KARPAGAM ACADEMY OF HIGHER EDUCATION

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Department of Management

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Department: **Management**
Subject Code: 17**MBAPI401B** Semester: **IV** Year: **2017-19 Batch**
Subject: **International Economics - Lesson Plan**

UNIT 1			
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8	1	International Monetary Fund - objectives, functions and performance	T2:Page No:588-591, T3:Page No:394-403,
9	1	World Bank – objectives, functions and performance	T3:Page No:409- 421
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UNIT 5			
1	1	Foreign trade in India - Recent changes in the composition and direction of foreign trade	T2: Page No: 48-51 T3: Page No: 351-355
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3	1	World Trade Organisation and India - Export Promotion Measures	T2: Page No: 286-295 T3: Page No: 464-471
4	1	Export Promotion – Contribution of SEZ	W3
5	1	Partial and Full convertibility of Indian Rupees	T2: Page No: 550-558
6	1	Foreign Trade Policy 2009	T2: Page No: 238-259
7	1	Role of Multinational Corporations in India	T3: Page No: 390-393 T2: Page No:222-232
8	1	Recapitulation and discussion of Important questions	
Total Number of hours planned for Unit 5			**8**
9	1	Discussion of previous year ESE Question papers	
10	1	Discussion of previous year ESE Question papers	
11	1	Discussion of previous year ESE Question papers	
Total Number of hours planned for Unit 5 and discussion of previous year ESE Question papers			**8+3=11**

Suggested Readings:

Text books:

1. Kindleberger & Peter H. Lindert. (2009). *International Economics*. New Delhi: Macmillan Publication.

2. Paul Krugman., Maurice Obstfeld & Marc Melitz. (2011). *International Economics***.** New Delhi: Pearson Education

3. Jhingan, M. L. (2014).*International Economics.* New Delhi: Tata McGraw Hill

References:

1. Bo Sodersten & Geoferry Reed. (2007). *International Economics.* New Delhi: Macmillan Publication.

2. Salvatore. D. (2008). *International Economics.* Singapore: John Wiley & Sons

Website:

W_1: www.tutor2u.com

W_2: https://www.freeeconhelp.com

W_3: https://www.countryeconomy.com

W4: https://www.statisticstimes.com

UNIT-I - Introduction to International Trade

SYLLABUS

Introduction: International Economics - Meaning, Scope & Importance, Inter-regional and international trade, Importance of international trade. Theoretical Aspects of Economic Integration: Free Trade Area, Customs Union and Common Market - Theory of Customs Union - Trade Creation and Diversion effects.

INTRODUCTION TO INTERNATIONAL ECONOMICS

International Economics is a specialized branch of Economics focusing on the external trading relations of nations. Generally external trade involves the exchange of goods and services among nations crossing the national territories. Trade not only strengthens the economic interdependence among nations but promotes consumer welfare also by providing a variety of commodities. Since it involves several countries a different set of rules and regulations are necessary for the smooth functioning of the system. This is why international economics is treated as a separate branch of study.

Broadly the Scope of International Economics can be categorized into five broad groups.

1. International Trade Theory

It concentrates on the theoretical aspects of trade like reasons of trade, gains of trade etc. Different schools of theories are discussed in this section.

2. International Trade Policy

This area deals with the international rules and regulations regarding the flow of transactions. It includes various trade restrictions like tariffs, quotas, changes in exchange rates etc. The regulatory mechanisms and various international institutions for monitoring it are also come under this section.

3. Balance of Payment

With the progress of trade, nations have to make and receive payments. All these economic transactions of a nation with the rest of the world are systematically recorded in this account. The fluctuations in BOP and the associated policy regulations are also included in this section.

4. Balance of Payment Adjustments or Open Economy Macroeconomics

With the progress of transactions, sometimes either the credit or the debit may outweigh the other side. It will lead to imbalances in BOP. This situation is normally coined BOP disequilibrium which demands correction either automatically or externally imposed by the governments. The external repercussions are also brought into the study.

5. International Organizations

International trade is a complex activity involving multiple countries and currencies. Commodities and capital flow across countries. Hence it requires separate rules and regulations. It should be monitored by international level organizations also. All these aspects are monitored under the head global economic organizations.

The Difference between Inter Regional and International Trade

1. Factor Immobility:

The classical economists advocated a separate theory of international trade on the ground that factors of production are freely mobile within each region as between places and occupations and immobile between countries entering into international trade. Thus, labor and capital are regarded as immobile between countries while they are perfectly mobile within a country.

There is complete adjustment to wage differences and factor-price disparities within a country with quick and easy movement of labour and other factors from low return to high sectors. But no such movements are possible internationally. Price changes lead to movement of goods between countries rather than factors. The reasons for international immobility of labour are—difference in languages, customs, occupational skills, unwillingness to leave familiar surroundings, and family ties, the high travelling expenses to the foreign country, and restrictions imposed by the foreign country on labour immigration.

The international mobility of capital is restricted not by transport costs but by the difficulties of legal redress, political uncertainty, ignorance of the prospects of investment in a foreign country, imperfections of the banking system, instability of foreign currencies, mistrust of the foreigners, etc. Thus, widespread legal and other restrictions exist in the movement of labour and capital between countries. But such problems do not arise in the case of inter-regional trade.

