is prescribed. The franchiser makes a total marketing programme available, including the brand name, logo, products, and methods of operations. In return, the franchiser receives a franchise right fees and royalties. The franchisee invests capital and provides the knowledge about the host country environment. The main difference between licensing and franchising is that franchiser not only grants rights to the franchisee but also helps the latter in its operation through the supply of raw materials and other inputs while in licensing only the knowledge is sold. The franchiser generally has better control over the quality of product that under licensing. Major forms of franchising are manufacturer-retailer systems (e.g. automobile dealership) manufacturers-wholesalers systems (e.g. soft drink companies) and service firm-retailer system (e.g. hospitality services and fast food restaurants). The franchise operations in hospitality business and in retailing are becoming increasingly popular. Several companies are successfully exploiting the opportunities in foreign markets through franchising arrangements overseas. Among these companies are McDonald's, Burger King, Kentucky Fried Chicken and other U.S. fast food chains with operations in Latin America, Asia and Europe. According to terms of a franchise deal between Pepsi-Cola and Cadbury Schweppes, the Pepsi will bottle and distribute Cadbury Schweppes brands (including Schweppes and Canada Dry) in Poland, Hungry, and Slovakia. Service companies such as Holiday Inns, Hertz and Manpower Inc. have also adopted franchising to enter into foreign markets.

1.5.4 Management Contracts

A management contract is a low risk method of getting into a foreign market and it yields income from the beginning. It is an arrangement by which a company provides managerial assistance to another company in return for a fee. The firm providing the management know how may not have any equity stake in the enterprise to be managed. The supplier brings together a package of skills that will provide an integrated service to the client without incurring the risk and benefits of ownership. The arrangement becomes more lucrative. If the contracting firm is given an option to purchase some shares in the managed company within a stated period. Management contracts can also be used in case the operations of a firm are nationalized or expropriated. In certain situations, government pressure and restriction compel a foreign company either to sell its operations in host country or to relinquish control. In such a case and alternative way to generate revenue is to sign a management contract with the government or the new owner in order to manage the business. The new owner may lack technical and managerial expertise and may need the former owner to manage the investment until local employees are trained to manage the facility. Management contracts provide and opportunity from generating additional revenues for the managing company. It may obtain the business of exporting or selling otherwise products of the managed company. It may also be asked to supply the inputs that the managed company requires. Some Indian companies Tata Tea, Harrison Malayalam and AVT – have contracts to manage a number of plantations in Srilanka.

1.5.5 Turnkey Projects

A turnkey projects operation is an agreement by a seller to supply to buyer with a facility fully equipped and ready to be operated by the buyer's personnel. Its client need not search for individual contractors or

subcontractors. Instead, a package arrangement in the form of turnkey project permits the accumulation or responsibility in one entity, thus greatly simplifying the task of negotiation and supervision and subsequent accountability. This kind of arrangement is generally found in large scale projects such as production plants or utility constructions. These projects are undertaken by firms possessing vast financial, technical and managerial resources to execute projects in foreign countries. A turnkey contractor my sub-contract different phases/parts of the project.
This mode is appropriate for a foreign country which prohibits direct foreign investment and wants to develop an indigenous industry.

1.5.6 Local Manufacturing in Foreign Countries

Sometimes the exporting firm may find it either impossible or undesirable to supply all foreign markets from its domestic base. The goal of a manufacturing strategy may be set up a production base inside a target market country as a means of entering it. Other variations of this method range from complete manufacturing to contract manufacturing and partial manufacturing. Many companies find it beneficial to manufacture locally rather than supplying the particular market with products produced elsewhere. There are several reasons why a company prefers to invest in manufacturing facilities abroad. The main reason include: easy access to raw materials, lower labor costs; abundance of other factors of production e.g. energy, reduced transportation costs and risks market size, tariff barriers and political considerations. Due to the presence of these factors the imported goods may become uncompetitive. Honda with 68 per cent of its car sales coming from exports and 43 per cent from US market set up a Plant in Ohio in order to avoid future problems. A gun manufacturing company – Beretta- set up a manufacturing facility for handguns in Maryland, U.S.A. in order to meet the legal requirements that prohibit the import but not the sale of inexpensive, short-barreled pistols. The positive factors may also encourage a firm to produce abroad. Some markets like the European Union are large enough to ensure an efficient plant size. Also, the local production allows better attention to local needs concerning product design, delivery, and service. Finally, the motivation behind the location of plants in foeign countries may be reduced to cost-reduction rather than to enter new markets.

Approach to Overseas Manufacturing

The various approaches to foreign manufacturing vary in the extent of involvement in production and marketing activities. These approaches are as follows:

1.5.6.1 Contract Manufacturing:

Under contract manufacturing a company arranges to have its products manufactured by an independent local company on a contractual basis. The manufacturer's responsibility is limited to production. Afterwards, the marketing responsibilities for sales, promotion, and distribution are assumed by the international company. In a way, the international company hires the production capacity of the local firm to avoid establishing its own plant or to overcome trade barriers preventing import of its product. Contract manufacturing differs from licensing the local manufacturer produces goods on the basis of orders given by the international firm but the international firm gives no commitment beyond the placement of orders. However, quality control is usually a problem when production is undertaken by another firm.

1.5.6.2 Foreign Assembly:

In foreign assembly, the firm produces domestically all or a set of the components or inputs of a product and ships them to foreign markets for assembly (Assembly means fitting or joining together of fabricated components). In this strategy parts of components are produced in various countries in order to gain each country's comparative advantage. Capital investment parts may by produced in advanced nations, while labor-intensive assemblies are produced in less developed countries having low labor costs. This strategy is common among manufacturers of consumer electronics. Another reason encouraging the assembly operation is the lower import duty on parts and components than on the finished goods. Moreover, assembly operations can satisfy the "local content" demanded to some extent.

1.5.7 Foreign Direct Investment

Foreign Direct Investment (FDI) implies commitment of a company's capital, assets and personnel beyond national boundaries. It includes setting up of new operations as well as purchase of asset of existing companies. A number of factors are responsible for increasing popularity of FDI thorough out the world. Limited market opportunities in domestic market, desire for growth to preserve quality of foreign operations to have greater control over overseas operations and the need to overcome the barriers to trade of import restrictions are the major reasons for FDI flows In terms of ownership, foreign investment may take the form of joint venture or wholly owned subsidiary in host country.

1.5.7.1 Joint Venture

Joint Ventures are corporate partnerships created under a host country's law between multinational company and other parties. The essential feature of joint venture is that the ownership and management are shared between a foreign firm and a local firm. In some cases, there are more than two partners involved for example Pepsi's Indian Joint venture involved Voltas and Punjab Agro Industries Corporation. The most typical joint venture is a 50/50 venture, in which there are two parties, each of which holds a 50%

ownership stake and contributes a team of managers to share operating control. Some firms, however, seek joint ventures in which they have a majority share and thus tighter control. Joint ventures have a number of advantages. First, a firm benefits from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems, and business systems. Second, when the development costs and/or risks of opening a foreign market are high, a firm might gain by sharing these costs and/or risks with a local partner. Third, in many countries, political considerations make joint ventures the only feasible entry mode. Despite these advantages, there are major disadvantages with joint ventures. First, a firm that enters into a joint venture risk giving control of its technology to its partner. The second disadvantage is that a joint venture does not give a firm the tight control over subsidiaries that it might need to realize the experience curve or location economies. A third disadvantage with joint ventures is that the shared ownership arrangement can lead to conflicts and battles for control between the investing firms if their goals and objectives change or if they take different views as to what the strategy should be. These conflicts tend to be greater when the venture is between firms of different nationalities, and they often end in the dissolution of the venture.

1.5.7.2 Wholly Owned Foreign Subsidiary:

Wholly-owned means 100 per cent ownership by the international firm. In a wholly- owned subsidiary, the parent company owns 100 per cent of voting stock but its liability is limited to the assets of that subsidiary. This is the preferred type of foreign production ownership because it provides the multinational company with greater control and flexibility. It facilitates coordination among multinational operations.

The international firm can obtain wholly-owned foreign production facilities in two ways:

- buy out a foreign producer or joint venture partners- the acquisition route; or
- Develops its own facilities from the ground up.

The limitations of the wholly-owned subsidiary include the inadequacy of capital resources, shortage of management personnel, negative host-government and public relations effect. Further, 100 per cent ownership may deprive the firm of the local business and cultural knowledge and contracts of a national partner.

1.5.8 Strategic Alliances

Strategic Alliances have become popular in international business. This strategy seeks to enhance the long term competitive advantage of the firm by forming alliances with its competitors, instead of competing with each other. In an alliance, partners bring a particular skills or resource, usually one that is complementary. By sharing resources both partners are expected to gain an advantage from the other's experience. In this arrangement a new entity may or may not by formed. Typically, the alliances involve either distribution access technology transfers or production technology, with each partner contributing a different element to the venture. The automobile industry has witnessed many alliances for overseas operations. The Isuzu Motors Ltd. and Fuzi Heavy Industries Ltd. of Japan have set up a joint plant in the U.S.A. to build cars for Fuji and trucks for Isuzu on the same auto line. In India, Tata Tea has entered into an alliance with Tetley so that the marketing expertise of Tetley is available to market tea abroad. A strategic alliance implies: (i) that there is a common objective; (ii) that one partner's weakness is offset by the other's strength; (iii) that reaching the objectives alone would be too costly, take too much time, or be too risky; and (iv) together their respective strengths make possible what otherwise would be unattainable. In short, a strategic alliance is a synergistic relationship established to achieve a common goal where both parties benefit. Firms ally themselves with actual or potential competitors for various strategic purposes. First, it may facilitate entry into foreign market. For example, Motorola initially found it very difficult to gain access to the Japanese cellular telephone market. In the mid-1980s, the firm complained loudly about formal and informal Japanese trade barriers. The turning point for Motorola cam in 1987 when it allied itself with Toshiba to build microprocessors. As part of the deal, Toshiba provided Motorola with marketing help, including some of its best managers. This alliance also helped Motorola in securing government approval to enter the Japanese market. Strategic alliances also allow firms to share the fixed costs and associated risks of developing new products or processes. Motorola's alliance with Toshiba also was partially motivated by a desire to share high fixed costs of setting up an operation to manufacture microprocessors. The microprocessor business is so capital intensive – Motorola and Toshiba each contributed close to $I billion to set up their facility – that few firms can afford the costs and risks by themselves. Similarly, an alliance between Boeing and a number of Japanese companies to build the 767 was motivated by Boeing's desire to share the estimated $2 billion investment required to develop the aircraft.

1.6 Factors influencing choice of Entry Strategy

Choice of mode of entering cross-border markets is one of the strategic decision which a multinational enterprise has to make before investing resources. There is no specific rule to facilitate the choice of a correct method nor there single entry method which could meet the requirements of different situations. Choice of a particular entry method will, therefore depend upon various factors. Usually, any company approaching a new market is looking for profitability and growth. Alternative entry method should be analyzed for expected sale level, costs and assets level that will eventually determine profitability. Other important considerations influencing the choice of a mode of entry include size of the firm, exposure of the firm to international market , product life cycle stage of the firm's product, level of risk associated with different modes of market entry, and the political and legal environment of the foreign country concerned.

The mode of entering a foreign market is an important issue before a company that decides to go international. Several options are available and firm has to carefully decide which option to select. The modes of entry include indirect exporting, direct exporting, licensing, franchising, management contracts, turnkey projects, joint ventures and foreign direct investment etc. Firms normally start with indirect mode and ultimately reach a stage of direct investment over a period of time. Profits, control, and risks increase as companies move from indirect exports to foreign direct investment. Every mode has certain advantage and disadvantage.

There is, however, no specific rule to facilitate the choice of a correct method of entering foreign markets and also there is no single entry method which could meet the requirements of different countries. Choice of a particular entry method, therefore, depends upon various factors. Usually, any company approaching a new market is looking for profitability and growth, control of operations, and risks involved

1.7 Summary

The method of entering a foreign market is a crucial issue for a company that decides to go international. Numerous options are available, and the company must carefully determine which option to choose. Entry methods include indirect exporting, direct exporting, licensing, These include franchising, management contracts, turnkey projects, joint ventures, and foreign direct investment. Firms typically begin with the indirect method and eventually progress to the direct investment stage over time. As companies move from indirect exports to direct foreign capital investment, the benefits, controls, and risks increase. Each method has specific advantages and disadvantages However, there is no specific rule that facilitates the selection of the right method of entry into a foreign market, nor is there a single entry method that can meet the needs of different countries.

The selection of a specific entry method, therefore, depends on many factors. Generally, any company looking to enter a new market considers profitability and growth, control of operations, and the risks involved. Therefore, companies should analyze various alternative entry methods using these criteria and then decide on a specific entry method Export Management Companies: Companies that act as agents or intermediaries. They do not have their own production lines and act solely as international

marketing agents, receiving commissions from manufacturers based on the volume of goods they export. Management Contracts: A low-risk method of entering a foreign market, whereby one company provides managerial support to another in exchange for a fixed fee. Turnkey Projects: An arrangement in which the seller provides the buyer with complete facilities that the buyer's employees can immediately operate. Customers do not need to find individual contractors or subcontractors. Franchising: A specific type of licensing in which the franchise provider, the rights supplier, grants another independent firm the right to conduct business in a specified manner, called a franchise. Licensing: An arrangement in which a firm in one country allows a firm in another country to use its intellectual property rights, such as patents, trademarks, copyrights, technical and marketing skills, in exchange for payment of a royalty or fee. EMC: Export

1.8 **Glossary**

Export Management Company: These are companies that operate as agents or intermediaries. They do not have any production of their own; instead, they function solely as international marketing agents and earn commissions from manufacturers based on the volume of goods handled.

Management Contract: A low-risk method of entering a foreign market, whereby one company provides managerial assistance to another in exchange for a stipulated fee.

'Turnkey project': This is an arrangement in which the seller provides the buyer with a fully operational facility that the buyer's employees can operate immediately. The client does not need to seek out individual contractors or subcontractors.

'Franchising': This is a specific type of licensing in which the franchisor (the rights provider) grants another independent firm the right to conduct business in a prescribed manner; this arrangement is known as a 'franchise'.

Licensing: An arrangement in which a firm in one country grants a firm in another country permission to use its intellectual property rights—such as patents, trademarks, copyrights, and technical and marketing skills—in exchange for the payment of a royalty or fee.

EMC: Export Management Companies,

FDI: Foreign Direct Investment, S&T: Science and Technology,

OPEC: Organization of the Petroleum Exporting Countries,

EEC: European Economic Community

1.9 **Check your progress**

Fill in the blanks:

(1) The ____________________________ industry prefers licensing as an entry method over other methods.

(2) McDonald's entered Indian markets using the

__________________________ method.
(3) Indian Railways exports __________________________ projects to other countries.
(4) Multinational corporations prefer using __________________________ as a method of entry into foreign countries.
(5) Foreign direct investment organizers generate __________________________ in the country.

b) State True/False.
(1) International business is a broader term than international trade.
(2) Even in the long run, firms continue to grow without any influence from international business.
(3) Firms export when they have established themselves in the domestic market.
(4) Indirect exporting provides the same comparative advantage in the long run as direct exporting.
(5) Exporting is not a good method of entering foreign markets when hig tariff rates are imposed by the importing country

1.10 Answer to check your progress

A) (1) Service (2) Franchising (3) Turnkey (4) Local (5) Manufacturing (6) Employment.
B) (B) (1) True (2) False (3) True (4) False (5) True.

1.11 Terminal question

1. Explain the difference between direct and indirect exporting.
2. What is a licensing agreement? Bring out advantages and disadvantages of licensing mode of entry into foreign markets.
3. Write notes on:
   a) Strategic Alliances
   b) Turnkey Projects
4. What difficulties can be expected for a firm practicing only franchising as an entry strategy.

1.12 Suggest reading

(i) Keegan, W.J., "Global Marketing Management", 5th edition, Prentice Hall of India Pvt. Ltd., New Delhi, 1996.
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(iii) Philip Kotler, Swee Hoon Ang, Siew Meng Leong, and Chin Tiong Tan, "Marketing Management – An Asian perspective", Prentice Hall, Simon & Schuster (Asia) Pte. Ltd., Singapore, 1996, pp. 107-

143.

(iv) Philip R. Cateora, and John L. Graham, "International Marketing", 10th edition, Tata McGraw Hill Publishing Co. Ltd., New Delhi, 2001.

(v) Terpstra, Vern and Sarathy, Ravi, "International Marketing", 7th edition, The Dryden Press, 1997.

(vi) William J. Stanton, Michael J. Etzel, and Bruce J. Walker," Fundamentals of Marketing," McGraw Hill International, USA, 10th edition, 1996.

Unit-2 Gains from trade, terms of trade and foreign trade multiplier
Structure:

Structure

Objectives:

- After reading this unit, you will be able to understand:
- The concepts of gains from trade;
- Terms of trade;
- Concept of foreign trade multiplier;
- Income generation process through multiplier in a closed economy;
- Income generation process through the foreign trade multiplier in an open economy; and
- To study the effects of multiplier in foreign trade.

2.1 introduction

According to the classical theory, specialization based on the principle of comparative costs advantage is the major source of gain from international trade. An additional source is the possibility of exploiting economies of scale when the size of the market is extended through the free foreign trade of a country. Further, terms of trade (TOT) refers to the relative price of exports in terms of imports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods. An improvement of a nation's terms of trade benefits is that the country can buy more imports for any given level of exports. The terms of trade may be influenced by the exchange rate because a rise in the value of a country's currency lowers the domestic prices of its imports but may not directly affect the prices of the commodities it exports. Moreover, the foreign trade multiplier is a concept that states that net exports (exports minus imports) may magnify the impact on nation's income.

2.2 Gains from trade

In economics, gains from trade refer to net benefits to agents from allowing an increase in voluntary trading with each other. In technical terms, it is the increase of consumer surplus plus producer surplus from lower tariffs or otherwise liberalizing trade. Gains from trade are commonly described as resulting from specialization in production from division of labor, economies of scale, scope, and agglomeration and relative availability of factor resources in types of output by farms, businesses, location and economies, a resulting increase in total output possibilities, and (iii) trade through markets from sale of one type of output for other, more highly valued goods. Market incentives, such as reflected in prices of outputs and inputs, are theorized to attract factors of production, including labor, into activities according to comparative advantage, that is, for which they each have a low opportunity cost. The factor owners then use their increased income from such specialization to buy more- valued goods of which they would otherwise be high-cost producers, hence they gain from trade. The concept may be applied to an entire economy for the alternatives of autarky (no trade) or trade. A measure of total gains from trade is the sum of consumer surplus and producer profits or, more roughly, the increased output from specialization in production with resulting trade. Gains from trade may also refer to net benefits to a country from lowering barriers to trade such as tariffs David Ricardo in 1817 first clearly stated and proved the principle of comparative advantage, termed a "fundamental analytical explanation" for the source of gains from trade. But, from publication of Adam Smith's "The Wealth of Nations" in 1776, it was widely argued, that, with competition and absent market distortions, such gains are positive in moving toward free trade and away from autarky or prohibitively high import tariffs. Rigorous early contemporary statements of the conditions under which this proposition holds are found in Samuelson in 1939 and 1962. For the analytically tractable general case of Arrow-Debreu goods, formal proofs came in 1972 for determining the condition of no losers in moving from autarky toward free trade. It does not follow the concept that no tariffs are the best an economy could do. Rather, a large economy might be able to set taxes and subsidies to its benefit at the expense of other economies. Later results of Kemp and others showed that in an Arrow-Debreu world with a system of lump-sum compensatory mechanisms, corresponding to a customs union for a given subset of countries (described by free trade among a group of economies and a common set of tariffs), there is a common set of world's tariffs such that no country would be worse off than in the smaller customs union. The suggestion is that if a customs union has advantages for an economy, there is a worldwide customs union that is at least as good for each country in the world.

2.3 Measurement of gains from trade

According to Classical Economist there are two methods to measure the gains from trade; firstly, international trade increases national income which helps us to get low priced imports and lastly, gains are measured in terms of trade. To measure the gains from the trade comparison of cost of production between domestic and foreign countries some cost is required. But, it is very difficult to acquire the knowledge of cost of production and cost of imports in a domestic country. Therefore terms of trade method is preferable to measure the gains from trade.

2.4 factors affecting gains from trade

There are several factors which determine the gains from international trade:

(i) **Differences in cost ratio:** The gains from international trade depend upon the cost ratios of differences in comparative cost ratios in the two trading countries. The smaller the difference between exchange rate and cost of production the smaller the gains from trade and vice versa.

(ii) **Demand and supply:** If a country has elastic demand and supply gains from trade, the gains are higher if demand and supply are inelastic.

(iii) **Factor availability:** International trade is based on the specialization and a country specializes depending upon the availability of factors of production. It will increase the domestic cost ratios and thereby the gains from trade.

(iv) **Size of country:** If a country is small in size it is relatively easy for them to specialize in the production of one commodity and export the surplus production to a large country and can get more gains from international trade. Whereas, if a country is large in size then they have to specialize in more than one good because the excess production of only one commodity cannot be exported fully to a small sized country as the demand for good will reduce very frequently, so smaller the size of the country larger is the gain from trade.

(v) **Terms of Trade:** Gains from trade will depend upon the terms of trade. If the cost ratio and terms of trade are closer to each other more will be the gains from trade of the participating countries.

(vi) **Productive Efficiency:** An increase in the productive efficiency of a country also determines its gains from trade as it lowers the cost of production and price of the goods. As a result the country importing gains by importing cheap goods.

2.5 Static and dynamic gains from trade

Static The gains from trade can be classified into static and dynamic gains from trades. Static Gains means the increase in social welfare as a result of maximized national output due to optimum utilization of country's factor endowments or resources. Dynamic gains from trade are those benefits which accelerates economic growth of the participating countries. Static gains are the result of the operation of the theory of comparative cost in the field of foreign trade. On this principle countries make the optimum use of their available resources so that their national output is greater which also raises the level of social welfare in the country. When there is an introduction of foreign trade in the economy the result is called the static gains from trade. Dynamic gains from trade relate to economic development of the economy. Specialization of the country for the production of best suited commodities which result in a large volume of quality production promotes growth. Thus the extension of domestic market to foreign market will accelerate economic growth.

2.6 Terms of trade

Historically, the term (barter) terms of trade was first coined by the US American economist Frank William Taussig in his 1927 book International Trade. However, [i]an earlier version of the concept can be traced back to the English economist Robert Torrens and his book The Budget: On Commercial and Colonial Policy, published in 1844, as well as to John Stuart Mill's essay Of the Laws of Interchange between Nations; and the Distribution of Gains of Commerce among the Countries of the Commercial World, published in the same year, though allegedly already written in 1829-30. Terms of trade (TOT) is a measure of how much imports an economy can get for a unit of export goods. For example, if an economy is only exporting apples and only importing oranges, then the terms of trade are simply the price of apples over the price of oranges. In other words, how many oranges can you get for an apple? Since economies typically export and import many goods, measuring the TOT requires defining price indices for exported and imported goods and comparing the two. A rise in the prices of exported goods in international markets would increase the TOT, while a rise in the prices of imported goods would decrease it. For example, countries that export oil will see an increase in their TOT when oil prices go up, while the TOT of countries that import oil would decrease.

2.7 Two countries model

In the simplified case of two countries and two commodities, terms of trade is defined as the ratio of the total export revenue that a country receives for its export commodity to the total import revenue as it pays for its import commodity. In this case the imports of one country are the exports of the other country. For example, if a country exports 50 dollars' worth of product in exchange for 100 dollars' worth of imported product, that country's terms of trade are 50/100 = 0.5. The terms of trade for the other country must be the reciprocal (100/50 = 2). When this number is falling, the country is said to have "deteriorating terms of trade". If multiplied by 100, these calculations can be expressed as a percentage (50 per cent and 200 per cent respectively). If a country's terms of trade fall from say 100 per cent to 70 per cent (from 1.0 to 0.7), it has experienced 30 per cent deterioration in its terms of trade. When doing longitudinal (time series) calculations, it is common to set a value for the base year to make interpretation of the results easier. In basic Microeconomics, the terms of trade are usually set in the interval between the opportunity costs for the production of a given good of two countries. Terms of trade is the ratio of a country's export price index to its import price index, multiplied by 100. The terms of trade measures the rate of exchange of one good or service for another when two countries trade with each other

2.8 Multi-commodity multi-country model

In the more realistic case of many products exchanged between many countries, terms of trade can be calculated using a Laspeyres index. In this case, a nation's terms of trade is the ratio of the Laspeyre price index of exports to the Laspeyre price index of imports. The Laspeyre export index is the current value of the base period exports divided by the base period value of the base period exports. Similarly, the Laspeyres import index is the current value of the base period imports divided by the base period value of the base period imports.

$$\frac{p_x^c\, q_x^0}{p_x^0\, q_x^0} \bigg/ \frac{p_m^c\, q_m^0}{p_m^0\, q_m^0}$$

Where

$p_x^c =$price of exports in the current period $q_x^0 =$ quantity of exports in the base period $p_x^0 =$ price of exports in the base period $p_m^c =$ price of imports in the current period $q_m^0 =$ quantity of imports in the base period p_m^0 = price of imports in the base period

Basically: Export Price over Import price times 100. If the percentage is over 100 per cent then your economy is doing well (Capital Accumulation). If the percentage is under 100 per cent then your economy is not going well (More money going out than coming in).
However, terms of trade should not be used as synonymous with social welfare, or even Pareto economic welfare. Terms of trade calculations do not tell us about the volume of the countries' exports, only relative changes between countries. To understand how a country's social utility changes, it is necessary to consider changes in the volume of trade, changes in productivity and resource allocation, and changes in capital flows. The price of exports from a country can be heavily influenced by the value of its currency, which can in turn be heavily influenced by the interest rate in that country. If the value of currency of a particular country is increased due to an increase in interest rate one can expect the terms of trade to improve. However, this may not necessarily mean an improved standard of living for the country since an increase in the price of exports perceived by other nations will result in a lower volume of exports. As a result, exporters in the country may actually be struggling to sell their goods in the international market even though they are enjoying a high price. In the real world of over 200 nations trading hundreds of thousands of products, terms of trade calculations can get very complex. Thus, the possibility of errors is significant.

2.9 Foreign trade multiplier

The original idea of multiplier was given by R. F. Kahn, this multiplier was Employment Multiplier. The Employment Multiplier studies the effect of changes in employment on changes in income as per which the changes in income happens to be greater than the initial change in employment. It works through employment multiplier.
Algebraically, $\Delta Y = ke \cdot \Delta E$

ΔY stands for change in income. Ke stands for Employment Multiplier

ΔE stands for initial change in Employment. Lord J. M. Keynes borrowed the idea of his Investment Multiplier from R. F. Kahn‟s Employment Multiplier. The Post- Keynesian economists extended the Keyne‟s multiplier meant for closed economy to foreign trade multiplier meant for an open economy. The Concept of foreign trade multiplier was given by Mr. Leighton.

2.10 Income determination in a multiplier in a closed economy

In a closed economy the total national income is equal to the sum total of private spending *i.e.* C + I and the Government Spending i.e. G. When national income is looked at from the angle of total expenditure, it represents the expenditure side of the total national income of the country.
Algebraically,
$Y = C + I + G$

Y stands for total national income.

C Stands for total Consumption
expenditure. I stands for total
investment expenditure.
G stands for Governmental expenditure.

Since Government doesn't strictly follow the rules of economics its role gets omitted. Hence, in a closed economy the total national income will be equal to the sum of consumption and investment expenditure.
Algebraically,

$Y = C +$
I $C = f$
(Y)
Since consumption in an indigenous variable it depends upon total national income. As income rises consumption rises too but it rises at a diminishing rate
$I \neq f(Y)$

Since Investment is an exogenous variable it is not a function of total national income. $Y = C + S$
$Y = C + I$

C, C from both the equations get cancelled hence savings will be equal to investment and conversely investment will be equal to savings.
Algebraicall
y, $S = I$
$I = S$

If we allow time period to exert its influence on savings and investment then it will bring about changes in savings and investment. The change in savings will be equal to change in investment and *vice versa*.
Algebraicall
y, $\Delta S = \Delta I$
$\Delta I = \Delta S$

Keynes Multiplier depends upon the marginal propensity to consume (MPC) Algebraically,
$K = f(MPC)$

K stands for Multiplier.

f stands for functional relationship.

MPC stands for marginal propensity to consume.

The Marginal propensity to consume is equal to change in consumption upon change in income *i.e.*
Algebraically,

$$MPC = \frac{\Delta C}{\Delta Y}$$

There are two limiting cases to marginal propensity to consume viz.

(i) MPC is always positive ie it is always greater than zero.

(ii) MPC will never be never be equal to 1

Hence MPC will get sandwiched between zero and one to two extremes.
Mathematically,

$$0 < \frac{\Delta C}{\Delta Y} < 1$$

$$\left[K = f\left(\frac{\Delta C}{\Delta Y}\right)\right]$$

Since Multiplier in a function of MPC the multiplier also has two limiting cases. YC f K
i) The Multiplier will always be greater than one.

ii) The multiplier will never be equal to
infinity. Mathematically,
$1 < K < \alpha$

If K is equal to 1 then there will be no meaning to multiplier because the original value will not change for example 10*1 = 1. It means multiplier is meaningful only when it is greater than one. For example 10*2 = 20.
K is a ratio between increase in income and increase in
investment. Algebraically

$$K = \frac{\Delta Y}{\Delta I}$$

K stands for Multiplier. ΔY stands for change in National Income Δ I stands for change in Investment. Since we are interested in the income propagation through Multiplier with the initial change in investment given let us take out

ΔY from the
equation ΔY = K.
Δ I
It means the ultimate increase in income will be K times change in investment *i.e.* Δ I*K.

$$K = f\left(\frac{\Delta C}{\Delta Y}\right)$$

$$1 = \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$$

i.e. 1 is equal to MPC + MPS.

MPC stands for Marginal Propensity to Consume. MPS stands for Marginal Propensity to save.

Formulae for calculation of Multiplier

$$K = \frac{1}{1 - \frac{\Delta C}{\Delta Y}}$$

$$\therefore K = \frac{1}{\frac{\Delta S}{\Delta Y}}$$

$\Delta Y = K.\ \Delta I$

K is the reciprocal of MPS.

Let us assume that the value of ΔI is 1,000 crores rupees and the value of MPC *i.e.*

$\Delta C / \Delta Y = 3/4$ hence $\Delta S / \Delta Y = 1/4$.

Substituting the values in the formulae
we get, K=1/(1-3/4)
K=4

$\Delta Y = K.\ \Delta I$

Substituting the values we
get, ΔY = 4*Rs. 1000 crores
ΔY = Rs. 4000 crores.

2.11 Foreign trade multiplier in an open economy

Keynes concept of closed Economy-Multiplier was extended to open economy by Mr. Leighton to be termed as Foreign Trade Multiplier. It is also called as Export Multiplier. The Foreign Trade multiplier brings about the effect of change in exports on change in income. In the open economy exports are exogenous ie they do not depend upon national income of an economy. It gets determined exogenously in the external factors line taste and preferences of the residents of the foreign country and the national income of the foreign countries. While imports get determined by national income of an economy (Imports are indigenous)

Algebraicall
y, $M = f(Y)$
M stands for imports.

f stands for functional
relationship. Y stands for total
National Income.
There is a direct and positive relationship between imports and National Income. As total national income rises imports rise too and *vice versa*.
X#f (Y)

X stands for
exports. #It
signifies not.
f stands for functional
relationship. Y stands for Total
National Income.
In an open economy an equilibrium level of national income gets established when savings are equal to investment and imports are equal to exports.
Algebraicall
y, $S = I$
$M = X$

S stands for savings.

I stands for
Investment. M
stands for Imports.
X stands for
Exports.
The equilibrium condition of national income in an open economy will be as follows: $Y = C + I + X – M$
In a closed economy equilibrium of income takes place when savings are equal to investment. Algebraically,
$S = I$

While in an open economy the equilibrium of national income takes place when investment plus exports are equal to savings plus imports. Algebraicall

y, $I + X = S$

$+ M$

$I + X$ stand for Investment and exports which are injections. When they are injected into the economy they bring increment to national income. $S + M$ stand for Savings and Imports. They are leakages. They leak out the national income. Thus when

i) $I + X > S + M$ Expansion takes place

ii) $I + X < S + M$ Contraction takes place

When we introduce the change then the equation will be as follows:

$\Delta S + \Delta M = \Delta I + \Delta X$

ΔS stands for change in savings. ΔM stands for change in imports. ΔI stands for change in Investment. ΔX stands for change in Exports.

The marginal propensity to saving *i.e.* $\Delta S/\Delta Y$ determines change in savings which is designated as S while the marginal propensity to import determines the change in imports. $\Delta M/\Delta Y$

Which is designated as m hence the equation will be as follows: $(S + M)\ \Delta Y = \Delta I + \Delta X$

$\Delta Y = (\Delta I + \Delta X)/(S + M)$

The foreign trade multiplier is a function of marginal propensity to save plus marginal propensity to import.

Kf sets designated as Foreign Trade Multiplier. $Kf = f\ (S + M)$

Kf stands for Foreign Trade Multiplier. f stands for functional relationship.

S stands for marginal Propensity to save.

M stands for marginal Propensity to import. There is an inverse relationship between s

+ m and Kf. Smaller the s + m greater will the Kf. Conversely greater the s + m smaller will be Kf.

Hence the formula of income propagation through foreign trade multiplier will be as follows:

$\Delta Y = (\Delta I + \Delta X)/(S + M)$

$$Kf = \frac{1}{MPS + MPM}$$

The value of MPS =
0.25 The value of MPM
= 0.15
Substituting the values we get,
Kf=1/(0.25+0.15)
Kf=2.5

$\Delta Y = Kf.\Delta X$

If exports increase by 200 *i.e.* from 300 to
500; $\Delta I = 0$ $Y = 2.5*200 = 500$
$YE1 = YE + Y = 1000 + 500 =$
1500 $\Delta S = S\Delta Y = 0.25*500 =$
125
$\Delta M = m\Delta Y + 0.15*500 = 75$

At the point of changed equilibrium level of national income

$\Delta I + \Delta X = \Delta S +$
ΔM $0 + 200 =$
$125 + 75$
$200 = 200$

K = 4 in the closed economy while Kf = 2.5 in the open economy. Kf < K because of two leakages *i.e.* savings and imports.

2.12 Another viewpoint about foreign trade multiplier

In other words, the foreign trade multiplier also known as export multiplier operates like the investment multiplier of Keynes. It may be defined as the amount by which national income of a nation will be raised by a unit increase in domestic investment on exports. As exports increase there is an increase in the income of all persons associated with the exports industries. These in turn create demand for goods. But, this is dependent upon their marginal propensity to save (MPS) and marginal propensity to import (MPM). The smaller these two propensities are, the larger will be the value of multiplier and *vice-versa*. In very simple terms, we can say that foreign trade multiplier is a concept that states that net exports (exports minus imports) may magnify the impact on nation's income. The concept is can be understood clearly by considering the following points:

2.12.1 Postulations

The foreign trade multiplier based on the following:

(i) There is full employment in the domestic economy.

(ii) There is direct link between domestic and foreign country in exporting and importing goods and the country is small with no foreign country.

(iii) It is on a fixed exchange-rate system, the multiplier is based in instantaneous process without time lag and the domestic investments remains invariable.

(iv) There is no accelerator and the analysis is applicable to only two countries.

(v) There are no tariff barriers and exchange controls.

(vi) The government expenditure is constant.

2.12.2 Bathtub theorem

The bathtub theorem is an analogy that explains the effects of exports and imports on national income. According to the analogy used in the bathtub theorem, national income level is the water in the bathtub. Exports, government spending, or investments inject extra water in the tub, and thus raise the level, while imports, savings, or taxes cause leakages. According to the same analogy, there will be a neutral effect on the water (or national income) level if exports equal imports, an expansionary effect if exports exceed imports, and finally, a contrationary effect if imports exceed exports.

2.12.3 Net exports effects

(i) **Neutral effect:** exports equals imports, thus GDP does not change. In bathtub terms, injections are equal to withdrawals keeping the water level the same.

(ii) **Expansionary effect:** exports are greater than imports, thus GDP increases. In bathtub terms, injections are greater than withdrawals raising the water level of the bathtub.

(iii) **Contractionary effect:** exports are less than imports, thus GDP decreases. In bathtub terms, injections are less than withdrawals lowering the water level of the bathtub.

2.12.4 Assumptions of the open-economy model

(i) Imports depend on the level of national income. As the national income increases, than do domestic expenditures on imports. Thus, marginal propensity to import (MPM) is defined as:

MPM = change in imports / change in income

(ii) Exports have no relationship with the level of national income, thus they are independent.

2.12.5 Multiplier effect

(i) With the assumptions described above, an increase in exports tends to raise domestic income, but the increased income also encourages some imports, which act as "leakages." These tend to reduce the full multiplier effect that would exist if imports remained constant.

(ii) Open economy`s allocation of income is MPC + MPS + MPM = 1. Thus, MPM is the fraction of any increase in income that "leaks" into imports.

(iii) The foreign trade multiplier is defined as the reciprocal of all the leakages, including imports.

Foreign trade multiplier = 1 / (MPS + MPM) = 1 / leakage

(iv) If MPS is constant then the MPM has an inverse relationship with MPC. As more imports are consumed, there are smaller amounts to be consumed for domestic goods.

Example 2.1:

If the MPS = 0.15 and the MPM = .05, the total leakage is 0.20.
Therefore, Foreign trade multiplier = 1/(0.15 + 0.05) = 5
One unit change in aggregate expenditure will have a five-unit change in GDP. In contrast, the simple multiplier for a closed economy is 1/.15 = 6.67.

Example 2.2:

Let us assume the following:

MPS = 0.4, MPM = 0.4 and Δ X = $ 2,000 millions

Where MPS is Marginal Propensity to Save and MPM is Marginal Propensity to Import. Calculate the foreign trade multiplier
Solution:

The formula to calculate the foreign trade multiplier is Kf = 1/MPS + MPM

Where,

MPS = Δ S and MPM = Δ M

Δ Y = 1/(MPS + MPM)* Δ X
= 1(0.4 + 0.4) * 2,000
= 1/(0.8)* 2,000
= 2,500

It shows that an increase in exports by \$ 500 millions has raised national income though the foreign trade multiplier to \$ 2,500 millions, given the values of MPS and MPM.

Example 2.3:

An economy is characterized by the following equations:

Consumption $C = 120 + 0.9Yd$

Investment $I = 20$

Government $G =$

20 Expenditure

Tax $T = 0$

Exports $X =$

40

Imports $M = 20 + 0.05\ Y$

(i) What is the equilibrium income? (iii) Calculate trade balance. (iii) What is the value of foreign trade multiplier?

Solution:

(i) National Income

$$
\begin{aligned}
Y &= C + I + G + Nx \\
&= 120 + 0.9Yd + 20 + 20 + 40 - (20 - 0.05Y) \\
&= 120 + 0.9\,(Y - T) + 20 + 20 + 40 - 20 - 0.05Y \\
&= 120 + 0.9Y - 0 + 60 - 0.05Y \\
Y &= 180 + 0.85Y \\
Y - 0.85Y &= 180 \\
0.15\,Y &= 180 \\
Y &= 180 / 0.15 \\
Y &= 1{,}200
\end{aligned}
$$

(ii) Trade Balance $= X - M$

$$= 40 - (20 + 0.05Y)$$

Substituting the value of Y, we have

$$
\begin{aligned}
\text{Trade balance} &= 40 - [20 + 0.5(1{,}200)] \\
&= 40 - 20 - 60 \\
&= -\,40
\end{aligned}
$$

Trade balance is in deficit.

(iii) Value of foreign trade multiplier = 1

$$1 - b + m$$

Where b is marginal propensity to consumer and m is marginal propensity to import.

Foreign Trade Multiplier = 1/(1 – 0.9 + 0.05)

= 1/(0.15)

= 6.67

Example 2.4:

Behavioural and Structural equations of an economy are given below: C = 200 + b (Y – 100 – tY)

I = 100

G = 100

X = 20

M = 10 + 0.1Y

The marginal propensity to consume 'b' is equal to 0.8 and proportional income tax rate, t = 0.25.

(i) Find the equilibrium national income. (ii) Find foreign trade multiplier. (iii) Find equilibrium value of imports. (iv) If equilibrium national income falls short of full employment income by $ 100, how much government should increase its expenditure to attain full employment?

Solution:

(i) Reduced form of the equation for equilibrium income is Y = 1/1 – b (1-t) + m *(a - bT + I + G + X - $\acute{M}$)

Substituting the values of the variables and parameters we have

Y = 1/(1 – 0.8 (1-0.25) + 0.1) *(200 – (100*0.8) + 100 + 100 + 20 - 10)

Y = 330 / 0.5

Y = 660

(ii) Foreign Trade Multiplier

= 1/1 – b (1-t) + m

= 1/1 – 0.8 (1-0.25) + 0.1

= 0.5

(iii) Equilibrium value of imports can be obtained by substituting the equilibrium income 660 in the import function. Thus

M = 10 + 0.1Y

$M = 10 + 0.1(660)$

$M = 10 + 66 = 76$

(iv) Required increase in Government expenditures to attain $ 100 increase in income can be obtained as under:

ΔY = Foreign Trade Multiplier * ΔG

$\Delta Y = 2 * \Delta G$

Or $\Delta G = \Delta Y/2 = 100/2 = 50$

Example 2.5:

The equations in the economy are given as: $C = 400 + bYd$
$I = 140$

Tax $T = 120$

Government = 140

Expenditure G Exports X = 40
Imports $M = 20 + 0.1Y$

Marginal Propensity to consumer $b = 0.8$.

(i) Find the equilibrium level of income. (ii) The value of the foreign trade multiplier

(iii) The equilibrium level of imports.

Solution:

(i) The consumption function is

$C = 400 + 0.8Yd$

$C = 400 + 0.8(Y - T)$

$C = 400 + 0.8(Y - 120)$

The equilibrium condition is given as $Y = C + I + G + X - M$ Thus,

$Y = 400 + 0.8(Y - 120) + 140 + 140 + 40 - 20 - 0.1Y$

$Y = 400 + 0.8Y - 96 + 140 + 140 + 40 - 20 - 0.1Y$

$$Y = 604 + 0.7Y$$
$$Y - 0.7Y = 604$$
$$0.3Y = 604$$
$$Y = 604 / 0.3$$

Thus equilibrium level of income is 2,013.33.

(ii) Foreign Trade Multiplier

$$\Delta Y = 1/(1 - b + m)$$
$$= 0.3$$

(iii) Imports at the equilibrium level

$$M = 20 + 0.1Y$$
$$= 20 + 0.1\,(2{,}013.33)$$
$$= 20 + 201.333$$
$$= 221.333$$

The equilibrium level of imports is 221.333. Economies of scale and specialization are the major sources of gain from international trade. Terms of trade refers to the relative price of exports in terms of imports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods. Lord J.M. Keynes multiplier was investment multiplier which was meant for closed economy. Keynes multiplier is extended to open economy which gets referred to as foreign trade multiplier. The term foreign trade multiplier was given by Mr. Leighton. Closed economy multiplier gets designated as K which is a function of MPC. Foreign Trade Multiplier is a function of MPS + MPM.

2.13 Summary

Economies of scale and specialization are the primary sources of gains from international trade. Terms of trade refer to the relative prices of exports in terms of imports and can be defined as the ratio of export prices to import prices. It can be interpreted as the quantity of imported goods that an economy can purchase with one unit of its exported goods**.** The multiplier introduced by Lord J.M. Keynes was the investment multiplier, formulated for a closed economy; this concept was subsequently extended to an open economy and is known as the foreign trade multiplier. The term "foreign trade multiplier" was coined by Mr. Lehtan. The multiplier for a closed economy is expressed as a function of the Marginal Propensity to Consume (MPC), whereas the foreign trade multiplier is a function of the Marginal Propensity to Save (MPS) and the Marginal Propensity to Import (MPM).

2.14 Glossary

Terms of Trade - A measure of how many imports an economy receives for a unit of exports.

Dynamic Advantages - Advantages that accelerate the economic growth of participating countries.

Static Advantages - Advantages that result from the operation of the principle of comparative advantage in foreign trade.

GDP - Gross Domestic Product, TOT - Terms of Trade,

MPC - Marginal Propensity to Consume,

MPS - Marginal Propensity to Save,

MPM- Marginal Propensity to Import,

Injections - Inputs

2.15 Check your progress

Write True/False.

1. Expansion from the domestic market to the foreign market accelerates economic growth.
2. An increase in the prices of imported goods will also increase TOT.
3. Dynamic benefits from trade are related to the economic development of the economy.
4. Imports from one country are exports to another country.
5. The multiplier originally proposed by R.F. Kahn was the employment multiplier.
6. The concept of the foreign trade multiplier was propounded by Mr. Lehton.
7. In a closed economy, total national income is equal to the sum of all private expenditures.
8. The Dutch C is never equal to 1.
9. The multiplier will always be less than 1.
10. The foreign exchange multiplier is also called the export multiplie

2.16 Answers to Check your progress

1. True 2. False 3. True 4. True 5. True 6. True 7. True 8. True 9. False 10. True

2.17 Terminal question

1. Critically examine the concept of gains from the trade.
2. How you can measure the gains from the trade? Discuss.
3. Write down the factors affecting the gains from trade.

4. Differentiate the static and dynamic gains from trade.
5. Elaborate terms of trade between two nations.
6. Explain various models of terms of trade.
7. What do you mean by foreign trade multiplier? Explain.
8. Describe the procedure of income determination a closed economy.
9. What is the role of foreign trade multiplier in an open economy? Explain.
10. Write a note postulations and bathtub theorem.

2.18 Suggest readings

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Unit- 3 India's participation in information technology and global trade.
Structure:

Objectives:

This unit examines the status of Information Technology (IT) industry in India, the unique characteristics of government procurement market and the possible scenarios in terms of future market opening in India and abroad.

3.1 Introduction

In recent times, government sector across the world has emerged as one of the largest spenders on information technology (IT). This trend is expected to continue in the future, making government procurement market in IT sector an important source of revenue for IT companies around the world. The fast growing ageing population in Europe, United States and Asia, the increasing complexity, and the request for better and cheaper public services forces the governments to modernize their administrative systems. In wake of these developments, the IT and IT-enabling services play an important role, as they are vital amongst other services and help increase the efficiency of the public sector with reduced costs. Today most governments are focusing on modernizing and simplifying as well as increasing the efficiency and flexibility of their administrative structures. IT products and services are best suited to serve these goals. With the advancement in technology, IT has become an important constituent of the infrastructure which facilitates the flow of information in the economy. Procurement in information technology includes procurement of goods, services and works. The costs and management responsibilities in relation to information technology procurement can be divided into two main components: (i) the costs of initially acquiring the components which constitute the system, and (ii) the costs of management, maintenance and up gradation of the system. A government entity has the options to either purchase the technology/software or get it built through a service provider. The government entity also has the option to create this information technology solution within the government itself. Further, procurement of information technology and information technology-enabled services has a few features which are unique to it: (i) When a contract for IT services which is being procured by the government is cancelled, it cannot be sold elsewhere owing to the specific nature of the stipulations and the scale at which the production is done, which renders it difficult to implement; (ii) Sometimes the government may specify that certain products which are being specified by it are 'locked in' and cannot be sold to anyone else; and (iii)It is essential to include maintenance of what is procured as one of the critical terms in IT procurement – the conditions where a domestic supplier would be more suitable than an international supplier.An efficient IT sector is one of the most important attributes of a competitive economy. Arguably, developed countries use information technology in their governance activities in a more pervasive manner than the governments of developing countries. However, this notion is fast changing as developing countries are fast catching up and experts suggest that countries like Brazil and India will soon become very large users of Information Technology systems.Currently, the Indian government has undertaken various initiatives to improvise the administrative set up across government activities by employing information technology for good governance. The year 2011 witnessed a wave of purported reforms dealing with the maintenance of records on the Indian population for effectively performing its welfare functions. The food distribution schemes, the right to education, the right to employment legislations, and financial inclusion will all find their effective implementation in accurate management of information. Given the strategic role of IT in the functioning of the administrative system, and the parallel huge size of the Indian administrative system, it is evident that procurement of IT services in India offers an important source of revenue, labour and occupies a vast public space in transforming the country into one of the emerging economic powers. It, therefore, becomes inevitable to study the procurement of IT and ITeS by government and the policy thereof.

3.2 Competitiveness and market size of information technology and

information technology enabled services

3.2.1 Government Procurement Sector

Indian producers have relied on a business model of outsourcing of services which has allowed them to obtain economies of scale in a country where the costs of labour are lesser in comparison to most developed countries. The Information Technology (IT) and Information Technology enabled services (ITeS) industry has been one of the key driving forces fuelling India's economic growth. The IT/ITeS sector's contribution has risen from 1.2 percent in 1997-98 to an estimated 7.5 percent in 2011-12. This sector further plays a vital role in driving growth of the economy in terms of employment, export promotion, revenue generation and standards of living. The IT industry relies on approximately a pool of 3.5 million young graduates, a fairly good technology platform, constant yearly growth from 24 percent, as well as on 20 years of experience in delivering IT services. India has for a long time tried to establish itself as the premier area of excellence in IT, and it has been trying to get market access in other countries for both IT companies as well as IT consultants. The sector offers a strategic importance for the Indian economy, not only in terms of revenue generation and employment but also in terms of industrial development. The total IT Software and Services employment was estimated to be 2.20 million workers in 2008-09. If compared with seven years earlier, when the workforce was of 0.52 million in 2001-02, the industry has grown by three times. In addition, this sector has generated 8.2 million jobs connected to collateral industries. This translates into a total of 10.4 million jobs opportunities attributed to the growth of this sector. The sector generates huge revenues and is one of the fastest growing sectors of the Indian economy. Table 3.1 shows that export market generates a great share of the revenues while the domestic market has grown in importance in recent years.

Table 3.1: IT Industry Revenue Trends

YEAR/ITEM	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	CAGR
EXPORT	7.6	9.5	12.9	17.7	23.6	31.1	40.4	46.3	28.6
DOMESTIC	2.6	3.0	3.8	4.8	6.7	8.2	11.7	12.4	22.2
TOTAL	10.2	12.5	16.7	22.5	30.3	39.3	52.0	58.7	26.9

Source: Ministry of Communication and Information Technology, and Nasscom Regarding the procurement of IT/ITeS, recent years have witnessed that governments across the globe have emerged as one of the biggest spenders on information technology which essentially indicates an increase in procurement of IT and ITeS. The importance of IT/ITeS in procurement attains different meaning for different countries. In developed world, countries are increasingly spending on account of national security and also due to demographic changes while in developing countries, including India, are still building up their IT infrastructure, e-governance projects, document management, etc. There is also a growing interest worldwide in new initiatives such as cloud computing and green procurement among others. Also, governments are looking to improve their productivity and deliver goods and services as per the expectation of the taxpayers/citizens.The domestic IT market in India is in its transition phase, driven by rapidly growing ICT infrastructure, increasing customer awareness, rising spending capabilities of consumers and acceptance of technology as a business enabler. The structure of the Indian service sector has dramatically changed after the advent and increasing integration of IT/ITeS with the Indian economy. IT/ITeS industry now contributes significantly to the economic growth; it accounts for around 5.6 percent of the country's GDP and provides direct employment to about 2.3 million people and indirect employment to many more. Its consistent growth during the preceding decade (the sector grew at a compounded annual growth rate (CAGR) of over 24 percent) is indicative of its potential and scope in the coming periods. One of the main drivers of growth is the increased need of the public sector to rely on ITC platforms and services to increase the efficiency of the public administration. This section will look at the current market for IT procurement and at the status of the Indian IT industry.

Emerging Scenario and SLOT Analysis of Indian IT Industry

Technology has evolved and attained a stage where it influences the entire economy of India. It has penetrated to all sectors and key economic activities, including banking, financial services, retail and distribution, and manufacturing. It also facilitates services and customer interaction services such as data search, research, consultancy, and software products, and other

Table 3.2: SLOT Analysis of Indian IT Industry

Internal Factors	Strengths	Limitations
	• Vast market with huge potential to grow • Good and cost-competitive manufacturing base • Availability of Specialised personnel • Good technological skills	• Poor Regulatory Framework • Lack of competition in certain Procurement sectors • No strong IT manufacturing industry
External Factors	Opportunities	Threats
	• Growing market worldwide Potential; availability of European, US, and other developed markets. • Possibility of FDI inflows in the IT industry	• Presence of strict regulatory standards in many foreign markets

With these developments, the sector has emerged as one of the most important industries in Indian economy, contributing significantly to the growth of the economy. It is expected that in the coming periods, the penetration will become more pervasive and inclusive.

3.3 Market Access Opportunities in Foreign Procurement Markets

The IT and IT-enabling services sector is one of the most lucrative sectors for Indian companies wishing to export abroad. Indian companies have been off shoring IT services for the last two decades and have progressively acquired a reputation for its competence and cost-effectiveness. The global market of government procurement of IT services can be roughly divided into two major groups. On one side there are developing country governments, which constitute around 10-15 percent of the market. Developing countries are usually not "big purchasers", as they do not rely on IT as much as the developed countries do. Nonetheless, with the passage of time, the share of developing countries in the market of IT services will also eventually increase. Examples are Brazil, China, and South Africa, which are more and more focused on the modernization of their administrative facilities. On the other side, there are developed countries. According to a report, only 9 countries (namely the US, the UK, Japan, Germany, France, Italy, The Netherlands, Canada and Australia) account for over 80 percent of the global IT spending by Governments. All these countries are members of the WTO and signatories of the Government Procurement Agreement. As per this report, currently the total spending of European Union governments and US is around US$180-200bn and currently the focus of these governments is on increasing efficiency and cost optimization. Therefore, it is expected that the market for IT outsourcing will grow at a 6 percent rate annually, and reach the peak of US$350bn by 2020. Most of the outsourcing, around 60 percent of the total amount is focused on IT services, while IT-enabling services account only for a smaller share. The reason is the concern of government on privacy and security issues, which renders such services ill-suited for governments. At the outset it must be said that unlike other sectors, IT and especially IT-enabling services are highly susceptible to language barriers. Indian IT providers mostly supply English language products owing to which the analysis will be limited to Europe, US, and Canada.

3.4 The European Union and India

The European Union has a potential market of 27 States. Of these, Indian companies can successfully target only a handful of them. UK, Malta and Ireland are the three countries where English is the official language. Among them, the UK is the most promising target. Indeed, the UK Government has adopted a policy that tries to match increased efficiency with reduced budget spending. In doing so, it chose to focus on off shoring as the main tool to achieve this goal. The procurement system in UK is very transparent and it ensures free competition between foreign and European service providers, although the government has sometimes adopted protectionist policies to cope with the high unemployment rate. According to the requirements posed by UK legislation, ITC suppliers must maintain full transparency of their accounts in order to disclose their margins, subcontractors and also components of the projects, among other things. The UK market still presents a few barriers to entry revealed by some of the IT/BPO firms in the stakeholder interviews, such as a recent explicit cap set by the UK government on the total amount of outsourced work for a single enterprise. The rationale is to reduce overdependence on a single service provider and encourage subcontracting to ensure growth of the SMEs in the market. The contract is often subject to the condition that local presence is required for the delivery-this is a condition which is commonly inscribed in contracts with the government in many countries. This means that Indian companies will not be able to offer services on a cross-border basis. This is particularly relevant for IT-enabling services, which are often offered through such business models. It is important that Indian companies acquire a commercial presence in UK. The rest of the European market, with the exception of Malta and Ireland, is more difficult to penetrate. As it was said before, the language is the most difficult barrier to overcome, together with the requirement of the physical presence on site. Moreover, most European countries apply strict labour laws which require the hiring of locals and the compliance with strict labour requirements, which could inhibit the offering of outsourced services, especially on a cross border basis.

3.5 North America and India

The United States is a challenging market for government procurement, and especially for off-shored services. In 2007, the US government spent US$65mn in procurement of IT goods. It is estimated that 11 percent of all purchases of computers is made by governments. Overall, there is less favorable attitude of the US central and sub-central administrations towards off shoring, which culminated in the US Border Security Bill and 9/11 Responders Bill, which added barriers to the entry of such services. The State of Ohio, for instance, banned outsourcing of Government IT and IT enabling services to offshore locations, such as India, in order to favor local service suppliers. The US does not present language barriers, nonetheless from a regulatory point of view government procurement is fragmented in different sub- markets, as it is regulated independently by each State. Moreover, if a contract has received mixed funding from the state and federal, the service provider needs to comply with regulations of both the state and federal government. Visa policies are a particularly burdensome requirement for Indian professionals, and they could severely inhibit the provision of the service (on site). From May 31, 2011, the US government has amended the Federal Acquisition Regulations to exempt ITC products and services from the strict requirement of the Buy American Act, 1933.

3.6 Canada and India

Canada has a more liberal government procurement regime for IT, as it does not have the complexity of its southern neighbor. Nonetheless, the value of the Canadian market is much more limited compared to that of Europe or the US.

3.7 Barriers to Entry in Foreign Procurement Markets

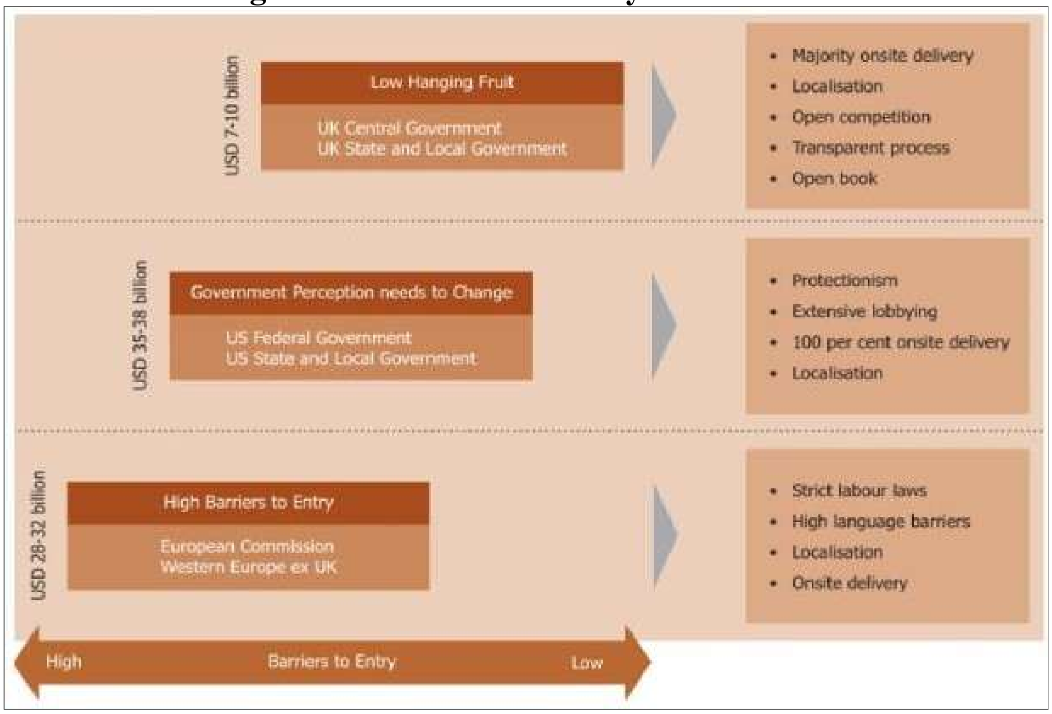
Indian players currently do not enjoy free access to international government procurement markets. Nonetheless, the accession of India to the GPA may provide an opportunity to Indian companies to avail market access rights to the procurement markets of 42 Members of the GPA. Having said that, it is important to note that the accession to the GPA will not ensure the removal of all barriers to government procurement – a few examples of barriers which impede Indian service providers from accessing international government procurement markets are as follows:

(i) Visa restrictions which impede the entry of IT consultants into the different territories all over;

(ii) preference policies favouring small and medium sized enterprises in certain countries; and

(iii) Required presence in the country where the product is to be supplied, amongst others (Table 3.1)

Figure 3.1: Barriers to entry in selected markets



Source: NASSCOM Study, "Indian IT-BPO Opportunities in the Indian Procurement Market Globally", 2011

3.8 Requirements for Attention/Support from the Government of India

A study by NASSCOM, India's apex conglomerate of the software industries, indicates that out of the total IT/BPO government spend by the US and West Europe, the addressable market for the Indian IT/BPO industry is approximately US$20bn which is likely to grow to US$70-US$80bn by 2020. However, so far, India has been able to harness only 2 percent of the total addressable market (US$0.5bn) in 2010, due to existence of regulatory barriers, such as visa restrictions, language barriers, lack of experience of Indian companies in lobbying EU or US governments, discouraging effect of provenness clause etc. As highlighted in the study, though India may be able to avail of at least 10 percent of the addressable market by 2020, it will still not be substantial for it to emerge as a major player in the market. Nonetheless, Indian companies can improve their business model to make it more competitive for government procurement markets. While dealing with India's capacity as a participant in international government procurement markets, it is essential to consider the following:

(i) The information technology sector is one of the potential sectors, especially the software services segment, where India may have an offensive interest and that it can attempt to penetrate further in foreign procurement markets. However, India would still need to strengthen other segments of the IT such as the hardware development and related R&D so as to attain export competitiveness and benefit from it before it enters into any bilateral or Plurilateral trade arrangement.

(ii) As noted above, there are a few restrictions and barriers prevailing in other country markets in general and in procurement which will require systematic and coherent negotiation strategy. It is also important to note that information technology enabled services fall within the scope of services. This requires the application of the Government Procurement in India: Domestic Regulations & Trade Prospects provisions of the GATS agreement and subsequent reflection of having altered the market access conditions and the national treatment specifications in the Offers of all the countries. Secondly, as noted before, from the point of view of the Indian government engaging in procurement activity, it is essential to keep in mind the following notions: (i) One of the most crucial requirements to effectively conduct Information Technology procurement includes the formulation of a 'statement of requirements' which formalizes the exact need of the department. It may be helpful to categorize the features which are included as essential/nonessential, but preferable and so on so as to be able to effectively negotiate and arrive at appropriate costing system; (ii) Some of the other specific facets of information technology which influence procurement in information technology are that it is essential for governments to ensure 'interoperability' of the systems which have been in place. This is in order to ensure that information management is smooth and can withstand technological developments over a period of time. It is critical to test the delivered products against the earlier defined requirements in order to determine whether the newly procured items actually fulfill the initial requirement; (iii) It is important to regard security elements while engaging in information technology procurement considering the vulnerability that information stored on the internet faces; and (iv) The government bodies could explore the option of engaging in consolidated purchase of hardware or Government Procurement in

India: Domestic Regulations & Trade Prospects software in order to ensure that some cost advantages are realised.

In addition to above, a few strategies which can be considered for the purposes of enhancing market penetration in the other members' government procurement markets are as follows:

(i) Visa requirements and procedures are the major barriers for the provision of IT services, as they de facto impede the entry of foreign professionals in EU and North American markets are not addressed by the GPA, and may possibly be removed through bilateral negotiations. India has long been pursuing negotiations on mode-4 liberalization under the GATS regime with major trading partners and also attempting to ensure preferential access for certain categories, including personnel specializing in IT.

i) Labor laws often provide cumbersome requirements, such as minimum standards, and employment of local personnel. Such barriers are difficult to remove, even at the bilateral level, as they are often the result of internal political pressure. India could try to negotiate the removal of these barriers through bilateral/plurilateral agreements.

(ii) Commercial presence on site for the delivery of the service is a requirement posed by many governments internationally. This could be one of the strongest barriers for Indian companies. India has so far relied on a business model for outsourcing of services, which envisages the cross border delivery of the service (mode-1). The presence of the service supplier in India allowed economies of scales and reduced prices, which are the two main drivers of the development of the Indian IT sectors and the roots of its competitiveness. The Indian government may pursue the matter and exchange market access opening on mode-1 of GATS and obtain concessions from the Indian side.

3.9 Summary

India's own competence and competitiveness in manufacturing, services and trade have to grow for it to become a sufficiently influential player in the global government procurement markets. Only when such a level of competitiveness is reached, will India be able to effectively negotiate its own offensive and defensive interests to achieve benefits out of its accession to the WTO GPA (Government Procurement Agreement). However, and in the long term, as an emerging economy with global potential, India would need to continue to assess, in a dynamic context, taking due account of its own ongoing internal initiatives to improve governance of the public procurement system, its growing market competitiveness and related factors, the costs and benefits of its accession to the WTO GPA.

3.10 Glossary

Procurement – The act of acquiring rights to an item.

WTO - (World Trade Organization)

IT-enabled – Encompasses a set of remote-controlled operations that utilize information technology to enhance an organization's efficiency.

Major State – Government procurement contract.

Efficiency – The level of knowledge regarding the techniques used to perform a task.

European Union – A group of several European countries.

3.11 Check your progress

Fill in the blanks-

- An efficient .... is a key attribute of a competitive economy .
- India is currently able to leverage only .... percent of global market access.
- Visa requirements and .... are major hurdles faced by Indian IT professionals.

3.12 Answer to check your progress

1. IT sector
2. percent (0.6 billion)
3. Processed

3.13 Terminal question

1. Elaborate the current scenario of IT industry of India..
2. What do you mean by competitiveness and market size of the IT/ITeS? Explain.
3. Give your comments towards the emerging Scenario and SLOT Analysis of Indian IT Industry.
4. Write down the involvement of Indian IT industry at global level.
5. Elaborate the market access opportunities before Indian IT industry.
6. What steps are required to be taken Indian Government for the growth of IT industry? Explain.

3.14 Suggest Readings

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Unit 4- Causes and Principles of International Trade

Structure:

Objectives:

After reading this unit, you will be able to:

(i) Understand international trade.

(ii) Compare and contrast different trade theories.

(iii) Determine which international trade theory is most relevant today and how it continues to evolve.

4.1 Introduction

Common sense suggests that some international trade is beneficial for all. Writing in his famous book, The Wealth of Nations, in 1776, Adam Smith argued that trade is beneficial because of differences between countries in the costs of producing different goods. Like all of his contemporaries, Smith held to a labour theory of value, according to which the cost of producing a good was given by the labour time required to produce it. Therefore, the differences in the costs of producing a certain good in different countries reflected differences in labour efficiencies in each country. However, rather than each country striving to produce all the products which they could, each should concentrate on those products in which they enjoy a cost advantage over other countries (core competencies of each country). The result will be that all are better off.

To see this, consider a simple numerical example of the kind used by Smith to illustrate this principle. Imagine two countries, A and B, which possess identical labour resources which they divide equally between the two activities, cloth and rice. The following figures give the amount (units) of the two goods which each country is able to produce if all its workers are fully employed.

	Country A	Country B	Total (Units)
Cloth	100	250	350
Rice	200	160	360

Clearly, A is more efficient at producing rice and B at cloth. Therefore, it pays A to specialize in rice and B in cloth. Hence, A switches all its resources into rice and B into cloth. In that case, situation may emerge as shown in the following table:

	Cloth	Rice
Country A	0	400
Country B	500	0
Total	500	400

4.2 International Trade Theories

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. International trade is then the concept of this exchange between people or entities in two different countries. People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this many sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade. To better understand how modern global trade has evolved, it's important to understand how countries traded with one another historically. Over time, economists have developed theories to explain the mechanisms of global trade. The main historical theories are called classical and are from the perspective of a country, or country-based. By the mid- twentieth century, the theories began to shift to explain trade from a firm, rather than a country, perspective. These theories are referred to as modern and are firm-based or company-based. Both of these categories, classical and modern, consist of several international theories.

4.3 Classical or Country-Based Trade Theories

4.3.1 Mercantilism

The doctrine of mercantilism propagated in the 16^{th} and 17^{th} centuries advocated that countries should simultaneously encourage exports and discourage imports. Mercantilism was premised on the notion that exports are per se good because they earn a country gold, while imports are per se bad because they result in an outflow of gold. Consequently, a country should strive to reduce its dependence on imports by producing as much as it could itself. In practical terms, it suggested that the government policy should seek to reduce imports by imposing duties on imports and restricting the amount of foreign goods that are allowed into the country. At the same time, every effort should be made to boost exports by whatever means. If one country succeeds in achieving a large export surplus, it can only do so if other countries run an equivalent trade deficit. It follows that, if all countries pursue such a policy, the result will be conflict among them. Either one country will succeed at the expense of the rest or else all will fail to achieve their objective. In other words, developed in the sixteenth century, mercantilism was one of the earliest efforts to develop an economic theory. This theory stated that a country's wealth was determined by the amount of its gold and silver holdings. In its simplest sense, mercantilists believed that a country should increase its holdings of gold and silver by promoting exports and discouraging imports. In other words, if people in other countries buy more from you (exports) than they sell to you (imports), then they have to pay you the difference in gold and silver. The objective of each country was to have a trade surplus, or a situation where the value of exports are greater than the value of imports, and to avoid a trade deficit, or a situation where the value of imports is greater than the value of exports. A closer look at the world history from the 1500s to the late 1800s helps explain why mercantilism flourished. The 1500s marked the rise of new nation-states, whose rulers wanted to strengthen their nations by building larger armies and national institutions. By increasing exports and trade, these rulers were able to amass more gold and wealth for their countries. One way that many of these new nations promoted exports was to impose restrictions on imports. This strategy is called protectionism and is still used today. Nations expanded their wealth by using their colonies around the world in an effort to control more trade and amass more riches. The British colonial empire was one of the most successful examples; it sought to increase its wealth by using raw materials from places ranging from what are now the Americas and India. France, the Netherlands, Portugal, and Spain were also successful in building large colonial empires that generated extensive wealth for their governing nations. Although mercantilism is one of the oldest trade theories, it remains part of modern thinking. Countries such as Japan, China, Singapore, Taiwan, and even Germany still favor exports and discourage imports through a form of neo-mercantilism in which the countries promote a combination of protectionist policies and restrictions and domestic-industry subsidies. Nearly every country, at one point or another, has implemented some form of protectionist policy to guard key industries in its economy. While export-oriented companies usually support protectionist policies that favor their industries or firms, other companies and consumers are hurt by protectionism. Taxpayers pay for government subsidies of select exports in the form of higher taxes. Import restrictions lead to higher prices for consumers, who pay more for foreign-made goods or services. Free-trade advocates and pours a shadow on how free trade benefits all members of the global community, while mercantilism's protectionist policies only benefit select industries, at the expense of both consumers and other companies, within and outside of the industry.

4.3.2 Absolute Advantage

In 1776, Adam Smith questioned the leading mercantile theory of the time in The Wealth of Nations. Smith offered a new trade theory called absolute advantage, which focused on the ability of a country to produce a good more efficiently than another nation. Smith reasoned that trade between countries shouldn't be regulated or restricted by government policy or intervention. He stated that trade should flow naturally according to market forces. In a hypothetical two-country world if Country A could produce a good cheaper or faster (or both); than Country B, then Country A had the advantage and could focus on specializing on producing that good. Similarly, if Country B was better at producing another good, it could focus on specialization as well. By specialization, countries would generate efficiencies, because their labor force would become more skilled by doing the same tasks. Production would also become more efficient, because there would be an incentive to create faster and better production methods to increase the specialization. Smith's theory reasoned that with increased efficiencies, people in both countries would benefit and trade should be encouraged. His theory stated that a nation's wealth shouldn't be judged by how much gold and silver it had but rather by the living standards of its people. Further, absolute advantage may come due to factors of climate, quality of land and natural resource endowments or difference in labour, capital, technology and entrepreneurship. Some nations have oil and some don't have. It appears sensible for each country to specialize in the product in which it has an absolute advantage and secure its needs of the product in which it has a disadvantage through trade.

4.3.3 Comparative Advantage

The challenge to the absolute advantage theory was that some countries may be better at producing both goods and, therefore, have an advantage in many areas. In contrast, another country may not have any useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country A had the absolute advantage in the production of both products specialization then trade could still occur between two countries. Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it can produce that product better and more efficiently than it does other goods. The difference between these two theories is subtle. Comparative advantage focuses on the relative productivity differences, whereas absolute advantage looks at the absolute productivity.

Conversely, we encounter the doctrine of comparative advantage first introduced by David Ricardo in the early 19th century. The doctrine emphasizes relative rather than absolute cost differences. The doctrine demonstrates that mutually advantageous trade can occur even when one trading partner has an absolute advantage. It makes sense for a country to specialize in the production of those goods that it produces less efficiently from other countries. This theory stresses that comparative advantage arises from differences in productivity. Ricardo focused on labour productivity and argued that differences in labour productivity between nations underline the notion of comparative advantage. Thus, whether French is more efficient than British in the production of wine depends on how productively it uses it resources. Let's look at a simplified hypothetical example to illustrate the subtle difference between these principles. Miranda is a Wall Street lawyer who charges $500 per hour for her legal services. It turns out that Miranda can also type faster than the administrative assistants in her office, who are paid $40 per hour. Even though Miranda clearly has the absolute advantage in both skill sets, should she do both jobs? No. For every hour Miranda decides to type instead of do legal work, she would be giving up $460 in income. Her productivity and income will be highest if she specializes in the higher-paid legal services and hires the most qualified administrative assistant, who can type fast, although a little slower than Miranda. By having both Miranda and her assistant concentrate on their respective tasks, their overall productivity as a team is higher. This is comparative advantage. A person or a country will specialize in doing what they do relatively better. In reality, the world economy is more complex and consists of more than two countries and products. Barriers to trade may exist, and goods must be transported, stored, and distributed. However, this simplistic example demonstrates the basis of the comparative advantage theory.

4.3.4 Heckscher-Ohlin Theory (Factor Proportions Theory)

The theories of Smith and Ricardo didn't help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to determine which goods they could produce more efficiently. In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, focused their attention on how a country could gain comparative advantage by producing products that utilized factors that were in abundance in the country. Their theory is based on a country's production factors—land, labor, and capital, which provide the funds for investment in plants and equipment. They determined that the cost of any factor or resource was a function of supply and demand. Factors that were in great supply relative to demand would be cheaper; factors in great demand relative to supply would be more expensive. Their theory, also called the factor proportions theory, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand.

For example, China and India are home to cheap, large pools of labor. Hence these countries have become the optimal locations for labor-intensive industries like textiles and garments.

4.3.5 Leontief Paradox

In the early 1950s, Russian-born American economist Wassily W. Leontief studied the US economy closely and noted that the United States was abundant in capital and, therefore, should export more capital-intensive goods. However, his research using actual data showed the opposite: The United States was importing more capital- intensive goods. According to the factor proportions theory, the United States should have been importing labor-intensive goods, but instead it was actually exporting them. His analysis became known as the Leontief Paradox because it was the reverse of what was expected by the factor proportions theory. In subsequent years, economists have noted historically at that point in time, labor in the United States was both available in steady supply and more productive than in many other countries; hence it made sense to export labor-intensive goods. Over the decades, many economists have used theories and data to explain and minimize the impact of the paradox. However, what remains clear is that international trade is complex; and is impacted by numerous and often changing factors. Trade cannot be explained neatly by one single theory, and more importantly, our understanding of international trade theories continues to evolve. In simple words, Using Huckster-Ohlin theory, Wassily Leontief (Winner of the Noble Prize in economics in 1973) postulated that since United States was relatively abundant in capital compared to other nations, the United States would be an exporter of capital intensive goods and an importer of labour intensive goods. To his surprise, however, he found that US exports were less capital intensive than US imports. Since this result was at variance with the prediction of the theory, it has become known as the Leontief paradox.

4.4 Modern or Firm-Based Trade Theories

In contrast to classical, country-based trade theories, the category of modern, firm- based theories emerged after World War II and was developed in large part by business school professors, not economists. The firm-based theories evolved with the growth of the multinational company (MNC). The country-based theories couldn't adequately address the expansion of either MNCs or intra-industry trade, which refers to trade between two countries of goods produced in the same industry. For example, Japan exports Toyota vehicles to Germany and imports Mercedes-Benz automobiles from Germany. Unlike the country-based theories, firm-based theories incorporate other product and service factors, including brand and customer loyalty, technology, and quality, into the understanding of trade flows.

Country Similarity Theory

Swedish economist Stefan Linder developed the country similarity theory in 1961, as he tried to explain the concept of intra-industry trade. Linder's theory proposed that consumers in countries that are in the same or similar stage of development would have similar preferences. In this firm-based theory, Linder suggested that companies first produce for domestic consumption. When they explore exporting, the companies often find that markets that look similar to their domestic one, in terms of customer preferences, offer the most potential for success. Linder's country similarity theory then states that most trade in manufactured goods will be between countries with similar per capita incomes, and intra-industry trade will be common. This theory is often most useful in understanding trade in goods where brand names and product reputations are important factors in the buyers' decision-making and purchasing processes.

4.4.2 Product Life Cycle Theory

Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. The theory, originating in the field of marketing, stated that a product life cycle has three distinct stages: (i) new product, (ii) maturing product, and (iii) standardized product. The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II. It has also been used to describe how the personal computer (PC) went through its product cycle. The PC was a new product in the 1970s and developed into a mature product during the 1980s and 1990s. Today, the PC is in the standardized product stage, and the majority of manufacturing and production process is done in low-cost countries in Asia and Mexico. The product life cycle theory has been less able to explain current trade patterns where innovation and manufacturing occur around the world. For example, global companies even conduct research and development in developing markets where highly skilled labor and facilities are usually cheaper. Even though research and development is typically associated with the first or new product stage and therefore completed in the home country, these developing or emerging-market countries, such as India and China, offer both highly skilled labor and new research facilities at a substantial cost advantage for global firms. Let us take the case of photocopiers, the products was first developed in the early 1960s by Xerox in the United States and sold initially, Xerox exported photocopy machines from US, primarily to Japan and the advanced countries. As demand began to grow in foreign countries, Xerox entered into joint ventures to set up production in Japan (Fuji-xerox), India (Modi-xerox), etc. As a consequence, exports from US declined, and the US users started importing some of their photocopiers from lower- cost foreign countries, particularly Japan. This evolution in the pattern of foreign trade is consistent with the product life cycle theory.

4.4.3 Global Strategic Rivalry Theory

Global strategic rivalry theory emerged in the 1980s and was based on the work of economists Paul Krugman and Kelvin Lancaster. Their theory focused on MNCs and their efforts to gain a competitive advantage against other global firms in their industry. Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. The critical ways that firms can obtain a sustainable competitive advantage are called the barriers to entry for that industry. The barriers to entry refer to the obstacles a new firm may face when trying to enter into an industry or new market. The barriers to entry that corporations may seek to optimize include like research and development, the ownership of intellectual property rights, economies of scale, unique business processes or methods as well as extensive experience in the industry, and the control of resources or favorable access to raw materials.

4.4.4 Porter’s National Competitive Advantage Theory

Michael Porter is a famous Harvard business professor. He conducted a comprehensive study of 100 industries in 10 nations to learn why do some nations succeed in international competition? Porter introduced this model in his book: The Competitive Advantage of Nations. He sought to explain why a nation achieves success in a particular industry. Why Indians did well in the software industry? Why are Japanese doing will in the automobile industry? Both Heckscher-Ohlin theory and Theory of Comparative Advantage is only partly able to explain. According to Porter, a nation attains a competitive advantage if its firms are competitive. Firms become competitive through innovation. Innovation can include technical improvements to the product or to the production process. In the continuing evolution of international trade theories, Michael Porter of Harvard

Business School developed a new model to explain national competitive advantage in 1990. Porter's theory stated that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified four determinants that he linked together. The four determinants are (i) local market resources and capabilities, (ii) local market demand conditions, (iii) local suppliers and complementary industries, and (iv) local firm characteristics.

(i) Local market resources and capabilities (factor conditions): Porter recognized the value of the factor proportions theory, which considers a nation's resources (e.g., natural resources and available labor) as key factors in determining what products a country will import or export. Porter added to these basic factors a new list of advanced factors, which he defined as skilled labor, investments in education, technology, and infrastructure. He perceived these advanced factors as providing a country with a sustainable competitive advantage.

(ii) Local market demand conditions: Porter believed that a sophisticated home market is critical to ensuring ongoing innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies. Many sources credit the demanding US consumer with forcing US software companies to continuously innovate, thus creating a sustainable competitive advantage in software products and services.

(iii) Local suppliers and complementary industries: To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry. Certain industries cluster geographically, which provides efficiencies and productivity.

(iv) Local firm characteristics: Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm's competitiveness. A healthy level of rivalry between local firms will spur innovation and competitiveness.

In addition to the four determinants of the diamond, Porter also noted that government and chance play a part in the national competitiveness of industries. Governments can, by their actions and policies, increase the competitiveness of firms and occasionally entire industries.

Porter's theory, along with the other modern, firm-based theories, offers an interesting interpretation of international trade trends. Nevertheless, they remain relatively new and minimally tested theories.

4.5 Implications of International Trade Theories

All these trade theories have implications on the business. The implications can be explained as follows:

(i) **Strategy for locations:** Most of the trade theories emphasize that due to different factors of production different countries have advantages in different productive activities. Hence it makes sense for the firm to disperse the production activities. Hence it makes sense for the firm to disperse the production activities to countries having maximum efficiency. This global web of productive activities is used by the firms while going in for globalization to get the competitive edge. Hence if design can be performed most efficiently in Germany, then this facility should be located there. Similarly, if the manufacturing is done most cheaply in India then the manufacturing facility should be located there. If the firm does not do it then it may find itself at competitive disadvantage relative to firms that do.

(ii) **Policy Implementations:** The firms are major players on the International trade scene since they do both import and export. The firms may tend to lobby to increase trade restriction or promote trade. However the International trade theories claim that free trade is good for the interest of country, although it may or may not be in the best interest of that particular firm. Porter's theory also contains policy implications. It suggests that it is in the best interest of business for a firm to invest in upgrading advanced factors of production, i.e., to invest in better training and R & D. Infosys is one such firm which has reaped immense benefit on account of this strategy. Thus, it makes all components of Porter diamond favorably. The government, therefore, should increase investment in education, infrastructure, and basic research (all advanced factors). The government should also adopt policies which promote strong competition within domestic markets since this enable the firm to achieve international competitiveness. In nutshell, these theories have helped economists, governments, and businesses better understand international trade and how to promote, regulate, and manage it these theories are occasionally contradicted by real-world events. Countries don't have absolute advantages in many areas of production or services and, in fact, the factors of production aren't neatly distributed between countries. Some countries have a disproportionate benefit of some factors. The United States has ample arable land that can be used for a wide range of agricultural products. It also has extensive access to capital. While it's labor pool may not be the cheapest, it is among the best educated in the world. These advantages in the factors of production have helped the United States become the largest and richest economy in the world. Nevertheless, the United States also imports a vast amount of goods and services, as US consumers use their wealth to purchase what they need and want-much of which is now manufactured in other countries that have sought to create their own comparative advantages through cheap labor, land, or production costs. As a result, it's not clear that any one theory is dominant around the world. This section has sought to highlight the basics of international trade theory to enable you to understand the realities that face global businesses. In practice, governments and companies use a combination of these theories to both interpret trends and develop strategy. Just as these theories have evolved over the past five hundred years, they will continue to change and adapt as new factors impact international trade.

4.6 Summary

Trade is the concept of exchanging goods and services between two people or entities. International trade is the concept of this exchange between people or entities in two different countries. While a simplistic definition, the factors that impact trade are complex, and economists throughout the centuries have attempted to interpret trends and factors through the evolution of trade theories. There are two main categories of international trade such as classical, country-based and modern, firm-based. Porter's theory states that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. He identified four key determinants: (i) local market resources and capabilities (factor conditions), (ii) local market demand conditions, (iii) local suppliers and complementary industries, and (iv) local firm characteristics. All the trade theories endeavors to explain why it is beneficial for a country to engage in International Trade and also explains the pattern of International Trade observed in the World Economy. The theories of Smith, Ricardo and Heckscher-Ohlin advocates free unrestricted trade. Whereas, Mercantilism support governmental intervention to promote export through subsidies and to limit imports through tariffs and quotas. While explaining the pattern of International Trade, with the exception of mercantilism, all other theories have to offer complimentary explanations. All theories taken together suggest which factors are important. Comparative advantage tells that productivity differences are important; Heckscher- Ohlin tells that factor endowments matter; Product life cycle theory tells that where a new product is introduced is important; Porter tells that all these factors may be important as far as they impact the four components of the national diamond.

4.7 Glossary

International Trade: The exchange of goods or services between individuals or entities of two different countries.

Factors of Production: Essential resources required for production, such as land, labor, capital, and human resources.

Classical: Ancient or traditional.

Competitive Advantage: A distinct advantage in cost reduction derived from the ownership of resources.

Innovation: The act of employing new or unique methods in production processes or technology.

The product life cycle collectively refers to the various stages a product goes through—from its market entry and maturation to its standardization.

Multinational companies are companies that conduct business in more than one country.

4.8 Check your progress

Fill in the blanks:

1 Trade is the exchange of goods and services between two individuals and..

2 Porter identified .... main determinants.

3 The product life cycle consists of the stages of introduction, maturity,and ....

True/False

1. The classical theory is also known as the firm-based theory.
2. Mercantilism advocates for free and unrestricted trade.
3. According to Heckscher-Ohlin, resource ownership matters in international trade.

4 Adam Smith propounded the theory of absolute advantage.

4.9 Answer to Check your progress

1. Institutions 2. Four 3. Standardized

1.False 2.False 3.True 4.True

4.10 Terminal question

1. Critically examine the theory of mercantilism, theory of absolute advantage and theory of comparative advantage.
2. Distinguish between Heckscher-Ohlin Theory (Modern Theory) and Leontief Paradox.
3. Demonstrate the product life cycle theory.
4. Discuss the four attributes of Porter's Diamond Model and analyze is link with real world.
5. What is international trade?
6. Summarize the classical, country-based international trade theories. What are the differences between these theories, and how did the

theories evolve?

7. What are the modern, firm-based international trade theories?
8. Describe how a business may use the trade theories to develop its business strategies. Use Porter's four determinants in your explanation.

4.11 Suggested Readings

1. Hill, Charles W. L. (2005). *International Business*. Boston, MA: McGraw Hill/Irwin.
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5. Charles Hill, "International Business" (5th ed.)", New Delhi: Tata McGraw- Hill.
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7. Porter, Michael E. (1990), "The Competitive Advantage of Nations", New York: Free Press.

Unit - Tariffs, quotas, and other measures and their effects

Structure

Objective

lyse the effect of commercial policy

1. To understand the instruments of commet

- To understand the concept of free trade.
- To analyze levy of tariffs and their importance.
- To understand the impact of tariffs on prices.
- To analyze the impact of tariffs on quality.
- To understand the types of tariffs.

5.1 Introduction

International trade is composed of imports from and exports to another country by a country. Why should a country import or export? This question has following reasons:

There is difference in relative productivity of different factors of production (like land, capital and entrepreneurship) in different countries. This difference causes differences in quantity, quality and costs (prices) of products of different countries. A country would like to import better quality products and lower costs products from other countries.

a) There is difference in availability of products among different countries. Some countries do not have certain products but they need those products. These countries import from the countries who have those products. Countries who have some products in larger quantities than the quantities they need. These countries identify the countries where those products are unknown but can be used for meeting hidden needs or solving some problems of their people. Such countries promote the use of their products in other countries by exporting such goods. Imports and exports between countries are economic necessities. But the political economy of the countries does not allow 'free trade'. Free trade between countries means that governments of these countries do not impose any restrictions for their citizens on their 'purchases' (imports) or sales (exports) of goods and services. This is the political reality of international trade (business). The governments of countries intervene international trade by their instruments of commercial policy (in other worlds, instruments of trade policy).

5.2 Tariffs

Tax levied on imports is called tariff. A tariff is imposed on a good when it crosses a national boundary or an official

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boundary. For example, when an Indian trader sells goods to a buyer of another country and the goods move from India to the country of the buyer, a tariff is imposed. A tariff increases the costs of goods. Buyer pays the price of goods plus the tariff.

An official boundary may be of a nation, or a group of nations like that of the European Union (EU). The EU imposed a common tariff on goods entering their bloc.

5.2.1 Reasons for and effects of tariff

A tariff is the commonly used type of trade restrictions. It increases the costs of goods traded. There are four reasons for a country to impose a tariff:

1. To discourage consumption of a particular good.
2. To generate revenue for the country.
3. To discourage imports.
4. To 'protect' or insulate a domestic industry from competition by discouraging producers of the same or similar goods of other countries.

A country uses tariffs as a tool of macroeconomic policy to reduce a balance of trade deficit. When payments to foreigners for imports exceed receipts from foreigners for exports, a balance of trade deficit situation happens. To reduce this deficit, a country imposes tariffs to a broad range of goods. That is why tariffs are a tool of macroeconomic policy.
In a developing economy, a domestic industry (which is in the development stage) needs protection from competition from foreign producers. For this protection, tariff is imposed on imports. As a result, imports become costlier. Domestic producers get opportunities to capture a larger share of the domestic market. They are able to sell at such prices which help survival and growth. Both prices and volume of sales of domestic producers get protection from competition from foreign producers.

A tariff is also called 'duty'. This duty influences both 'price' and 'volume' (quantity of sales). The influence of duty on price is s h o w n b y t h e F i g u r e A g i v e n b e l o w : -

c e (P)

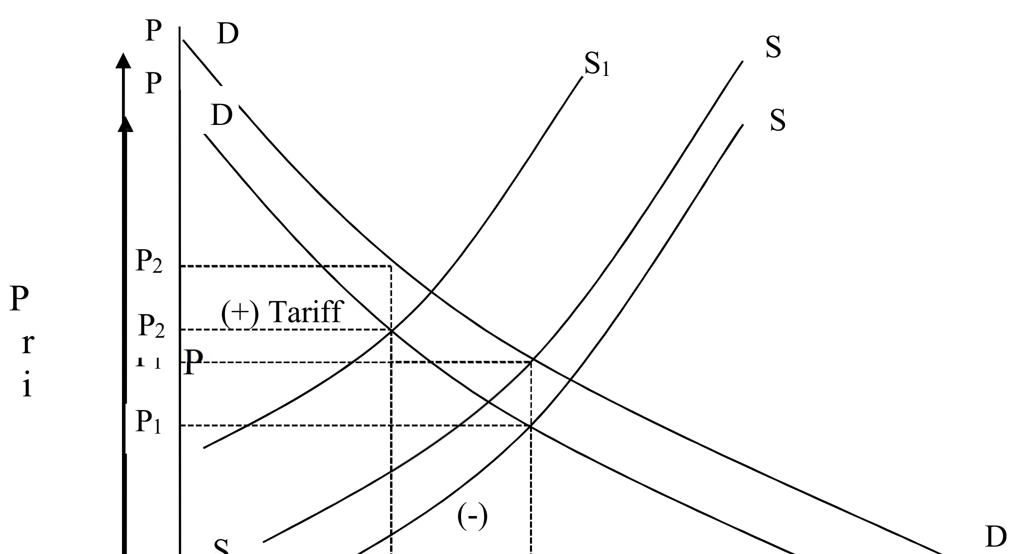
Volume of Sales (Q)

Figure –A : Direct price influence on quantity of sales

In Figure-A, the tax on import (Tariff) increases the price from P1, to P2 because tariff is added to P1.

P2 is higher than P1. Due to increase in price (P2), the demand of good decreases from Q1 to Q2. We know that the higher the price, the lower the quantity consumers demand.

We also know that suppliers (sellers) want to sell more at the higher price. But at a higher price, the demand will be less. Therefore, suppliers will be able to sell less. The quantity sold (Q1) at the lower price (P1) will decrease to Q2 from Q1. This trend is shown below:



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irect quantity influence

5.2.2 Types of Tariff

(a) Import Tariff: It is a tariff which is imposed on imports of goods and services.

(b) Export Tariff: It is a tax on export of raw materials and manufactured goods for which there is good demand in other countries.

(c) Transit Tariff: It is a tariff on the goods imposed by a country through which the goods have passed. But because of governmental treaties between two or among more than two governments, transit tariffs are vanishing.

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(d) Specific Tariff (Duty): When tariff is imposed on a per unit basis, it is called a specific duty.

Q2

(e) Ad Valorem Tariff (Duty): It is the duty which is imposed as a percentage of the value of the item.

Q1

(f) Compound Tariff (Duty): If a government applies both a specific duty and an ad valorem duty on the same product, there is combination of both types of duties. This combination of duties is called a compound duty.

Volume of Sales (Q)

Examples of Tariff

(1) If India charges a tariff of Rs 150 per unit of wrist watch imported from Japan, it is specific tariff.

(2) If India charges a tariff of 15% on the value of shirts imported from the USA, it is ad valorem tariff.

Measurement of a Country's Overall Tariff.

Figure B.D

Tariff rates differ across goods. A country applies different tariff rates to different goods. So for determining the overall level of tariff protection, calculation of some type of average of different tariff rates is done. There are two techniques or approaches for determining overall tariff protection:-

Example When the amount of imports of the two commodities are significantly unequal, the simple average tariff rate does not represent the overall level of tariff protection. It is shown with the help of following example in which total amount of tariff has been calculated and then used for finding out overall level of tariffs:

Suppose: Tariff rate for commodity A is 20% and the value of its imports is Rs 10,000; tariff rate for commodity B is 25% and the value of its imports is Rs 30,000. Imports of these commodities are significantly unequal in values. Calculate the average tariff rate, keeping in view the value of imports of these commodities.

Solution

Amount of tariff for A= 0.20 (Rs 10,000) = Rs 2,000 Amount of tariff for B = 0.25 (Rs, 30,000) = Rs 7,500

Total Tariff = Rs 9,500

Total tariff as % of total values of imports = Rs 9500 / Rs 40,000

= 0.237 OR 23.7%

Thus, overall level of tariffs is 23.7% which is significantly different than the simple average tariff rate 22.5%. This is because of significantly unequal amounts of imports of A and B.

Weighted - average Tariff Rate:

This approach or technique considers relative importance of commodities on the basis of their values in overall imports. A weighted – average measure considers the relative importance of commodities in the overall imports. Take the data of example, given earlier. On the basis of values of imports, commodity B is three times more important than commodity A, This importance is used as weight for calculating weighted average tariff rate. Weighted average tariff rate is calculated below.

Commodity	Tariff Rate (R)%	Sales value (Rs)	Weight on the basis of sales value (W)	R x W
A	.20	10,000	.25	0.050
B	.25	30,000	.75	0.187
Total		40,000	1.00	0.237

Weighted – average tariff rate = 23.7%

Weight for commodity A = Sales of A/ Total Sales = 0.25 Weight for commodity B = Rs 30,000 / Rs 40,000 = 0.75
The weight can be also expressed in terms of ratio of values, as given below:

Sales of A: Sales of B

= Rs 10,000: Rs 30,000 Or 1:3 or ¼: ¾

Weighted average tariff rate = .20 (¼) + .25 (¾) = .20 (.25) + .25 (.75)

= 0.05 + 0.187 = 0.237 or 23.7%

This weighted average tariff rate is equal to the tariff rate calculated on the basis of amounts of tariff for commodities A and B (Which is also 23.7%). The weighted – average tariff rate is a better representative of reality.

Prohibitive Tariff

It is a tariff which is imposed to discourage and restrict the import of a commodity. It is very high. It is so high that import falls very significantly or disappears.

In example above, if tariff on commodity B is increased from the present 25% to 80%, the import of this commodity will significantly decline or will be stopped by traders. If this happens, both simple unweighted average tariff rate and weighted – average tariff rate do not represent country's level of overall trade restrictions. Following example explains this statement.

Example

A country's tariff rates and imports of two commodities are:

Commodity – A: Tariff rate is 20% and Imports amount to Rs 10,000. Commodity – B: Tariff rate is 25% and Imports amount to Rs 30,000 The total imports = Rs 40,000

Now, the country imposes a tariff rate of 80% on commodity B to discourage and restrict its import. As a result, the import of commodity B reduces to Rs 10,000. The relative attractiveness of commodity A increases and its import increases from Rs 10,000 to Rs 30,000. The total of imports of the two commodities remain at the same level, that is Rs 40,000.

Calculate (a) simple unweighted average tariff rate and (b) weighted – average tariff rate. Comment on the level of trade restriction or trade liberalization.

Solution:

(a) Simple unweighted average tariff rate:- (.20 + .80) / 2 = .50 or 50%

(b) Weighted – average tariff rate:-

= (.20 x Rs 30,000) + (.80 x Rs 10,000) / Total Imports

= (Rs 6,000 + Rs 8,000) / Rs 40,000

= 0.35 or 35%

The total amount of imports, i.e., Rs. 40,000 remained the same, before and after the imposition of prohibitive tariff rate on commodity B. The fact is that the import of commodity B has been restricted to Rs 10,000 by imposing prohibitive tariff of 80% Import of commodity A has increased from Rs 10,000 to Rs 30,000 because it is relatively more attractive after imposition of prohibitive tariff on commodity B. Simple unweighted average tariff rate of 50% does not restrict the total import. Similarly, weighted average tariff rate of 35% does not represent the level of trade liberalization. This is the limitation of measuring a country's overall restrictions (or liberalization).

Effects of Tariff

Countries impose import tariff after careful assessment of the effects of tariffs on production, consumption, price, and country's welfare. The effects of imposition of tariffs differ according to the size of the country imposing the import tariffs and stage of its economic growth.

Following are the effects of tariff on imports of goods.

(i) The government gains in terms of increase in its revenue.

(ii) The domestic producers gain in terms of protection against foreign competitors. If tariff is imposed, the cost of imported foreign goods increases, discouraging the buyers. Buyers tend to purchase domestic products which became cheaper as compared to foreign products.

(iii) Tariffs are pro-producer and anti-consumer. Import tariffs make the goods costly for consumers in the form of higher prices.

(iv) Import tariffs reduce efficiency of producers. A protective import tariff does not put pressure on domestic firms for producing efficiently to reduce costs. This results in an inefficient utilization of valuable resources. Sometimes, available resources are used in an unproductive manner.

(v) Export tariff raises revenue for the government. It reduces export from a specific industry of the country. It is imposed for political reasons also.

5.3 Non-tariff barriers and their influence:

Governments influence the price and the demand of products for restricting trade by using non-tariff barriers. Some of these non-tariff barriers are:

(a) Subsidies

(b) Import quota and voluntary import restrains

(c) Export quota

(d) Antidumping duty

(e) Local content requirement

(f) Administrative trade policies

(g) Restrictions on services

(h) Aid and loans

(i) Customs valuation

(j) Special fees, Minimum price levels, and Timing of customs deposits

Descriptions of these barriers are presented here for understanding them and their effects.

5.32. Subsidies

A subsidy is the money government pays to an organisation/firm to reduce the costs of producing goods or rendering services. The purpose of subsidy is to keep the prices of goods/services low.

(A) Export subsidies:

When domestic companies sell abroad at lower prices to promote exports of certain commodities, they suffer losses. Governments of many countries from time-to-time encourage such exports. Governments make direct payments to exporting companies to compensate them for losses incurred while selling abroad. Such payments from the governments to the domestic companies are called export subsidies. Subsidies help domestic producers. Their international competitiveness increases. They are able to sell at competitive prices.

Following are the commonly found subsidies:

(i) Cash grants

(ii) Low-interest loans

(iii) Tax breaks

(iv) Government equity participation in domestic firms

Largest beneficiary of subsidies is the agriculture sector in a large number of countries of the world. Non-agricultural subsidies are lower as compared to agricultural subsidies. But these subsidies are significant.

Subsidies help those industries to grow where economies of scale are important.

Subsidy has two major disadvantages for welfare of the economies. First, it may protect inefficient production. Second, it may result in excess production than what is required. Examples of inefficient producers are found in agriculture. Countries are encouraged to overproduce subsidized agricultural products. Subsidies tend to reduce international trade in agricultural products. Subsidies are negative taxes. Negative taxes are payments from a governments to support an activity.

Subsidies sometimes lead to trade disputes in the area of international trade. Disputes arise because of the following views:-

(i) **The Importing-Country View:**

Domestic industries complain about "unfair" competition from foreign industries which are subsidized by foreign governments to export. As subsidy is a negative tax, it lowers the price for imported goods from abroad at which domestic consumers buy them. The price of the same good or similar goods or close substitutes produced by domestic industries falls. Because of this fall in price, the margins reduce for domestic producers. Import of lower-priced products reduces sales volumes of domestic firms. Producers of importing countries, therefore, lobby for protection from 'unfair' subsidized products from abroad.

The provision for countervailing duty is made under WTO rules to offset the competitive advantage provided by trading partners' export subsidies. The countervailing duty increases the cost for importing-country consumers. From the point of view of importing country, a countervailing duty 'represents a win of domestic producers who pressurize the government for protection'.

Following are the important advantages from a countervailing duty:-

(a) It cancels consumption and production inefficiencies created or encouraged by subsidy.
(b) It improves total welfare because generally the costs of subsidy to exporting countries are higher than the benefits of subsidy to the importing countries.

(ii) **The Exporting-Country View:**

Exporting country's subsidized producers gain at the expense of exporting country's consumers and/or taxpayers. Taxpayers pay to finance the subsidy. The welfare losses exceed the gains. If many exporting countries subsidize, price in the export market falls down. This decline in price in the export market is represented by subsidy. Export subsidies help the domestic producers in maintaining their export markets.

5.3.7 Import Quota and Voluntary Export Restraints

'An import quota is a direct restriction on the quantity of some good that may be imported into a country' (Hill and Jain, p.264). Import quota is for a specified period. Reasons for imposing import quota are similar to the reasons for imposing import tariff. Quota provides protection to domestic industry from foreign competitors. Import quota is implemented by issuing import licenses to firms/certain trading companies. Import quota gives the right to import a specific quantity of a product. In the case of some products example, import of sugar and textiles), quota is allocated to the governments of exporting countries. A trade barrier may be a hybrid (mix) of tariff and quota. The name of the mix is 'tariff rate quota' In a tariff rate quota, tariff rate is lower for import within the quota than the tariff rate for import over the quota. Following example explains.

Example: Country X imports rice form country Y. There is an ad valorem tariff rate of 10% on rice import within the quota. The tariff rate for import of rice over the quota is 30%. The quota for rice import is 5,00,000 tones. Country X imports 8,00,000 tons of rice. The tariff rate for 5,00,000 tons is 10%. The tariff rate for 3,00,000 tons (more than the quota) is 30%.

In agriculture, the tariff rate quota is common. The objective of applying tariff rate quota is to restrict imports in excess of quota.

Voluntary Export Restraint (VER) is also a type of quota on trade. Exporting country may impose this restraint. The government of importing country may request the government of exporting country for VER. For good political and economic relations, exporting country may agree to the request of importing country for imposing quotas and VERS. Both, the import quota and VER help domestic producers by protecting them from foreign competition. Both the import quota and VER raise the price of an imported good. Therefore, domestic consumers pay higher prices for goods. Import quota and VER are not in the interest of domestic consumers.

Because of restrictions on supply of goods imposed by quota and VERs, exporters get higher prices. This results in extra profit for foreign producers. This extra profit is called quota rent. Quota rent may also benefit domestic producers and importers if they have power to increase the prices of domestic products, keeping in view the higher prices of imported goods due to quota and VERs. If the domestic producers charge a price that is higher than world price plus the tariff, consumers are likely to reduce or stop buying from domestic firms. As a result, domestic industry may face a shrinking market.

5.3.9 Export Quota

Exports quota is less common than import quota. An export quota restricts the number of units of a good to be exported. Small countries impose export quota to the goods cheaper in domestic market in the interest of consumers. Large countries impose export quota to get higher prices for their goods in foreign markets.

An export quota limits the supply of a good in the foreign markets. An export quota imposed by small countries decreases domestic production, increases domestic consumption and reduces the domestic prices, other things remaining the same. Export quota imposed by the big countries decreases domestic production, increases domestic consumption, reduces the domestic prices and pushes up the world price by restricting the amount of a good for sale on the world market.

Antidumping Duty

'To dump' means to get rid of goods by selling them often at a very low price, in another country. There are two definitions of dumping. One is price-based definition. Another is cost-based definition. When a firm sells a good in a foreign market at a price which is below the price in its domestic market, it is price-based dumping. When a firm sells a good in the foreign market at a price which is below its production costs, it is cost-based dumping.

There are three categories of dumping:

(a) Sporadic Dumping;

(b) Persistent Dumping; and

(c) Predatory Dumping.

(a) Sporadic Dumping: It means sale of a good for a short time in a foreign market. The selling price is below the domestic price or the cost of production. It is just like 'sale' in a foreign market. It is done by an exporting country to dispose of unwanted inventories.

Sporadic dumping imbalances the domestic market. Domestic industry may not be injured. During the period of sporadic dumping, domestic consumers enjoy the benefit of imported goods at significantly low prices.

(b) Persistent Dumping: This dumping is for a long time period. The price of exported product is kept lower in the foreign market by the exporters than the price they charge in their domestic market. This lower price for dumping is based on the concept of price discrimination. The exporting firm should be able to distinguish or separate its customers into groups having different elasticities of demand for the product of the firm. The firm should be able to charge a higher price in the domestic market if the buyers in the domestic market have lower elasticity of demand of the product than the elasticity of demand of the product in the foreign market. The firm in the domestic market gets opportunity to price discriminate in the foreign market if there is more competition in the foreign markets. More competition in the foreign market implies that elasticity of demand in response to reduction in price exceeds the elasticity of demand in the home market, other things remaining the same. This situation encourages a firm to price discriminate. Price in foreign markets is, therefore, kept lower than the price in the domestic market. This is the important characteristic of price-based persistent dumping. Persistent dumping under the cost-based definition means sale of goods below cost of a long period. If cost means firm's, marginal cost of production, no firm is likely to sell at a price below its marginal cost, that too for a long period. Cost- based definition of dumping does not use the marginal cost of exporting firm. In the short run, an exporting firm is likely to sell at price below its average total cost. A firm which has a large portion of its total costs as fixed costs is likely to sell below its average total costs in the period of low demand of its product. This period is commonly known as recession. A profit-maximizing firm would like to produce and sell if sales revenue is sufficient to cover variable cost, because fixed cost is already committed. The price in such a situation will be equal to variable cost, which is lower than average total cost. Selling below the average total cost helps the firm to continue production.

Cost-based definition of dumping has a problem of determining foreign production costs. It is often difficult to determine foreign production costs. Direct measures of costs are, often, not available. Therefore, indirect measures of costs are used, which are often imprecise. If the producers of a country have comparative advantage and therefore, are able to sell at lower price in the foreign markets, they are accused of dumping in those markets (which have comparative disadvantage).

It is difficult to determine cost-based dumping if the producers' country does not use market-determined prices of inputs. It is also difficult to determine price- based dumping when the producers do not sell the products in the domestic market and therefore, domestic prices are not available for comparison with prices charged by them in the foreign markets. This is found when entire production of a good is for export.

(c) **Predatory Dumping:** When foreign firms sell in the domestic market at a price lower than their costs of production to drive out the domestic firms from the market, it is called predatory dumping. Predatory dumping forces the domestic firms to close their business. As a result, foreign producers become dominant sellers in the market. After achieving dominance in the domestic market, foreign producers begin exploitation of domestic buyers by charging high price. Also, they charge unreasonably high prices for making high profits to compensate for past losses suffered during the periods of predatory dumping by them. It is difficult to prove 'predatory dumping' with facts and data. Predatory dumping can not continue for a long period as it is viewed as 'unfair competition'. Domestic firms may borrow funds to remain in business and force the foreign firms to 'give up' predatory dumping.

When the foreign producers sell in the domestic market below their "fair" market value, its is also dumping. "Fair' market value of a good is to be greater than the cost of production as it includes a "fair" profit margin: What is antidumping duty? On the complaints of domestic firms, the domestic government may conduct investigations to find out occurrence of dumping and the harm done to domestic industry. If the domestic government finds that predatory dumping exists and harms the domestic firms, the government imposes antidumping duty. An antidumping duty is an import tariff which is at least equal to dumping margin. In practice anti dumping duties are high because dumping margins are vague and not precisely determinably. Cost-based definition of dumping suffer firm high cost estimates. Domestic firms wanting protection may be biased in providing cost information and cost estimates by them are likely to be higher than the real costs. This may result in large dumping margins and therefore, high antidumping duties. Antidumping duties aim at protecting domestic producers from "unfair" competition from foreign producers. Antidumping duties are also called 'Countervailing duty, Anti-Dumping Measure is a government action that seeks to stop and remedy the dumping of imported goods into the territory of a WTO member by imposition of an anti-dumping duty. Countervailing measure (also known as 'countervailing duty') refers to a special duty or tax imposed by an importing country on an imported product for the purpose of offsetting any subsidies provided in the exporting country, directly or indirectly, for making, production, or export of the product'. (Demystifying WTO, Centre for Trade & Development, New Delhi, p. 37 and p. 38)

Local Content Requirements

Local content requirement means some portion (specific) of a good is to be produced in the domestic area. This requirement is mentioned in two ways: (a) in physical terms, (b) in value terms.

Example of physical terms: 50 percent of constituent parts of a good is to be produced locally. **Example of value terms:** 40 percent of the value of a good is to be produced locally. Generally, developing countries put the requirement of local content. Developed countries also use the requirement of local content. The objective of developing countries is to promote local manufacture of component parts of a product which is assembled with parts manufactured in foreign countries. The objective of developed countries is to maintain the level of local jobs and to protect local industry from competition from foreign companies.

The main purpose of local content requirements is to restrict competition from abroad. Domestic producers gain in producing the components. The prices of imported components increase because of restriction on their imports. As a result the buyers of final products pay higher prices.

Administrative Trade Policies

These are bureaucratic rules which restrict imports and exports. These are informal trade barriers. These include technical product standards and regulatory standards, and government-procurement policies.

Technical barriers are put on the basis of considerations of health, safety or environment. For example, 'governments require imported foods to meet hygienic standards, toys and autos to meet safety standards, and products to conform to labeling laws to prevent fraud and provide consumer information (Yarbrough, Beth V. and Yarbrough, Rober M., p. 205)

Technical and regulatory barriers have high costs for developing economies. These barriers, in fact, reflect protectionist intent, in many cases. Countries devise these barriers to allow the sale of domestic products but to restrict sale of foreign made goods. The technical barriers add to production costs. For example, if the label conditions are imposed, the label needs translation for each export market. In modern times, a large number of products use raw materials, components, and designs from more than one country. These inputs, therefore, have mixed origin. It becomes difficult for companies to indicate on the labels of the products the nation/country/place of their manufacture. Some governments require importers or exporters to seek permission from government authorities for their trade transactions. This permission is known as import/export license. A foreign exchange control

requires an importer to secure the foreign currency for the imports. It is also a barrier and obstructs foreign trade.
There may be intentional administrative delays which increase the cost of carrying inventory. For example, custom delays because of lack in administrative systems. These delays work as barrier to trade.
Reciprocal requirements also are trade barriers. These requirements are of two types: (a) exporters are to take foreign merchandise and not the money as payments for their sales and (b) exporters are to promise to purchase goods or services in foreign countries to which they export; their purchases are likely to be equal in value to the value of their exports. These requirements are found in the case of defense industries/aerospace industries. Countries prescribing reciprocal requirements have the objective of securing jobs or technology in their countries by promoting their domestic industries. Reciprocal requirements are just like barter transactions. These barter transactions are called countertrade or offsets. Traders tend to avoid countertrade. The reason: many a time, they have to find markets for goods which are not in lines of their experience and expertise, but they have to take under countertrade agreements.

Restrictions on Services

Countries sell services in foreign markets to earn revenue. Common such services are: insurance, banking transportation, consulting and the like. The term 'services' covers a wide range of activities. The WTO secretariat has classified services into 12 sectors – business (including professional and computer); communication; construction and engineering; distribution; educational; environmental; financial; health; tourism and travels; recreational; cultural and sporting; transport.
In the international trade, the growth in services is significant. 'The integration of telecommunication and computer technology has made virtually all services tradable across borders'. (Economic Survey: 2010-11, Ministry of Finance, Government of India, p. 170).

Countries have following three reasons to restrict trade in services: (1) Essentiality, (2) Standards and (3) Immigration.
Essentiality of a service is judged on the basis of social assistance to the citizens of the countries. Governments of these countries feel that some services 'should not be sold for profit'. 'Not-for-profit services' include, for example, the services like education, mail, and hospital health services. Countries restrict foreign firms to compete in these services. They prescribe price controls and /or subsidize government-owned service organizations. Both restrict, or become disincentives for, exporters of services.

Governments prefer local ownership of essential services. This preference works as barrier for foreign firms. Governments restrict the use of their domestic routes for transportation activities by foreign firms (for example, aviation); media, banking, utilities, communications are the services which are considered essential services by many countries. The governments of these countries put barriers on trade in these services, and restrict entry of foreign firms. Standards are used as trade barriers to maintain the level of services which are rendered by qualified professionals (for example, accountants, architects, engineers, hairstylists, physicians, real estate brokers, teachers, lawyers and the like). Such professionals need license to render their services in foreign countries as well as for domestic clients. There are many prerequisites which are time taking and which require extra efforts for meeting the standards of a country. (For example, internships, course work, taking an examination at a local university, etc.) Immigration requirement is a protection of job opportunities and security of citizens in a country. Qualified personnel of a country need work permits to provide their services in another country. Hiring of foreigners is made difficult by this requirement. Immigration requirement works as a trade barrier in service industry. Many countries require their organizations to exhaust all the efforts to find service personnel locally, before giving chance to foreigners to serve them. The effect is availability of job opportunities to local workforce. Aid and Loans Government provides financial aids and loans to other countries. These aids and loans are 'tied'. Tied aids or tied loans require the recipient country to use the funds in the donor country. Tied aids protect the suppliers in donor countries from competition. Tied loans require the recipient country to purchase equipment's or to acquire know-how and technologies. The effect of tied loans is similar to that of tied aids. Recipients of tied loans are obliged to buy from the producers of lender countries, even at prices higher than the prices in the world market. This is a barrier on trade.

5.3 Customs Valuation

Exporters and importers intentionally write low price on invoices to pay less ad valorem tariff. Customs officials in doubt about the values mentioned on invoices use their discretionary power to assess the values which are likely to be too high and arbitrary. This practice prevents imports of goods.

Trade in many different products creates problems in valuation. Some times, products are misclassified and customs tariffs are mischarged and misaligned. The affected traders enter into dispute and take the matters to the court of law. This situation works as trade barrier and affects the valuation and prices.

Special Fees, Minimum Price Levels and Timing of Customs

Deposits

Sometimes, special fees (such as for customs clearance and documents), requiring the traders to deposit customs duties before shipment takes place, and putting minimum price levels at which goods after customs clearance can be sold-all are viewed as the barriers.

5.4 Measurement of Nontariff Barriers

The list of nontariff barriers can only be illustrative. The reason is that nature of non- tariff barrier is not describable precisely. However, a country does prepare its list of nontariff barriers by deciding on which barrier to be included in the list of nontariff barriers (NTBs).

There are four types of measures used to measure NTBs:

(a) The NTB coverage ratio;

(b) The Implicit tariff;

(c) Producer-subsidy equivalents and

(d) Consumer-subsidy equivalent

The NTB Coverage ratio = Value of imports subject to NTBs/Total imports.

Example of the NTB Coverage ratio: Country A imports good X worth Rs. 100 crore. The imports of X are limited by a quota. The imports quota for X is maximum of Rs. 100 crore. Country A also imports good Y worth Rs. 300 crore. There are no NTBs for imports of good Y. The total imports, thus, amount to Rs. 400 crore. Calculate the NTB coverage ratio.

Answer Country A's NTB coverage ratio = Rs. 100/Rs. 400 = 0.25

The Implicit tariff uses the equivalence between tariffs and quotas. A tariff rate is determined which effect on trade is equal to the effect of quota or NTBs on trade. This tariff rate is implicit tariff which is taken as measure of nontariff barriers.

Producer-subsidy equivalents (PSEs) measures the difference between (a) producers' income with tariffs and NTBs and (b) the income producers would earn with no tariffs and no NTBs. This difference is expressed as percentage of income without barriers.

Example: If producers earn Rs. 10 crore with quota and if they earn Rs. 5 crore under free trade (no barrier of quota), the producers subsidy equivalent (PSF) = (Rs. 10 crore – Rs. 5 crore)/Rs. 5 crore = 1 or 100%.Generally, PSE have been calculated for agricultural products in many countries.

Consumer-subsidy equivalents (CSEs) :Because of import quota, consumers are likely to pay higher prices for limited quantity available. Since consumers pay higher prices under quota system than the prices they would have paid without quota system, they receive a negative subsidy. Payment of higher prices results in negative subsidy.

Example: Calculate consumer-subsidy equivalent with the help of following information:-

There is import quota for a good X. Consumers pay Rs. 10 crore for purchase of X. If there was no quota for X, consumers would have got X for Rs. 7 crore.

Solution: Quota's consumer – subsidy equivalent (CSE) = (Rs. 7 crore- Rs. 10 crore)/Rs. 7 crore = – Rs. 3 crore/Rs. 7 crore = -0428 or -42.8 percent. Negative sign is because consumers have to pay higher prices due to quota barrier.

For an industry, NTBs (non-tariff barriers) affect producers and consumers in opposite ways. For example, PSE for the abovementioned situation = (Rs. 10 crore- Rs. 7 crore)/ Rs. 7 crore = Rs. 3 crore/ Rs. 7 crore = 0.428 or 42.8%. This is positive subsidy for producers.

5.5 Summary

Tariff, quota and other-measures affecting international trade are instruments of commercial policy of a country. They are barriers to trade. They are trade restrictions. Economic rationales for such restrictions are unemployment, protections for infant industry, protection to promote industrialization, and economic relations with other countries. Non-economic rationales for such restrictions are prevention of trade with unfriendly countries, preservation of national identity, protection of essential industries and the like.

Trade barriers influence volume (production and consumption), price and political relations. Tariffs, subsidies, arbitrary custom-valuation methods and special fees directly affect price and indirectly affect quantity. Quotas, VERs, 'buy local' legislation, arbitrary standards, licensing arrangements, foreign-exchange controls, administrative delays, and requirements to 'take goods in exchange' directly affect quantity and indirectly affect price. Key

5.6 Glossary

Tariff-rate quotas and other measures and their effects

Compound Tariff (Duty): If a government applies both a specific duty and an ad valorem duty on the same product, it results in a combination of both types of duties.

5.7 Check your progress

Fill in the blanks

1. A .... is imposed when crossing a national or official border.
2. When a tariff is levied on a per-unit basis, it is called a ....

.

3. .... is a tariff imposed to discourage and restrict the import of goods.

4. Money paid by the government to an organization or firm that reduces the cost of producing goods or providing services is called ....

5.8 Answer to check your progress

1) Tariff	2. Specific duty
3. Prohibitive tariff/duty	4. Subsidy

5.9 Terminal questions

1. What is Average Tariff?
2. What is Ad Valorem Tariff?
3. Define 'Subsidy'.
4. What is 'Specific Tariff'?
5. What is 'Weighted – Average Tariff Rate'?
6. What is 'Export Quota'
7. What is 'Local Content Requirement'
8. What do you mean by 'dumping'? What are the categories of dumping?
9. What is 'tariff'? Describe the reasons for and effects of tariff.
10. Describe the views of the importing countries and of the exporting countries regarding subsidies.
11. Explain 'Import Quota and Voluntary Export Restrains' with examples.
12. What are different types of non-tariff barriers?
13. What is the difference between tariff and non-tariff barriers?
14. Explain the restriction on services?

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Unit 6: Components and Accounting System of Current and Capital Accounts

Structure

Objective

Objectives of this unit are:

- To help you in understanding the meaning of current account and capital account
- To understand the items of currency inflows and currency outflows in a BoP statement
- To analyze the components of current account and capital account
- To develop linkage between current account and capital account.
- To explain the accounting systems which are used in preparation of a BoP statement.

6.1 Introduction

In this unit, you will learn about the two parts of Balance of Payments (BoP), namely, Current Account and Capital Account, and the accounting systems used in preparation of BoP.

6.2 Balance of Payments:

Current Account and Capital Account are the two of the three components of Balance-of-payments (BoP). The third component of BoP is 'Official Reserves Account'.

'The balance of payments is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries' (Alan C. Shapiro, p. 127)

'Balance of payments is a record of a country's international transactions'. (Daniels, Radebaugh and Sullivan, p. 122)

Paul A. Samuelson described BoP as "balance of international trade and capital movements' or 'balance of international payments' (p. 631). According to Samuelson,

BoP statement accounts: Coming in (the home country) and going out (from the home country to other countries) the following:

- The values of all capital loans (or "10Us")
- The values of all gold
- The values of all goods
- The values of all gifts and foreign aids

All above transactions are economic/business transactions which have taken place between two countries. All are international transactions. Some examples of these transactions are:

(i) Indian business firms exporting goods to some firms of the USA

(ii) Indian business firms providing transportation of goods in the UK

(iii) Indian business firms providing accommodation in the property owned by them in the USA to the American firms and charging rent for this service.

(iv) Indian firms buying debentures/bonds of corporate organizations of Italy, and getting interest.

(v) Indian firms purchasing manufacturing plants in South Africa.

6.2.1 Items of Currency Inflows and Outflows:

In all these examples, there are currency inflows and outflows. In the BoP statement, all inflows of currency are recorded as credits and shown with a plus sign (+); all outflows of currency are debits and shown with a minus sign (-). Following statements present the lists of 'Debit' items and 'Credit, Items of BoP:-

Statement: I Items of currency inflows in BoP statement of home country Currency inflows are Credited (+)

Items	Credit (+)

1. Exports of goods	(+)
2. Sale of services to foreigners	(+)
3. Receipt of interests, dividends, rents and royalties from foreigners.	(+)
4. Gifts and aids from foreigners.	(+)
5. Portfolio investments by foreigners in home country.	(+)
6. Direct investments by foreigners in home country.	(+)
7. Long-term claims on foreigners.	(+)
8. Increase in long term liabilities to foreigners.	(+)
9. Short-term claims on foreigners.	(+)
10. Increase in short term liabilities	(+)
11. Decrease in official reserves of gold.	(+)
12. Decrease in official reserves of foreign exchange.	(+)

<u>Statement – II</u>

Items of currency outflows in BoP statement of home country
Currency outflows are debited

Items	Debit (-)
1. Import of goods	**(-)**
2. Purchase of services from foreigners.	**(-)**
3. Payment of interests, dividends, rents and royalties to foreigners	**(-)**
4. Gifts to foreigners and aids given to other countries.	**(-)**
5. Portfolio investments by residents of home country in a foreign country.	**(-)**
6. Direct investments by residents of home country in foreign countries.	**(-)**
7. Long-term claims on foreigners.	**(-)**
8. Decrease in long-term liabilities to foreigners.	**(-)**
9. Short-term claims to foreigners.	**(-)**
10. Decease in short-term foreign liabilities.	**(-)**
11. Increase in official reserves of gold	**(-)**
12. Increase in official reserves of foreign exchange.	**(-)**

6.2.2 Components of BoP

Balance of Payments statement has following components:

I. **Current Account:** This account presents the record of inflows and outflows of goods (merchandise), services, and transfers.

II. **Capital Account:** This account presents the record of investment and lending activities of public institutions and private sector.

III. **Official Reserves Account:** This account presents the record of changes in holdings of gold and foreign currency by official monetary institutions

6.2.2 Meaning and Components of Current Account:

Current account is a record of trade in goods and services and income from assets owned in foreign countries. Like any account, it has two sides: Credit and Debit. Inflow of currency is written in the Credit and marked by the sign of plus (+). Outflow of currency is written in the Debit and marked by the sign of minus (-).

Credit (+) aspect of the transactions recorded in the current account relate to:-

(a) Export of merchandise (goods)

(b) Export of services.

(c) Current income received on international investments

(d) Unilateral transfers resulting in currency inflow.

The debit (-) aspect of transactions recorded in the current account relate to. Import of merchandise

(e) Import of services

(f) Current income paid on international investments

(g) Unilateral transfers resulting in currency

outflows. Some details of above-mentioned transactions are given below:

(a) **Export of Goods:** For example, sale of gems and jewellery by a resident firm of India to a company which is a resident firm of the US) Export of goods from a country causes currency inflows in the country. Therefore, export is credit and marked by the sign of plus **Export of services:** This includes travel, passenger fares, any other transportation, royalties and license fees, government services, private services. Some prominent services exported from India are software services, travel, transportation, non-software services such as business services, financial services and communication services. Outcome of export of services is inflow of currency from abroad. Therefore, export of services is Credit and marked by the sign of plus (+).

(b) Current income on International Investments:

This includes receipts of rent on country-owned assets abroad, dividend on direct investments abroad, home country's government receipts from foreign countries, profits on Indian-owned manufacturing plants abroad, spending by Japanese tourists on religious places like Varanasi/Haridwar, remittances from Indians working overseas. All these receipts are inflows of currency from abroad and are Credit, marked by the sign of plus (+).

(c) Unilateral Transfers received:

These include remittance from workers (Indians) employed abroad, grants and aids received from foreign governments, receipts of pensions from foreign governments. Unilateral transfers are not sales or purchases of goods or services. Unilateral transfers to India are currency inflows and therefore, are credit marked by the sign of plus

For example, import or purchase of food, edible oils and pulses, fuel imports. As import of goods takes place, there is payment for import. There is outflow of currency, marked by the sign of minus (-).

(d) Import of Services:

For example, import of business services, travel, transportation, insurance, software services, financial services, communication services, Government not included elsewhere i.e. GNIE, government miscellaneous services. Business services are the most important category in import of services. Import of services causes outflow of currency. Therefore, import of services is Debit and is marked by sign of minus (-).

(e) Current Income payments:

For example, payments on international investments on foreign-owned assets in India, payment on direct investments, other private payments, government payments, compensation paid to foreign employees. These payments cause outflow of currency and are debit, marked by the sign of minus (-).

(f) Unilateral transfers made from India to abroad:

For example, remittances of foreigners employed in India to their own countries, pension paid to former residents of India living abroad, gift of commodities by the Government of India to other countries. These transfers cause outflow of currency from India. These are, therefore, debit, marked by the sign of minus (-).

Balance of Current Account

A country's current account transactions with the rest of the world may show surplus or deficit. A current account surplus is just like an excess of current income of an individual over his/her current expenditure. A current account deficit means current outflow exceeding current inflow of currency. Surplus in current account happens when Credits > Debits. Deficit in current is found when Credits < Debits. International economic transactions which result in income flows (currency inflows) and payment flows (currency outflows) taking place within a year (current period) are recorded in current account.

Current account does not include the following:

- borrowing and lending activities.
- purchases and sales of assets. (for example, a house purchased by an Indian company abroad)
- changes in money balances.

Current account 'surpluses' may be used by the home country to

- lend money.
- pay off old loans
- purchase of assets
- increase money balance

Current account 'deficit' may require the country to borrow, sell assets, reduce money balances. The current account balance may be calculated as under:-

All the credits (+) ---------------

Less: All the debits (-) ---------------

Current Account Balance. ---------------

Current account balance is arrived at following stages:

- Merchandise (exports and imports) Trade balance.
- Invisibles balance
- Goods and Services balance.

Trade balance shows changes in exports and imports. Invisible balance reflects the combined effect of transactions relating to international trade in services, income associated with non-residents assets and liabilities, labour, property and cross-border transfers, mainly workers' remittances.
Invisible transactions are classified into three categories:

(A) Services: travel, transportation, insurance, Government not included elsewhere (GNIE) and miscellaneous (such as communication, construction, financial, software, news agency, management and business services); (B) Income and (C) Transfers (grants, gifts, remittances, etc) which do not have any quid pro quo (something in return or an equivalent).

As an example, Table 1 gives summarized current account of India's BOP:

Table 1: India's Balance of Payment: Current Account (US $ billion approx)

Sr. No.	Item	Year	
		2008-09	2009-10 (PR)
1	Exports	+ 189	182
2	Imports	-309	301
	Trade Balance (exports-imports)	-120	-119
3	Invisibles (net) : (A) + (B) + (C)	+92	80
	(A) Non-factor services	54	36
	(B) Income	-07	-08
	(C) Transfers	45	52
4	Goods and Services Balance = (Trade balance) + (Non-factor services)	-66	-83
5	Current Account Balance = (Trade balance) + (Invisibles)	-28	-39

Source: Economic Survey 2010-11, Government of India. p.137 (it is based on RBI data)

*PR: Partially Revised.

Meaning and Components of Capital Account

"The capital account records international borrowing and lending and purchases and sales of assets". (Yarbrough and Yarbrough, The World Economy, p.413). It shows capital flows. It shows capital inflows in a country and capital outflows from that country. In some governments' reports, the complete name of capital account is 'Capital and financial account'.

Capital Outflows: Following types of transactions between two countries cause capital outflows from one country to the other:

(i) Purchase of foreign assets (imports of the titles to the assets)

(ii) Lending to foreign borrowers.

Purchase of a foreign asset by a resident of a country results in capital outflow from that country. Similarly, lending by resident of a country to the borrower of a foreign country (non-resident) results in capital outflow from the country of the lender.Capital outflows are debit in Capital Account. It is easy to understand debit in capital account. You have to think that India is importing some assets when foreign assets are purchased by India's private business firms or by Indian government agency. The general rule of accounting for imports is 'Debit what comes in'. This rule applies in the case of real account. Imports of assets relate to real account. When import of assets takes place, assets come in and capital goes out of the country, i.e., there is capital outflow. When Indian firms, individuals or companies or government lend to foreign parties, they get 10Us. 10U is a written promise to pay money to somebody at a future date to whom the writer owes. It is a way of writing 'I owe you'. Thus there is import of 10Us. Foreign parties borrowing from Indian parties are treated as personal account. The general accounting rule for recording the transaction relating to personal account is 'Debit the receiver'. The outflow of capital from India to the borrower of a foreign country means borrower is a receiver. Thus for lending (the capital outflow from India), there is receiver. Receiver is debited. Assets purchased may be in the form of bonds/debentures/shares of companies of foreign countries or a house purchased in some foreign country by a resident of India. Capital outflows from India represents increases in ownership of foreign assets. Capital outflows from India by way of lending to parties abroad result in creation of financial claims against foreigners. Examples of capital outflows which are debit in the capital account:

(i) Foreign investment from India which means direct or portfolio ownership of assets in another country. Foreign direct investment (FDI) is an investment that gives the Indian investor a controlling (managing) interest in a foreign company.

(ii) Portfolio investment is an investment in the form of either debt or equity that does not give the Indian investor a controlling interest in any company or venture belonging to a foreign country.

Some Other Examples:

(i) Investments of Aditya Birla group's Hindalco which has 61% of its assets outside India.
(ii) SBI purchase of assets from banks in the US and Europe for its overseas expansion.
(iii) Purchase of US-based Senate's patents, trademarks and automated manufacturing equipment for auto-injectors by Ranbaxy Laboratories of India.
(iv) Tata Motor bought Daewoo Commercial Vehicle in Korea.
(v) Joint Ventures of Mahindra & Mahindra in China, one with Jiangling and the other with Yueda Yancheng in production of tractors.

Capital Inflows

Following types of transactions between two countries cause capital inflows from other countries to the home country (India).

(i) Sale of assets to foreigners
(ii) Borrowing from the foreign lenders. Capital inflows are Credit in capital account.

Some Examples:

(i) Purchase of Indian real estate by a Japanese firm.
(ii) Foreign direct investments in the Government owned Air India
(iii) Investments of ABB- a Swiss-Swedish Company- in ABB India
(iv) Investments of the South Korean steel maker POSCO in its galvanised steel sheet plant in Raigad district of Maharastra.

The following table presents summarised Capital Account of India's BoP:

Table: 2 Balance of Payment: Capital Account (US $ billion, approx)

S. No.	Items	Year	
		2008-09	2009-10 (PR)*
1.	External Assistance	02	03
2.	External commercial borrowings (net)	08	03
3.	Short-term Debt	-02	08
4.	Banking Capital (net)	-03	02
5.	FDI (net)	20	19

6.	Portfolio (net)	-14	32
7.	Other Flows (net)**	-04	-13
	Capital Account balance	**07**	**54**

Source: Economic Survey 2010-11, p.137 (based on RBI data)
*PR Partially revised.

** Other flows include, among others, delayed export receipts and rupee debt service.

Capital Account balance is net capital flow. For example, in 2009-10, the gross capital inflows amounted to US $ 345.7 billion, and gross capital outflows amounted to US $
292.3 billion. As a result, net capital flow was at US $ 53.4 billion (54 billion approximated in Table 2).

In 2009-10, Foreign Direct Investment (FDI) inflow amounted to US $ 33.1 billion. FDI outflow amounted to US $ 14.4 billion. Consequently, the net FDI (inward FDI minus outward FDI) was US $ 18.8 billion, approximated to US $ 19 billion in the table:2.

Official Reserves Account:

The reserves are an important constituent of BoP. An economy's external position should be analyzed taking into account official reserves. These reserves comprise:

- Foreign currency assets (FCA)
- Gold
- Special drawing rights (SDRs)
- Reserve tranche position (RTP) in the International Monetary Fund (IMF)

Foreign currency assets (FCA) are maintained in major currencies like the US dollar, euro, pound sterling, Australian dollar and Japanese yen. Reserves are denominated and expressed in the US dollar, for convenience. For managing foreign exchange reserves in India, RBI is guided by two objectives, visa, safety and liquidity.

Foreign exchanges includes foreign currency notes (for example, $10) or traveler's cheese in a foreign currency or a demand draft drawn on a foreign bank or short-term claims on foreigners written in foreign currency.

Table 3: Shows the summary of overall balance (current account balance, capital account balance and errors and omissions) and reserves.

Table3. Balance of Payments: Summary of Overall Balance, and Reserves (US

$ billion approx)

S. No.	Item	Year	
		2008-09	2009-10
1	Current Account Balance	-28	-39
2	Capital Account Balance	07	54
3	Error and Omission	01	-02
4	Overall Balance	-20	13
5	Reserves Increase (-) Decrease (+)	20	-13

Source: Economic Survey 2010-11, p.137

6.2.3 Usefulness of Bop

All Bop transactions have dual aspect. A surplus in merchandise trade may be offset by a deficit in some other components of Bop, for example, a deficit in investment income. Following are the uses of Bop:

(i) Bop is a comprehensive indicator of economic stability of a country, particularly financial stability in the world market.
A deficit in merchandise trade means that consumers of the country are using its currency to buy more from other countries. It means supply of currency of the country is increasing in other countries. It may result in depreciation in the value of country's currency.

(ii) Managers of business firms of a country use Bop data in deciding to do or not to do business in another country. Factors that could lead to currency instability or government actions to correct an imbalance are important information for formulating and implementing a firm's strategy for its international business. For example, a trade deficit may require increase in exports. In order to encourage the firms to export more, the Government of the country may offer incentives and awards to exporters.

(iii) Monetary policy of a country takes into consideration the details of Bop. A country having current account deficit may revise interest rates upward to get short-term capital inflow. Also, the country may encourage foreign direct investment (FDI) to finance current account deficit (CAD),

LINKAGE between Current Account and Capital Account

(i) Net capital outflow must be equal to balance on the current account. Any foreign exchange earned by a country by exporting to other countries is either spent on import or exchanged for claims against foreigners (IOUs). A country's capital outflow is equal to net amount of IOUs.

(ii) The surplus in current account of a country means the country is net exporter of capital. Similarly, a deficit in current account of the country means the country is a net capital importer.This can be explained with the help of an example of trade in goods and service. Suppose that India and Japan are involved in trade in goods and services. Both the countries are exporting to and importing from. If India has a trade deficit with Japan, it means India is buying more goods and services from Japan than she is exporting to Japan. It also means Japan is investing more in India than India is investing in Japan. Thus between India and Japan,

any deficit in the current account is equal to the surplus in the capital account. Thus following equation holds true:

Net foreign investment = Export – Imports.

Accounting Systems:

Balance of Payment is a statement of sources and uses of funds. Funds here mean foreign exchanges. Total of all sources is equal to total of all uses of foreign exchange, for an accounting year (financial year, for a country). Sources and uses of funds statement records continuing flow of purchases, sales, payments and receipts between a country and rest of the world. All these international business transactions relate to real assets and financial assets. Real assets are goods, all sorts of other physical assets and services. Financial assets are financial claims like shares, debentures, bonds, other financial papers (bill of exchange, IOUs) or any other financial instruments. All international business transactions involve two accounts. Accounting entries for a business transaction are made simultaneously in these two accounts. A transaction may involve a combination of (a) a current account and a capital accounts (b) two current accounts or (c) two capital accounts. Following are the examples of combinations:-

(i) An Indian firm exports goods to a firm of the US. The invoice for this export is in US $.

The two aspects of this transaction are merchandise export and foreign currency claim. Merchandise export is an item of Current Account and will be recorded in current account. Foreign currency claim is an item of Capital Account and will be written in Capital Account.

(ii) An Indian firm imports edible oils from a foreign firm and in return exports to the same firm readymade garments of value equal to the value of import.

In this transaction merchandise import (edible oils) and merchandise export (readymade garments) are involved. Both merchandise import and merchandise export are items of current account and both will be recorded in Current Account.

(iii) Bank of India purchases bonds issued by the Government of the UK and pays for this purchase in Pound (£) from its account in a bank of the UK.

Both bonds and deposits in bank are financial assets. Financial assets are items of Capital Account. Both purchase of bonds and payment from account in the bank of UK will be recorded in Capital Account.

Government of India gifts medical supplies to Government of Libya, valued in$. Medical supplies are like merchandise export and value of gift is a transfer from India to Libya. This transfer is a unilateral transfer. It is called "unrequited transfer". Unrequited transfer is effected out of love and kindness. There is no exchange of benefits in monetary terms. Both export (gift of medial supplies) and unilateral transfer are items of current account. Both will be recorded in current account.

(iv) An Indian company gifts to a **'Dharmshala'** (a lodging accommodation) in South Africa a sum of Rs 1 crore. This gift is deposited in the account of 'Dharmshala' in a bank in India. Because of this transaction, India's foreign liabilities have increased. The gift is unilateral unrequited transfer and is an item of Current Account. It has increased the liability of India to a foreign Dharmshala. Therefore, it is an item of Capital Account also. This gift (donation) will be recorded in both Current Account and Capital Account.It is important to remember that Bop is prepared for a country, following the general rules of accounting. Accounting for Bop is essentially a double –entry book-keeping. The effect of each international transaction is recorded twice with the same amount; once in debit side and second time, in the 'credit side' of the relevant accounts (either both sides of Current Account or both sides of Capital Account or one side of the Current Account and the other side of Capital Account)

Entry or recording of a transaction is a two-step process:

Step1. Determination of the accounts: current or capital or both the accounts Step2. Determining the side of the account: 'Debit' or 'Credit'.

For Step1, lists of items of Current Account and Capital Account are helpful.

Step2: A transaction which creates demand for foreign exchange (foreign currency) of the country is 'Debit" and a transaction which generates supply of foreign exchange is 'Credit" in the relevant accounts. In other words, 'outflow' of foreign exchange from the country is Debit, and 'inflow' of foreign exchange to the country is 'Credit'.

Following accounting equation is followed while recording the effects of a transaction: Debit = Credit

Assets = Liabilities

Debits are, indicated by minus sign i.e. (-)

Increase in assets

Decrease in liabilities.

Credits are, indicated by plus sign i.e. (+)

Decrease in assets

Increase in liabilities

Example:

Following are India's international transactions in the financial year 2010-11:

(a) India imports goods from Korea worth $1,000.

(b) India exports goods to Libya worth $ 2,000.

(c) India exports gems and jewelers worth $10,000 to the USA in return for chemicals from the USA worth $10,000.

(d) An Indian bank purchased bonds issued by the Government of Hong Kong valued at $20,000 and wrote a cheese on an account it has with correspondent bank in Hong Kong.

(e) India gifted blankets and readymade garments for people of Indonesia valued at $30,000.

(f) A resident of the UK made a gift of $10,000 for school-going children of BPL families in the state of Jharkhand to an NGO of the state for its utilization.

(g) A Japanese company bought a piece of land in U.P. for constructing its factory to manufacture automobile parts. The vale of the property was US
$ 1,000,000.

(h) An Indian company bought a machine for its plant in Ahmedabad for $ 50,000 from a manufacturer of Singapore.

Required

Write the entries for India's Balance of Payments Accounts

Solution

The application of double entry book- keeping is described as follows.

For entries in the books of account of a business entity, accounts are classified into three types: Personal Account, Real Account and Nominal Account. In this transaction, Real Account (Import of Merchandise) and Personal Account (the exporter) are involved. The rule for recording personal account is 'Debit the receiver and credit the giver'. The rule for recording real account is 'Debit what comes in and credit what goes out'.

The entries will be made in Current Account and Capital Account, keeping in view the general rules for entries and nature of items.

Transaction (a)

Import of goods from Korea by India is an item of Current Account. Import involves actual or prospective (likely to be or to happen) payment of foreign exchange. Till the payment is made. it is a liability. A liability is an item of 'Capital Account'. The entries in Current Account and Capital Account are given below.

Current Account		
	Debit (-)	Credit (+)
Merchandise import	10,000	

Capital Account		
	Debit	Credit
Increase in short-term liabilities (credit the exporter or foreign bank paying to the exporter on behalf of the importer).		10,000

Further explanation is provided by taking the transaction through Journal and ledgar, according to general rules of book-keeping.

Journal		
At the time of Purchase (import)	**Debit ($)**	**Credit ($)**

Purchases A/c (Import of merchandise) To Seller A/c (Exporter A/c) (Merchandise is a real account and it is coming in. Therefore, purchase of merchandise A/c will be 'Debit'; the seller or exporter is a personal A/c. The seller is giver. Therefore, seller A/c will be 'Credit'	10,000	10,000
At the time of Payment		
Seller A/c (Exporter A/c) To foreign Bank A/c (correspondent Bank account	10,000	10,000

of the importer in the country of exporter) This entry shows the outflow of foreign exchange of the importer's country. Both Seller A/c and Bank A/c are personal accounts. The rule applicable is debit the receiver and credit the giver).		

Ledger (for posting the Journal entries)

Debit Purchase A/c (Imports A/c) Credit

	Amount		Amount
To Seller A/c (Exporters A/c)	10,000	By Balance c/d	10,000
To Balance b/f	10,000		

Debit Seller (Exporter) A/c Credit

	$		$`
To foreign Bank (A/c)	10,000	By Purchases A/c (Import A/c)	10,000
	10,000		10,000

Debit Foreign Bank A/c Credit

	$		$`
To Balance c/d	10,000	By Seller A/c (Exporter A/c)	10,000
		By Balance b/f	10,000

Trial Balance

(For summary effect)

Accounts	**Balance**	
	Debit **$**	**Credit** **$**
Purchases (Import of merchandise)	10,000	
Foreign Bank (outflow of foreign exchange on behalf of importer)		10,000
Total	10,000	10,000

Note:

Imports are written in the Debit side of the Current Account of BoP. Short-term borrowing from foreign bank to make the payment is an inflow of foreign exchange and is an item of Capital Account and will be written in the Credit side of Capital Account.

Transaction (b)

Debit Current A/c Credit

	Amount		Amount
		Export of Merchandise (Goods going out / decrease in assets)	$2000

Debit Capital Credit

	Amount		Amount

'IOU' from the importer in Libya (inflow of foreign exchange / increase in claims on foreign bank / increase in current assets)	$2000		

Transaction (c)

In this transaction, export of gems and jewellery and import of chemicals, both are the items of current account. So, entries will be made in Current Account.

Debit Current Account Credit

	Amount		Amount
Import of Chemicals (Debit what comes in / increase in assets)	$10,000	Export of gems and jewellery (credit what goes out / decrease in assets)	$10,000

Transaction (d)

In this transaction, purchase of bonds has created a claim on foreigners and drawing a cheque is an outflow of foreign exchange. Bonds and cheques both are financial assets and therefore, items of Capital Account. Entries will be recorded in Capital Account as given below.

Debit Capital Account Credit

	Amount		Amount
Purchase of bonds (increase in financial assets in the form of foreign bond holdings)	$20,000	Claim of Govt of Hong Kong (increase in liability, will decrease foreign bank deposits)	$20,000

Transaction (e)

This transaction has an item of Current Account, i.e., Gifts. In its effect it is similar to export of merchandise. But there is no corresponding inflow of foreign exchange. It is an unrequited transfer. The entry will be made only in Current Account. Since this gift decreases the assets and assets are going out, merchandise gifts will be shown in the credit of Current Account (Rule: Debit what comes in, Credit what goes out).

Debit Current Account Credit

	Amount		Amount
Unrequited Transfers	$30,000	Merchandise export (gift of blankets and readymade garments)	$30,000

Transaction (f)

There in an inflow of foreign exchange. There is no corresponding outflow of physical assets or financial assets. This inflow of foreign exchange is an item of Capital Account because transfer will be effected by crediting the NGO's account in a bank in the UK. This inflow of foreign exchange is a gift of a nature of unrequited transfer to India. It will be credited in the Capital Account and debited in the Current Account, as unrequited transfers at the country level (at the unit level the NGO is receiving the gift, so 'debit the receiver under the group name of 'Unrequited Transfers').

Debit Current Account Credit

	Amount		Amount
Unrequited Transfers	$10,000		

Debit Capital Account Credit

	Amount		Amount
		Increase in foreign liabilities (inflow of foreign exchange)	$10,000

Transaction (g)

In this transaction, both the aspects, sale of land and payment of purchase consideration, are items of Capital Account. This transaction results in an increase in the supply of foreign exchange (inflow of foreign currency). Increase in foreign exchange is recorded in the credit side of Capital Account.

Debit Capital Account Credit

	Amount ($)		Amount ($)
Sale of land to Japanese Company (Decrease in liabilities / decrease in foreign claims)	10,00,000	Foreign private investment in India (FDI) Increase in liabilities	10,00,000

Transaction (g)

Purchase of machine and prospective payment both are items of Capital Account.

Debit Capital Account Credit

	Amount ($)		Amount ($)
Purchase of Machine (increase in assets, increase in demand for foreign exchange)	50,000	Increase in foreign liabilities	50,000

Accounting Rules to Remember

(a) A transaction causing an increase in demand for foreign exchange is a 'Debit' entry.

(b) A transaction causing an increase in the supply of foreign exchange is a 'Credit' entry.

Suggestion

Enter the transactions in Current Account and Capital Account, keeping in

mind the impact of the transaction on Balance of Payment of India.

6.5 Balance of payment

The balance of payments is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries. These are international business transactions. The main components of BoP are Current Account, Capital Account and Official Reserves Account. Current account is a record of trade in goods and services and income from assets owned in foreign countries. A country's current account transactions with the rest of the world may show surplus or deficit. A current account deficit means current outflow exceeding current inflow of currency. The capital account records international borrowing and lending and purchases and sales of assets. Capital Account balance is net capital flow. Official Reserves Account are an important constituent of BoP. An economy's external position should be analyzed taking into account official reserves. These reserves comprise of foreign currency assets (FCA), Gold, Special drawing rights (SDRs) and Reserve tranche position (RTP) in the International Monetary Fund (IMF). BoP is a comprehensive indicator of economic stability of a country, particularly financial stability in the world market.

6.6 Glossary

Balance of Payments: An accounting statement that summarizes all economic transactions between the residents of the home country and the residents of all other countries.

Capital Account: This account records the investment and borrowing activities of public institutions and the private sector.

6.7 Check your progress

Fill in the blanks

1. The .... account records changes in the holdings of gold and foreign currency by official monetary institutions.
2. .... transfers do not involve the sale or purchase of goods or services.

6.8 Answer to check your progress

1. Government stocks 2. Unilateral

6.9 Terminal question

1. What is trade surplus?

2. Explain deficit in Current Account.

3. What is 'IOU'? How an 'IOU' received by an Indian firm from an importer of Germany will be treated in BoP?

4. What is 'unilateral transfer'? Give examples of unilateral transfer. What are the uses of Current Account 'Surplus'?

5. What are categories of 'Invisibles, in India's Balance-of-Payments?What is 'Capital Account' in the Balance-of-Payments?

6. What are the items of foreign exchange reserves?

7. Define 'Current Account'. Describe the content of Current Account. List items of foreign currency flows along with their plus / minus signs.

8. What are capital outflows? Explain with the help of suitable examples and give accounting treatment.

9. What are the linkages between capital and current account?

6.11 Suggest readings

1. John D. Daniels, Lee H. Radebaugh and Daniel P. Sullivan, International Business, 10the ed. (Delhi; Pearson Education, 2004), Chapter -4, pp. 123- 124.
2. Beth V. Yarbrough and Robert M. Yarbough, The Word Economy: Trade and Finance, Seventh Edition (Thomson South – Western, First Indian Reprint, 2007), Chapter-13; 'The Balance of Payments Accounts'.
3. Government of India, Ministry of Finance, Department of Economic Affairs, Economic Division, Economic Survey – 2010-11, (New Delhi, Oxford University Press, 2011), pp. 136-142
4. Michal R. Czinkota, Ikka A. Ronkainen and Michal H. Moffett, International Business, 7th Edition (New Delhi; South –Western Cengage Learning, Second Indian Reprint. 2008), Chapter -6.
5. Alan C. Shapiro, Multinational Financial Management, Forth Edition (New Delhi, Prentice – Hall of India Private Limited, 1996), Chapter 6.
6. Paul A. Samuelson, 'Economics: An Introductory Analysis', Seventh Edition (New York, McGraw-Hill Book Company, 1967), Chapter-33.

Unit 7: Issues in Investment, Technology Transfer, and Pricing Regulation

Structure

Objectives

- To familiarise you with meaning, nature and scope of issues in investment in the context of international business;
- To explain the meaning and necessity of technology transfer for growth in international business and to outline the various issues in technology transfer; and
- To explain the factors influencing pricing regulations in the context of international business.

7.1 Introduction:

Issues in investment (in the context of international business and finance) are important for capital flows and for integrating the economies of the world. WTO since 1 Jan, 1995 has made efforts to facilitate agreements on various issues of international trade related investments and intellectual property. Issues of intellectual property are closely related to technology transfer. Pricing regulations make the market for goods, services and financial assets attractive or dull, and contribute to reduction/increase in systematic risks. Therefore, pricing regulations are significant influencers for movements in goods, services, and capital markets.

Investment in the context of International Business

International or foreign investments affect balance of payments (BoP) of a country. Both foreign direct investments (FDI) and foreign portfolio investments affect BoP of a country. For example, India's balance of payments position comes under stress because of increase in trade deficits. Historically, the current account of India's BoP has been funded by capital flows. Whenever foreign portfolio investors sell-off in the equity market, the Indian currency falls. (TOI, New Delhi, May 3, 2012). Cross-border trade improvements are helpful in ensuring investments, particularly in the form of joint ventures. Establishing very strong trade and investment relations is likely to work for friendly political and cultural relations between unfriendly countries. For example, Adi Godrej, Chairman of Godrej Group and president of CII said that the growing interaction between the businessmen of the two neighbours (India and Pakistan) will also help repair political ties, and improvement in trade ties would be beneficial for all of South Asia. (TOI, New Delhi, April 23,2012).Many host governments consider the effect of FDI on country's balance of payments as an important issue. There is link between FDI and balance of payments accounts. This link is explained below:-

(a) 'Investment income' recorded in the current account includes the income (interest, dividend, etc.) from foreign investments of the residents of home country and payments (interest, dividend, royalty) made to foreign investors in the home country.
(b) Capital account records purchase and sale of assets (both real and financial). A credit in capital account is capital inflow as a result of investments (direct or portfolio). A debit in capital account is capital outflow from the home country to foreign countries as a result of investments abroad.

Trade Related Investment Measures (TRIMS) are taken by host countries to attract and regulate foreign direct investments in their territories. These include grant of fiscal incentives and requirements to host country's national priorities. The requirements can take the form of (a) local content requirements, (b) manufacturing requirements,
(c) export performance requirements, (d) technology transfer or licensing requirements, etc. These measures constitute the terms and conditions for the entry of investment into the host country. Multilateral Investments Guarantee Agency (MIGA) set up by the World Bank recognizes these requirements. (MB Rao and Manjula Guru, p. 120).

Investors consider and evaluate comforts and benefits, disadvantages and hardships of the abovementioned requirements while deciding to invest overseas, besides the financial benefits. These requirements may be viewed as issues in investment, technology transfer and pricing regulation. These issues are described in this unit. Understanding of these issues requires knowledge about concepts relating to investment, technology transfer and pricing regulation. In further description, you will know about these and related issues.

7.2.3 What is foreign Direct Investment?

'Foreign direct investment occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country' (Charles W. L. Hill, p. 214). Here, product includes service also.

Foreign direct investment is effected in following forms:

(a) Green field investment: This involves taking up a wholly new operation (business) in a foreign country.
(b) Investment by acquiring or merging with an existing firm in the foreign country.
(c) Expansion and diversification (related as well as unrelated) of operations of an existing business entity in the foreign country.

FDI is an active investment. Foreign direct investor acquires voting power of an enterprise in a foreign economy either

(a) by incorporating a wholly owned subsidiary or a company, or

(b) by acquiring shares in an associated enterprise; or

(c) by a merger with or an acquisition of an unrelated enterprise; or

(d) by participating in an equity joint venture with another investor or enterprise.

The objectives of foreign investors in making direct investments are to take advantages of

(a) cheaper wages; (b) special investment privileges offered such as tax-exemptions or tax-holiday; (c) tariff-free access to the markets; (d) huge market potential; (e) availability of technology, mainly in the form of joint ventures; (f) Export Processing Zones (E PZ); (g) free land and/or land subsidies; (h) infrastructure subsidies; (i) R & D support; (j) deregulation to free a commercial or business activity from rules and controls.

FDI aims at acquiring a lasting management interest in enterprises operating abroad. It usually involves participation in management, transfer of technology and expertise in functional areas like production and distribution and/or marketing. When cross border trade starts expanding, investments follows in the form of opening of stores and establishments of manufacturing facilities. Both affect investments. FDI represents international factor movements (capital, entrepreneurial capability and talent). In a developing economy, FDI increases transfer of skills, job opportunities and local productivity growth. FDI excludes investment through purchase of shares from the stock markets (the secondary market of Capital Market). For identifying and understanding issues in foreign direct investment, its effect on BoP of host country should be assessed. (A host country is any foreign country in which an international company operates.). FDI provides the host country valuable foreign exchange for importing goods, services, technical know-how, plants and managerial talent. Host country also uses foreign exchange for paying its foreign debt off. Initial capital inflows from foreign direct investors are positive to the host country. But over a time period, remittances (dividends, transfer of reserves and surplus) by investors to their own countries may exceed, in some cases far exceed, the initial capital inflows. If this happens, it is negative effect of FDI on BoP of host country. It is a positive effect of FDI on BoP of nvesting country or home country.

7.2.3.5 What is International Portfolio Investment?

International portfolio investment, commonly called foreign portfolio investment (FPI), is the flow of funds across national boundaries for financing investments. Foreign Portfolio Investments (FPI) are investments by individuals, firms or public bodies (e.g. national and local governments) in foreign financial markets (e.g. government bonds, foreign stocks or equities). Thus, FPI transfers funds between countries.

FPI differs from FDI. FPI is not done to take a significant equity stake in a foreign business entity whereas FDI is done to take a significant equity stake. The factors affecting FPI are different than the factors affecting FDI. Therefore, issues raised in FPI are different than issues raised in FDI.

FPI is highly mobile. It can be effected by an electronic transfer of funds. It involves very low cost of transfer. Its transaction cost is very low. FDI takes much longer time because of permission and approvals to be obtained.

FPI is a passive investment. It does not have interest in management and operational control of the enterprises whose financial assets are purchased. FDI is an active investment. FPI, like FDI, is an item of the capital account of BoP data. FPI includes purchases of financial assets with a maturity greater than one year. It is different from short-term investment. Short-term investment is purchase of securities (financial assets) with a maturity of less than one year. Like FPI, short-term investment is an item of capital account of BoP.

Investors of FPI aim at wider range of investment opportunities by entering into global capital market. Investors make decisions to diversify their portfolios internationally to reduce their risk and to increase their return. As an investor increases the number of stocks in portfolio, risk declines. The investor's portfolio's risk, over a period of time, approaches the systematic risk of the market. Systematic risk refers to the movements in stock portfolio's value due to macroeconomic forces affecting all firms in an economy. The systematic risk is the level of non-diversifiable risk in an economy. The level of systematic risk is an important issue in FPI. Some of the macroeconomic forces contributing to the level of systematic risks are: advances in information technology and deregulation by governments. FPI uses large volumes of information about markets, risks, exchange rates, interest rates, credit- worthiness and the like. Following types of decisions are based an above mentioned information:-

- Where to invest and how much to invest
- When to invest
- What are values and riskiness of financial assets including corporate bonds, stocks, government securities and currency.

Deregulation is by governments such as allowing commercial banks to perform the functions of investment banks, allowing the foreign investors to purchase significant equity position in domestic companies, increasing acceptance of the free market ideology on economic and political considerations Deregulation has facilitated the growth of international capital market in a number of important countries.

Recent examples of deregulatory steps taken by India for encouraging investment by foreign institutional investors are (a) increase in the current limit of FII (Foreign Institutional Investors) investment in government securities by US $ 5 billion, raising the cap to US $ 15 billion; (b) increase in the current limit of FII investment in corporate bonds by US $ 5 billion, raising the cap to $ 20 billion (the incremental limit of US $ 5 billion can be invested in listed corporate bonds; (c) for increasing access to Indian capital markets, QFIs (Qualified Foreign Investors) were allowed to directly invest in the Indian equity market in January 2012; this was done to widen the class of investors, attract more foreign funds, reduce market volatility and deepen the Indian Capital Market. (Economic Survey 2011-12, pp. 124-125). Overall limit for FII investment in corporate bonds and government securities is US $60 billion. In addition to the deregulation of the financial services industry, 'many countries beginning in the 1970s started to dismantle capital controls, loosening both restrictions on inward investment by foreigners and outward investment by their own citizens and corporations. By the 1980s, the trend spread from developed nations to the emerging economies of the world. Countries across Latin America, Asia, and Eastern Europe started to dismantle decades-old restrictions on capital flows'. (Charles W.L. Hill, p. 388).

A managerial issue encompassing all types of foreign investment is '<u>Delays in decision making on the part of government and government agencies</u>'. Lakshmi Mittal, India-born chairman of Arcelor Mittal, - the world's largest steel making company-said in an interview, "I do not think, there is policy paralysis, but decision making is too slow in India". This comment was also related to Arcelor Mittal's planned Rs. 30,000 crore investment in India. (TOI, New Delhi, may 12, 2012).

<u>A regulatory issue has come up</u> in May 2012 which relate to <u>formation of holding companies</u>. Reserve Bank of India (RBI) has prepared a draft, 'Overseas Investment (Reserve Bank) Direction, 2012' for Core Investment Companies. According to RBI, any core investment company (CIC) which will invest in the financial sector overseas will be required to register itself with RBI. A core investment company is an investment entity created solely for the purpose of owning promoters' share in group companies. This type of companies are registered as finance companies. They do not engage in business on their own. RBI has barred Indian corporate from creating complex

holding structure for overseas investment. All subsidiaries and joint ventures set-up abroad must be operating entities. (TOI, 12 May 2012).

Issues in Investments (Foreign Investments)

Some of the present-day general issues in foreign investment (both FDI and Foreign Portfolio Investment), keeping in view Indian economy are described here.

Issue of Investment in Banking Sector

The extent of voting right cap for foreign investors in private sector banks on India is an important issue for international investment in banking sector. Even if a foreign investor has 40% stake (equity investment) in a bank, its voting right is capped at 10%. In a step towards liberalization, the Indian government proposed to raise this voting right to 26%. How much meaningful it is? A 26% vote will enable the investor to veto (disallow) resolutions. But it will not be enough for foreign investors to build their authority in management control.

Issue of Investment in Insurance Sector:

There is foreign investment ceiling for insurance upto 26 percent. Both FDIs and FIIs are allowed in this sector under the automatic route. There is need for and demand of FDI inflows in insurance sector. A developing insurance sector is of high importance for every modern economy. Insurance sector (a) encourages the savings habit, (b) offers a safety net to rural and urban enterprises and productive individuals. Insurance is necessary to protect enterprises against risks such as fire and natural disasters. There are 23 insurance companies operating in the life insurance segment. Of these companies, 20 are in joint venture with foreign partners. There are 18 private insurers in the non-life segment. Of these companies, 16 are in collaboration with foreign partners. Thus 36 insurance companies in the private sector were operating in the country in collaboration with established foreign insurance companies from across the globe as on 31 march 2011 (Economic Survey 2011-12, p 127). The measurement of growth in the insurance sector is 'insurance penetration' and 'insurance density'. Insurance penetration is the ratio of premium underwritten in a given year to the gross domestic product (GDP). Insurance density is the ratio of premium underwritten in given year to total population. After liberalization, the insurance sector has raised the levels of insurance penetration from 2.5 (for life 1.8 and for non-life 0.7)) in 2000 to 5.1 (for life 4.4 and for non-life 0.7) in 2010. Indian insurance has been underdeveloped with low levels of insurance penetration and density.

In order to develop insurance, the issue of greater foreign investment has been debated. The government has intention to increase the foreign investment ceiling for insurance from 26% to 49%. For almost a decade in the past, this increase has been debated and no decision has been arrived at because of lack of support from the political parties who are not ruling parties.