2. Differences in Natural Resources:

Different countries are endowed with different types of natural resources. Hence they tend to specialise in production of those commodities in which they are richly endowed and trade them with others where such resources are scarce. In Australia, land is in abundance but labour and capital are relatively scarce. On the contrary, capital is relatively abundant and cheap in England while land is scarce and dear there.

Thus, commodities requiring more capital, such as manufactures, can be produced in England; while such commodities as wool, mutton, wheat, etc. requiring more land can be produced in Australia. Thus both countries can trade each other's commodities on the basis of comparative cost differences in the production of different commodities.

3. Geographical and Climatic Differences:

Every country cannot produce all the commodities due to geographical and climatic conditions, except at possibly prohibitive costs. For instance, Brazil has favourable climate geographical conditions for the production of coffee; Bangladesh for jute; Cuba for beet sugar; etc. So countries having climatic and geographical advantages specialise in the production of particular commodities and trade them with others.

4. Different Markets:

International markets are separated by difference in languages, usages, habits, tastes, fashions etc. Even the systems of weights and measures and pattern and styles in machinery and equipment differ from country to country. For instance, British railway engines and freight cars are basically different from those in France or in the United States.

Thus goods which may be traded within regions may not be sold in other countries. That is why, in great many cases, products to be sold in foreign countries are especially designed to confirm to the national characteristics of that country. Similarly, in India right-hand drive cars are used whereas in Europe and America left-hand driven cars are used.

5. Mobility of Goods:

There is also the difference in the mobility of goods between inter-regional and international markets. The mobility of goods within a country is restricted by only geographical distances and transportation costs. But there are many tariff and non-tariff barriers on the movement of goods between countries. Besides export and import duties, there are quotas, VES, exchange controls, export subsidies, dumping, etc. which restrict the mobility of goods at international plane.

6. Different Currencies: The principal difference between inter-regional and international trade lids in use of different currencies in foreign trade, but the same currency in domestic trade. Rupee is accepted throughout India from the North to the South and from the East to the West, but if we cross over to Nepal or Pakistan, we must convert our rupee into their rupee to buy goods and services there.

It is not the differences in currencies alone that are important in international trade, but changes in their relative values. Every time a change occurs in the value of one currency in terms of another, a number of economic problems arise. "Calculation and execution of monetary exchange transactions incidental to international trading constitute costs and risks of a kind that are not ordinarily involved in domestic trade."

Further, currencies of some countries like the American dollar, the British pound the Euro and Japanese yen, are more widely used in international transactions, while others are almost inconvertible. Such tendencies tend to create more economic problems at the international plane. Moreover, different countries follow different monetary and foreign exchange policies which affect the supply of exports or the demand for imports. "It is this difference in policies rather than the existence of different national currencies which distinguishes foreign trade from domestic trade," according to Kindleberger.

7. Problem of Balance of Payments:

Another important point which distinguishes international trade from inter-regional trade is the problem of balance of payments. The problem of balance of payments is perpetual in international trade while regions within a country have no such problem. This is because there is greater mobility of capital within regions than between countries.

Further, the policies which a country chooses to correct its disequilibrium in the balance of payments may give rise to a number of other problems. If it adopts deflation or devaluation or restrictions on imports or the movement of currency, they create further problems. But such problems do not arise in the case of inter-regional trade.

8. Different Transport Costs:

Trade between countries involves high transport costs as against inter- regionally within a country because of geographical distances between different countries.

9. Different Economic Environment:

Countries differ in their economic environment which affects their trade relations. The legal framework, institutional set-up, monetary, fiscal and commercial policies, factor endowments, production techniques, nature of products, etc. differ between countries. But there is no much difference in the economic environment within a country.

10. Different Political Groups:

A significant distinction between inter-regional and international trade is that all regions within a country belong to one political unit while different countries have different political units. Inter-regional trade is among people belonging to the same country even though they may differ on the basis of castes, creeds, religions, tastes or customs.

They have a sense of belonging to one nation and their loyalty to the region is secondary. The government is also interested more in the welfare of its nationals belonging to different regions. But in international trade there is no cohesion among nations and every country trades with other countries in its own interests and often to the detriment of others. As remarked by Friedrich List, "Domestic trade is among us, international trade is between us and them."

11. Different National Policies:

Another difference between inter-regional and international trade arises from the fact that policies relating to commerce, trade, taxation, etc. are the same within a country. But in international trade there are artificial barriers in the form of quotas, import duties, tariffs, exchange controls, etc. on the movement of goods and services from one country to another.

Sometimes, restrictions are more subtle. They take the form of elaborate custom procedures, packing requirements, etc. Such restrictions are not found in inter-regional trade to impede the flow of goods between regions. Under these circumstances, the internal economic policies relating to taxation, commerce, money, incomes, etc. would be different from what they would be under a policy of free trade.

Conclusion: Therefore, the classical economists asserted on the basis of the above arguments that international trade was fundamentally different from domestic or inter-regional trade. Hence, they evolved a separate theory for international trade based on the principle of comparative cost differences.

International trade

International trade is closely linked to development. Most fast growing economies also have a dynamic trade sector. When a firm or an individual buys a good or a service produced more cheaply abroad, living standards in both countries increase. There are other reasons consumers and firms buy abroad that also make them better off—the product may better fit their needs than similar domestic offerings or it may not be available domestically. In any case, the foreign producer also benefits by making more sales than it could selling solely in its own market and by earning foreign exchange (currency) that can be used by itself or others in the country to purchase foreign-made products. The gains(importance) of trade is generally reflected in the following manner.