Issue of Investment in Housing and Infrastructure Projects

A recent liberalization policy of Indian government is to allow builders to raise overseas debt only for projects where 90 percent of the devilling units are for low or middle income groups. This move is likely to spur investments of foreign funds in low cost housing projects because overseas funds could be raised at lower rates. In 2009, the government allowed real estate firms external commercial borrowings (ECBs) only for integrated townships. (The Economic Times, April 27, 2012). In November 2011, ECB policy was modified keeping in view the developments in global financial markets and macro-economic conditions. (Economic Survey, 2011-2012, p. 125). The all-in-cost ceiling of ECBs was increased. It is required that the proceeds of ECBs raised abroad for Rupee-expenditure in India should be bought in immediately. The High Level Committee on ECB took a number of decisions on 15 September 2011 to expand the scope of ECB. Some of the decisions are:

(a) ECBs for interest during construction (IDC) that accumulates on a loan during the project execution phase for companies in the infrastructure sector would be permitted.
(b) The existing ECB limits under the automatic route were enhanced from US $ 500 million to US $ 700 million for eligible corporates as per the extant ECB guidelines.

Both these decisions are facilitating steps for ECBs.

Issue of International Rating:

International rating appraises an economy’s strengths, weaknesses, opportunities and challenges from the point of view of prospects (or lack of prospects) for international investments. Improvement in rating of an economy is an important issue for international investment.

Global rating of an economy (nation) indicates its outlook which influences foreign investors; view about short-term and long–term investment prospects. There are global rating agencies like S & P (Standard and Poor), Moodys, Fitch which continuously evaluate economies of the world and give their rating on the basis of major indicators (measures) such as growth numbers (GDP, GNI), fiscal deficit (gap between government spending and government income), debt-burden of economies, government’s actions for economic reforms. On the basis of rating, foreign investors assess the investment grade of a country (like A, B, C and so on). For example, as on 25 April, 2012, global rating agency Standard and Poor (S&P) rated Indian economy at BBB (minus) indicating low investment grade rating. This hurtled sentiment in financial markets and tripped shares, the rupee and bonds (TOI, April 26, 2012). Rating and its management in the context of international investment is an important issue. It affects (a) overseas borrowing costs, (b) investment risks (variability in return and maintenance of value of investments), (c) flows of foreign money in the stock market of economies, (d) fiscal discipline, (e) subsidies, (f) prices of goods and services, (g) value of currency for foreign exchange, (h) global investment plans of corporates which depend hugely on international finance (for example, S & P put three private sector companies, namely Infosys, TCS and Wipro and three public sector entities NTPC, NHPC and SAIL on its negative list for investment as per news item in TOI, New Delhi, April 26, 2012). Occasionally, rating is adversely affected by unfavorable announcements in the Budgets of Governments (for example, the Indian government announced in its Budget for 2012- 13, a retrospective amendment to the IT-Act affecting international investment of Vodafone). Government policies are an important tool for management of rating of economies. Due to the Bop crisis in India in 1991, S&P downgraded India to 'junk status' for international investments. But in Jan 2007, S&P upgraded India's sovereign rating to investment grade as a result of factors favorable to international investments. In order for managing rating of India, government and private sector both should work for reducing policy uncertainty about taxation, mergers and acquisitions involving foreign companies with assets in India, and capital market reforms for greater integration with rest of the world and easing of restrictions on foreign ownership of various sectors such as banking, insurance and retail sectors.

In all economies, economic outlook and political outlook are intertwined. Both affect rating of a country for international investments. Managing these outlooks are an important issue in investment.

Credit ratings for India in recent time by some global agencies are given below.

Agency	Rating	Outlook for Investment
S&P	BBB	Negative
Moody's	BAA3	Stable
Fitch	BBB	Stable

Source: The Times of India, April 26, 2012, p.1

Issue of FDI in Retail

The advantages associated with FDI in retail are better price to farmers, reduction of exploitation by middlemen, creation of new jobs as a result of expansion of organized retail, setting –up of supply chain infrastructure, thirty percent procurement from SMEs (small and medium enterprises). Some of the issues relating to FDI in retail sector are customer shopping experience, impersonal retail order and convenience, displacement of wholesalers, contract farming, direct purchase from farmers, adverse impact on neighborhood retail store such as loss of business jobs (it is a self-employment option for many) and profit (due to competition). Evidences in other economies show displacement of 'mom and pop' stores by establishment and expansion of large format retail outlets, emergence of monopolistic stranglehold over producers and consumers due to foreign direct investments in retail. Due to abovementioned favorable and unfavorable impacts of FDI in retail, the issue is '<u>should or should not FDI in retrial sector be allowed?' And if allowed, to what extent?</u>

In India, FDI is prohibited except single brand product retailing. In the case of single brand product retailing, FDI up to 51 percent is allowed subject to prior approval. The government announced at the fag end of 2011, the opening up of much awaited foreign direct investment in the multi-brand retail. This announcement was greeted with applause from around the world. But it could not go through. Many political parties, other than ruling parties of UPA government, vehemently apposed. Entry of large foreign retailers is on hold for the time being. The government may move on the issue in near further because FDI in multi–brand retail has good potential of checking inflation and high food price.

<u>Issues relating to Taxation</u>

Many governments tax income earned outside (in other countries) by enterprises based in their own countries. For example, the US government can tax the earnings of the Indian subsidiary of an enterprise incorporated in the United States. There is double taxation when income of a foreign subsidiary is taxed both by host-country government and home-country government. In order to compensate for double taxation, tax-credit is allowed to an entity to reduce the taxed paid to the home government by the amount of taxes paid to the foreign government. Often there is an agreement between two countries specifying the income which will be taxed by the government of the country where the income is earned. This agreement is called tax treaty between two countries. Business firms investing in foreign countries aim at minimizing their global tax liabilities. For this objective, firms use tax havens. Tax haven is a country which has exceptionally low, or no income tax. Firms avoid or defer income taxes by establishing a wholly owned subsidiary in the tax haven. Thus taxation is an important issue in international investment. Uncertainty about tax proposals (new as well as amendments to the existing tax laws) is an important issue in foreign investments. For example, the news about the introduction of the General Anti-Avoidance Rule (GAAR) has led to slowdown in FII inflows in India. (TOI, 21 March 2012). GAAR aims at countering aggressive tax avoidance routes. Foreign investors are more worried about governments' intention to open up old cases under GAAR to see if tax was avoided earlier. Under GAAR, the Indian government wants to go-ahead with retrospective tax on buyouts of Indian assets by companies based outside India. The background of the GAAR is the government's view that several investors are using Double Tax Avoidance Agreement between two countries to avoid paying taxes anywhere. GAAR is an internationally accepted practice. It is going to apply in India prospectively as per government's plan. The issue is about its application retrospectively. Since the tax proposals (GAAR) were mentioned in the budget 2012, India's government has been under pressure from foreign investors and governments across the world. Foreign investors are worried about the Indian government's intention to amend the Income Tax Act from 1962 to ensure it can tax mergers and acquisitions involving foreign companies with assets in India. Several international lobby groups as well as the British and US finance ministers have taken up the issue with finance minister of India to water down the proposal (Times of India, 25 April, 2012). The finance ministry of India is planning to keep foreign institutional investors outside the proposed GAAR. But the government appears firm in its persuit to tax a dozen overseas deals of mergers and acquisitions under GAAR to ensure that foreign investors using Double Tax Avoidance Agreement do not escape without paying tax in either country.

Some prominent market investors have expressed that the idea of having retroactive taxation is a big policy mistake. Foreign investors have raised concerns on two Indian provisions: seeking to tax indirect investments and combat tax evasion. The first gives India power to retroactively tax the indirect transfer of assets. The second targets tax evaders via the General Anti-Avoidance Rule, putting the onus on investors registered in other countries with special tax-exemptions to prove they do not intend to explicitly avoid tax. Due to proposed GAAR, some foreign investment institutions have exited fearing lower investment returns. (Times of India, 12 May, 2012). The government of India has deferred implementation of controversial GAAR by one year for reviving the investment climate (Times of India, 8 May 2012).

Technology Transfer: Meaning and Issues

What is technology? According to UNCTAD draft International Code on the Transfer of Technology, technology is “systematic knowledge for the manufacture of a product, for the application of a process or for the rendering of a service”. This definition excludes goods that are sold or hired.

What is transfer of technology? It is the process of skill transferring knowledge, technologies, methods of manufacturing, samples of manufacturing. Transfer of technology aims at further development and exploitation of technology into new products, processes, applications, materials or services. It is closely related to knowledge transfer. Transfer of technology takes place when the technology has commercial value. It can involve licensing agreements or setting-up joint ventures and partnerships to share the risks and rewards of bringing new technologies to market. The approach of the Tenth Five Year Plan (Govt. of India) emphasized the development of indigenous technologies and import of technologies available elsewhere. The main issue of technology transfer is–how to increase international cooperation of science and technology for scientific and technological capabilities. Related issue is generation and protection of Intellectual Property Right (IPR) through patents. Another issue of technology transfer is its usability and timeliness. Technology should be relevant to the business needs. If the technology developed is ahead of the times and too sophisticated, it will be rejected by the market. For example, Mantuan Systems, an Indian company, aimed at software product development, and making top-class products. The company was successful in making the product using highly complex and advanced technology. But the product was rejected by the American retail giant Walmart Inc. on the ground it was too sophisticated and complex. Then the company developed simplified products which were accepted by several multinationals, like McDonald’s, Crocs, Eco, Ashley Stewart and Ripley. Now Mantuan Systems operates in 20 countries (The week, April 29, 2012, pp. 52-53). Indian software companies still have products targeted at certain sectors only. The general issue is: development of technology based products / processes which are sector independent and, therefore, can be used across enterprises and across sectors.

What are The Specific Issues in Technology Transfer?

Many developing countries are eager to receive the technology on suitable terms of transfer. Following are the specific issues in technology transfer:

(i) The nature of the relation between developing and developed countries that will be fostered by technology transfer.

(ii) The assessment of the implications of adoption of new technology for developing countries.

(iii) International competition in environmentally sound technologies.

(iv) Technologies declared obsolete and inefficient in the countries of their development but are commercially useful in other countries which are lacking in development of their own technologies.

(v) Dependency relationships on the practices and policies of multinational corporations.

(vi) The impact of the technology transfer on managerial power, ownership and control of enterprise.

(vii) The bias of technologies transferred towards large, centralized and capital intensive processes.

(viii) The extent of undermining the self-sufficiency of the local economy by introduction of new technologies developed abroad.

(ix) Displacement of local existing economic activities because of introduction of new technologies transferred from other countries.

(x) Disruption of the existing pattern of labour, contribution to structural unemployment and acceleration of urbanization.

(xi) Impact of technology transfer on existing local and indigenous cultures, values and social organizations.

(xii) Shifts caused by technology transfer in patterns of consumption, particularly towards products that require more energy and contribute to release of CO_2 and other greenhouse gases in their production and distribution.

(xiii) Impact of use of new technology transferred on the natural environment and disclosure of full costs of their adoption (for example, consideration of waste disposal requirements).

(xiv) Impact of use of new technology transferred on the natural environment and disclosure of full costs of their adoption (for example, consideration of waste disposal requirements.

Related to abovementioned issues in technology transfer are following problems:

(a) Protection of intellectual property rights attributable to traditional knowledge and wisdom.

(b) Understanding of the relationships between the use and application of environmentally sound processes and the social and cultural context in which they are practiced.

For the success of technology transfer, following conditions are important:

(a) Provision of exceptional terms for technology transfer with respect to costs and licensing agreements; and

(b) Development of the legal, institutional and technical infrastructure to support the implementation of technology.

Some of the types of technology transfer transaction are

(i) The assignment, sale and licensing of all forms of industrial property.

(ii) The provision of know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, guide, formulae, detailed engineering designs and equipment for training, services (technical advisory, management personnel and personnel training).

(iii) The provision of technological knowledge needed for installation, operation and functioning of plant and equipment, and turnkey projects.

In international technology transfer, horizontal and vertical transfers are found. The movement of an established technology from one operational environment to another is called horizontal transfer (for example, transfer of technology from one company to another). When there is transmission of new technology developed as a result of R & D activities to application in the industrial and agricultural sectors, it is called vertical transfer.

In international business, most of the technology transfers are effected by foreign direct investment (FDI). One of the benefits of FDI to host countries (particularly, developing countries) is that it provides technology required to stimulate economic growth (for example, technological know-how with regard to discovery, extraction and refining of oil). Another way of transfer of technology is to license that technology from foreign multinational enterprises (MNE). Japanese firms preferred transfer of technology through licensing agreements over transfer of technology through FDI. The reason for this preference is that host-country firms are given direct access to valuable technology in return for royalty payments. In the case of transfer of technology through FDI, the technology is ultimately controlled by the foreign MNEs and firms of host country are denied access to the basic technology. MNEs often transfer significant technology when they invest in a foreign country. Transfer of technology through FDI does not provide scope to host country's firms to develop their own technology. Licensing option is less attractive to the MNE because there is risk of creating future competitor. Thus an important issue in transfer of technology is the mode for transferring technology – licensing or FDI. It is a major negotiating point between an MNE and firms of host countries. If the technology is complex and making the technology operational requires substantial experience, the FDI is the wanted mode of transfer of technology (Charles W.L. Hill, pp 245-246)

7.4 Issue in Pricing Regulations

Price regulation refers to the policy of setting price by a government agency, legal statute or regulatory authority. Under this policy minimum and / or maximum prices may be set. Price regulation also includes 'guidelines' which specify the magnitude by which prices can increase. The bases of regulated prices vary. These may be 'on cost', return on investment, mark-ups, market-based price. Different costs are used as bases for pricing such as full cost, marginal cost, prime cost plus manufacturing overheads, etc. Price is also influenced by purchasing power of customers because a firm should consider the ability of buyer to pay.

In international business, following other factors influence pricing:

- Tariff
- Subsidies
- Dumping
- Foreign Exchange Rate

All the above mentioned factors require some type of regulation.

Tariff and Price

The system of tariff primarily provides protection from unfair and distorted competition. Tariff influences price. WTO regime provided for reduction in tariff rates. Individual member countries of WTO listed their commitments to reduce the tariff rates. Developed countries under this commitment were to cut the average tariff levels on industrial products. A number of developing countries also agreed to reduce their tariffs. Because of these commitments, the weighted average levels of tariffs applicable to industrial products were expected to fall in a period of 5 years from 1 Jan 1995, as given below:

- from 6.3 percent to 3.8 percent in developed countries;
- from 15.3 percent to 12.3 percent in developing countries.
- from 8.6 percent to 6 percent in the transition economies.

A reduction in tariff means a reduction in price for the international business.

Subsidies and Price

Governments of countries having some export targets to meet pay subsidies to producers. Government financial assistance to a domestic producer is subsidy. Subsidy enables the producer to export at low price, even at a price lower than 'full cost' or 'marginal cost'. The aim of the government may be to manage BoP and employment levels within the country. Subsidy, thus, reduces the price in the international market and enables the exporters to face the competition in the international markets. The issues in pricing in relation to subsidy are the coverage, the size and the basis of subsidies. The Doha Ministerial Declaration, 14 November 2001 on Agriculture called for reduction of all forms of export subsidies, with a view to phasing out. Agriculture tends to be one of the largest beneficiaries of subsidies in most countries.

Dumping and Price

'Dumping' describes the practice of selling a product in one national market at a lower price than it is sold in another national market. Dumping is price discrimination between national markets. Governments consider dumping by foreign producers to be bad. Low price because of dumping is harmful for the economic growth of countries, in the long run. Therefore, governments of many countries have antidumping regulations. These regulations usually involve punitive antidumping duty to raise the prices above the average levels. The governments thus counteract the harmful effects of dumping on domestic producers.

India has been the top user of anti-dumping measures in terms of the investigations initiated in the last decade. As a rule, India imposes only the lesser duty and not the full dumping margin as is done by some WTO members. This underscores the fact that the trade remedies are not used as a protectionist tool. (Economic Survey 2011- 12, p.172 and 175).

Foreign Exchange Rate and Price.

Foreign exchange rate is the rate at which the market converts one currency into another. Exchange rate is the price of one currency in terms of another. Activities relating to imports and exports, services availed of from and rendered to foreigners, investments in short-terms and long-term securities across the international boundaries, foreign bilateral and multinational assistance and the like make the moderation of foreign exchange rate necessary. The exchange rate helps in comparing the relative prices of goods, services and financial assets in different countries. Prices are influenced by exchange rate movements. By managing exchange rate, international prices can be monitored and regulated.

The weakness of home currency in relation to foreign currencies makes imports costlier and may reduce trade deficit in the long run, other things remaining unchanged. It may make exports more attractive and may reduce trade deficit. It may reduce current account deficit by making NRI remittances

more attractive.
In international business, firms are exposed to foreign exchange risks due to unanticipated changes in exchange rates (or foreign exchange fluctuations). The values of a firm's assets, liabilities and operating income fluctuate due to change in foreign exchange rate. Exchange rate is like a pipeline that links India to the rest of the world. It is through this pipeline that goods, services and investments flow in and flow out of a country. A country's growth and inflation both react to changes in foreign exchange rate. Central banks of countries monitor the exchange rates. In India, RBI steps into market to influence exchange rate. For example, the Indian rupee has depreciated sharply. The exchange rate was Rupees 43.94 to the US dollar on 27 July 2011 and came down to Rs49 by the third week of Feb 2012, and on May 16,2012 it further came down to Rs 54.13 for a US dollar. In order to regulate the price of US dollar, the Reserve Bank of India sold dollars to bring back the rupee to 53.80 for a dollar. One of the reasons for depreciation of rupee was reduction in foreign capital flows into the country and FIIs (Foreign Institutional Investors) becoming net sellers and thereby increasing the net outflow of capital. Foreign investments are closely associated with exchange rate movements and their influence on prices of commodities and services. In India, Foreign Exchange Management Act (FEMA) came into effect from January 1, 2000. One of the objectives of FEMA is promotion of orderly development and maintenance of foreign exchange market in India. According to this Act, RBI regulates, to a great extent, capital account transactions in foreign exchange market. The Act has made comprehensive provisions regarding Indian investments abroad in joint ventures and wholly owned subsidiaries. The RBI has been granted power to permit such investments. Another regulatory body is Securities Exchange Board of India which registers Foreign Institutional Investors (FIIs) like Pension Fund, Investment Trust, Assets Management Companies, etc. Registered FIIs are permitted to invest on full repatriation basis in the Indian primary and secondary stock markets.
SEBI has, among others, the objective (power) to reduce the fluctuations in the market prices of shares and thus influence the exchange rate movements and prices of foreign currencies in relation to rupee

7.5 Summary

International investments are closely associated with international trade and trade related commercial activities. Foreign investments take two forms: foreign direct investment (FDI) and foreign portfolio investment (FPI). Both FDI and FPI affect BoP. There are several issues in international investments. Of these, relatively more important issues discussed are: increase of FDI in banking sector and insurance sector; removal of impediments to investment in housing and infrastructure projects; international rating (for example Sovereign Credit Rating of India) for indicating to the world the strength of macroeconomic fundamentals of the economy; FDI in retail sector; taxation of income and gains of foreign investors.

In the context of international business, issues in technology transfer are numerous. Besides the general issues of usability, timeliness and protection of intellectual property rights (IPRs), several other issues raised and debated include impact on relations between /among countries which are developed, developing and less developed; environmentally sound technology; impact on sharing of managerial power and control in collaborating organizations; impact on employment, local culture, values and social organization.

Some issues in price regulation, with a focus on international business, have been described. Besides demand and supply, prices are affected by measures such are tariffs, subsidies, dumping and foreign exchange rate. All these are indirectly related, but are quite important issues for foreign investment of any form and direction (inflows and outflows of foreign investments).

7.6 Glossary

Foreign Direct Investment (FDI): When a firm directly invests in production and/or markets in a foreign country.

Technology Transfer: The process of transferring skills, knowledge, technology, manufacturing methods, manufacturing designs, and operational processes.

7.7 Check your progress

Fill in the blanks:

1. The objective of Foreign Direct Investment (FDI) is to acquire .... in enterprises operating abroad.
2. .... describes the practice of selling a product in a national market at a lower price than in another national market.
3. .... is the rate at which the market converts one currency into another.
4. In India, the Foreign Exchange Management Act (FEMA) came into effect on ....

7.8 Answer to check your progress

1. Lasting management interest 2. Dumping
3. Foreign exchange rate 4. 1 January, 2000

7.9 Terminal questions

1. What is FDI?
2. How do FDI and FPI influence BoP of a country?
3. What are TRIMS?
4. What is systematic risk?
5. What is the issue of investment in Insurance Sector?
6. What is General Anti-Avoidance Rule (GAAR) for tax collection.
7. List the factors influencing pricing.

7.10 Suggest readings

1. Charles W.L. Hill, International Business: Competing in the Global Marketplace, 5^{th} ed. (New Delhi, Tata McGraw-Hill Publishing Company Limited, 2005). Chapters 6 and 7.
2. M B Rao and Manual Guru, WTO and International Trade, 2^{nd} ed. (New Delhi, Vikas Publishing House Pvt. Ltd., 2003). Chapters 10 and 11.
3. Rakesh Mohan Joshi. International Business, First edition (New Delhi, Oxford University Press, 2009). Chapter 12
4. Government of India, Ministry of Finance, Economic Survey 2011-12, (New Delhi, Oxford University Press, March 2012). Content No.5- Major Policy Initiatives, p. 124).
5. Foreign Direct Investment Policy 2006, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, New Delhi, 2006 (this publication has been amended from time to time to address issues as and when they have arisen)
6. The Week, Dec 11, 2011, 'Retail tails', (Kochi, Malayala Manarama Co. Ltd.)
7. R M Srivastava, Multinational Financial Management, 12th ed. (New Delhi, Excel Books, 2008). Chapter 13.

Unit 8: Contemporary Developments and Issues in International Trade

Objectives

After reading this unit, the learner shall be able to understand:

- To introduce the participants about contemporary challenges & opportunities in International Business.
- To explain the major challenges that exists in international in volatile, uncertain, complex and ambiguous times.
- To explain the reasons for failure of Doha Development Agenda.
- To explain the impact of rising trade account deficit in India's international business.

8.1 Introduction

To explain the increasing debate on environmental issues in international business. No country can remain untouched from the developments that are taking place in the field of international business in the world as world economy has seen metamorphic transformation in the previous two decades due to increased economic globalization and liberalization. International business is a term that is used to describe all commercial transactions that are taking place from one country to another. These transactions may be at relating to exports and imports thus affecting the balance of trade situation of a country. The changes in balance of trade have far reaching implications for subsequent capital and current account transactions. For example Indian suffers from balance of trade deficit which has its repercussions on weakening of Indian rupee which has been constantly depreciating vis a vis dollar. In addition to this, the general economic activity of the country has been affected as there has been tightening of monetary regime by RBI, Capital follow restrictions by Ministry of Finance and increased import restrictions or hiking of duty on imported items by Ministry of finance in consultation with Ministry of Commerce & Industry. Indian traders has been challenged in effectively participating in international trade post subprime crisis as there was lack of demand from developed country such as United States, Canada and United Kingdom. There has been significant demand in Indian exports to Europe also due to European debt crisis. Indian exporters cannot find buyers in its two markets of North American and Europe and has to scramble around in Africa, Middle-East and Latin America to find out alternative markets as international trade environment has been increasingly volatile, uncertain, complex and ambiguous. Following are the additional challenges international traders are finding in addition to the normal changes that exist in international trade for an international trader.

1. Unstable Political System And Policy
2. Different Economic Policy
3. Different Legal System
4. Different Language/ Communication Barrier
5. Different Quality Standards
6. Different Corporate And Local Culture
7. Different Curranty & Exchange Markets
8. Import And Export Regulations

1. Trade Agreements Business Environment Is :
   A. Volatile
   B. Uncertain
   C. Complex And
   D. Ambiguous
2. Failure Of Doha Development Agenda
3. Current Account Deficit
4. Fiscal Deficit
5. Increased Environmental Compliance And Restrictions

Source: Author

Indian rupee volatility has also posed increased challenges for Indian traders and business people as as on the one hand it has made our imports expensive thus creating inflationary impact in the economy. RBI has hiked the bank rate and has taken other momentary measures to control liquidity in the system thorough CRR/ Repo Rate and Reverse Repo Rate. Monetary tightening has impacted badly the industrial growth rate impacting revenue collections and resulting in unemployment. As a result, government is facing fiscal challenges as revenue receipt has been lower in comparison to expenditure which in turn is creating increased pressure on all aspects of the Indian economy. lackening of export has also been a contemporary problem area as Indian exporter cannot take advantage of rupee weakening due to latent demand in all developed key markets of Europe and North America. Rupee depreciation and increased volatility has also been problem area for Indian companies which has taken short term loans to fund their business operations and has to pay more while making repayments due to rupee depreciation. Above all, increased volatility has raised questions whether the economic indicators and fundamental of Indian economy are intact or not as various market rating agencies has predicted that the downgrade of Indian economy is imminent in the light of poor economic performance, increased fiscal deficit, increased current account deficit, poor industrial growth rate, rising unemployment and ability of Indian policy makers to take the corrective measures to bring Indian economy on growth path. Failure of Doha Development Agenda at WTO trade negotiations has stopped the process of economic liberalization especially in the areas where Indian is interested most i.e. trade in services. It has badly impacted Indian prospects for increased intentional trade activity and its spillover effects on various sectors of Indian economy. Other contemporary challenges that Indian traders face in today's VUCA environment are increased trade restrictions due to environmental compliance and increasing role of technology in international business. It is unfortunate to note that Indian economic system is still not have internationally competitive in industrial innovation, patents, technological breakthrough which is a key to success in international business in contemporary business environment. In the light of above, the chapters aimed to study the conceptual as well as practical aspects of various contemporary challenges faced by international trade in global trade and business.

:8.2 Managing international business in 'vuca' times

The concept of a VUCA world was for the first times coined by the United States Military after the end of Cold War. VUCA means volatile, uncertain, complex, and ambiguous environment where one is not certain who is its political or economic or military adversary as there was an emergence of multilateral world with active involvement of both states and non state actors. With technological breakthrough, even the small non-state actors can challenge the economic and military might of world strongest nations. For example, U.S. was stunned when it was attached by non- state actors on 9th September 2001. The subsequent events in all areas be a it military, economic or political has happened in a extremely volatile, uncertain, complex and ambiguous environment. Following are the some of the the contemporary challenges that international business has faced in recent time.

Subprime Crisis:

The U.S. subprime mortgage crisis was a set of events and conditions that led to a financial crisis in United States of American and its resultant contagion in all over the world economy. There are many reasons for subprime crisis but the prime reason being the extreme loosening of monetary control, no regulatory compliance and foreclosures of mortgages delinquencies resulting decline of securities backed by said mortgages. These mortgage- backed securities (MBS) initially offered attractive rates of return due to the higher rates interest on the mortgages; however, the lower credit quality ultimately caused massive defaults. Several major financial institutions collapsed in September 2008, with significant disruption in the flow of credit to businesses and consumers and the onset of a severe global recession. The subprime crisis had severe, long-lasting consequences for the world economy in general and for economies of United States and European economies in particular. There was complete collapse of United States Banking system and many banks filed for bankruptcy. The banks which have exposure to such US banks were also exposed to economic losses all over the world. There was a complete shock to investor community as they lost billions of dollars due to plunging of stock prices all over the world. The economy of United States of America entered a deep recession. It is estimated that there was a loss of nearly 9 million jobs during the years 2008 and 2009 which amounts to roughly 6-7% of the workforce if taken in percentage of population. There was a great decline in prices of property as the U.S. housing prices fell nearly 30% on average. Stock prices of NASDAQ listed shares fell approximately 50% by early 2009. The sub-prime crisis made us aware that what can be the economic consequences if the markets remain completely unregulated and are governed by market forces. The awe of sub- prime crisis still exists all over the world as there came of series of other crisis mainly due to sub-prime crisis. For example, the volatility of Indian rupee is increasingly due to federal impetus tapering that is taking place in United States and which was introduced post sub-prime crisis so as to revive US economy from recession and industrial slowdown.

European Debt Crisis:

The Euro zone crisis which is a result of sub-prime crisis is the ongoing economic crisis that has been affecting the countries of the Euro zone since late 2009. This crisis began from Greek which has increasingly high debt in percentage to its GDP. The trigger point was the exposure of some Greek Banks to sub-prime mortgages in United States. As many banking institutions collapsed in United States, it impacted badly the banking system of Europe as many European banks have loans/ exposures to these failed US banks. Some economists refer it to be a far deeper crisis than only the result of sub-prime as they say that European Debt crisis is is the combined result of of sovereign debt crisis, banking crisis and a growth and competitiveness crisis. It is also known as Euro Crisis. According to Peter Praet, a member of the Executive Board of the European Central

Bank (ECB), The Euro zone crisis is the result of following three facts:

(i) That the solvency of some EU banks was strained by significant exposures to domestic sovereign debt;

(ii) That the market value drop of government bonds led to liquidity strains, as these bonds were widely used as collateral in interbank markets and

(iii) In some instances, EU governments had to provide funding to vulnerable domestic banks, at the expense of their countries' debt.

The consequence of the Euro-zone Crisis is that it made it difficult or impossible for many EU countries in the euro area to repay or re- finance their government debt without the assistance of third parties. The problems get further aggravated as some banks in the Euro zone were undercapitalized and have faced liquidity problems in the recent years. What caused the most stress to European countries was the slowing down of economic growth in the whole of the Euro zone and is unequally distributed across the member states. For example, when Germany was economically growing, the countries such as Greek, Portugal, Spain, and Italy were in recession.

Volatility in Indian Rupee:

VOLATILITY OF INDIAN RUPEE IN RECENT YEARS

Indian rupee is witnessing the depreciating trend due to variety of reasons. The prime among them are the widening of current account deficit as exports are not growing but the imports are growing very fast due to price increase in oil prices, gold imports, diamond imports, edible oil imports, coal imports etc. increased fiscal deficit coupled with government policy paralysis on taking key decision is contributing to increased volatility in Indian rupee to downside. Rupee has touched the historic low on august 29th, 2013 to the level of 67 Rs vis a vis a US Dollar. The table as under indicates the time series for rupee volatility in the recent period.

8th January 2008	39.11
30 August 2008	43.80
1 January 2009	48..09
1 January 2010	46.61
1 Jan. 2011	44.70

1 Jan. 2012	53.06
1 Jan. 2013	54.68
29th August 2013	67.70

Source: www.xe.com

Volatility of Indian rupee has posed variety of challenges to contemporary business people in India. Importers are complaining of rising imports cost as they have to pay more Indian rupees to convert them into dollars. As imports cost of rising, there is inflationary trend in the markets as the cost of Indian POL has increased. Government of India has already hiked the prices of petrol/ diesel/ gas many times. The input costs of Indian exportable goods are also getting higher as the result of depreciation of Indian rupee. Various services importers are complain of rising cost of business due to increased volatility in Indian rupee.

Widening Trade Deficit:

One of the prime reasons for increased volatility in Indian rupee causing depreciation of Indian rupee to an alarming level is the the widening trade gap of the country. India's trade deficit for fiscal year 2012-13 stood at 191 billion US dollar and for the fiscal year 2011-12, it stood at a record high of $185 billion which is nearly 55 percent above the trade deficit in 2010-11. Strong dollar is another factor that has contributed to the depreciation of Rupee. The increased demand from importers further added pressure on the rupee. The dollar has been particularly strong in global markets broadly in last few months due to tapering off the fiscal stimulus package by US Federal Reserves. The foreign trade performance and trade deficit position of India for the period 2005-2012 is tabled as under:

YEAR	IMPORT	EXPORTS	BALANCE OF TRADE
2005-06	140	100	40
2006-07	178	121	57

2007-08	218	145	72
2008-09	315	181	133
2009-10	266	176	89
2010-11	350	220	129
2011-12	462	301	160
2012-13	488	289	199

Taxation Worries:

Another contemporary challenge that Indian traders are facing is that of resultant repercussion from low sentiments of foreign investors about Indian markets due to taxation worries and resultant fiscal deficit in the country. Lack of clarity over taxation has created worries among foreign investors and has impacted fund inflows. Analytics point out that the impact has fallen heavily on the depreciation of rupees also. India's policy makers has failed to clarify the confusions on widening fiscal deficit due to unregulated government spending but poor revenue receipts due to poor industrial growth. The table as under elucidates the macroeconomic scenario of Indian fiscal position.

India's Fiscal Situation – Statement of Revenue Receipts and Expenditure & percentage Fiscal Deficit			
	Budget Est.	**Revised Est.**	**Budget Est.**
	2012-2013	**2012-2013**	**2013-2014**
Revenue Receipts	935685	871828	1056331
Capital Receipts	555241	558998	608967
Total Receipts	1490925	1430825	1665297
Non-Plan Expenditure	969900	1001638	1109975
Plan Expenditure	521025	429187	555322
Total Expenditure	1490925	1430825	1665297
Revenue Deficit	350424	391245	379838
	(3.4)	(3.9)	(3.3)
Effective Revenue	185752	266970	205182
Deficit	(1.8)	(2.7)	(1.8)
Fiscal Deficit	**513590**	**520925**	**542499**
Fiscal Deficit in % to GDP	**(5.1)**	**(5.2)**	**(4.8)**

Source: www.indianbudget.nic.in

In turbulent times, when whole world economy is facing the slowdown and rupee is falling, Indian government should not resort to measures that cause flutter in stock markets and foreign investor sentiments. It is important that government should clarify its stand on General Anti Avoidance Rule or GAAR (General Anti-Avoidance Rule). With the widening current account deficit, it is important for our policy makers to adopt a policy stand that that does not disturb the balance of payment situation of the country.Mid-year course correction with suitable policy response became imminent in the contemporary business scenario. Fiscal consolidation by way of regulating deficits and cutting expenditure to create positive business environment was immediate need of the hour. Government accordingly appointed Kelkar Committee in August, 2012 to suggest 'Roadmap for Fiscal Consolidation' within one month's time period. Kelkar committee held series of meetings with Ministry of Finance, concerned line ministries and Planning Commission to finalize its report within the given timeframe. Deliberating on various issues facing the economy, Kelkar committee suggested a slew of measures to contain the rising trend of fiscal deficit. The committee observed that deficit financing through domestic sources tends to be inflationary. At the same time, twin deficits hypothesis implies that, given a certain level of private savings, an increase in fiscal deficit will have to be balanced by either a reduction in private investment or an increase in the current account deficit. The Indian economy has been witnessing both. Government of India has taken major exercise of rationalizing both Plan and Non-plan spending to match the revenues in order to address this contemporary challenge. Therefore, with a view to rationalize of expenditure and optimize available resources, measures for economy cut, reduction in plan and non-plan expenditure to reprioritize releases based on implementation schedule and actual requirements based on pace of expenditure etc. were taken to contain public spending within the available resource limits and targeted levels of fiscal deficit. While, government took major steps towards containing its spending and mopping up resources in keeping with fiscal discipline, important steps were also taken to infuse confidence in the market for growth revival. Government took important administrative decisions including allowing FDI up to 49 per cent in Insurance sector, permitting FDI in multi brand retailing, carrying out amendment in banking regulation laws to allow foreign banks, deferring General Anti- Avoidance Rule etc. Government's proactive stance in carrying forward reforms along with credible steps to limit spending and contain fiscal deficit has been instrumental in reviving the market sentiments and infusing fresh confidence in the Indian economy, the result of which will be seen to some extent in the days to come.

Failure of the Doha Development Agenda:

The Doha Development Agenda is the ninth WTO multilateral trade round of negotiations launched in Doha, Qatar in November 2001 that was to be concluded by early 2005. Some of the main points on the agenda were reduction of barriers in the services sector, environmental issues, and freer trade in agricultural goods. Moreover, Doha was the first WTO round in which big emerging markets like Brazil, China or India had an important saying, thus increasing the complexity of negotiations. However, talks collapsed several times and deadlines were constantly overdue. After ten years, trade negotiators have failed to reach an agreement and it seems challenging to end the Doha Round in the foreseeable future. Due to Doha's collapse a number of countries are resorting to bilateral negotiations or regional trade agreements instead of the lengthy multilateral process negotiations of the WTO. The failure of Doha threatens the credibility of the multilateral trade system and raises attention on the need of reforming the outdated structure of WTO in order to reflect better the circumstances of the 21st century.

The causes of failure of Doha Development are many. Some of the causes for failure are discussed herewith. Firstly, Doha's failure was partly due to the division between developed and developing countries. Emerging economies have become a dominant force in the global economy and are having a stronger power of influence than ever. For example, when China entered the WTO in 2001, no one expected it to become the world's largest exporter in 2010; now, issues like China tariff profile or renminbi value have become of global interest giving China great influence during negotiations. During Doha's negotiations, the emerging economies pursued maximum flexibility for their group and focused on the market-opening obligations of the developed countries. On the other hand important actors like the United States or the European Union have lost ground in negotiating. The greatest cuts in tariffs and the most significant burdens fall on the developed countries, while developing countries enjoy more relaxed cuts and slower implementation time, having significant flexibility. In this sense, it can be observed that balance of power is shifting and emerging economies gain more and more influence while the US and EU are losing ground. Another issue was agricultural trade, a sensitive topic especially for countries like US and the EU that heavily subsidy this economic sector. Negotiators showed concerned that the severe tariff cuts will affect their economies without any significant gains. So it was difficult for governments to convince domestic interest groups to agree with the tariff cuts. Nevertheless, at the Hong Kong Ministerial in 2005, governments reached an agreement in this direction (the EU agreed to eliminate agricultural export subsidies by 2013 while industrialized countries agreed to eliminate 97% of the tariffs on exports of the least developed countries). In addition to all these contemporary challenges, the Doha round was confronted with the financial crisis and with the rapid changes that took place in the global economy which made the negotiation structure and the dichotomy between developed and developing countries obsolete.

Trade and Environmental Challenges:

Since environmental problems often transcend national borders, the response must involve concerted action at the international level. WTO members have long recognized the need for coherence amongst international institutions in addressing global environmental challenges. The current negotiations on the WTO-MEA relationship provide a unique opportunity for creating positive synergies between the trade and environment agendas at the international level. In addition, there is regular and routine contact between the WTO ecretariat and secretariats of multilateral environmental agreements. The current Doha Round of negotiations gives members a chance to achieve an even more efficient allocation of resources on a global scale through the continued reduction of obstacles to trade. The Round is also an opportunity to pursue win-win-win results for trade, development and the environment. For example, the Doha Round is the first time environmental issues have featured explicitly in the context of a multilateral trade negotiation and the overarching objective is to enhance the mutual supportiveness of trade and environment. Members are working to liberalize trade in goods and services that can benefit the environment. They are also discussing ways to maintain a harmonious co-existence between WTO rules and the specific trade obligations in various agreements that have been negotiated multilaterally to protect the environment. Other parts of the Doha negotiations are also relevant to the environment, for example aspects of the agriculture negotiations and also disciplines on fisheries subsidies.Indian traders has to leverage their strategies and decisions to all these contemporary challenges in the present volatile, uncertain, complex and ambiguous (VUCA) time to tide over all contemporary challenges and make India a great place to do business with so that all round economic and social prosperity is achieved for all sections of the society.

8.4 Summary

No country can remain untouched from the developments that are taking place in the field of international business in the world as world economy has seen metamorphic transformation in the previous two decades due to increased economic globalization and liberalization. Indian traders has been challenged in effectively participating in international trade post subprime crisis as there was lack of demand from developed country such as United States, Canada and United Kingdom. There has been significant demand in Indian exports to Europe also due to European debt crisis. Indian exporters cannot find buyers in its two markets of North American and Europe and has to scramble around in Africa, Middle-East and Latin America to find out alternative markets as international trade environment has been increasingly volatile, uncertain, complex and ambiguous. The concept of a VUCA world was for the first times coined by the United States Military after the end of Cold War. VUCA means volatile, uncertain, complex, and ambiguous environment where one is not certain who is its political or economic or military adversary as there was an emergence of multilateral world with active involvement of both states and non state actors. Wit technological breakthrough, even the small non-state actors can challenge the economic and military might of world strongest nations. Following are the some of the contemporary challenges that international business has faced in recent time. Subprime Crisis

- European Debt Crisis

- Volatility in Indian Rupee
- Widening Trade Deficit
- Failure of Doha Development Agenda
- Trade & Environmental Challenges

Indian traders has to leverage their strategies and decisions to all these contemporary challenges in the present volatile, uncertain, complex and ambiguous (VUCA) time to tide over all contemporary challenges and make India a great place to do business with so that all round economic and social prosperity is achieved for all sections of the society.

8.5 Glossary

- **VUCA Times:** VUCA refers to Volatile, Uncertain, Complex and Ambiguous times under which international trade has been mired post 2008 series of economic crisis all over world.
- **Sub Prime Crisis:** Subprime Crisis refers to mortgages delinquencies that occurred in United States in 2008.
- **Euro Zone:** Euro Zone is the area with European Union where the currency Euro has been accepted. There are 18 countries as of now in 28 nations EU having Euro as currency.
- **Doha Development Agenda:** It is trade negotiation round at WTO and is aimed at reducing trade barriers in agriculture, trade facilitation, services trade and provide better negotiating opportunity to developing country vis a vis developed countries.
- **Trade Deficit:** Trade Deficit refers to situation when the imports are higher than imports. It is also known as unfavorable situation of balance of Trade.

- **Fiscal Deficit:** When a government's total expenditures exceed the revenue that it generates (excluding money from borrowings). Deficit differs from debt, which is an accumulation of yearly deficits.
- **Deprecation of Rupee:** It is situation when the internal value of rupee decreases vis a vis other currency for example dollar. Depreciation in rupee makes imports expensive into markets but makes exports attractive in foreign markets.

8.6 Check your progress

Fill in the blanks

1. When the government's total expenditure exceeds its revenue (excluding borrowed funds), it is called ....
2. Depreciation of the rupee occurs when the value of the rupee .... against other currencies, such as the dollar.
3. The subprime crisis of 2008 occurred in .... and reflects flaws related to mortgages.
4. The .... round of multilateral trade negotiations under the World Trade Organization—the Doha Development Agenda—was launched in Doha, Qatar, in November 2001.

8.7 Answer to check your progress

1. Fiscal deficit 2. Intrinsic value 3. United States of America 4. 9th

8.8 Terminal questions

Q. No. 1: Explain the key contemporary challenges that India is facing in the present business environment?

Q. No. 2: Explain the subprime Crisis of United States and its impact on global business environment?

Q. No. 3: Write an essay on Euro Zone Crisis and its impact on contemporary business environment?

Q. No. 4: Discuss the causes of Trade Deficit in Indian economy? Explain the pattern of trade deficit from 2005-12?

Q. No. 5: Explain with causes of Fiscal Deficit in Indian economy and its likely impact on depreciation of Indian rupee?

Q. No. 6: What are causes of Doha Development Agenda? Explain

Q. No. 7: How is the role of environmental issues increasing in global trade negotiations? Explain with examples.

8.9 Suggest readings

- International Economics, Raj Kumar, Excel Publication, 2008
- International Economics, Francis Cherunilam, The McGraw Hill Publication, 5th Edition,
- International Economics, Steven Husted and Michael Melvin, Pearson Publication, 9th Edition.
- International Economics, James Gerber, Pearson Publication, 6th Edition
- International Economics, D.M. Mithani, Himalaya Publishing House; Edition 11th ISBN No. 8178660962
- International Economics: Theory And Policy, 8th Edition, Paul R. Krugman, Pearson Education India
- International Economics, Dr Nirmal Bhalerao & SSM Desai, Himalaya Publishing House, 1st Edition
- International Economics, M.L. Jhingan, Vrinda Publishing House
- International Economics, D. N. Dwivedi, ISBN : 8122005349
- International Economics, Steven L. Husted, Michael Melvin , Harper-Collins Press
- Johan Daniel, and Lee H. Radebaugh, International Business Environment and Operations, Pearson Publication, 14th Edition.
- Rakesh Mohan Joshi, International Business, Oxford Press, India Edition.
- Why has the unsuccessful Doha round resulted in bilateral and inter-regional FTAs and what are the consequences for global trade excerpted from www.geopolitics.ro

Unit 9 National Regulation of International Business

Structure:

Objectives:

International business is normally subject to various kinds of regulatory environment. The present chapter discusses the regulation of international business at the national level. After reading this unit, you will be able to understand:

(i) foreign trade policy of India;
(ii) foreign trade policy 2009-2014;
(iii) government policy on Foreign Equity Investment;
(iv) foreign direct investment into India;
(v) routes under foreign direct investment;
(vi) examine the rationale behind regulation of FDI from the viewpoints of both the home country and the host country; and
(vii) Discuss the modalities of FDI regulation in both, the home country and the host country.

9.1 Introduction

Trade is an indispensable means for sustaining the economic growth and development of a nation. In India, the main legislation governing foreign trade is the Foreign Trade (Development and Regulation) Act, 1992. As per the provisions of the Act, the government of India formulates and announces a foreign trade policy and amends it from time to time. The new Foreign Trade Policy (FTP) announced in August, 2004, covering a five year period of 2004-2009 is a comprehensive policy for the overall development of India's foreign trade sector. It is built around two major Objectives :-

(i) to double India's percentage share of global merchandise trade within the next five years; and (ii) trade to act as an effective instrument of economic growth by giving a thrust to employment generation. The Ministry of Commerce and Industry is the most important organ concerned with the promotion and regulation of foreign trade in India. The Ministry has an elaborate organizational set up to look after the various aspects of trade. Its two important offices concerned with trade are the "Directorate General of Foreign Trade (DGFT)" and the "Directorate General of Commercial Intelligence and Statistics (DGCI&S)". DGFT is responsible for implementing the Foreign Trade Policy/Exim Policy with the main objective of promoting Indian exports. It also issues licenses to exporters and monitors their corresponding obligations through a network of regional offices. DGCI&S is entrusted with the work of collecting, compiling and publishing/ disseminating trade statistics and various types of commercial information required by the policy makers, researchers, importers, exporters, traders as well as overseas buyers. India is also engaged in trade negotiations and agreements at multilateral, regional and bilateral levels. It is interacting with international agencies such as the World Trade Organisation (WTO), the United National Conference on Trade & Development (UNCTAD), the Economic and Social Commission for Asia and Pacific (ESCAP), etc as well as with individual countries or group of countries on a wide range of issues including tariff and non- tariff barriers, international commodity agreements, preferential/free trade arrangements, investment matters, etc. Some of the major regional trading arrangements that India has entered into include:- Agreement on South Asian Free Trade Area (SAFTA); Asia-Pacific Trade Agreement (APTA); Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India; etc.

9.2 India: Foreign Trade Policy

In recent years, the government's stand on trade and investment policy has displayed a marked shift from protecting 'producers' to benefiting 'consumers'. This is reflected in its Foreign Trade Policy for 2004/09 which states that, "For India to become a major player in world trade ...we have also to facilitate those imports which are required to stimulate our economy." India is now aggressively pushing for a more liberal global trade regime, especially in services. It has assumed a leadership role among developing nations in global trade negotiations, and played a critical part in the Doha negotiations.

In India, the main legislation concerning foreign trade is the Foreign Trade (Development and Regulation) Act, 1992. The Act provides for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from, India and for matters connected therewith or incidental thereto. As per the provisions of the Act, the Government : (i) may make provisions for facilitating and controlling foreign trade; (ii) may prohibit, restrict and regulate exports and imports, in all or specified cases as well as subject them to exemptions; (iii) is authorised to formulate and announce an export and import policy and also amend the same from time to time, by notification in the Official Gazette; (iv) is also authorised to appoint a "Director General of Foreign Trade" for the purpose of the Act, including formulation and implementation of the export-import policy. Accordingly, the Ministry of Commerce and Industry has been set up as the most important organ concerned with the promotion and regulation of foreign trade in India. In exercise of the powers conferred by the Act, the Ministry notifies a trade policy on a regular basis with certain underlined objectives. The earlier trade policies were based on the objectives of self-reliance and self-sufficiency. While, the later policies were driven by factors like export led growth, improving efficiency and competitiveness of the Indian industries, etc.

With economic reforms, globalization of the Indian economy has been the guiding factor in formulating the trade policies. The reform measures introduced in the subsequent policies have focused on liberalization, openness and transparency. They have provided an export friendly environment by simplifying the procedures for trade facilitation. The announcement of a new Foreign Trade Policy for a five year period of 2004-09, replacing the hitherto nomenclature of EXIM Policy by Foreign Trade Policy (FTP) is another step in this direction. It takes an integrated view of the overall development of India's foreign trade and provides a roadmap for the development of this sector. A vigorous export-led growth strategy of doubling India's share in global merchandise trade (in the next five years), with a focus on the sectors having prospects for export expansion and potential for employment generation, constitute the main plank of the policy. All such measures are expected to enhance India's International competitiveness and aid in further increasing the acceptability of Indian exports. The policy sets out the core objectives, identifies key strategies, spells out focus initiatives, outlines export incentives, and also addresses issues concerning institutional support including simplification of procedures relating to export activities.

The key strategies for achieving its objectives include:-

(i) Unshackling of controls and creating an atmosphere of trust and transparency;

(ii) Simplifying procedures and bringing down transaction costs;

(iii) Neutralizing incidence of all levies on inputs used in export products;

(iv) Facilitating development of India as a global hub for manufacturing, trading and services;

(v) Identifying and nurturing special focus areas to generate additional employment opportunities, particularly in semi-urban and rural areas;

(vi) Facilitating technological and infrastructural up gradation of the Indian economy, especially through import of capital goods and equipment;

(vii) Avoiding inverted duty structure and ensuring that domestic sectors are not disadvantaged in trade agreements;

(viii) Upgrading the infrastructure network related to the entire foreign trade chain to international standards;

(ix) Revitalizing the Board of Trade by redefining its role and inducting into it experts on trade policy; and

(x) Activating Indian Embassies as key players in the export strategy.

Foreign Trade Policy and Different Sectors

The FTP has identified certain thrust sectors having prospects for export expansion and potential for employment generation. These thrust sectors include: (i) Agriculture;

(iii) Handlooms & Handicrafts; (iii) Gems & Jeweler; and (iv) Leather & Footwear. Accordingly, specific policy initiative for these sectors has been announced.

Agriculture sector

A new scheme called “Vishesh Kristi Upaj Yojana (Special Agricultural Produce Scheme)” to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products has been introduced. Under the scheme, exports of these products qualify for duty free credit entitlement (5 per cent of Free On Board (f.o.b) value of exports) for importing inputs and other goods;

(i) Duty free import of capital goods under Export Promotion Capital Goods (EPCG) scheme, permitting the installation of capital goods imported under EPCG for agriculture anywhere in the Agri- Export Zone (AEZ);

(ii) Utilizing funds from the 'Assistance to States for Infrastructure Development of Exports (ASIDE) scheme' for development of AEZs;

(iii) Liberalization of import of seeds, bulbs, tubers and planting material, and liberalization of the export of plant portions, derivatives and extracts to promote export of medicinal plants and herbal products.

Handlooms and handicraft sector

(i) Enhancing to 5 per cent of Free On Board (f.o.b) value of exports duty free import of trimmings and embellishments for handlooms and handicrafts;

(ii) Exemption of samples from countervailing duty (CVD);

(iii) Authorizing Handicraft Export Promotion Council to import trimmings, embellishments and samples for small manufacturers; and

(iv) Establishment of a new Handicraft Special Economic Zone.

Gems and jeweler sector

(i) Permission for duty free import of consumables for metals other than gold and platinum up to 2 per cent of Free On Board (f.o.b) value of exports;

(ii) Duty free re-import entitlement for rejected jewelry allowed up to 2 per cent of f.o.b value of exports;

(iii) Increase in duty free import of commercial samples of jewelry to Rs. 1 lakh; and

(iv) Permission to import of gold of 18 carat and above under the replenishment scheme.

Leather and footwear sector

The specific policy initiatives are mainly in the form of reduction in the incidence of customs duties on the inputs and plants and machinery. These include:

(i) Increase in the limit for duty free entitlements of import trimmings, embellishments and footwear components for leather industry to 3 per cent of Free On Board (f.o.b) value of exports and that for duty free import of specified items for leather sector to 5 per cent of f.o.b value of exports;

(ii) Import of machinery and equipment for Effluent Treatment Plants for leather industry exempted from customs duty; and

(iii) Re-export of unsuitable imported materials (such as raw hides and skin and wet blue leathers) has been permitted.

In order to review the progress and policy measures, each year, "Annual Supplements" to the five year Foreign Trade Policy (FTP) have been announced by the Ministry:

(i) The Annual Supplement announced in April, 2005 incorporated additional policy initiatives and further simplified the procedures. It provided for an active involvement of the State Governments in creating an enabling environment for boosting international trade, by setting up an Inter-State Trade Council. Also, different categories of advance licenses were merged into a single category for procedural facilitation and easy monitoring. The supplement provided renewed thrust to agricultural exports by extension of "Vises Kris Puja Yohan" to poultry and dairy products and removal of chess on exports of all agricultural and plantation commodities.

(ii) The Annual Supplement put forward in April 2006, announced the twin schemes of "Focus Product" and "Focus Market". To further meet the objective of employment generation in rural and semi urban areas, export of village and cottage industry products were included in the "Vises Kristi Puja Yovanna", which was renamed as "Vises Kristi and Gram Udo Yovanna". Also, a number of measures were introduced in order to achieve the objective of making India a gems and jeweler hub of the world. These include: (i) allowing import of precious metal scrap and used jeweler for melting, refining and re-export; (ii) permission for export of jewelers on consignment basis; (iii) permission to export polished precious and semi precious stones for treatment abroad and re-import in order to enhance the quality and afford higher value in the international market.

(iii) Likewise, the third Annual Supplement to the Foreign Trade Policy was announced on 19 April, 2007 (effective from 1st April, 2007). Some of the important measures introduced by it are:- (i) exemption from service tax on services (related to exports) rendered abroad; (ii) service tax on services rendered in India and utilized by exporters would be exempted/remitted; (iii) categorization of exporters as "One to Five Star Export Houses" has been changed to "Export Houses & Trading Houses", with rationalization and change in export performance parameters; (iv) expansion of ceiling, scope and coverage under the "Focus Market Scheme (FMS)" and "Focus Product Scheme (FPS)".

The final annual supplement to the Foreign Trade Policy for 2004-2009 was announced in April 2008 in which several innovative steps were proposed. They included the following:

(i) Import duty under the EPCG scheme is being reduced from 5% to 3%, in order to promote modernization of manufacturing and services exports.

(ii) Income tax benefit to 100% EOUs available under Section 10B of Income Tax Act is being extended for one more year, beyond 2009.

(iii) To promote export of sports and toys and also to compensate disadvantages suffered by them, an additional duty credit of 5% over and above the credit under "Focus Product Scheme" is being provided.

(iv) Our export of fresh fruits and vegetables and floriculture suffers from high incidence of freight cost. To neutralize this disadvantage, an additional credit of 2.5% over and above the credit available under Vises Kristi and Gram Udo Yovanna (VKGUY) is proposed.

(v) Interest relief already granted for sectors affected adversely by the appreciation of the rupee is being extended for one more year.

(vi) DEPB scheme is being continued till May 2009.

(vii) Trade Facilitation Measures (Supplement To Foreign Trade Policy 2004-09) Announced On 26th February 2009,

(viii) DUTY CREDIT SCRIPS under DEPB scheme to be issued without waiting for realization of export proceeds;

(ix) Special package of Rs. 325 crore for leather and textiles sector;

(x) STCL, DIAMOND INDIA, MSTC, GEM & JEWELLERY EPC and STAR

TRADING HOUSES added as nominated agencies for import of precious metals;

(xi) Gem and Jeweler export: import restrictions on worked corals removed;

(xii) Bhilwara and Surat recognized as towns of export excellence for textiles and diamonds;

(xiii) Threshold limit for recognition as premier trading houses reduced to 7500 crore;

(xiv) Under EPCG scheme, export obligation extended till 2009-10 for exports during 2008-09;

(xv) DEPB/DUTY CREDIT SCRIP utilization extended for payment of duty for import of restricted items also;

(xvi) Procedure for claiming duty drawback refund & refund of terminal excise duty further simplified;

(xvii) Re-credit of 4% SAD for VKGUY, FPS and FMS allowed;

(xviii) A new office of DGFT to be opened at Srinagar;

(xix) Value cap under DEPB revised for two products;

(xx) Electronic message transfer facility for advance authorization and EPCG to be established;

(xxi) Gem & Jeweler units in EOU to be allowed – personal carriage of gold up to 10 kg;

(xxii) Advance licenses issued prior to 1.4.2002 requiring MODVAT/CENVAT certificate dispensed with;

(xxiii) Export obligation period against advance authorizations extended up to 36 months;

(xxiv) Reimbursement of additional duty of excise levied on fuel to be admissible for EOUS;

(xxv) Early refund of service tax claims & further simplification of refund procedures on the anvil.

In accordance with the provisions of the Act, a "Directorate General of Foreign Trade (DGFT)" has been set up as an attached office of the Ministry of Commerce and Industry. It is headed by the 'Director General of Foreign Trade' and is responsible for formulating and executing the Foreign Trade Policy/Exim Policy with the main objective of promoting Indian exports. The DGFT also issues licenses to exporters and monitors their corresponding obligations through a net work of 32 regional offices located at the following places:- Ahmedabad; Amritsar; Bangalore; Baroda (Vadodara); Bhopal; Kolkata; Chandigarh; Chennai; Coimbatore; Cuttack; Ernakulum; Guwahati; Hyderabad; Jaipur; Kanpur; Ludhiana; Madurai; Moradabad; Mumbai; New Delhi; Panaji; Pan pat; Patna; Pondicherry; Pune; Rajkot; Shilling; Srinagar(Functioning at Jammu); Surat; Thiruvananthapuram; Varanasi; and Vishakhapatnam.

Foreign Trade Policy 2009-2014

As per the Chapter 2 of Handbook of Procedures (Vol. I) [HBP v1], 27th August 2009 - 31st March 2014, Government of India, Ministry of Commerce and Industry, Department of Commerce (website: http://dgft.gov.in), the general provisions regarding exports and imports or international business are mentioned below under:

Countries of Imports / Exports: Unless otherwise specifically provided, import / export will be valid from / to any country. Above provisions shall, however, be subject to all conditionality, or requirement of authorization as required under Schedule I and / or Schedule II of ITC (HS).

(i) **Application Fee:** The scale of fee, mode of payment, procedure for refund of fee and categories of persons exempted from payment of fee are contained in Appendix-21B.

(ii) **Territorial Jurisdiction of Regional Authorities (RA):** Every application, unless otherwise specified, shall be submitted to RA concerned, as indicated in Appendix-1 of HBP v1.

(iii) **Filing of Application:** An incomplete or unauthorized application is liable to be rejected giving specific reason for rejection. In case of manual applications, applicant would furnish a soft copy of the application in MS word format.

(iv) **Profile of Importer/Exporter:** Each importer / exporter shall be required to file importer/exporter profile once with RA in ANF 1. RA shall enter such information in database so as to dispense with need for asking information again. In case of any change in information given in ANF 1, importer / exporter shall intimate same to RA.

(v) **Self Addressed Stamped Envelope:** Applicant shall furnish a self addressed envelope of 40x15 cm with required postal stamp affixed, for all documents required to be sent by Speed Post.

(vi) **Importer Exporter Code (IEC) No Exempted Categories:** Following categories of importers or exporters are exempted from obtaining IEC number:

(i) Importers covered by clause 3(1) [except sub-clauses (e) and (l)] and exporters covered by clause 3(2) [except sub-clauses (i) and (k)] of Foreign Trade (Exemption from application of Rules in certain cases) Order, 1993. (ii) Ministries / Departments of Central or State Government. (iii) Persons importing or exporting goods for personal use not connected with trade or manufacture or agriculture. (iv) Persons importing / exporting goods from / to Nepal, Myanmar through Indo-Myanmar border areas and China (through Gundi, Nagoya Shipkila and Nathula ports), provided CIF value of a single consignment does not exceed Indian Rs.25, 000. In case of Nathula port, the applicable value ceiling will be Rs. 100,000. However, exemption from obtaining IEC number shall not be applicable for export of Special Chemicals, Organisms, Materials, Equipments and Technologies (SCOMET) as listed in Appendix- 3, Schedule 2 of ITC (HS) except in case of exports by category
(ii) above. (v) Following permanent IEC numbers shall be used by non- commercial PSUs and categories of importers/exporters mentioned against them for import/export purposes:

S.No	**Code Number**	**Categories of Importers / Exporters**
1.	0100000011	All Ministries / Departments of Central Government and agencies wholly or partially owned by them.
2.	0100000029	All Ministries / Departments of any State Government and agencies wholly or partially owned by them.
3.	0100000037	Diplomatic personnel, Counselor officers in India and officials of UNO and its specialised agencies.
4.	0100000045	Indians returning from / going abroad and claiming benefit under Baggage Rules.
5.	0100000053	Persons / Institutions / Hospitals importing or exporting goods for personnel use, not connected with trade or manufacture or agriculture.
6.	0100000061	Persons importing / exporting goods from / to Nepal
7.	0100000070	Persons importing / exporting goods from / to Myanmar through Indo-Myanmar border areas

8.	0100000088	Ford Foundation
9.	0100000096	Importers importing goods for display or use in fairs / exhibitions or similar events under provisions of ATA carnet. This IEC number can also be used by importers importing for exhibitions/fairs as per Para 2.29 of HBPv1.
10.	0100000100	Director, National Blood Group Reference Laboratory, Bombay or their authorized offices.
11.	0100000126	Individuals / Charitable Institution /Registered NGOs importing goods, which have been exempted from Customs duty under Notification issued by Ministry of

Finance for bonfire use by victims affected by natural calamity.

12. 0100000134 Persons importing/exporting permissible goods as

notified from time to time, from/to China through Gunji, Namgaya Shipkila and Nathula ports, subject to
value ceilings of single consignment as given in Para 2.8(iv) above.

13. 0100000169 Non-commercial imports and exports by entities who

have been authorized by Reserve Bank of India.

(vii) **Application for Grant of IEC Number:** An application for grant of IEC Number shall be made by Registered Office, in case of companies and Head Office in case of proprietorship concerns, partnership concerns and HUFs, of applicant, except EOUs and SEZ units, to concerned RA in ANF2A with documents prescribed therein. Only one IEC would be issued / allowed against a single PAN number. The application (ANF 2 A) for issuance of fresh IEC or modification of IEC shall indicate the name and designation of the person whose photograph has been affixed on the Bank Certificate. A photograph of the person along with his/her name and designation shall also be affixed on the IEC No. to be issued (Appendix 18 B).

(viii) **IEC Format and Statements**: RA concerned shall issue an IEC number in prescribed format (Appendix-18B). A copy of such IEC number shall be endorsed to concerned banker (as per details given in ANF 2A). A consolidated statement (in Appendix 18 C) of IEC numbers issued by RA shall be sent to Exchange Control Department of RBI as given in Appendix-18D.

Validity of IEC No.: An IEC number allotted to an applicant shall be valid for all its branches / divisions / units / factories.

Duplicate Copy of IEC Number: Where an IEC Number is lost or misplaced, issuing authority may consider requests for grant of a duplicate copy of IEC number, on an affidavit.

Surrender of IEC Number: If an IEC holder does not wish to operate allotted IEC number, he may surrender same by informing issuing authority. On receipt of such intimation, issuing authority shall immediately cancel it and electronically transmit it to DGFT and Customs authorities.

(ix) **Application for Import and Export of Restricted Items**: An application for grant of an authorization for import or export of items mentioned as restricted in ITC (HS) may be made to RA as specified under relevant Chapters of this Handbook.

9.4 Foreign Direct Investment

The Indian Government's attitude towards foreign investment has changed significantly during the past decade. Until the 1980s, foreign investment was permitted only in cases where a desired technology was not obtainable on any other terms. With the introduction of the Statement on Industrial Policy of 1991, the government began taking a more liberal attitude. Automatic approval was granted in specified high-priority industries for up to 51 per cent direct foreign investment and in trading companies engaged primarily in export activities. In 2000, the Foreign Direct Investment (FDI) policy was further liberalized and now foreign investment up to 100 per cent for new and existing companies / firms, is permitted under the automatic route (i.e. without requiring prior approval) for all items/activities except for a few specific sectors. Foreign investment is allowed in all areas other than the following sectors in which foreign investment is prohibited: (i) Retail Trading (ii) Atomic Energy (iii) Lottery Business/ Gambling & Betting (iv) Agriculture (excluding floriculture, horticulture, seed development, animal husbandry, viniculture and cultivation of vegetables, mushrooms etc.) (v) Plantations (excluding Tea plantation). For all other sectors, there are two approval routes for foreign investment in India:

(i) automatic route under delegated powers exercised by the Reserve Bank of India (RBI),
(ii) approval by the Government through the Foreign Investment Promotion Board (FIPB) under the Ministry of Finance,
(iii) FDI up to 100 per cent for new and existing companies/joint

Government Policy on Foreign Equity Investment

Foreign Direct Investments (FDI) ventures /firms, is permitted under the automatic route for all items/activities except the following:

(i) proposals that require compulsory industrial licensing
(ii) where the foreign collaborator has an existing venture/tie-up in India in the same field ('same field' means 1987 NIC code) as on January 12, 2005, with the exception of following cases which would not require prior FIPB approval:
(iii) Investment by a Venture Capital Fund registered with SEBI
(iv) Existing joint venture has less than 3% investment by either party
(v) Existing joint venture is defunct or sick acquisition of shares held by resident shareholders of an existing Indian company in the following cases :
(vi) Indian company is engaged in financial services sector;

(vii) Where SEBI (Substantial Acquisition of Shares and Takeover) Regulation, 1997 is triggered.

(viii) Proposals falling outside notified sectoral policy/caps or sectors in which FDI is not permitted.

(ix) Downstream investment subsequent investment in India by foreign-owned Indian holding companies (commonly referred to as "Downstream investments") are allowed in accordance with the FDI guidelines mentioned above. Prior approval of FIPB is required to act as a holding company. Domestic funds cannot be leveraged by the foreign owned Indian holding company for downstream investments.

9.5 Procedure for Automatic Route

The foreign investor is not required to obtain any prior approval. Only a post facto filing is required to be made by the company in India which is receiving the foreign investment. This filing entails submission of notifications to the concerned regional office of RBI in the prescribed form within 30 days of receipt of inward remittances and within 30 days after issue of shares by the Indian company to the foreign investor. For all sectors excluding those falling under Government Approval, NRIs (which also includes Persons of Indian Origin -PIOs) are eligible to bring investment through the automatic route of RBI. The Government through the FIPB considers all other proposals, which do not fulfill any or all of the criteria for automatic approval. Further, under the non-repatriation scheme (i.e. capital is not reportable outside India), NRIs are permitted to invest even in those sectors where sectoral caps are prescribed under the FDI policy. NRIs are also permitted to purchase and sell shares/convertible debentures under the portfolio investment scheme through a branch designated by an authorized dealer for the purpose and duly approved by the RBI, subject to fulfillment of certain conditions.

The total holding by each NRI cannot exceed 5% of the total paid up equity capital or 5% of the paid up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all NRIs put together cannot exceed 10% of paid up equity capital or paid up value of each series of convertible debentures. This limit of 10% may be increased to 24% by the concerned Indian company by sanction of the shareholders through a special resolution.

Advantages to the foreign investor

(i) India emerging as a major global player – the rapid growth of its economy on a worldwide scale, particularly the services and information technology sector, provide ample opportunity for foreign investors.

(ii) Deregulation in India – Inward FDI trends have been increasing ever since the reform in FDI regime which has provided simplified procedures and policies, with foreign investors facing less restrictions.

(iii) Incentives to promote investments e.g. government subsidies, attractive borrowing rates.

(iv) Efficiency-seeking investments i.e. lower production costs.

(v) Market-seeking investments i.e. fast-growing population and economy.

Advantages to India as the host economy

(i) Generates Employment

(ii) Transfers technology, knowledge, expertise, managerial know-how

(iii) Brings in capital-and added bonus of foreign currency

(iv) Develops infrastructure-economic and social progress

9.10 Modes of Foreign Investment into India

Routes under foreign direct investment

(A) Automatic route - All sectors allow up to 100% FDI under the automatic route, where no prior Government approval is required. This is the case except for the following which do require prior approval from the Government:

(i) Where provisions of Press Note 1 (2005 Series) issued by the Government of India are attracted.

(ii) Where more than 24 per cent foreign equity is proposed to be inducted for manufacture of items reserved for the small scale sector.

(iii) FDI in sectors/activities to the extent permitted under automatic route does not require any prior approval either by the Government or the Reserve Bank of India.

(iv) The investors are only required to notify the Regional Office concerned of the Reserve Bank of India within 30 days of receipt of inward remittances and file the required documents along with form FC-GPR with that office within 30 days of issue of shares to the non-resident investors.

(B) Government route - FDI in activities not covered under the automatic route requires prior Government approval and is considered by the Foreign Investment Promotion Board (FIPB). Application can be made in Form FC-IL. Plain paper applications carrying all relevant details are also accepted. Decision of the FIPB is usually conveyed in 4-6 weeks. Thereafter, filings have to be made by the Indian company with the RBI.

(C) General permission of RBI under FEMA - Indian companies having foreign investment approval through FIPB route do not require any further clearance from the Reserve Bank of India for receiving inward remittance and issue of shares to the non- resident investors. The companies are required to notify the concerned Regional Office of the

Reserve Bank of India of receipt of inward remittances within 30 days of such receipt and submit Form FC-GPR within 30 days of issue of shares to the non- resident investors.

9.6 Foreign institutional investment

Foreign Institutional Investors (FIIs) are entities established or incorporated outside India and make proposals for investments in India. Distinction can be made between FDI and FIIs, where FDI is longer-term and thus less affected by short-term liquidity problems compared with FIIs. The FII, given its short-term nature, might have bi- directional causation with the returns of other domestic financial markets like money market, stock market, foreign exchange market, etc. These investment proposals by the FIIs are made on behalf of sub-accounts, which may include foreign corporates, individuals and funds and so on. The biggest source through which FIIs invest is the issuance of Participatory Notes (P-Notes), which are also known as offshore derivatives. FIIs can invest in the stocks and debentures of the Indian companies. In order to invest in the primary and secondary capital markets in India, they have to venture through the Portfolio Investment Scheme (PIS). According to the RBI Regulations, the ceiling for overall investment for FIIs is 24 per cent of the paid-up capital of the Indian company. The limit is 20 per cent of the paid-up capital in the case of public sector banks. However, if the Board and the general body approve and pass a special resolution, then the ceiling of 24 per cent for FII investment can be raised up to sectoral cap for that particular segment. There is a long list of entities that are eligible to get registered as FIIs such as pension funds, mutual funds, insurance

Companies, investment trusts, banks, university funds, endowments, foundations, sovereign wealth funds, hedge funds and charitable trusts. In fact, asset management companies, investment managers, advisors or institutional portfolio managers set up and/or owned by NRIs are also eligible to be registered as FIIs. The nodal point for FII registration is SEBI and, hence, all FIIs must register themselves with SEBI and should also comply with the Exchange Control Regulations of the Central Bank. Apart from being allowed to invest in securities in primary and secondary markets, FIIs can also invest in mutual funds, dated Government securities, derivatives traded on a recognized stock exchange and commercial papers. FIIs are among the major sources of liquidity for the Indian markets. If FIIs are investing huge amounts in the Indian stock exchanges, then it reflects their high confidence in the markets, so FIIs are usually net buyers. But with the current global credit crunch and liquidity freeze in the international markets, FIIs have become net sellers. Market regulator Security Exchange Board of India (SEBI) recently announced new rules for foreign investments through financial instruments such as participatory notes, asking FIIs to wind up P-Notes for investing in derivatives within 18 months. The SEBI has also imposed restrictions on P-Notes for investing in spot market, where FIIs will not be allowed to issue P-Notes more than 40 per cent of their assets under custody. The reference date for calculating such assets will be September 30. Those FIIs who have issued P-Notes of more than 40 per cent of their assets could issue such instruments only if they cancel, redeem, or close their existing PNs. Those FIIs who have issued P-Notes less than 40 per cent of their assets under custody can issue additional instruments at the rate of 5 per cent of their assets.

Foreign venture capital investment

In the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ('the Principal Regulations'), "As per clause (iiia) of regulation 2 'Foreign Venture Capital Investor' means an investor incorporated and established outside India which proposes to make investment in Venture Capital Fund(s) or Venture Capital Undertaking(s) in India and is registered with SEBI under SEBI (Foreign Venture Capital Investors) Regulations, 2000;" As per clause (ixia) of regulation 2 "'Venture Capital Fund' means a fund established in the form of a trust, a company including a body corporate and registered under the Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996 which has a dedicated pool of capital raised in a manner specified under the said Regulations and which invests in Venture Capital Undertakings in accordance with the said Regulations. "Investment by Foreign Venture Capital Investor - A registered Foreign Venture Capital Investor (FVCI) may, through the SEBI, apply to the Reserve Bank for permission to invest in Indian Venture Capital Undertaking (IVCU) or in a VCF or in a scheme floated by such VCFs. Permission may be granted by the Reserve Bank, subject to such terms and conditions as may be considered necessary. The registered FVCI permitted by the Reserve Bank under sub-paragraph (1), may purchase equity/equity linked instruments/debt/debt instruments, debentures of an IVCU or of a VCF through initial public offer or private placement or in units of schemes/funds set up by a VCF. The amount of consideration for investment in VCFs/IVCUs shall be paid out of inward remittance from abroad through normal banking channels or out of funds held in an account maintained with the designated branch of an authorized dealer in India.

Non-residential investment

Non Resident Investors (NRIs) and Persons of Indian Origin (PIOs) are eligible to bring investment trough the automatic route of the RBI for all sectors excluding those falling under government approval. Further, under the non-repatriation scheme (i.e., capital is not reportable outside India), the NRIs are permitted to invest even in those sectors where sectoral caps are prescribed under the FDI policy. The NRIs are also permitted to purchase and sell shares/convertible debentures under the portfolio investment scheme through a branch designated by an authorized dealer for the purpose and duly approved by the RBI, subject to fulfillment of certain conditions. The total holding by each NRI cannot exceed 5 per cent of the total paid up equity capital or 5 per cent of the paid up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all NRIs put together cannot exceed 10 per cent of paid up equity capital or paid up value of each series of convertible debentures. This limit of 10 per cent may be increased to 24 per cent by the concerned Indian company by sanction of the shareholders through a special resolution.

9.11 Summary

Although India has steadily opened up its economy, its tariffs continue to be high when compared with other countries, and its investment norms are still restrictive. This leads some to see India as a 'rapid globalizer' while others still see it as a 'highly protectionist' economy. Till the early 1990s, India was a closed economy: average tariffs exceeded 200 percent, quantitative restrictions on imports were extensive, and there were stringent restrictions on foreign investment. The country began to cautiously reform in the 1990s, liberalizing only under conditions of extreme necessity. Since that time, trade reforms have produced remarkable results. India's trade to GDP ratio has increased from 15 percent to 35 percent of GDP between 1990 and 2005, and the economy is now among the fastest growing in the world. Average non-agricultural tariffs have fallen below 15 percent, quantitative restrictions on imports have been eliminated, and foreign investments norms have been relaxed for a number of sectors. India however retains its right to protect when need arises. Agricultural tariffs average between 30-40 percent, anti-dumping measures have been liberally used to protect trade, and the country is among the few in the world that continue to ban foreign investment in retail trade. Although this policy has been somewhat relaxed recently, it remains considerably restrictive. The Indian Government's attitude towards foreign investment has changed significantly during the past decade. Until the 1980s, foreign investment was permitted only in cases where a desired technology was not obtainable on any other terms. With the introduction of the Statement on Industrial Policy of 1991, the government began taking a more liberal attitude. Automatic approval was granted in specified high-priority industries for up to 51 per cent direct foreign investment and in trading companies engaged primarily in export activities. In 2000, the Foreign Direct Investment (FDI) policy was further liberalized and now foreign investment up to 100 per cent for new and existing companies / firms, is permitted under the automatic route (i.e. without requiring prior approval)

9.11 Glossary

Foreign Trade Policy (FTP) – This policy, covering a five-year period, is a comprehensive framework for the development of India's foreign trade sector.

Special Agricultural Produce Scheme' – Launched to boost the exports of fruits, vegetables, flowers, minor forest produce, and their value-added products.

Automatic Route – Under this procedure, a foreign investor is not required to obtain any prior approval. Only a factual report needs to be submitted subsequently in India by the company receiving the foreign investment.

Director General of Foreign Trade (DGFT)

Directorate General of Commercial Intelligence and Statistics (DGCI&S)

Non-Resident Investor (NRI)

Person of Indian Origin (PIO)

Importer-Exporter Code (IEC)

9.13 Check your progress

- Although India has already opened up its economy, its tariffs remain consistently higher compared to other countries, and its investment norms continue to be restrictive.
- Under the automatic route, foreign investors are not required to obtain any prior approval.
- FIIs are generally net sellers.
- The total holding by NRIs cannot exceed 5% of the paid-up share capital or 5% of the paid-up value of each series of convertible debentures issued by an Indian company.

_9.14 Answer to check your progress

(1) True (2) True (3) False (4) True.

9.15 elf Terminal questions

- Write down various provisions under foreign trade policy?
- Describe different provisions for foreign trade of agricultural products.
- Discuss different provisions for foreign trade of handlooms and handicraft products.
- Explain various provisions for foreign trade policy 2009-14.
- Define foreign direct investment and its route.
- Explain the provisions given in government policy on foreign equity

9.16 Suggest readinds

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Unit 10 -Multinational Regulation of Trade and Investment

Structure:

Objectives:

After reading this unit, you will be able to understand:

(i) the concept of multilateral trading system;
(ii) the Agreement on Technical Barriers to Trade;
(iii) the Agreement on the Application of Sanitary and Phytosanitary Measures;
(iv) Agreement on the application of sanitary and phytosanitary measures;
(v) Other trade-related international regulatory issues such as Environment

and Labour standards;

(vi) Agreement on trade-related investment measures (TRIMs);

(vii) Agreement on trade-related aspects of intellectual property rights (TRIPs);

(viii) The multilateral trading system and countries in economic transition;

(ix) Benefits for countries in economic transition; and

(x) Difficulties faced by countries in economic transition in entering the multilateral trading system

10.1 Introduction

Standards have many roles and functions. Not only do they establish a common trading language between buyers and sellers, but they also ensure public safety and the protection of the environment within and outside national borders. Moreover, in today's globalized production systems, standards ensure that parts produced across borders fit and that networks are compatible. Regulations and standards and the verification of their application through conformity assessment procedures have, therefore, many benefits. However, inappropriate regulations can result in high costs and inefficiencies in trading partner countries as well as in the domestic economy and have international repercussions.

The World Trade Organization (WTO) supports a free and open multilateral trading system by encouraging its member countries to adhere to five core principles. These principles include the following:

(i) Non-discrimination, meaning a country should not discriminate between domestically produced and imported products, nor between trading partners;

(ii) A decrease in trade barriers;

(iii) Increased confidence by trading partners that they will not be subject to arbitrary tariffs;

(iv) Increased competition through fair and open trade;

(v) Special provisions under WTO agreements for developing countries.

To encourage the adoption of these principles, WTO members have implemented several agreements geared towards eliminating the use of regulations to create technical barriers to trade. Among these are the Agreement on Technical Barriers to Trade (TBT), the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) and other trade-related regulatory issues such as investment measures and intellectual property rights.

Discussions have also been held on trade-related aspects of environment and labour standards. In recent years, particular note has been made of the obstacles faced by developing countries and countries in economic transition in implementing WTO agreements and dealing with these issues.

Agreement on Technical Barriers to Trade

A technical barrier to trade may take many forms. The most common TBTs include non-harmonized technical regulations and standards, duplicative and complex conformity assessment procedures, a lack of transparency in applicable laws and technical regulations, certain bureaucratic procedures, and a lack of operating procedures for private standards bodies that is consistent with open trade. As global tariff rates have decreased, there is concern that increased regulation is being used to create TBTs in order to protect domestic industries and block import competition. In response to this concern and to strengthen the multilateral free trade system by reducing global barriers to trade, WTO members adopted the Agreement on Technical Barriers to Trade in the Uruguay Round of Multilateral Trade Negotiations, which was concluded in 1994. By June 1998, 132 Governments had accepted the obligations of W TO and thus of the TBT Agreement.

Principal provisions of the agreement

Specific provisions under the TBT Agreement pertain to technical regulations, standards, conformity assessment practices, notification requirements and standards developing bodies. These differ from previous provisions under the Standards Code, which was adopted during the Tokyo Round in 1979. Key provisions pertaining to technical regulations and standards include process and production methods related to the characteristics of the product, as opposed to the Standards Code which only covered manufactured products. Specifically, in the area of technical regulations and standards, the TBT Agreement states that members should:

(i) Ensure national treatment of products, i.e. accord the same treatment to imported products as that accorded to similar domestically produced goods;

(ii) Accord the same treatment to all similar imported products, regardless of origin;

(iii) Ensure that any technical regulations and standards used to protect human, animal or plant life or health or the environment are not more trade-restrictive than necessary;

(iv) Use, in part or in whole, relevant international standards as a basis for technical regulations whenever possible;

(v) Participate in relevant international standards bodies to develop and adopt appropriate technical regulations and standards;

(vi) Recognize technical regulations of other members as equivalent provided these regulations meet the objectives of their own regulations;

(vii) Emphasize product performance requirements rather than design or descriptive requirements;

(viii) Notify other members of proposed technical regulations and standards that may significantly affect trade.

Conformity assessment provisions have also been expanded from the Standards Code to include not only testing and certification programmes but also inspection, registration, laboratory accreditation and quality system registration. Specific provisions encourage members to:

(i) Ensure non-discrimination towards products;

(ii) Restrict the use of conformity assessment procedures which create unnecessary obstacles to international trade;

(iii) Use international guides or recommendations pertaining to conformity with technical regulations and standards issued by international standard developing bodies;

(iv) Participate in international standards bodies that develop conformity assessment guides and recommendations with the goal of harmonizing conformity assessment procedures;

(v) Notify other members of proposed conformity assessment procedures that may significantly affect trade;

(vi) Recognize conformity assessment procedures of other members as equivalent provided these procedures provide guarantees of health and safety equivalent with those of their own procedures;

(vii) Allow conformity assessment bodies located in territories of other members to participate as equally in conformity assessment procedures as bodies located in their territory or located in the territory of any other country.

In addition to the above measures, the TBT Agreement contains several other important mechanisms aimed at facilitating international trade. Article 10 of the Agreement requires each member to establish and maintain an enquiry point. The enquiry point is responsible for responding to all requests from other members pertaining to technical regulations, standards and conformity assessment procedures and for notifying proposed governmental and State technical regulations, standards and conformity assessment procedures that may significantly affect trade. The enquiry point also disseminates information about proposed foreign regulations to interested domestic parties. The TBT Agreement contains the Code of Good Practice for the Preparation, Adoption and Application of Standards (Annexure -3). The Code outlines general guidelines for the preparation and use of standards by private-sector standards bodies. It encourages standards bodies to ensure transparency, non-discrimination towards imported products, alignment of national standards with international standards whenever possible and prohibits the implementing of regulations that may cause barriers to international trade. The Code is notable for being the first agreement to outline a framework of operation for private standards bodies that is consistent with the practice of open trade. With adoption of the Code voluntary, more than 60 national standards bodies currently adhere to it.

Provisions for developing countries

The Agreement recognizes the difficulties that developing countries face in complying with its provisions. It specifically recognizes that the necessary infrastructure to develop and implement standards, conformity assessment procedures and technical regulations may be underdeveloped or even non-existent. The Agreement therefore requests developed countries to give technical assistance to developing countries in any or all of the areas covered by the provisions. It also states that, in certain circumstances, developing member countries may be excused from adhering to the provisions of the Agreement if they have special developmental, financial and trade needs.

The committee on technical barriers to trade

As part of its responsibilities to ensure the full and effective implementation of the Agreement for an open world economy, the TBT Committee conducts a triennial review to assess the operation of the Agreement. In its first review, which was submitted in November 1997, the Committee reported that the degree of country implementation of the Agreement "was not satisfactory". The Committee noted the important role that international standards play in productive efficiency, international trade and the transfer of technology from developed to developing countries. However, it felt that member countries do not fully comply with the procedures outlined in the Agreement relating to the development and use of standards and technical regulations. For instance, many members do not fully participate in the process of developing international standards. This means that there exist international standards which do not incorporate the interests of all affected parties and may have an adverse effect on international trade. Regarding conformity assessment, the Committee reported that complex and duplicative conformity assessment procedures create costly, unnecessary barriers to international trade. It was agreed that the Committee would research the principle of "one standard, one test", which would be accepted everywhere in order to help countries more easily meet the requirements that other countries and regional groups impose for market access for goods. The Committee was also of the opinion that initial steps must be taken to establish confidence in the conformity assessment procedures of other WTO members by adopting common procedures such as those specified in ISO/IEC Guides.

The Committee encouraged national standards developing bodies to adhere to the Code of Good Practice, citing the adverse effects on trade should national bodies not conform to international practices and adopt international standards whenever possible. National standards-developing bodies were also encouraged to play a larger role in developing international standards and to coordinate their involvement with other standards-developing bodies in their particular country and region.

The Committee also recognized that developing countries may face difficulties in complying with the notification procedures required under the TBT. Issues noted for future examination by the Committee include capacity building, dissemination of knowledge about TBTs, the role of developing countries in international standards developing bodies and the convening of international TBT-related meetings in developing countries.

10.3 Agreement on the Application of Sanitary and Phytosanitary Measures

In August 1997, the United States of America brought before the WTO Dispute Settlement Board a case concerning the European Union's Council "Directive 81/602/EEC", Council "Directive 88/146/EEC" and Council "Directive 88/299/EEC". The United States claimed that these directives violate several international agreements, including the WTO Agreement on the Application of Sanitary and Phytosanitary Measures. The directives prohibit the import of meat to which growth- promoting hormones have been administered and further prohibit the placing on the market of meat from such animals; the processing of meat from such animals and the placing on the market of me at products prepared from or with such meat. Claiming this was a protectionist measure enacted to block imports, the United States engaged in bilateral discussions to resolve the situation. When these efforts failed, the United States brought the case before the Dispute Settlement Board, with Australia, Canada, New Zealand and Norway reserving their rights to participate in the Panel proceedings as third parties. WTO recognizes that some trade restrictions may be necessary to adequately protect national food safety and animal and plant health but such measures should be justified in accordance with WTO rules. Otherwise, sanitary and phytosanitary regulations may be used in an unnecessary and unjustifiable manner to protect domestic industries from import competition.

Agreement on the application of sanitary and phytosanitary measures

The WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) addresses the above issues. It is a stand-alone Agreement that applies to all domestically produced food or local animal and plant pests and diseases, as well as all imported products. The Agreement is based on previous GATT measures enacted to restrict the use of SPS measures for trade protection. The following are specific provisions of the Agreement:

(i) Members have the right to protect health through the application of sanitary and phytosanitary measures, provided these measures are not more trade restrictive than necessary to ensure an adequate level of health protection and provided the measures are based on scientific principles;

(ii) Members should harmonize sanitary and phytosanitary measures with international standards, guidelines and recommendations as much as possible;

(iii) Members should participate in relevant international standards organizations which develop sanitary and phytosanitary standards, guidelines and recommendations;

(iv) Members should accept the SPS measures of all other countries on an equal basis when the exporting countries demonstrate that their measures achieve the level of health protection required by the importing country;

(v) Members should develop appropriate risk assessment methods as a basis for sanitary and phytosanitary measures;

(vi) Members do not have to align sanitary and phytosanitary measures to international standards should scientific evidence indicate that there are health risks entailed should the country do so;

(vii) Members should notify standards and technical regulations pertaining to sanitary and phytosanitary goods to other members;

(viii) Members should observe procedures for control, inspection and approval. While the SPS Agreement does not prohibit countries from developing and implementing national standards that are more stringent than international standards, members must be aware that if they do not align national requirements with international requirements, they will have to justify their reasons for a more stringent standard if this standard restricts trade. The SPS Agreement specifically notes that there are alternatives to trade barriers which also ensure national protection of health. Examples are quarantining, treatment and increased inspections.

Provisions for developing countries

By decreasing trade obstruction, the Agreement has the potential to benefit consumers and food and agricultural product industries in all WTO member countries. It also has the potential to benefit developing countries even more. Like the TBT Agreement, the SPS Agreement contains special provisions for developing countries. It recognizes that many developing countries have inadequate food safety and animal and plant health protection systems. Developed countries are therefore encouraged to assist developing countries in implementing this infrastructure. The Agreement accords developing countries more time to meet SPS requirements than developed countries. In the interim, developing countries' SPS measures do not have to comply with the provisions detailed in the SPS Agreement. Another advantage of the Agreement for developing countries is the fact that the Agreement is international in scope, meaning that the same SPS measures apply equally to all countries. No country can be discriminated against with regard to sanitary and phytosanitary products based on other reasons. In addition, the Agreement mandates that, regardless of origin, all food and agricultural products be accepted for import, as long as the product in question meets the safety requirements of the importing country.

Sanitary and phytosanitary committee

A Sanitary and Phytosanitary Committee has been established to monitor the implementation of the Agreement. It meets twice a year and thus far has undertaken work on notification requirements, risk assessment procedures and issues pertaining to monitoring the use of international standards.

10.4 Other trade-related international regulatory issues

Many other trade-related international regulatory issues also have the potential to create unnecessary barriers that may distort trade. These issues affect both developed and developing WTO members and include topics such as environment, labour standards, trade-related aspects of intellectual property rights (TRIPS) and trade- related investment measures (TRIMs).

Environment

WTO transparency provisions ensure that members' environmental and trade policies are implemented in a complementary way. They also help to ensure that environmental requirements such as labelling and packaging requirements do not create unnecessary trade restrictions. However, should the situation arise, WTO members may place needs such as regarding the environment, national public health, or safety, ahead of their WTO obligation not to implement trade restrictions. In this case, environmental measures that incorporate trade provisions must not discriminate between domestic goods and imports, nor between different trading partners. ISO 14001 (the international environmental management systems requirements standard) is heavily discussed and debated by countries in economic transition. While it is clear that product-related eco-labels and related standards are covered by the TBT Agreement, the position is less clear for environmental management systems. The question as to whether management standards (such as ISO 9000 and 14000) or only those standards directly related to products should be covered by the Agreement remains subject to internal discussion at WTO. There is as yet no empirical evidence of trade implications arising from the use of the ISO 14000 series of standards. Trade-related measures permitted for environmental purposes include those carried out within the framework of multilateral environmental agreements (MEA). Although most MEAs do not contain such environmental measures the few that do also contain provisions relating to non-discrimination and transparency. WTO notes that MEAs provide an effective alternative to trade obstruction in order to achieve multilateral solutions to trans-boundary environmental problems. The gradual removal of other trade restrictions, specifically tariffs, non-tariff barriers, as well as export and import restrictions, has fostered hope among both developed and developing countries that a more open multilateral trade system will facilitate the protection of the environment and accelerate the progress of sustainable development efforts.

Labour standards

Labour standards refer to core standards governing the way workers are treated. The current body with responsibility for labour standards is the International Labour Organization (ILO). Although WTO is not carrying out any studies on the subject, some WTO members feel that labour standards are also an appropriate subject for WTO to examine. Thus far, WTO has for various reasons considered labour rights to be outside its purview. The first issue concerns the appropriateness of establishing a relationship between trade action and core labour rights. Some members claim that to do so would create an excuse for protectionism. A central question here is whether countries that are violating workers' rights should be subject to disciplinary trade action. A second issue relates to the assertion that countries with lower labour standards have an unfair export advantages, an assertion if proved true could mean that labour standards may indeed be included within the scope of WTO. Many developed member countries of WTO consider labour standards an appropriate issue to be discussed in the forum of WTO. They argue that encouragement from WTO would provide a powerful incentive for other members to improve work conditions. Other members feel that establishing a link between labour standards and multilateral trade negotiations would create an easy justification for protectionism. Still other countries feel that the effort to bring discussions about labour standards into WTO is but a ploy by developed countries to undermine the comparative advantage of countries, particularly low-wage developing countries, as noted during the WTO Singapore Ministerial Conference in 1996.

10.5 Agreement on trade-related investment measures (TRIMs)

The Agreement on Trade-Related Investment Measures (TRIMs) is an elaboration of GATT recognition that investment measures may restrict and distort trade. Noting that international investment promotes economic growth, the Agreement has objectives for the promotion of free trade and the facilitation of international investment. Similar to the TBT and SPS agreements, the provisions of the TRIMs Agreement state that:

(i) National treatment shall be accorded to all products, regardless of origin;

(ii) Members will notify all non-conforming TRIMs, with the goal of eliminating these TRIMs within a certain time period;

(iii) Members may apply non-conforming TRIMs to new enterprises during the member's transition period provided the reason for such an action does not put disadvantages to the established enterprises which are subject to the TRIMs and provided the TRIMs are eliminated within the established time-frame;

(iv) Members must ensure that TRIMs are transparent.

The TRIMs Agreement includes a list of examples of non-conforming TRIMs. Two examples of non-conforming TRIMs are local content requirements and trade- balancing requirements. The time line for elimination of non-conforming TRIMs is two years for developed countries, five years for developing countries and seven years for least developed countries. In addition to stating that developing countries have a longer period of time to eliminate non-conforming TRIMs, it is emphasized that developing member countries gain the most from the Agreement in terms of investment, which will lead to economic growth. In addition, it is recognized that developing countries have special trade, development and financial needs that must be taken into consideration when implementing this Agreement.

10.6 Agreement on trade-related aspects of intellectual property rights (TRIPs)

Intellectual property rights are the rights over an individual's own creation. The rights belong exclusively to the individual for a certain period of time. Because of widely varying standards and regimes to protect and enforce intellectual property rights, barriers to trade have been created in the areas of copyright issues and industrial property. Theft and counterfeiting are rampant. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) builds on the obligations derived at the Berne, Paris and Rome conventions. It covers issues pertaining to copyright, trademarks, geographical indications, industrial designs, patents, licensing practices, protection of undisclosed information and layout designs of integrated circuits. In each of these areas, minimum standards of protection are established.

Similar to other WTO agreements, the Agreement urges members to:

(i) Respect obligations agreed upon in previous conventions;

(ii) Not discriminate between relevant domestically produced and imported products, nor between trading partners;

(iii) Protect and enforce intellectual property rights in a way that promotes technological innovation, technology transfer and social and economic welfare;

(iv) Adopt measures to promote public health and welfare and public interest in sectors of socio-economic and technological development, as long as those measures are not in conflict with other provisions of the Agreement;

(v) Ensure that intellectual property rights procedures are applied in a manner so as not to create barriers to trade;

(vi) Ensure that intellectual property rights are not abused thereby causing trade to be adversely impacted; and

(vii) Ensure that procedures concerning the enforcement of intellectual property rights are open and fair.

The Agreement includes special provisions for developing countries and some countries in economic transition. While developed member countries have one year to meet their obligations, developing countries and select countries in economic transition have five years and least developed countries have up to eleven years. Countries in economic transition that fall into this category are those which are facing problems in preparing and implementing intellectual property laws. These countries must ensure that any regulations later implemented do not violate the TRIPS Agreement. As in the SPS and TBT agreements, this Agreement requests technical assistance from developed countries to developing countries.

10.7 The multilateral trading system and countries in economic transition

A country in economic transition to a market system may encounter specific obstacles to participating in world trade. These obstacles may differ from those encountered by market-oriented systems. To understand the obstacles, the principal goals of WTO will be revisited. These goals are, to:

(i) Ensure non-discrimination;

(ii) Decrease trade barriers;

(iii) Increase confidence by trading partners that they will not be subject to arbitrary tariffs;

(iv) Increase competition through fair and open trade; and

(v) To ensure that special needs of developing countries are adequately met in provisions of multilateral trade agreements.

10.8 Benefits for countries in economic transition

Some countries in economic transition are already members of WTO. Others are currently acceding or considering accession to WTO. WTO emphasizes the importance of transparent trade regimes in facilitating an open trading system between members. For a country with an economy in transition, greater transparency will help develop and improve trade relations, attract foreign direct investment and ensure that once trade reforms are achieved, they will be maintained in spite of domestic protectionist impulses. These improvements will, in turn, better enable the countries to complete the transition to market systems. There is debate over whether WTO membership helps accelerate this transition and whether a quick transition is better than a slow one. Countries undergoing slow reforms claim that this strategy helps them better finance the high cost of transition, while those undergoing a quick transition claim they are better able to arrest declining output and set their economies on the road to a stable, market-oriented economy. While there are no definitive case studies showing that WTO membership has any effect on the rate of the transition process, many countries in transition believe that membership does accelerate the process. For countries in transition, WTO also provides a forum for fair trade. The WTO treats all of its members equally, regardless of geographic location or size. This equal treatment extends to the dispute-settlement mechanism of WTO, ensuring that trade disputes are settled in a fair manner.

10.9 Entering the multilateral trading system: Difficulties

It may be difficult for some countries in transition to meet the goals of WTO. These countries, therefore, need to consider carefully the requirements they must meet as members of WTO. The TBT and SPS agreements contain six core common provisions:

(i) Measures to protect human or plant and animal life or health or the environment are allowed so long as these measures are not more trade- restrictive than necessary;

(ii) Non-discrimination;

(iii) Acceptance of the trade and SPS measures of other members so long as they meet the objectives of the importing country;

(iv) Alignment of technical regulations with international regulations and participation in international standards developing bodies;

(v) Transparency of technical regulations;

(vi) Special measures for developing countries.

To achieve these goals, the countries in transition must make several changes. They need to develop and maintain sound regulatory, legislative, enforcement and institutional frameworks. A regulatory regime that comprises complex or badly implemented regulations will obstruct economic growth, competitiveness, foreign investment and job creation and will raise administrative costs. On the other hand, regulations that are properly constructed and implemented can help create competitive market economies and raise living standards. It can be difficult for countries in economic transition to develop and implement sound regulatory regimes. One obstacle is their limited access to pertinent information and technical expertise. When drafting legislation related to regulatory reform, many countries find themselves lacking adequate sources of information and expertise about current regulatory issues and thus draft inappropriate or ineffective legislation. Another problem is enforcement. Even if properly drafted legislation is in place, these countries may not have the necessary infrastructure to enforce such legislation. For this they will require investment in institutions, equipment, personnel and training.

10.10 Difficulties faced by countries in economic transition in entering the multilateral trading system

Agreement on Technical Barriers to Trade

The central tenet of the TBT Agreement is to decrease trade barriers and the various distortions that they bring. When the barriers are decreased in an effective manner, this has a twofold effect on countries in economic transition. First, exposure to international competition forces changes in the domestic production systems and regulations, thereby increasing the efficiency of domestic producers. Secondly, the depth of trade-policy reform helps/influence the scope and rate of other structural changes being implemented. It has been suggested by both developing countries and countries in transition that some of the most effective ways for countries in transition to further their participation in the multilateral trading system are by:

(i) Ensuring consistency between trade and macroeconomic policies;

(ii) Considering use of trade-policy mechanisms for nontrade objectives if necessary (such as collecting revenue);

(iii) Consider using WTO-monitored import taxation as a means of addressing balance-of-payments problems resulting from difficulties faced by economies in transition in accessing markets of developed countries.

In terms of TBT requirements concerning participation in bodies that develop international standards, several countries have pointed out that the situation of developing countries and of countries in economic transition differs from that of developed countries. Less developed countries often do not have the funding to participate in these activities. They argue that because of this international standards are based on the needs of technologically developed countries. They go on to state that countries which cannot participate in the development of standards are also unlikely to have the means to comply with those standards, either financially or technologically. Developing countries and countries in transition note, for instance, the potentially high expenditure associated with putting in place conformity assessment infrastructures that will enable them to certify locally produced products to meet international requirements. Many countries do not have operational accreditation infrastructures that could provide a basis for the recognition of test results and certificates in foreign markets. They also lack the funds required to purchase the necessary equipment.

An even more significant problem in some countries is the lack of trained personnel.

Agreement on the Application of Sanitary and Phytosanitary Measures

The SPS Agreement deals with domestic and imported food or local animal and plant pests and diseases. It has generally been agreed that this Agreement marks the beginning of a turning away from government control over these goods and will gradually allow a more market controlled system. For countries in economic transition, current exports in goods regulated by SPS measures have been disappointing owing to the products' inability to meet the sanitary and quality standards required in destination countries. This decrease in international trade, coupled with factors such as low productivity and high input costs present in the agricultural industry, helps to illustrate why domestic producers often cannot afford to buy the base agricultural products with which to make a finished good even though they may have the technology and training to do so. These base materials are often exported to be made into a finished product which is then imported back into the country.These obstacles can be resolved if effective SPS measures are implemented. As with trade policies, international competition will force the restructuring of resources and agricultural policies. To help create the appropriate legal and institutional framework and to train personnel, assistance is provided under the SPS Agreement by developed countries.

Environment

Countries in transition recognize that environmental issues cannot be ignored in the privatization process. They also recognize that in the light of WTO agreements, they hould not implement policies that are more trade restrictive than necessary while attempting to protect the environment. In addition, investment is needed to develop environmental policies and risk assessment methods in order to better address pollution control and conservation. There are two key ways in which countries in economic transition are seeking to resolve the question of environmental investment. First, the provisions of the international agreements mentioned in this paper call for technical assistance for developing countries. Countries in economic transition could use this assistance to provide environmental facilities, equipment, personnel and training. This assistance could also be provided in the form of loans by international financial institutions. The second way for these countries to address environmental concerns has been to earmark revenues derived from other means for environmental improvements. However, it is often difficult to collect the pollution charges and other fees that serve as the main source of revenues for these funds. In addition, there may be numerous bureaucratic difficulties involved in the management of environmental funds.

Labour standards

In terms of labour standards, many countries in economic transition currently lack proper mechanisms to enforce labour laws. In addition, many labour laws are not complementary with current social policies, such as retirement incentives. Countries in transition need to create more employment (but with a different allocation of labour resources among different industries) if they are to restructure effectively and to maintain the non-inflationary growth. To do so, they have begun investing in their labour forces by providing services such as training and job placement.

These countries also need to develop effective mechanisms for enforcing labour standards. While many have begun restructuring their enforcement mechanisms, others have not yet done so to any significant extent. With this in mind, many countries in transition argue that it is inappropriate to link labour standards to trade action at this time. To do so may enable other countries to use labour issues as a shield for protectionism which could damage the trade, and hence the output, of countries in economic transition.

Agreement on Trade-Related Investment Measures

The TRIMs Agreement cites international investment as an engine of growth. To attract investment, there must be confidence in the country's economic stability. The countries must therefore implement reforms in the financial sector. The banking system and capital markets must be strengthened, inflation must be curbed and the current account deficit stabilized. Enterprises which are still State-owned must be privatized and the countries must eliminate all non-conforming TRIMs.

Agreement on Trade-Related Aspects of Intellectual Property Rights

The TRIPS Agreement presents a special challenge for countries in transition. Theft and counterfeiting of intellectual property are widespread throughout the world but especially in developing countries and countries in economic transition. Technologically advanced countries are putting heavy pressure on developing countries and countries in transition to develop and enforce intellectual property rights procedures. However, as with the other WTO agreements, countries in transition may lack the necessary infrastructure to adequately monitor intellectual property rights. Another disadvantage is that costs of enforcement may be higher. Lastly, the fact that much of the violation of intellectual property rights takes place underground or on the black market makes violations extremely difficult to monitor. Countries in economic transition will therefore need to develop a sound regulatory and legislative framework to enforce intellectual property rights. One advantage for these countries is that a number of reviews of countries already meeting their TRIPS obligations have been carried out. The results of these reviews serve as models for countries seeking to implement their own intellectual property rights legislation.

10.11 Summary

To achieve a multilateral trading system that offers fair trade to all its members and promotes economic growth, one has to overcome several barriers. Potential barriers to trade include standards, technical regulations, conformity assessment procedures, sanitary and phytosanitary measures, environmental issues, labour standards, trade- related investment measures, as well as trade-related aspects of intellectual property rights. Overall, most countries in economic transition will need to restructure their institutional, legislative and regulatory frameworks, as well as to invest in human resources and equipment in order to enter effectively the world market. Developed countries can help in these matters through financial investment and through technical assistance. WTO has already reviewed some of the agreements for effectiveness and has mechanisms in place to review most of the other areas mentioned. All the agreements and discussions share one common characteristic. They all contain the underlying theme that one day the global market place will become a true global market place where all producers can sell their goods without fear of encountering trade discrimination or restrictions.

10.12 Glossary

Agreement on Technical Barriers to Trade (TBT) – This includes specific provisions regarding technical regulations, standards, conformity assessment procedures, notification requirements, and standard-setting bodies.

Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) – This deals with domestic and imported food, as well as local animals, plants, pests, and diseases.

WTO: World Trade Organization,

TBT: Agreement on Technical Barriers to Trade,

SPS: Sanitary and Phytosanitary Measures,

ILO: International Labour Organization,

TRIMs: Agreement on Trade-Related Investment Measures,

TRIPS: Agreement on Trade-Related Aspects of Intellectual Property Rights.

10.13 Check your progress

(a) **Fill in the blanks:**

(1) The World Trade Organization supports a free and multilateral trading system by encouraging member countries to adhere to .... fundamental principles.

(2) The Agreement on Technical Barriers to Trade (TBT) was adopted in ....

(3) The Sanitary and Phytosanitary Committee meets .... times a year.

(4) The TRIMs Agreement presents international investment as a means of .... growth.

(5) The TBT and SPS agreements contain .... common provisions.

10.14 Answer to check your progress

(a) (1) Five (2) In 1994 (3) Two (4) Engine (5) 6.

(b) (1) True (2) True (3) False (4) True (5) True.

10.15 Terminal question

1. Explain various provisions about an agreement on technical barriers to trade.
2. Describe different provisions for developing countries towards agreement on technical barriers to trade.
3. Write down provisions about an agreement on the application of sanitary and phytosanitary measures.
4. Discuss different trade-related international regulatory issues.
5. Describe various provisions about an agreement on trade-related investment measures (TRIMs).
6. What do you mean by agreement on trade-related aspects of intellectual property rights (TRIPs)? Explain.
7. Elaborate the concepts of the multilateral trading system and countries in economic transition.
8. What are the benefits for countries in economic transition?
9. What types of difficulties faced by countries in economic transition in entering the multilateral trading system? Explain.

10.16 Suggest readings

1. United Nations Economic Commission for Europe Standards and Regulations in International Trade (1998). Summary of Proceedings of Round Table on the impact of standards on international trade, Geneva, June 15. Retrieved from http://www.unece.org/fileadmin/DAM/trade/ctied/wp6/documents/ece-trd-248.pdf on November 29, 2013.
2. Hill, Charles W. L. (2005). *International Business*. Boston, MA: McGraw Hill/Irwin.
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11 Unit- Regional Economic Integration

Structure:

Objectives:

After going through this lesson, you will be able to understand

- The concept of regional economic integration and
- You can identify the major regional economic areas of cooperation.

11.1 **Introduction**

An economic integration is an arrangement between two or more regions to reduce or to abolish the trade barriers and to maintain the coordination between monetary and fiscal policies. The aim of economic integration is to reduce costs for both consumers and producers, as well as to increase trade between the countries taking part in the agreement. There are varying levels of economic integration, including preferential trade agreements (PTA), free trade areas (FTA), customs unions, common markets and economic and monetary unions.

The more integrated the economies become, the fewer trade barriers exist and the more economic and political coordination there is between the member countries. By integrating the economies of more than one country, the short-term benefits from the use of tariffs and other trade barriers is diminished. At the same time, the more integrated the economies become, the less power the governments of the member nations have to make adjustments that would benefit themselves. In periods of economic growth, being integrated can lead to greater long-term economic benefits; however, in periods of poor growth being integrated can actually make things worse

11.2 Concept of Regional Economic Integration

The concept of regional economic integration implies that nations of a geographic region come together in some type of partnership to foster trade and development. Regional economic integration can be manifest as a free trade area, a customs union, a common market, an economic union, or in its most extreme form, as a political union. NAFTA, discussed below, is an example of a free trade area, while the European Union (EU) evolved from a common market form of regional economic integration (i.e., the European Common Market) to an economic union. In brief, regional economic integration has enabled countries to focus on issues that are relevant to their stage of development as well as encourage trade between neighbors. There are four main types of regional economic integration.

11.2.1 Free trade area:

This is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves but are free to independently determine trade policies with nonmember nations. An example is the North American Free Trade Agreement (NAFTA).

11.2.1Customs union:

This type provides for economic cooperation as in a free- trade zone. Barriers to trade are removed between member countries. The primary difference from the free trade area is that members agree to treat trade with nonmember countries in a similar manner. The Gulf Cooperation Council (GCC) is an example.

11.2.2 Common market:

This type allows for the creation of economically integrated markets between member countries. Trade barriers are removed, as are any restrictions on the movement of labor and capital between member countries. Like customs unions, there is a common trade policy for trade with nonmember nations. The primary advantage to workers is that they no longer need a visa or work permit to work in another member country of a common market. An example is the Common Market for Eastern and Southern Africa (COMESA).

11.2.3 Economic union:

This type is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies. An example is the European Union (EU). In the past decade, there has been an increase in these trading blocs with more than one hundred agreements in place and more in discussion. A trade bloc is basically a free-trade zone, or near-free-trade zone, formed by one or more tax, tariff, and trade agreements between two or more countries. Some trading blocs have resulted in agreements that have been more substantive than others in creating economic cooperation. Of course, there are pros and cons for creating regional agreements.

11.3 Advantages and Disadvantages of Regional Economic Integration

The advantages of creating regional agreements include the following:

1) Trade creation:

These agreements create more opportunities for countries to trade with one another by removing the barriers to trade and investment. Due to a reduction or removal of tariffs, cooperation results in cheaper prices for consumers in the bloc countries. Studies indicate that regional economic integration significantly contributes to the relatively high growth rates in the less-developed countries.

2) Employment opportunities:

By removing restrictions on labor movement, economic integration can help expand job opportunities.

(i) **Consensus and cooperation:** Member nations may find it easier to agree with smaller numbers of countries. Regional understanding and similarities may also facilitate closer political cooperation.

The disadvantages of creating regional agreements include the following:

(i) **Trade diversion:** The flip side to trade creation is trade diversion. Member countries may trade more with each other than with nonmember nations. This may mean increased trade with a less efficient or more expensive producer because it is in a member country. In this sense, weaker companies can be protected inadvertently with the bloc agreement acting as a trade barrier. In essence, regional agreements have formed new trade barriers with countries outside of the trading bloc.

(ii) **Employment shifts and reductions:** Countries may move production to cheaper labor markets in member countries. Similarly, workers may move to gain access to better jobs and wages. Sudden shifts in employment can tax the resources of member countries.

(iii) Loss of national sovereignty: With each new round of discussions and agreements within a regional bloc, nations may find that they have to give up more of their political and economic rights. In the opening case study, you learned how the economic crisis in Greece is threatening not only the EU in general but also the rights of Greece and other member nations to determine their own domestic economic policies.

11.4 Major Areas of Regional Economic Integration and Cooperation

There are more than one hundred regional trade agreements in place, a number that is continuously evolving as countries reconfigure their economic and political interests and priorities. Additionally, the expansion of the World Trade Organization (WTO) has caused smaller regional agreements to become obsolete. Some of the regional blocs also created side agreements with other regional groups leading to a web of trade agreements and understandings.

North America: NAFTA

The North American Free Trade Agreement (NAFTA) came into being during a period when free trade and trading blocs were popular and positively perceived. In 1988, the United States and Canada signed the Canada–United States Free Trade Agreement. Shortly after it was approved and implemented, the United States started to negotiate a similar agreement with Mexico. When Canada asked to be party to any negotiations to preserve its rights under the most-favored-nation clause (MFN), the negotiations began for NAFTA, which was finally signed in 1992 and implemented in 1994. The goal of NAFTA has been to encourage trade between Canada, the United States, and Mexico. By reducing tariffs and trade barriers, the countries hope to create a free-trade zone where companies can benefit from the transfer of goods. In the 1980s, Mexico had tariffs as high as 100 percent on select goods. Over the first decade of the agreement, almost all tariffs between Mexico, Canada, and the United States were phased out. The rules governing origin of content are key to NAFTA. As a free trade agreement, the member countries can establish their own trading rules for nonmember countries. NAFTA's rules ensure that a foreign exporter won't just ship to the NAFTA country with the lowest tariff for nonmember countries. NAFTA rules require that at least 50 percent of the net cost of most products must come from or be incurred in the NAFTA region. There are higher requirements for footwear and cars.

For example, this origin of content rule has ensured that cheap Asian manufacturers wouldn't negotiate lower tariffs with one NAFTA country, such as Mexico, and dump cheap products into Canada and the United States. Mexican maquiladoras have fared well in this arrangement by being the final production stop before entering the United States or Canada. Maquiladoras are production facilities located in border towns in Mexico that take imported materials and produce the finished goods for export, primarily to Canada or the United States. Canadian and US consumers have benefited from the lower-cost Mexican agricultural products. Similarly, Canadian and US companies have sought to enter the expanding Mexican domestic market. Many Canadian and US companies have chosen to locate their manufacturing or production facilities in Mexico rather than Asia, which was geographically far from their North American bases.

When it was introduced, NAFTA was highly controversial, particularly in the United States, where many felt it would send US jobs to Mexico. In the long run, NAFTA hasn't been as impactful as its supporters had hoped nor as detrimental to workers and companies as its critics had feared. As part of NAFTA, two side agreements addressing labor and environmental standards were put into place. The expectation was that these side agreements would ensure that Mexico had to move toward improving working conditions.Mexico has fared the best from NAFTA as trade has increased dramatically. Maquiladoras in Mexico have seen a 15 percent annual increase in income. By and large, Canadians have been supportive of NAFTA and exports to the region have increased in the period since implementation. "Tri-lateral [merchandise] trade has nearly tripled since NAFTA came into force in 1994. It topped $1 trillion in 2008." Given the 2008 global economic recession and challenging impact on the EU, it isn't likely that NAFTA will move beyond the free-trade zone status to anything more comprehensive (e.g., the EU's economic union). In the opening case study, you read about the pressures on the EU and the resistance by each of the governments in Europe to make policy adjustments to address the recession. The United States, as the largest country member in NAFTA, won't give up its rights to independently determine its economic and trade policies. Observers note that there may be the opportunity for NAFTA to expand to include other countries in Latin America. Chile was originally supposed to be part of NAFTA in 1994, but President Clinton was hampered by Congress in his ability to formalize that decision. Since then, Canada, Mexico, and the United States have each negotiated bilateral trade agreements with

Chile, but there is still occasional mention that Chile may one day join NAFTA.

South America: MERCOSUR

The Common Market of the South, Mercado Comin del Sur or Mercosur, was originally established in 1988 as a regional trade agreement between Brazil and Argentina and then was expanded in 1991 to include Uruguay and Paraguay. Over the past decade, Bolivia, Chile, Colombia, Ecuador, and Peru have become associate members, and Venezuela is in the process for full membership. MERCOSUR constituents compose nearly half of the wealth created in all of Latin America as well as 40 percent of the population. Now the world's fourth-largest trading bloc after the EU, NAFTA, and the Association of South East Asian Nations (ASEAN), the group has been strategically oriented to develop the economies of its constituents, helping them become more internationally competitive so that they would not have to rely on the closed market arena. MERCOSUR has brought nations with long-standing rivalries together. Although this is an economic trade initiative, it has also been designed with clear political goals. MERCOSUR is committed to the consolidation of democracy and the maintenance of peace throughout the southern cone. For example, it has taken stride to reach agreements between Brazil and Argentina in the nuclear field. MERCOSUR has emerged as one of the most dynamic and imaginative initiatives in the region. Surging trade, rising investment, and expanding output are the economic indicators that point to the group's remarkable achievement. More than this, the integration is helping transform national relations among South American nations and with the world as a whole, forging a new sense of shared leadership and shared purpose, which is sending ripples of hope across the continent and beyond.

CARICOM and Andean Community

The Caribbean Community and Common Market (CARICOM), or simply the Caribbean Community, was formed in 1973 by countries in the Caribbean with the intent of creating a single market with the free flow of goods, services, labor, and investment. The Andean Community (called the Andean Pact until 1996) is a free trade agreement signed in 1969 between Bolivia, Chile, Colombia, Ecuador, and Peru. Eventually Chile dropped out, while Venezuela joined for about twenty years and left in 2006. This trading bloc had limited impact for the first two decades of its existence but has experienced a renewal of interest after MERCOSUR's implementation. In 2007, MERCOSUR members became associate members of the Andean Community, and more cooperative interaction between the trading groups is expected.

CAFTA-DR

The Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR) is a free trade agreement signed into existence in 2005. Originally, the agreement (then called the Central America Free Trade Agreement, or CAFTA) encompassed discussions between the US and the Central American countries of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. Also, before the official signing of the agreement, the Dominican Republic joined the negotiations and the agreement was renamed as CAFTA-DR.

The goal of the agreement is the creation of a free trade area similar to NAFTA. For free trade advocates, the CAFTA-DR is also seen as a stepping stone toward the eventual establishment of the Free Trade Area of the Americas (FTAA)—the more ambitious grouping for a free trade agreement that would encompass all the South American and Caribbean nations as well as those of North and Central America (except Cuba). Canada is currently negotiating a similar treaty called the Canada Central American Free Trade Agreement. It's likely that any resulting agreements will have to reconcile differences in rules and regulations with NAFTA as well as any other existing agreements.

Europe: EU

The European Union (EU) is the most integrated form of economic cooperation. As you learned in the opening case study, the EU originally began in 1950 to end the frequent wars between neighboring countries in the Europe. The six founding nations were France, West Germany, Italy, and the Benelux countries (Belgium, Luxembourg, and the Netherlands), all of which signed a treaty to run their coal and steel industries under a common management. The focus was on the development of the coal and steel industries for peaceful purposes. In 1957, the six nations signed the Treaty of Rome, which established the European Economic Community (EEC) and created a common market between the members. Over the next fifty years, the EEC added nine more members and changed its name twice—to European Community (EC) in the 1970s and the European Union (EU) in 1993. The entire history of the transformation of the EEC to the EU has been an evolutionary process. However, the Treaty of Maastricht in 1993 stands out as an important moment; it's when the real economic union was created. With this treaty, the EU identified three aims. The first was to establish a single, common currency, which went into effect in 1999. The second was to set up monetary and fiscal targets for member countries. Third, the treaty called for a political union, which would include the development of a common foreign and defense policy and common citizenship. The opening case study addressed some of the current challenges the EU is facing as a result of the impact of these aims. Despite the challenges, the EU is likely to endure given its historic legacy. Furthermore, a primary goal for the development of the EU was that Europeans realized that they needed a larger trading platform to compete against the US and the emerging markets of China and India. Individually, the European countries would never have the economic power they now have collectively as the EU. Today, the EU has twenty-seven member countries. Croatia, Iceland, Macedonia, and Turkey are the next set of candidates for future membership. In 2009, the twenty- seven EU countries signed the Treaty of Lisbon, which amends the previous treaties. It is designed to make the EU more democratic, efficient, and transparent and to tackle global challenges, such as climate change, security, and sustainable development. The European Economic Area (EEA) was established on January 1, 1994, following an agreement between the member states of the European Free Trade Association (EFTA) and the EC (later the EU). Specifically, it has allowed Iceland (now an EU candidate), Liechtenstein, and Norway to participate in the EU's single market without a conventional EU membership. Switzerland has also chosen to not join the EU, although it is part of similar bilateral agreements. The biggest advantage of EU membership is the monetary union. Today, sixteen member countries use the the euro. Since its launch, the euro has become the world's second-largest reserve currency behind the US dollar. It's important to remember several distinctions. First, the EU doesn't consist of the same countries as the continent of Europe. Second, there are more EU member countries than there are countries using the euro. Euro markets, or euro countries, are the countries using the euro. The European single market is the foremost advantage of being a member of EU. According to Europa, which is the official website of the EU (http://europa.eu), the EU member states have formed a single market with more than five hundred million people, representing 7 percent of the world's population. This single market permits the free flow of goods, service, capital, and people within the EU. Although there is a single tariff on goods entering an EU country, once in the market, no additional tariffs or taxes can be levied on the goods. Businesses conducting business with one country in the EU now find it easier and cheaper, in many cases, to transact business with the other EU countries. There's no longer a currency–exchange rate risk, and the elimination of the need to convert currencies within euro markets reduces transaction costs. Further, having a single currency makes pricing more transparent and consistent between countries and markets. Despite the perceived benefits, economic policymakers in the EU admit that the Union's labor markets are suffering from rigidity, regulation, and tax structures that have contributed to high unemployment and low employment responsiveness to economic growth. This is the case, particularly, for relatively low-skilled labor.

Europe's economy faces a deeper recession and a slower recovery than the United States or other parts of the world. Because the EU's $18.4 trillion economy makes up 30 percent of the world economy, its poor prospects are likely to rebound on the United States, Asia, and other regions. Fixing the EU's banking system is particularly tricky, because sixteen of the twenty-seven countries share the euro currency and a central bank, but banking regulation mostly remains under the control of the national governments. The Europe 2020 strategy put forth by the European Commission sets out a vision of the EU's social market economy for the twenty-first century. It shows how the EU can come out stronger from this crisis and how it can be turned into a smart, sustainable, and inclusive economy delivering high levels of employment, productivity, and social cohesion. It calls for stronger economic governance in order to deliver rapid and lasting results.

Asia: ASEAN

The Association of Southeast Asian Nations (ASEAN) was created in 1967 by five founding-member countries: Malaysia, Thailand, Indonesia, Singapore, and the Philippines. Since inception, Myanmar (Burma), Vietnam, Cambodia, Laos, and Brunei have joined the association. ASEAN's primary focus is on economic, social, cultural, and technical cooperation as well as promoting regional peace and stability. Although less emphasized today, one of the primary early missions of ASEAN was to prevent the domination of Southeast Asia by external powers—specifically China, Japan, India, and the United States. In 2002, ASEAN and China signed a free trade agreement that went into effect in 2010 as the ASEAN–China Free Trade Area (ACFTA). In 2009, ASEAN and India also signed the ASEAN–India Free Trade Agreement (FTA). In 2009, ASEAN signed a free trade agreement with New Zealand and Australia. It also hopes to create an ASEAN Economic Community by 2015. While the focus and function remains in discussion, the intent is to forge even closer ties among the ten member nations, enabling them to negotiate more effectively with global powers like the EU and the United States.

Asia: APEC

The Asia-Pacific Economic Cooperation (APEC) was founded in 1989 by twelve countries as an informal forum. It now has twenty-one member economies on both sides of the Pacific Ocean. APEC is the only regional trading group that uses the term member economies, rather than countries, in deference to China. Taiwan was allowed to join the forum, but only under the name Chinese Taipei.As a result of the Pacific Ocean connection, this geographic grouping includes the United States, Canada, Mexico, Chile, Peru, Russia, Papua New Guinea, New Zealand, and Australia with their Asia Pacific Rim counterparts. This assortment of economies and cultures has, at times, made for interesting and heated discussions. Focused primarily on economic growth and cooperation, the regional group has met with success in liberalizing and promoting free trade as well as facilitating business, economic, and technical cooperation between member economies. With the Doha Round of the WTO dragging, APEC members have been discussing establishing a free-trade zone. Given its broader membership than ASEAN, APEC has found good success—once its member countries agree. The two organizations often share common goals and seek to coordinate their efforts.

Middle East and Africa: GCC

The Cooperation Council for the Arab States of the Gulf, also known as the Gulf Cooperation Council (GCC), was created in 1981. The six member states are Bahrain, Kuwait, Saudi Arabia, Oman, Qatar, and the United Arab Emirates (UAE). As a political and economic organization, the group focuses on trade, economic, and social issues. The GCC has become as much a political organization as an economic one. Among its various initiatives, the GCC calls for the coordination of a unified military presence in the form of a Peninsula Shield Force.

In 1989, the GCC and the EU signed a cooperation agreement. "Trade between the EU and the GCC countries totaled €79 billion in 2009 and should increase under the FTA. And while strong economic relations remain the basis for mutual ties, the EU and the GCC also share common interests in areas such as the promotion of alternative energy, thus contributing to the resolution of climate change and other pressing environmental concerns; the promotion of proper reform for the global economic and financial policies; and the enhancement of a comprehensive rules-based international system." In 2008, the GCC formed a common market, enabling free flow of trade, investment, and workers. In December 2009, Bahrain, Saudi Arabia, Kuwait, and Qatar created a monetary council with the intent of eventually creating a shared currency. Since its creation, the GCC has contributed not only to the expansion of trade but also to the development of its countries and the welfare of its citizens, as well as promoting peace and stability in the region.

Middle East and Africa: AEC

The African Economic Community (AEC) is an organization of the African Union states. Signed in 1991 and implemented in 1994, it provides for a staged integration of the regional economic agreements. Several regional agreements function as pillars of the AEC:

(i) Community of Sahel-Saharan States (CEN-SAD)

(ii) Common Market for Eastern and Southern Africa (COMESA)

(iii) East African Community (EAC)

(iv) Economic Community of Central African States (ECCAS/CEEAC)

(v) Economic Community of West African States (ECOWAS)

(vi) Intergovernmental Authority on Development (IGAD)

(vii) Southern African Development Community (SADC)

(viii) Arab Maghreb Union (AMU/UMA)

Ambitiously, in 2017 and after, the AEC intends to foster the creation of a free-trade zone and customs union in its regional blocs. Beyond that, there are hopes for a shared currency and eventual economic and monetary union.

11.5 Impact of Regional Trade Agreements on International Business

Overall, global businesses have benefited from the regional trade agreements by having more consistent criteria for investment and trade as well as reduced barriers to entry. Companies that choose to manufacture in one country find it easier and cheaper to move goods between member countries in that trading bloc without incurring tariffs or additional regulations. The challenges for businesses include finding themselves outside of a new trading bloc or having the "rules" for their industry change as a result of new trade agreements. Over the past few decades, there has been an increase in bilateral and multilateral trade agreements. It's often called a "spaghetti bowl" of global bilateral and multilateral trade agreements, because the agreements are not linear strands lining up neatly; instead they are a messy mix of crisscrossing strands, like a bowl of spaghetti, that link countries and trading blocs in self-benefiting trading alliances. Businesses have to monitor and navigate these evolving trade agreements to make sure that one or more agreements don't negatively impact their businesses in key countries. This is one reason why global businesses have teams of in-house professionals monitoring the WTO as well as the regional trade alliances. For example, American companies doing business in one of the ASEAN countries often choose to become members of the US–ASEAN Business Council, so that they can monitor and possibly influence new trade regulations as well as advance their business interests with government entities. It’s easy to see how complicated the relationships can be with just one trading bloc. A global firm with operations in North America, the EU, and Asia could easily find itself at the crosshairs of competing trade interests. Staffed with lawyers in an advocacy department, global firms work to maintain relationships with all of the interested parties. If you are curious about a business career in trade, then you may want to consider combining a business degree with a legal degree for the most impact.

11.6 Summary

Regional economic integration refers to efforts to promote free and fair trade on a regional basis. There are four main types of economic integration such as (i) Free trade area is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves, but are free to independently determine trade policies with nonmember nations, (ii) Customs union provides for economic cooperation. Barriers to trade are removed between member countries, and members agree to treat trade with nonmember countries in a similar manner, (iii) Common market allows for the creation of an economically integrated market between member countries. Trade barriers and any restrictions on the movement of labor and capital between member countries are removed. There is a common trade policy for trade with nonmember nations, and workers no longer need a visa or work permit to work in another member country of a common market and (iv) Economic union is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies. The largest regional trade cooperative agreements are the European Union (EU), the North American Free Trade Agreement (NAFTA), and the Asia–Pacific Economic Cooperation (APEC). The African Economic Community (AEC) has more member countries than the EU, NAFTA, and APEC but represents a substantially smaller portion of global trade than these

11.7 Glossary

Regional economic integration refers to the fostering of trade and development through the collaboration of countries within a specific geographical region.

11.8 Check your progress

1. The Gulf Cooperation Council (GCC) is an example ....
2. In 1988 , ... and Canada signed the Canada-United States Free Trade Agreement.
3. The European Economic Area (EEA) was established in ....
4. AEC is an organization of the .... economic community.

11.9 Answer to check your progress

1. Customs Union 2. United States of America 3. 1 January 1994 4. African

11.10 Terminal questions

- Explain the meaning of regional economic integration.
- Outline the advantages and disadvantages of regional trade agreements.
- Describe the European Union (EU) and explain why it is considered the most highly integrated economic agreement.
- Explain two ways in which regional economic integration can assist global companies.
- Define free trade area, customs union, common market, and economic union.

11.11 Suggest readings

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Unit-12 Political, legal, and economic environment

Structure

Objective

- To acquaint the students with the business environment in the global markets.
- To understand the dynamics of political environment
- To assess the legal environment of the place of business
- To understand the economic environment faced by the companies operating in overseas markets.

12.1 Introduction

In the present multi- polar world, the situations of undertaking the business functions are much more uncertain and complex than they were in the earlier t imes. The globalization of economy has made the foreign competition knocking the doors of every company and in order to survive, they have to understand the dynamics of global business environment and their strategy formulation must entail an understanding of the crit ical importance of analysing t he international business environment. The essence of any successful busine ss strategy is its environmental orientation. Since, there are some fundamental differences between the business operations in the domestic and the international markets, for a successful strategy, there is a need to understand the complexities of the international markets. It is more than unlikely that a firm can extend its domestic strategies into the foreign markets in light of the uncertainties posed by different business environments prevailing in foreign countries. Nations differ in their political set- up, their policies, laws, rules and regulations, and the economic conditions. The ease of doing business in a foreign country would be directly affected by these factors.

The recent economic decisions taken by the g overnment and the political fallout is an example of how political environment can influence the business. For example, the recent government decisions to allow FDI into the retail and the insurance sectors has seen wide spread protests. Any foreign investor would consciously evaluate the political conditions before taking a decision to invest its money. Similarly, in the recent times, there is global economic downturn. All nations are facing the problems due to economic slowdown and the investors are keeping their fingers crossed on whether to invest or not. This unit explains the impact of various components of international business environment, particularly the political, legal and the economic environment on international business.

12.2 Components of international business environment

Before studying the political, legal and economic environments in detail, it is pertinent to revise the basics of business environment once again. As a firm starts its business across its national boundaries, it encounters three different sets of external environments:

- Domestic environment
- Foreign environment
- Global environment

These environmental components can be represented in the form of the following diagram:

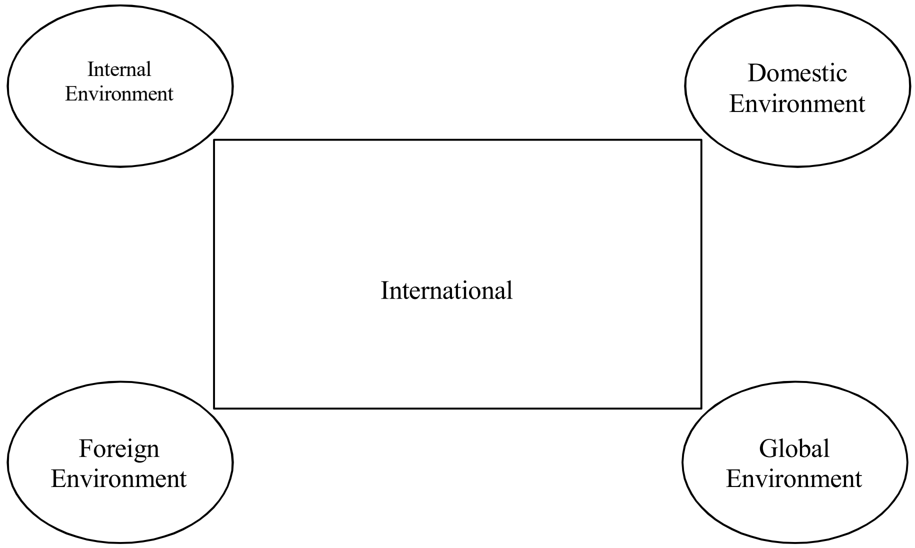

Figure 1: Components of international business environment (Source: Cherunilam)

Internal (Controllable) environment

The internal environment of a firm forms the basis of its capabilities and core competences to do business in the foreign countries. Since this environment lies within the firm itself, and it can be changed by the top management of a firm, it is also called as the controllable component of international business environment. However, the company can control it to some extent only because several other factors can hinder the internal functioning of the firm. Some of the components of the internal environment of a firm are:

Mission

The mission decides the course of action that a firm will follow in order to survive and grow. In the present times, the firms develop a few core competences and develop their entire global business plan on its basis. They do not dissipate their resources by venturing into too many businesses, but concentrate on their core strengths and do not mind outsourcing the rest. Strategy The mission ttranslates into more operational paradigm in the form of strategy, which operates at various levels. Firms often develop core competences, but only a few are able to convert it into successful business. The classical case of Cannon vversus Xerox is an example. Both the companies started by developing core competence in optical scanning, but over a period of t time, Xerox outsmarted the former by its superior strategy. Cannon, at one ttime, had practically driven Xerox even out of its home country i. e. USA. But, Xerox developed a very comprehensive marketing and customer service strategy and regained its leadership in the photocopier industry.

Operations

The operations refer to the operating competence of a company i. e., how well it is able to undertake the work at the ground level. It is that paradigm of the strategy, which can be implemented. A firm' s cost leadership, its market ing strategy, its production efficiency and the nature of its human resources have a significant impact on the success of a company. Although, the above components are called as the controllable components of business environment, but in a strict sense, they might not remain controllable at all times. The external uncontrollable components can become too powerful and can even influence the strategy of a company. For example, when Coke and Pepsi faced a problem because of the presence of pesticides, their strategies had to be redrafted because of a sudden development in the external environment. In this case, the politictal environment in India was not conducive for them to do business. Therefore, they preferred to leave the Indian market instead of complying with the rules of the Government of India.

External (Uncontrollable) environment

The external environment, also called as uncontrollable has been divided into two components, namely foreign and international. The foreign environment comprises of the environmental conditions prevailing in the host country, while the international environment refers to the overall international circumstances, which influence the conduct of business. In practice, such a division is not followed strict ly and the external environment is studied as one component. Some of the sub - components of the external environment are:Political environment

Legal and regulatory environment Economic environment

In the following discussion, we shall study these components of external environment in detail.

Political environment

As a firm starts its operations in other countries, it has to deal with different political set - ups. There are differences in the types of political systems, the stability of the governments and the prevail ing sets of rules and regulations within t hose countries. Some of the components of the political environment are:

Types of political systems

There are many types of political systems – democracy, dictatorship, communism, etc. Even within each form, different types of political systems prevail. After the demise of USSR, by and large, most of the countries have shifted to free market economies in a democratic set up. Although the communist or the socialist form of government is not working in many countries, but the impact of socialism as a philosophy does persist. There are countries like Pakistan, Saudi Arabia, which follow dictatorship style of government, while most countries in Europe and North America follow democracy. Even democracy has various forms such as the presidential form, as prevalent in USA, or the parliamentary form of government, as in UK and India. Some countries in the Middle East have a typical theist –political set- up, while others are secular countries. In business, the form of government has a direct impact, because each form of government has its own typical set of policies, programmers and priorities. These have an impact on the regulatory mechanism of the countries and the business has to comply with the laws of the land. Most of the democratic countries have a free market system operating in their countries. Countries with communist system, such as China, still have a very tight control over the business. Middle East countries allow freedom to do business, but have very strict rules for entry of goods and services into their countries. Level of corruption is also highly dependent upon the type of political system and many times, the firms have to abide by the prevailing systems in those countries.

Political instability

Despite diverse political systems, no system is bad if it works in a stable manner. The biggest problem arises when there is political instability. Some of the examples of political instability are:

- In Italy, over 45 governments changed in 50 years
- Last decade has seen rapid changes of governments in Japan
- India is passing through the era of coalition governments
- Pakistan had a military coup and then a democracy, controlled by the military dictator
- Afghanistan was under the rule of fundamentalist Taliban and then is heading towards a more democratic set up
- Iraq, Egypt and Libya have seen a change in regime, enforced by America and the Western forces.
- There are coups and genocides in Sierra Leone, Ethiopia,

Eritrea, Congo and many other African countries

- In recent times, there is high degree of political uncertainty within India and government could not take any major decision due to this.

In each of the examples quoted above, we find an element of political uncertainty. The forms of government change and so do the nature of doing business with that country. For a firm aspiring to market its products abroad, it has to carefully study the type of the political system and the stability. In countries, which are politically instable, the business takes extra protective measures and restricts its operations to exporting or joint ventures. However, in the countries with high political stability, the business makes direct investments. Despite being a communist country, China has attracted maximum foreign direct investment because of a stable pro - business attitude of the government. Despite being a socialist state, China has transformed itself to the needs of time and has opened up its economy at a fast rate. On the other hand, the ghost of regulatory set - up of the yesteryears continues to haunt India and we see less investment here. Even within India, we see lesser investment in the states such as Kerala and West- Bengal because of the leftist parties in power. Lot of investment has been channelized to states like Maharashtra and Gujarat, while the northern states have seen almost no investment in business. The difference lies because the government's friendliness towards business and some states do not have proper law and order, infrastructure, etc. to support business. Different political parties have different policies towards investment. For example, while the NDA regime saw major investments in India because of their pro - business policies, the UPA government has concentrated on the social sector and formulated schemes like MNREGA. This has diverted the funds for investment from infrastructure to social sector, attracting lesser foreign investment in India.

Political risk

Although, often correlated, political instability and political risk do not go together always. In the first three examples quoted in the above para we find that although the governments changed rapidly in India, Japan and Italy, the basic policies of the government did not change. Business had a sense of security while doing business in these countries. However, the war in Afghanistan and Iraq has had a tremendous impact on the business. Not many companies are taking the initiative of doing business in these countries. They prefer to wait till normalcy returns.

Political risk in more associated with the uncertainty and unpredictability of the political parties in power in a country. Basically, political risk depends on two factors:

(i) The willingness of a government to keep the situation under control.

(ii) The ability of the government to keep the situation under control

The careful analysis of the political system can greatly reduce the associated risks.

Analysis of political risk

Sundaram and Black have summarized the analysis of political risk in the form of the following points:

Step 1

- Determine the critical economic/business issues relevant to the firm.
- Assess the relative importance of these issues.

Step2

- Determine the relevant political events.
- Determine the probability of occurring.
- Determine the cause and effect relationship.
- Determine the government's ability and willingness to respond.

Step 3

- Determine the initial impact of the probable scenarios.
- Determine the possible responses to the initial impacts.
- Determine the initial and ultimate political risk.

12.1 Legal and regulatory environment

The marketers must carefully study the legal and regulatory system prevalent in the countries to avoid the situations that might result in conflict, misunderstanding or outright violation of the laws of the foreign country. Some of the important aspects, worth consideration, in the legal and regulatory environment are:

12.1.1 International Law

International law has existed since the sixteenth century, although, it has significantly changed in the form over the years. The international bodies such as UN, WTO and the regional groupings have been instrumental in developing the international rules and regulations. These international laws are ratified by the participating countries and are binding in nature. Hence, the business must understand them correctly to ensure compliance. As a result of the pressure from the international bodies, such as WTO, IMF, etc., the nations are changing their laws to meet with the international norms. For example, India has changed the patent laws, reducing the list of restricted items, procedures for granting approval to FDI, etc. to comply with the international norms.

12.1.2 Conflict of laws

While doing business across nations, there can arise situations when the laws of two or more countries can be conflicting. The businessmen must study these laws and take measures to avoid being caught in such a situation. For example, most of the countries of Middle East want that the goods should be dispatched to them only in those ships, which do not go to Israeli ports. They ask for a certificate from the shipping line in this regard. If an exporter ignores this law, he can be in a very difficult situation and can incur heavy losses. Similarly, the Latin American countries ask for Counselor invoice and USA has stringent regulations for the import of food products. An exporter must study the conflicts or differences in the laws between the countries and comply with them.

12.1.3 Freedom of contracts

In developed countries and those which have a very sound legal system, the principles of contract are taken for granted and are strictly enforced by the law. However, in some countries, government interference with these principles can cause a loss to the businessman. One should be vigilant especially while participating in global tenders or the projects of long gestation periods. For example, take the case of Enron's contract in India. Indian government agreed to buy electricity in foreign currency, which increased the cost of per unit of electricity, making the whole project unviable and the investment was wasted. While signing international contracts, firms must be very careful and should read the regulations carefully and take a prior legal opinion.

Patents and Trademarks

Another important issue for a multinational corporation is the protection of its patents, trademarks and the intellectual property. Most companies invest heavily in research and development.

However, unscrupulous manufacturers of some developing countries take the advantage of the difference in the patent laws and manufacture e a duplicate of the product, causing a heavy loss to the original manufacturer. The companies, why chi has invested heavily in R&D must analyze these situations and take protective measures. The issue has been addressed by WTO, which has instituted TRIPS (Trade Related Intellectual Property Rights) mechanism to avoid loss to the original manufacturers. In many countries, counterfeit products are freely sold in the markets. In such markets, there is a high risk of your product being imitated and a low cost version being sold into the market, harming the sale. For example, in Thailand, it is common to find a counterfeit of I-phone, costing far less than the original one, causing heavy losses to Apple.

Conflict resolution

It is very difficult to achieve an ideal situation when there is no conflict between the trading partners. Conflicts do happen, but there has to be a sound system for resolution of the conflicts. There are sets of principles laid down for international arbitration. The businessmen must be aware of these and carefully analyze the devotion of the partners towards implementing them.

Besides arbitration, there are alternate mechanisms to solve and settle a dispute developed by international bodies. Some of the international bodies, which have instituted mechanisms for international arbitration, are:

- (ICC) International Chamber of Commerce
- (AAA) American Arbitration Association
- (IACAC) Inter-American Commercial Arbitration Commission
- (ICSID) International Centre of Settlement of Investment Disputes
- Swedish Arbitration Institute
- (UNCITRAL) United Nations Conference on International Trade Law

Recourse In case of a legal action, the operation of law can be very lengthy and costly procedure in many countries. If a country engages in long legal disputes in a country, it tarnishes its image, besides incurring loss of time, money and efforts. The row over taxation in case of Vodafone is an example of how the image of a firm is tarnished and how costly a legal recourse can be for the firms in t he overseas markets. Similarly, there has been no rightful compensation granted to the victims of Bhopal gas tragedy till date, and at the same time Union Carbide has also suffered indelible loss of reputation worldwide.

Tariff mechanism

The tariff and taxation structure of the foreign countries must be clear to the business to avoid complications at a later stage. Although, the tariff structures are being standardized across nations, still there exist some differences and these must be carefully Stride. The tariff policy is highly dependent upon the nature of the political system as different governments have different approach towards laying the tariff. The economic situation of a country also influences the tariff mechanism as countries use this as a means to encourage or dissuade the free flow of goods into their countries.

Equity control

Different countries have different laws regarding equity participation of the foreign partner. Some might allow 100% FDI in some sectors, while there might be limits on investment. Some countries make the participation of a domestic partner obligatory. Such different situations must be carefully studied before taking any investment decision. For example, in India, there have been limits on foreign investment in insurance and retail sectors and recently the Government has increased these limits. In the insurance sector, foreign equity participation has been increased up to 49% from 26%, and in the multi- brand retail sector it has been increased to 100%. This means that the foreign company will have a lot of participation in the management and will control the affairs of the company.

Documentation and formalities While most countries are dismantling the tariff barriers, they are yet to make the procedures more easy and user kindly. It is notable that China's economic success story has a lot to do with the ease of doing business there. There is little red- tapism and most of the regulatory requirements are cleared speedily. On the other hand, business has to run from pillar to post to get approvals and the essential registrations for doing business in India. A thorough knowledge of the prevailing system is essential for the success in a foreign country.

Economic environment

The economic environment is a major determinant of market potential and opportunity. Since the single most important indicator of market potential is income, the first step in determining the potential of a country or a region, and even more significantly, the per capita income. In general, as the income of the people rises, they spend less on the necessities and more on the discretionary purchases. One of the ways of determining market potential for a product is to evaluate product saturation levels. In general, it is appropriate to compare the saturation levels of countries or of consumer segments with similar income levels. Countries and markets go through t ypical stages of market development. Although, development is on a continuum, it is possible to identify distinct stages and formulate general est images about the type of the market that will be found in a country or a market at a particular stage of development. In advanced countries, for example, more than half the GNP is accounted for by t he services as opposed to goods. In under- developed countries, the proportion of services is very low.Some of the t ypical characteristics of economic environment are: Changes in world economy Over the years, several changes have taken place in the world economy, which have changed the very manner of doing business. Keegan has identified the five most significant changes in the world economy, which have occurred in the past decades, and will influence the conduct of business. These changes are: Capital movement rather than trade have become the driving forces of world economy. The capital movement represents the attractiveness of a country for investment. For example, by its favorable pro - business policies, China has attracted the maximum investment. In not time, China is likely to emerge as the manufacturing base for the whole world. Although, many country are ahead of China in terms of trade, but they feel the threat to their economy because of a sudden increase in the economic potential of China, arising because of huge foreign investment.

a) Production has become uncoupled from employment

Although, the Government of India claimed to have touched 8% growth in the GDP, the growth is a jobless growth. The increase in productivity does not translate into more jobs for the people. Such a situation is not good for the economies in the long run because a large section of the society will be siphoned out of the economic activities.

b) Primary products have become uncoupled from the industrial economy

In the industrial economy, focus is more on innovation and value addition and not mere value addition. Michael Porter has stated in his book, "The Competitive Advantage of Nations," that as an economy progresses, it is driven by the factors of production, namely land, labour, capital and management. However, after one stage, it stops getting leverage out of mere factors of production. It becomes a wealth driven economy. Here, wealth begets more wealth. However, in long run, such a strategy is not going to deliver results. I f an economy aspires to grow further r, it has to become an innovation driven economy. Thus, primary products cease to the driving forces of the industry. Industry is going in for rapid innovation and thus is aiming at delivering higher value to its customers.

c) The world economy is in control. The macro economics of nation-states no longer control economic outcomes

Keegan observes a gradual separation between economics and politics, although the shift is very subtle. The economy is in the control of the market forces because more and more gover moments are opening up and allowing business to work freely.

d) The 75- year contest between capitalism and socialism is over. The clear success of the capitalist system over the communist centrally controlled model has led to the collapse of communism as a mod el of organization of economic activity and as an ideology

By the above remarks, it is c learn that the world economy is heading for a new world economic order. The left is forces are not as strong as they were on the yesteryears. The world is no longer a bi-polar world, but is now a multi- polar world with many regional economic groupings and powers. The democracy has shown a definite edge over other systems and is likely to persuade more and more countries to allow free play of the market forces.

12.7 Economic systems

Although, communism is said to have failed, but a socialistic thought does influence the economic decision- making. People feel that the fruits of economic development must pass on the larger sections of the society. Traditionally, the economic systems are classified as capitalist and communist. However, in the present t limes, a new blend of the two is emerging, as has been very successful y shown by China. German, the home of Karl Marx does hold the socialist philosophy in high esteem and its ideology can be seen in the regulatory framework of the country. Workers have a participation in the decision making process of the companies. Countries like China have a single party system of governance, but he has developed special economic zones, where there is a lot of freedom to the business. Such areas have emerged as the global centers of investments and manufacturing. On the other hand, country like Bangladesh, Pakistan, etc. have free market systems, but due to their systemic problems, they have failed to achieve economic growth and investment into their countries.

Stages in market development Due to unequitable distribution of the wealt h, the markets are at different stages of development. There are a few (27) countries in t he high - income group, while a large number (55 each) lie in the upper middle income group and the lower middle income group countries. There are 42 countries, which have been classified as low- income countries. The extent of economic disparities has increased with the globalization of t ride, as is shown by various reports on human development, released by UNO. The following problems are often encountered as the econ omics health of a country deteriorates:

- Low industrialization
- High dependence of agriculture
- High birth rates
- Low literacy rates
- Political instability y and unrest
- Low education and health levels of people

Such problems influence the purchasing behaviour of people and thus the business prospects in the region. Balance of payments

Several poor countries face the situation of adverse balance of payments. In such a situation, the government discourages import and encourages export. The balance of payment situation of a country is an indicator of its economic health. I f it is too adverse, there is a likelihood of the default of payment by the host country and thus increasing the business risk. India had a very favorable condition of balance of payment and the foreign exchange reserves had reached a trillion mark. But the fluctuations in currency and the political uncertainty had eroded investor's confidence and shifted the balance of tride, impeding the balance of payment as well.

Foreign exchange problem Some countries like India face a unique problem of adverse foreign exchange rate situation, despite having a favourable balance of payments. A strong rupee is discouraging exports and encouraging imports. Similar situation is faced by many countries, which are strongly t ied up with the t rade in US Dollar. Governments of these countries intervene and regulate the exchange rates. Such unfavourable exchange rates can influence the investment and marketing strategies of the mult inational companies. In last few months, India has witnessed a very high fluctuation in t he exchange rate of dollar and rupee. This has created lot of uncertainty in the traders and created an unfavorable situation for the nation. RBI had to take measures to stabilize the exchange rate, but it has not helped much. While the exporters have gained out of this fluctuation, the importers have suffered losses

Inflation Inflation has emerged as a major problem in t he recent t imes as many countries, including India, have suffered due to double digit inflation. Inflation reduces the demand of goods and services and overall sentiment of the business is low. People are left with lesser disposable income and they come out for lesser shopping, leading to a slowdown of demand, and also investment. All the measures of RBI and the government have largely been ineffective in dealing with the problem of inflation and this has been one of the reasons why foreign investment is at its all- t ime low in India.

12.8Summary

The business is a part and parcel of the social system and is influenced by several forces. In order to be successful, an understanding of the culture is essential, particularly if a marketer wants to venture out of his national boundaries. There is a sea change in the degree of r isk and uncertainty in international business, which is driven primarily by t he environmental forces. The business managers must be able to scan the opportunities and identify the threats posed by t he environment and make a way for their success. It is noteworthy that there are several tools and techniques for analyzing the environment and the students are advised to refer to standard textbooks for the same.

12.9 Glossary

Patent: Exclusive Rights granted by the state for a limited period of time to the inventor.

Foreign Exchange: The currency of any other country apart from hone country which earned during an act of business.

Trademarks: It is a recognizable sign which identifies products or services from other products.

Risk: The uncertainty associated with doing business

12.10 Check your progress

(a) **Fill in the blanks -**
(b) A company's vision and specific work environment are .... components.
(c) Strategy is the operationalization of ....
(d) Democracy is a .... form of government.
(e) Business does not function well if the political environment is ....
(f) Despite the .... nature of its government, China has attracted significant foreign investment.

b) State whether the following are true or false:

- India had to amend its patent laws to comply with international regulations.
- A government can impose tariffs at its own discretion.
- Economic risk is directly linked to political risk.
- Inflation reflects economic growth.
- A high value of the rupee is beneficial for the Indian economy

12.11 Answer to check your progress

(1) Controllable (2) Objective (3) Stable (4) Instability (5) Communist

B) (1) True (2) False (3) False (4) False (5) True

12.13 Terminal questions

- Define business environment. What do you mean by controllable and uncontrollable components of business environment?
- What are different types of political systems prevailing in the world? How do they influence trade?
- Does political instability also mean political risk? Give reasons.
- Briefly discuss the role of legal environment on business?
- How have the recent economic events – inflation, currency fluctuations, etc. influenced the business in

India?

12.13 Suggest readings

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2. Terpestra, Vern, International Marketing, Halt, Reinhart and Winsten Inc.
3. Sundaram, Anant K. and J. Stewart Black , The International Business Environment: Text and Cases, Prentice Hall of India Pvt. Ltd., New Delhi.
4. Keegan, Warren J., Global Marketing Mangement, Prentice Hall of India Pvt. Ltd., New Delhi.
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Unit-13 International Capital Structure and Portfolio Investment Decisions

Structure

Objectives

- To make the students aware of the capital structure decisions of a company and
- To develop an understanding about international portfolio investments in globalized era.

After going through this unit, they shall be able to comprehend the following-

- To understand international capital structure and cost of capital.
- To analyze international portfolio investments and its related issues

13.1 Introduction

Optimal capital structure of a company is one of the important concerns of the finance manager. The globalization, liberalization and deregulation of financial markets have widened the scope of accessing international markets. Integration of economies has led to fast movement of capital and other business resources. As the markets are not fully integrated, there is a fair chance of availing of the advantage of market imperfections. Companies are now a days, exploring the international markets to obtain their desired capital structure. Since the recent past, due to the liberalized financial environment, faster money transfer system, internet based trading and prompt communication the investors are blessed with ample investment opportunities. The share markets of most of the countries have shown upward trends. High economic growth usually goes hand in hand with high growth in the country's capital market and thus attracts investors from abroad. International portfolio investment allows investors to participate in the faster growth of other countries via purchase of securities in foreign capital markets. Specially, the markets of developing countries like India, China, Brazil, and Singapore have grown at a faster rate. The foreign portfolio investors (FII) invest abroad to increase their returns on investments and to reduce their portfolio risk.

13.2 Capital Structure

Capital Structure of a firm stands for the ratio of the capital raised from different sources. The capital structure decision is the trade-off between minimization of cost and minimization of risk. Ultimate objective is to obtain optimal capital structure to maximize the returns. Broadly there are two sources of capital- equity and debt. Equity capital can be raised by floating shares and debt capital could be raised through floating debt instruments i.e. debentures and bonds or by raising long term loans from the financial institutions. The companies often create a mix of the two types of the capital. Depending upon the financing policy of the organization, certain portion of capital is raised through shares and the remaining through debt instruments and borrowings. The capital structure decision is one of the core financial decisions of the companies. The capital raised through any source carries some cost. That's why managers are concerned about the appropriate capital mix in which the overall cost of capital is minimum. That appropriate capital mix is known as the **optimal capital structure** of the company. As the managers are concerned about the optimization of returns, they need to be guided by the following fundamental principles –

i. Maximization of Returns
ii. Minimization of Cost
iii. Maximization of Control
iv. Minimization of Risk

13.2.1 Decision Areas

In order to secure appropriate mix of capital, a manager should address to the following issues –

(1) What should be appropriate mix of debt and equity capital?
(2) What would be the method of financing?
(3) Which of the capital market should be accessed?

1-<u>What should be appropriate mix of debt and equity capital?</u>

The answer to this basic question lies in the very nature of equity and debt capital. Equity capital represents owners' funds consisting of share capital and retained earnings. Holders of shares participate in the profit and get dividends as their proportionate claim in the profit of the company. The dividend is not a compulsory obligation of the company. The advantage that companies derive from the borrowed fund is that its providers don't participate in the prosperity of the company. The company mandatorily has to pay interest on borrowed capital. The interest paid/payable on debts, is allowable under the income tax law which ultimately reduces the cost of capital of the firm. The advantage with debt capital is that capital suppliers do not participate in the profits and there is no need to liquidate the ownership also.

Now, depending upon the conditions and constraints, company should decide equity, debt or a mix of the two. Payment of interest in case of debt capital is obligatory for the company whereas payment of dividends is not mandatory in case of equity capital. As per risk and funds associate to a project, the financing decision may be taken in the following manner –

1- High Risk & Huge funds :Equity Capital
2- Low Risk & Assured high returns : Debt Capital
3- Moderate risk & Moderate Returns : Mix

While arriving at a capital structure decision, application of theory of leverages plays an important role. Leverage is the ratio of equity and debt in the capital structure. The capital structure without debt capital is known as leverage-free capital structure. There are two types of leverages i.e. operating leverage and financial leverage. **Operating leverage** refers to the extent of fixed cost over total cost. If a high percentage of total cost is fixed, the firm is said to have high degree of operating leverage. High operating leverage leads to high degree of risk as when the demand of the products comes down even then company has to spend much on fixed expenses. Low operating leverage refers to less proportion of fixed cost i.e less risky. **Financial leverage** refers to the extent to which fixed cost bearing funds are used in a firm's capital structure. It may be high, low or moderate. High financial leverage leads to more commitment on external dues or vice-versa. There may be four combinations of operating and financial leverages for a firm which may guide in deciding the optimum capital structure in various situations –

i. Low Operating Leverage and Low Financial Leverage
ii. High Operating Leverage and Low Financial Leverage
iii. High Operating Leverage and High Financial Leverage
iv. Low Operating Leverage and High Financial Leverage

First combination of operating and financial leverage is considered as highly conservative approach of the management. Second combination is considered as tolerable while, the third combination is considered as highly risky as the financial commitment to external parties is very high. Fourth combination of leverage is considered as best for the company, as it carries least risk and higher returns.

3) What would be the method of financing?

Floatation of capital market securities and term loans are the methods of financing of a project. The capital market securities like equity shares, preference shares, International equity (in the form of ADRs and GDRs), debentures, bonds, international bonds and euro bonds may be floated in the international financial markets. As issue of securities requires compliance of variety of norms stipulated by respective regulatory authorities, company may decide to raise a term loan from the domestic or foreign financial institutions. Loan raised from foreign sources is called External Commercial Borrowings. Cost of capital of various methods of financing is basic point of decision for the managers. The interest rates in different countries may vary from each other. In international financing the managers also have to address to the forex rate issues. Currency appreciation/depreciation has bearings on international transactions. Taking care of the changing market scenario and its potential ability to pay the dues, the managers select appropriate instruments and methods of financing.

Which of the capital market should be accessed?

Company can access its domestic capital market or international capital markets. If company selects equity route, it may bring equity issue in domestic market, international equity issue (through DRs) or euro equity issue to access many capital markets at the same time. Similarly, debentures & bonds may be issued to access domestic market, international bonds in one particular foreign market and euro bonds can be issued to access capital markets of many countries at the same time.

Based upon the market reputation and credit worthiness, company may decide the appropriate capital market where full subscription of the issued instruments is expected and comparatively low cost of financing is possible.

13.2.2 Cost of Capital

Cost of capital refers to the financial commitment of the firm towards the capital employed in the project. Cost of debt capital is paid in form of interest. Interest rate on debt capital comprises of risk free cost of capital and risk premium. Cost of equity varies on risk associated to the project, company and industry. Cost of equity financing comprises of risk free cost of capital and premium of bearing market and business specific risk.

The Cost of Equity Capital can be calculated on the basis of Capital Asset Pricing Model (CAPM). Under this method the cost of the equity (i.e return for the investor) can be explained by as following –

$$\mathbf{Re = Rf + \beta\ (Rm - Rf)}$$

Re = rate of returns on equity

Rf = risk free rate of return
β (Beeta) = Correlation between the market returns and
securities return Rm = Market returns
Kd = Cost of debt capital is the interest rate or coupon interest rate paid to the lender.

Here, (Re) the investors expected returns on equity investment will be treated as the cost of equity capital for the company. Risk free rate of return is the return that can be obtained by investing the funds in non risky assets (like government securities). Second part of the equation i.e., β (Rm - Rf) explains risk premium to the equity holder. This risk premium refers to the reward of bearing market risk in that equity investment. β is correlation between market returns and equity returns. It denotes impact of market movement on equity returns.

Cost of Debt Capital is the cost of capital at risk free investments added with risk premium. i.e. Cost of debt capital (Kd) = Rf + Risk premium

Projects carry varying degree of risk, accordingly their risk premium varies. Risk premium and risk free rate of returns also vary from market to market, that creates difference of cost of debt in domestic and foreign markets.

If the company holds mix of equity and debt, weighted average cost of capital is calculated. Weighted average cost of capital is the composite cost of individual sources of capitals (i.e., equity/debt) as per their proportion in total capital. The overall cost of capital could be expressed as follows-

Ko = (1-W) Ke + W (1-t) Kd

Ko = overall cost of capital Ke = Cost of equity capital Kd = Cost of debt capital
W = Weight of the debt capital

Overall cost of capital depends upon cost of its elements. like- Ke & Kd and relative weights of equity and debt capital. The retained earnings may also be one sources of capital.

13.2.3 Cost of Capital and International Borrowings

The companies accessing international capital markets may have comparative advantage of differential cost of capital. Differential interest rates of different markets create the opportunities of interest rate arbitrage. Companies find leverage while borrowing funds from the countries at lower interest rates. Hence, the companies may enhance their profitability by borrowing from international capital markets instead of only borrowing from their domestic market.

This can be understood by comparing internal rates of returns (IRR) of the project in two different financing options. The internal rate of return on investment refers to the rate that is essentially required to achieve to avoid losses in the project. So, IRR should be equal to the cost of capital. If suppose there are two options of borrowings – one, from domestic market at K^d rate of interest and second from foreign capital market with K^f rate of interest, provided K^f is less than K^d.

I^f - Internal rate of returns in international financing

In the above graph, it can be easily understood that through international financing of the project, how companies could minimize their overall cost of capital. If company decides to raise funds from domestic market at cost of K^d, it must have to achieve I^d internal rate of returns (IRR) while in case of international financing, since the cost of international financing is K^f, the required internal rate of return to achieve is I^f. Here, I^f will be comparatively lower than I^d, just because K^f is less than the domestic cost of capital K^d. Hence, through international financing, company may add more to profitability i.e. I^d-I^f.

Exercise-1:

Q.1. What do you understand by capital structure of a company?

Q.2. State the decisions taken under capital structure decisions.

Q.3. What is leverage?

Q.4. How the cost of capital is different across the countries?

13.3International Portfolio Investment Decision:

Portfolio investment refers to the investment in bonds, shares (stocks) and other financial market securities. A portfolio is the basket of securities invested in. It may consist of equity, debt or both types of securities. Equity investment is one of the best investment alternatives. This is the investment from which one can secure considerably higher returns than other investment avenues. At the Same time the market carries high degree of risk also. Stock market is very sensitive market, variety of national and international factors are having bearing on it. Prices of stocks keep on changing on the basis of company's performance, industry prospects, government policy, market conditions, past trends, future expectations and on so many variables. Investors with high risk appetite go with such investments. Stock markets have shown tremendous growth worldwide.