Acquisition of Capital Goods Industries:

The under-developed countries (UDCs) are enabled by foreign trade to obtain in exchange for their goods capital equipment and heavy engineering machines to foster their countries' economic development. For example, India exports spices, cotton and cotton textiles, marine products, gems and jewellery and in exchange we import heavy machinery, defense equipments, and other capital equipment from the developed countries.

Market Extension

The foreign trade can extend the scope of the business to the international market. The domestic market is limited; the foreign trade sector opens new vistas, new marketing channels and new markets. When the markets are extended, the economies of scale are reaped; the efficiency and productivity will increase. Accordingly, the forces of development will set themselves in motion.

Foreign Investment:

The foreign trade is also helpful in attracting foreign investment. The foreign investors are attracted towards active trading countries and invest in the form of capital goods and technical expertise. In this way, the assembling plants, the manufacturing plants and the latest technology will come into the country. Foreign Direct Investments and off shoring will stimulate the economic climate of a nation.

National Income:

When there is imports and exports of goods and services, the government can earn the revenue in form of tariffs, custom duty, import license fees, etc.

Employment Opportunities:

Moreover, the external sector also opens the employment opportunities for the country-men in the foreign countries. Hundreds of thousands of Indians are working abroad. India is earning billions of dollars through foreign exchange remittances and stands in the second position just behind China. Therefore, such remittances are proved to be a major source of foreign exchange earnings.

ROLE AND IMPORTANCE OF INTERNATIONAL TRADE

International trade plays an important role in countries growth and development. The area like Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders. There are some important roles given below:

1. Boost Economic Development: Trade can help boost development and reduce poverty by generating growth through increased commercial opportunities and investment, as well as broadening the productive base through private sector development.

2. Enhances Competitiveness: Trade enhances competitiveness by helping developing countries reduce the cost of inputs, acquire finance through investments, increase the value added of their products and move up the global value chain.

3. Export Diversification: Trade facilitates export diversification by allowing developing countries to access new markets and new materials which open up new production possibilities.

4. Encourages Innovation: Trade encourages innovation by facilitating exchange of knowhow, technology and investment in research and development, including through foreign direct investment.

5. Expand Business Opportunities: Trade openness expands business opportunities for local companies by opening up new markets, removing unnecessary barriers and making it easier for them to export.

6. Expand Choice: Trade expands choice and lowers prices for consumers by broadening supply sources of goods and services and strengthening competition.

7. Improvement of Quality: Trade plays a role in the improvement of quality, labour and environmental standards through increased competition and the exchange of best practices between trade partners, building capacity in industry and product standards.

8. Cutting Government Spending: Trade contributes to cutting government spending by expanding supply sources of goods and services and strengthening competition for government procurement.

9. Strengthen Ties Between the Nations: Trade strengthens ties between nations by bringing people together in peaceful and mutually beneficial exchanges and as such contributes to peace and stability.

ADVANTAGES OF INTERNATIONAL TRADE

The fundamental reason for international trade is to sell something that we don't need and to buy something we do need. Trade creates jobs, attracts investments, attracts new technology and materials, and offers wider choice in products and services. The main advantage of international trade is as follows:

1. Meeting Nation's Need: Trade is always balanced if it is fair. If two people trade baseball cards and one gives another 6 cards, they should get 6 back. Many businesses can create a surplus inventory of goods and services. Many nation farms produce more food than they can eat, manufacturers make more products than they use, and service providers can provide service to other countries.

Some nation cannot produce fruits like bananas and oranges and many other products in their own nation and these products are imported. Both trading partners nation get something they need by trading something they don't need.

2. Job Creation: Unlike the battering that used to go on between trading partners, now businesses receive money from selling their products or services to foreign businesses. When foreign businesses buy Indian products it creates jobs for Indians. Exports are very important for international trading partner because it increases the flow of funds to the nations and creates job opportunities. When trade is balanced, businesses remain profitable and may grow faster.

3. Attracting Investment: Investment follows trade. Many foreign companies will invest in an office, factory, or distribution warehouse to simplify their trade and reduce cost. This investment also creates more jobs. It also attracts international investors.

4. New Technology and Materials: New technology promotes competitiveness and profitability. If a business could create a machine that works better, faster, or cheaper (or all three), then the business will have to produce a more competitive product for national and international markets.

5. Diverse Products and Services: A century ago, many products were considered a rare treat; people put them in stockings for children. Now, we can buy these products at local grocery stores thanks to better preservation and trading technologies. Foreign trade turns the world into a giant market, delivering food, fashions, etc.

6. Transfer of Knowledge and Technology: According to the Adam Smith International trade leads an additional benefit namely that it transfers knowledge and technology between different nations. The adoption and use of new production techniques lead to productivity growth and thus, to economic development and an increase in wealth. For example, China already has a large domestic market and would therefore primarily gain from open trade with Europe by getting access to its technology rather than by widening its market

New services such as banking, travel, and consultation are also available now. Business competition is no longer on a city scale; instead, businesses compete against worldwide businesses. The result is better quality goods, lower prices and functional design.

DISADVANTAGES OF INTERNATIONAL TRADE

The Global market has made it easy to buy and sell international goods. While this has benefits, it also presents a problem. Such trade can cause countries to be prosperous for a short time, but leads to economic exploitation, loss of cultural identity and even physical harm.