An international portfolio investment refers to international investment in the foreign based financial securities, i.e. stocks and bonds of foreign capital markets. 'At first sight, the idea of investing internationally seems exciting and full of promise because of the many benefits of international portfolio investment. By investing in foreign securities, investors can participate in the growth of other countries, hedge their investment basket against exchange rate risk, realize diversification effects and take advantage of market segmentation on a global scale. Even though these advantages might appear attractive, the risks of and constraints for international portfolio investment must not be overlooked. In an international context, financial investments are not only subject to currency risk and political risk, but there are many institutional constraints and barriers, significant among them.*'*International Portfolio Investment: Theory, Evidence, and Institutional Framework Söhnke M. Bartram and Gunter Dufey
The prominent issues in international portfolio management are as follows-

1. Higher Expected Returns
2. Diversification of portfolio internationally
3. Valuation of Securities
4. Risk Management
5. Comparing risk & return on domestic vs. foreign market investment
6. Performance measurement of international investment

There are two prime motives of international portfolio investments, i.e expectation of higher returns and reduction of risk through appropriate mix of foreign securities. As the economic growth rates of the countries are different, investors can participate in the growth of fast growing economies. Share market is said to be the mirror of the economy, high growth of the economy is reflected in share prices. International investors mobilize their funds to foreign markets with the expectation of higher returns than that in their own market. Such investment is known as FII investment. In India, as per SEBI guidelines following foreign entities may be registered as FII with SEBI –

1- Pension Funds
2- Mutual Funds
3- Insurance Companies
4- Investment Trusts
5- Banks
6- University Funds
7- Endowments
8- Foundations
9- Charitable Trusts / Charitable Societies

Further, following entities proposing to invest on behalf of broad based funds, are also eligible to be registered as FIIs:

1. Asset Management Companies
2. Institutional Portfolio Managers
3. Trustees
4. Power of Attorney Holders

There are three ways of international portfolio investments –

1. Investing in Depository Receipts (DR) issues of foreign companies (ADRs & GDRs issues) brought in investors home market in domestic currency
2. Direct investment in foreign capital markets in the currency of that market and
3. Indirect investment through mutual funds and other country specific investment schemes of investing agencies.

13.3.1 Diversification of portfolio internationally

Diversification of the portfolio is another thrust of the international portfolio investment. Diversification refers to the heterogeneity of the selected securities in the portfolio. This is done with the motive of reducing portfolio risk. Through the international investment, investors get exposure to foreign securities and their portfolio gets internationally diversified. Few of the markets have been seen negatively correlated while few others are less correlated to each other. 'There is reason to expect the correlation of returns between foreign securities and domestic securities to be lower than that between only domestic securities. In the latter case, all returns will be partially affected by purely national events, such as real interest rates rising due to a particular government's anti-inflation policy. Within any single country, a strong tendency usually exists for economic phenomena to move more or less in unison, giving rise to periods of relatively high or low economic activity. The reason for this is that the same political authority is responsible for the formulation of economic policies in a particular country. For example, the monetary, fiscal, trade, tax, and industrial policies are all the same for the entire country, but may vary considerably across countries. Thus, regional economic shocks induce large, country- specific variation of returns. A second explanation for international diversification consists of the industrial diversification argument which is based on the observation that the industrial composition of national markets varies across. As industries are less than perfectly correlated, investing in different markets enables the investor to take advantage of diversification effects simply because of the composition of his portfolio with respect to different industries'*. The markets are integrated today. Fast communication and low cost capital movement have facilitated easy international investments, but most of the investors are still biased to domestic market. They are reluctant to trade in foreign markets. *International Portfolio Investment: Theory, Evidence, and Institutional Framework Söhnke M. Bartram and Gunter Dufey The probable reasons may be that they might not be conversant with international investment procedures and the vehicles (schemes) of foreign investment.

13.3.2 Risk & Return Analysis

More risk may be assumed with the expected high returns. The risk premium is the prominent lure of risky investments. Three types of risks are involved in the international investment.

1. Foreign Exchange (FOREX) Risk
2. Foreign Market Risk
3. Local Market Risk

With the same degree of risk and returns, domestic investment is advisable to the investor than international investment because international investments carry additional forex risk. Forex risk arises in the international investments as foreign currency based realization has to be converted into domestic currency at an unknown future currency exchange rate on maturity.

The risk and return on the equity investment may be
calculated as under - Risk in equity investment
SD = ∑√ (er-mr)2
Returns on equity investment
Ri = Rf + β (Rm - Rf)
Where:
SD – Standard Deviation
er – expected returns on
equity mr – mean returns

The investor should appraise his portfolio on the parameters of risk and returns. Time to time inclusion and exclusion of relevant securities is necessary for best returns from portfolio investments. The portfolio returns are the returns that holder enjoys by holding underlying securities. Portfolio returns can be calculated with the help of Markowitz theory. The formula to find out the portfolio returns is given below –

Rp = ∑ Wi Ri
W^1 - weight of security-in the total portfolio
investments Ri– returns from security-1 &
security-2 respectively

The portfolio risk is measure of uncertainty of portfolio returns. The risk of portfolio containing two securities can be calculated as under –

Portfolio Variance (risk) = X1 SD1 + X2 SD2 + 2 X1 X2 SD1 SD2
Cov. 1 & 2 Where:
X1 & X2; are the weights of securities 1&2 respectively
SD1 & SD2 are standard deviations of security 1 & 2
respectively Cov.1&2 is the covariance between security
1 security 2 Performance Evaluation:

A prudent investor periodically appraises its portfolio performance. As soon as he finds another portfolio better than existing, he revises his portfolio accordingly to secure optimum returns. Portfolio performances should be analyzed and compared with each other. Some times through arbitrage portfolio the returns from investments could be increased at same risk content without changing the financial commitment. For comparing the performance of the portfolios, different measures can be applied such as Sharpe measure, Trey nor measure and Janson's measure. They are widely used tools to appraise the portfolios. The portfolios may be ranked and compared with following Sharpe measure technique –S.D of portfolio

Rp- Average rate of return on portfolio
Rf- Average rate of return on risk free
investments S.D.- Standard Deviation of
portfolio returns

Foreign market risk analysis is essential part of international portfolio investment. Dealing in overpriced securities leads to losses. The returns must be in line with risk assumed. A rational investor continuously strives to build an efficient portfolio. An efficient portfolio is the portfolio that carries minimum risk at particular return class of securities or in other words it gives maximum returns at given level of risk.

Appropriate time of market entry and exit should be prudently acknowledged. The opportunity cost of international portfolio investment returns may be other possible portfolio returns from domestic or foreign securities. The market forces are continuously changeable. The promising securities may remain no longer promising with the passage of time, hence changes in local markets should also be carefully scanned.

13.3.3 Comparing Risk & Returns from Domestic vs. Foreign Market Investments

International portfolio investment is to decide to invest in particular foreign market or markets, leaving other domestic and international options of investments. A periodic market analysis is required to acknowledge the market changes. The investors should compare the two markets at regular time intervals. The determining factors and condition of international investment may be considered as follows –

If, Re. 1 invested in Indian equity market, with G^r annual growth rate and D^d rate of dividend annually for n years, the final sum at maturity would be as follows-

$= 1\ (1+ D^d + G^r)^n$

$= (1+ D^d + G^r)^n$

and If, Re. 1 invested in international equity market, with G^f annual growth rate and D^f rate of dividend annually for n years, the final sum at maturity would be as follows-

$= 1\times 1/S^o \times (1 + D^f + G^f)^n\ S^1$

$= S^1/S^o \times (1 + D^f + G^f)^n$

Where:

S^1 – future forex rate on maturity of the sum

S^o – current forex rate at the time of investment

Now, the foreign investment would be advisable only when the total outcome from the international investment is more than the outcome of domestic investments. Symbolically-

$S^1/S^o \times (1 + D^f + G^f)^n \geq (1+ D^d + G^r)^n$

With the above equation it is evident that with the equal rate of growth and dividend, international investment would be advantageous when foreign currency is expected to be strengthened at the time of maturity. The determinants of the international portfolio investments are D^f, D^d, G^f, G^d, S^1 and S^o.

13.4 Summary

Capital structure decisions are one of the strategic financial decisions of the business. The optimum capital structure i.e. appropriate mix of debt and equity capital reduces the overall cost of capital to its minimum. The international capital markets have given tremendous options of raising funds to the companies. Since the capital markets are not fully integrated, hence there is scope of interest rate arbitraging (earning more returns from the markets where returns are different). The important decisions in international capital structure decisions are to decide appropriate leverage, the market to be accessed and selection of appropriate instruments of capital market for raising long term funds.There is a significant growth in international portfolio investments. The globalization of economies has given rise to their integration and free capital movements. Investors can participate in the growth of the countries. The investors get international exposure without investing funds abroad through instruments like ADR, GDR or investment in the shares of MNCs. With the diversified portfolio more returns could be secured from such investments but at the same time forex risk, domestic & foreign market volatility risk, political risk and other procedural barriers are also to be dealt with.

13.5 Glossary

Portfolio – A bunch of securities

SEBI – Securities and Exchange Board
GDR – Global Depository Receipt
ADR – American depository Receipt
FOREX – Foreign Exchange
FII – Foreign Institutional Investors

13.6 Check your progress

Write True or False:

1. Leverage is the ratio of equity to debt in the capital structure.
2. If a large proportion of the total cost is fixed, the firm is considered to have high operating leverage.
3. The cost of capital represents the firm's obligations regarding the capital invested in a project.
4. Companies with access to international capital markets can derive a comparative advantage from differences in the cost of capital
5. The IRR should be equal to the cost of capital.
6. In an international context, financial investments involve not only monetary and political risks but also various significant institutional pressures and constraints.
7. Trading in overvalued securities does not result in losses.
8. Investors should compare the two markets at regular intervals.
9. The capital market is fully integrated.
10. Better returns can be obtained from a diversified portfolio.

13.7 Answer to check your progress

1.	True	2.	True	3.	True	4.	True	5.	True
6.	True	7.	False	8.	True	9.	False	10.	True

13.8 Terminal questions

1. What do you understand by Capital structure of a company?
2. State the decisions taken under capital structure decisions.
3. What is leverage?
4. Why cost of capital for MNCs differs from domestic companies cost of capital?
5. What do you understand by portfolio investment?
6. What are the objectives of international portfolio investment?
7. What are the important issues related with international portfolio investment decisions?
8. Which of the entities can be registered as FII in Indian capital market?
9. What are the determinants of foreign market investments? How the risk & returns of domestic investment can be compared with the foreign investments?
10. What is weighted average cost of capital? How the cost of capital

is calculated for different sources of capital?

11. What are the objectives of foreign portfolio investments? Discuss determinants of foreign market investments?

13.9 Suggest readings

1. Shapiro Allen, Multinational Financial Management, Prentice-Hall of India Pvt. Ltd.
2. Vij Madhu, International Financial Management, Excel Publication.
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4. Apte P.G.International Financial Management,Tata McGraw Hill Publication.
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6. Sharan V, International Financial Management, Himalya Publishing House.
7. International Portfolio Investment, Theory, Evidence, and Institutional Framework by Söhnke M. Bartram and Gunter Dufey.
8. http://madaan.com/fii.html
9. http://sebi.gov.in/fii.html
10. http://rbi.org.in

Unit-14 International money and capital markets

Structure

Objectives

- To make the students aware of international money market and international capital markets.
- To develop an understanding towards international money market and International capital market
- To analyze Eurocurrency market and instruments of Eurocurrency market
- To understand equity and debt instruments of international capital market

14.1 Introduction

International financial market comprises of a group of accessible national financial markets that facilitate the investors and borrowers to access the markets at world level. Comparing with the domestic market, international financial market is quite large in terms of total trading volume, number of instruments and liquidity. For short term assistance, international money markets and euro currency markets provide standard and tailor-made instruments. Euro Certificate of Deposits, Euro Notes, and Euro Commercial Papers are the most traded Eurocurrency market instruments. International capital market provides ample opportunities of investments and borrowings across many countries. The geographical boundaries are no longer obstacles in cross border lending and borrowings. Most of the economies have opened their doors for international business and investments.

Investors can participate in the growth of many companies of the different countries. The multinational companies are accessing the foreign capital markets through raising external commercial borrowings and through floating international and global financial securities.

14.2 The Financial market

It can be explained as the market where funds could be invested and borrowed in various schemes or instruments. The prime objectives of financial markets are capital formation and facilitating movement of capital within the economy so as to ensure maximum use of scarce resources. An efficient financial market contains high liquidity and depth. The availability of variety of instruments enhances the worth of the market. There are two segments of financial markets -- money market and capital market. Money market is the market where short term investment and short term borrowing activities are performed, while in the capital markets long term investment and long term borrowing activities takes place. The prominent participants of this market are Central Banks, Commercial Banks, Corporate houses, Traders and other Non- Banking Financial Companies (NBFCs). Banks and NBFCs offer different investment schemes to the public and collect small savings from them. A big pool of capital is created from the collection of small savings from numerous investors. This process is known as capital formation. Normally, investments and borrowings take place through the exchange of financial instruments. Broadly there are of three types of instruments i.e. issued by Governments, Banks and Corporate houses. The organizations that need funds they issue instruments and other market participants having surplus funds, buy instruments in the market. This way funds are mobilized in the market. The key instruments of Indian financial markets are as follows- Treasury Bills (T-Bills), Government Dated Securities (GDS), Certificate of Deposits (CDs), Term Money, Call Money and Commercial Papers for money market while in the capital market the prominent instruments are Shares, Debentures and Bonds.

14.2.1 Global financial markets

are relatively recent phenomenon. Prior to 1980, National markets were largely isolated from each other and financial intermediaries in each country operated principally in that country. The London based foreign exchange market, Eurocurrency and Eurobond markets were the only markets that were truly global in their operations.'* The global financial market can be characterized as composite of national financial markets in which the global market participants access the different national markets. It comprise of forex market, eurocurrency market, international capital markets and money markets. In this era of globalization, most of the economies are open economies and free cross border capital movements are taking place. As the macro economic factors vary from country to country, the return on capital invested is different in different countries. Investors in search of higher returns, invest in foreign avenues. Another motive of international investors is to diversify their asset portfolio internationally to reduce the degree of risk. The stock market returns of many countries are seen as negatively correlated. The appropriate mix of the securities of such markets can reduce the investors' portfolio risk. * International Financial Management, Apte P.G., Tata-McGraw Hill Publication, pg no. 583 issue 2010.

14.2.2 International Money Market

An International money market can be characterized as the money market where participants of other nations can also participate. In this market local laws permit the participants worldwide to access the money market of that country. Thus, international money market comprises of all such markets where international participants are allowed to transact instruments. London is considered as oldest centre of international money market. Now a days, France, Canada, Singapore, Japan are also emerged as the prominent centers of international money market. Eurocurrency market is a segment of international money market.

14.2.2 Eurocurrency market

It is core of the international money market. The market where international currencies could be deposited and lent is known as Euro currency market. Eurocurrency is the currency that is deposited in other than its originating economy market. It is in no way related to European Union currency EURO. The currency that is deposited in a bank outside the country of its origin is known as Eurocurrency.

Example:

If, Indian Rupees have been deposited in a foreign bank or foreign branch of a domestic bank located outside from India, will be known as Euro rupe**es**. US Dollars (USD) deposited with a bank in India is Eurodollars and British Pounds deposits with a bank in New York will be known as Euro pounds. 'The origin of eurocurrency market can be traced back to the 1950s and early 1960s. When the former Soviet Union and Soviet Block countries sold gold and commodities to raise hard currency. Because of anti soviet sentiments these communist countries were afraid of depositing their dollars in non-US banks for fear that the deposits could be frozen or taken. Instead they deposited dollars in a French bank whose telex address was euro bank. Since that time, Dollars deposits outside the United States have been called as Eurodollars and banks accepting eurocurrency deposits are called **Euro banks**.'*A Euro Bank accepts deposits and lends in different foreign currency denominations. Loan extended in USD by a non US bank at London is a Eurodollar loan. The international banks and corporate are prominent members of market. This is a short term market. Funds may be deposited or borrowed for less than one year time period. This market is less regulated market that is almost free from Central Banks and Governments regulations. Hence, Participants are not required to exhibit much information. Eurocurrency Time Deposit Certificates are the key instruments of eurocurrency market. The participants may have time deposits with Euro banks with the term of one month, two months, six months, Euan & Resnick, International Financial Management, page no. 274, Tata McGraw Hill Publication. nine months and twelve months. Such time deposits are not negotiable in nature, hence lack liquidity. Another, Eurocurrency market instrument is Eurocurrency Certificates of Deposits or CDs. These are issued against euro currency time deposits. The euro CDs are negotiable and are easily transacted in secondary market. Euro currency CD provides the depth and liquidity to the euro currency market. Most of the transactions of Eurocurrency market are interbank transactions. The banks having excess funds make deposits while banks having lack of funds borrow from eurocurrency market. The interest rates charged are said as interbank euro currency bid rates. The spread between interbank bid and ask rates usually remains 0.012%.

The interest rates in euro currency market are purely dependent upon market conditions. More demand of one currency leads to higher interest rate of that currency or vice- versa. London Interbank Offered Rates (LIBOR) is the base rate for euro currency market. LIBOR is the reference rate of the day declared by British Bankers Association on every day. There are several other reference rates used in different centers of Eurocurrency market. Like in Singapore Interbank Offered Rate (SIBOR), Mumbai Interbank Offered Rate (MIBOR), Tokyo Interbank Offered Rate (TIBOR) is few other euro currency reference rates. Now you can understand that euro currency market is world spread money market, where funds could be deposited or borrowed in different currencies.

Let's understand how such deposits and borrowings in international currencies take place. As in the domestic Indian money market, banks, corporate and Governments (through RBI) issue different securities (like- Call Money Certificates, Term Money Certificates, Certificates of Deposits, T-Bills, Government Dated Securities and Commercial Papers) for their financing requirements and on the other hand participants having investible funds buy those securities according to their liquidity requirements. Eurocurrency market is highly liquid market that is advantageous over national markets in terms of liquidity, returns and cost of financing

14.2.3 Instruments of Eurocurrency Market

The prominent instruments of Eurocurrency markets are as follows-

1-Eurocurrency Fixed Deposit Notes

2-Eurocurrency Negotiable Certificate of Deposits

3-Euro Notes

4-euro Credit

5-Euro Commercial Papers

Eurocurrency Fixed Deposit Notes: Eurocurrency Fixed Deposit Notes are fixed term deposit certificates issued by the Euro banks against the funds deposited. These certificates are not negotiable certificates. Under Fixed Deposit Notes, funds are invested for different maturity periods ranging from one day to one year. Normally, fixed deposits of 2 months, 3 months, 6 months, 9 months and 12 months are prominent time deposits of euro currency market. The interest rates vary for different maturity periods. For longer maturity period, higher interest rates are paid. Different interest rates are paid for different set of currencies. As interest rates for eurodollars may range as 2.10% - 2.20% per annum and for eurosterlings interest rates may be 5.166% – 5.20% per annum. Though, these time deposits are fixed term deposits certificates but these can be liquidated before their maturity also. Euro banks liquidate the premature certificates at heavy discounts. That's why often these certificates are liquidated on maturity only.

Eurocurrency Negotiable Certificate of Deposits: The Negotiable Certificates of Deposits (NCDs) are negotiable certificates. They can be traded in secondary Eurocurrency market. They are more advantageous than fixed term Euro Currency Certificates. As the NCDs carry high liquidity, they are issued against the Eurocurrency fixed deposit certificates. NCDs give more depth, worth and acceptability to the euro currency market. The multinational corporations, international banks and companies manage their short term working capital requirements through this market. As this market provides the opportunity of depositing funds in multiples of international currencies, the MNCs dealing in many nations, many currencies find this market very worthwhile. Under the centralized cash management system of MNCs the excess funds are invested in such a highly liquid instruments of Eurocurrency market. This market is also lucrative because less government regulations are prevalent in this market.

(i) Euro Notes:

Euro Notes are issued and undertaken by a group of commercial banks or investment institutions.

(ii) Euro Commercial Paper:

Commercial Papers are issued by corporate. These are unsecured loans by companies. Taking the advantage of wide reputation and creditworthiness, companies instead of going for bank loan, they issue commercial papers in money market. Through commercial papers, less costly loan is accessed by the corporate houses. In the Indian money market, the issue of commercial paper must be credit rated. Credit rating agencies like- Standard & Poor's, Moody's, Fitch, CRISIL rate them as AAA^{+}, AA^{+},A^{+} , BBB^{+}, BB as per the credit worthiness of the issuer.

Similarly in the eurocurrency market, Euro Commercial Papers are issued by international companies. Euro commercial papers are widely traded in the euro currency market. These are issued at above LIBOR interest rates. The maturity period normally ranges from one month to six months. This is one of the options of international short term bank borrowings in many foreign currencies.

(iii) Euro Credit:

Euro credit is a short term loan by euro banks. The participants borrow euro credit from eurocurrency market. As Eurocurrency market is world spread, many centers of this market are instrumental. This market provides higher depth to international borrowers. This facilitates borrowings in many international currencies at many international locations. There is also less need of disclosures and declaration. This makes the market more attractive for the borrowers.

Excersice-1:

Q.1. What do you understand by financial market? Specify the role of financial markets.

Q.2. What is international money market? Explain Eurocurrency market in this reference.

Q.3. What is LIBOR?

Q.4. What are the prominent instruments of eurocurrency market?

Q.5. How eurocurrency market is advantageous over domestic money market?

14.3 International Capital Market

Capital market is the financial market for long term deposits and borrowings. The surplus fund units invest funds in the market for earning returns and the units those need funds borrow from the market and use the funds in more productive ventures. Hence, the prime function of the capital market is mobilization of capital in the economy. Investors, borrowers and intermediaries are three pillars of this market. Market intermediaries like underwriters, issue managers, registrars and bankers to the issue are key intermediaries those help the borrowers in flotation of securities in the market. The funds are mobilized through exchange of securities. Securities are the instruments issued by borrowing institutes and purchased by the investing institutes. By this way, the money is exchanged between investor and borrower. Shares, Bonds, Debentures are the prominent Indian capital market securities. The wide range of securities provides the depth to the capital market. Liquidity and safety of funds are the virtue of an efficient capital market. Though, the regulatory authorities should also be vigilant towards the functioning of intermediaries. Investor's interest should be protected and malfunctions must be provoked. International capital market is the market where worldwide participants are allowed to participate. The borrowers and investors can access the foreign markets. This is the market where sovereign government has allowed the international participants to capital transactions. International banks, multinational companies, governments and traders are the participants of the international capital market. The international capital market broadly comprises of two types of financial instruments. Equity Instruments

1- Debt Instruments. Through equity instruments ownership is liquidated to the security subscribers while, market borrowings are raised through debt instruments. Depending upon the market for equity issue, there may be three types of equity issue i,e. equity issue for domestic market, equity issue for specific foreign market and equity issue for many foreign markets simultaneously (except domestic market). First category of equity issue is known as Domestic Equity Issue, second is Foreign Equity Issue and the third is Euro Equity Issue. The equity instruments are issued by the companies when they want to raise large amount of corpus for a risky venture.

14.3.1Foreign Equity Issue

Foreign equity issue refers to the equity issue in foreign market made by a nonresident company. **E.g.** If, a company registered in India, brings its Dollars based equity issue in US capital market, it will be known as foreign/international equity issue. In such an issue the investors of that economy are eligible to subscribe the issue. This is an international issue. When company finds it better to access foreign market in comparison to domestic market, company goes to such international issue. International issue is made in the form of 'Depository Receipts'. A depository receipt is a negotiable instrument issued abroad, often in lightly regulated markets such as Luxembourg, to represent underlying domestic shares. DR makes it easier for foreign investors to take an exposure to the issuing company without moving money across borders. According to Bloomberg data, there have been 457 overseas GDR listings by Indian companies since 1993. "A Depository Receipt is a negotiable certificate that usually represents a company's public traded equity or debt. Depository receipts are created where a broker purchases the companies share on the home stock market and delivers those to the depository's local custodian bank, then after instructs the depository bank, to issue Depository Receipts. Depository receipts are quoted and traded in the currency of that country in which they are traded. They are governed by the trading and settlement procedure of the market where they are issued. The ease of trading and settling of DRs makes them an attractive investment option for investors wishing to purchase shares in foreign companies"*. The companies in international equity issue offer DRs in foreign capital market denominated in the currency of that country. The foreign based such an issue must be listed in any of the stock exchanges of that market, so as to provide liquidity to the DR instruments. The DR may comprise of many shares of the company. The DR could be converted in to shares with a predefined process. Such issues are identified by different names of issue. The company issuing DRs in United States are known as American Depository Receipts (ADRs). Non-Indian company issuing DRs in India is known as Indian Depository Receipts (IDRs). Issuing DRs in foreign capital market comes under the ambit of regulatory authorities of that country. SEBI is the regulatory authority of Indian capital market. All IDR issues are subject to prior approval from SEBI. IDR holders have voting rights with respect to the shares underlying the IDRs and will generally be entitled to vote on resolutions of the issuer. IDR holders are entitled to instruct the depository to exercise voting rights in respect of shares represented by their IDRs subject to the right of depository to request certain legal opinion from the issuer's legal counsel in advance of any such exercise in certain limited circumstances. * International Financial Management, Mahdi Vij, Excel Publication, Pg.no. 589 According to their closing prices on various overseas exchanges, $1.87 trillion (Rs. 83.4 trillion) worth of investor wealth is parked in such stocks by foreign entities

14.3.2 Euro Equity Issue

Euro equity issue is the equity issue in more than one foreign market except the domestic market of the issuing company and denominated in the currency other than that of issuer's home country. In the euro equity issue the investors of all over the world can invest except the investors of issuer's home country. The instrument through which this issue is made is known as Global Depository Receipts (GDRs). Hence, GDR is the vehicle to raise funds from multiple of the markets simultaneously. The GDR issue is registered with foreign based stock exchange and it may be denominated in any one convertible foreign currency or few of the convertible foreign currencies. GDR security may comprise of one or many underlying shares. The GDR may be converted into the underlying shares of that company. GDRs are the freely negotiable instruments in the international capital market.

14.3.3 Debt Instruments

Debt instruments provide leverage to the borrowers (issuing companies). Without liquidating the ownership of the company the managers get the long term capital for the projects. Less risky project with moderate funds requirement could be financed through floating debt instruments in the capital market. Domestic capital market, foreign capital market or many foreign capital markets at the same time could be accessed in this context. Bonds, Debentures, Trade credit and bank borrowings are the important instruments of debt market. In the international capital market the debt instruments primarily are International Bonds, Global Bonds and External Commercial Borrowings.

14.3.3 Foreign Bond Issue

Companies can access foreign capital market through floating their bonds in foreign markets. Foreign bond issue or international bond issue is an event in which bonds are floated by the foreign companies denominated in the currency of that country. Example: Indian company issuing Bonds in US market with the face value in US Dollars is an international Bond issue or any US Company issuing bonds in Australian capital, market in terms of Australian Dollars is an international bond issue. International Bonds are issued to access particular foreign capital market. When companies find foreign market more worthy than domestic market in terms of interest rate structures or in terms of subscription probabilities, they decide to go for international bond issue. The foreign bond issue is known by its name as for particular foreign market. Like; International bond issue in US by non-US companies is known as Yankee Bond issue. Issuing Bonds in Japan capital market by non Japan based companies are known as Samurai Bonds and Bulldog Bonds Issue when non UK based companies bring their issue in UK.

Euro Bond Issue

Euro bonds issue is the issue through which multiple of the capital markets are accessed simultaneously. In the euro bond issue the investors of all around the globe can subscribe the issue except the investors of issuing home country. The issue may be denominated in one currency or in many currencies. Like it may be dollar denominated issue, the investors may invest in USD and coupon or maturity payments will be made in USD. Sometimes it may be denominated in many currencies. Like USD, GBP, JPY or AUD. The investor can invest and can get payments in the currency of his choice. Euro bond market is wide liquid market. It is a lucrative to the companies as less stringent rules and disclosure norms prevails in this market. 'In the past decade, the Euro bond market has grown explosively, due to a variety of reasons- primarily the deregulation of markets. The weakening of the dollars in 1985 also caused a shift out of dollars towards Euro-yen and Euro-Duectch marks issue. The control of inflation in the industrial countries also had resulted in a big demand for financial assets, allowing companies to issue bonds in unprecedented quantities and in variety of currencies. The major benefit of euro bond market is that it is relatively unregulated. Its income is essentially untaxed, and there appear to be greater flexibility in making issues that is the case in purely national markets'*.

14.3.6 External Commercial Borrowings

External Commercial borrowings are international borrowings raised by corporate. The companies may raise a foreign currency long term loan from the foreign bank located at any foreign destination. External commercial borrowings are subject to the approval of monetary authorities, as it leads to balance of payment deficit or surplus, hence RBI (Central Bank) regulations have to be followed. The developing countries need huge funds for infrastructure and industrial development. The companies raise long term loan from the banks of developed country at relatively low rates. The major risk in such borrowings is currency risk. If the currency in which loan was taken gets depreciated, at the time of repayment of loan, the borrower will be at advantage due to depreciation more units of borrowed currencies could be obtained from domestic currency. * International Financial Management, Mahdi VI, Excel Publication, Pg.no. 499

14.4 Summary

International money and capital markets provide tremendous avenues for international investing and borrowings. As these markets are worldwide markets with very large number of participants. They have the virtue of high degree of liquidity. Multinational companies efficiently take the advantage of these markets in their cash management process and in settlement of intra corporate transactions. The countries, where full capital account convertibility is applicable, they are the efficient centers of international capital markets.

14.5 Glossary

NCD - Non Convertible Debentures

MNC	- Multinational Companies
SEBI	- Security Exchange Board of India
LIBOR	- London Interbank Offered Rates
DR	- Depository Receipts
NBFC	- Non Banking Financial Companies
ADR	- American Depository Receipts
GDR	- Global Depository Receipts
OTC Market	- Over the Counter Market
UK	- United Kingdom (Britain)
US	- United States of America
USD	- US Dollars
NBFC	- Non Banking Financial Companies
GBP	- Great Britain Pounds
JPY	- Japanese Yens
AUD	- Australian Dollars

14.6 Check your progress

State whether true or false.

1. The 'Euro' is not related in any way to the European Union's currency, the 'Euro'.
2. In a short-term market, funds can be deposited or borrowed for a period of less than one year.
3. The Eurobond market is a broad, liquid market that is attractive to companies because it involves less stringent regulations and disclosure standards.
4. Due to devaluation, a larger amount of funds can be raised through loans denominated in the domestic currency.
5. Liquidity and safety of funds are characteristics of an efficient capital market.
6. An issue made by a non-British company in Britain is known as a Samurai bond issue.

14.7 Answer to check your progress

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

14.8 Terminal questions

1. What do you understand by financial market? Specify the role of financial markets.
2. What is international money market? Explain Eurocurrency market in this reference.
3. What is LIBOR?
4. What are the prominent instruments of euro currency market?

5. How Eurocurrency market is advantageous over domestic money market?
6. What is International Capital Market? How it is different with the domestic capital markets?
7. What are the equity and debt instruments? Explain the equity instruments of international capital market.
8. How Depository Receipts are different with shares?
9. How international capital market is advantageous over domestic capital market.
10. Explain Euro bond issue and differentiate with external commercial borrowings.
11. What is international capital market? In what conditions the multinational companies float there shares in foreign markets?
12. What are the characteristics of Eurocurrency market? Elaborate various instruments of international money market.

14.9 Suggested Readings

1. Shapiro Allen, Multinational Financial Management, Prentice-Hall of India Pvt. Ltd.
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5. Eun & Resnick, International Financial Management, Tata McGraw Hill Publication
6. Sharan V, International Financial Management, Himalya Publishing House.
7. Melamed Leo, Evolution of International Monetary Market, Cato Journal, Vol. 8, N0.2 (Fall 1988)
8. Marrwejik Charles van, An Introduction to International Money and Foreign Exchange Markets

Unit-15 Foreign Exchange and Interest Rates: Impact on Trade and Investment Flows

Structure

Objectives

- To develop awareness of foreign exchange and interest rates along with their impact on economic growth of the country.
- To understand foreign exchange, forex markets, its participants and activities in forex market.
- To analyze impact of exchange rate fluctuations on trade and investment flows.
- To comprehend impact of changes in interest rates on trade and investment flows.

15.1 Introduction

Foreign exchange and interest rates are two important determinants of the growth of any country. Government keeps foreign exchange reserves to meet their import requirements as well as to make foreign exchange rate stable through market operations from time to time. Foreign exchange primarily consists of foreign currencies that are earned by exporting goods and services and are paid on imports. So, foreign exchange rate (at which currency is exchanged) plays a crucial role for exporters and importers. As Foreign Exchange Rates (FOREX RATES) are volatile in nature, it is a major concern for international traders and investors. Interest rate is the rate of return that is earned by investing the funds with the banks and other institutions and it is the rate that is charged on borrowings by the financial institutions. Borrowed capital is one of the significant sources of business capital for the traders. They get it from commercial banks and financial institutions, and they pay interest as cost of capital. Rise in interest rates makes the capital dearer for the businesses that are reflected in increased cost of production of goods and services whereas low interest rates leads to enhanced manufacturing and trading activities in the economy.

15.2 Foreign Exchange

Foreign exchange comprises of foreign currencies, foreign government bonds & securities and precious metals like gold and silver. Governments keep foreign exchange reserves in its treasury to meet the contingent import requirements and to use foreign exchange reserves to make forex rate stable. Foreign government bonds and foreign currencies are key components of foreign exchange reserves. Foreign currencies and bonds are the assets for the holding country as their monetary value is guaranteed by issuing government. Normally, the foreign currencies are considered as foreign exchange. Each sovereign government has its own currency that is operational in its economy. Foreign currencies like US Dollars, British Pounds, Australian Dollars, Japanese Yen and European Euro are important international currencies those are most commonly used in international business. The market where currencies are exchanged with each other is known as Foreign Exchange Market. It is also known as 'Forex Market or Currency Market'. Any place where currencies could be converted into each other is known as forex market place. Forex market is spread all around the globe. Now a days, in the IT era, the markets are electronically connected. It is a virtual market where no physical place is essential. It exists anywhere, where currency conversion could take place. Forex market operates through authorized commercial banks and money dealers. Commercial Banks are the providers of the liquidity to the economic system. They hold portfolio of many currencies in this respect. They buy as well as sell foreign currencies as per the need of customers. Trading in Foreign currency is one of the important sources of revenue for the banks. Banks offer the currencies at prevailing currency exchange rate at that time. They offer bid rate to buy and ask rate to sell the currency. Hence, they help forex traders and provide platform to the forex market. Example, Suppose Mr. Vinay wants to visit UK for his business promotion trip. Then, he needs British Pounds for his travel, boarding and lodging expenses in London. For that, first he will go to the bank that is authorized foreign exchange dealer. Bank will offer him a particular rate at which he could purchase one unit of British Pound by paying specified amount of Indian Rupees (say Rs./£: 74). This rate is known as forex rate, at which he may purchase any number of British Pounds. Foreign exchange markets facilitate availability of foreign currencies that helps to promote international business among the countries.

The exchange of currencies in international trade takes place on the basis of current purchasing power of respective currencies. Purchasing power refers to the quantity of goods which can be bought from a given unit of currency. In other words purchasing power of any currency is the real power or value of the currency through which goods and services are purchased from the market. The unique feature of forex market is that the seller is simultaneously a buyer and the buyer is seller also at the same time. The traders buy one currency by selling another currency. E.g. when an Indian firm exports the goods to a US based importer, it may accept US Dollars or Indian Rupees or any third currency as its trade proceeds. If it gets its payment in US Dollars, it has to exchange those Dollars into Indian Rupees. In the exchange process it will sell Dollars and will purchase Rupees.

Governments, central banks, commercial banks, international traders, multinational companies, non-government organizations and individuals are the participants of the forex market. Government participates in this market for making international investments, international borrowings and to facilitate exports-imports by government agencies. Central banks of different countries buy or sell the foreign currencies to ensure the forex rates stability. The traders buy and sell foreign currency for making payments internationally. MNCs sell their product internationally and they purchase the raw material, other goods and services from abroad, thus they need foreign currency to pay their suppliers. The companies and international traders buy and sell currencies to settle their business transactions. Individuals participate in the forex market for different motives. Individuals transact the currencies in form of NRI Remittances, monetary gifts, donations and to facilitate tourists and travelers across the world. Currencies are exchanged on specific rate i.e. forex rate. Foreign exchange rate is volatile in nature, it keeps on changing continuously on market conditions. Few currencies are more fluctuating in values, while few others are less. Less fluctuating currencies are considered as strong currencies and high fluctuating (less stable) currencies are considered as weak currencies. The reasons of currency volatility lie with the market forces. As forex market is so huge that a single transaction can hardly affect the rates of currencies. But the similar trend of the transactions collectively can make market rate change. If the US Dollar is more in demand in the market, its value will get appreciated against other currencies and if there is increase in supply of US Dollar, it will get depreciated against other currencies. The demand and supply of currency is affected by the operations of the forex market participants, like- Governments of the countries, multinational companies, international traders, FDI, FIIs, international investors and borrowers affect the demand & supply of currencies to settle international transactions.

e.g.: LMJ International, India has consigned Tea worth $1 million. For that it got payment in Dollars. When Dollars are converted into Rupees, it will make supply of Dollars and demand of Rupee.

15.2.1 Types of Forex Market

There are two types of Forex Market:

15.2.1.1 Spot Forex Market and
15.2.1.2 Forward Forex Market

Spot market is the market where currencies are transacted on the spot. In this market, one can exchange currencies at prevailing spot rates. The rate at which currencies are traded in spot market is *spot rate i.e. denoted as symbol* ***S (.)***. Spot prices are determined on the basis of current market forces. Spot rates can be expressed as under –

S (Rs/$): 54.2376 – 55.4397

The **forward market** is the market where contracts are made to settle currency transactions in a future specified date. The contract to exchange currencies is made on a fixed rate i.e. forward rate. Forward rate can be written in following manner –

$F^{\text{I month}}$ (Rs/$): 53.2343 – 54.2397

For Example

M/S. Savitr fertilizers exported the material of $ 100,000 on 1st Jan, 2012 to a US based company on credit basis. The spot rate is 50.4563 Rs/$. It is expected to receive payment after 3 months on 31st March 2012. As the exchange rate of any future date cannot be predicted, so exporter will be in dilemma in respect of net Rupee inflows on transaction date. The net inflows will depend upon appreciation/depreciation of Rupees against Dollars. If Rupee gets appreciated, it will result in forex losses or vice- versa. In order to avoid this uncertainty the manager may enter into a forward contract with a bank, in which he may book the forward rate of exchange. The forward contract may be like-

To transact	: $100000 for Rupees
At forward rate of	: 52.7535 Rs/$
Transaction date	: 31/03/2012
Parties	: M/S Savitr Fertilizers and HDFC Bank Ltd.

Both the parties will honor the contract and no party can breach the contract without the consent of second party. In case, one party refuses to honor the contract, latter may sue in the court under the Law of Contract. Forward contracts are advantageous for future currency transactions. As future exchange rate is uncertain that's why one could not be sure about his future net receipts/payments. Through forward contract, one could fix the currency rates for future transactions and can avoid uncertainty.

15.2.2 Activities of Forex Market

Currency trading is chief activity of the forex market. Different traders participate with varying objectives. The participants usually buy and sell the currency to set off their payment settlement requirements as well as for international investments and borrowings. Besides payment settlement requirements, few traders pursue trade activities for other motives also. These activities are:

i. *Hedging*
ii. *Speculating and,*
iii. *Arbitraging*

Hedging: Currency trading with the objective of covering the risk of forex rate changes is known as hedging and such traders are known as hedgers. As the forex rates are volatile, they may lead to forex gains or losses. To avoid this uncertainty, hedgers opt various hedging techniques like forward contract, future contract, option contract, swap or money market hedging to hedge their forex exposure.

Speculating is another prominent activity in the forex market. Speculators invest money in few currencies with expected appreciation in the value of the currency. If the currency appreciates, they gain or vice-versa. The approach is to make short term gains from ups and downs of the currency rates.

Arbitraging: It can be characterized as securing gains by taking advantage of price differentials of any commodity in two markets. Currency arbitrage is Taking advantage of price differentials of the same currency in two markets at one point of time. Arbitragers take the benefits of different prices of currency at two markets. Arbitragers buy the currency from the market where it is cheap and sell the currency in the market where it is dearer. The gain they earn by this manner is called as arbitrage gain. Though forex market is perfect competition market and interconnected with electronic system. One price exists for the same currency in all the forex markets at a time. But due to short term excess supply or short term excess demand of specific currency in one market or due to communication gap the currency prices in the market may be different with other currency market.

<u>Forex Rates and Quotations</u>

The forex rate is the rate at which currencies are transacted with each other. This is the ratio between the units of one currency with the unit of other currency. Forex rates are written in the following manner:

(Rs/**$**) **= Rs. 53.1675**

Or $ **1 = Rs. 53.1675**

Forex rates comprise of 4 digits after decimal in every rate. Above rate signifies that one $ is equal to Rs. 53.1675. Here, in the symbol (Rs/$), the currency at denominator may be considered as unit currency because the currency at numerator is compared against one unit of the currency at denominator. The bank offers the different forex rates for different set of currencies. Since bank buy and sell the foreign currency, they offer two rates – one for buying the currency and other to sell the same currency. Like:

S (Rs. /**$**) = **53.1675 - 54.5650**
(BID RATE) (ASK RATE)

Bid Rate is the rate at which bank is ready to purchase unit currency (i.e. $ in above rate) and ask rate is the rate at which bank is ready to sell the unit currency (i.e. $ in above rate).

In the above example one unit of $ is compared with the units of Rupees. So, $ is the unit currency. Bank will buy $ at Bid Rate (Rs/$: 53.1675) and bank will sell unit currency ($) at ask rate (Rs/$:54.5650). Ask rate is always higher than bid rate. The difference of the two rates is known as **spread**. Spread may be different for different sets of currencies. It is expected to be lower with respect to strong currency, while spread would be higher with respect to weak currencies. Spread can be calculated in percentage terms as;

$$\text{Spread \%} = \frac{\text{Ask Rate} - \text{Bid Rate} \times 100}{\text{Ask Rate}}$$

Forex rates are offered for spot and forward market separately.
In the Spot Market the rates are shown as under -
S (Rs. /$): 51.6560 - 52.7870

The symbol **S (Rs./$)** denotes the spot market.
Forward market rates are the rates of currencies offered by banks or authorized money dealers for future transactions.

$F^{1\ \text{month}}$ (Rs/$) = 51.6560 - 52.7870
(1 month forward rate) 1 $ = Rs. 51.6560 – Rs.52.7870

The forward rate is written as Bid and Ask Rate. In the above rate, bank offer rates to buy $ 1 at Rs. 51.6560 (Bid Rate) and to sell $ 1 at Rs. 52.7870 (Ask Rate).

Sometimes quotations (rates) are written in short like:

S (Rs/$): 52.3835 – 3895
or
S(Rs/$): 52.3835 - 95

It means real quotation is S (Rs. /$): 52.3835 – 52.3895
It can be understood that last digits of quotations (i.e. two or four) denotes the last digits of ask rate and rest digits of ask rate are same as bid rate.

In the forward market, the quotation may be written as –

F$^{1\ month}$ **(Rs/$): 54.3835 – 55.8680**
F$^{2\ month}$ **(Rs/$): 56.4560 - 56.9192**
F$^{6\ month}$ **(Rs. /$): 55.1020 -56.1375**

The F(Rs/$) symbol denotes the forward market quotation. Prefix time as 1 month or 2 month or 6 month shows the very date of transaction in future from today. As *(1 month)* **F (Rs/$): 54.3835 – 55.8680** is the forward rate of one month hence from today.

You may ask the question, "How the rate of future date is decided today"?

The answer is that the forward rate is not exactly the spot rate on a specified date. Spot Rate is decided on demand and supply conditions of currency on daily basis. So, the future demand and supply of the currency on future date cannot be accurately calculated but forward rate is mutually agreed price of the currencies between parties to contract. That price is observed on the basis of future expected demand and supply of that currencies on that very date. Forward contracts are advantageous for future currency transactions. As future exchange rate is uncertain, that's why one could not be sure about his future net currency receipts or payments. Through forward contract one could fix the currency rate for future transaction and avoid uncertainty.

Forex Quotations

There are two types of quotations in the forex market called Direct Quote and Indirect Quote. As we know the forex rate is valuation or comparison of values of two currencies. So, it is a ratio between the units of one currency and units of another currency. Hence, a unit of foreign currency may be compared with the units of domestic currency or a unit of domestic currency may be compared with units of foreign currency.

Direct Quotation

In the direct quotation one unit of foreign currency is compared with the units of domestic currency.

For Example

In Delhi Market

S (Rs/$) : 51.6550 - 52.1565

It is a direct quote where one unit of foreign currency $ is compared with the units of domestic currency Rs.

Indirect Quote

In the indirect quote, one unit of domestic currency is compared with the units of foreign currency.

For Example

In Delhi market

S ($/Rs.): 0.01212 - 0.0214

It is an indirect quote, as one unit of domestic currency (Rs) is compared with units of foreign currency $.

15.2.2 Converting as inverse quote

Inverse quote means inverse of given quotation. Like-direct quote is inverse quotation of indirect quote and indirect quote is inverse quotation of direct quotation. Direct quote can be converted in to its inverse and vice-versa.

For example-

15.2.2.1 S (Rs/$): 51.3245 is a direct quote for Mumbai forex market. It can be converted into indirect quotation for Mumbai forex market by as follows-

S ($/Rs) = 1/51.3245 =0.0195

15.2.2.2 If direct quotation for Mumbai forex market is like S (Rs/$): 51.3245 - 52.3456. Its indirect quotation for Mumbai forex market will be as follows-

S ($/Rs) = 1/52.3456 – 1/51.3245
S ($/Rs) = 0.0191 - 0.0195

15.2.3 Cross Rates

Often currency rates are shown in terms of few currencies. The currency rates for rest of the currencies can be obtained with the help of cross rates. Cross rates are the currency rates found with the help of given quotations of the currencies?
For example-
S (£/€): 0.6534 – 0.6887
S (Rs/ €): 65.8975 – 66.0341

From the above quotes, one can find the quotation (rates) between S (Rs/£).

I.e. Bid rate of S (Rs/£) = $\frac{\text{Bid of S (Rs/ €)}}{\text{Ask of S (£ / €)}} = \frac{65.8975}{0.6887} = 95.68389$

Ask rate of S (Rs/£) = $\frac{\textbf{Ask} \text{ of S (Rs/ €)}}{\text{Bid of S (£ / €)}} = \frac{66.0341}{0.6534} = 101.06228$

S (Rs/£): 95.68389 – 101.06228

15.2.4 Currency Derivatives:

Derivatives are the financial instruments value of which is derived through underlying assets. Currency derivatives like currency futures and currency options are the financial derivative contracts. Their value is determined on the basis of underlying currency. Risk reduction is thrust of the currency trading. Forward contract market and money market hedging are the OTC (over the counter) market hedging activities. Currency derivatives are exchange based currency trading instruments. Currency derivatives are used to hedge the forex risk by taking the Contra positions. In India, currency future contracts in USD-INR, EUR-INR, GBP-INR and JPY-INR are available at commodity and currency exchanges.

15.2.5 Impact of Foreign Exchange on Trade and Investment Flows

The impact of foreign exchange on trade and investment flows can be explained as follows –

15.2.6 Impact of Interest rates on Trade and Investment Flows

Interest rate is the rate that is earned on deposits with banks and financial institutions. On other hand, interest rate is paid on the bank and other borrowings. Interest rate is important determinant of the economic growth of a country. Growth of domestic business, returns on bonds, returns from securities market and foreign investment largely depends upon the prevailing interest rates in the economy. Interest rate is fixed as per demand and supply of capital in the market. The supply part is largely based on rate of savings and demand is based on entrepreneurial and development activities in the country. The central bank Reserve Bank of India (RBI), through its monetary policy tries to ensure monetary stability and sustain development of the country. The interest rate is key tool of monetary policy that is regulated through repo rate, reverse repo rate, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR) and Bank Rate. The key impacts of interest rates on trade and investment flows are as follows -

1. Interest rates determine the cost of capital and trade volume. Low rates of interest facilitate low cost financing and low production cost to the business. Goods and services are offered at comparatively low prices to the consumers resulting in increase in volume of trade.

2. Low interest rate increases the purchasing power of the people. People may avail low cost loans from the banks and spend on produces in the market. This leads to more demand of the products.

3. Exporters also get advantage of low interest rates as cheap financing gives the competitive edge to produce the product at competitive prices. With better quality and lower prices exporters get more orders.

4. Capital is one of the basic business resources. Multinationals in Search of cheap financing, cheap labour availability and potential market growth internationalize their operations. As such the business of the countries providing cheap finance and labour etc. shall grow at relatively faster rate.

5. Developing countries are having ample scope of business growth and development. The GDP growth rate of developing countries has been seen growing at a faster rate. The growth rate of BRICS Countries (India, China, Brazil, Russia, South Africa) is quite high than the growth rate of other developed countries. The higher growth rate is the symbol of high demand of business resources as well as capital in that country. High demand leads to higher prices of the capital supplied by investors. Hence, they get the opportunity to earn more returns on capital invested in fast growing economies.

6. Higher interest rates (rates of return) attract the foreign investors. The foreign

investment may be in form of Foreign Institutional Investment (FII) and Foreign Direct Investments (FDI).

Foreign institutional investment is the investment that foreign investment agencies invest in stock markets of any other country. This is also known as foreign portfolio investments. In India, no foreign individuals are allowed to invest in Indian stock markets, only registered foreign institutional investors can invest in same. When foreign investors want to participate in the growth process of developing country and want to take advantage of its growth in the terms of high rates of returns, they invest with FIIs.

In the FII investments, funds are invested in stocks of foreign companies. The market professionals identify the right time to invest at bearish market and at appropriate time with bullish market they liquidate their investments. With this way, they take the advantage of market movements. Fundamental and technical analyses are two prominent analyses in this context.

FDI investment is done by the international, multinational companies with an ambition to start and control the business operations in foreign locations. There may be different motives of FDI investments, like market seeking, resource seeking, in search of cheap capital, cheap labour and economic stability. The FDI may be done in various forms like 100% wholly owned subsidiary, Joint venture, Mergers and Acquisitions.

Here, the objective is to obtain the managerial and decision making position in foreign investments.

7. Developing countries often lack capital. FDI and FII investors invest their capital to earn more returns, but at the same time they are also concerned about the safety and liquidity of their funds. Host country's social and political environments shall be thoroughly scrutinized while taking international investment decisions.

8. Interest rates of the two countries determine the relative exchange rate of currencies. As difference in the interest rates create the interest rate arbitrage opportunities and the interest arbitragers actively borrow the currencies at lower interest rate countries and invest in the countries where interest rates are higher, provided currency risk is acknowledged accordingly.

15.3 Summary

In this chapter we have discussed the importance of exchange rates and interest rates and their impact on trade and investment flows. Purchasing power is transacted among the participants through exchange of two sets of currencies. There are two types of currency market- Spot and forward forex market. Exchange rates and interest rates are key determinants of trade and investment flow in a Country. Interest rate is important determinant of the economic growth of a country. Growth of domestic business, returns on bonds, returns from securities market and foreign investment largely depends upon the prevailing interest rates in the economy.

15.5 Glossary

FDI	-	Foreign Direct Investments
FII	-	Foreign institutional investment
GDP	-	Gross Domestic Product
Volatility	-	Fluctuations
NRI Remittances	-	Funds remitted by Indian residents Working abroad to their relatives and known ones in India
Host Government	-	The foreign country government where company's foreign operations are located
Home Government	-	The Government of Company's Local country
Blocked Fund Risk	-	Host government regulations Over funds transmission for host country
Interest rate arbitraging	-	Taking advantage of interest rate difference in two countries, borrowing at low interest rates and investing at higher interest rates
CRR	-	Cash Reserve Ratio
SLR	-	Statuary Liquidity Ratio

15.7 Check your progress

State whether true or false.

- Commercial banks provide liquidity to the economy.
- Trading in foreign currencies is a major source of income for banks.
- In the spot market, currencies can be exchanged at currently prevailing rates.
- The forex rate is the ratio between one unit of a currency and one unit of another currency.
- The interest rate is determined by the demand for and supply of capital in the market.
- Low interest rates do not increase people's purchasing power.
- Developing countries often face a shortage of capital.
- Taking advantage of interest rate differentials between two countries is called arbitrage.

15.8 Answer to check your progress

1.True 2. True 3. True 4. True 5. True 6. False 7. True 8. True

15.9 Terminal questions

- What do you mean by foreign exchange?
- What is foreign exchange market? Explain the types of forex market.
- Differentiate between Speculation, Hedging and arbitraging of currencies.
- Specify the reasons of exchange rate volatility?
- What is forward contract? How forward contract is advantageous for the currency traders?
- What are Bid & Ask rates? Give examples.
- What are direct and indirect forex rate quotations?
- S (Rs./$): 51.8975. Is it a direct quote for New Delhi forex market? Convert it into inverse quote.
- S (£/€): 0.6334 – 0.6887. Is this an indirect quote for Paris? Convert it into inverse quote.
- What do you mean by cross rates?
- What is the role of Forex Market? Discuss its type and the participants of Forex market
- Elucidate the impact of exchange rates and interest rates on the trade flows of a country.

15.9 Suggest readings

- Shapiro, Alan, *International Financial Management*, Prentice Hall of India Pvt. Ltd.

- Vij, Madhu, *International Financial Management*, Excel Publications

- Bhalla, V.K., *International Financial Management*, Anmol Publications

- Apte, P.G., *International Financial Management*, Tata McGraw-Hill Publications

- Eun & Resnick, *International Financial Management*, Tata McGraw-Hill Publications

- Saran, V., *International Financial Management*, Himalaya Publishing **House**

Unit-16 International Accounting and Taxation Issues

Structure

16.1 Introduction

Objectives

- To make the students aware of international accounting and taxation issues.
- To understand the concept of international accounting
- To analyze related issues of international accounting
- To comprehend the concept of international taxation and related issues

Accounting as the language of business, acts as mechanism of preparing and maintaining financial records and communicating the results thereof to the parties interested in the business affairs. Accounting system consists of specific set of rules, principles and conventions which are used in the preparation of financial statements (portraying the results of operations of the business at the close of a given period of time and the financial position on the last date of the same period) such as Profit & Loss Accounts and Balance Sheets. In order to standardize the process of preparation of accounting records and their finalization, in a nation generally, a statutory body is authorized. In India, it is the 'Institute of Chartered Accountants of India (ICAI)' and in US it is 'Financial Accounting Standard Board (FASB)'.

16.1 Introduction

Globalization has led number of countries to open their doors to foreign trade and investments. As business expands across borders, both the public and private sector companies are increasingly recognizing the need for globally accepted accounting, auditing and taxation standards. Major capital markets of the world are emphasizing on convergence towards a single set of globally accepted accounting standards. High quality, globally consistent and uniformly regulated accounting standards is the need of the hour. This chapter focuses upon the concepts of international accounting, the institutes working in this issue at world level and the international taxation system.

16.2 International Accounting

International Accounting refers to that branch of accounting which deals with the recording and translation of foreign transactions, preparation and presentation of foreign financial statements and presentation of financial reports in accordance with international Generally Accepted Accounting Principles (GAAP).
International accounting involves accounting for international transactions, the operational aspects of international firms, comparison of accounting principles & practices found in foreign countries and the procedures by which they were established.[1]'It covers various aspects such as recording of foreign currency transactions, currency translations, consolidation, accounting for price level changes, foreign financial reporting & disclosures, international taxation, environmental accounting, derivative trading and harmonization of accounting practice[22]. International accounting plays an important role for the companies engaged in cross border financial transactions. Understanding of accounting practices of different countries is necessary because of -

- Difference in Accounting Procedures across the countries
- Difference in inflation rates
- Transactions pertaining on different currencies
- Forex rate volatility

The difference in the accounting procedure arises due to different accounting standards and practices being followed in different countries. For example, different consolidation procedures, different auditing standards, different depreciation procedures and different practices for inflation adjustments etc.

The world trade has grown enormously. Cross border intra-corporate transactions, cross-border investments and borrowings have been increased with high volumes. The diversities in accounting practices create problems in financial reporting and understandings. Like an international investor may not be well acquainted with the differing foreign accounting principles, so he may face difficulty in analyzing the financial statements of that country. **Harmonization** of accounting standards is need of the hour. Harmonization refers to the uniformity of accounting principles and practices across the countries. It strives to erode diversities in the accounting system worldwide.

'Due to the serious variations in accounting practices, it is not easily possible to harmonize the accounting practices and standard of various countries. Many international organizations have tried to harmonize world wide accounting standards. Accounting Standard are the policy documents issued by professional accounting bodies at national and international levels in relation to different aspects of measurement, treatment, disclosure and presentation of accounting information.

The main purpose of the accounting standards is to minimize the diversities of accounting systems, followed by the nations. The most important sources of regional and international standards are the International Organization of Securities Commission (IOSCO), the Organization for Economic Cooperation & Development, the International Federation of Accountants (IFAC) and the International Accounting Standard Committee (IASC). In the year 1973, the organization of professional accounting organizations founded the IASC to harmonize regulations, accounting standards and accounting procedures."[3] This was later replaced by the International Financial Reporting Standards (IFRS) in the year 2000. The IASC later restructured as International Accounting Standard Board (IASB) with effect from 2001. The IASB has so far IFRS and 41Accounting Standards (IAS). IFRS are considered as accounting principles i.e. set of standards in that they establish broad rules as well as dictating specific treatments for accounting. The list of IFRS and IAS has been given as under –

List of IFRS Statements

IFRS 1: First time Adoption of International Financial Reporting Standards
IFRS 2: Share-based Payment
IFRS 3: Business Combinations
IFRS 4: Insurance Contracts
IFRS 5: Non-current Assets Held for Sale and Discontinued Operations
IFRS 6: Explorations for and Evaluation of Mineral Resources
IFRS 7: Financial Instruments: Disclosures
IFRS 8: Operating Segments

List of International Accounting Standards (IAS)

IAS 1: Presentation of Financial Statements
IAS 2: Inventories
IAS 7: Cash Flow Statements
IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10: Events after the Balance Sheet Date
IAS 11: Construction Contracts IAS 12: Income Taxes
IAS 16: Property, Plant and Equipment
IAS 17: Leases
IAS 18: Revenue
IAS 19: Employee Benefits
IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

IAS 21:	The Effects of Changes in Foreign Exchange Rates
IAS 23:	Borrowing Costs
IAS 24:	Related Party Disclosures
IAS 26:	Accounting and Reporting by Retirement Benefit Plans
IAS 27:	Consolidated Financial Statements
IAS 28:	Investments in Associates
IAS 31:	Interests in Joint Ventures
IAS 32:	Financial Instruments: Disclosure and Presentation
IAS 33:	Earnings per Share
IAS 34:	Interim Financial Reporting
IAS 36:	Impairment of Assets
IAS 37:	Provisions, Contingent Liabilities and Contingent Assets
IAS 38:	Intangible Assets
IAS 39:	Financial Instruments: Recognition and Measurement
IAS 40:	Investment Property
IAS 41:	Agriculture

In the above mentioned IAS standards only 28 are in use. The remaining 13 standards have either been merged with other IAS or IFRS as per the changing environment. Synchronizing accounting standards across the globe is an ongoing process in the international accounting community. IFRS are used in many parts of the world, including the European Union, Hong Kong, Australia, Pakistan, India, Russia, South Africa and Singapore.

Though goal of IFRS is to make international comparisons as easy as possible, but the comparison is difficult because to a large extent each country has its own set of rules. For example: U.S. Generally Accepted Accounting Principles (GAAP) is different from Canadian GAAP. But in order to harmonize the accounting standards, the countries are adopting the IAS. ICAI has stipulated 32 Accounting Standards (AS) so for. These are as under -

List of Indian Accounting Standards (AS)

AS		**Broad Title/ Theme**
AS 1	:	Disclosure of Accounting Policies
AS 2	:	Valuation of Inventories
AS 3	:	Cash flow statement
AS 4	:	Contingencies and events occurring after the balance date
AS 5	:	Net Profit or Loss for the period, prior period of extra ordinary Items and changes in accounting policies
AS 6	:	Depreciation Accounting
AS 7	:	Construction Contracts

AS 8	:	Accounting for Research and Development
AS 9	:	Revenue Recognition
AS 10	:	Accounting for fixed Assets
AS 11	:	Accounting for the affects of changes in foreign exchange rates
AS 12	:	Accounting for government grants
AS 13	:	Accounting for investments
AS 14	:	Accounting for Amalgamation
AS 15	:	Accounting for retirement benefits in the financial statements of employers
AS 16	:	Borrowing Costs
AS 17	:	Segmental Reporting
AS 18	:	Related Party Disclosures
AS 19	:	Leases
AS 20	:	Earnings per Share
AS 21	:	Consolidated Financial Statements
AS 22	:	Accounting for Taxes on Income
AS 23	:	Accounting for investments in Associates in consolidated financial statements
AS 24	:	Discontinuing Operations
AS 25	:	Interim Financial Reporting
AS 26	:	Intangible Assets
AS 27	:	Financial Reporting of Interest in Joint Venture
AS 28	:	Impairments of Assets
AS 29	:	Provisions, Contingent liabilities and contingent Assets
AS 30	:	Financial Instruments- Recognition & Measurement
AS 31	:	Financial Instruments –Presentation
AS 32	:	Financial Instruments - Disclosure

From accounting point of view international financial transactions are categorized into two types. First, the international transactions leading to the cross border transaction of money denominated in a foreign currency as result of international trade, investments or borrowings. Second, interpretation of the foreign currency denominated accounts of branch/ subsidiary working abroad. i.e. **Accounting for Foreign Currency Transactions** and **Accounting for Foreign Operations.**

16.2.2 Accounting for Foreign Currency Transactions:

Exports, imports, international investments, borrowings and sale/purchase of foreign based assets lead to international monetary transactions. The prominent issues in recording of such transactions is the selection of the currency and fixation of exchange rate for transaction. The selection of currency to be transacted is subject to mutual agreement of the traders. The exchange rate is changeable in nature. If sale is made on credit basis or on installments basis the effective exchange rates on payment realization would be different than the spot rate of transaction. Exchange rate changes leads to forex gains or losses that should be acknowledged in the profit and loss accounts in same accounting year. IAS 21 provides guidelines for accounting on effect of exchange rate changes. For accounting treatment of foreign currency based credit sale transaction, the initial entry should be recorded as reflecting transaction (using spot exchange rate). For recording collection/payment of another installment thereof, relevant spot exchange rate will be taken and the forex gains or losses (as compare to spot rate of transaction date) should be acknowledged. At the closing date of balance sheet foreign currency based accounts receivables/payables are retranslated into reporting currency by using the closing rate and forex gains or losses should be recognized in the P & L account. The accounting entries in this respect may be understood with this example –

ABC ltd. on 1st Jan. 2012 exported goods worth of USD 10,000 that is to be collected on two equal installments on 28th Feb. and 31st May, 2012. Company closes its accounts on 31st March. The forex rates (Rs/ $) on respective dates are as follows-

1st Jan. 2012	: 47. 55	28th Feb. 2012	: 48.25
31st March, 2012	: 47.05	31st May, 2012	: 53.56

These transactions can be recorded in the books of ABC Ltd. As under –

			Rs	Rs
1- 1 Jan., 2012	Account Receivable a/c ($10,000× 47.55)	Dr.	4, 75,500	
	To Sales a/c			4, 75,500
	(Being sale made on credit basis)			

2- 28 Feb, 2012

Bank a/c Dr. 2,41,250 ($ 5000 × 48.25 = 2,41,250)

To Forex Gains a/c 3500

($5000× 48.25-47.55)

To Account Receivable a/c 2,37,750

(Being first installment received and forex gain incurred)

2- 31 March 2012

Forex Losses a/c Dr. 2500

(47.55-47.05× $ 5000)

To Account Receivables a/c 2500

(Being forex losses acknowledged at closing of accounts)

3- 31May 2012

Bank a/c Dr

267800 (53.56 × $5000)

To Forex Gains a/c 30,050

(53.56-47.55×$5000)

To Account Receivables a/c 237,750

(Being final installment received and forex gain realised)

The fluctuating forex rates may leads to uncertainty in the future cash flows. To avoid this trader may undergo to a forward contract with a bank. Forward contract refers to the contract under which two parties agree to exchange fix amount at fix rate of two set of currencies at specified future date. This is made to avoid forex risk. e.g. M/S Taj exporters sold antiques worth of USD 10,000 to a US based trader on 1st Jan., 2012. The payment will be realized on 1st May, 2012. The respective exchange rates on date of transaction as on 31st March were 48 & 51(Rs/$). To avoid forex losses and uncertainty M/S Taj Exporters has entered into 4 months forward contract with a bank on 1st Jan. 2012 to exchange USD 10,000 at the rate of 52.5 (Rs/$). On 1st May the spot rate comes as 53.5(Rs/$). Its corresponding accounting entries can be made as under –

1 Jan. 2012 1- Sundry Debtor a/c Dr. 4,80,000

To Sale a/c 4,80,000

($ 10,000 ×48)
(Being sale transaction held)

The Forward contract made with bank to pay $ and receive Rs at 52.5 Rs/$

2- Forward Con. (Rs) Receivables a/c Dr 5,25, 000
To Deferred Premium a/c 45,000
(52.5-48 × $ 10000)
To Forward Con. ($) Payable a/c 4, 80,000
(Being forward contract made & forex gain on forward contract recognized) 31st March 2012

3- Deferred Premium a/c Dr. 33,750
(45000 × ¾ = 33,750)
To Foreign Exchange Gains a/c 33,750
(Being deferred premium amortised proportionately) 1st May 2012

4- On settlement of transaction

Bank a/c Dr 4,70,000
Exchange Loss a/c Dr 10,000
(53.5-52.5× $10,000)
To Sundry Debtor a/c 4,80,000
(Being payment collected and loss compared with spot rate of settlement date & forward rate)

5- Closing of forward contract

(i) Forward Con. ($) Payable a/c Dr 4,80,000
Foreign Exchange Gains a/c Dr 45,000
To Cash 5,25,000
(Being foreign currency paid to forward contract dealer as per contract)

(ii) Cash a/c Dr 5,25,000
To Forward con. (Rs) Receivable a/c 5,25,000
(Being payment received in domestic currency Rs from forward contract dealer as per contract)

6- Deferred Premium a/c Dr. 11,250
(45000 × ¼ = 11,250)
To Foreign Exchange Gains a/c 11,250
(Being deferred premium amortised proportionately)

16.2.2 Accounting for foreign operations:

The subsidiaries or the foreign branches of the business working in foreign countries prepare their financial statements in foreign currency adhering to the country specific accounting practices. The issues of consolidation of statements, translation of statements, inflation accounting and treatment of exchange gains/losses are the important areas of international accounting in respect to accounting for foreign operations. The parent companies prepare **consolidated statements** for analyzing overall performance and for stakeholder's interest. Consolidation of financial statement refers to the combining of statements of subsidiaries along with parent company (pertaining all assets and liabilities of the entire group) in one currency denomination. There are two ways of consolidation of statements i.e. **Gross Consolidation Method and Net Consolidation Method.** Under the Gross consolidation method, corresponding assets and liabilities of the subsidiaries are added to the parent company's assets and liability on gross terms without considering the parent company's stake and later the minority's interest as absolute term is written on liability side. Under the Net Consolidation method the value of the assets/liabilities of the subsidiary limiting the stake of the parent company only is added to corresponding asset and liabilities of the parent company. A consolidated statement gives combined and overall information to the stakeholders. 'In the United States of America, all companies have to consolidate accounts, except where there control over subsidiaries is only temporary or where the control does not rest with the majority owners. In UK, the Companies Act 1989 makes the consolidation compulsory, except in some cases where consolidation is not practical and where it involves undue expenses and time. The German law makes consolidation compulsory, especially where the parent company has a major stake in the subsidiary.'[4]

Translation of statement refers to the translation of the foreign currency based financial statements in to the reporting currency. Translation of financial statements of subsidiaries into reporting currency, are required to prepare the reports and performance appraisal of the foreign based business unit. As the forex rate keep on changing it is to be decided that at which rate conversion would be done. There are four methods of translating the values of assets and liabilities denominated in foreign currencies –

- Current rate method

- Current- Non Current rate method
- Monetary-Non Monetary Method
- Temporal Method

Under the current rate method, all the assets and liabilities belonging to subsidiary or foreign branches are converted at prevailing current spot rate on the date of conversion. Under the current – non current rate method, all such assets and liabilities are categorized as fixed and current assets. Fixed assets & liabilities are converted at their historical rates and current assets & liabilities at prevailing current spot rate on the date of conversion. In the monetary and non-monetary method, the assets & liabilities are classified as their monetary and non monetary nature. The items (assets/liabilities) which reflect future financial claims are considered as monetary items like account receivables/payables, debtors/creditors or bank overdrafts etc. Under this method all such monetary items are converted at current rate and remaining non-monetary items at their historical rates. Temporal method is alike with monetary and non-monetary method. The only difference is that inventory (stock) is converted at current rates in the temporal method. Inflation is one of the important areas of concern of accounting. Inflation refers to the rise in price level. The prices may change in a short span of time. The new increased prices of raw material, labour or other supplies should be recognized while fixing the selling price of product produced at old rates. Overlook of inflation rate changes leads to misleading and overstated profits. Inflation adjustment is required to address the issues of determining cost of goods sold, deferred expenses and charging depreciation on assets. The foreign based subsidiary working at inflationary environment also needs inflation adjustment to arrive at justified income, expenses and profits. There are two methods of inflation adjustment of a subsidiaries statement i.e. **restate-translate method** and **translate-restate method**. Under the restate-translate method first inflation is adjusted and values are converted in reporting currency whereas in translate-restate method values are converted in reporting currency and inflation is adjusted.

International accounting helps to analyze foreign financial statements. Segment reporting, accounting for joint ventures and interim financial reporting are other important areas addressed under international accounting.

International Taxation

"International taxation has become too complex an issue. It has made the legal circles rethink the jurisprudence of tax jurisdiction… Innovation in applying settled legal dictum is the need of the hour," All the controversies relating to international taxation are about interpretations of the provisions of domestic law and the treaties and conventions concerning double taxation avoidance."

-Chief Justice Swatantra Kumar, Bombay High Court

International taxation is a very peculiar issue for the multinational companies and the international investors. The international taxation environment consists of the tax policies and norms of both the host country and home country, and hence, it becomes the crucial matter of consideration to the MNCs. These tend to reduce the tax liability simultaneously with following the tax regulations. The profitability of the firm and transfer pricing decisions depend on the tax structure of the country. The primary motive of the tax planning is to minimize the overall tax liability of the corporate group. International tax policy is determined through complex interactions between host and home governments.

There are two principles of determining income tax liability -

- Source of income rule
- Residence rule

As per the source of income rule, the income may be subject to tax in the country, where income is earned or accrued, whether the earner is resident or non-resident. While as per the residence rule, the tax liability is determined according to the residential status of the assesse. The countries follow either of the two methods of income tax while some countries follow the mix of the two rules. Since the tax structure of the countries is different, the MNCs working in different countries face complex problems while making their tax decisions. 'The causes pertaining to variations in the tax burdens of the countries are as follows –

1. Statuary tax rates vary across countries from high tax countries to tax heaven countries
2. Differences in the treatment of transactions among the parent companies and its subsidiaries
3. The treaty between the two countries
4. Varying interpretation of tax neutrality
5. Differed tax system
6. Difference in Methods of calculating the net taxable income
7. Difference in the compensation for double taxation"[5]

There are two accepted methods of implementing the taxes -

(1) Imposing the tax liability on the basis of global profits earned or

(2) Imposing the tax liability on the basis of geographical boundaries under which income is generated

In the first method, company's total income (through all global operations) is considered for determining tax liability. There shall be chances of double taxation under this approach.
For example; the income of the subsidiary of a US Company in India will be taxed in India first and then the same will be taxed in US as per the theory of taxation on the basis of global profits.

Double taxation refers to taxation on same income of an entity in more than one country. The companies have to pay the income tax twice under the double taxation. Hosts as well as home governments both charge income tax on the same income. The occurrences of double taxation reduce the profitability of the companies and that's why reducing their attractiveness towards business ventures in foreign countries. So the countries for the sake of growth of business activities, want to avoid double taxation incidence. This can be removed by the negotiations or through the tax treaties between the countries. Two types of tax treaties may be there -

(a) Bilateral tax treaties
(b) Unilateral tax treaties

Bilateral assistance is provided to the assessee by home country by entering into an agreement between the host country and home country. Section 90 of the Income Tax Act empowers the Government of India to enter into a bilateral treaty for this issue, while section 91 empowers the government to provide unilateral assistance to the double taxed assessee.

The bilateral agreement is worked out on mutual agreement between the two sovereign states. "Agreement for bilateral relief may be of following two kinds-

(i) Agreement where two countries agree that income from various specified sources which are likely to be taxed in both the countries should either be taxed only in one of them or that each of the two countries should tax only a particular specified portion of income, so that to escape with overlapping.
(ii) Another way to escape is to provide compensation to the assessee against the double tax paid in two countries. Compensation can be provided for the payment of double tax paid if it is proved by the payee.

In addition the government may enter into an agreement of following also-

(a) Transformation of information for the prevention of evasions or avoidance of income tax chargeable under any income tax act, rule or law of corresponding countries.
(b) For recovery of income tax, under this act or law in force in the country."[6]

The governments can enter into the agreement by their mutual understanding. Hence the treaties among countries are not identical but it is very much desirable in order to avoid complexities. The tax treaties are designed to fulfill several objectives like preventing double taxation, to specifying the tax subsidies and for the predictability of the tax obligations. Tax treaties lead to the harmonization of the tax systems of two countries. As cross-border trade is on the rise, there is a need for rationalizing the imposition of tax to ensure a fair and more efficient application of tax laws.The bilateral agreement may be of two types - limited agreements and comprehensive agreements. The limited agreement refers to the agreement entered to avoid the double taxation relating to income derived from carriage of cargo, ships, freight and operations of aircraft. While the comprehensive agreement comprises of wide range of incomes like income from immovable property, capital gains, dividends, royalties fees for technical services. It is the document which lay down in detail how incomes under various heads may be dealt with and by which manner taxation can be laid down.

Unilateral tax assistance may be provided to the assessee under the unilateral tax treaties. If the government does not have bilateral treaty with the government of the other country where assessee is double taxed, the government can extend relief under section 91 of the Income Tax Act. Proceedings of section 91 can be applied in the case where any person who is resident of India in any previous year proves that in respect of his income which is accrued during the previous year outside India, he has paid taxes in any country with which there is no agreement under section 90 for the relief of double taxation. He shall be entitled to the deduction from the Indian income tax payable by him of a sum calculated on such double taxed income at the rate of tax of the said country or Indian rate of income tax whichever is lower.

16.3.1 Basic Principles of International Taxation:

The issue of international taxation is more important for developing countries as they have to perform a balancing act for good governance. There is a difference between principles of governance in the domestic field and at international levels. Every nation is free to evolve, in international law, principles of governance which are suited to its ideals and priorities. At the same time, due to increase in regional cooperative treaties, nations are compelled to rethink about their polity, principles of governance and priorities. Nations cannot ignore common minimum rights of people even across the border. The international taxation system is based on two basic notions that are notion of tax Neutrality and notion of tax Equity.

International tax policy is determined with the interactions between host and home governments. In general, the host government acts first and the home government determines policies according to the host government policies. While setting the tax policy of the home country, the governments have to consider the following parameters-

(i) Treatment of foreign income

(ii) Treatment of foreign taxes paid

(iii) Timing of taxation

Treatment of foreign income refers to the determination of tax rates, deductions and rebates permissible for the income earned or accrued outside the country. There may be four different ways to fix the tax liability on foreign income.

1- No domestic tax on foreign income
2- Tax credit is allowed (tax will be charged that is excess of tax paid to foreign government)
3- Permitting deduction on foreign taxes paid
4- Tax foreign profits by ignoring the tax paid in the foreign country (i.e. double taxation).

The home country by its policies can extend relief for the foreign taxes paid by the assesse. This relief can be provided under section 90 and section 91 of the Income Tax Act, by bilateral or unilateral treaties among the countries.

The time factor is also crucial for formulating tax policies. The tax obligations on foreign income can be imposed on two occasions. First at that fiscal year in which the income is earned. This system is prevailing in US and some European countries. Secondly, the tax can be laid down at the time when profits are repatriated as dividends. Notion of Tax Neutrality tends to global welfare. Tax neutrality refers the null effect of tax provisions of the host country and home country. Null effect means there is no effect of tax policies and tax structure on the movement of capital. If the investor is indifferent for investment in domestic country or in foreign country, that means there is no any effect of taxes on investment in abroad or domestically (null effect), is known as tax neutrality.

'Notion of neutrality tends to the global welfare because it tends to free mobility of the capital towards the high returns opportunity of the world. In the tax neutral environment the investors are indifferent from tax rates prevailing in the countries and hence capital can be used for the most useful manner for the global welfare. But sometimes this policy does not claim national welfare simultaneously. Because the capital of a nation may move to other countries in search of better returns, and the home country faces the lack of capital which hazards the growth of the home country."

Another basic principle of international taxation is notion of equity. Notion of tax equity refers to that all taxpayers in similar situations be subject to the same tax rules. That means foreign corporate and domestic corporate should be charged same tax rate for the same earnings, while there should be same treatment with foreign earnings and other incomes of the corporate.

16.4 Summary

In this era of globalization, world trade has grown at high volume, cross border international investments-borrowings, international joint ventures, mergers & acquisitions are common now days. In this scenario, international accounting has gained great significance. International accounting institutions are working for standardization of accounting rules, concepts and conventions worldwide.

International accounting addresses to the issues of foreign currency translation, consolidation of statements, inflation accounting, transfer pricing, foreign statement analysis, segment reporting and interim financial reporting.

International taxation is very important factor having bearing in internationalization decisions of the corporate. As the tax rates, structure and tax policies vary from country to country, the companies have to analyze the tax liabilities at different global locations. Understanding of tax neutrality, tax equity and tax heaven countries help the companies for their tax planning. Governments enter into bilateral and unilateral tax treaties to avoid double tax burden on the companies.

16.5 Glossary

GAAP	: Generally Accepted Accounting Principles
IOSCO	: International Organization of Securities Commissions
ICAI	: Institute of Chartered Accountants of India
OECD	: Organization for Economic Cooperation & Development
IFRS	: International Financial Reporting Standards
IFAC	: International Federation of Accountants
IASC	: International Accounting Standard Committee
AS	: (Indian) Accounting Standards
IAS	: International Accounting Standards
FOREX	: Foreign Exchange

Reporting currency: The currency in which financial statements to be prepared

16.6 Check your progress

State whether true or false.

- The temporal method is similar to the monetary/non-monetary method.
- Exchange rates are fixed in nature.
- IAS 21 provides guidelines for accounting for the effects of changes in exchange rates.
- According to the source-of-income rule, tax on income is payable in the country where the income is earned or arises, regardless of whether the earner is a resident or a non-resident.

16.7 Answer to check your progress

1. True 2. False 3. True 4. True 5. True 6. True 7. True 8. True

16.8 Terminal questions

1. What do you understand by international accounting?
2. What is the procedure of recording an international transaction pertaining on credit sale?
3. What is forward contract? How the accounting entries are made to record hedging with forward contract?
4. What is the need of harmonization of accounting standards?

5. What is consolidation of statements? Specify the methods of consolidation.
6. What are the principles of determining income tax liability?
7. What do you understand by tax neutrality?
8. What are tax treaties? How companies get benefits from that?
9. How MNCs are concerned with the international tax environment?
10. Write a detail note on international accounting. Describe the broad areas covered under international accounting.
11. What do you understand by international taxation? How double taxation can be avoided through international tax treaties?

16.9 Suggested Readings

1. Mohapatra A.K.Das, International Accounting, Prentice Hall of India Ltd
2. Ashwathapa K, International Business, Tata McGraw Hill Publishing Co. Ltd.
3. Seth A.K,International Financial Management,Galgotia publication
4. Vij Madhu, International Financial Management, Excel Publication.
5. Bhall V,K., International Financial Management, Anmol Publication.
6. Apte P.G.International Financial Management,Tata McGraw Hill Publication.
7. IASB:"IFRS around the world", http://www.iasb.org/About+Us/About+IASB/IFRS+Around+the+World.htm
8. Singapore Illustrative Financial Statements 2007, http://www.kpmg.com.sg/publications/audit_sifs2007.html
9. http://www.sec.gov/rules/final/2008/33-8879fr.pdf
10. Chief Justice of the Bombay High Court, Mr.Swatanter Kumars speaking snatches at the International Tax Conference, organised by IFA (International Fiscal Association) India and the OECD (Organisation for Economic Cooperation and Development), in Mumbai.

Unit 17: WTO, IMF, WORLD BANK AND UNCTAD

Structure:

Objectives:

After reading this unit, the learner will able to understand:

- To understand the macroeconomic environment regarding the establishments of various international economic institutions.
- To explain the history of WTO, its functions and objectives.
- To explain the organizational structure of World Trade Organization.
- To explain the history of establishments, functions and role of International Monetary Fund.
- To explain the establishment of World Bank and its functions and organization structure.
- To understand the functions of UNCTAD and main activities it perform to ensure sustainable trade expansion and development.

17.1 Introduction:

It was during the Second World War, intellectuals including that of economists debated the reasons for such war and consequent loss of human being, environment and infrastructure. The result of these talks culminated into Breton Woods conference in 1944 held at New Hampshire USA, paving the way for setting of economic institutions which can act as a helping hand to countries in times of crisis, thus save such loss to mankind. It was in the context of Second World War, when countries mistrusted each other on economic cooperation's resulting in great economic depression that has given space to fundamentalist forces to garner support from their fellow citizens. When such fundamentalist forces peaked into arrogance, Second World War began in August 1939. During Breton Woods's conference three international economic organizations were to be set up but consensus can be made only for two which came into force were International Monetary Fund (IMF) with the aim of ensuring macroeconomic stability and World Bank W.B.) with the aim of helping countries rebuild from the destruction caused during second world war and development of newly independent countries of Asia, Africa and Latin America. Third economic institution planned was International Trade Organization (ITO) which could not see light due to lack of consensus among negotiating members. Thus, GATT an adhoc body was set up in lieu of ITO. The eight rounds of GATT negotiations resulted in setting up of World Trade organization on January 1st, 1995. Newly liberated countries of Africa and Asia felt the need of think tank which can guide them and address their economic concerns at global level. These countries felt the need of using trade as an instrument for promoting economic growth, earning previous foreign exchange which will help them service their import bills, generating additional economic activity in their economic system thus ensuring employment and controlling social unrests. Accordingly, a conference took place under the guidance and supervision of United Nations at Belgrade; Yugoslavia. As an outcome of negotiations held during conference it was decided to set up United Nations Conference on Trade and Development (UNCTAD) with its headquarters at Geneva Switzerland. International economic institutions such as WTO, IMF, World Bank and UNCTAD have an important bearing on the international business environment and economics in variety of ways. For example, IMF helps assess the country's economic environment and provide important policy inputs to address the challenges and reap upon opportunities. It also helps stabilize macroeconomic environment through funding and also fund operations aimed at poverty alleviation. World Bank extends credit facilities to national governments as well as an individual organization for ensuring balanced development of the country. Interest changes are much lower than what one has to pay to private party. World Bank through its associates, also undertakes equity investments, provides international guarantee, address international trade disputes and guide countries on global economic developments. WTO deals with issues that deal with liberalization of trade through various agreements like, Agreement on Agriculture, Non-Agricultural Market Access (NAMA), Trade Related Investments Measures (TRIMS) and Trade Related Intellectual Property Rights (TRIPS) etc. UNCTAD has played a key role in assisting developing countries to access the markets of developed countries by providing both consultative guidance and technical supports. Generalized System of Preferences (GSP) scheme has been one among other key achievements of UNCTAD as it provides preferential treatment to developing countries while exporting to developed countries. A thorough understanding of the international economic institutions like IMF/WTO/ World Bank and UNCTAD provides an important understanding of international business environments and its repercussion both at international and national level. In the subsequent sections of this unit, the international economic organizations such as WTO, IMF, World Bank and UNCTAD have been discussed in detail.

17.2 World Trade Organization

The World Trade Organization was established on January 1^{set}, 1995 after the successful conclusion of 8th round of Trade Negotiations (Uruguay Round) in April 14^{the}, 1994 at Marrakesh, Morocco (Africa). WTO replaces the General Agreement on Tariff & Trade (GATT) which was established in 1948 as an adhoc mechanism to eliminate the tariff and non-tariff barriers. WTO is a permanent and multilateral trade organization and is based in Geneva, Switzerland with 159 countries as its members. WTO is playing pivotal role in international trade negotiations by promoting free trade & commerce among member countries. Following are main differences in GATT & WTO.

MAIN DIFFERENCES BETWEEN GATT & WTO		
	GATT	**WTO**

Full form	General Agreement on Tariffs and Trade (GATT)	World Trade Organization (WTO)
Year of Establishment	It was set up in 1948	It is set up in 1995
Purpose of Establishment	GATT aimed at strengthening international trade by abolishing tariff & non-Tariff barriers.	WTO aims at governing GATT frameworks, globalizing trade, ensuring transparent and non-discriminatory development of international trade among Member countries.
Governance Structure	It was adhoc body with no permanent structure or framework for Governance.	WTO has permanent structure with a permanent framework, agreed set of rules and procedure for governance and Business.
Scope	GATT aimed at liberalizing the trade in goods only.	WTO mandate is much wider as it activities includes liberalizing the trade in goods; trade in services and trade-related Aspects of intellectual property rights and trade related investment measures.
Dispute Resolution	GATT had a permanent appellate body to review findings and settle disputes among member countries.	WTO has a well-established mechanism in transparent, nondiscriminatory manner to settle disputes among member countries. Disputes are resolved much faster within a select time frame under WTO.

Source: Adapted from WTO Website www.wto.org

WTO persuades countries through mutually accepted negotiations based on nondiscrimination and transparency to lower their import tariffs and eliminate other trade barriers. At WTO, countries negotiate and agree on ways and means on how to open markets their markets in phased manner and eliminate the non tariff practices such as use of import licenses, export subsidies, Sanitary-Photo-Sanitory barriers and other non-tariff barriers. The membership of WTO is continuously expanding the inclusion of important economies like China and Russia to its fold; has made the WTO, the most important international economic organization governing international trade rules. WTO advocates free movement of goods and service across the world continuously cherish the cause of free trade in all sectors in nondiscriminatory and transparent manner through rule based system.

Functions Of WTO:

General Agreement on Tariff and Trade (GATT) which was predecessor to WTO was not really an organization; it was merely an ad-hoc arrangement so as to conduct trade negotiations, WTO, on the other hand, is a multilateral international trade organization and is a permanent body and organizational structure. WTO is established by member country after detailed discussions and it play the role of a watchdog in the spheres of trade in goods, trade in services, trade in intellectual property, trade in agriculture, subsidies, government procurements, trade facilitation, foreign investment & trade, trade & labor issues and trade and environment etc. Article III of WTO agreement set out the following five functions of WTO. These are:

a. The WTO, an apex international trade institution, should facilitate the implementation, administration and operation of various agreements signed under its aegis from time to time. It should constantly endeavor to achieve the major objectives as laid down in various agreements signed under its aegis.
b. WTO should constantly endeavor for implementation, administration and operationization of various Multilateral & Plurilateral Trade Agreements. It should promote regionalism which help it achieves the objectives of globalization in world economy.
c. The WTO shall act as platform or forum for trade negotiations for various agreements under discussion among its members. It should also deal with issues concerning multilateral trade relations among member countries.
d. The WTO shall provide managerial as well as technical assistance to member countries to enable them to administer the rules and procedures governing the settlement of trade disputes.
e. The WTO shall administer Trade Policy Review Mechanism (TPRM) of member countries and point out the noncompliance issues so that a corrective action can be taken up by member countries.
f. WTO shall act in tandem with policy decision of other international economic institutions in order to achieve greater coherence in global economic policy making. In order to realize this, WTO shall co-operate international economic bodies like International Monetary Fund (IMF), World Bank & its affiliated agencies and UNCTAD.

OBJECTIVES OF WTO:

The World Trade Organization (WTO) is an international economic organization that is established with the key objectives of supervising and liberalizing the international trade in world economy. WTO provides a rule based, non discriminatory and transparent framework for negotiating and formalizing the various trade agreements. It also provides a rule based dispute resolution system which is aimed at enforcing member countries adherence to WTO agreements. These trade agreements are signed by ambassadors of member governments and ratified by member country's parliaments. In the light of above, the important objectives of WTO are mentioned below:

a. WTO is assigned the objective of implementing the various trade agreements as agreed upon among member countries.

b. WTO promotes the orderly development of world trade in a manner that benefits every member country.

c. WTO follow the objective of special and differential treatment thus ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade.

d. WTO is assigned the objective to demolish all obstacles to an open and transparent global trading system and usher in international economic renaissance as international trade is the most effective instrument to foster economic growth.

e. WTO has an objective of enhancing the trade competitiveness of all its members so as to benefit consumers and help in global integration. This is done by guiding countries to reap the dividend such as comparative cost advantages, absolute cost advantages, factor endowment advantages etc.

f. WTO constantly endeavors to increase the level of production and productivity among member countries with the objective of promoting employment in member countries.

g. WTO aims at expanding and utilizing the world resources in the best possible manner.

h. WTO aims at improving the standard of living for the member countries population and design the polices which may speed up economic development of the member nations.

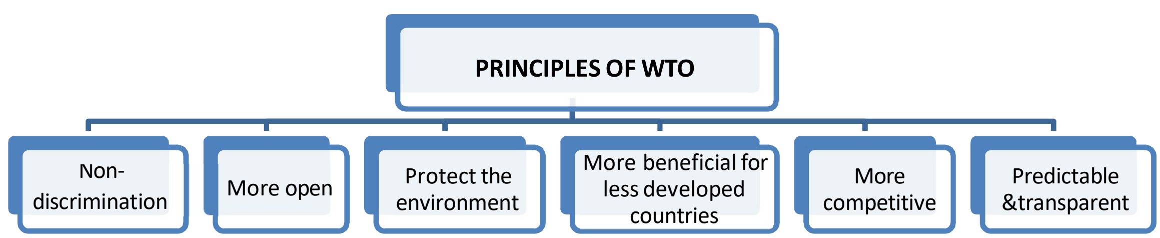
PRINCIPLES OF WTO:

The formation of WTO has come on certain principles which were agreed among member countries during various stages of trade negotiations in different round of GATT. As WTO agreements are lengthy and complex involving legal texts and covering a wide range of inter-related and interconnected activities having far reaching impact from one to another. It becomes tough sometimes to understand that where the source of problem or solution itself lies may become a problem due to such interrelated activities. There are number of simple and fundamental principles which help us understand the guiding tenets through which these WTO agreements are negotiated and implemented. These principles are the foundation of the multilateral trading system and are briefed as under:

i. **Non-Discrimination:** Most important principle of WTO which states that no country should not discriminate between its trading partners and it should also not discriminate between its own and foreign products, services or nationals.

j. **More Open:** WTO functioning is based on the principle of more open manners thus **l**owering trade barriers is one of the most obvious ways of achieving economic globalization among member countries. Trade Openness encourages trade by reducing the customs duties or tariffs and non-tariff measures like import bans or quotas or SPS/TBT.

k. **Predictable and Transparent:** WTO rules ensures predictable and transparent trade regime among member's countries. Foreign companies, investors and governments when trading with other countries or making an investment decision in another country, can be confident that trade barriers should not be raised arbitrarily by host country. Thus, WTO rules bring more stability and predictability in trading and investment regime among member countries encouraging foreign investor, companies and governments to investment more, trade more. These have adverse effects in the market and help create jobs, increased market consumption and higher growth in GDP of the country.



Source: www.wto.org

l. **More Competitive:** WTO rules discourages unfair, unlawful and restrictive trade practices such as quota regime, export subsidies and dumping of products at below cost to gain market share in target country. WTO rules and procedures lay down clear cut rules defining what is fair and what is unfair and pass its verdict which the member country should obey.

m. **Protect the Environment:** Degrading environment is a major concern before our society and WTO's agreements and rules has provision that member countries can take necessary steps to protect not only the environment but also public health, animal health and plant health. As WTO preaches non-discrimination, these measures must be applied in the same way to both national and foreign businesses. No county shall be allowed to use environmental protection measures as a means of disguising protectionist policies to control imports or provide protection to domestic industry.

ORGANIZATIONAL STRUCTURE OF WTO:

As discussed above, World Trade Organization came into existence on January 1, 1995 after replacing the previous GATT. Now, WTO secretariat is fully responsible for administering the international trade regime among member countries. The organization structure of WTO can be better understood from the following chart as under:

Source: Understanding the WTO 2011

Following are some of the important organs of WTO organization structure and are explained as under:

n. **The Ministerial Conference**: It is the supreme body involving he trade ministers from all member countries. All trade negotiations are concluded and agreed at Ministerial Conference only. It is also the apex governing body of the WTO that is responsible for setting the strategic direction of the organization for trade negotiations, rules setting and concluding agreements.

All final decisions relating to various aspects of trade agreements are taken here. The Ministerial Conference must meet at least once every two years however meeting can be called earlier also depending on urgency and needs of member countries. In majority of the cases, the decisions are taken on the basis of consensus but voting can take place on certain issues as it is difficult sometimes to reach o consensus on the trade body comprising 159 member countries, having diverse economic interest and priorities.

o. **The General Council:** General Council is composed of senior country representatives who are usually at the level of ambassador from all members' countries. General Assembly is the most important and integral part of WTO as it is responsible for overseeing the day-to-day business and management of the WTO. General Council meetings take place usually at WTO headquarters in Geneva but sometimes retreat meetings takes place to discuss the subject matter informally. Practically it is the key decision- making arm of the WTO for most trade negotiations and other issues. All other bodies except Minsters (Ministerial Conference) report their business directly to the General

Council.

p. **The Trade Policy Review Body:** TPRB consist of all the WTO members and is responsible for looking after the Trade Policy Review Mechanism as agreed in Uruguay Round of trade negotiations. It has the mandate to periodically review the trade policies and practices of all member states. Trade Policy Review Reports are important in the sense that it indicates how member countries are implementing their obligations and commitments made under various trade agreements. It aims at improving the adherence of member countries for commitments and obligations agreed under agreements of WTO.

Source: www.wto.org

q. **The Dispute Settlement Body**: This body comprises of all 159 member countries of WTO. It is responsible for looking after the implementation and effectiveness of the dispute resolution process for all WTO agreements including the issues relating to implementation of the decisions on WTO disputes. Trade disputes of member countries are heard and ruled on by dispute resolution panels which are carefully chosen individually for each case. In case of grievance, member country can go to permanent Appellate Body that was established in 1994. The decisions made by Dispute Settlement Body are mandatory and binding on all members and should be accepted in letter & sprit by member countries.

r. **The Councils on Trade in Goods and Trade in Services:** It operates under the mandate of the General Council and consists of all members' countries. It is tasked to oversee the details of the general and specific agreements on trade in goods & services. For example, it is mandated to oversee the implementation of agreements on textiles and agriculture which are extremely vital to member countries due to higher export intensity of textile industry and employment generation. Council on Trade in Goods and Services is also mandated to look-after the progress "Agreement on Trade- Related Aspects of Intellectual Property Rights"

s. **The Secretariat:** The Secretariat of WTO is based at Geneva and is headed by the Director General. There are staffs of over 600 employees in the Secretariat which comprises the legal expert, economist, trade analysts and counsellors & communication experts. Secretariat is responsible for all administrative functions aimed at smoothly and systematically running the organization. Although, the Secretariat has no legal decision-making powers but it provides vital services for taking the negotiations agenda forward. The current director general of WTO Secretariat is Pascal Limy. The Director General is elected by the members' countries.

17.5 INTERNATIONAL MONETARY FUND

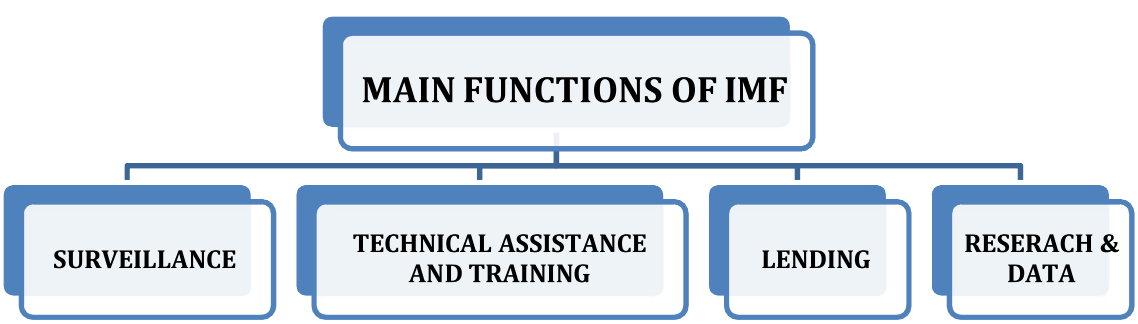
International Monetary Fund was established by 44 nations under the Bretton Woods Agreement of July 1944. The main aim for establishing IMF was to remove the economic failures that gripped the world economy into economic depression and resultant wars and economic destruction of physical resources. There were efforts by countries to return to Gold Standard System which failed due to the absence of trust among countries resulting to Great Economic Depression. This provided the opportunity to the fundamentalist forces in countries like Germany and Italy to mobilize masses which resulted in Second World War. Due to absence of mutually acceptable economic and trade regime and absence of trust among countries, countries followed purely nationalistic policies whereby almost every country imposed trade Restrictions, exchange control, and resorted to exchange depreciation in order to encourage their exports and control their imports resulting in wide ranging trade imbalances among nations. The leaders from 44 countries towards the end of Second World War held several round of negotiations on the drafts proposed by two economists Marshall and Whiteman and finally agreed for establishing two economic institutions. The first was International Monetary Fund; which will mainly aim macroeconomic stabilization and help countries fight against economic odds including poverty alleviation. International Bank for Reconstruction and Development, also known as World Bank would mainly aim at financing of reconstruction activities in war ravaged countries and development activities in newly independent countries of Asia and Africa. Accordingly, representatives from 44 countries assembled at the "United Nations Monetary and Financial

Conference" at Bretton Woods, New Hampshire (USA) from 1st July to 22nd July 1944 to establish these two economic institutions. IMF started functioning from 1st March 1947. International Monetary Fund also provides policy advice on financing alternatives and instruments to member's countries in economic difficulties. Its policies are largely aimed at helping developing countries to achieve macroeconomic stability and reduce poverty. Such policy inputs and timely alerts help countries to cushion and protect themselves from massive movements of capital and abrupt shifts in comparative advantage in areas such as labor, trade, and tax policies. Thus, IMF helps countries to avoid potential downsides of globalization. Some of the main objectives of IMF are summarized as under:

- It analyze the country specific as well global economic trends and prepare policy inputs for members countries and central banks based on similar cross-country experiences;
- It conduct primary as well secondary research, compile statistics, forecasts the possible future course of action, analyze global, regional and individual economies data and based on all this suggest policy advice to member countries.
- It extends loans to member's countries to tide over the economic difficulties and challenges in difficult times.
- Its efforts are aimed at reducing poverty in developing and least developed countries. Accordingly, it offers concessional loans to member countries to fight poverty and
- It offers technical assistance and training to member countries so as to enable them to improve overall efficiency, effectiveness and productivity in their economies.

17.31 FUNCTIONS OF IMF:

The main function of the International Monetary Fund is to ensure the macro-economic stability of the international monetary and financial system. IMF was set up with the main objective of resolving economic crises in addition to working with member's countries to promote economic and social growth and alleviate poverty. The charter of IMF mandates three main functions to it for achieving those objectives. These functions are:



Source: International Monetary Fund

- **Surveillance:** The main function of the IMF is to promote economic stability, ensure faster global economic growth, balanced socio-economic development. IMF guides member's countries to adopt sound economic and financial policies aimed at achieving these objectives. It regularly monitors global, regional, and sub-regional economic developments in order to appraise and examine the impact of these policies on member countries both in long run and short run.

  International Monetary Fund is also mandated to carry out extensive economic, social and environmental analysis of global and regional economic developments and trends. This is called as multilateral surveillance and helps bring out three semi-annual publications. These are:

  a. World Economic Outlook,

  b. Global Financial Stability Report

  c. Fiscal Monitor

  In addition to above it also publishes a series of regional economic outlooks aimed at understanding the socioeconomic development so as to deal with them. In recent years, IMF has further endeavored to improve its analytical work aimed at enhancing the multilateral, financial, and bilateral surveillance among member countries.

- **Technical Assistance and Training:** Second important function of IMF is to offer technical assistance & training to its member countries policy makers so that they are able to design and implement effective socio-economic policies aimed at macro-economic stabilization, promoting growth & employments, ensuring balanced and sustainable economic development, correcting regional and global imbalances and above all alleviating poverty. Following are some of the areas where IMF offers technical assistance and training to member's countries. These are:

  a. Fiscal policy

  b. Monetary Policy

  c. Exchange rate policies

  d. Economic and financial legislation.

  e. Banking and financial system supervision and regulation

f. Compiling authentic statistics

- **Lending Loans:** Third main function of IMF is to provide finances usually on long term basis to member countries. In an era of global economic globalization, countries are exposed to not only domestic shocks; they are not free from external shocks emanating from member countries poor economic health. For example, many European countries were gripped in contagion of Greek Economic Crisis of 2011. Funding from IMF provides breathing room to member countries to correct their balance of payments problems. The rate of interest varies, depending on the purpose, for which such loan has been extended by IMF. Usually, low income countries are charged concessional rate of interest.
- **Research and Data Compilation:** Last but not the least the function of conducting research and compiling data from member countries so as to design right economic policies for them. IMF publications are widely referred globally as benchmark to compare the economic and social position of two countries. IMF interacts with member countries to design good accounting standards & codes aimed at strengthening the international financial sectors. It is constant endeavor of IMF to strengthen national and global financial systems so those global, regional and national economic and financial crises are avoided at **best.**

PHASES OF IMF HISTORY:

The various phases of IMF history in managing its assigned affairs are briefed as under:

- **Cooperation and Reconstruction (1944–71):** In the first phase which is titled as phase of Economic Cooperation and Reconstruction, IMF mainly aimed at rebuilding the war ravaged national economies of Germany/ France/ UK/ Italy and Japan. IMF pumped billions of Dollars for reconstruction efforts popularly also known as Marshall Plan in these countries. The IMF played its vital role in supervising the international monetary system and acted swiftly wherever required to ensure exchange rate stability. It also impressed upon its members countries to eliminate exchange restrictions as these measures hinder free flow of orderly international trade.

- **Breakdown of Bretton Woods System (1972–81) : As we know that "F**ixed Exchange Rates System" collapsed in 1971 and US dollar was no more a Standard Currency. Countries became free to choose their exchange arrangement which was usually based on basked of currency rather than only US Dollar. There was steep rise in oil prices due to cartelization of OPEC which controlled oil supplies of Oil producing countries to seek higher oil prices. This badly impacted the balance of payment situation of many countries and badly impacted the economic growth and development of international trade as there were structural imbalances in world economy. IMF stepped in so as to help countries deal with the consequences of breakdown of fixed exchange rate system and oil shocks.

- **Painful Years of Debt and Reforms (1982–89):** Rise in oil prices globally badly impacted the world economy and there were countries which suffered huge oil shocks including India with huge international debts. There were some countries which have balance of payment crisis. In order to fight with international debts, many countries opened there economies especially China, South East Asian countries such a Vietnam, Thailand and Malaysia. IMF assisted the the countries in synergizing the national policy response with global response.
- **USSR DISINTEGRATION, GERMANY INTEGRATION AND ASIAN UPHEAVAL**

  (1990–2004): USSR disintegrated into 15 independent countries and all these including Russia struggled in deep economic crisis. Similarly East and West Germany integrated whereby West Germany was developed and East Germany was way behind in economic development. There was a exchange rate crisis in South East Countries which started from Thailand and took the whole region into its grip, resulting in economic slowdown and employment loss. The IMF played a central role in helping all these countries of the former Soviet bloc transition from central economic planning to market-driven economies. It helped Germany with additional financing aimed at speeding the economic development of East Germany and helped countries of South East Asia tide over the economic crisis of 1997.

17.8 GLOBALIZATION, ECONOMIC RECESSION AND EUROPE DEBT CRISIS (2005

to PRESENT): Economists are still studying the implications of the continued rise of global capital flows from one region to another and its impact on world economy. Uncontrolled foreign exchange flow, creation of hedging instruments like derivatives and unregulated financial markets poses greater economic challenges to world economy. The subprime crisis of USA, followed by economic recession in world economy has badly affected the growth of international trade of developing countries including that of India. European Debt crisis has made the economic scenario to be worse as classical instruments of reviving economic growth and recovery has miserably failed in Europe. It is now wait and watch situation and one is not sure when world economy will come into high economic and trade growth trajectory. IMF is playing its best possible role it can play for such vast economic crisis by assisting countries with policy inputs, liberal financing and poverty alleviation schemes so as to stabilize the economic situation in impacted economies.

17.3 WORLD BANK

The International Bank for Reconstruction and Development (IBRD) aims to reduce poverty in middle-income countries and creditworthy poorer countries by promoting sustainable development through loans, guarantees, risk management products, and analytical and advisory services. Established in 1944 as the original institution of the World Bank Group, IBRD is structured like a cooperative that is owned and operated for the benefit of its 188 member countries. IBRD raises most of its funds on the world's financial markets and has become one of the most established borrowers since issuing its first bond in 1947. The income that IBRD has generated over the years has allowed it to fund development activities and to ensure its financial strength, which enables it to borrow at low cost and offer client's good borrowing terms.

17.41 History of World Bank: Founded in 1944 to help Europe recover from World War II, the International Bank for Reconstruction and Development (IBRD) is one of five institutions that make up the World Bank Group. IBRD is the part of the World Bank (IBRD/IDA) that works with middle-income and creditworthy poorer countries to promote sustainable, equitable and job-creating growth, reduce poverty and address issues of regional and global importance. Structured something like a cooperative, IBRD is owned and operated for the benefit of its 187 member countries. Delivering flexible, timely and tailored financial products, knowledge and technical services, and strategic advice helps its members achieve results. Through the World Bank Treasury, IBRD clients also have access to capital on favorable terms in larger volumes, with longer maturities, and in a more sustainable manner than world financial markets typically provide. Specifically, the IBRD:

- **a.** Supports long-term human and social development needs that private creditors do not finance;
- **b.** Preserves borrowers' financial strength by providing support in crisis periods, which is when poor people are most adversely affected;
- **c.** Uses the leverage of financing to promote key policy and institutional reforms (such as safety net or anticorruption reforms);
- **d.** Creates a favorable investment climate in order to catalyze the provision of private capital;

e. Provides financial support (in the form of grants made available from the IBRD's net income) in areas that are critical to the well-being of poor people in all countries.

Middle-income countries, where 70 percent of the world's poor live, have made profound improvements in economic management and governance over the past two decades and are rapidly increasing their demand for the strategic, intellectual and financial resources the World Bank has to offer. The challenge facing the IBRD is to better manage and deliver its resources to best meet the needs of these countries.

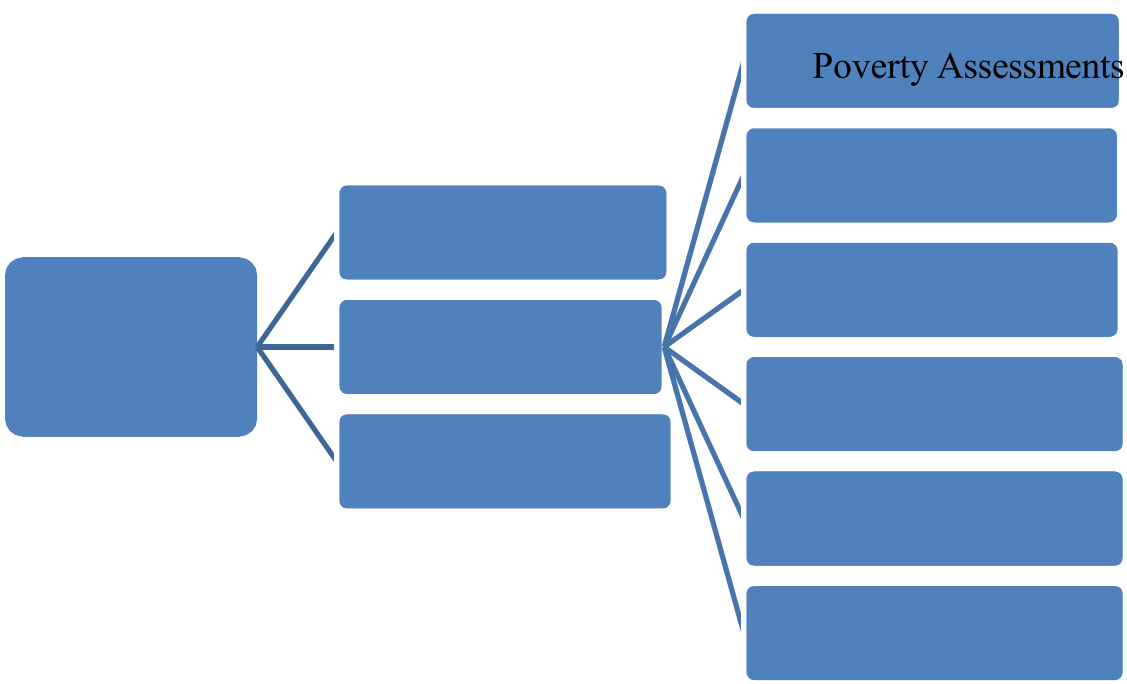
To increase its impact in middle-income countries, IBRD is working closely with the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), the International Monetary Fund (IMF) and other multilateral development banks. In the course of its work, IBRD is also striving to capitalize on middle-income countries' own accumulated knowledge and development experiences and collaborates with foundations, civil society partners and donors in the development community. For more information about this effort, see Strengthening Middle Income Countries Engagement.

FINANCING OF WORLD BANK:

IBRD raises most of its funds on the world's financial markets. It has become one of the most established borrowers since issuing its first bond in 1947 to finance the reconstruction of Europe after World War Two. Investors see IBRD bonds as a safe and profitable place to put their money and their cash finances projects in middle-income countries. IBRD became a major player on the international capital markets by developing modern debt products, opening new markets for debt issuance, and by building up a broad investor base around the world of pension funds, insurance companies, central banks, and individuals. The World Bank's borrowing requirements are primarily determined by its lending activities for development projects. As World Bank lending has changed over time, so has its annual borrowing program. In 1998 for example, IBRD borrowing peaked at $28 billion with the Asian financial crisis. It is now projected to borrow between $10 to 15 billion a year. IBRD borrows at attractive rates on the capital markets thanks to its triple-A status that it has had with credit rating agencies since 1959. This has enabled it to borrow in U.S. dollars, for example, at an overall funding cost that comes close to that of the U.S. Treasury. IBRD enjoys its high credit rating because it is backed by the capital commitments of its 186 shareholder governments. It is also the result of IBRD's strong balance sheet, prudent financial policies, and its expected treatment as a preferred creditor when a country has difficulty in repaying its loans. IBRD has also profited from anticipating shifts in investor preferences and investing in the risk management and systems to take advantage of those trends. IBRD has to its credit a string of firsts in its borrowing program. These include the first currency swap in international markets in 1981, through to the introduction of the first global bond in 1989, to the first fully integrated electronic bond offering via the Internet in 2000. In 2003, the World Bank executed the first fully electronic swap auction. Innovations by IBRD have also supported its goal of promoting development. Although much of its borrowing is in U.S. dollars, IBRD has over the years offered bonds in more than 40 different currencies. Its issues in nascent capital markets have often been a catalyst for improving market infrastructure and efficiency. IBRD's earns an income every year from the return on its equity and from the small margin it makes on lending. This pays for IBRD's operating expenses, goes into reserves to strengthen the balance sheet and also provides an annual transfer to the International Development Association (IDA). IBRD has raised the bulk of the money loaned by the World Bank to alleviate poverty around the world. This has been done at a relatively low cost to taxpayers, with governments paying in $11 billion in capital since 1946 to generate more than $400 billion in loans.

17.42 PRODUCTS & SERVICES OF WORLD BANK:

IBRD aims to reduce poverty in middle-income and creditworthy poorer countries by promoting sustainable development through loans, guarantees, risk management products, and (non- lending) analytical and advisory services. IBRD has three main business lines:



At its Annual Meeting in September 2006, the World Bank — with the encouragement of its shareholder governments — committed to make further improvements to these services within a year. The World Bank originally began a program to upgrade its services for middle-income countries — overhauling financial and risk management products, broadening the provision of free-standing knowledge services and making it easier for clients to deal with the Bank — in 2002. The latest commitment to take further steps was an acknowledgment by the Bank that more needs to be done to meet the increasingly sophisticated demands of middle-income countries.

ORGANIZATIONAL STRUCTURE & ASSOCIATES INSTITUTIONS: Together

With four affiliated agencies created between 1957 and 1988, the IBRD is part of the World Bank Group. The Group's headquarters are in Washington, D.C. It is an international organization owned by member governments; although it makes profits, these profits are used to support continued efforts in poverty reduction. Technically the World Bank is part of the United Nations system[citation needed], but its governance structure is different: each institution in the World Bank Group is owned by its member governments, which subscribe to its basic share capital, with votes proportional to shareholding. Membership gives certain voting rights that are the same for all countries but there are also additional votes which depend on financial contributions to the organization. The President of the World Bank is nominated by the President of the United States and elected by the Bank's Board of Governors. As of 15 November 2009 the United States held 16.4% of total votes, Japan 7.9%, Germany 4.5%, the United Kingdom 4.3%, and France 4.3%. As changes to the Bank's Charter require an 85% super-majority, the US can block any major change in the Bank's governing structure. Associated Agencies in World Bank Group consists of:

a. the International Bank for Reconstruction and Development (IBRD), established in 1945, which provides debt financing on the basis of sovereign guarantees;

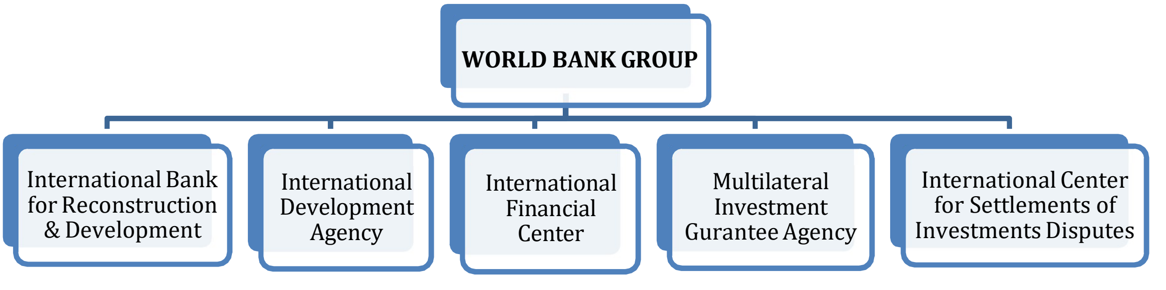
b. the International Finance Corporation (IFC), established in 1956, which provides various forms of financing without sovereign guarantees, primarily to the private sector;

c. the International Development Association (IDA), established in 1960, which provides concessional financing (interest-free loans or grants), usually with sovereign guarantees;

d. the International Centre for Settlement of Investment Disputes (ICSID), established in 1966, which works with governments to reduce investment risk;

e. The Multilateral Investment Guarantee Agency (MIGA), established in 1988, which provides insurance against certain types of risk, including political risk, aw primarily to the private sector.

The term "World Bank" generally refers to just the IBRD and IDA, whereas the term World Bank Group or WBG is used to refer to all five institutions collectively.



Source: World Bank

17.4 UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT:

There was growing concerns among the developing countries especially those which have just become independent for their development agenda and plan. As a result, developing countries from all over the world held several rounds of formal and informal negotiations under the leadership of Pt. Jawaharlal Lal Nehru, Nasser of Egypt and Marshall Tito of Yugoslavia. Many of these countries to call for the convening of a full-fledged conference focusing on trade and development plan for them. They advocated for preferential treatment for the products originating from developing countries as their manufactures cannot compete with manufactures of developed countries due to lack of machination in their manufacturing process. Developing countries asked for solutions to their problems and identifying appropriate international actions to address them out. Accordingly, the first United Nations Conference on Trade and Development (UNCTAD) was held in Geneva in 1964. As there were diverse problems for a range of countries spanning from all over worked which were different in their stage of development, growth models, history as some of them were under colonial empire for decades and social set up. In order to address these diverse problems,, leaders agreed to institutionalized to meet on trade & development every four years and make UNCTAD a permanent body under the aegis of United Nations. There came pressure groups within the UNCTAD deliberations and negotiations, the prominent among them were the "Group of 77" which worked as a single group to press for their agenda of increased market access and economic development. The first Secretary General of UNCTAD was the prominent Argentinean economist Rail Perish who had earlier headed the United Nations Economic Commission for Latin America and the Caribbean. Over the years, UNCTAD has progressively evolved into an important economic institution where intergovernmental discussion and deliberations take place. It provides very good policy based knowledge inputs to developing countries. In recent years, its role is shifting towards providing policy inputs to small island nations, landlocked countries and least developed countries. Its efforts are constantly aimed to help shape current policy debates and thinking on global economic development especially for vulnerable and least developed countries. It is helping developing countries to shape and focus domestic policies for international action so as to ensure sustainable development. Followings are the key functions performed by UNCTAD.

- UNCTAD is an international forum for intergovernmental deliberations which help shape actions at other economic institution for example at WTO. The discussions at UNCTAD are made by specialists, areas experts who provide lot of practical thinking, logical understanding and share previous experiences which help in bringing consensus in decision making.

- UNCTAD is the think tank of developing countries and it undertakes lot of economic, social and environmental research, conduct policy analysis of national policies and its likely impact on international development. UNCTAD is the prime agency for data collection for the debates of government representatives and experts.
- UNCTAD provides technical assistance tailored to the specific requirements of developing countries. In recent years, UNCTAD is paying special attention to the needs of the least developed countries and of economies in transition. UNCTAD also coordinates and cooperates with other organizations and donor countries in the delivery of technical assistance to Land locked countries, small Island Nations and Least developed countries.

17.51 MAIN ACTIVITIES OF UNCTAD: For the easy understanding of the various activities which UNCTAD do for its member countries, they can be clubbed into following areas.

- **Globalization and Development Strategies:** One the main role that UNCTAD in recent years has been playing is that of ensuring sustainable, inclusive and mutually benefitting globalization of developing countries' economies which is aimed at bringing development to the country in general and common public in particular. It helps countries identify the macro economic trends and broad areas of future economic prospects in the world economy, such as the recent rise in "South-South" trade. It also helps countries identify solutions to the economic development challenges of African countries. It analyzes the effects international aid on least developed countries and offer tailor-made inputs to promote development. It also helps developing countries in restructuring their country debts.
- **Trade in Goods and Services:** UNCTAD assist developing countries in all aspects of their trade negotiations and analyze the impact of competition laws and policies on development of developing and

vulnerable economies. It encourages the inclusion of environmental issues, such as climate change and preservation of biodiversity, in trade and development policies.

- **Commodities: UNCTAD is playing a crucial role by e**xamining the the factors that influences the global commodity markets. It also helps developing country efforts to achieve sustainable commodity exports. UNCTAD is helping the commodity-dependent countries to diversify their economies so as to tide over the cyclical trends and its ill effects on the economy.
- **Investment and Enterprise Development:** UNCTAD analyzes the global trends in foreign direct investment and their impacts on development of least developed and other vulnerable economies. It helps countries participate in international investment agreement by providing them guidance which is needed in attracting, negotiation and implementing such investments in their economies. UNCTAD also advises the member governments on their investment policies through investment policy reviews, guides, and training. UNCTAD has been of immense help in the creating and nurturing the small and medium-sized enterprises of developing countries. UNCTAD has been helping the countries in establishing and observing the international standards for accounting in recent years.
- **Technology and Innovation:** UNCTAD is helping the member countries in identifying the policies to take advantage of new technologies, including the Internet and e-business. It is helping the member governments to set up effective policies on science, technology, and innovation. UNCTAD is also helping the developing countries in gaining access to useful and appropriate technology and knowledge so as the meet the challenges in globally competitive environment.
- **Trade Logistics and Human Resource Development:** UNCTAD is partnering with

Developing Countries to address Transport and Trade Facilitation challenges and opportunities in an era of economic globalization. It is offering them the technical assistance in Trade Facilitation reforms and Customs automation. UNCTAD is offering its assistance and support for enhancing the cooperation in transit and transport systems for landlocked of Africa and Asia. UNCTAD is conducting the research in maritime and sustainable transport so as to advise member countries about adverse developments if any and solution therein. IT is helping in shaping the legal framework and regulatory compliance for transport related issues. It is building the training networks and organizes training in all areas of international trade, in particular for least developed countries.

17.5 SUMMARY

The World Trade Organization was established on January 1st, 1995 after the succesful conclusion of 8th round of Trade Negotiations (Uruguay Round) in April 14th, 1994 at Marrakesh, Morocco (Africa). WTO replaces the General Agreement on Tariff & Trade (GATT) which was established in 1948 as an adhoc mechanism to eliminate the tariff and non tariff barriers. WTO is a permanent and multilateral trade organization and is based in Geneva, Switzerland with 159 countries as its members. WTO is playing pivotal role in international trade negotiations by promoting free trade & commerce among member countries. International Monetary Fund was established by 44 nations under the Bretton Woods Agreement of July 1944. The main aim for establishing IMF was to remove the economic failures that gripped the world economy into economic depression and resultant wars and economic destruction of physical resources. Accordingly, representatives from 44 countries assembled at the "United Nations Monetary and Financial Conference" at Bretton Woods, New Hampshire (USA) from 1st July to 22nd July 1944 to establish these two economic institutions. IMF started functioning from 1st March 1947. The International Bank for Reconstruction and Development (IBRD) aims to reduce poverty in middle-income countries and creditworthy poorer countries by promoting sustainable development through loans, guarantees, risk management products, and analytical and advisory services. Established in 1944 as the original institution of the World Bank Group, IBRD is structured like a cooperative that is owned and operated for the benefit of its 188 member countries. The first United Nations Conference on Trade and Development (UNCTAD) was held in Geneva in 1964. As there were diverse problems for a range of countries spanning from all over worked which were different in their stage of development, growth models, history as some of them were under colonial empire for decades and social set up. In order to address

these diverse problems, leaders agreed to institutionalize to meet on trade & development every four years and make UNCTAD a permanent body under the aegis of United Nations.

17.6 Glossary

- **IMF:** IMF is an international economic institution which was set in 1944 at Bretton Woods New Hampshire USA with the aim of promoting exchange rate stability and to facilitate the international trade flow of currencies.
- **WTO:** World Trade Organization (WTO) came into existence in 1995 and is the only international economic organization that is dealing with the rules of trade between nations. It is based at Geneva, Switzerland.
- **IBRD:** The International Bank for Reconstruction and Development (IBRD) is an international financial institution which came into existence along with IMF in 1944 at UN conference held at Bretton Woods New Hampshire USA. It offers loans to middle-income developing countries for meeting development needs.
- **World Bank:** World Bank involves IBRD and International Development Agency and is established to offer loans to developing countries for capital programs. It helps the member countries to eradicate poverty by guiding them through trade and investments policies aimed at speeding up development in critical areas of economic activity.
- **UNCTAD:** UNCTAD came into existence in 1964 for

providing research and technical inputs to developing and newly liberated countries of Africa and Asia. It is one of the principal organ of the United Nations General Assembly that is dealing with trade, investment, and development issues, the world economy is facing**.**

17.9 Check your progress

- Fill in the blanks:
  - The World Trade Organization was established on January 1, 1995, after eight rounds of negotiations regarding ....
  - The WTO is an institution in the field of international trade dealing with ....
  - Based on the Bretton Woods Agreement, ... countries jointly established the International Monetary Fund.
  - The first conference of UNCTAD was held in .... in 1964

17.10 Answer to check your progress

1) GATT 2. Apex/Top-level 3 44 4. Geneva

17.11 Terminal questions

- Highlight the need for the establishment of the WTO, IMF, World Bank, and UNCTAD.
- Write about the history of the WTO's establishment. What are the functions of the WTO?
- Explain the organizational structure of the WTO.
- What are the fundamental principles governing trade agreement negotiations within the WTO?
- Provide a brief introduction to the IMF. What are the functions of the IMF?
- Highlight the various stages of the IMF's achievements.

- Q. No. 1: Write a short note explaining the need of establishment of WTO, IMF, World Bank and UNCTAD?

- Q. No. 2: Explain the establishment history of WTO? What are the functions of WTO?
- Q. No. 3: Explain the organizational structure of WTO?Q.No. 4: What are the key principles which shape the trade negotiations agenda at WTO?
- Q. No. 5: Discuss in brief about IMF? What are the functions of IMF?
- Q. No. 6: Write a short note on the various phases of achievements of IMF?
- Q. No. 7: Write an essay on history and functioning of World Bank? What are the key products and services of World Bank?
- Q. No. 8: Write an essay on organizational structure of World Bank?
- Q. No. 9: Explain the establishment need of UNCTAD? What are the main activities performed by UNCTAD?

17.12 Suggested Readings:

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1. International Economics, Raj Kumar, Excel Publication, 2008
2. International Economics, Francis Cherunilam, The McGraw Hill Publication, 5th

   Edition,
3. International Economics, Steven Husted and Michael Melvin, Pearson Publication, 9th Edition.
4. International Economics, James Gerber, Pearson Publication, 6th Edition
5. International Economics, D.M. Mithani, Himalaya Publishing House; Edition 11th

   ISBN No. 8178660962
6. International Economics: Theory And Policy, 8th Edition, Paul R. Krugman, Pearson Education India
7. International Economics, Dr Nirmal Bhalerao & SSM Desai, Himalaya Publishing House, 1st Edition
8. International Economics, M.L. Jhingan, Vrinda Publishing House
9. International Economics, D. N. Dwivedi, ISBN : 8122005349

10. International Economics, Steven L. Husted, Michael Melvin , Harper-Collins Press
11. Johan Daniel, and Lee H. Radebaugh, International Business Environment and Operations, Pearson Publication, 14th Edition.
12. Rakesh Mohan Joshi, International Business, Oxford Press, India Edition.
13. WTO Reports on Agreement on Textile.

Unit 18: Agreement on Textile & Clothing, Gsp, Gstp And Other International Agreements

Structure:

Objectives:

After reading this unit, the student shall be able to:

- To understand the macroeconomic environment of tariff preference under various preferential schemes of International Trade Agreements.
- To explain the Agreement on Textile and Clothing and it's phasing out under the mandate of World Trade Organization.
- To understand the various tariff preference schemes such as Generalized System of Preferences (GSP) & Generalized System of Trade Preferences (GSTP).
- To appraise the various international agreements and their role in international trade.

18.1 : INTRODUCTION

Tariff preference and Quota system has been the instruments used by countries to strengthen their economic relationship, offer assistance to poor and vulnerable countries to developed countries markets and ensuring the orderly, sustained and balanced development of international trade. Non-tariff barriers like quota regime, quantitative restrictions, non reciprocal duty preference have existed for a long time in world trade. The scope of these instruments has been almost diminished in nondiscriminatory and transparent trade regime under World Trade Organization. However, there is "Special and Differential Clause" of WTO which allow member countries to offer duty preference, zero duty schemes to developing, Least developed, poor and vulnerable countries. Global textiles and Apparel industry has been the most common industry which has been subject to quota regime from developed countries. When WTO came into existence, an effort was made to eliminate the quota regime through a transparent but orderly arrangement so that economic interests of all developing countries can be protected. Accordingly, Agreement on

Textiles & Clothing's was negotiated and signed thus paving the way for phasing out of Multi-Fiber Agreement which was aimed at enforcing the quota regime in world textiles & apparel trade. Duty preference is vital for developing countries as it provide them critical market access to developed markets. Generalized System of Preference (GSP) has been the main scheme which ensured non reciprocal, nondiscriminatory market access to developing countries in developed markets i.e. duty preference was offered by developed countries to developing countries. Subsequently, developing countries started offering each other duty preference or zero duty market access as it promote trade among developing countries thus help them earn foreign exchange, generate employment and additional economic activity. International agreements and treaties has also been an important instruments for strengthening the economic partnerships. Developed countries offered duty free, preferable and unrestricted markets access to select developing, least developed, poor and vulnerable nations. The prominent among them are Africa Growth and Opportunity Act whereby the goods from poor Sub Saharan African Region enjoy duty free access in US market. Everything but Arms is the international trade agreement whereby EU countries has allowed duty free, preferential and usntresticted markets access to 49 Least Developed countries. Other important international agreements are Duty Free Tariff Preference Scheme of India (DFTP), Caribbean Basin Initiatives (CBI) of United States, The Andean Trade Preference Act (ATPA), Canadian Trade, Investment and Industrial Cooperation program (CARIBCAN), Lomé Convention and South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) and are discussed subsequently.

18.2 : Agreement on Textile And Clothing

The Multi Fiber Arrangement (MFA) was a discriminatory arrangement by developed countries against developing countries thus restricting their exports to a certain quota only and providing protection to domestic textiles industry. It is evident that cotton is produced mainly in developing countries for example, China, India, Pakistan, Egypt, Sub- Saharan African countries with only exception being the United States. It is also evident that the labor and other input cost have been traditionally been much cost effective in developing countries that the developed countries of west. Developed countries imposed the quantitative restrictions on import of textiles and garments from 1974 to 2004 through Multi-Fiber Agreement. When WTO came into existence, a transparent, nondiscriminatory and multilateral trade regime came into existence. Accordingly, Agreement on Textiles and Clothing was signed which provided for phase wise abolition of MFA regime by end of 2004. Thus, MFA quota regime expired on 1 January 2005.

Multi Fiber Agreement was introduced for the first time in 1974 by developed country as a short-term measure which was aimed at adjusting the imports from the developing world. As developing countries have a natural advantage due to factor endowment working in their favor with large cotton production coupled with cheap labor, the exports from certain developing countries started increasing very fast. Developed countries wanted to streamline the import regime by importing a fixed quantity from a particular country irrespective to the fact that the goods originating from this country were not only cost competitive by were of good quality as well. Various studies indicated that international trade of textiles was taking place on the basis of natural comparative cost advantage but at the whims & fancies of developed countries which had an agenda to pursue their other economic interest by favoring the select countries. One such study on the likely impact of MFA agreement on developing countries by World Bank/International Monetary Fund (IMF) indicated that this arrangement has costed the developing world 27 million jobs and $40 billion a year in lost exports. This agreement was negative for countries like China and India but favored least developed countries such a Bangladesh and Vietnam and Laos Republic as these countries got the guaranteed market access at duty free or preferential regime in developed countries markets. The success of Bangladesh textiles and apparel industry and dominance of textiles export in Bangladesh export basket is largely attributed to MFA agreement. On the conclusion of Uruguay Round, a fair transparent and non discriminatory regime for orderly and sustained development of international textiles and apparel trade was envisaged through the "Agreement on Textiles & Clothing". The Agreement on Textiles & Clothing provided for the gradual dismantling of the quotas that existed under the MFA. This process was completed on 1 January 2005. Following was the phase wise duty quota reduction in four phases of Multi-Fiber Agreement.

18.3 : Generalized System Of Preferences (Gsp)

There was a growing gaps in areas of economic activity i.e. trade expansion, economic growth, employment generation, manufacturing growth etc between the developed countries of West and newly liberated countries in Asia, Africa and Latin America. There was a debate among newly liberated countries in Asia and Africa that they cannot compete with low priced developed countries products as there is huge difference in production methods. The developed countries used to have large production thus economies of scale with products manufactured with machines and latest technology. On the other hand; newly liberated countries plus which are still under foreign empire at nascent stage of industrialization and goods were produced using traditional methods having higher labor contents, low productivity but an aesthetic appeal. With growing developmental differences between developed countries and developing countries, the idea of tariff preferences for developing countries was the subject of considerable discussion at United Nation's. The discussion so culminated resulted in establishment of United Nations Conference on Trade and Development (UNCTAD) in the 1964 at Geneva, Switzerland. The negotiations at UNCTAD among developed and developing countries resulted in "Trade Preference" for developing countries. The main demand of developing countries was that Most Favored Nations (MFN) was creating a disincentive for richer countries to reduce and eliminate the tariff and other trade restrictions with enough speed to benefit the developing countries. Thus; the Generalized Schemes of Preferences (GSP) was announced whereby developed countries will offer "generalized", "non-reciprocal" and "non-discriminatory" tariff preference to developing countries so as to provide them greater market access in developed countries. Developed countries from Europe were first to offer GSP benefits to developing countries. USA started offering it after 1971 when GATT followed the lead of UNCTAD and enacted two waivers to the MFN that permitted tariff preferences to be granted to developing country goods. In initial offer, GATT offered the MFN Waiver for tariff preference only for a period 10 years but in it established a permanent exemption to the MFN obligation by way of the enabling clause. Generalized System of Preferences has worked extremely well and has provided greater access to developing countries in markets of developed countries.

Following are the list of countries which offer GSP benefit as of now to developing and least developed countries.

LIST OF COUNTRIES OFFERING GSP BENEFIT TO INDIA	
1. Australia	2. Republic of Bulgaria
3. Canada	4. Republic of Hungary
5. Czech Republic	6. Republic of Poland
7. Ireland	8. Russian Federation
9. Japan	10. Slovakia
11. New Zealand	12. Switzerland
13. Norway	14. United States of America
15. Republic of Belarus	16. Italy
17. Austria	18. Netherlands
19. Denmark	20. Portugal
21. Finland	22. Spain
23. France	24. Sweden
25. Germany	26. United Kingdom
27. Greece	

Source: Export Inspection Council of India, New Delhi

The rationale given for GSP Scheme was based on an economic theory that preferential tariff rates in developed markets like that of USA/ UK? Germany/ France / Japan/ Canada/ Italy/ Australia and other EU countries could promote export-driven industry growth in developing countries. This will also help developing countries manage their trade balances, import high end engineering items from developed countries and will ensure macroeconomic stability in international trade and monetary system. There was a sound economic rationale in GSP scheme as the markets of industrialized trading partners were large enough to provide enough economic stimuli to attain these goals and orderly development of international trade among countries. Following were the key objectives of granting trade preferences to developing countries by developed countries:

To Promote Industrialization In Developing Countries

To Encourage The Diversification Of Developing Countries

To Help Developing Countries Manaage Their Trade Balances and BOPs Situation

To Encourage Economic Grwoth And Employment In Developing Cuntries

Source: United Nations Conference on Trade & Development, Geneva

BENEFITS OF G.S.P. SCHEME: Exporters of developing countries including Indian exporters have been benefitted indirectly from GSP Scheme whereby an exporter' goods get the tariff preference in country of import i.e. the importer has to pay reduced tariff or even duty free entry of eligible Indian products in developed markets. This helps Indian exporter win cost competitive markets of industrialized nations as the reduction or removal of import duty on an Indian product makes it more cost effective and competitive to the importer. Thus, Indian goods become cheaper and price attractive to consumers vis a vis that of competitors from developed countries with other things being equal (e.g. quality). This tariff preference helps the new Indian exporters to penetrate the markets of developed countries. Established Indian exporters get a chance to increase their market share and to improve upon the profit margins in the countries which have offered India the GSP benefit. The list of countries most benefited out of GSP Tariff Preference in the year 2012 is listed as under:

Table: Top GSP Beneficiary Developing Countries in the Year 2012	
India	$4.5 Billion
Thailand	$3.7 Billion
Brazil	$2.7 Billion
Indonesia	$2.2 Billion
South Africa	$1.3 Billion
Philippines	$1.2 Billion
Turkey	$1.1 Billion
Angola	$632 Million
Russia	$544 Million
. Argentina	. $233 Million

Source: Office of US Trade Representative 2013

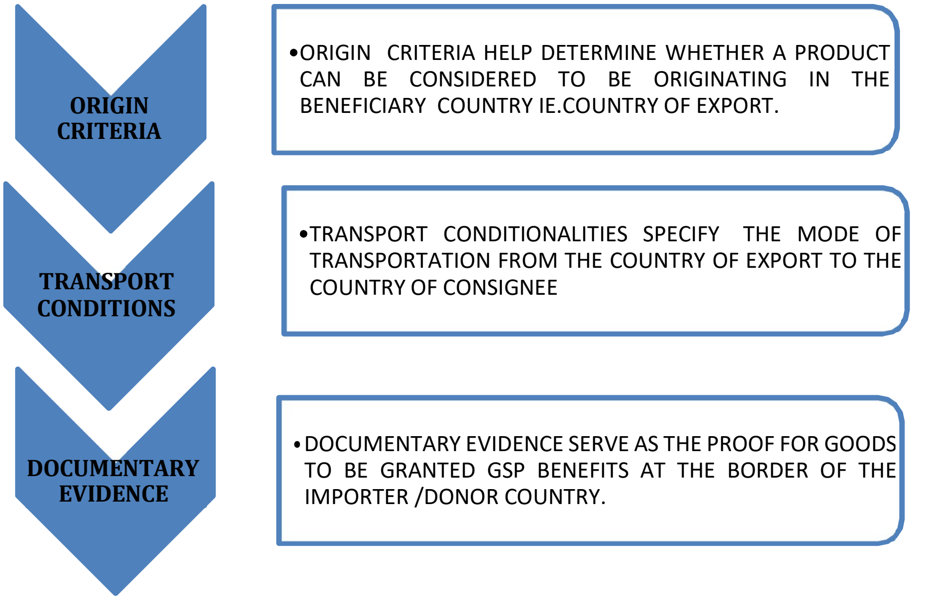
All European countries offered GSP benefit from 1968 and United States of America started to offer it from 1971. Indian exporters have been immensely benefitted in many areas for example, textiles, engineering goods, gems and jeweler, handlooms, handicrafts etc. Some of Indian goods have been phased out from GSP benefit as India has attained more than 3.3% global market share in these exports. GSP rules forbid the grants of GSP benefits to established export industries. Many other countries have withdrawn this benefit to India however some other are still offering it. In the changed global context, GSP benefit is offered more to Least Developed Countries (LDC) as they have been benefitted from this scheme so far and major benefits were taken by few emerging countries like China, India, Malaysia, Indonesia, Brazil, Chile etc. In order to deepen economic relationship with India, Some CIS countries such as Kazakhstan, Kyrgyzstan, Lithuania and Ukraine may also be allowing preferential tariff treatment to select Indian goods.

Eligible Products: The benefit of GSP scheme is offered based on rules of origin criteria which differ slightly from country to country as per their GSP offer scheme. Only those goods which fulfils the rules of origin criteria are entitles for tariff preference in country of import. For example, only those Indian goods which will fulfill the rules of origin requirements as laid down by country of import shall be eligible for preferential tariff treatment on import into the markets of donor countries. In case of 15 countries from European Union countries which offer preferential tariff to India, only Indian product is considered eligible which fulfils the requirements of Rules of Origin as laid down in the Community legislation, namely in Regulation (EEC) No. 2454 / 93, as amended by Regulation (EC) No. 12 / 97 and Regulation (EC) No: 1602 / 2000[1]. The guiding principles for rules of origin are discussed the subsequent section.

Rules Of Origin: Fulfillment of Rules of origin criteria is must to be eligible for availing a GSP tariff preference in country of import. GSP rules of origin comprise a set of requirements which are laid down by the importing country and must be fulfilled by an exported product in order to avail the preferential tariff treatment in the country of import. The rules of origin are unique and are aimed at preserving the purpose of GSP benefit which is to give preferential tariff only to developing and least developed countries so as to enable them to spur economic growth, generate employment, promote export, address issues related to trade deficit and above all ensure macroeconomic stability for orderly economic development.

GSP rules of origin are aimed at preventing the misuse of GSP tariff preference by third countries goods from unduly exploiting the system.

As some importing follow the scheme of national quotas and import ceilings, the efficient use of GSP is important for both country of import as well country of export. GSP rules of origin are flexible also in the sense that it provides sufficient scope for import or sourcing of raw materials and semi-manufactured products or parts to be used in exportable goods under GSP scheme. It prescribes the criteria of value addition to be achieved in such cases. Broadly, following are the guiding principles in framing and implementation of GSP rules of origin. They are:



Source: Adapted from "Handbook of Rules of Origin of GSP Scheme" Export Inspection Council, Government of India

18.4: Global System of Trade Preferences (Gstp)

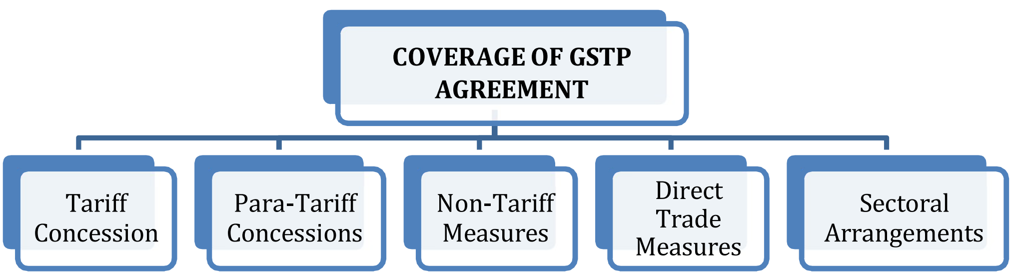
Under GSP scheme; Tariff Preference was given by developed countries to developing countries. A similar arrangement was deliberated, negotiated and agreed upon among Group of 77 countries (G-77) whereby developing countries are supposed to offer tariff preference to developing countries thus trade expansion and diversification among developing countries. The agreement to this effect known as "Global System of Trade Preferences" (GSTP) was signed and ratified among developing countries on 13th April, 1988 at Belgrade following conclusion of the First Round of trade negotiations to this effect. GSTP scheme of tariff preference came into being after a long process of trade negotiations at various meetings of G-77 Foreign Affairs Ministers. Some of the prominent negotiations were held at Ministerial Meeting of the Group of 77 at Mexico City in 1976 followed by another meeting at Arusha (Tanzania) in 1979 and Caracas (Venezuela) in 1981. As the result of these discussions, the Ministers of Foreign Affairs of the Group of 77 (G-77) decided to formalize the negotiations agenda and decided to set up "GSTP Negotiating Committee" at New York meeting in 1982. The New Delhi Ministerial declaration which took place at New Delhi (India) in July 1985 gave further impetus to the GSTP negotiation agenda. The Brasilia Ministerial Meeting held at Brasilia (Brazil) in May 1986 launched the First Round of GSTP Negotiations. There was broad consensus among leaders of G-77 that enhanced the need for deepening of economic ties among developing countries. The First Round of Tariff Concession Negotiations was concluded at the beginning of 1988 and G- 77 ministerial meeting held at Belgrade (Former Yugoslavia) in April signed the draft GSTP agreement on 13 April 1988. However; the GSTP Agreement came into force on 19th April 1989. Forty-four countries from G-77 have ratified the Agreement and have become participants. The list of member countries is tabled as under:

MEMBER COUNTRIES TO GSTP AGREEMENT UNDER MANDATE OF G-77		
1. Algeria	**15.** Ghana	**28.** Pakistan
2. Argentina	**16.** Guinea	**29.** Peru
3. Bangladesh	**17.** Guyana	**30.** Republic of Korea
4. Benin	**18.** India	**31.** Romania

5. Bolivia	19. Indonesia	32. Singapore
6. Brazil	20. Iran (Islamic Republic of)	33. Sri Lanka
7. Cameroon	21. Iraq	34. Sudan
8. Chile	22. Libyan Arab Jamahiriya	35. Thailand
9. Cuba	23. Malaysia	36. Trinidad and Tobago
10. Democratic People's	24. Morocco	37. Tunisia
11. Philippines	25. Mozambique	38. United Republic of Tanzania
12. Republic of Korea	26. Nicaragua	39. Viet Nam
13. Ecuador	27. Nigeria	40. Yugoslavia
14. Egypt		41. Zimbabwe

Source: Group of 77 (G-77)

The GSTP tariff preference scheme establishes a framework for the tariff concessions among the members of the Group of 77. The draft agreement of GSTP lays down mutually accepted and agreed rules, principles and procedures for conduct of trade negotiations and for implementation of the results of the trade negotiations. The coverage of the GSTP scheme extends to the following areas diagrammed as under:



Source: Adapted from Draft GSTP Agreement, Group of 77 (G-77)

Member states of GSTP Tariff Preference Scheme follow the principle of step by step furthering and deepening the economic and trade engagement among member countries. GSTP has been continuously improved upon and has been extended in successive stages to achieve these objectives. Following are the declared objectives of the GSTP scheme by member countries:

a. GSTP Scheme is aimed at promoting and sustaining the mutual trade among member countries.

b. GSTP scheme aim at further developing and deepening the economic co-operation among developing countries of Group of 77 countries.

In the recent years, the GSTP Negotiating Committee meeting was held at Accra (Ghana) on the sidelines of the UNCTAD 12th Ministerial Conference. The Negotiating Committee has agreed on the following points in order to further the cause of tariff preference among member states.

a. Member countries agreed to carry out negotiations for further reducing the tariff barriers by following the formula which includes the “Across the Board Reductions, Line by Line Reductions and Linear Cut of 20 to 40 per cent on dutiable tariff lines.

b. Member countries agreed that they shall continue the “Request and Offer” and “Sectoral Negotiations for tariff reduction and removal.

c. Member countries have agreed to offer tariff preference to each other on at least 70% of dutiable tariff lines.

The basis of tariff preference from one country to another is Certificate of Origin which is issued at present by following organizations in India. These are:

S. NO.	ORGANIZATION	COMMODITY
1	Export Inspection Council through their field offices known as Export Inspection Agencies with offices all over India.	All Products
2	Tobacco Board, Guntur	Tobacco &

		Tobacco products

18.4 : INTERNATIONAL AGREEMENTS AND TREATIES

In addition to above discussed tariff preference schemes like GSP/ GSTP, there are some other international agreements and treaties among countries aimed at strengthening the international cooperation for development. There has been the unilateral promulgation and implementation of non-reciprocal preferential trading schemes by developed countries as well as developing countries in favor of developing and least developed countries. There is a long list of such international agreements and treaties but only important international agreement are discussed here under. These are:

a. Everything but Arms (EBA) of European Union

b. The African Growth and Opportunity Act (AGOA) of United States

c. Duty Free Tariff Preference Scheme of India

d. Caribbean Basin Initiatives (CBI) of United States

e. the Andean Trade Preference Act (ATPA)

f. Canadian Trade, Investment and Industrial Cooperation program (CARIBCAN)

g. Lomé Convention

h. South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)

These international trade agreements and treaties are aimed at allowing the import of goods from developing and least developed countries at a lower or nil rates of customs duty and other levies in either developed or developing countries. In the fast changing global trade environment, even developing countries are offering non reciprocal tariff preference to least developed countries. India has also offered one such scheme entitled as “Duty Free Tariff Preference for Least Developed Countries” whereby the goods from 49 LDCs are getting zero duty on 92% of the tariff lines in India.

These trade preference agreements & treaties are principally, but not exclusively, designed to enable developing countries/least developed countries to have greater access to markets of industrialized countries such as EU/ USA/ Canada/ Japan/ Other OECD countries. China has offered plenty of such benefits to Least Developed countries and other emerging countries like Brazil/ Mexico/ Chile / Russia/ South Africa are also offering such tariff preference schemes through international agreements and treaties. Brief discussion of some select international agreements & treaties is as under

18.4 **Everything but Arms (Eba):**

Everything but Arms (EBA) is a tariff preference initiative of the European Union whereby all the imports to the European Union markets are either duty free or quota free with an exception of arms & ammunition from the Least Developed Countries. Thus, there are around 49 Least Developed Countries of the world which are beneficiary of this arrangement. EBA is part of existing GSP scheme offered by selected European Union countries. The only difference being that GSP benefit is offered by only 15 countries whereby "Everything but Arms" duty preference benefit is offered by all 27 EU member states. GSP is applicable to developing as well as LDC countries whereby EBA is dedicatedly only for Least Developed Countries. EBA was agreed upon among EU member states after long deliberations and entered into force on 5 March 2001.The real benefit from EBA agreement to LDC is debated as rules of origin requirement are strict and finished goods particularly those which have been manufactured by sourcing raw material/ catalyst and components from different countries are not eligible for duty free access under EBA to EU markets. For Example, Bangladesh which is LDC and its main exports are textiles and apparel, it is not offered duty free access as cotton plus other inputs are imported by Bangladesh from other countries. Similarly; there is transitional arrangement for phasing out of quota regime for Banana, Rice and Sugar and has been subject to prolonged negotiations within EU member states for phasing out of quota regime on these items. There are success stories such as the export of honey and cut flowers from Republic of Rwanda. The macroeconomic aim of EBA scheme is to encourage exports from world's poorest countries and promote developments efforts in these countries.

18.5 The African Growth And Opportunity Act (Agoa) The

African Growth and Opportunity Act (AGOA) were passed by U.S. Congress in May 2000. The main purpose of AGOA is to assist the economies of sub-Saharan Africa in export promotion, foreign exchange generation, employment generation and generating additional economic activity thereby promoting all rounds of developments in these countries. It is also aimed at improving the economic relations between the United States and the select African countries. AGOA like other tariff preference agreements provides trade preferences for quota and duty-free entry into the United States for certain goods from select African countries. AGOA thus expands the tariff preference benefits provided under the Generalized System of Preferences (GSP) by United States. AGOA has been instrumental in promoting the development of textiles and apparel industry in Southern Africa. However, with phasing out of MFA agreement, African suppliers cannot withstand the tough competition coming from China, Bangladesh, Vietnam, Turkey and India. In recent years, African countries have been successful in diversifying their export basket by supplying products such as cut flowers, horticultural products, automotive and steel. Nigeria and Angola are the largest exporters under AGOA to United States of America. South Africa has most diverse export basket which is not limited to energy sector unlike some other African countries. There are some countries such as Lesotho, Swaziland, Kenya and Madagascar which have been major beneficiary of AGOA Scheme. High quality agricultural products from African countries are a promising area for trade under AGOA scheme, provided African exporter are able to fulfill SPS and TBS standards as per US requirements. In order to streamline supply chain and achieving optimum freight efficiency with economies of scale in logistics operations, the U.S. government has established three regional trade hubs in Africa under AGOA Scheme. These are based at Accra (Ghana); Gaborone (Botswana) and Nairobi (Kenya).

18.6 Duty Free Tariff Preference Scheme Of India:

India has offered the non reciprocal tariff preference to Least Developed Countries for assisting them to promote export, generate employments and enhance economic growth and development. Hong Kong Ministerial declaration of WTO meeting provides for increased market access to Least Developed Countries. India's DFTP Scheme grants duty free access to 49 Least Developed Countries in Indian markets on 94% of India's total tariff lines. DFTP scheme will be implemented in phases over a period of five years. India's DFTP scheme is unique in the sense that it provides preferential market access on tariff lines that comprise 92.5% of global exports of all LDCs. India has offered market access in products of immediate interest to African countries which includes primary items like cotton, cocoa, aluminum ores, copper ores, cashew nuts, cane-sugar, ready-made garments, fish fillets and non-industrial diamonds. Under DFTP scheme, the preferential market access will be available to all the 49 LDC members including 33 LDCs in Africa. The countries which are interested to avail the benefit of this scheme will have to "Letter of Intent" to the Government of India so that Indian customs officials are informed about the same through a notification. 13 least developed countries (LDCs) mainly from Africa and South East Asia has already submitted their letter of intent. The list of potential 49 beneficiaries is as under:

34 LDCS COUNTRIES FOR AFRICA	
1. Angola	**18.** Madagascar
2. Benin	**19.** Malawi
3. Burkina Faso	**20.** Mali
4. Burundi	**21.** Mauritania
5. Central African Republic	**22.** Mozambique
6. Chad	**23.** Niger
7. Comoros	**24.** Rwanda
8. Democratic Republic of the Congo	**25.** São Tomé and Príncipe
9. Djibouti	**26.** Senegal
10. Equatorial Guinea	**27.** Sierra Leone
11. Eritrea	**28.** Somalia
12. Ethiopia	**29.** South Sudan
13. Gambia	**30.** Sudan
14. Guinea	**31.** Togo
15. Guinea-Bissau	**32.** Tanzania
16. Lesotho	**33.** Uganda

17. Liberia	**34.**Zambia
14 LDCS COUNTRIES FROM ASIA	
1. Afghanistan **2.** Bhutan **3.** Bangladesh **4.** Cambodia **5.** East Timor **6.** Kiribati **7.** Laos	**8.** Myanmar **9.** Nepal **10.** Samoa **11.** Solomon Islands **12.** Tuvalu **13.** Vanuatu **14.** Yemen
1 LDC COUNTRY FROM AMERICA	
1. Haiti	

Source: United Nations

Caribbean Basin Initiative (Cbi):

Caribbean Basin Initiative is the trade promotion and facilitation program of United States government. Caribbean Basin Initiative has legacy of two earlier trade promotion program of US government these are Caribbean Basin Economic Recovery Act (CBERA) which came into force in 1983 and has substantially expanded the economic cooperation between US and Caribbean countries in 2000 through the U.S.-Caribbean Basin Trade Partnership Act (CBTPA), These two trade programs are now collectively known as the Caribbean Basin Initiative (CBI) which is of vital significance to both US and Caribbean countries economic interests. It is aimed at promoting and facilitating the economic growth and development of Caribbean countries through export promotion, export expansion and diversification and employment generation in key areas of economic activity in Caribbean countries. Caribbean Basin Initiative agreement provides duty free access to Caribbean Countries in the world largest market of United States. Following is the list of countries which are beneficiary under CBERA and CBTPA agreement.

EXISTING BENEFICIARY COUNTRIES	EXISTING BENEFICIARIES UNDER

	UNDER CBERA AGREEMENT		CBTPA AGREEMENT
1	Antigua and Barbuda	1	Barbados
2	Aruba	2	Belize
3	The Bahamas	3	Guyana
4	Barbados	4	Haiti
5	Belize	5	Jamaica
6	British Virgin Islands	6	Panama
7	Dominica	7	St. Lucia
8	Grenada	8	Trinidad and Tobago
9	Guyana		
10	Haiti		
11	Jamaica		
12	Montserrat		
13	Panama		
14	St. Kitts and Nevis		
15	St. Lucia		
16	St. Vincent and the Grenadines		
17	Trinidad and Tobago		

Source: Office of the US Trade Representative 2013

The Andean Trade Preference Act (Apt): **The Andean**

Trade Preference Act (ATPA) was enacted in December 1991, to help four Andean countries (Bolivia, Colombia, Ecuador, and Peru) in their fight against drug production and trafficking by expanding their economic alternatives. The Andean Trade Promotion and Drug Eradication Act (ATPDEA), enacted on August 6, 2002, renewed and amended the ATPA to provide duty-free treatment for certain products previously excluded under the ATPA. The benefits are subject to the countries meeting the program's eligibility criteria. Under the Reports tab below are the reports USTR has submitted to Congress every two years regarding the operation of the program. The latest report was submitted on April 30, 2009. The reports describe the major features of the program, its operation during the reporting period and the performance of the beneficiary countries with respect to the program's eligibility criteria.

Canadian Trade, Investment And Industrial

Cooperation Program (Caribcan):

Similar to non reciprocal tariff preference international agreement of US and EU, Canada also offer duty free, preferential and unrestricted markets access to Caribbean countries through the Caribbean-Canada Trade Agreement (CARIBCAN). It is a Canadian government program and was agreed, signed and ratified by Canada Parliaments in 1986. CARIBCAN agreement was aimed at promoting trade and investment by offering duty free, preferential markets access to group of Caribbean countries in large market of Canada. Following were the key features of this agreement.

- Organizing Seminar For Businesspersons Of The Caribbean Region
- Training On Market & Product Identification
- Workshop On Intenritonal Business Entry Strategy To Canada Market
- Expanding Export Capabilitites Of Carribean Industry In Canada
- Assistance Of The Canadian Department Of Industry to Carribean Exporters
- Technology In The Caribbean Region

Source: Canada Trade Commissioner Service

Following are *the* key objectives of CARIBCAN Agreements:

a. To enhance the Commonwealth Caribbean's existing trade and export earnings;

b. To improve the trade and economic development prospects of the region;

c. To promote new investment opportunities; and

d. To encourage enhanced economic integration and cooperation within the region."

Following is the list of countries getting benefitted from CARIBCAN agreement.

1. Anguilla,	**10.** Republic of Guyana,
2. Antigua and Barbuda,	**11.** Jamaica,
3. The Bahamas,	**12.** Montserrat,
4. Bermuda,	**13.** Saint Kitts and Nevis,
5. Barbados,	**14.** Saint Lucia,
6. Belize,	**15.** Saint Vincent and the Grenadines,
7. The British Virgin Islands,	**16.** The Republic of Trinidad and Tobago,
8. The Cayman Islands,	**17.** The Turks and Caicos Islands
9. The Commonwealth of Dominica, Grenada,	

Source: Canada Trade Commissioner Service

18.62 LOMÉ CONVENTIONS: The Lomé Convention is an international agreement between the European Community (EC) and 71 African, Caribbean, and Pacific (ACP) countries and is aimed at promotion and facilitation of trade and aid to these 71 poor countries. It was signed at Lome, Togo Africa in February 1975 and is popularly known as Lomé Convention. It came into force from April 1976 was designed to provide a new economic framework for enhancing trade and aid cooperation between the then European Community (EC) and developing ACP countries. It is evident to note that these countries are poor, vulnerable to political instability and had been colonies to either U.K. or Dutch or Belgian or France. Lome Convention has two main aspects. First, it provided the duty free or preferential access to most of ACP agricultural and mineral exports the European Community. The preferential access to European Community is based on a quota system. For example, quantity restrictions were imposed on some products like sugar and beef which posed competition to domestic producers of European community. In the second category, European Community has committed itself that it would offer ACP countries an aid & investment of $ 3 billion in the ACP countries.

South Pacific Regional Trade And Economic Cooperation Agreement (Spartech):

Following lines of other developed countries, Australia and New Zealand decided to offer non reciprocal tariff preference and unrestricted markets access on select product to developing countries located in Pacific Ocean through the South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA). It was signed in 1980 in between the donor and recipient countries at Tarawa (Kiribati) however come into force on January 1st 1981. SPARTECA agreement is also subject to Rules of Origin regulations for duty free and unrestricted market access and is of immense importance to developing countries located in Pacific Ocean as it address the larger question of unequal trade relationships between the two groups. The developing countries of Pacific Island Forum have been benefitted in sectors like textiles, clothing and footwear etc through SPARTECA. Following is the list of beneficiary countries under SPARTECA international agreement.

LIST OF BENEFICIARY COUNTRIES UNDER SPARTECA AGREEMENT			
1	Cook Island	**9**	Samoa
2	Australia	**10**	Solomon Islands
3	Fiji	**11**	Tonga

4	Marshall Islands	12	Tuvalu
5	Micronesia	13	Vanuatu
6	Nauru	14	Kiribati
7	New Zealand	15	Niue.
8	Papua New Guinea		

Source: www.austrade.org

18.6: Summary:

Tariff preference and Quota system has been the instruments used by countries to strengthen their economic relationship, offer assistance e to poor and vulnerable countries to developed countries markets and ensuring the orderly, sustained and balanced development of international trade. Non-tariff barriers like quota regime, quantitative restrictions, non reciprocal duty preference have existed for a long time in world trade. Multi Fiber Agreement was introduced for the first time in 1974 by developed country as a short-term measure which was aimed at adjusting the imports from the developing world. As developing countries have a natural advantage due to factor endowment working their favor with large cotton production coupled with cheap labor, the exports from certain developing countries started increasing very fast. Developed countries wanted to streamline the import regime by importing a fixed quantity from a particular country irrespective to the fact the goods originating from this country were not only cost competitive but were of good quality as well. Generalized Schemes of Preferences (GSP) was announced in 2nd UNCTAD Conference (1968) whereby developed countries will offer "generalized", "non-reciprocal" and "non-discriminatory" tariff preference to developing countries so as to provide them greater market access in developed countries. Under GSP scheme; Tariff Preference was given by developed countries to developing countries. A similar arrangement was deliberated, negotiated and agreed upon among Group of 77 countries (G- 77) whereby developing countries are supposed to offer tariff preference to developing countries thus trade expansion and diversification among developing countries. The agreement to this effect known as "Global System of Trade Preferences" (GSTP) was signed and ratified among developing countries on 13th April, 1988 at Belgrade following conclusion of the First Round of trade negotiations to this effect.