1. Support of Non-democratic Systems: Great hardship can be caused when people make poor decisions about land use or surplus production for export and do not take the general population's welfare into consideration. For example: Landowners in many nations want farmers to grow coffee beans because it is a very profitable cash crop, however, the farmers would like to use the land to grow more food for their families. The farmer's wishes are ignored because they do not actually own the land.

2. Cultural Identity Issues: Culture is a major export in the world. It displays and promotes values and lifestyles worldwide. The "culture consumer" in other countries is sometimes overwhelmed by developed nation's ideas. Products also carry cultural ideas and messages. There are values of the culture that make the product. For example: Coca-Cola, McDonalds, Nike, and Microsoft all sell products that symbolize American values and symbolize and reflect American corporate culture.

3. Social Welfare Issues: Maintaining safety standards, minimum wages, worker's compensation and health benefits are all social welfare issues that cost business money. If a running shoe is made in a country where these issues are not met then the shoe can be sold for less in other nation. The downside to this is that substandard safety conditions cause death and injury in the workplace.

4. Environmental Issues: In international trading environment this is one of the important issues. International traders ignore the rules and regulations to clean the environment. There motive is only to make profit. They are not interested in protecting the environment because it is costly business. Due to this international traders decide to move their operations to countries where it is less regulated.

5. Political Issues: Precious commodities such as gold, diamond, oil or farmland are so important for countries to have control that wars have been started and as a result people are killed. Trade of these items has caused political alliances that do not help the people in the trading nation but only the powerful corporations that control the commodity.

INTERNAL VS INTERNATIONAL TRADE

Internal and International trade are the two very frequently employed terms, the former implying
an exchange between the two parties belonging to the same nation while the latter suggesting the trade between two political independent sovereign nations. Internal trade is also referred to as interregional or domestic trade, while international trade is termed as external or foreign trade. Thus, a trade between two regions, say Mumbai and Chennai becomes internal or domestic trade while that between India and South Africa is called external or international trade.

Two basic questions arise in this context. First, is there any fundamental difference between domestic and foreign trade. Second and more important issue relates to why countries produce and export certain goods and why do they import certain others rather than producing them domestically? In other words what determines the international specialization. An answer to first question can be had by explaining the similarities and dissimilarities between internal and international trade. The answer to the second question lies in the analysis of trade theories.

Similarities

At the outset, it must be understood that broadly both the types are same in many aspect such as :

- Specialization is the basis of both, domestic as well as foreign trade.
- Both have same requisites, viz., two parties, two commodities and determination of relative prices.
- Gains or benefits, is the primary concern of the regions or nations involved in trade.

- In both cases cost of production is the chief criterion. Individuals, regions or nations produce and sell those commodities in which they are more efficient, i.e., can produce at a lower cost.

As against it, they buy from others those goods which they either cannot produce or require higher cost.

Dissimilarities (Differences)

The economist like, Adam Smith, David Ricardo, J.S. Mill, etc., strongly believed that international trade exhibits such peculiar, features which distinguish it clearly from internal trade.

Frederich List of Germany aptly observes, “Domestic trade is among us. International trade is between us and them.” Major dissimilarities between domestic and foreign trade can be summerised as follows.

1. Currency Differences: A peculiar feature of international trade is the use of different currencies by different countries that participate in the exchange, e.g., Indian rupee, Japanese yen, British pound sterling, American dollar, etc. In contrast, domestic trade is carried out through a uniform currency. No doubt, it is possible to arrive at an exchange rate between different currencies. Nevertheless, the currency differences make international trade more complex and complicated as compared to internal trade. Frequent and wide change, in exchange rate generate an element of instability and uncertainty in respect of foreign trade from which internal trade is free.

2. Resource Mobility: It is rightly observed by economists like Ricardo, that labour is perfectly mobile within a country and perfectly immobile between the countries. As a result of this the factor prices and hence, the cost of production significantly differ in different countries. Moreover due to immobility of productive resources, certain countries are unable to produce certain commodities. This paves the way for international specialization and trade. In contrast a perfect mobility of factors, within a country ensures uniform factor rewards, cost of production and hence, equal prices

3. Policy Differences: Since international trade involves the participation of different politically independent units, it is bound to be affected by the independent economic and the other policies adopted by them. Pattern of international trade, i.e., its volume, composition and direction is significantly affected by different national policies. In contrast, in respect of domestic trade the policies are uniform throughout the nation.

4. Endowmental Differences: Different countries have different factor endowments. It is commonly observed that some countries have rich natural resources while in others human resources may be better both quantitatively as also qualitatively. These differences are nonexistent in the context of domestic trade. Thus, a different factor endowment leads to distinction between interregional and international trade

5. Geographical and Other Differences: Countries widely differ in respect of geographical or natural conditions. These relate to quality and quantity of natural resources, climatic conditions, rainfall, land varieties, etc. Such differences though existing do not have a great bearing on internal trade.

6. Trade Restrictions: Countries adopt certain practices which artificially restrict or enhance international transactions. Heavy import duties, customs, fixation of quotas, etc., effectively restrict imports and exports. As against it bilateral agreements, subsidies, tax concessions, etc., boost up the imports and exports. Such practices are non-existent in respect of domestic trade.