There are some other international agreements and treaties among countries aimed at strengthening the international cooperation for development. There has been the unilateral promulgation and implementation of non-reciprocal preferential trading schemes by developed countries as well as developing countries in favor of developing and least developed countries. There is a long list of such international agreements and treaties but only important international agreement are discussed here under. These are:

a. Everything but Arms (EBA) of European Union
b. The African Growth and Opportunity Act (AGOA) of United States
c. Duty Free Tariff Preference Scheme of India
d. Caribbean Basin Initiatives (CBI) of United States
e. the Andean Trade Preference Act (ATPA)
f. Canadian Trade, Investment and Industrial Cooperation program (CARIBCAN)
g. Lomé Convention
h. South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)

18.7 Glossary

- **Multi-Fiber Arrangement:** MFA is n international trade agreement on textile and clothing which came into force for the first time in 1974 and was in force till 2004. With the Agreement on Textiles & Clothing, phase wise abolition of MFA quota regime took place from 1995 to 2004.
- **GSTP:** GSTP is a preferential trade agreement whereby developing countries offer tariff preference to developing or least developed countries. India is founding member of GSTP scheme. It came into force on 13 April 1988 and is still actively used by participating countries including India.
- **GSP:** GSP is non reciprocal, differentially discriminatory tariff scheme whereby developed countries offer duty free or preferential tariff to goods originating from developing countries. Now, this scheme is more focused towards Least Developed Countries.
- **AGOA:** African Growth and Opportunity Act was an initiative of US Congress to offer duty preference to select poor African countries to US markets.
- **EBA:** Everything Bu Arms is a duty preference scheme of EU countries to Least Developed, poor and vulnerable economies of world.
- **DFTP:** India has launched Duty Free Tariff Preference Scheme for Least Developed Countries whereby the goods originating from LDCs are entitled to preferential access in Indian markets. At present around 94% tariff lines are covered this scheme.

18.8 Check your progress

1.Developed countries imposed .... on imports of textiles and clothing under the Multi-Fibre Arrangement from 1974 to 2004.

2. The difference between the GSP and EBA schemes is that GSP is granted by only 15 countries, whereas under EBA, all .... European Union member countries have agreed to provide tariff preferences.

3. The Caribbean Basin Initiative is a trade promotion and facilitation program that is administered by ....

18.9 Answers to check your progress

1. Quantitative Restrictions 2. 27 3. United States of America 4. January

18.7 : Terminal questions

Q. No. 1: Write a short note on the macroeconomic environment of tariff preference and quota regime?

Q. No. 2: Explain the Multi fiber Agreement and its impact on global textiles trade?

Q. No. 3: Discuss the various phases of elimination of MFA arrangement under Agreement on Textiles & Clothing?

Q. No. 4: What is GSP scheme? What is the benefit under this scheme?

Q. No. 5: Explain the GSTP Scheme? Also discuss the declared objectives of GSTP scheme?

Q. No. 6: What are some other international agreements, treaties and schemes aimed at tariff preference in international trade?

Q. No. 7: Write a short note on any two of following?

- **a.** Everything But Arms
- **b.** Africa Growth and Opportunity Act
- **c.** Duty Free Tariff Preference
- **d.** Caribbean Basin Initiative

18.9: **Suggested Readings**

1. International Economics, Raj Kumar, Excel Publication, 2008
2. International Economics, Francis Cherunilam, The McGraw Hill Publication, 5th Edition,
3. International Economics, Steven Husted and Michael Melvin, Pearson Publication, 9th Edition.

4. International Economics, James Gerber, Pearson Publication, 6th Edition
5. International Economics, D.M. Methane, Himalaya Publishing House; Edition 11th ISBN No. 8178660962
6. International Economics: Theory And Policy, 8th Edition, Paul R. Krugman, Pearson Education India
7. International Economics, Dr Nirmala Bhalerao & SSM Desai, Himalaya Publishing House, 1st Edition
8. International Economics, M.L. Jhingan, Vrinda Publishing House
9. International Economics, D. N. Dwivedi, ISBN : 8122005349
10. International Economics, Steven L. Husted, Michael Melvin , Harper-Collins Press
11. Johan Daniel, and Lee H. Rudabaugh, International Business Environment and Operations, Pearson Publication, 14th Edition.
12. Rakesh Mohan Joshi, International Business, Oxford Press, India Edition.
13. WTO Reports on Agreement on Textile.

Unit 19: Theories of Custom Union, Common Market and Free Trade Area

Structure:

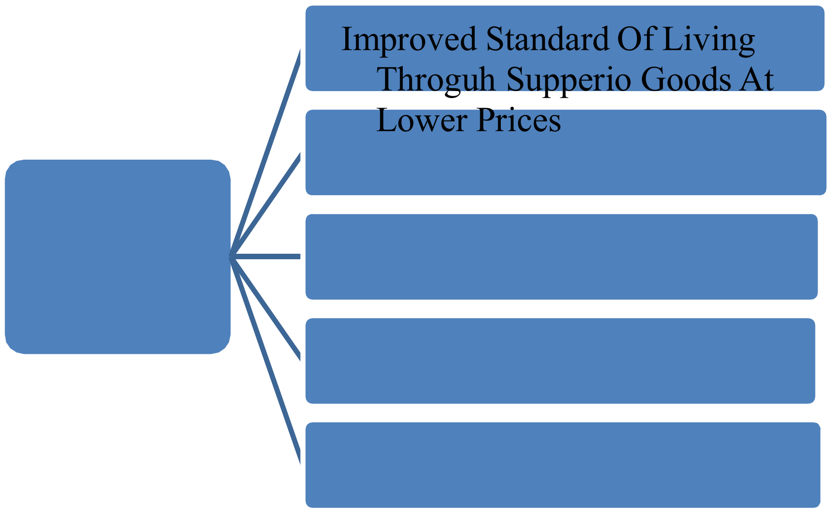
Objectives:

After reading this unit, the student shall be able to:

- To understand the history of evolution of regional economic integration in world trade.
- To explain the rationale and benefits of regional economic integration.
- To discuss the economic theory of regional economic integration.
- To appraise the various stages of economic integration and economic opportunities therein.
- To explain the India's initiatives in bilateral and regional economic cooperation in recent years.

19.1 : Introduction

After second world, countries realized the importance of trade not only for economic development but for promoting peace and prosperity in the region. Regional trade agreements were formulated, particularly in Europe where countries pool their coal resources in order to help each other and avoid conflicts. These small initiatives result in formation of European Union after passing through various stages of economic integration. Today, there is no region in the world that does not have free trade agreements or other initiatives for free trade & commerce. Various stages of economic integration have been evolved namely preferential trade, free trade, custom union, common market and economy union. Free Trade encourages labor force specialization and also help countries specializes in the areas of their factor endowments. In other words, free trade allows a country to produce and export what it does best and most efficiently, while allowing it to import specialized goods from other countries. Thus, free trade from both countries helps to save costs while gaining superior products through the exchange of goods & services. Free trade has many other benefits which can be diagrammatically understood as under:



Source: Adapted from Why America Needs to Support Free Trade, by Laura Agido, The Heritage Foundation, USA

Such economic formations are taking place irrespective to stage of country /region economic development. Countries are enthusiastic to become members of regional block or free trade pact or forging some sort of economic alliance with one grouping or other for promoting trade and investments. With formation of WTO, countries are increasingly relying on Free Trade & Commerce as a tool for economic integration, employment generation, growth promotion and political stabilization. Free trade agreements have become reality since the early 1990s. According to WTO Regional Trade Agreement database, there are around 546 Free Trade / Regional Trade Agreements (counting goods, services and accessions separately) till January 10^{th}, 2013. Of these, 354 Free Trade /Regional Trade Agreements were in force. What makes these free trade agreements special is that these are "reciprocal trade agreements" between two or more partners. List of free trade agreements can be accessed at http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx

19.2 History Of Regional Economic Integration:

The benefits of free trade were stressed by economist from all range of theorist from Mercantilist to Classical to Neo- Classical to Modern theorist. After Second World War, European Coal & Steel Community was first sincere attempt by countries such as France, Italy, Belgium, Luxembourg, Netherlands and West Germany in 1951 through treaty of Paris. This arrangement lifted some restrictions on German productivity. The period of 1958-1972 see the rise of three communities aimed at promoting free trade, investments and commerce. Important among these economic communities were European Economic Community and Euro atom. These economic communities were merged in 1967, paving the way for single European Community. Free trade & commerce flourished and after having passed through different stages of economic integration, European Union was formed in 1992 through Treaty of Maastricht.

Back home, India's economic model was based on free trade & commerce from the times of Mohenjo-Daro/ Harappa civilization. After independence, India realized the importance of free trade little late and thus initiated the formation of Free Trade Block on South Asia. Attempts were made first through SAPTA and now with SAFTA; however the success has been limited mainly due to political factors. The features of Free Trade can be understood as under:

- Free trade refers to trade of goods without taxes meaning there are no tariff barriers (duties & taxes) / non tariff barriers (quotas / quantitative restrictions etc) on export as well as on imports for producers / exporters and importers.
- There is trade in services without taxes or other trade barriers between two or more countries.
- There is absence of "trade-distorting policies" or "protectionist measures" such as anti-dumping duty/ safeguard duty, other taxes & duties aimed at restricting trade/ subsidies / regulations or laws.
- Country treats domestic as well as foreign firms at par and do not offer any preference to any or make rules that give domestic firms an advantage over foreign firms. There is complete rule based transparency.
- There is free access to market to parties under FTA.
- There is free access to market information.
- A last essential feature of free trade is that domestic firms are not allowed to distort free market functions through government-imposed monopoly or oligopoly power.

19.3 Rationale & Benefits Of Regional Economic Integration:

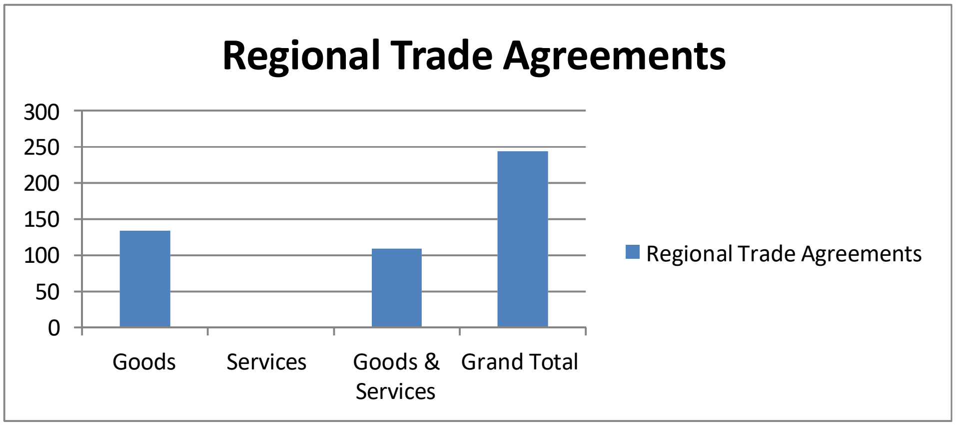
Regional economic integration was started in two waves; first during the period of 1951-80 after the second world war and second from 1970- to date. The first wave of regional economic integration was marked by the establishment of the European Economic Community, European Free Trade Agreements and the Council for Mutual Economic Assistance. There emerged a plethora of regional trade blocs in developing and least developed countries. Prominent among them were ASEAN / COMESA / MERCUSOR / Andean Community / Central American Common Market etc. These regional economic grouping started against the backdrop of the Cold War, decolonization of Asia and Africa and were aimed at promoting peace through political & economic stabilization. The need for regional trade integration in the recent years has arisen from a number of socio-economic, political and security considerations. Political considerations in singing of Regional Trade Agreements are rooted in foreign policy, commercial diplomacy and development policy interests of countries. At times when Doha Round of Trade Negotiations has to be inconclusive due to differing interest of countries, countries are leveraging regional economic agreements in order to expand & diversify trade in goods & services, attract investments, promote employment etc. Important issues such as trade in services, investment, competition, environment, trade facilitation and labor standards which cannot be amicably concluded at multilateral forum like WTO, can be effectively resolved bilaterally or regionally. This has led to proliferation of regional trade agreements in the recent past. The table below has RTAs in force, sorted by Type of Agreement:

List Of Regional Trade Agreement In Force In World Till January 2013

	Enabling clause	**GATS Art. V**	**GATT Art. XXIV**	**Grand total**
Customs Union	8		10	18
Customs Union - Accession	1		6	7
Economic Integration Agreement		110		110
Economic Integration Agreement - Accession		3		3
Free Trade Agreement	12		202	214
Free Trade Agreement - Accession	0		1	1
Partial Scope Agreement	14			14
Partial Scope Agreement - Accession	1			1
Grand total	36	113	219	**368**

Source: www.wto.org

Similarly; the list of physical Free Trade / Regional Trade Agreements in force on the basis of coverage is as under:



Source: www.wto.org

The advantage of regional economic integration is that it leads to "trade creation". There occur an increase in production of the goods & services in the lowest cost member country. Countries exchange specialized and cost competitive goods with each other. It helps boost jobs and wealth in the area. For achieving all this, countries have to work for 'equalizing border taxes' and reducing 'red tape'. Countries should also promote trade facilitation measures aimed at less paper work / custom rules simplification and should be able to transport goods between member States with not only ease but at lower cost. The disadvantages of regional economic integration can be trade diversion leading to higher employment, lower foreign exchange inflows and pressure on balance of payments. If implemented properly advantages of regional economic integration outweigh the disadvantages.

19.3 Rationale for Regional Economic Groupings:

Formation of Regional Economic Groupings is aimed at leveraging the instrument of international trade in order to make an essential contribution towards the economic development of the country. Empirical studies show that free trade has benefited the participating countries. Accordingly the rationale of regional economic cooperation for any is multidimensional and is based on a number of factors discussed as under:

- Foremost rationale for formation of regional economic groupings is that it enables the participating countries to overcome the problem of small market size of their domestic markets. Small economy usually face the problem of achieving the desired economy of scale & scope in order to be competitive in the market as there is a "threshold" levels in many economic and technological activities. Greater economies of scale help countries to specialization and increase cost competitive exports and help achieve better terms of trade.
- Regional economic groupings help participating countries to make fuller use of their innate resources. Country can effectively engage in industries as per its factor endowments and efficiently exploit its human and technological resources. Participating countries has the market

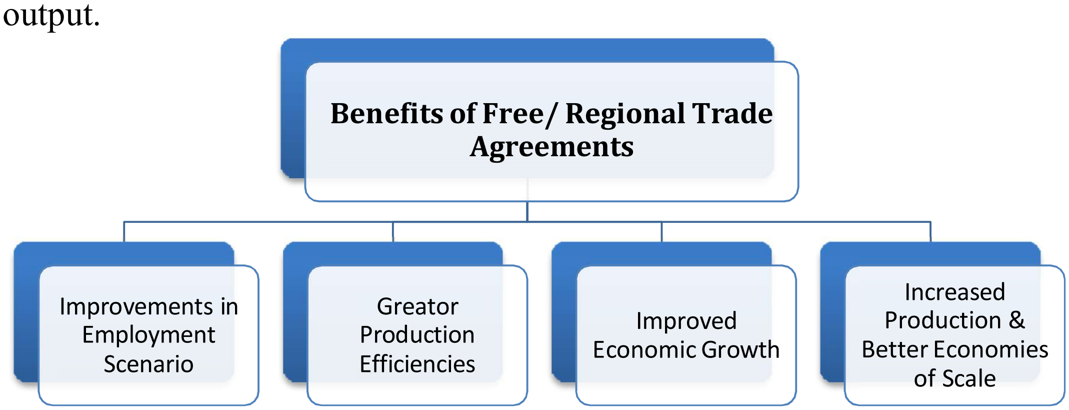
choice to expand and diversify in the existing industrial activities and also to foray in new areas of business. Country can achieve perfection in all areas of economic activities namely agriculture, manufacturing and services.

- There is scope of to exploit the complementarities among the participating countries. Firms from participating countries can enter into strategic alliance/ joint venture agreement or can make licensing / franchising agreement in order to improve their competitiveness in global markets.
- Regional economic agreements no doubt create spill-over effects; spanning over all areas of economic, social and technological cooperation among participating countries. Increased levels of cooperation among firms, business houses, service enterprises, academic & research institutions, professional and technical experts and civil society pave the way for wider cooperation in many other areas such as art, literature, culture, sports, education and related fields. All this has its bearings on improving the quality of human life and standard of living of people among the participating countries.
- Last but the least, regional economic integration helps countries harmonized their rules and regulations / custom procedure / quality standards and improve physical infrastructure of trade logistics. This helps in reducing the transaction costs of doing business and also results in higher trade expansion / diversification / investment inflow to region. Investors world over, looks such regions for investments in existing and new industries.

19.4 Benefits of Free Trade / Regional Trade Agreements:

Following are the benefits of Regional Economic groupings / Free Trade Agreements.

- **Increased Production & Better Economies of Scale**: Free Trade / Regional Trade Agreements enable participating countries to specialize in the production of those commodities in which they have a comparative advantage or factor endowment. Increased specialization in areas of core competency enables countries to take advantage of efficiencies generated from economies of scale and scope, higher productivity and increased output.

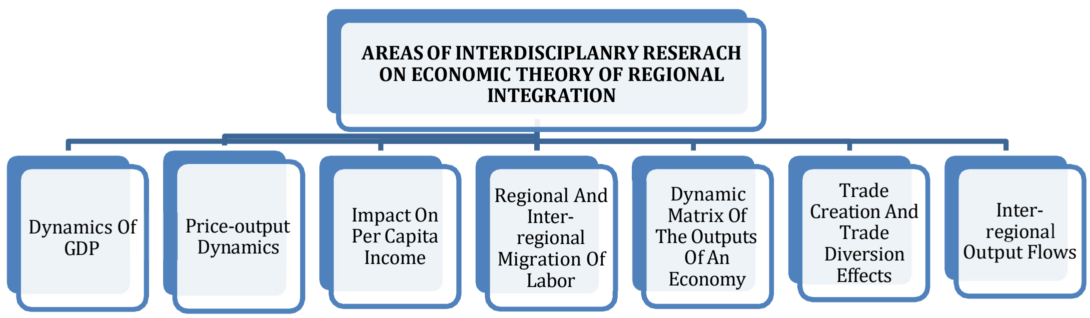


- **Greater Production Efficiencies:** Free Trade Agreements helps on effective division of resources and improve the efficiency of resource allocation. Effective & efficient resource allocation results in higher productivity and increasing total domestic output of goods and services. Firms from the participating countries compete for market share leading to innovative production techniques, use of new technology, better management practices and marketing skills and cost effective distribution and transportation methods.
- **Improvements in Employment Scenario**: Free Trade Agreements create more business opportunities and investor throng to such cost competitive areas of business. This leads to improvements in employment scenario in exporting industries. For example, with liberalized trade regime in service sector, India has created 4 million direct jobs in software and IT enabled industry.
- **Improved Economic Growth:** Regional Trade/ Free Trade Agreements improve the overall business environment due to spill effects resulting in higher standard of living, higher wages leading to increased real incomes and improved economic growth due to increased consumers spending.

19.5 ECONOMIC THEORIES OF REGIONAL INTEGRATION:

Economic theory of regional economic integration was for the first time proposed by economist Jacob Viner in 1950 who defined the trade creation and trade diversion effects resulting from regional economic integration of countries. Jacob was of the opinion that there will be increased interregional flow of goods mainly due to changes in customs tariffs of the country. Similarly, some of the trade will start taking place within the region itself. Jacob, after having conducted the empirical finding based on the

Trade flows between two states prior and after their unification, compared them with the rest of the world. The findings were very interesting the countries which were part of regional economic initiatives benefitted a lot from both trade creation and trade diversion due to formation of regional economic grouping. Thus, the findings of Jabot Viner became the foundation and basis of the theory of economic integration. Subsequently, the efforts were made by economist Linsey to enlarge the static analysis of trade flow between three states with rest of world. Hungarian economist Bela Balassa summarized the benefits and other aspects related to regional economic integration in his essay in 1960. Balassa, econometrically proved that as economic integration increases among countries, the barriers of trade between country markets diminish proportionately to stage of economic integration. Balassa was of the strong belief that as regional economic grouping are formed, the market size become bigger coupled with free movement of economic factors across national borders, this result in additional demand for further integration for economic, social and political reasons. Balassa, in 1960, proposed that economic union are likely to be be shaped as political unions also and his remarks stands absolutely correct as European Union is increasingly moving towards a single political union with one parliament, one president and a common law. Subsequently to Balassa comments on static gains from regional economic grouping, there was a research on analyzing the dynamic gains from regional economic groupings. An efforts was made to study both the dynamics of trade creation and trade diversion effects from regional economic grouping by economist Pareto who included the in his research the efficiency of factors such as labor and capital due to formation of regional economic grouping. Economist Ravshanbek Dalimov made a wonderful contribution by proving it mathematically. Thus, theory of economic integration was accepted as a pure economic theory by other discipline also and this provided scope for interdisciplinary research in the areas of economic integration. Following were the main areas of interdisciplinary research where economic theory of regional integration was successfully applied. These are:



Adapted from: Negishi, T. Customs Unions and the Theory of the Second Best, International Economic Review, 1969

19.6 STAGES OF ECONOMIC INTEGRATION:

Various stages and levels of economic integration were proposed by economists and trade specialists. Following is an exhaustive list of various level of economic integration that can be achieved by a country. The degree of economic integration can broadly be categorized into seven stages:

1. Preferential trading area
2. Free trade area, Monetary union
3. Customs union, Common market
4. Economic union, Customs and monetary union
5. Economic and monetary union
6. Fiscal union
7. Complete economic integration

However, practically there exist four types of regional economic grouping, differentiated on the basis of level of economic integration. However; all of them are aimed at protecting the participating countries from imports from non-members countries. WTO recognized the importance of regional trading blocs for realizing the mission of multilateral trade system based on non discrimination and transparency. Trade blocs are formed by the countries so that they can jointly focus on the issues which are of vital importance to their stage of economic development. Trade blocs undoubtedly lead to increased production and trade among participating countries has offered several benefits as discussed above. There are several types of regional economic groupings and are discussed as under:

- **Preferential Trading Arrangement:** PTA is first small step towards regional integration and is aimed at eliminating tariff as well non tariff barriers on selected goods or there is preferential tariff that one country offers another member country. An example of PTA is India-Mercosur PTA and India-Chile PTA.
- **Free Trade Area:** FTA is first genuine step towards forming a regional economic grouping and is aimed at removing all tariff & non tariff barriers to trade among participating countries. Countries are however; free to independently determine their economic and trade policies with nonmember countries. The instrument for facilitating free trade between countries is Certificate of Origin. Examples of FTA are NAFTA and India-ASEAN FTA.

Levels of Economic Integration in Regional Economic Groupings

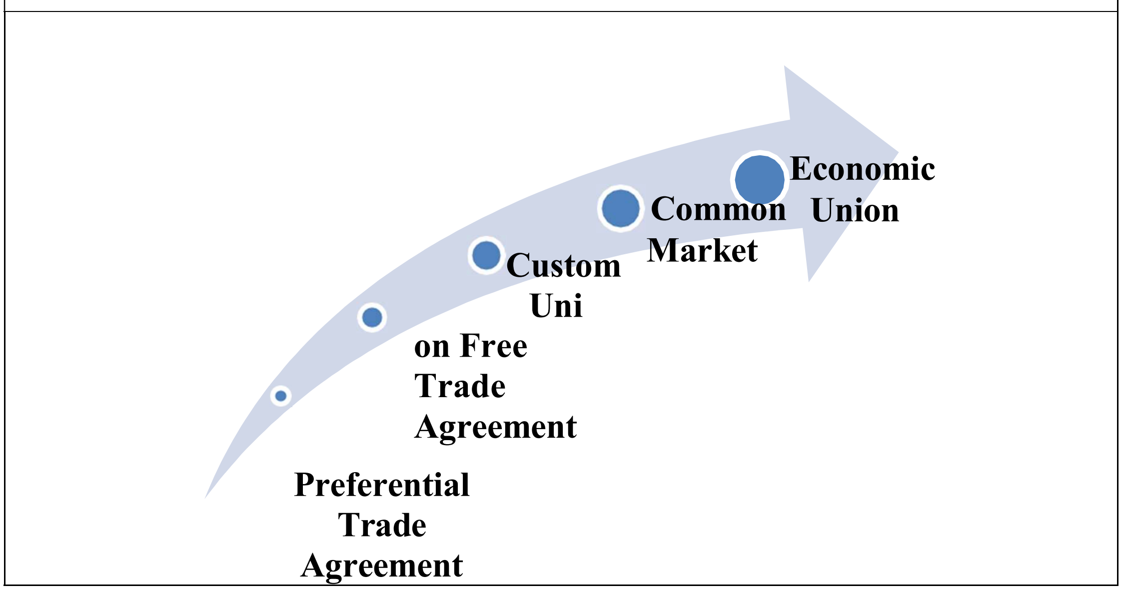
Level of Integration	**Preferential Duty Regime**	**No Tariff and Non Tariff Barriers**	**Common External Tariffs and Harmonized NTB**	**No Restrictions on Movements of Labor & Capital**	**Harmonized/ Unified Economic Policies & Institutions**	**Unified Economic & Political Policies & Institutions**
Preferential Trade Agreement	Yes	No	No	No	No	No
Free Trade Area	Yes	Yes	No	No	No	No
Custom Union	Yes	Yes	Yes	No	No	No
Common Market	Yes	Yes	Yes	Yes	No	No
Economic Union	Yes	Yes	Yes	Yes	Yes	No
Political Union	Yes	Yes	Yes	Yes	Yes	Yes

Source: World Trade Organization

- **Customs Union:** Custom Union is an next level extension for economic integration after FTA. When participating countries decide to have common external tariff which they will charge when having trade with non member countries, it is known as Custom Union. It provides for extended scope for economic cooperation and free trade. Examples of Custom Union are Gulf Cooperation Council (GCC) and South African Custom Union (SACU).
- **Common Market:** Next level of economic integration is Common Market which is aimed at creating "economically integrated markets" among member countries. In addition to free trade and common external tariff, Common Market removes all the restrictions on free movement of labor and capital between member countries. In a Common Markets scenario, workers from one country need not to take Visa to work in associated participating countries. Similarly, investors can plan their investment decision in any of participating countries. Rules are harmonized for free trade / common external tariff / movement of capital and labor etc. Examples of Common Markets are Central American Common Market (CACM) and Common Market for Eastern and Southern Africa (COMESA).

The level of complexity in each stage of economic integration can be understood as under:

Stages of Economic Integration: Increasing Level of Complexity



- **Economic Union:** The formation of Economic Union is aimed at removing all trade barriers, having single trade & investment policy, free of movement of labor & capital, having common banking & monetary policy and possible a single currency also. There are unified economic institutions and harmonized trade policies. Best example of Economic Union is European Union (EU).
- **Political Union:** The existence of Political Union is still a hypothetical concept. Formation of Political Union is aimed at consolidated group of

nations or states that share joint government and such union is internationally acknowledged. Under Political Union, Countries will have one head of state, one foreign policy, one defense policy and there exist no restrictions in all areas of life i.e. common economic, social, technological, cultural, foreign, legal, environmental polices among participating countries. It is highest form of regional economic cooperation in international trade. There is no single example of Political Union in the world till date, however European Union is slowly moving towards Political Union.

19.7 **India's Experience In Regional Economic Cooperation**:

India started negotiating & signing Free Trade / Regional Trade Agreements only after it become member of WTO and gained confidence that domestic industry can compete vis a vis a foreign companies. Trade Liberalization coupled with foreign investments in key areas of industry from 1991 onwards enthused confidence among India producers and Traders. Indian policy makers accordingly realized that it is important to integrate the Indian economy with global economy in phases but in a sustainable manner. First Free Trade Agreement was signed with Sri Lanka which becomes operations from year 2000. Earlier; India has some failed initiatives for free trade in South Asia through SAPTA / SAFTA. As of now India has several Free Agreements / Preferential Agreements concluded and it is negotiating many of them with diverse set of countries from all around the globe. The list of operational PTA/FTAs is as under:

19.61 AGREEMENT ALREADY CONCLUDED:

- South Asia Free Trade Area (SAFTA)
- Asia Pacific Trade Agreement (APTA)
- India-Singapore Comprehensive Economic Cooperation Agreement (CECA)
- India- Malaysia Comprehensive Economic Cooperation Agreement
- Global System of Trade Preferences (GSTP)
- Duty Free Tariff preference to LDCs
- India Chile PTA
- India Afghanistan PTA
- India ASEAN Free Trade Agreement
- India Bhutan Trade Agreement (Treaty of Friendship)
- India Japan CEPA

- India Korea CEPA
- India MERCOSUR PTA
- India Nepal Trade Treaty (Treaty of Friendship)
- India Sri Lanka FTA
- SAARC Agreement on Trade in Services (SATIS)
- Treaty of Transit between India and Nepal

There are several other Free Trade / Economic Cooperation Agreements that India is negotiating with its trade partners. The indicative list of such agreements under negotiation is as under:

Agreement under Negotiations:

- India-Sri Lanka Comprehensive Economic Partnership Agreement (CEPA)
- India-Thailand Comprehensive Economic Cooperation Agreement (CECA)
- Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Agreement (FTA)
- India-Gulf Cooperation Council (GCC) Free Trade Agreement (FTA)
- India-Mauritius Comprehensive Economic Cooperation and Partnership Agreement (CECPA)
- India-SACU Preferential Trade Agreement (PTA)
- Second Review of India-Singapore Comprehensive Economic Cooperation Agreement
- Expansion of India-Chile Preferential Trade Agreement (PTA)
- India-MERCOSUR Preferential Trade Agreement (PTA)
- India-Pakistan Trading Arrangement
- India-EU Board Based Trade and Investment Agreement
- India European Free Trade Association (EFTA) Negotiations on broad based Bilateral Trade and Investment Agreement
- Global System of Trade Preferences (GSTP)
- Asia Pacific Trade Agreement (APTA)
- India -New Zealand Free Trade Agreement / Comprehensive Economic Cooperation Agreement
- India-Canada Comprehensive Economic Partnership Agreement (CEPA)

- India-Australia Comprehensive Economic Cooperation Agreement (CECA)
- India-Indonesia Comprehensive Economic Cooperation Agreement (CECA)

India is currently a marginal player in the global trade with market share less than 2%. It is ranked no. 19 in list of global exporters and no. 11 in list of global importers. Although; there has been significant trade expansion since 2004 but Indian industry is not competitive. As a result; majority of Free Trade / Regional Trade agreement has been signed with similar kinds of countries. India does not hold a free trade agreement with its main trader partners namely EU and NAFTA. As a result; there has been trade diversion in certain areas for example, Indian textile & apparel has lost opportunities to Mexican exporters because Mexico has Free Trade Agreement with USA and transport costs are also less.

In the rapidly changing global scenario, India has to strike a balance between regionalism and multilateralism. Indian policy makers has to strike a balance between both and if the agreements are negotiated properly keeping in minds the core strengths and weakness of Indian economy, each such trade agreement could be a progressive step toward integrating India's economy with rest of the world.

19.8 Summary

The benefits of free trade were stressed by economist from all range of theorist from Mercantilist to Classical to Neo- Classical to Modern theorist. After Second World War, European Coal & Steel Community was the first sincere attempt by countries such as France, Italy, Belgium, Luxembourg, Netherlands and West Germany in 1951 through treaty of Paris. Regional economic integration was started in two waves; first being during the period of 1951-80 after second world war and second from 1970- to date. The first wave of regional economic integration was marked by the establishment of the European Economic Community, European Free Trade Agreements and the Council for Mutual Economic Assistance. There emerged a plethora of regional trade blocs in developing and least developed countries. Prominent among them were ASEAN / COMESA / MERCUSOR / Andean Community / Central American Common Market etc. Following are the benefits of regional economic groupings.

a. Increased Production & Better Economies of Scale

b. Greater Production Efficiencies

c. Improvements in Employment Scenario.

d. Improved Economic Growth

Economic theory of regional economic integration was for the first time proposed by economist Jacob Viner in 1950 who defined the trade creation and trade diversion effects resulting from regional economic integration of countries. Jacob was of the opinion that there will be increased interregional flow of goods mainly due to changes in customs tariffs of the country. Similarly, some of the trade will start taking place within the region itself. Jacob, after having conducted the empirical finding based on the trade flows between two states prior and after their unification, compared them with the rest of the world. The findings were very interesting the countries which were part of regional economic initiatives benefitted a lot from both trade creation and trade diversion due to formation of regional economic grouping.

There exist four types of regional economic grouping, differentiated on the basis of level of economic integration. However; all of them are aimed at protecting the participating countries from imports from non-members countries. WTO recognized the importance of regional trading blocs for realizing the mission of multilateral trade system based on non discrimination and transparency. Trade blocs are formed by the countries so that they can jointly focus on the issues which are of vital importance to their stage of economic development. Trade blocs undoubtedly lead to increased production and trade among participating countries has offer several benefits as discussed above. There are several types of regional economic grouping and are discussed as under:

a. Preferential Trade Agreements

b. Free Trade Agreement

c. Custom Union

d. Common Market

e. Economic Union

f. Political Union

India started negotiating & signing Free Trade / Regional Trade Agreements only after it become member of WTO and gained confidence that domestic industry can compete vis a vis a foreign companies. Trade Liberalization coupled with foreign investments in key areas of industry from 1991 onwards enthused confidence among India producers and Traders. Indian policy makers accordingly realized that it is important to integrate the Indian economy with global economy in phases but sustained manner. First Free Trade Agreement was signed with Sri Lanka which becomes operations from year 2000. Earlier; India has some failed initiatives for free trade in south Asia through SAPTA / SAFTA. As of now India has several Free Agreements / Preferential Agreements concluded and it is negotiating many of them with diverse set of country from all around the globe.

In the rapidly changing global scenario, India has to strike a balance between regionalism and multilateralism. Indian policy makers has to strike a balance between both and if agreements negotiated properly keeping in minds the core strengths and weakness of Indian economy, each such trade agreement could be a progressive step toward integrating India's economy with rest of the world.

19.9 Glossary

Preferential Trading Arrangement: PTA is first small step towards regional integration and is aimed at eliminating tariff as well non tariff barriers on selected goods or there is preferential tariff that one country offers another member country.

Free Trade Area: FTA is first genuine step towards forming a regional economic grouping and is aimed at removing all tariff & non tariff barriers to trade among participating countries.

Customs Union: When participating countries decide to have common external tariff which they will charge when having trade with non member countries, it is known as Custom Union.

Common Market: Common Market removes all the restrictions on free movement of labor and capital between member countries in addition to abolition of tariff / Non tariff barriers and have common external tariff.

Economic Union: The formation of Economic Union is aimed at removing all trade barriers, having single trade & investment policy, free of movement of labor & capital, having common banking & monetary policy and possible a single currency also.

Political Union: Formation of Political Union is aimed at consolidated group of nations or states that share joint government and such union is internationally acknowledged. It is highest form of regional economic cooperation in international trade.

Trade Diversion: Trade diversion is a situation where trade is diverted to non member countries, as an outcome of the formation of regional grouping.

19.10 Check your progress

1. The first attempt towards free trade after the Second World War was the .... agreement of 1951.

2. Following ...., the production of goods and services increases in the member country where production costs are the lowest.

3. .... was the first to present the economic theory of regional integration in 1950.

4. The objective of the .... agreement is to reduce tariff and non-tariff barriers on selected goods.

5. In the context of India, NAFTA (NAFTA) and .... are two strong examples of free trade areas.

19.10 Answers to Check your progress

1. Paris, 2. Regional integration, 3. Jacob Viner, 4. Preferential trade, 5. ASEAN

19.11 Terminal questions

Q. No. 1: Explain the history of evolution of regional economic integration in world trade.

Q. No. 2: Write an essay on present state of regional economic integration? What are the benefits of regional economic integration?

Q. No. 3: Discuss with examples the rationale and benefits of regional economic integration?

Q. No. 4: Explain the economic theory of regional economic integration?

Q. No. 5: Critically appraise the various stages of economic integration and economic opportunities therein?

Q. No. 6: Explain with examples the India's initiatives in bilateral and regional economic cooperation in recent years?

Q. No. 7: Explain the India's engagements in regional trade agreements both under negotiations and already implemented?

Q. No. 8: How could an Indian firm take advantage of positive aspects of regional grouping to step up its exports?

Q. No. 9: Discuss India's policy stance on Regional Economic Groupings?

19.12 Suggested Readings

1. International Economics, Raj Kumar, Excel Publication, 2008
2. International Economics, Francis Cherunilam, The McGraw Hill Publication, 5th Edition,
3. International Economics, Steven Husted and Michael Melvin, Pearson Publication, 9th Edition.
4. International Economics, James Gerber, Pearson Publication, 6th Edition
5. International Economics, D.M. Mithani, Himalaya Publishing House;

Edition 11th

ISBN No. 8178660962

6. International Economics: Theory And Policy, 8th Edition, Paul R. Krugman, Pearson Education India
7. International Economics, Dr Nirmal Bhalerao & SSM Desai, Himalaya Publishing House, 1st Edition
8. International Economics, M.L. Jhingan, Vrinda Publishing House
9. International Economics, D. N. Dwivedi, ISBN : 8122005349
10. International Economics, Steven L. Husted, Michael Melvin , Harper-Collins Press
11. Johan Daniel, and Lee H. Radebaugh, International Business Environment and Operations, Pearson Publication, 14th Edition.
12. Rakesh Mohan Joshi, International Business, Oxford Press, India Edition.

UNIT 20: EC, NAFTA AND REGIONAL ECONOMIC COOPERATION

Unit 20: Ec, Nafta and Regional Economic Cooperation

Structure:

Objectives:

After reading this unit, the students will able to understand:

- To understand the various stages in evolution of European Community and existing trade patterns.
- To explain establishment of North America Free Trade Agreement, its objectives and its trade patterns.
- To understand the importance of regional economic groupings and their rationale in present business environment.
- To explain the evolution and role of Asian regional economic grouping.
- To appraise the various stages of economic integration and economic opportunities therein.

20.1introduction:

After the Second World War, significant developments in the areas of international trade have taken place. Countries especially in Europe realized the fact that it is important to have orderly development in a region and efforts should be made to utilize the natural and other resources optimally so that future conflicts can be best avoided. Accordingly, in 1952 the first regional economic agreement named as European Coal & Steel Community was established. Economic cooperation was enhanced with treaty of Rome in 1957 by establishment of European Economic Community. Subsequently, more countries from Europe had joined by establishing some institutions aimed at enhancing economic cooperation among countries from Europe. The significant development had been the establishment of European Union that makes 28 countries of Europe as Single Market. Realizing the importance of economic cooperation and its spillover effects in the Europe region, the North American Countries namely, United States, Canada and Mexico formed thee North America Free Trade Agreement. NAFTA is the largest economic block in the world by area. Even the countries from South East Realize the importance of regional economic cooperation and established Association of South East Asian Nations (ASEAN). By the early nineties, there was growing feeling among countries world over that regional economic blocks can be an important instruments in export promotion, employment generation, promoting economic growth and development of the countries. The establishment of WTO in 1995 provided a globally applicable single trade regime thus ensuing sustainable globalization and liberation in world markets. Nations world over from all continents started signed Preferential Trade Agreement / Free Trade Agreement / Custom Union and Common Markets agreement depending on the level of economic integration achieved. There were plethora of regional trade blocs which were formed by developing countries, prominent among them were ASEAN, CARICOM and MERCUSOR. Majority of these regional economic initiatives were started against the backdrop of the Cold War. Developing countries, on the other hand want to reap quick economic benefits by forming regional economic grouping so as to tide over the developmental odds they face after decolonization. Most of western efforts on regionalism were aimed at creation of trade among member states however some other from southern hemisphere were more interested in following either of Cold war power ie. US or USSR so as to address any hegemonistic odds they face from neighbors. As per WTO website there are some 546 notifications of RTAs (counting goods, services and accessions separately) as on January 10th 2013. Of these regional trade agreements, there are around 354 that are currently in force. In brief, the unit aims at appraising the participants about the European Community, North America Free Trade Agreement (NAFTA) and various other important regional trade agreements.

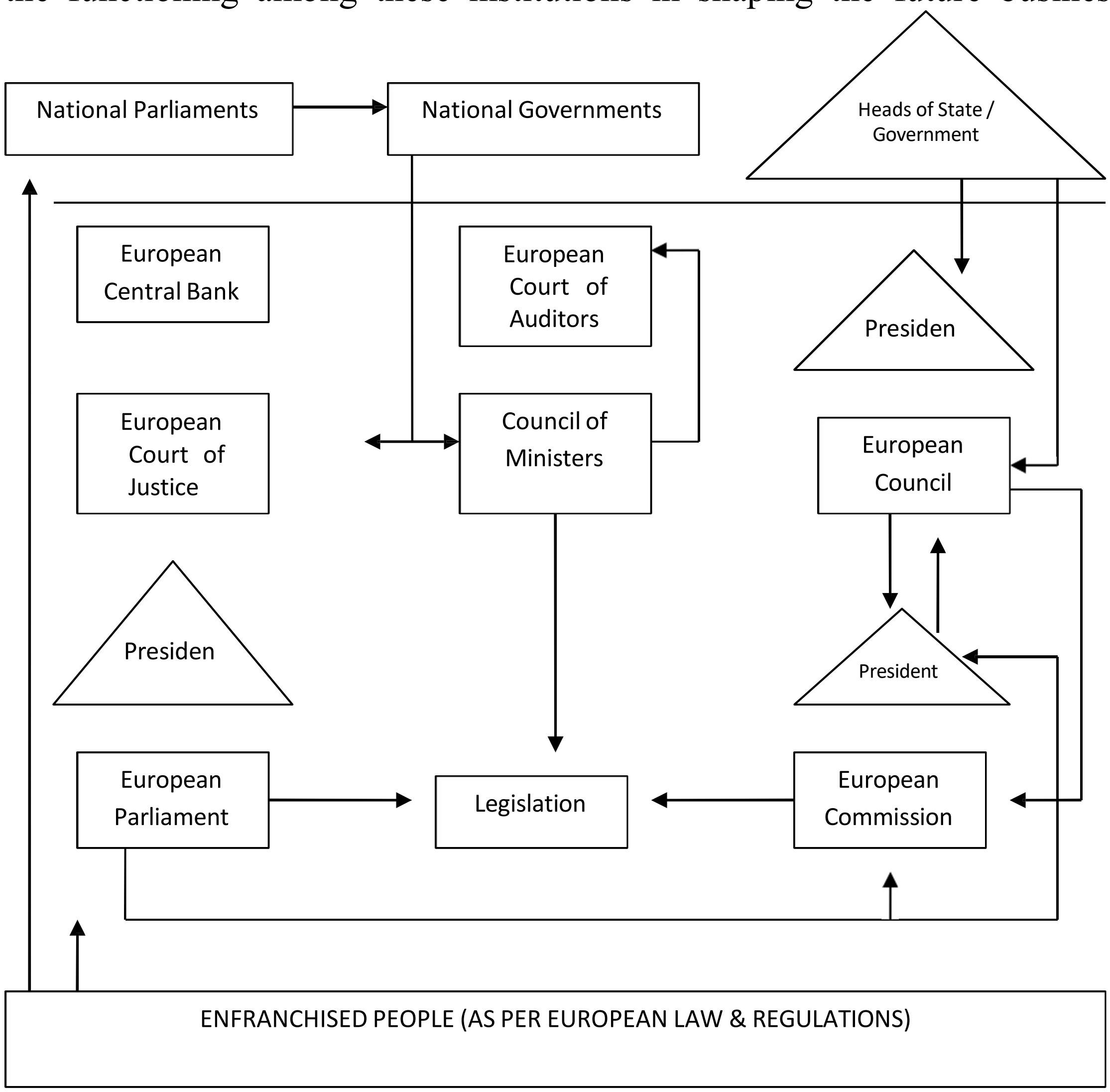
20.2 European Community:

European Community which subsequently has become European Union has long history of evolution from a small industrial input agreement to full scale economic cooperation's with common bank and currency. It was in 1952 that the European Coal and Steel Community (ECSC) was established by six democratic countries of Europe. The ECSC was first proposed by French foreign minister Robert Schuman on 9 May 1950 as a way to prevent further war between France and Germany. ECSC reached to next level with Treaty of Rome singed in n 1957 whereby six European countries extended the earlier co-operation of European Coal and Steel Community (ECSC) and created the European Economic Community (EEC). EEC created not only free markets among these six European countries but moved one step ahead by adopting Common External Tariff thus establishing a customs union. These six countries also signed another treaty so as to establish the European Atomic Energy Community (EURATOM) for increasing mutually beneficial co-operation among six countries in developing nuclear energy. Both European Economic Community and EURATOM treaties came into force in 1958. The European Economic Community and Erratum were created separately from European Coal & Steel Community. In 1967, the Merger Treaty was signed in Brussels which brought all three communities under a single set of institutions. Thus the name coined to refer to these three communities was European Community (EC). Efforts were made to enlarge the European Community to include more European countries with similar interests. Accordingly, in 1973, the Communities were enlarged to include Denmark, Ireland, and the United Kingdom. Greece joined the European Community in 1981 followed by Portugal and Spain in 1986. In 1993 the three communities were subsumed into one and a Single Economic Union was established. It is known as European Union (EU). Following countries are member of European Union.

Name of Country	**Year of Entry**	**Name of Country**	**Year of Entry**
1. Austria	1995	Italy	1952
2. Belgium	1952	Latvia	2004
3. Bulgaria	2007	Lithuani	2004
4. Croatia	2013	a	1952
5. Cyprus	2004	Luxembour	2004
6. Czech Republic	2004	g Malta	1952
7. Denmark	1973	Netherland	2004
8. Estonia	2004	s Poland	1986
9. Finland	1995	Portugal	2007
10. France	1952	Romania	2004
11. Germany	1952	Slovakia	2004
12. Greece	1981	Slovenia	1986
13. Hungary	2004	Spain	1995
14. Ireland	1973	Sweden	1973
		United Kingdom	

Source: European Parliament, Belgium

The business of the European Union (EU) is governed by seven institutions set up for this purpose these are the European Parliament, the European Council, the Council of the European Union, the European Commission, the Court of Justice of the European Union, the European Central Bank and the Court of Auditors. The diagram as under is self illustrative for understanding the functioning among these institutions in shaping the future business .



Source: European Commission, EU Brussels, Belgium

European Union is number one in international trade in the world. It has just 7% of world population but it has share of 20% in global trade of goods and services. As a single union of 28 countries, it is the largest exporter and importer of goods and services in the world. Although around 70% trade is intra Europe trade but is an important market for any country of the World.

For Example, India's single largest trade partner (both export and import put together) is European Union. It is the prime reason that India has started trade negotiations aimed at establishing the Free Trade Agreement with European Union. The European Union countries have achieved a strong position by acting together as single trade commissioner with one voice on the global stage rather than with 28 separate trade strategies. European Union is an attractive global market for any country including due to following reasons.

- European Union has 500 million consumers with percapita of more than $35000.
- European Union is World Largest Single market with Transperent Rules and Regualtions
- European Union strong logistics networlks, port infrasturcutre and easy movement of cargo from one country to anotehr with EU
- European Union has storng legal and distpute rederessal system protectign investor/ exproter interest
- European Union is the most open market for developing countries like India
- 18 Countries with in EU has Single Currency thus help exporter manage exchange rate risks

Source: Adapted from European Union Website www.ec.europa.eu

The European Union has total imports of 1791 billion Euro in the year 2012 and total exports of 1686 Billion Euro in trade of goods only. European Union is leader in export of services and has favorable balance at current account. Although; there are wide disparities among European Countries in export and import performance at country level. The largest exporter as well as importer among European countries is Germany. The second largest exporter is France followed by Netherland Italy and United Kingdom. When it comes to Imports, United Kingdom is second largest importer followed by France, Netherland and Italy. The list of main trading partners of European Union for the year 2012 is as under and is self explanatory.

Main trading partners of European Union in 2012

Rank	Partners	Imports (million euro)	% (of total)	Exports (million euro)	% (of total)	Total trade (million euro)	% (of total)
-	**Total EU**	**1,791,727**	**100%**	**1,686,774**	**100%**	**3,478,501**	**100%**
1	United States	205,778	11.5%	291,880	17.3%	497,658	14.3%

2	China	289,915	16.2%	143,874	8.5%	433,789	12.5%
3	Russia	213,212	11.9%	123,262	7.3%	336,474	9.7%
4	Switzerland	104,544	5.8%	133,341	7.9%	237,885	6.8%
5	Norway	100,437	5.6%	49,821	3.0%	150,258	4.3%
6	Turkey	47,789	2.7%	75,172	4.5%	122,961	3.5%
7	Japan	63,813	3.6%	55,490	3.3%	119,303	3.4%
8	Brazil	37,090	2.1%	39,595	2.3%	76,685	2.2%
9	India	37,295	2.1%	38,468	2.3%	75,764	2.2%
10	South Korea	37,861	2.1%	37,763	2.2%	75,624	2.2%

Source: www.ec.europa.eu

India is the 9th largest trade partner of European Union but only 2.1% of the goods imported by European Union are originating from India and in case of exporters, it represent just 2.2% of the total exports of European Union countries. The absolute value of both exports as well as imports of European Union in the table as under and is self-explanatory.

European Union Total Exports to World including the 5 Top Exporters from 2008-12 (in Thousand Dollars)					
Exporters	**Value in 2008**	**Value in 2009**	**Value in 2010**	**Value in 2011**	**Value in 2012**
European Union (EU 27)	5,817,364,355	4,497,281,842	5,057,960,129	5,883,285,488	5,685,422,286
1. Germany	1,466,137,413	1,127,839,933	1,271,096,329	1,482,202,274	1,416,184,199
2. France	594,504,995	464,112,811	511,651,043	581,541,871	556,575,682
3. Netherlands	545,853,405	431,502,452	492,645,872	530,575,759	554,677,907
4. Italy	542,949,393	406,861,961	448,041,394	523,574,762	501,221,676
5. United Kingdom	457,743,376	351,163,468	405,868,895	473,757,115	481,225,754

European Union Total Imports From World including the 5 Top Importers from 2008-12 (in Thousand Dollars)

Importers	Value in 2008	Value in 2009	Value in 2010	Value in 2011	Value in 2012
European Union (EU 27) Aggregation	6,092,657,707	4,563,157,341	5,172,135,871	6,020,724,429	5,727,202,132
1. Germany	1,204,209,307	938,363,080	1,066,816,752	1,260,297,537	1,173,287,645
2. United Kingdom	634,448,968	482,893,374	562,501,058	637,243,366	689,137,011
3. France	695,004,283	540,502,283	599,171,506	700,851,646	663,268,640
4. Netherlands	494,936,571	382,190,422	439,986,633	492,837,632	501,134,302
5. Italy	562,126,240	415,054,892	487,854,121	559,124,701	487,118,338

Source UN Comtrade

20.3 Nafta :

The North American Free Trade Agreement (NAFTA) is the largest trade block in world by area as well as by size of GDP. NAFTA is a regional economic cooperation agreement that is signed by the governments of Canada, Mexico, and the United States. It is a trilateral trade bloc in North America region. NAFTA agreement came into force from January 1st, 1994 and is successfully operating so far. NAFTA was established to enhance the economic cooperation at all levels among USA, Mexico and Canada and it superseded the earlier existing free trade agreement between Canada and United States of America. In addition to NAFTA, there are are two supplements to this agreement these are:

a) North American Agreement on Environmental Cooperation (NAAEC)

b) North American Agreement on Labor Cooperation (NAALC)

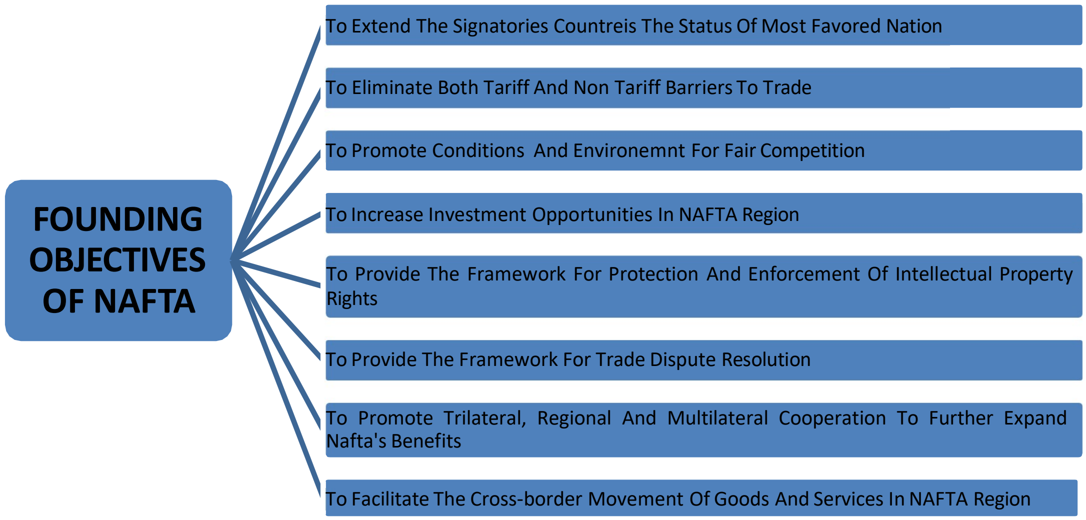
The broad objectives of creating a trilateral economic cooperation agreement involving three countries was to reduce trading costs, increase business investment, and help North America to be more competitive in the global marketplace. As each country in North America is differently endowed, For example, United States is endowed with abundance of Land and Capital and Canada is endowed with abundance of Land which has to be developed for cultivation. Mexico on the other hand is abundant in labor. The technology intensive industry of United States and cheap labor from Mexico region create a win win situation for all the countries. In the beginning of 2008, all tariffs barriers in NAFTA region were eliminated. The overall trade both export & import scenario of NAFTA region is tabled as under:

NAFTA EXPORT TO WORLD FROM 2008-2012 (IN THOUSAND US DOLLAR)					
Exporters	**Value in 2008**	**Value in 2009**	**Value in 2010**	**Value in 2011**	**Value in 2012**
World	15,989,372,712	12,327,153,144	15,055,401,572	17,999,547,615	17,981,277,146
NAFTA Countries Export to World	2,046,795,870	1,601,601,246	1,961,994,137	2,279,729,226	2,369,772,912
United States of America	1,299,898,877	1,056,712,078	1,277,109,162	1,479,730,169	1,545,565,186
Canada	455,632,184	315,176,831	386,579,900	450,430,008	453,380,895
Mexico	291,264,809	229,712,337	298,305,075	349,569,049	370,826,831
NAFTA IMPORT FROM WORLD FROM 2008-2012 (IN THOUSAND US DOLLAR)					
Importers	**Imported value in 2008**	**Imported value in 2009**	**Imported value in 2010**	**Imported value in 2011**	**Imported value in 2012**

World	16,393,518,947	12,591,039,320	15,325,394,862	18,333,981,514	18,192,973,477
NAFTA Imports from World	2,882,179,319	2,157,507,915	2,660,087,186	3,064,007,529	3,166,920,534
United States of America	2,164,834,031	1,601,895,815	1,966,496,750	2,262,585,634	2,333,805,233
Canada	408,762,168	321,227,568	392,108,702	450,579,509	462,369,245
Mexico	308,583,120	234,384,532	301,481,734	350,842,386	370,746,056

Source: UN Comrade

The declared objectives of NAFTA are many but the first and foremost aim is to strengthen the economic growth of the participating countries by means of abolishing all tariffs and non-tariff barriers, promoting intra-regional investments and enhancing all round economic cooperation at bilateral, trilateral and multilateral levels so as to reap the best economic dividends form trade liberalization and economic globalization. With all this, NAFTA became a single market, thus giving their industries a possibility to increase the number of possible sales and locate industries to areas where they enjoy maximum economies of scale and scope. Another aim of NAFTA is to increase the competitiveness of their industries on a global scale, thus controlling their imports and enhancing their exports and having favorable balance of trade. NAFTA member countries are also committed for framing transparency and nondiscriminatory rules of trade, ecological initiatives and equal labor rights so as to ensure social and environmental stability in the region along reaping of economic dividends. There is established framework which enables member countries at all level to resolve their differences and trade disputes amicably. This ensures stable macroeconomic environment for outside investors to come and invest in and also a common basis to facilitate a predictable framework for the firms. As a consequence NAFTA's expected positive impact on the nations' economies is anticipated to create new jobs and enhance the living standards. As per article 102 of NAFTA agreement, following are the objectives enshrined at the time of establishing it as a regional economic cooperation agreement. These are diagrammed as under:



Source: Adapted from NAFTA Secretariat (NAFTA FAQ) 2013

Pros Favorable Nafta:

Following are the points which clearly indicate that NAFTA as a regional economic grouping has been successful. These are briefed as under:

a. **Elimination of Tariffs:** Tariffs are duties which an importer has to pay while getting his cargo cleared from customs. One of the significant achievements of NAFTA agreement has been the complete elimination of tariff barriers from 1st January, 2008, thus paving the way for world largest single markets not only in area but also in GDP terms.
b. **Increase in Wage Across all Countries:** Another advantage of the NAFTA agreement has been the increase in the real wages of employee/ Workers across all countries. It indicates that there has been improvement in living standards, quality of life for workers across all three countries.
c. **Increased Trade Flows among Member States:** There has been significant trade expansion among all three participating countries and table as above is self-explanatory of the fact that each countries has expanded its foreign trade and have enjoyed spillover effects from trade expansion. Fo example, United States of America alone has traded $1.7 trillion in goods and services with its NAFTA partners in 2012.
d. **Industrial Integration of NAFTA countries:** NAFTA agreement has resulted in huge benefits for industries especially from United States and Canada as industries moved from these two countries to areas which have lower labor cost i.e. Mexico thus enhancing cost competitiveness of goods and services across NAFTA market and exporting them to neighboring countries.

Cons against Nafta:

Following are some of the failures listed as under of NAFTA agreement.

a. **Mexico is not as benefitted as expected:** There was lot of hue and cry about the US factories to be set up alongside the border of Mexico whereby Mexican workers will employment and goods will be sold all over NAFTA region. These factories are known as "Maquiladoras" and Mexico was expecting lot of investments by US and Canada however Canada as well as
U.S. find it cheaper to employ Asian workers mainly from China/ India and Philippines etc and actual investments as expected have not taken place so far. There has not been any benefit to Mexican middle class and there has not been an increase in the per capita income of Mexican working class.

b. **Only Tariffs are Abolished but not the Procedural Formalities:** Trade experts, exporter and importers have usually complained about the high procedural formalities which they have to complete in order export cargo from one country to another or to import cargo from another country. There are exporters complaints about the rules of origin and certificate of origin for which custom authorities are check posts pose many questions thus resulting in delay of cargo movements. The valuation rules of customs have very complex and cumbersome procedure thus resulting in delays for importers while importing the cargo from member states. In addition to this there are non tariff issues such as compliance of Sanitary Standards, Phyto- Sanitary Standards and Technical barriers to trade etc. There is a general feeling among trade community that although tariff barriers has been abolished but a lot need to be done in order to streamline the regulatory formalities and procedure governing cross border trade among NAFTA members.

20.**4 Rregional Economic Cooperation**

Regionalism refer to Regional Economic Groupings or Regional Trade Agreements that countries enter in order to reap the benefits of Free Trade, increased commerce, increased economic cooperation, free movements of goods and services resulting in higher growth of economy and higher per capita income. In a era of economic globalization, nations are trying hard to reap the benefits of comparative and competitive cost advantages vis a vis other by forming various regional economic groupings.

The first waves of regionalism started after the First World War. It started with formation of European Coal & Steel Union in 1951 and entered into various phases of economic cooperation till 1970. It was marked by the establishment of the European Economic Cooperation in 1957, European

Free Trade Area in 1960 and the Council for Mutual Economic Assistance (CMEA) in 1949. There were plethora of regional trade blocs which were formed by developing countries, prominent among them were ASEAN, CARICOM and Mercosur. Majority of these regional economic initiatives were started against the backdrop of the Cold War. Developing countries, on the other hand want to reap quick economic benefits by forming regional economic grouping so as to tide over the developmental odds they face after decolonization. Most of western efforts on regionalism were aimed at creation of trade among member states however some other from southern hemisphere were more interested in following either of Cold war power ie. US or USSR so as to address any hegemonistic odds they face from neighbors. Eight rounds of trade negotiations under GATT, popularly known as Uruguay Round, have transformed the context of regionalism. There come a genuine willingness among nations to pursue regionalism thus use trade as an engine for economic development. It started with formation of European Union in 1991 and followed by North America Free Trade Agreement in 1992 involving countries such as US, Canada and Mexico. Thus, the leading actors in the international system were actively involved in promoting regionalism and participating globally in the process of regionalism. There came sudden waves of regional economic grouping in the backdrop of this. Some of them formed are discussed as under:

- US-Israel Free Trade Area
- MERCOSUR
- Australia-New Zealand Closer Economic Relations Agreement (ANZCERTA),
- Asian Free Trade Agreement (AFTA)
- Asia Pacific Economic Cooperation (APEC)
- South Asian Free Trade Agreement (SAFTA)
- Free Trade Area of the Americas (FTAA)

Following are the types of regional economic grouping that are coming into existence. Some of them are tabled as under along with level of integration:

Level of Integration	**Examples**
Preferential Trad e Agreement	India's DFTP Scheme for LDCs, India-Afghanistan Preferential Trade Agreement, India-Chile PTA, India-Mercosur PTA
Free Trade Area	India- Srilanka FTA, India-Asean FTA, GCC, India-Japan Comprehensive Economic Cooperation

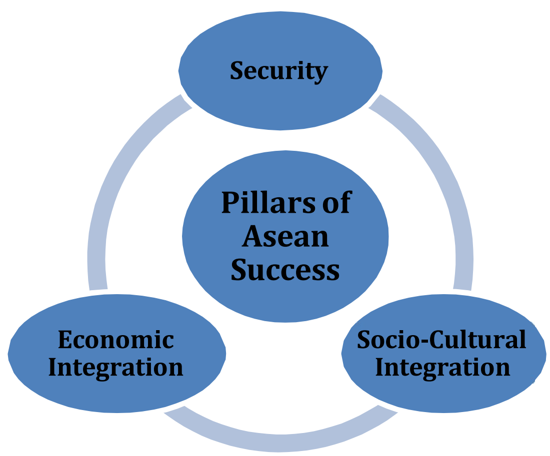
Custom Union	SACU, East Africa Community, Andean Community, EU- Turkey, EU- Andorra, Mercusor
Common Market	COMESA, Caricom, , CACM, EEA, EFTA, CES
Economic Union	EU
Political Union	Not Available

Source: World Trade Organization

Regional Trade Agreements, in changing global environment, have been effectively used by countries to prompt and consolidate the economic and political reforms in prospective members. For example, when any country wish to become the member of European Union, it has to cross certain economic, social, political and environmental benchmarks thus prompting prospective member state to reform on all fronts. This is important for all member countries as regional economic cooperation at present is accompanied by high levels of economic interdependence among member states. A contagion in one country can create ripple effect in other member states thus causing unacceptable economic loss to member states for example; recently Greek faced the crisis causing ripple effect crisis in Italy, Spain, Portugal and other adjoining states and badly affecting the economic prospects for EU member states. In an era of economic globalization under WTO, Regional Trade Agreements (RTAs) are indispensable instruments to ensure economic integration. Even after having a multilateral framework, WTO recognizes the importance of various FTAs/ Custom Unions/Common Markets and Economic Union and any other bilateral trade promotion arrangements. Regional economic grouping are perhaps the irreversible feature of today's multilateral trading system under WTO. It is the main reason that countries are increasingly singing free trade / preferential trade agreements to ensure faster economic integration. For example, Chile, a South American Country, has signed more than 56 FTAs till 2008 and no. is still increasing. As the multilateral talks under Doha Development Agenda have not reached to any conclusion, RTAs has been seen the best instruments for reaping economic benefits by countries all around the world. Accordingly to WTO website, there are around 546 notifications of Regional Trade Agreements till January 10th, 2013. Out of which, some 354 regional trade agreements are already in force. Regional Trade Agreements initiatives have intensified all across the globe particularly in the regions such as South Asia, South East Asia, North America, Middle-East, Central America and Africa.

20.5 Association Of South East Asian Nations:

The Association of Southeast Asian Nations (ASEAN) is a regional economic grouping involving countries such as Indonesia, Cambodia, Singapore, Vietnam, Myanmar, Brunei, Malaysia, the Philippines, Laos Republic and Thailand. It was founded on 8th August 1967. The secretariat of Asean is based at Jakarta, Indonesia which coordinates all the economic, social, scientific, technical activities of ASEAN regional economic grouping. It is one of the most successful regional economic groupings after European Union and has been successful to achieve its objectives as laid down at the times of its foundation. The basis of Asean success is its emphasis on three principles of cooperation these are security and socio-cultural and economic integration among member states.



Source: Asean Secretariat, Jakarta, Indonesia

Asean has made noteworthy progress in economic integration and it aims to create an ASEAN Economic Community (AEC) by the year 2015. If created, Asean Economic community will have combined total population of over 560 million people and a gross domestic product of over $1.2 trillion. Asean as a regional economic grouping has matured over the years and has developed following institutions to its fold.

VARIOUS INSTITUTIONS WORKING UNDER THE ASEAN FORUM		
ASEAN POLITICAL – SECURITY COMMUNITY	**ASEAN ECONOMIC COMMUNITY**	**ASEAN SOCIO - CULTURAL COMMUNITY**

• ASEAN	• ASEAN Economic Ministers	• ASEAN Ministers
Intergovernmental natal Commission on Human Rights (AICHR) • ASEAN Ministerial Meeting (AMM) • ASEAN Regional Forum (ARF) • ASEAN Defense Ministers Meeting (ADMM) • ASEAN Law Ministers Meeting (ALAWMM) • ASEAN Ministerial Meeting on Transnational Crime (AMMTC)	(AEM) • ASEANFree Trade Area (AFTA Council) • ASEAN Ministers on Energy Meeting (AMEM) • ASEAN Ministerial Meeting on Agriculture and Forestry (AMAF) • ASEAN Finance Ministers Meeting (AFMM) • ASEAN Investment Area (AIA) Council • ASEAN Ministerial Meeting on Minerals (AMMin) • ASEAN Ministerial Meeting on Science and Technology (AMMST) • ASEAN Mekong Basin Development Cooperation (AMBDC) • ASEAN Transport Ministers Meeting (ATM) • ASEAN Telecommunications and IT Ministers Meeting (TELMIN) • ASEAN Tourism Ministers Meeting (M-ATM) • Initiative for ASEAN Integration (IAI) and Narrowing the Development Gap (NDG) • • Sectoral Bodies under the Purview of AEM	Responsible for Culture & Arts (AMCA) • ASEAN Ministerial Meeting on Disaster Management (AMMDM) • ASEAN Education Ministers Meeting (ASED) • ASEAN Ministerial Meeting on Environment (AMME) • COP to AATHP (Conference of the Parties to the ASEAN Agreement on Trans-boundary Haze Pollution) • ASEAN Health Ministers Meeting (AHMM) • ASEAN Ministers Responsible for Information (AMRI) • ASEAN Labor Ministers Meeting (ALMM) • ASEAN Ministers Meeting on Rural Development and Poverty Eradication (AMRDPE) • ASEAN Ministerial Meeting on Science and Technology (AMMST) • ASEAN Ministerial Meeting on Social Welfare and Development (AMMSWD) • ASEAN Ministerial Meeting on Women (AMMW)

		• ASEAN Ministerial Meeting on Youth (AMMY)

Source: www.asean.org

But the most successful of all these institutions have been ASEAN Free Trade Area (AFTA), which allow the free movement of goods and services among Asean Countries. Asean has special and differential clause so as to look after the economic interest of Least Developed Countries such as Laos Republic, Myanmar and Cambodia. Asean has also allowed the free flow of investment and services and the elimination of all types of non-tariff barriers among member states. The objectives of ASEAN regional economic grouping are detailed as under:

- Asean is established so as to accelerate the economic growth, social progress and cultural development in the region through joint endeavors in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations.

- Asean is established so as to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.

The fundamental Principles of Asean which were agreed among member states and endorsed through "The Treaty of Amity and Cooperation (TAC) in Southeast Asia". This treaty was signed at the First ASEAN Summit on 24 February 1976 whereby the member states have agreed and openly declare that their relations with one another i.e. the contracting parties to Asean Charter should be guided by the following fundamental principles. These are:

- Asean is established so as to nurture mutual respect for the independence, sovereignty, equality, territorial integrity, and national identity of all nations;
- Asean Charter provides for the right of every State to lead its national existence free from external interference, subversion, or coercion;
- Asean Charter mandates for non-interference in the internal affairs of one another;
- Asean Charter mandates for settlement of differences or disputes by peaceful manner;
- Asean charter calls for renunciation of the threat or use of force; and
- Asean Charter mandates for effective cooperation among member states.

20.6south Asian Association For Regional Cooperation (Saarc)

The South Asian Association for Regional Cooperation (SAARC) was established on 8th December, 1985 at Dhaka (Bangladesh) by South Asian nations involving countries such as Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan became the member of SAARC after getting free from clichés of Taliban. SAARC, as regional initiatives provides for the promotion of economic and social progress of member states, promoting cultural development within the South Asia region and ensuring an environment of friendship and cooperation among member states. The head quarter of SAARC is based in Kathmandu, Nepal. SAARC is dedicated to economic, technological, social, and cultural development of all member states with equal partnership and responsibility for all member states. The charter of SAARC emphasizes the collective self-reliance among member states. Heads of states of member countries meet annually at SAARC summit which is held in any country according to alphabetical order of name of member countries. The meetings of foreign secretaries of member states is held twice annually so as to take stock of progress and commit additional efforts to meet the goals set by heads of states. Main objectives of SAARC are listed as under:

- SAARC was established so as to promote the welfare of the people of South Asia and to improve their quality of life.
- SAARC was established so as to accelerate economic growth, social progress and cultural development in the South Asia region and to provide all individuals the opportunity to live their life with dignity and to realize their full potential to achieve their cherished dreams.
- SAARC was established so as to promote and strengthen the selective self- reliance among the countries of South Asia.
- SAARC was established so as to contribute to mutual trust, understanding and appreciation of one another's problems in South Asia region.
- SAARC was established so as to promote the active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields among people and institutions in South Asia region.
- SAARC was established so as to strengthen the economic, social, technical, scientific and environmental cooperation with other developing countries.
- SAARC was established so as to strengthen the cooperation among themselves in international forums on matters of common interest; and
- SAARC was established so as to cooperate with international and regional organizations with similar aims and purposes.

20.7Summary:

European Community which subsequently has become European Union has long history of evolution from a small industrial input agreement to full scale economic cooperation’s with common bank and currency. It was in 1952 that the **European Coal and Steel Community** (**ECSC**) was established by six democratic countries of Europe. The ECSC was first proposed by French foreign minister Robert Schuman on 9 May 1950 as a way to prevent further war between France and Germany. ECSC reached to next level with Treaty of Rome singed in n 1957 whereby six European countries extended the earlier co-operation of European Coal and Steel Community (ECSC) and created the European Economic Community (EEC). EEC created not only free markets among these six European countries but moved one step ahead by adopting Common External Tariff thus establishing a customs union. The North American Free Trade Agreement (NAFTA) is the largest trade block in world by area as well as by size of GDP. NAFTA is a regional economic cooperation agreement that is signed by the governments of Canada, Mexico, and the United States. It is a trilateral trade bloc in North America region. NAFTA agreement came into force from January 1st, 1994 and is successfully operating so far. The first waves of regionalism started after the First World War. It started with formation of European Coal & Steel Union in 1951 and entered into various phases of economic cooperation till 1970. It was marked by the establishment of the European Economic Cooperation in 1957, European Free Trade Area in 1960 and the Council for Mutual Economic Assistance (CMEA) in 1949. There were plethora of regional trade blocs which were formed by developing countries, prominent among them were ASEAN, CARICOM and Mercusor.

2.8 Glossary

- **NAFTA:** NAFTA is a trilateral free trade agreement involving countries such as United States of America, Canada and Mexico. It came in force from 1st January 1994.
- **ECSC:** European Coal and Steel Union came into force in 1952 and was an initiative of six democratic European countries to pool coal and steel resources in such a fashion that further war/ tensions in Europe are avoided at best.
- **EURATOM:** EURATOM agreement was established in 1957 in order to pool the resources in a fashion that the best possible use of nuclear energy can be made.
- **Free Trade Area:** Free Trade Area refers to a stage of bilateral / regional economic cooperation that is aimed at eliminating all tariff and non tariff barriers.
- **Economic Union:** Economic Union is that stage of regional economic grouping whereby all participating countries follow common economic, banking and trade policies on all matters. For Example, European Union has common bank, trade policy and common other economic policies.
- **Regional Economic Groupings:** In order to integrate their economy with rest of world, countries are entering into PTAs/ FTAs/ Custom Union/ Common Market and Economic Union agreements so as to reap the economic as well social benefits and grow faster economically.

- **Trade Diversion:** Trade diversion is a situation where trade is diverted to nonmember countries, as an outcome of the formation of regional grouping.

20.10 Check your progress

1. The administration of the European Union is carried out by .... institutions.
2. The NAFTA agreement came into existence on January 1, ...
3. The ASEAN Secretariat is located in ...., from where all its activities are conducted.
4. When trade shifts towards non-member countries due to regional economic integration, it is termed a situation of ....

20.10 Answers to Check your progress

1. Seven, 2. 1994, 3. Jakarta, Indonesia, 4. Trade diversion

20.11 Terminal question

Question No. 1: Write a short note on emerging global environment of economic cooperation by citing some examples?

Question No. 2: Explain the evolution phase of European Community? Also discuss why European Union so important markets for Exporters globally?

Question No. 3: Discuss the evolutionary phase of NAFTA? What are its objectives?
Questions 4: Explain the pros & cons of North America Free Trade Agreement?

Question No. 5: Explain the role of Regional Trade Agreements in promoting regional and international trade in globalized era?
Question No. 6: Explain with examples the various kinds of regional economic grouping that has come into existence so far?
Question No. 7: When was ASEAN founded? Where is it's headquarter? What are the objectives of ASEAN?
Question No. 8: Explain by forming a table about the various institutions that has come under ASEAN forum?
Question No. 9: Discuss the main objectives of SAARC? When was it founded and where?

20.12 Suggested Readings

1. International Economics, Raj Kumar, Excel Publication, 2008
2. International Economics, Francis Cherunilam, The McGraw Hill Publication, 5th Edition,
3. International Economics, Steven Husted and Michael Melvin, Pearson Publication, 9th Edition.
4. International Economics, James Gerber, Pearson Publication, 6th Edition
5. International Economics, D.M. Methane, Himalaya Publishing House; Edition 11th ISBN No. 8178660962
6. International Economics: Theory And Policy, 8th Edition, Paul R. Krugman, Pearson Education India
7. International Economics, Dr Nirmala Bhalerao & SSM Desai, Himalaya Publishing House, 1st Edition
8. International Economics, M.L. Jhingan, Vrinda Publishing House
9. International Economics, D. N. Dwivedi, ISBN : 8122005349
10. International Economics, Steven L. Husted, Michael Melvin , Harper- Collins Press
11. Johan Daniel, and Lee H. Rudabaugh, International Business Environment and Operations, Pearson Publication, 14th Edition.
12. Rakesh Mohan Joshi, International Business, Oxford Press, India Edition.
13. WTO Annual Reports, 2012, Geneva.

Unit-21 Complexities, Subject Matter (Issues), and Approaches to International Business Management

Structure:

Objectives:

After reading this unit, you will be able to understand:

(i) issues and challenges in international business;
(ii) the changing scenario of international marketplace;
(iii) complexities in the international business; and
(iv) Approaches to international business management.

21.1 Introduction

As we know, the term international business refers to commercial activities performed to promote the transfer of technologies, goods, services, resources, people, and ideas across national boundaries. International business occurs under many different formats, from the movement of goods from one country to another (exporting and trade); to contractual agreements giving firms in foreign nations legal permission to use products, services, and processes from other nations (franchising, licensing, subcontracting production); to companies setting up sales, manufacturing, research and development, and distribution facilities in foreign markets. The study of international business gives an understanding that how and why technologies, goods, services, and ideas cross national borders, and what factors affect their acceptance (or rejection) in foreign markets. The flows of goods, services, technologies, resources, people, and ideas among markets have major effects on countries and their governments, companies, and individuals. At the nation-state level, participation in international business activities helps countries take advantage of national expertise in commerce to deliver goods and services into the international marketplace. It also increases the varieties of goods and services available in national markets and exposes consumers to new lifestyles and ideas. Over the years' time, these exposures affect national cultures including their political and economic institutions, and impact society's behaviors, attitudes, and lifestyles. Governments have major effects on international business activities in determining how open (or closed) national economies are to external influences such as trade and investment. For companies, international business increases competition in domestic markets and opens up new opportunities abroad. Global competition forces firms to be more innovative and efficient in their use of resources. For consumers, international business brings increased varieties of goods and services into the international marketplace and enhances living standards. Just as important, open borders means increased exposure to new ideas, technologies, and ways of doing things.

21.1Issues and challenges in international business

As business people survey the international market place today, they are both impressed and intimidated by the diversity and change they see in more than 200 national markets with more than 6 billion people. Yet this is the market place they must understand in order to build products and services for worldwide customers in the face of increasing international competition. Successful international corporations are those that recognize the diversity of the international marketplace, and are able to cope up with the uncertainties of doing business in continually changing market environments. The task of understanding the issues of the international marketplace is immense. International executives must cope with the following:

(i) **Political diversity:** Political diversity as world markets may be governed by autocracies (chiefs, kings, dictators, one-party governments) or democracies.

(ii) Economic diversity as national wealth disparities vary from \$107 per capita per year in Burundi to over \$71,000 per capita in Norway.

(iii) **Regional diversity in distributions of wealth and population:** North America has 5–6 percent of the world population but controls almost one-third of world gross domestic product (GDP); Asia has about 60 percent of the world population,

(iv) **Cultural/linguistic diversity:** The 200 nations of the world are divided into about 10,000 linguistic/cultural groups, a crude average of some 50 languages or ethnic groups per country. Sudan has 600 ethnic groups and 400 different languages spread across its 31 million population. India has Hindi and English as its major languages, but supports many hundreds of dialects across its regions.

(v) **Diversities in country size and populations:** The number of countries in the world economy was about 60 at the start of the 20th century. This rose to 96 by 1960 and to over 200 as the millennium drew to a close. The population of these countries varies, from Mainland China and India with 1.3 and 1.1 billion inhabitants, respectively, to 43 nations with less than 1 million inhabitants each.

(vi) **Developmental diversities:** Developmental diversities between industrialized nations (80 percent urban populations, 3 percent of GDP from agriculture) and industrializing nations such as those in sub-Saharan Africa and parts of Asia that are 30 percent urbanized and obtain over 30 percent of their GDPs from agriculture.

21.2 The Changing International Marketplace

The international marketplace is characterized by constant change, resulting in major political, economic, cultural, and financial uncertainties. Political change occurs as nations seek to establish stability and order within their national borders. In democratic nations, there are uncertainties as voters decide what political directions their countries should take. On average, there are national elections somewhere in the world almost every week. Companies with major trade or investment commitments in those markets pay attention to national, regional, and local elections to determine how they will affect business, whether new governments are likely to support commercial developments, and how they are likely to impact national demands for products and services. In some developing countries, especially where democracies are not established, there are uncertainties as rival ethnic, religious, or social groups compete for political recognition (for example, in Somalia, Sudan, and Ethiopia). In democratic nations, account must be taken of splinter groups (e.g., environmental "Green" movements in Western Europe, fundamentalist Muslim groups in Iran, leftist guerillas in Colombia). Wherever there are major differences in political opinions, there is the potential for political unrest. Economic change has become increasingly

Important with the growing interdependences among national economies. Economic downturns in North America or Western Europe reverberate throughout the world economy. Developing country problems (such as the U.S./UN–Iraq war in 1990–1991 and the Asian financial crisis over 1997-1999), caused downturns in worldwide economic activity. Executives must be able to analyze global and regional economic trends and appreciate their impacts on corporate activities. At the nation-state level, managers must recognize symptoms of governmental mismanagement of the economy: unbalanced budgets (insufficient income from taxes to support government spending), corruption (e.g., in government contracts and spending), unfair tax structures, balance-of-payment problems, and so forth. Two major economic problems are inflation (which causes erosions of savings, consumer purchasing power, and living standards) and high unemployment. Both can result in public discontent and political unrest. Cultural changes create uncertainties through their effects on political and economic climates. Religious problems in particular have caused strife at national and international levels. Within nations, religious conflicts can be highly disruptive (e.g., between Hindus and Muslims in the Kashmir in India; Christians and Muslims in Nigeria and Indonesia; and between fundamentalist and mainstream Muslim groups in Iran, Pakistan, Saudi Arabia, Egypt, Algeria, and Palestine). For many peoples of the world, religion is the most important part of their lives-more important than money and wealth, more important than country affiliations, more important than other worldly issues. This causes problems, as religion often supersedes national allegiances and makes religious conflicts among the most difficult to resolve. Financial changes occur as international businesses conduct transactions in a international marketplace with over 180 currencies. When most international business transactions occur, exchange rates (the price of one currency in terms of another) are involved. Firms must monitor two types of financial change: First, the values of many currencies fluctuate with respect to each other, affecting pricing and asset valuations as goods and resources cross-national borders. Second, countries' abilities to make payments to foreigners are variable. Only a minority of national currencies (the dollar, yen, euro, and a few others) are fully acceptable ("convertible") in all world markets. Many developing country currencies, for example, are unacceptable to nonresidents as means of payment ("inconvertible"). As increasing numbers of developing countries enter the international marketplace, a key issue is how they can pay for needed goods and services. Many of these (e.g.,) Argentina) have built up major debts as they have fallen behind in their abilities to pay import bills. Others undergo significant economic turmoil as they strive to make their currencies acceptable (convertible) internationally. The 1997-1999 Asian financial crises occurred when key nations in that region realigned their national currencies in efforts to make them convertible. Coping with political, economic, and cultural diversity and change is what international business is all about. The task of international managers is to understand foreign markets and to craft strategies to facilitate international transactions and out-compete rivals in the international marketplace. This requires not only understanding the principles underlying sound business strategies, but also having in-depth knowledge of the world markets and their characteristics, behaviors, and trends.