7. Different Markets: Different nations have different markets for selling (exports) and buying (imports). These depend upon political ideology, economic system, relations which other nations, etc. This factor distinguishes foreign trade from domestic trade.

8. Special Issues: International trade faces certain specific issues and problems not encountered in respect of interregional trade. Mention in this context can be made of international liquidity, international cooperation and understanding etc. These factors are bound to affect international trade but have no concern with the internal trade.

All the above differences lead to the conclusion that international trade widely differs from internal trade and hence, it is argued that both cannot be treated at par. Natural, political, social and above all economic factors play a vital role in distinguishing international trade from domestic or internal trade. The traditional belief in the need for a separate theory of international trade is founded basically on these differences.

Modern Views

Modern economists opine that the differences in internal and international trade are superfluous rather than being genuine. Bertil Ohlin must not be totally neglected when he observes, *"International trade is but a special case of inter-local and interregional trade because countries are nothing more than regions separated by political boundaries."*

The modern economists do not support the classical stand on the differences between domestic and foreign trade and argue that those differences are only apparent and not real. The classical arguments in this respect are countered on the strength of following points:

- The differences in factor mobility are of degree and not of type. Resources are neither perfectly mobile within a country nor are they perfectly immobile between. At the most, we can say that they are more mobile within and less mobile between the countries.

- Existence of different currencies is not so strong an argument as to regard international trade to be totally different from internal trade. Moreover once the exchange rate is arrived at, the issue of different currencies does not produce any services problems.

- It is wrong to argue that domestic trade is free from restrictions and encouragement. They do exist even within a country.

- Absence of transport cost is not peculiar to foreign trade alone. In fact, this relates to market structure like perfect competition and not to type of trade.
- The modern economists argue that comparative cost provides the basis not only for international trade but for domestic trade also.
- General equilibrium theory can explain the pattern of international trade.

In brief, there are no fundamental differences between internal and international trade. The latter only implies extension of a single market price theory of the internal trade to a multi-market theory of the latter.

Economic integration

Economic integration is the unification of economic policies between different states through the partial or full abolition of tariff and non-tariff restrictions on trade taking place among them prior to their integration. This is meant in turn to lead to lower prices for distributors and consumers with the goal of increasing the level of welfare, while leading to an increase of economic productivity of the states.

Stages of integration

Different stages of economic integration

Different stages of economic integration between countries	No of internal barriers	Common external tariff	Factor asset mobility	Common currency	Common economic policy
Free Trade Area	X				
Customs Union	X	X			
Single Market	X	X	X		
Monetary Union	X	X	X	X	
Economic Union	X	X	X	X	X

Levels of Economic Integration

Economic integration can be classified in five additive levels, each present in the global landscape:

- **Free trade.** Tariffs (a tax imposed on imported goods) between member countries are significantly reduced, some abolished altogether. Each member country keeps its own tariffs in regard to third countries. The general goal of free trade agreements is to develop economies of scale and comparative advantages, which promotes economic efficiency.
- **Custom union.** Sets common external tariffs among member countries, implying that the same tariffs are applied to third countries; a common trade regime is achieved. Custom unions are particularly useful to level the competitive playing field and address the problem of re-exports (using preferential tariffs in one country to enter another country).
- **Common market.** Services and capital are free to move within member countries, expanding scale economies and comparative advantages. However, each national market has its own regulations such as product standards.
- **Economic union** (single market). All tariffs are removed for trade between member countries, creating a uniform (single) market. There are also free movements of labor, enabling workers in a member country is able to move and work in another member country. Monetary and fiscal policies between member countries are harmonized, which implies a level of political integration. A further step concerns a monetary union where a common currency is used, such as with the European Union (Euro).

- **Political union.** Represents the potentially most advanced form of integration with a common government and were the sovereignty of member country is significantly reduced. Only found within nation states, such as federations where there is a central government and regions having a level of autonomy.

FREE TRADE AREA

Definition of free trade area

When two or more countries eliminate tariff and other barriers affecting their trade, while at the same time maintaining or applying tariffs to imports from non-member countries. An example is the North American Free Trade Agreement (NAFTA) between the US, Canada and Mexico.

A free trade area is a grouping of countries within which tariffs and non-tariff trade barriers between the members are generally abolished but with no common trade policy toward non-members. The North American Free Trade Area (NAFTA) and the European Free Trade Association (EFTA) are examples of free trade areas.

North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement is a treaty between Canada, Mexico and the United States. That makes NAFTA the world's largest free trade agreement. The gross domestic product of its three members is more than $20 trillion. NAFTA is the first time two developed nations signed a trade agreement with an emerging market country.

The three signatories agreed to remove trade barriers between them.

By eliminating tariffs, NAFTA increases investment opportunities. The NAFTA agreement is 2,000 pages, with eight sections and 22 chapters.

On January 23, 2017, President Donald Trump signed an executive order to renegotiate NAFTA. He wants Mexico to cut its value-added tax and end the maquiladora program. Trump prefers bilateral trade agreements to multilateral ones.

NAFTA's pros and cons are hotly debated. Critics point to three main disadvantages of NAFTA. First, it sent many U.S. manufacturing jobs to lower-cost Mexico. Second, workers who kept jobs in those industries had to accept lower wages. Third, Mexico's workers suffered exploitation in its maquiladora programs.

But NAFTA also has three significant advantages. U.S. grocery prices would be higher without tariff-free imports from Mexico. Imported oil from both Canada and Mexico has prevented higher gas prices. NAFTA has also increased trade and economic growth for all three countries.

What Does NAFTA Do?

First, NAFTA **grants the most-favored-nation** status to all co-signers. That means countries must give all parties equal treatment. That includes foreign direct investment. They cannot give better treatment to domestic investors than foreign ones. They can't offer a better deal to investors from non-NAFTA countries.

Governments must also offer **federal contracts** to businesses in all three NAFTA countries.

Second, **NAFTA eliminates tariffs** on imports and exports between the three countries. Tariffs are taxes used to make foreign goods more expensive. NAFTA created specific rules to regulate trade in farm products, automobiles and clothing. These also apply to some services, such as telecommunications and finance.

Third, exporters must get **Certificates of Origin** to waive tariffs. That means the export must originate in the United States, Canada or Mexico. A product made in Peru but shipped from Mexico will still pay a duty when it enters the United States or Canada.

Fourth, NAFTA establishes procedures to **resolve trade disputes**. Chapter 52 protects businesses from unfair practices. The NAFTA Secretariat facilitates an informal resolution between the parties. If this doesn't work, it establishes a panel to review the dispute. That helps all parties to avoid costly lawsuits in local courts. It helps the parties interpret NAFTA’s complex rules and procedures. These trade dispute protections apply to investors as well.

Fifth, all NAFTA countries must respect **patents, trademarks, and copyrights**. At the same time, the agreement ensures that these intellectual property rights don't interfere with trade.

Sixth, the agreement allows **business travelers easy access** throughout all three countries.

NAFTA has two other agreements that update the original. The North American Agreement on Environmental Cooperation supports the enforcement of environmental laws. The North American Agreement on Labor Cooperation protects working conditions.

How NAFTA Affects the U.S. Economy

NAFTA increased the competitiveness of these three countries in the global marketplace. It allows them to better compete with China and the European Union. In 2007, the EU replaced the United States as the world's largest economy. In 2015, China replaced both.

It took three U.S. presidents to put NAFTA together. President Ronald Reagan kicked it off during his campaign in 1980. He wanted to unify the North American market to better compete with the EU.

In 1984, Congress passed the Trade and Tariff Act. That gave the president "fast-track" authority to negotiate free trade agreements. It permits Congress only the ability to approve or disapprove. Congress can't change negotiating points. Otherwise, countries would never concede valuable trade privileges.

In 1992, President George H.W. Bush signed NAFTA after he took office. It then went back to the legislatures of all three countries for ratification.

In 1993, President Bill Clinton signed it. NAFTA became law January 1, 1994. For more, see History and Purpose of NAFTA.

NAFTA would have been smaller than two other agreements. But the Trump administration pulled out of the Trans-Pacific Partnership. It has not pursued the Transatlantic Trade and Investment Partnership.

Disadvantages of NAFTA

NAFTA has received a lot of criticism for taking U.S. jobs. While it has also done good things for the economy, the North American Free Trade Agreement has six weaknesses. These disadvantages had a negative impact on both American and Mexican workers and even the environment. Among the agreement's critics is Donald Trump, who promised to renegotiate or withdraw from NAFTA.

1. U.S. Jobs Were Lost

Since labor is cheaper in Mexico, many manufacturing industries withdrew part of their production from the high-cost United States.

Between 1994 and 2010, the U.S. trade deficits with Mexico totaled $97.2 billion. In the same period, 682,900 U.S. jobs went to Mexico. But 116,400 of those jobs were displaced after 2007. The 2008 financial crisis could have caused them instead of NAFTA.

Almost 80 percent of the losses were in manufacturing. The hardest-hit states were California, New York, Michigan and Texas. They had high concentrations of the industries that moved plants to Mexico. These industries included motor vehicles, textiles, computers and electrical appliances.

2. U.S. Wages Were Suppressed

Not all companies in these industries moved to Mexico. Some used the threat of moving as leverage at union organizing drives, though. When it became a choice between joining the union or losing the factory, workers chose the plant. Without union support, the workers had little bargaining power.

That suppressed wage growth. Between 1993 and 1995, 50 percent of U.S. manufacturing companies in industries that were moving to Mexico used the threat of closing the factory. By 1999, that rate grew to 65 percent.

3. Mexico's Farmers Were Put Out of Business

Thanks to NAFTA, Mexico lost 1.3 million farm jobs. The 2002 Farm Bill subsidized U.S. agribusiness by as much as 40 percent of net farm income. When NAFTA removed trade tariffs, companies exported corn and other grains to Mexico below cost. Rural Mexican farmers could not compete. At the same time, Mexico reduced its subsidies to farmers from 33.2 percent of total farm income in 1990 to 13.2 percent in 2001. Most of those subsidies went to Mexico's large farms. These changes meant many Mexican farmers were out competed by highly subsidized American farmers.

4. Maquiladora Workers Were Exploited

NAFTA expanded the maquiladora program by removing tariffs. Maquiladora is where United States-owned companies employ Mexican workers near the border. They cheaply assemble products for export back into the United States. The program grew to employ 30 percent of Mexico's labor force. The workers had "no labor rights or health protections," according to Continental Social Alliance. In addition, the "workdays stretch out 12 hours or more, and if you are a woman, you could be forced to take a pregnancy test when applying for a job."