21.4 Complexities in the international business

Developmental differences among and within nations demonstrate those technologies and ideas which diffuse at variable rates throughout world markets. Not surprisingly, this affects the extent to which companies can leverage technologies, products, and services across markets. The diffusion of innovations occurs at two levels: between markets and within markets.

The international diffusion process

The diffusion process begins in advanced markets like the United States, Japan, and Western Europe. While innovations today can occur anywhere in the world, commercialization tends to occur first in these regions because of their affluence. Also, the competitiveness of these markets, and their high levels of education and affluence have constantly stimulated the development of new products and technologies. As corporations see commercial opportunities in foreign markets, new products and technologies are transferred into other industrialized countries through export sales and overseas manufacturing in foreign affiliates. Over time, and through exports and foreign direct investments, products and technologies diffuse into developing countries and throughout world markets.

The diffusion process in national markets

Within individual countries, the diffusion process usually begins in urban centers. In industrializing countries in particular, major metropolitan areas are the seats of government, have developed infrastructures (power grids, telecommunications, road, rail systems, airports), and contain concentrations of economically significant customers. This has made cities ideal springboards for the diffusion of new products and technologies in emerging markets. Over time, and just as they did in medieval Europe, infrastructures develop, general levels of education and affluence rise, and innovations spread outside of towns into semi-urban areas (where rural migrants settle) and eventually into rural markets. As successive waves of technologies and products diffuse, modernization and industrialization begin to take hold. In developed markets, this process has already occurred. Urban-rural differences in affluence and education levels are minimal, and established infrastructures facilitate speedy diffusions of new ideas, products, and services.

Many factors affect the rates at which new ideas and technologies diffuse through international markets, including the following:

(i) Country openness to external influences: The diffusion of technologies and new ideas into country markets is affected by national interactions with the outside world. In some cases, a country's geographic position can effectively isolate it from outside influences (for example, China and Japan up to the late 19th century). In other cases, countries take steps to protect national industries and cultures from international influences (for example, through trade and investment restrictions), essentially limiting their abilities to benefit from other countries' innovations. Middle Eastern and some Asian economies have been apprehensive about the importation of Western lifestyles that they perceive as disruptive to their national cultures. The importance of education and literacy: Use and adoption of technologies requires educated personnel. Ineffective national education systems are problematic for three reasons. First, they hinder national abilities to invent and be at the cutting edge of industry innovations. Second, the number and caliber of technical and educated personnel affects countries' abilities to adopt and use technologies for national development. Third, poorly educated consumers are less able to appreciate and adopt new ideas and technologies.

(ii) **Literary rates:** literary rates also affect diffusion rates for new ideas, as consumer education is limited to personal experiences and local interactions. While the growth of broadcast media such as radio and television can offset literacy problems, the combination of low literacy rates and poverty, particularly in developing countries, limits educational opportunities and exposures to new ideas and technologies. The Importance of national infrastructures: How quickly new ideas and innovations spread within countries depends on the degree of national infrastructure development (roads, energy grids, transportation systems, water facilities). The ease with which nations can develop infrastructures to link communities and populations in turn is influenced by country size, national resources, topographies, and climates.

(iii) **Effects of national ethnic and linguistic compositions:** Cultural and linguistic differences between countries affect the ease with which nations can communicate and do business with each other. Similarly, within nations, cultural heterogeneity (i.e., many different ethnic and language groups) slows the diffusion of new ideas, products, and technologies. Conversely, single-language and culturally homogeneous nations have fewer obstacles in diffusing new technologies and ideas. The rate of innovation diffusion depends on how different products and services are, and how customers perceive the costs and benefits of the innovation. Innovations must get around two sets of obstacles to diffuse effectively throughout world markets. First, when they cross country borders they must overcome national differences in culture and development. Second, when they are rolled out into rural areas, particularly in developing markets, differences in urban–rural cultures must be negotiated. For example, introducing a new brand of toothpaste into developing country towns and cities is a minor innovation. Rolling out toothpaste into rural markets is a different matter, and may involve disrupting traditional dental hygiene patterns (for example, in India where charcoal is commonly used in rural areas to clean teeth). Cumulatively, the introduction of new products, technologies, and business methods continues to have major impacts on national cultures and mindsets. While many are welcomed, some are not. When introducing new products and technologies into foreign markets, international corporations must take account of diffusion processes in their choice of strategies.

21.5 Approaches to international business management

Cultural understanding approach

Implementing strategies across international markets requires in-depth understandings of national cultures and international trends. Anyone can read the local or international press and find out what is going on in a particular country, but while that knowledge is important, it is not sufficient for making important resource allocation or strategy decisions. International business managers must know not only what is going on but why. They must be able to interpret international events and assess their significance in wider national, regional, or worldwide contexts. It is impossible for managers to know everything about national cultures and international trends, but the relentless accumulation of worldwide market knowledge is the hallmark of all top international executives. They never stop learning. To be effective, however, managers must also have suitable frameworks to aid interpretations of market trends and events.

The cultural ignorance exists when individuals have no knowledge of cultural differences. Business people at this stage are liabilities to their companies and may do more harm than good on overseas assignments. Cultural awareness takes place when people know there are cultural differences and they are looking for them. Businesspeople at this stage are less likely to commit social or cultural blunders. Cultural knowledge is an extension of cultural awareness. Business people at this stage know how to offer appropriate greetings (i.e., the bow of Japan) and what behaviors to expect in foreign markets. They observe, catalog, and analyze foreign behaviors and look for the reasons behind them. Cultural understanding occurs when businesspeople not only know what behaviors are appropriate, but also understand why those behaviors are correct for that culture. Individuals at this stage are often fluent in the local language and are aware of the behavioral and attitudinal subtleties of a culture

Multidisciplinary Nature Approach

Understanding international markets requires knowledge from a broad range of social- scientific disciplines. Business studies draws heavily from the social sciences of economics, sociology, and psychology in its examinations of corporate, social, and individual behaviors. When the study of business goes beyond national borders, the conceptual foundations of international business extend to include the following areas of study. Political science is the study of politicians, political institutions, and their effects on business and society. Democracies are present in many countries, but over 30 percent of people live under autarchies-hereditary monarchies, dictatorships, chiefs, shahs, and the like. In autarchies, the leader's word is often law, and usually, that person's control is absolute. In democracies, politicians control national destinies, but are accountable to voters. International businesses must therefore routinely monitor political changes via elections, wars, and revolutions. Politicians have major impacts on economic conditions-whether national markets grow or contract (major influences on corporate sales and profit levels). Governments also control corporate access to national markets via trade and investment policies. Just as important, governments provide the legal frameworks that ultimately control business behaviors within their national borders. Anthropology is the study of the evolution of mankind in its various environments. The evolution of human behaviors during economic development from traditional to modern societies entails major disruptions to political and economic institutions, as well as group and individual behaviors. A major key to understanding important emerging markets like India and China is appreciating how economic development changes affect business operations in rapidly industrializing markets. Economic development occurs as nations industrialize and grow economically. As they progress toward higher living standards, significant changes occur in national institutions and behaviors. These changes, in political, economic, and cultural institutions, affect behaviors and values at all levels of society. Knowledge of these institutions and the development process helps businesspeople understand changes in foreign markets and provides insights as to how a country's past affects its present and future prospects. Understanding the economic and cultural development process requires insights from the anthropological, sociological, and economic development fields to illustrate the multifaceted nature of change as nation-states move from simple, self-sufficient societies to complex nation-states producing varieties of goods and services. Sociology is the study of group behaviors in society. In tradition-based societies, extended family units are common, and familial obligations run deep in affecting business behaviors, the awarding of contracts, and employment opportunities. Another group behavior-the assigning of social class- determines societal hierarchies. In traditional societies, hereditary criteria (family pedigree) and seniority (equated with wisdom) are major sources of social status. But as countries urbanize, industrialize, and modernize, money and the accumulation of wealth become key indicators of social class standing. Finally, as countries industrialize, gender roles change, and male-oriented (patriarchal) societies come under pressure as female contributions to societal well-being outside of the home are recognized. Religion is a primary determinant of behaviors and attitudes in all countries. In North America and Western Europe, Christian religions (including Protestantism and Roman Catholicism) provide behavioral and ethical guidelines to followers, but their effects on daily lives are not as pronounced as in other parts of the world. In the developing world, religion tends to have profound effects on daily lives. It is difficult to understand the Middle East without significant knowledge of the Islamic (Muslim) faith. Similarly, attitudes and behaviors in India are best understood when placed in their Hindu context. Both Islamic and Hindu religions have followings of over 1 billion people. Some religions are non-theistic (that is, they do not recognize or worship a god or gods) but are life-guiding philosophies affecting behaviors. Confucianism and Daoism have affected Chinese behaviors for centuries. Buddhism, another non theistic religion, affects daily behaviors in many Asian nations (e.g., Korea, Thailand, Laos, Cambodia, China, Japan). Thus, understanding international markets requires in-depth appreciations of the world's major religions and their effects. Geography is a known quantity to national companies competing in their native markets. It warrants little analysis or commentary. In advanced national markets, technology (e.g., bridges, tunnels, irrigation systems) overcomes many geographic obstacles, and products and services are easily adjusted to prevailing climatic conditions. But as businesspeople evaluate new international markets, geography, climate, and topography (the study of terrains and land surfaces) become major elements in market analysis. Geographic resource availability (minerals, agriculture) is a key shaper of national development. Topography and climate influence target markets (where populations reside); distribution (how to reach and service customers); and, in a more general sense, attitudes toward life (e.g., in severe climates or harsh terrains, where "Mother Nature" determines life's outcomes). History's contribution to world business is often underestimated by businesspeople whose major orientations are to the present and the future. Yet it is difficult to understand country markets without appreciating how national histories have shaped current political, economic, and cultural circumstances. Historical analysis, with its emphasis on how the past influences the present, is a key tool in interpreting and anticipating market behaviors and trends.

21.6 Strategy formulation and implementation in international business

Historically, countries have developed at varying rates and in different ways. They have different resource bases, climates, topographies, languages, values, attitudes, and behaviors. In the competitive international marketplace, the challenge for international business executives is to recognize what aspects of business strategy can be transferred to other markets with few or no adaptations (a standardized or global strategy to take advantage of customer similarities), and what aspects need to be adapted to facilitate customer acceptance and use (an adaptive or multi-domestic strategy).

The arguments for standardized strategies

The temptation to standardize products has never been stronger. Global customer awareness and appreciation of new products and technologies has never been higher. International media, trade, the Internet, and the increasing presence of international corporations in world markets have homogenized tastes to the point that customer similarities across markets have outstripped national differences. The constant sharing of technologies, goods, and services among developed markets in particular has reduced national differences in customer preferences. This globalization trend has encouraged firms to standardize products and services across markets. International companies have taken advantage of the globalization trend by transferring products, services, and technologies abroad. Initial product rollouts usually occur first in developed countries with similar demand patterns (e.g., North America and Western Europe). While companies make some adaptations (voltage changes for electronic goods, right-/left hand drives and minor stylistic changes for autos, labeling changes for consumer products), essentially products and services are similar from market to market. This is a global or multimarket standardization strategy. Also, in urban parts of developing markets, outside of translations and language differences, customer tastes are similar to those in developed markets as modernization trends have taken hold. Global and multimarket strategies have a number of advantages, as under:

(i) Global, regional, or multimarket rollouts of new products maximize their competitive impact. Opportunities exist to transfer products and brand images across markets; and policies regarding distribution and pricing can be standardized to varying degrees. Carlsberg beer is brewed and marketed identically in over 30 countries; and Hollywood movies go into world markets with minimal changes (except dubbing and subtitles).

(ii) Supply chain activities and management philosophies can be integrated across nations. This includes global sourcing of products, raw materials, and components. Manufacturing methods can be transferred abroad to capitalize on home-market efficiencies and expertise. Toyota routinely transfers Japanese production methods and standards to its overseas plants. Where foreign-market infrastructures and conditions are favorable, management processes such as total quality management, just-in-time supply chains, and reengineering can be assessed for use. Worldwide R&D efforts and globally orchestrated new product-development processes can be coordinated, and common corporate cultures can be developed to bond together managements from different countries and cultures.

The arguments for localized strategies

Foreign markets and customers have not been equally receptive to cross-border influences and trends. Hundreds or sometimes thousands of years of national-culture continuity breed habits and behaviors that are not easily set aside. Where local markets retain their traditional national cultures, modern products and technologies are slow to be assimilated (for example, in the Middle East and Asia where national cultures are deeply rooted). This occurs where protectionist tendencies are present, where local traditions are strong enough to resist the diffusion of modern technologies, and where business acumen dictates that localization strategies are optimal. In such markets, national tastes are less influenced by global trends, and international firms must cater to local needs to be successful. This involves taking full account of national cultures, values, and behaviors. Localization strategies become key competitive tools as international firms compete not only against other worldwide companies but also against national competitors with superior knowledge of local customs and behaviors. But while completely localized strategies are tempting options, they are not the answer for most international companies for three reasons. First, localized approaches are expensive and time-consuming, as top-to-bottom assessments of customer needs are necessary for each new market. Second, localized strategies often do not differentiate corporate output from that of local rivals. Third, they do not take advantage of the international company's worldwide experience and economies of scale often key reasons why firms have been successful in international markets in the first place. In many situations, though, business strategies must be adapted and localized to optimize their appeals. Localization strategies are as under:

(i) Adapting imported product ideas and custom-building goods and services so they can maximize their appeal to national tastes. Television networks such as MTV in the United States and Star TV in Asia have recognized that customizing programming to national tastes is a major key to marketplace success.

(ii) Use of country-oriented manufacturing techniques (for example, more labor intensive production processes), local sources of supply, and adherence to local management styles and supply chain relations. Hankou Tire, a global top-5 tire manufacturer, deliberately gives its foreign subsidiaries decision-making autonomy to respond quickly to local market needs.

(iii) Adoption of localized marketing strategies, with advertising and promotional strategies oriented toward national and local values and major adaptations to local distribution and pricing habits. In China, McDonald's and Kentucky Fried Chicken both adorned their restaurants with Spring Festival decorations to maximize local appeal, while Coca Cola printed cartoon snakes on bottles to celebrate the Year of the Snake. Historically, standardization and adaptation have been viewed as opposite strategies. In reality, companies tend to standardize some aspects of their strategies (for example, building global or multimarket brands) and adapt other aspects of their operations (manufacturing methods, promotions, distribution). Also, wherever firms have foreign-market facilities, executives must adapt to local cultures in face-to-face dealings, and comply with local laws and customs with respect to human resources, manufacturing, and distribution. The globalization-localization mix varies by industry, company, and market. It is management's task to ensure that foreign operations have the appropriate global-local mixes for their situations.

21.7 Summary

Firms use a variety of strategies to enter and penetrate international markets. The strategy making process begins as industry and company analyses are brought into the corporate planning process. In this most important part of the management processes, corporate missions, assets, and competencies are reviewed, and businesses and market strengths and weaknesses are assessed. From these evaluations, companies prepare to internationalize their operations or, if they are seasoned campaigners, to integrate their activities globally. These processes ensure that firms have the appropriate organizations and managerial talent to cope with the rigors of extending businesses over increasing numbers of markets, and to ensure that personnel, corporate processes, and organizational structures are matched to industry, business, and market needs. Once internal analyses are complete, firms review and evaluate their choices of market entry and servicing strategies. Firms compete in world markets with two basic strategies. In countries where the globalization process has taken root, markets and customers tend to be similar and countries have few restrictions to trade and commerce. In these cases, companies can extend products and services (with often minor changes) either worldwide or into multiple markets. These strategies are competitor strategies, whether firms should compete against or form alliances with regional and national rivals in world markets.

21.8 Glossary

International Business: International business involves the execution and promotion of commercial activities beyond national borders, as well as the transfer of technology, goods (merchandise), services, resources, individuals, and ideas.

21.9 Check your progress

1. The rate of diffusion of .... depends on the variety of products and services available and the customers' orientation towards costs and benefits.

2. In ....societies, seniority based on lineage and knowledge constitutes a major component of social prestige.

21.10 Answers to Check your progress

1. Renewable, 2. Conventional

21.11 Terminal questions

1. Write a detailed not on issues and challenges in international business.
2. Explain the changing scenario in international marketplace.
3. Write down different approaches to international business for mangers to get success at global level?
4. Differentiate between cultural understanding approach and multidisciplinary nature approach.
5. Describe complexities faced by managers in the international business.
6. How can strategies are formulated and implemented in international business?
7. Write down the arguments in favour and against for standardized and localized strategies at international level.

21.12 Suggest readings

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Unit-22 Environmental Observation, Control and Management Information System

Structure

22.1 Objectives

The objectives of this lesson are:

1 To provide a description of the nature of environmental scanning.

2 To describe the types of environmental scanning.

3 To identify the sources of environmental scanning.

4 To understand the concept of SWOT analysis.

22.2 Introduction

No organization can exist in a vacuum it derives its existence from the environment. The changes in customer's tastes, supplier's conditions, government policies and legislation, political conditions, international conditions etc. have a profound effect on the business policy and strategy. Therefore, scanning of the business environment is one of the most sensitive areas from any top management point of view. Once the mission and objectives of the organization are decided, the next step for the management is to scan the environment in which the organization has to operate. The formulation of corporate strategy and the identification of its business objectives are also largely governed by the top management view of environmental opportunities and threats. A number of forces and factors combine to form an opportunities and threat. In doing all these things, the management relies on environmental scanning.

22.3 Meaning and definition of scanning

The meaning of the word scanning is to look carefully into or to examine. The term environmental scanning in business means to carefully analyze the various factors influencing the business. Environmental scanning is not once and for all rather it is a continuous process. As the business environment is continuously changing management has to continuously analyze and diagnose the environment. It is a process by which the organizations monitor their relevant environment to identify opportunities and threats affecting their business. "Environmental scanning is used as a overview of wide range of phenomenon in the environment projected usually in a time period beyond the typical formula planning range and designed to stimulate thinking of managers and staff about potential events that will have an important impact on company affairs".

22.4 Need of environmental scanning

Empirical studies have proved that the firms which carry out environmental analysis enjoy enhanced financial performance. Quite often companies become convinced that they are almost invincible and need not examine what is happening in the market place. When the company ceases to adjust the environment to its strategy or does not react to the demand of the environment by changing its strategy the result is lessened achievement of corporate objectives. Environmental scanning is needed because of the following reasons: -

1. **Effective utilization of resources: -** The key to business success is the most effective utilization of the company resources, existing resources as well as the additional resources it can mobilize. All this involves the evaluation of the company's strengths and weaknesses in the light of the environmental threats and opportunities and taking formulation of strategies accordingly. Companies which fail to do so are doomed to failure.
2. **Constant monitoring of the environment: -** Environmental scanning provides a clear-cut idea about the existing environment. Without environmental scanning it would not be possible to know the change in customers tastes and preferences cogitators moves, latest innovations, latest policy developments etc. constant monitoring of the environment will not be possible without environmental scanning.
3. **Strategy formulation: -** Environmental scanning will indicate the areas for diversification and growth as well as measures to face the problems. Reliance has diversified into areas of import substitution. Knowledge and understanding of its environment by a firm leads to more effective strategic decision making by permitting proactive strategy based upon forecast proactive for its business.
4. **Identification of threats and opportunities: -** Environmental analysis can help the firm in identifying its threats and opportunities. After the proper identification, strategies can be adopted to exploit the environmental opportunities and to overcome the threats.
5. **Useful for the managers: -** Managers have found much value in environmental analysis in many ways. If we compare the overall economic performance of the companies that made

environmental assessments with those who did not, we will find out that those that did make such assessment out performed those who did not.

6. **Prediction for the future**: - Predicting future has become one of the most important functions and skills of the management. Future managers have to be more anticipative than reactive and problem solvers. Thus by scanning environment managers can discharge their functions in a better way.

22.5 Factors to be considered for environmental scanning

The external environment in which an organization exists consists of a variety of factors. These factors are as explained below:-

1. **Events:** Events are important and specific occurrences taking place in different environmental sectors e.g. the gas leakage accident at the Union Carbide factory at Bhopal and the resulting holocaust was an event.
2. **Trends:** Trends are the general tendencies or the courses of action along which events take place. For example, from Bhopal Gas tragedy that has arisen is a general tendency on the part of regulatory authorities and organizations to be conscious about safety from hazardous exposure to chemicals.
3. **Issues:** Issues are the current concerns that arise in response to events and trends. For example, the major issue, nowadays of the rising concerns is about environmental pollution.
4. **Expectations of people:** The expectations of the general public from the government are of legislating changes in rules and regulations pertaining to safety measures and strict enforcement through various mechanisms. With the help of proper environmental scanning an organization can consider the impact of the above factors on its strategic management process. For that it is important to devise an approach or a combination of approaches to environmental scanning.

22.6 Approaches to environmental scanning

Different approaches can be there for sorting out information for environmental scanning. KUBR has suggested three approaches:

1. **Systematic approach**

The important features of this approach are as given below:-

- In this approach information for environmental scanning is collects systematically.

- Information which is pertaining to business and industry could be collected continuously to monitor changes and take the relevant factors into account.
- Continuous updating such information is necessary not only for strategic management but also for operational activities.

In this approach the information which is collected generally relates to markets and customers changes in legislation and regulation govt. policy statements etc. that have a direct impact on an organization's activities.

2. **Ad-hoc approach**

The important steps involved in this approach are as:

- Under this approach an organization may conduct special surveys and studies to deal with specific environmental issues from time to time.
- Such studies may be conducted when an organization has to undertake special projects evaluate existing strategies or to devise new strategies.
- Changes and unforeseen developments may also be investigated with regard to their impact on the organization.

3. **Processed from approach**

- The organizations generally use information in processed from i.e. supplied by government agencies or private institution.
- The organizations also use secondary sources of data available from different sources both inside and outside the organization

Organizations generally use different practical combination of approaches to monitor their relevant environments. Whatever approach is used but data collection is necessary for deriving information about environmental scanning.

22.7 Sources of information for environmental scanning

Whatever may be the organizational arrangement for study of the environment the sources for scanning remain the same. Following are the important sources.

A. **Daily newspapers**

- Economic times
- Business standard
- Financial express
- The times of India
- The Hindu
- International Herald Tribune

B. **Journals**

- Business India
- Business world
- Update
- Fortune India
- The Sunday observer
- The economic and political weekly
- Main stream
- India today
- Commerce
- Seminar
- Harvard business review
- Sloan management journal
- Long range planning journal
- Fortune international
- Finance and development (world bank publication)
- Economist
- I.M.F. World Economic Outlook

C. **Government publications**

- Government information sources like censes of India reports five year plan reports, statistical abstracts of India etc.
- Periodical reports like economic surreys annual survey of industries annual report of ministries etc.
- Occasional reports brought out by various statuary agencies such as guidelines to industries policies related to specific industries export import policies.
- RBI's department of statistics also publishes valuable occasional papers related to different aspect of the economy and industry.
- Reference such as India a reference published by the ministry of information contains comprehensive information on the geographic and demographic features of India its political and social institutions economy and culture plans programmes etc.

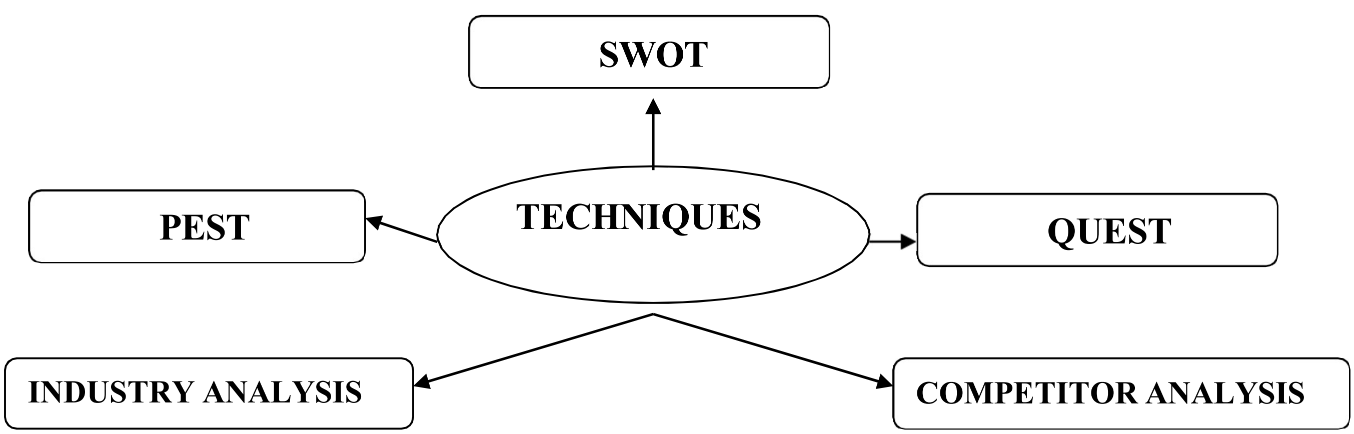
D. Institutional publications

- Bombay stock exchange directory.
- The center for monitoring Indian economy
- Kolhare's industrial directory of India
- Publications of market research agencies such as operation research group.
- Publications of trade and industry federations such as FICCI, ASSOCHAM and industry associations like ATMA.
- Annual company reports.

E. Industrial espionage agencies

Private agencies provide information and reports on competitor's plans and activities which are essential for strategic planning.

22.8 Environmental scanning and monitoring techniques



22.9 PESTEL analysis

The six environmental factors of the PESTEL analysis are the following:

Political factors

- Taxation Policy

- Trade regulations
- Governmental stability
- Unemployment Policy, etc.

Economical factors

- Inflation rate
- Growth in spending power
- Rate of people in a pensionable age
- Recession or Boom
- Customer liquidations

Socio-cultural factors

- Age distribution
- Education levels
- Income level
- Consumerism
- Population growth
- Life expectancies
- Expectation of society from the business

Technological factors

- Internet
- E-commerce
- Social Media
- Electronic Media

Environmental factors

- Competitive advantage
- Waste disposal
- Energy consumption
- Pollution monitoring, etc.

Legal factors

- Unemployment law
- Health and safety
- Product safety
- Advertising regulations
- Product labeling
- Labor laws etc.

22.10 SWOT Analysis

Identification of the threats and opportunities in the environment (external) and strengths and weaknesses of the firm (internal) is the cornerstone of business policy formulation; it is these factors which determine the course of action to ensure the survival and growth of the firm.

22.11 Diagram of SWOT analysis

	Helpful to achieving the objective	**Harmful** to achieving the objective
Internal (attributes of the organization)	**Strengths**	**Weaknesses**
External (attributes of the environment)	**Opportunities**	**Threats**

22.12 International Management Information System

Introduction

Information can be considered the lifeblood of business and a strategic resource that can provide a competitive advantage. The ability to gather, store, and process information is essential for making timely decisions. As much as 80% of an executive's time is devoted to receiving, communicating, and using information in performing a variety of tasks. Because all organizational activities depend on information, systems must be developed to produce and manage them. No complex organization can function without an IS. "An information system is a set of people, data, and procedures that work together to provide useful information". Organizational success greatly depends on effective information management and dissemination. The need for an effective management information system (MIS) function is particularly crucial for the survival and success of MNCs. Crossing national borders, MNCs are vulnerable to the uncertainties associated with the multiple political, cultural, and economic systems within which they operate. Therefore, an effective MIS is integral to the success of an MNC. An organization's MIS is a system for obtaining, processing, and delivering information that can be used in managing the organization. The mission of IS is to improve the performance of people in the organization through the use of IT. Before the advent of computers, due to technological limitations, the bulk of MIS consisted of paper reports generated by functional areas, such as accounting, manufacturing, and marketing. Accessing this information was very slow and time-consuming. There was a time lag between the generation of information and its use. Depending on the physical distance between the source and the user of information, the time lag ranged from a few hours to weeks. As a result of the limitation in information management, greater geographical distances from the headquarters implied a higher degree of autonomy for the subsidiaries. Today, IT comprises computers and telecommunication networks that allow instantaneous access to information regardless of the physical distance between the source and the user of the information. The newfound MIS capability not only allows more timely decision making, it also enables better control of distant operations. Such a capability is especially beneficial to MNCs. IT affects MNCs in two different ways. First, it provides a coordination mechanism for geographically dispersed activities, thereby facilitating globalization. Second, it provides a mechanism for building a coalition among separate organizations, making global operation more cost-effective. Management information system can be analyzed thus:

1. **Management**: Management covers the planning, control, and

administration of the operations of a concern. The top management handles planning; the middle management concentrates on controlling; and the lower management is concerned with actual administration.

2. **Information**: Information, in MIS, means the processed data that helps the management in planning, controlling and operations. Data means all the facts arising out of the operations of the concern. Data is processed i.e. recorded, summarized, compared and finally presented to the management in the form of MIS report

3. **System**: Data is processed into information with the help of a system. A system is made up of inputs, processing, output and feedback or control. Thus, MIS means a system for processing data in order to give proper information to the management for performing its functions.

22.13 Definition

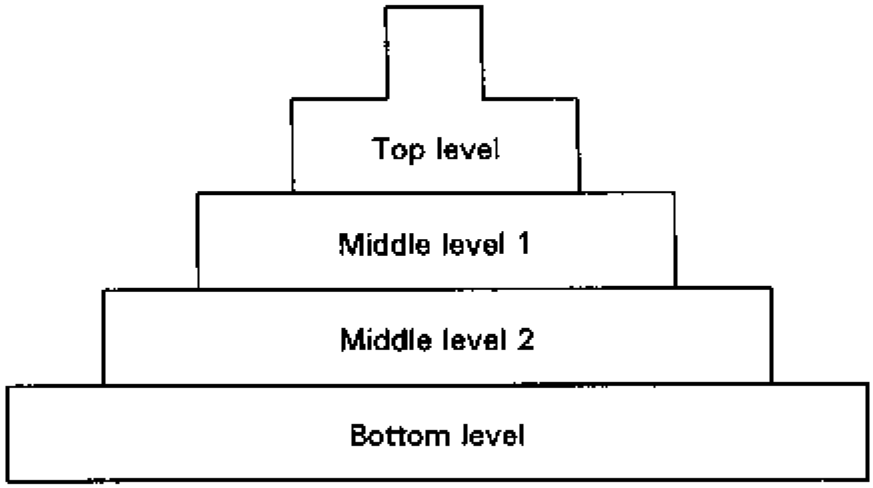
"An integrated user-machine system for providing information to support operations, management and decision-making functions in an organization. The system utilizes computerized and manual procedures; models for analysis, planning, control and decision making; and a database."

22.14 MIS Characteristics

In general, management information systems have a number of characteristics, which include the following:

1. **Report with fixed and standard formation:** For example, scheduled reports for inventory control may contain the same type of information placed in the same location on the reports.
2. **Have report developed and implemented using information system personnel, including systems analysts and computer programmer:** Typically analysts and programmers are involved in developing and implementing MIS reports. User is normally involved in the design of the reports, but they are not typically involved in writing the computer programs to produce them.
3. **Require formal request from user:** Because information systems personnel typically develop and implement MIS reports, a formal request to the information systems department for report is usually required.
4. **Produce scheduled and demand reports:** The major type of reports produced by MIS is scheduled, demand reports.
5. External data is not captured by the organization but is used by the MIS. (i.e., customer, supplier and competitor information).

22.15 MIS as a pyramidal structure



22.16 Computer-Based Information Systems

CBIS play a vital role in today's businesses. The many benefits organizations seek to achieve through CBIS may be classified as follows: (1) efficiency gains, (2) effectiveness gains, and (3) competitive advantage. Efficiency gains are concerned with doing more with the same or fewer resources. CBIS can bring about efficiency gains by automating tasks in the factory as well as in the workplace. Effectiveness gains are concerned with doing the right things and achieving the established goals. CBIS can bring about effectiveness gains by improving internal as well as external Communications and by facilitating superior managerial decision making. Competitive advantage is concerned with providing the organization with a significant and long-term benefit vis-à-vis the competition. CBIS can bring about competitive advantage by allowing the firm to differentiate itself from its competitors, become the lowest-cost/price producer in the marketplace, or carve market niches for it self through innovative services and/or products. The use of any tool creates dependence, and computers the most enabling tool created by man are heavily used already. By the same account, nearly half of all capital investment in the United States is being put into IT. Therefore, management of IT investment has become a critical concern, because there are real risks associated with an inept organizational response to the rapid pace of developments in IT.

22.17 Information Architecture (IT)

The solution that emerged in the late 1980s to deal effectively with the rapid pace of change in IT was to build information architecture that is, to create a framework within which current as well as future organizational needs for information could be met with impunity from changing technology. The IS architect, however, must often pay dearly for the mistakes of the past. IS like buildings and streets, have a tendency to grow haphazardly. As in a building, we do not like to break down an "outside wall," but if we cannot modify the inside walls to make the architecture useful for today's context (i.e., information needs), then there is no other choice. Figure below depicts a model information architecture. It is based on providing infrastructures for communication integration as well as data integration on which the IT portfolio (i.e., the various application systems ranging from purchase order entry to research and development planning) would be developed. In addition, the above model emphasizes four application portfolios that mature IS will comprise:

6. **Institutional portfolio:** IS applications are directed at recording and reporting on business activities. Examples include transaction processing systems such as payroll, order entry, purchasing, production scheduling, and accounting IS.
7. **Professional support portfolio:** IS applications are directed at managerial problem solving and decision making, competitive intelligence, and personal productivity. Examples include critical success factor reporting systems, decision support systems, expert systems, and such tools as are used for document preparation, computer-based messaging, electronic meetings, and workgroup computing.
8. **Physical automation portfolio:** IS applications are directed at replacing manual work with IT, on the factory floor as well as in offices. Examples include computer-aided design and engineering, robotics, automated response units, and workflow automation.
9. **External portfolio:** IS applications are directed at linking the firm with its suppliers, customers, or other firms for the purpose of creating a strategic alliance. Examples include ERP, SCM, EDI, and inter organizational systems.

Figure: Model Information Architecture

It is important to note that while the above model acknowledges that the application portfolios must address the information requirements at all levels of management, it neither assumes a particular hardware or software architectural platform nor advocates a centralized or decentralized approach to building the architecture. These choices are left to the eventual architect, who must fit the suggested architectural form to the specific context of the organization. However, because of the significant role that SCM, ERP, and EDI play in helping MNCs manage their worldwide operations, they are discussed subsequently.

(A) Supply Chain Management

Supply chain management can be defined as the way a company finds the raw components it needs to make products or services, produces those products or services, and delivers them to customers. To have better SCM, most companies implement the following five basic steps.

1. ***Plan:*** Establish a plan to manage all the resources that go toward meeting customer demand for products or services.
2. **Source:** Choose the suppliers that will deliver the required components, materials, parts, or services. Also, develop a set of pricing, delivery, and payment processes with suppliers and create measurements for monitoring and improving relationships with them. Then, put together processes for managing the inventory of goods and services that are received from suppliers, verifying them, transferring them to the manufacturing facilities, and authorizing payments.
3. **Make:** Schedule the activities necessary for production, testing, packaging, and preparation for delivery of the goods or provision of the services.
4. **Deliver:** Coordinate the receipt of orders from customers, develop a network of warehouses, select carriers to deliver the products to customers, and set up an invoicing system to receive payments.
5. **Return:** Create a network for receiving defective and excess products returned by customers and supporting customers who have problems with the delivered products.

As an example, Wal-Mart has implemented a global SCM system. This system gives its major suppliers a complete view of the inventory position of their own products in each of Wal-Mart's stores.

(B) Enterprise Resource Planning

ERP's main objective is to attempt to integrate all departments and functions across a company onto a single computer system that can serve all those departments' particular needs. for example, building a single software program that serves the needs of people in the finance department as well as those of the human resources (HR) department and in warehousing. ERP creates a single, integrated system that runs on an enterprise-wide database, so that the various departments can more easily share information and communicate with each other. The integrated approach can have a tremendous payback once the organization adopts and adapts to the business processes implemented by the ERP software. Each department typically has its own computer system optimized for the particular ways that the department operates. General Motors, for example, uses ERP software to connect all its worldwide operations as well as its suppliers and dealers in a global network that permits sharing of up-to-the-minute information.

(C) Electronic Data Interchange

EDI is the exchange of documents and information in standardized form between organizations in an automated manner directly from a computer application in one organization to an application in another. EDI's roots go back to the time of the Cold War. In 1948, for 1 year, the Soviet Union shut down access between Germany and the parts of Berlin that were controlled by the United States, England, and France. To deal with such a crisis, in 1949, a U.S. Army Master Sergeant, Edward A. Guilbert, and other officers developed a manifest system that could be transmitted by telex, radio-teletype, or telephone. By 1968, truckers, airlines, and ocean shipping companies were using electronic manifests and formed the Transportation Data Coordinating Committee (TDCC) to create cross-industry standards. In 1975, the TDCC published its first EDI standards. Due to the wide range of benefits that EDI provides, it is increasingly becoming a preferred way of carrying out business transactions among trading partners. The following are some of the benefits of EDI:

1. Higher processing speed, shorter turnaround time, and greater efficiency.
2. Less data reentry and transcription, less likelihood of error, and greater accuracy.
3. Lower cost and more convenience with less physical transportation of documents.
4. Less paper consumption due to electronic transmission and storage transactions. The automotive industry is a champion of EDI. By reducing the time taken to process orders, EDI has enabled cost savings through just-in-time management of automotive parts. Similarly, the transportation industry, which continuously exchanges routing and customs documents, has embraced EDI.

22.18 The IS Function With in the Multinational Corporation

Not surprisingly, MNCs have adopted different approaches for their IS functions. Some are centralized, some are decentralized, and some are distributed. Some are integrated but most are not. There are several classifications of international IS. The following provides a useful starting categorization.

10. **Multinational information systems:** This most prevalent model is characterized by essentially autonomous data-processing centers in each nation-state in which the MNC operates. This approach suffers from problems of redundancy and duplication in data, applications, and operations. However, it historically represents the easiest solution available to the MNC given the conditions of national markets (i.e.,

regulations, language problems, facilities problems, etc.,) that have encouraged the autonomy of business operations in each country.

11. **International information systems:** This model is characterized by a computer network that operates in more than one nation-state and in which data cross international borders in the process of completing a transaction. This model is now increasingly based on the Internet as its medium of data transfer.
12. **Global information systems:** This relatively new model is fundamentally characterized by the integration of data. Support for manufacturing operations that must coordinate inputs and outputs of plants located in different countries on a real-time basis has been one of several driving forces leading to the establishment of such systems.

22.19 International IS Issues

IT is an important mechanism to facilitate, sustain, and promote international business. International IS Issues may be categorized international IS issues into intra corporate, intergovernmental, host government, and reactive international IS issues.

(A) Intra corporate IS Issues

Intra corporate interactions provide the interface between the corporate unit (and its IS function) and its overseas subsidiary (and its IS function). In this category, there are two IS issues: (1) those pertaining to the IS function only and (2) those pertaining to the role of IS in supporting competitive strategy. The issues pertaining only to the IS function emanate from the design of the linkage between the IS function at the corporate unit and the IS function in the overseas subsidiary. The linkages are of three types:

1. **Organizational linkage** design must address the organizational structure of IS at the subsidiary, its control systems and reporting procedures, and its participation in the IS function of the corporation as a whole. Both company-level variables and subsidiary specific variables must be taken into account in designing the organizational linkage. The former includes the overall organizational structure and organizational strategy, while the latter involves the information dependency of the subsidiary, its importance (knowledge contribution), and its ownership.
2. **Architectural linkage** design must address the issues of communication integration, data integration, application portfolio, and hardware and software platforms. What is the desired level of connectivity? What is an acceptable level of standardization of codes (e.g., ethnic classification codes)? The Internet has influenced all this.

3. Personnel linkage design must address the functions of selection, staffing, appraisal, and compensation of IS personnel in subsidiaries. What is the appropriate mix of local employees, who speak the language and understand the culture and the political system, and expatriate employees, who can emphasize firm wide rather than local objectives?

The issues pertaining to the role of IS in supporting competitive strategy are influenced by industry-level variables as well as country-level variables. When MNCs in the same industry operate in the same countries, they cannot exploit comparative advantage sources (e.g., lower labor costs, raw material, etc., in one country vis-à-vis another). On the other hand, when similar MNCs operate in different countries, the IS function should focus its efforts on exploiting sources of comparative advantage.

(B) Intergovernmental IS Issues

The interactions between the IS function and intergovernmental units are concerned with either technical issues or regulatory concerns. There are several benefits from user participation in standard-setting organizations such as the International Standards Organization (ISO). Perhaps the most important of such benefits is remaining closely informed of directions in open systems (i.e., nonproprietary) standards and technologies and assessing their impact on the corporation's IS infrastructure. While developing coherent international standards is important for any IS function, a consistent pattern of international regulatory practices is a prerequisite to information transfers required by the global firm. As a result, we find that telecommunications and IS issues have been prominent at various international negotiations, including those sponsored by the World Trade Organization (WTO). Liberalization of global communications, in particular, can bring significant advantage to MNC's.

(C) Host Government IS Issues

Issues pertaining to the interactions between the IS function and a host government emanate from an MNC's deployment of information technologies and the host government's reaction to it. These issues can be divided into four categories: (1) political, (2) economic, (3) technological, and (4) socio cultural.

1. Political issues is the concern for ownership and the sovereignty of a nation over its resources, including its information resources. IT, in the form of satellite communications, for example, can render national control of information ineffective. Similarly, it is, at times, feared that MNCs headquartered in developed countries can, through the use of IS and trans border data flow (TDF), remotely control the physical operations of their factories and potentially bring operations in a less developed country to a halt.

2. **Economic issues** have typically surfaced in the form of restrictive policies against the use of IS for fear of displacement or unemployment of workers. In addition, host government policies for the development of indigenous IS industries can force the MNC's IS function into an unfavorable reliance on outsourcing in the host country and the deployment of less-than-optimal technologies.

3. **Technological issues** relate to host governments' IS-related policies regarding access to communication facilities and international networks. Host governments have a keen interest in IS through which technology transfer takes place.

4. **Socio cultural issues** deal with the stance of host governments on protecting the needs of the individual versus the needs of society. While there are no universal standards in maintaining a balance between the two host governments often would like to see that an MNC's practices do not stir up opposition from groups or interests within the society.

(D) Reactive International IS Issues

Often, national IS-related policies are formulated in response to changes in similar policies in other countries. These policies have an enduring impact on the IS functions of MNCs. As pointed out by the National Telecommunications and Information Administration (NTIA), "As direct beneficiaries or victims of many policy decisions, private firms have a critical stake in the nature and effectiveness of governmental decision making". European policies on the development of standards for telecommunication services and equipment, for example, prompt corresponding decisions by the U.S. government, which in turn will have ramifications for MNCs operating in the United States.

In addition to the above four categories of IS issues, there are also Inter government interactions as well as interactions between governments and intergovernmental bodies.20 These interactions primarily translate into bilateral, regional, and multilateral negotiations regarding issues that directly or indirectly affect the IS function of MNCs. As an example, the North American Free Trade Agreement (NAFTA) includes computer and telecommunications service agreements to provide nondiscriminatory access, maintain existing rights of access, and limit anticompetitive practices, and it contains provisions for TDFs and access to data banks

22.20 Summary

Environmental scanning is used as a overview of wide range of phenomenon in the environment projected usually in a time period beyond the typical formula planning range and designed to stimulate thinking of managers and staff about potential events that will have an important impact on company affairs. The changes in customer's tastes, supplier's conditions, government policies and legislation, political conditions, international conditions etc. have a profound effect on the business policy and strategy. Therefore scanning of the business environment is one of the most sensitive areas from any top management point of view. Once the mission and objectives of the organization are decided, the next step for the management is to scan the environment in which the organization has to operate. The formulation of corporate strategy and the identification of its business objectives are also largely governed by the top management view of environmental opportunities and threats. Technological changes and innovations affect all aspects of our lives and the conduct of business, locally and globally. No technological change has had as profound an impact in a short time on modern enterprise as the advent of computers and telecommunications. The ability to send, receives, process, and otherwise manages an immense amount of information enables MNC's to exercise closer control over their foreign subsidiaries. IS management can be used not only to enhance internal operations but also to create a competitive advantage. Instantaneous information exchange among MNC's worldwide operations drastically reduces geographical distances and brings dispersed subsidiaries closer to one another. While IS decrease the barriers to centralization, they also create opportunities for decentralization. The constant flow of information between MNC's headquarters and their subsidiaries empowers them to operate more locally and at the same time allows their headquarters to formulate strategies globally.

22.21 Check your progress

1. Sources such as the Indian Census Report, Five-Year Plan reports, and the Statistical Abstract of India fall under ....

2. The collection, storage, and analysis of information in a timely manner are essential for ....

22.22 Answers to check your progress

1. Government information source, 2. Appropriate decision

22.23 Terminal questions

1. Define environmental scanning. Why is environmental scanning essential for managers?
2. What elements are involved in environmental scanning?
3. Describe the methods of environmental scanning.
4. Why is the management of multinational companies difficult?
5. Why do multinational companies have different information requirements compared to local organizations?

22.24 Suggested readings

- Suresh Bedi - Business Environment (Excel Books, 1st Edition).
- Francis Cherunilam–Business Environment, Text and Cases (Himalaya Publishing House, 8th Edition).
- Crowe, T., & Avison, D.E. 1982. Management Informationfrom Databases. London: Macmillan.
- Kumar, H. 1989. Management Information Systems: A Conceptual and Empirical Approach. New Delhi: Ashish Publishing House.
- Lucas, H.C., Jr. 1978. Information Systems Concepts for Management. New York, NY: McGraw-Hill.

Unit-23 Organizational and Controllable Elements of International Operations

Structure

23.1 Introduction

23.2 Nature of International Organizational Structure

23.3 Global Organizational Structure

23.4 Aspects of Global Organizational Structure

23.5 Controllable Elements of International Business

23.6 Managing Control Functions in International Business

23.7 Essential Control Techniques

23.8 Practical Aspects of International Control

23.9 Remedies for Resistance to Control

23.10 Cultural Aspects of International Control

23.11 Additional Control Issues for Multinational Companies

23.12 Summary

23.13 Glossary

23.14 Check your progress

23.15 Answers to Check your progress

23.16 Terminal questions

23.17 Suggest readings

Objectives

The objectives of this lesson are:

1. To define and discuss the nature of international organizational structure and identify and describe the initial impacts of international business activity on organizational structure.
2. To identify and describe five advanced forms of international organizational structure and discuss hybrid global designs.
3. To identify and describe related issues in global organization design.
4. To explain the general purpose of control and the levels of control in international business.
5. To describe how international firms manage the control function.
6. To clarify why companies may need to use modes other than exporting to operate effectively in international business.
7. To comprehend why and how companies make foreign direct investments.
8. To understand the major motives that guide managers when choosing a collaborative arrangement for international business.
9. To define the major types of collaborative arrangements.
10. To describe what companies should consider when entering into arrangements with other companies.
11. To grasp what makes collaborative arrangements succeed or fail.
12. To see how companies can manage diverse collaborative arrangements.

23.1 Introduction

An international organization can only be considered as such under the Financial Regulation if the following criteria are met:

- It is international.
- It is a public sector organization.
- It is set up by inter-governmental agreements.

An organization with global mandates, are generally funded by contributions from national governments. Organization design, also known as organization structure, is the overall pattern of structural components and configurations used to manage the total organization.
Examples include the International Committee of the Red Cross, the International Organization for Migration, and United Nations agencies also called IO.

23.2 The nature of international organization structure

1. A firm, through its design, allocates organizational resources, assigns tasks to its employees, instructs those employees concerning the firm's rules, procedures, and expectations about their job performances, and collects and transmits information necessary for problem solving and decision-making.
2. There is no single best structure for all organizations, rather organizations should select a design that fits with their situations. Factors affecting the selection of organization design include size, strategy, technology, environment, and cultures of the countries in which it operates. The text provides examples of why Procter and Gamble and Black & Decker have selected their organization designs.
3. Organization design is an ongoing process that reflects the changes in a firm's strategy.
4. Organization design changes as a firm expands internationally. At their start, many firms do not consider international markets in their strategies, and may in fact make their initial entrance to foreign markets through indirect exporting. As indirect export sales grow, however, firms begin to consider pursuing opportunities in new markets. The text provides an example of how O.I. International went through this process.
5. The corollary approach: An initial response to international markets may be through the corollary approach whereby a firm delegates responsibility for processing international orders to individuals within an existing department, such as finance or marketing.
6. The export department: As export sales grow, firms may form a separate export department which takes responsibility for overseeing international operations, marketing products, processing orders, working with foreign distributors, and arranging financing when necessary. Eventually, the department may hold a similar status to other functional areas.

23.3 Global organization structure

1. A firm's international division is typically abandoned in favor of a global organization design as a firm moves from being domestically oriented with international sales to being a multinational corporation. A global design must enable a firm to integrate three types of knowledge: area, product, and functional.
2. A firm will usually select one of five common global organization designs (product, area, functional, customer, or matrix) depending on its situation in the market, its firm-specific advantages, and its managerial philosophy. Each of the design types typically emphasize on one type of knowledge (area, product, and/or functional), and thus

reflects a company's weighting of the importance of each.

23.4 Related issues in global organization structure

Not only must firms select an appropriate organization design, but they must also contend with issues related to centralization versus decentralization, the role of subsidiary boards of directors, and coordination issues among the firm's various operations.

1. **Centralization versus Decentralization**

   One critical decision a MNC must make when designing its organization is the level of autonomy, power, and control it wants to give its subsidiaries. Because centralization and decentralization have both advantages and disadvantages, most MNCs use a blend of the two forms of organization.

2. **Role of Subsidiary Boards of Directors**

   In most countries, each corporation, including a wholly owned subsidiary of a foreign MNC, is required to have a board of directors. A key decision facing MNCs is whether to view the creation of the subsidiary board of directors as a pro forma exercise or whether to empower the board with substantial decision-making authority.

- The advantage of empowering the board is that it promotes decentralization, giving foreign subsidiaries the ability to respond to changes in the environment quickly. A second advantage of decentralization is that the active board can act as accountability and reporting link to the parent. In addition, if prominent local citizens are appointed to the board, they may facilitate business in that country. The text notes that Apple was able to increase its credibility in the Japanese market through the appointment of several prominent local executives to the board of directors.
- Empowering a subsidiary's board of directors is not without disadvantages, however. For example, the subsidiary may become too independent if its board has too much autonomy and fails to maintain accountability to the parent.
- A subsidiary board is considered to be most useful when the subsidiary has a great deal of autonomy, has its own self-contained management structure, and has a business identity separate from the parent's.

3. **Coordination in the Global Organization**

   - A final step in creating an effective organizational design is addressing the issue of coordination. Coordination is defined to be the process of linking and integrating functions and activities of different groups, units, or divisions. The amount of coordination necessary is a function of the degree of interdependence among the firm's divisions and functions.

- There are three levels of interdependence. The highest coordination needs are found in organizations that have reciprocal interdependence (each division or activity is dependent on all other divisions or activities because work flows back and forth between divisions in a reciprocal manner).
- Moderate coordination needs are characterized by sequential interdependence (each division or activity is dependent on only some of the others because work flows between divisions in a one-way or sequential fashion).
- Finally, organizations that have a lower need for coordination have pooled interdependence (each division or activity functions with relatively little dependence on the others because it does its own work and its results are pooled with those at the corporate level).
- MNCs can use a variety of strategies to achieve their desired level of coordination including the organizational hierarchy and temporary or ad hoc coordination techniques such as using employees in liaison roles, task forces, or informal management networks. The text provides examples of each type of strategy. An informal management network is a group of managers from different parts of the world who are connected to one another in some way. These networks are effective because they can avoid the delays that might arise from bureaucracy, and allow firms to get things done more quickly and effectively.

23.5 Control aspects of international business

No organization can accomplish its goals without proper control. The imperative of organizational control is heightened when firms cross national borders and expand into unfamiliar foreign markets. This topic is all about how international operations and foreign subsidiaries are controlled. We first look at various control mechanisms and discuss, in detail, three approaches to control. The cultural aspects of multinational company (MNC) control, which is effective in dealing with the uncertainty and complexity of the international market, are elaborated. Finally, within the context of the historical evolution of the international environment, the corresponding MNC coordination and control mechanisms are summarized. There are differences between the control of an MNC and that of a domestic firm. These differences are due to the complexity and uncertainties surrounding the MNC environment, with a resulting potential for difficulty. The relationship with the host government creates additional problems. Following a discussion of control problems of MNCs, the influence of host government actions on MNC control is analyzed.

Control is the process of monitoring ongoing performance and making necessary changes to keep the organization moving toward its performance goals. Control can be implemented at the strategic, organizational, and operational levels.

1. **Strategic Control**

Strategic control is intended to monitor both how well an international business formulates its strategy and how well it goes about implementing it. Strategic control allows a company to see how effectively it is achieving its goals and whether it is maintaining its desired strategic alignment with its environment. The text provides an example of how Tyco used strategic control to assess its purchase of Matchbox. Strategic control may also affect a company's decisions regarding foreign market entry and expansion. The text point out that Unilever is using strategic control to assess its opportunities in India. Control is particularly important when it comes to a company's financial resources. A lack of control in the area can be detrimental to a firm's competitiveness. In fact, the text notes that it was poor financial control that led to man trust's difficulties after it bought Van Camp Seafood. A special managerial position may be created to handle financial control. The position is usually called a controller. A primary responsibility of an international controller is managing the inventory of various currencies necessary for the smooth functioning of the company's operations. In some cases, management of exchange rate fluctuations is centralized at the corporate parent level, while in other cases it is decentralized to the subsidiary level. Information networks are a critical means of supplying controllers with relevant, current, and accurate information. Strategic control is also important in joint ventures and strategic alliances. In most cases, an independent control system is developed for each joint venture or strategic alliance.

2. **Organizational Control**

Organizational control focuses on the design of the organization itself. It is important to recognize that a firm's design may change as its situation (internal and external environment) changes. Responsibility center control is the most common type of organizational control system. The system, a decentralized one, involves identifying fundamental responsibility centers within an organization such as SBUs. Individual centers are then evaluated on how well they meet their goals. The text provides an example of how Nestle uses responsibility center control. Some businesses use generic organizational control. This type of control is most frequently used when a firm pursues similar strategies in each market where it competes. Since there is no strategic variation between markets, control is centralized at headquarters, and the control systems used are the same for each unit. The text illustrates this concept with an example of United Distillers PLC's control system. Under the planning process control approach, which can be used in combination with either responsibility center or generic controls, firms concentrate their organizational control systems on the actual mechanics and processes they use to develop strategic plans. The focus is on the process rather than on the outcomes. The text points out that Northern Telecom uses planning process control. Organizational control must be addressed at multiple levels. Not only must the appropriate form of organization design be adopted for the entire organization, but each subsidiary or operating unit must also be organized appropriately.

3. Operations Control

Operations control focuses specifically on operating processes and systems within an organization, as well as its individual subsidiaries and operating units. Operations control generally focuses on relatively short periods of time, and is typically more specific and focused than strategic or organizational control systems.

23.6 Managing the Control Function in International Business Establishing International Control Systems

Control systems in international business are established through four basic steps. The steps are applicable to any area and any level of control.

1. **Set Control Standards for Performance**. The first step in establishing a control system is defining relevant control standards defined here to be a target or desired level of the performance component that the organization is attempting to control. Control standards should be objective and consistent with the goals of the company.
2. **Measure Actual Performance.** The second step in establishing a control system is to develop a valid measure of the performance component being controlled.
3. **Compare Performance Against Standards**. Step three in the process of establishing a control system is to compare measured performance (obtained in step two) against the original control standards (specified in step one). Depending on how well-defined control standards and performance measures are, this step may be fairly simple or fairly complicated.
4. **Responding to Deviations**. The last step in the process is responding to deviations that are observed in step three. The three possible outcomes of this comparison are: the control standard was met, the control standard was not met; and the control standard was exceeded. Responses will vary depending on which situation has occurred.

23.7 Essential Control Techniques

There are some essential control techniques which are as follow:

1. **Accounting Systems.** Accounting is a comprehensive system for collecting, analyzing, and communicating information about an organization's financial resources. Because accounting procedures are heavily regulated, comparisons between the financial performances of firms within a given country are easy. International companies, however, must frequently deal with situations in which the accounting standards and procedures in one country are incompatible with those in another country. Not only must an MNC translate the accounting records of each subsidiary into the parent company's currency using the parent company's accounting procedures, but an MNC must also decide whether subsidiaries will be evaluated on the basis of their accounting practices or those of the MNC.
2. **Procedures**. Most firms use a variety of procedures to maintain effective control. Moreover, procedures may be changed in some cases, as is illustrated with the example of the Ford/Firestone tire recall.
3. **Performance Ratios**. Performance ratios such as inventory turnover are also commonly used by international businesses. The text notes that British Airways uses performance ratios to maintain control of its airline operations.

23.9 Behavior Aspects of International Control

Human behavior plays a role in the effectiveness of control systems. For example, some people resist control.

23.9.1 **Resistance to Control**. Control may be resisted for several reasons. For example, most people will resist over control (when an organization tries to exert more control over individuals than they think is appropriate).

23.9.2 People may also resist control if they feel that it is not focused appropriately. For example, they may feel that the organization is inadvertently trying to control the wrong things.

23.9.3 Finally, people may resist control because it increases their accountability.

23.10 Overcoming Resistance to Control

Resistance to control can be minimized in several ways depending on the culture in question. First, if the employees who are going to be affected by new controls are allowed to participate in the planning and implementation of the system, they will be less likely to resist it. Second, control systems should be developed with an appropriate focus and reasonable accountability. Third, diagnostic mechanisms for addressing unacceptable deviations should be developed. Finally, companies may try to alter behavior variations associated with national culture by hiring individuals that will fit into the company's corporate culture and by providing management development programs that impart the company's corporate culture.

23.11 Cultural Aspects of international control

Culture is the most effective control mechanism. Societies effectively manage and control their people by devising cultural controls. Through the socialization process, members internalize the values and norms of society, which become the criteria for judging behavior. The internalized values are also strong motivating forces that induce people to behave according to society's expectations. Organizations employ culture and socialization for control purposes too. Because MNCs operate in culturally diverse environments, the challenge, however, is to build a control system that capitalizes on the synergy of cultural diversity. Corporate socialization could be described as the process by which members learn what behaviors and perspectives are customary and desirable in the work environment. Through the corporate socialization process, new members "learn the ropes" and are indoctrinated with the basic goals of the organization, the preferred means of goal achievement, the responsibilities of the members, the behavior pattern required for effective performance, and the rules for the maintenance of corporate identity and integrity. Corporate socialization takes place through a combination of obvious and subtle means. The obvious means of corporate socialization include job rotation, management development programs, and informal company-sponsored events. Of course, the corporate reward and compensation system is an obvious and powerful tool for shaping employee behavior and promoting the socialization process.

23.12 Additional control problems of MNC's

In addition to the control problems associated with managing dispersed subsidiaries in economically and politically diverse environments, MNCs also encounter several other specific control problems:

1. Language and cultural differences
2. Geographic distance between the headquarters and subsidiaries
3. Legal differences

4. Security issues
5. Currency exchange rate fluctuations

1. Language and Cultural Differences

Diversity in language and culture among various foreign operations is the source of many of the difficulties the MNCs' headquarters encountered. Some of the problems can be reduced by assigning expatriates who are "acculturated" at headquarters to key managerial positions in the subsidiaries and identifying local managers who are proficient in the language of the headquarters. Typically, however, most staff at headquarters have limited or no foreign language skills, and the language problem remains real. The result is that communication between most of the headquarters' staff and foreign subsidiaries is limited to contacts with those subsidiary personnel who can speak the language of the headquarters. This reality reduces the amount of information the headquarters staff receives and processes. Without the ability to directly reach the sources of most information, they are at the mercy of subsidiary staff who have language skills or interpreters. This problem is magnified if several languages are spoken by the local workforce. Such is the case in Africa and India. Even in European countries, which employ a large number of guest workers, control problems arise from the linguistic variety. Language diversity often creates fewer strategic and more operational control problems. In part, it is typical for upper-level managers to be involved in strategic control, and there is a higher level of foreign language proficiency among this group of managers. In contrast, there are two reasons why language diversity creates problems in operational control, particularly in developing countries.

2. Geographical Distance

Telecommunication technologies and improvements in transportation facilities have greatly aided the expansion of MNC operations. Vast geographical distances between the MNCs' subsidiaries, however, pose control problems that even today's modern telecommunications and ease of travel have not been able to fully overcome. Nothing can substitute for face-to-face communication and personal visits. Written communication, telephone calls, and voice and computer messages are not the same as personal visits. Often, to travel from headquarters and visit a foreign subsidiary takes at least a couple of days and much advance preparation. Distance matters even within a host country. When an MNC has a number of business operations in a country, the physical distances between them can have a negative influence on the ease with which headquarters manages them. In some cases, this added travel time permits host country staff to rig personal visits by headquarters to show a different and rosier picture of the operations.

3. Legal Differences

Although a whole chapter is devoted to the legal aspects of international management, here we briefly examine some major legal problems with MNC control. Laws and legal procedures are central to the concept of organizational control. The control of a business firm depends on the legal institution and practices of the host country. The practices that legally are accepted or rejected in one country are not necessarily honored or rejected by another. An MNC's control of foreign subsidiaries can take place only with in the confines of the legally accepted business norms of host countries. In effect, a host country's legal system may place limitations on the control that headquarters can exercise. The host country's legal requirements in virtually all aspects of business operations, including labor relations, finance, marketing, and manufacturing, limit MNCs' control over subsidiaries. Some countries limits the equity ownership of domestic firms by MNCs. Equity ownership limits are more common among developing countries. In these countries, instead of direct control over the operations of the subsidiary, MNCs may assume the minority position and may have to rely on advice and persuasion.

4. Security Issues

Most nations have benefited from globalization. However, increased international trade; the information explosion, including the use of the Internet; and increased immigration have also made it easier for various groups to engage in terrorism. Terrorism adversely affects international business and poses serious questions regarding control of MNC operations. For a long time, developing countries had certain concerns over the loss of control to MNCs. Now, developed countries are facing a similar dilemma, albeit of a different nature. Europeans and especially Americans are uneasy about, if not completely against, handing over to foreigners the management of firms they consider either national jewels or subject to security concerns. A number of European countries, for example, have blocked the takeover of local firms even by MNCs from other European countries. The issue of national security as it relates to increased acts of terrorism has become a very sensitive and important matter in the United States after the tragedy of September 11, 2001. Experts have been sounding alarms about securing the nation's borders and particularly its ports. The national security issue of MNCs' control can be viewed from the perspectives of economic benefits and less favored nations. First, from the economic benefits point of view, control of MNC operations grants decision-making authority and, ultimately, distribution and the use of revenues. Previously, this aspect of control was thought to be directly related to ownership rights. This assumption, however, proved to be less critical when it was tested against the sovereign power and rights of host governments. Developing countries learned that even without ownership rights, they could use their sovereignty to achieve their strategic goals. The rise of international terrorism has made the control of MNC operations a national security issue. International terrorism has negatively affected the operations of all MNCs. Some MNCs, however, have been more severely affected. With or without merit, MNCs with their headquarters or owners in certain countries have been negatively affected by this issue. From this perspective, certain MNCs should not be granted the opportunity to manage and control business enterprises, if such operations pose national security concerns. An example of this type of control feature was underlined when the sale of the laptop computer division of IBM went through a very rigorous examination by the U.S. Congress. Another example was the case of DPW.

5. **Currency exchange rate fluctuations:** A market-based exchange rate will change whenever the values of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply (this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency). Increased demand for a currency can be due to either an increased transaction demand for money or an increased speculative demand for money. The transaction demand is highly correlated to a country's level of business activity, gross domestic product (GDP), and employment levels. The more people that are unemployed, the less the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions. Speculative demand is much harder for central banks to accommodate, which they influence by adjusting interest rates. A speculator may buy a currency if the return (that is the interest rate) is high enough.

6. **Intra firm business transactions (transfer pricing):** Firms can use various strategies for entering into foreign markets, including exports, contractual agreements, and direct investment. An export-oriented firm is dominated by product flows from the home country to foreign markets. The flow of capital from the home country to host countries characterizes firms using investment as an entry strategy. Knowledge

flows from MNCs to host countries through licensing and contractual agreements. In some countries, MNCs cannot fully exercise their property rights. Various host government restrictions imposed on the MNCs limit the free flow of resources among subsidiaries. When repatriation of profits is restricted by host governments, for example, control and exercise of property rights on corporate earnings are limited. Some countries go even further and establish production and export requirements for MNCs, which effectively curtail operational control over their subsidiaries. China, for example, requires most MNCs to export a significant portion of their production that takes place in China.

23.12 Summary

An effective system is essential for the successful management and operation of any organization. Control in a multinational company is relatively more complex compared to domestic business. Unlike domestic operations, a foreign subsidiary. It cannot have requirements that are dictated by the local/host country or are specific to the dominant multinational company. An effective control system for a multinational company involves adapting to local conditions and adapting to the host country environment. There should be a sense of accountability towards them. For the top management of any multinational company, devising a control system that aligns with the situations of all corporate counterparts is a challenging task. This system should be beneficial for all associates. In other words, if the associates understand the strategic process and are appropriately integrated into the control system, they will readily accept it.

23.13 Glossary

Strategic Control: This involves assessing how effectively goals can be achieved and the extent of strategic alignment with the environment.
Accounting Method: Through this accounting method, information regarding the organization's financial resources is collected and analyzed.

23.14 Check your progress

Multiple Choice Questions -

1. An organization's strategic process involves -
(a) Long-term impact on production and efficiency
(b) Being similar to a flexible strategy

(c) Achieving various objectives, including cost-related ones
(d) How resources are to be converted into goods and services
(e)All of the above are true

2.Which of the following are characteristic of a process control system?
(a) Possession of sensitivity
(b) Computer analysis of digitized data to obtain feedback
(c) Sensitive evaluation on a periodic basis
(d) All of the above

23.15 Answers to check your progress

1. (e) 2. (d)

23.16 Terminal questions

13. Explain the primary effects of international activities on the organizational structure.
14. What is the global production structure? Outline its advantages and weaknesses.
15. What is the difference between the control processes of a local entity and a multinational company?
16. Describe the various control techniques used by multinational companies.
17. Why is the control system a key managerial function in international business?

23.17 Suggest readings

1. Sundaram, Anant K. and J. Stewart Black, The International Business Environment: Text and Cases, Prentice Hall of India Pvt. Ltd., New Delhi.
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UNIT 24 Skills and Management of International Collaborative Arrangements

Unit Outline

Objective

After studying this unit, you will be able to:
•Explain the objectives of the collaborative management system.
•Describe the types of collaborative management systems.
•Explain the problems associated with the collaborative management system.

24.1 Introduction

When forming objectives and implementing strategies in a variety of country environments, firms must either handle international business operations on their own or collaborate with other companies. Although exporting is usually the preferred alternative since it allows firms to produce in their home countries, participating in some markets may require using a variety of other equity and non-equity arrangements. These can range from wholly owned operations to partially owned subsidiaries, joint ventures, equity alliances, licensing, franchising, management contracts, and turnkey operations.

24.2 Motives for collaborative arrangement

Each participant in a collaborative arrangement has its own basic objectives for operating internationally as well as its own motives for collaborating with a partner.

A. Motives for Collaborative Arrangements: General

Companies collaborate with other firms in either their domestic or foreign operations in order to spread and reduce costs, to specialize in particular competencies, to avoid or counter competition, to secure vertical and/or horizontal linkages and to learn from other companies.

1. **Spread and Reduce Costs.** When the volume of business is small, or one partner has excess capacity, it may be less expensive to collaborate with another firm. Nonetheless, the costs of negotiation and technology transfer must not be overlooked.
2. **Specialize in Competencies.** The resource-based view of the firm

holds that each firm has a unique combination of competencies. Thus, a firm can maximize its performance by concentrating on those activities that best fit its competencies and relying on partners to supply other products, services, or support activities.

3. **Avoid or Counter Competition.** When markets are not large enough for numerous competitors, or when firms need to confront a market leader, they may band together in ways to avoid competing with one another or combine resources to increase their market presence.
4. **Secure Vertical and Horizontal Links.** If a firm lacks the competence and/or resources to own and manage all of the activities of the value-added chain, a collaborative arrangement may yield greater vertical access and control. At the horizontal level, economies of scope in distribution, a better smoothing of sales and earnings through diversification and an ability to pursue projects too large for any single firm can all be realized through collaboration.
5. **Gain Knowledge.** Many firms pursue collaborative arrangements in order to learn about their partners' technology, operating methods, or home markets and thus broaden their own competencies and competitiveness over time.

B. International Motives for Collaborative Arrangements

Companies collaborate with other firms in their foreign operations in order to gain location-specific assets, overcome legal constraints, diversify geographically and minimize their exposure in high-risk environments.

1. **Gain Location-Specific Assets.** Cultural, political, competitive, and economic differences among countries create challenges for companies that operate abroad. To overcome such barriers and gain access to location- specific assets (e.g., distribution access or a competent workforce), firms may pursue collaborative arrangements.
2. **Overcome Governmental Constraints.** Countries may prohibit or limit the participation of foreign firms in certain industries, or discriminate against foreign firms via tax rates and profit repatriation. Firms may be able to overcome such barriers via collaboration with a local partner.
3. **Diversify Geographically.** By operating in a variety of countries, a firm can smooth its sales and earnings; collaborative arrangements may also offer a faster initial means of entering multiple markets or establishing multiple

sources of supply.

4. **Minimize Exposure in Risky Environments.** The higher the risk managers perceive with respect to a foreign operation, the greater their desire to form a collaborative arrangement.

24.3 Types of collaborative arrangements

While collaborative arrangements allow for a greater spreading of assets across countries, the various types of arrangements necessitate trade-offs among objectives. Finding a desirable partner can be problematic. A firm has a wider choice of operating forms and partners when there is less likelihood of competition and when it has a desired, unique, difficult-to-duplicate resource.

A. Some Considerations in Collaborative Arrangements

Two critical variables that influence the choice of collaborative arrangement are a firm's desire for control over its foreign operations and its prior expansion into foreign ventures.

1. **Control.** The loss of control over flexibility, revenues and competition is a critical variable in the selection of forms of foreign operation. The more a firm depends on collaborative arrangements, the more likely its control will be lessened over decisions regarding quality, new product directions and production expansion.
2. **Prior Expansion of the Company.** If a firm already owns and controls operations in a foreign country, the advantages of collaboration may not be as attractive as otherwise.

B. Licensing

Under a licensing agreement, a firm (the licensor) grants rights to intangible property to another company (the licensee) to use in a specified geographic area for a specified period of time; in exchange, the licensee ordinarily pays a royalty to the licensor. Such rights may be exclusive or nonexclusive. Usually the licensor is obliged to furnish technical information and assistance, while the licensee is obliged to exploit the rights effectively and pay compensation to the licensor. Intangible property may be classified as:

- patents, inventions, formulas, processes, designs, patterns
- copyrights for literary, musical, or artistic compositions
- trademarks, trade names, brand names
- franchises, licenses, contracts

- methods, programs, procedures, systems.

1. **Major Motives for Licensing.** Licensing often has an economic motive, such as the desire for faster start-up, lower costs, or access to additional property rights (e.g., technology). For the licensor, the risks and costs of a given venture are lessened; for the licensee, costs are less than if it had to develop a product or process on its own. Cross-licensing represents the situation in which companies in various countries exchange technology rather than compete with each other with every product in every market.
2. **Payment.** The amount and type of payment for licensing arrangements may vary. Each contract tends to be negotiated on its own merits; the bargaining range is based on dual expectations. Both agreement-specific and environment-specific factors may affect the value of a license.
3. **Sales to Controlled Entities.** Many licenses are given to firms owned in part or in whole by the licensor. From a legal standpoint, subsidiaries are separate companies; thus, a license may be required in order to transfer intangible property.

B. Franchising

Franchising represents a specialized form of licensing in which the franchisor not only sells an independent franchisee the use of the intangible property essential to the franchisee's business, but also operationally assists the business on a continuing basis. In a sense, the two partners act like a vertically integrated firm because they are interdependent and each produces a part of the product that ultimately reaches the customer.

1. **Organization of Franchising.** A franchisor may penetrate a foreign country by dealing directly with its foreign franchisees, or by setting up a master franchise and giving that organization the right to open outlets on its own or to develop sub-franchises in the country or region.
2. **Operational Modifications.** Franchise success is derived from three factors: product standardization, effective cost control and high recognition. Nonetheless, franchisors face a classic dilemma: the more they standardize on a global basis, the lower the potential for product acceptance in a given country; the more they permit adaptation to local conditions, the less the franchiso*r* can offer the franchisee, the higher the costs and the less the control by the franchisor.

C. Management Contracts

A management contract represents an arrangement in which one firm provides management personnel to perform general or specialized functions to another firm for a fee. A firm usually pursues such contracts when it believes a partner can manage certain operations more efficiently and effectively than it can itself.

D. Turnkey Operations

Turnkey operations represent a type of collaborative arrangement in which one firm contract with another to build complete, ready-to-operate facilities. Usually, suppliers of turnkey facilities are industrial-equipment and construction companies; projects may cost billions of dollars; customers most often are government agencies or large MNEs.

E. Joint Ventures

A joint venture represents a direct investment in which two or more partners share ownership. As a firm's share of the equity declines, its ability to control a given operation also declines. A consortium represents the joining together of several entities (e.g., companies and governments) to combine resources and/or to strengthen the possibility of pursuing a major undertaking. Other forms of joint ventures include:

- Two companies from the same country joining together in a foreign market, such as NEC and Mitsubishi (Japan) in the United Kingdom.
- A foreign company joining with a local company, such as Great Lakes Chemical (U.S.) and A. H. Al Zamil in Saudi Arabia.
- Companies from two or more countries establishing a joint venture in a third country, such as that of Diamond Shamrock (U.S.) and Sol Petroleo (Argentina) in Bolivia.
- A private company and a local government forming a joint venture (sometimes called a mixed venture), such as that of Philips (Dutch) with the Indonesian government.
- A private company joining a government-owned company in a third country, such as BP Amoco (private British-U.S.) and Eni (government-owned Italian) in Egypt.

F. Equity Alliances

An equity alliance represents a collaborative arrangement in which at least one of the collaborating firms takes an ownership position (usually a minority) in the other(s). The purpose of an equity alliance is to solidify a collaborating contract, thus making it more difficult to break.

24.4 Problems of collaborative arrangements

Dissatisfaction with the results of collaboration can cause an arrangement to break down. Problems arise for a number of reasons.

1. **Collaboration's Importance to Partners**

   One partner may give more attention to the collaboration than the other often because of a difference in size. An active partner will blame the less active partner for its lack of attention, while the less active partner will blame the other for poor decisions.

2. **Differing Objectives**

   Although firms may enter into collaborative arrangements with complementary capabilities and objectives, their views regarding such things as reinvestment vs. profit repatriation and desirable performance standards may evolve quite differently over time.

3. **Control Problems**

   When no single party has control of a collaborative arrangement, the venture may lack direction; if one party dominates, it must still consider the interests of the other. By sharing assets with another firm, a company may lose some control over the extent and/or quality of the assets' use. Further, even when control is ceded to one of the partners, both may be held responsible for problems.

4. **Partners' Contributions and Appropriations**

   One partner's ability to contribute technology, capital and other assets may diminish (at least on a relative basis) over time. Further, in almost all collaborations the danger exists that one partner will use the others' contributed assets, or take more than its fair share from the operation, thus enabling it to become a direct competitor. Such weaknesses may cause a drag on a venture and even lead to the dissolution of the agreement.

5. **Differences in Culture**

   Differences in both national and corporate cultures may cause problems with collaborative arrangements, especially joint ventures. Firms differ by nationality in terms of how they evaluate the success of an operation (e.g., profitability, strategic market position and/or social objectives). Nonetheless, joint ventures from culturally distant countries tend to survive at least as well as those between partners from similar cultures.

24.5 Managing foreign arrangements

As a collaborative arrangement evolves, partners need to reassess certain decisions in light of their resource bases and external environmental changes.

1. Dynamics of Collaborative Arrangements

The evolutionary costs of a firm's foreign operations may be very high as it switches from one operational mode to another, especially if it must pay termination fees. Thus, a firm must develop the means to evaluate performance by separating the controllable and uncontrollable factors at its various profit centers.

2. Finding Compatible Partners

A firm may actively seek a partner for its foreign operations, or it can react to a proposal from another company to collaborate with it. Potential partners should be evaluated both for the resources they can offer and their willingness to work together. The proven ability to handle similar types of collaboration is a key professional qualification.

1. **Negotiating Process**

   Certain technology transfer considerations are unique to collaborative arrangements; often pre-agreements are set up to protect concerned parties. The secrecy of financial terms, especially when government authorities consult their counterparts in other countries, is an especially sensitive area. Market conditions may dictate the need for different terms in different countries.

2. **Contractual Provisions**

   To minimize potential points of disagreement, contract provisions should address the following factors:

   - Terminating the agreement if the parties do not adhere to the directives
   - Methods of testing for quality
   - Geographical limitations on the asset's use
   - Which company will manage which parts of the operation outlined to the agreement?
   - What each company's a future commitment will be?
   - How each company will buy from, sell to, or use intangible assets that come from the collaborative arrangement?

5. Performance Assessment

All parties should establish mutual goals so all involved understand what is expected, and a contract should spell out expectations. In addition to the continuing assessment of the venture's performance, a firm should also periodically assess the possible need for a change in the type of collaboration.

24.6 Summary

An effective control system is needed to manage an organization successfully. In MNCs, control is a much more complex and demanding issue than it is in a domestic business. Unlike a domestic operation, a foreign subsidiary cannot, for long, subordinate its business requirements, which are often dictated by the host country, to those of the parent MNC. An effective MNC control system should allow for local adaptability and responsiveness to the host country environment. A challenging task for MNC top management is to build a control system that, while promoting the overall corporate competitive position, is beneficial to individual subsidiaries as well. In other words, if subsidiaries consider the strategy process and associated control system fair, they will accept it more readily. Subsidiaries' managers consider a corporate strategy more attractive when it includes interests important to the subsidiaries. Moreover, when subsidiaries' interests are not totally abandoned in favor of promoting corporate objectives, the strategy process will be considered to be fairer. This, in turn, provides greater incentive for compliance by the subsidiary and makes corporate control much easier. Of course, a fair strategy-making process has a built-in control mechanism that is also fair. Return on investment evaluations do not reflect the impact of decisions made by the headquarters for the benefit of the whole MNC's operation. Those decisions may have a negative impact on the subsidiary's earnings. Various control mechanisms and approaches used by domestic firms are applicable to MNCs. The diversity of the international environment, however, makes it more difficult to apply these controls. Effective MNC control employs a combination of formal, informal, direct, and indirect mechanisms to account for the uniqueness of each subsidiary while addressing the total MNC strategic and operational requirements.

24.7 Glossary

Licensing: Under a licensing agreement, an entity (licensor) grants another company or entity (licensee) the right to use intangible assets within a specific geographical area and for a specific period.

Franchising: Franchising is a specific type of licensing in which the franchisor grants the franchisee the right to use the intangible assets of its business.

24.8 Check your progress

Multiple Choice Question -

1. Which of the following is a key driver of globalization for business?

(a) High standard of living in the US and Europe

(b) Technology

(c) GATT trade agreement

(d) Increasing ethnic diversity among nations

(e) Improved political stability

2.Operational management applies to –

(a)Primarily the service sector

(b)Only services

(c)The major manufacturing sector

(d)Manufacturing and service sectors

(e)Only the manufacturing sector

24.9 Answers to check your progress

1. (b) 2. (d)

24.10 Terminal questions

Q 1 What are some of the initial impacts of international activity on organization design?

Q 2 What is the global product design? What are its strengths and weaknesses?

Q 3. What are the differences between the control processes of MNCs and domestic firms?

Q 4. Describe the various control mechanisms that MNCs could use.

Q 5. What control mechanisms work well for an integrated MNC?

Q6. Why is MNC control more difficult than the control of a domestic business?

Q7. Does geographical distance create any difficulty for the control of an MNC?

Q8. Why is control an important management function in international business?

24.11 Suggested readings

1 Sundaram, Anant K. and J. Stewart Black, The International

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