5. Mexico's Environment Deteriorated

In response to NAFTA's competitive pressure, Mexico agribusiness used more fertilizers and other chemicals, costing $36 billion per year in pollution. Rural farmers expanded into marginal land, resulting in deforestation at a rate of 630,000 hectares per year.

6. NAFTA Called for Free U.S. Access for Mexican Trucks

Another agreement within NAFTA was never implemented. NAFTA would have allowed trucks from Mexico to travel within the United States beyond the current 20-mile commercial zone limit. A demonstration project by the Department of Transportation was set up to review the practicality of this. In 2008, the House of Representatives terminated this project. It prohibited the DOT from implementing it without Congressional approval.

Congress worried that Mexican trucks would have presented a road hazard. They are not subject to the same safety standards as U.S. trucks. U.S. truckers' organizations and companies opposed it because they would have lost business. Currently, Mexican trucks must stop at the 20-mile limit and have their goods transferred to U.S. trucks.

There was also a question of reciprocity. The NAFTA agreement would have allowed unlimited access for U.S. vehicles throughout Mexico. A similar arrangement works well between the other NAFTA partner, Canada. But U.S. trucks are larger and carry heavier loads. They violate size and weight restrictions imposed by the Mexican government.

What is EFTA and how is it different from the EU?

The European Free Trade Association (EFTA) is an intergovernmental organization working to promote free trade and economic integration for its member states. It was founded in 1960 by Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom, and later joined by Finland, Iceland and Liechtenstein. However, currently there is only four EFTA countries – Iceland, Liechtenstein, Norway and Switzerland – as the other members left at different times in order to join the European Union.

The European Free Trade Association (EFTA) is an intergovernmental organisation, established in 1960 by the EFTA Convention for the promotion of free trade and economic integration between its Member States (today Iceland, Liechtenstein, Norway and Switzerland), within Europe and globally.

EFTA does not envisage political integration. It does not issue legislation, nor does it establish a customs union.

EFTA's first objective was to liberalise trade between its Member States. In 1972, each EFTA State negotiated bilateral free trade agreements (FTAs) with the EEC. Currently, the EFTA States have 26 FTAs in force or awaiting ratification covering 36 partner countries worldwide.

Since 1994, the EFTA Secretariat has assisted Iceland, Liechtenstein and Norway in the management of the EEA Agreement.

The EFTA Secretariat is not involved in the management of the bilateral agreements between Switzerland and the EU. Since 2001, the EFTA Convention has been updated on a continuous basis in order to align its content with the Swiss-EU bilateral agreements and the EEA Agreement. This includes, for example, provisions on the free movement of persons between all of the EFTA States.

What characterizes EFTA's free trade agreements?

EFTA's FTAs typically foresee the elimination of import duties on industrial goods and fish. Increasingly, the EFTA States have added substantive rules and commitments on services, investment and/or public procurement to their FTAs, responding more broadly to opportunities and challenges in today's globalised economic environment. Since 2010, EFTA has begun to introduce provisions on sustainable development in its negotiating processes and reviews of existing FTAs. These address environmental and labour standards insofar as they relate to trade and investment.

Can the EFTA Member States also sign bilateral free trade agreements?

Yes, the EFTA States are not obliged by the EFTA Convention to conclude preferential trade agreements as a group. They maintain the full right to enter into bilateral third-country arrangements.

Mercosur

The EU is currently negotiating a trade agreement with the four founding members of Mercosur (Argentina,Brazil, Paraguay, and Uruguay) as part of the overall negotiation for a bi-regional Association Agreeent. Venezuela has been a member of Mercosur since 2012 and is an observer in the trade negotiations, but is not a party to the trade negotiations

Current trade relations between the EU and Mercosur are governed by an inter-regional Framework Cooperation Agreement which entered into force in 1999. In addition, the EU and individual Mercosur countries have bilateral Framework Cooperation Agreements, which also establish a structure for dealing with trade-related matters.

The Mercosur Free Trade Agreement

An EU-Mercosur negotiation was re-launched in May 2010. Ten negotiation rounds took place mostly focused on rules (as opposed to market access commitments) before negotiations were paused in 2012.

On 11 May 2016, the EU and Mercosur exchanged offers for the first time since the re-launch, followed by a negotiation round in October 2016. The next round should take place in Brasilia between 2 and 6 October 2017.

The current negotiations cover a broad range of issues including:

- tariffs

- rules of origin
- technical barriers to trade
- sanitary and phytosanitary measures
- services
- government procurement
- intellectual property
- sustainable development
- small- and medium-sized enterprises

This free trade agreement will be part of the overall negotiation for a bi-regional Association Agreement which also comprises a political and a cooperation pillar.

Trade picture

Mercosur countries:

- Argentina, Brazil, Paraguay, Uruguay,Venezuela
- For the four Mercosur countries negotiating with the EU, the EU is Mercosur's first trading partner, accounting for 21% of the bloc's total trade in 2015.
- The EU's exports to the region have increased from €21 billion in 2005 to €46 billion in 2015. Mercosur's exports have increased from €32 billion to €42 billion over the same period.
- Mercosur's biggest exports to the EU in 2015 were agricultural products, such as foodstuffs, beverages and tobacco (24%), vegetable products including soya and coffee (18%) and meats and other animal products (6%). Other exports include mineral products (14%), wood and paper products (8%) and machinery (5%).
- The EU's exports to Mercosur include machinery (29%), vehicles and parts (17% of total exports) and chemicals and pharmaceuticals (24%).

- The EU is also a major exporter of commercial services to Mercosur (€20 billion in 2014).
- The EU is the biggest foreign investor in the region, rising from €130 billion in 2000 to €387 billion in 2014.
- Mercosur is a major investor in the EU, with stocks of €115 billion in 2014.

CUSTOMS UNION

A customs union is a type of free trade agreement (FTA) which involves the removal of tariff barriers between members, together with the acceptance of a common (unified) external tariff (CET) against non-members.

Countries that export to other countries in the customs union only need to make a single payment (duty), once the goods have passed through the border. Once inside the union goods can move freely without additional tariffs. Tariff revenue may then be shared between members, with the possibility that the country that collects the duty retaining a share (between 20 and 25% in the European customs union) to cover the additional administration costs associated with border trade.

A customs union comprises countries which agree to:

- **Abolish tariffs and quotas between member nations** to encourage free movement of goods and services. Goods and services that originate in the EU circulate between Member States duty-free. However these products might be subject to excise duty and VAT
- **Adopt a common external tariff (CET) on imports from non-members countries**. Thus, in the case of the EU, the tariff imposed on, say, imports of Japanese TV sets will be the same in the UK as in any other EU country
- **Preferential tariff rates** apply to preferential or free trade agreements that the EU has entered into with third countries or groupings of third countries

The advantages of a customs union

Increased trade flows

Like an FTA, the main positive effect of a customs union is that trade between members is likely to increase.

However, while the removal of trade barriers between members will encourage trade between them it is likely to reduce trade between members and non-members. How beneficial this is depends upon whether membership of a customs union increases or decreases the efficient allocation of scarce resources, and the satisfaction of the wants and needs of consumers and producers.

Trade creation vs trade diversion

The effect of a customs union is commonly explained in terms of trade creation and trade diversion. With trade creation, more efficient members can now sell more to less efficient (domestic) members. However, with trade diversion, more efficient non-members may now sell fewer goods to members, creating an opportunity for less efficient members to capitalize by selling more within the union.

Following the work of Jacob Viner, economists often start their analysis of customs unions by assessing whether the gains from trade creation outweigh the losses from trade diversion. If they do, then membership of a customs union will increase the welfare of member countries.

Solving the problem of trade deflection

One of the strongest arguments for a customs union (over a simple free-trade agreement) is that it solves the problem of trade deflection. Trade deflections occur when non-members ship their goods to a low tariff FTA member (or set up a subsidiary in the low tariff country) and then re-ship to a high tariff FTA member. Hence, without a unified external tariff, trade flows would become distorted.

For example, assuming Europe operated a simple FTA, rather than a customs union, and if Germany imposes a high 40% tariff on Japanese cars, while France imposes just a 10% tariff, Japan would export its cars to French car dealers, and then re-sell them to Germany on a free-trade basis. This trade deflection is avoided if Germany and France (and others) form a customs union.

A common external tariff, along with 'rules of origin', are likely to eliminate some of the problems that would occur with tariff differentials that may exist in a simple FTA.

This is precisely what the original six members of the *European Economic Community (EEC)* did when they formed a European Customs Union in 1968.

Closer integration and cooperation

Finally, the establishment of a customs union may pave the way for closer economic integration and political collaboration, including the formation of a single internal market, (common market) monetary union, and fiscal union. This is, of course, something which may generate as many new problems as it solves existing ones.

The disadvantages of a customs union

Loss of economic sovereignty

Members of a customs union are obliged to negotiate collectively with non-members, or organisations like the WTO, as a single group (bloc) of countries. While this is essential to maintain the customs union, it means that members are not free to negotiate individual trade deals in their own national interest.

For example, if a member wishes to support a declining industry, or protect an infant industry, it cannot do so through imposing its own tariffs, or other discriminatory trade policies. Equally, if it wishes to liberalize its trade, and open up to complete free trade, it cannot do so if a common tariff exists.

Also, it makes little sense for a particular member to impose a tariff on the import of a good that is not produced at all within that country.

For example, the UK does not produce its own bananas, so a tariff on banana imports only raises price and does not protect domestic producers. The current EU tariff on bananas imported from outside the EU is 10.9%.

Allocation of tariff revenues

There is also a potential disadvantage to a single member in how the tariff revenue is allocated. Members who trade relatively more with countries outside the union, such as the UK, may not get their 'fair share' of tariff revenue.

Furthermore, the revenue retained by members who collect the initial revenue - between 20 and 25% in Europe - has been estimated to greatly exceed the actual collection costs of that revenue.

Complex tariff schedules, exceptions and 'sensitive' lists

A further problem associated with customs unions is that negotiations regarding the setting of common tariff levels can be very complex and costly, both in terms of time and the use of resources.

Inevitably there are exceptions and 'sensitive' products, where members find it difficult to relinquish control over a key resource. This leads to lengthy negotiations and tradeoffs - the greater the number of countries in a customs union, the lengthier the period of negotiation.

This problem is generally associated with customs unions between developing countries, though it has become relevant to likely Brexit negotiations. Exemptions for particular goods or countries may reintroduce the problem of trade deflection, which a customs union is designed to remove.

Theory of Customs Union

One of the major aspects of international trading relations during the post-war period has been the development of regional trade grouping or blocks, primarily in the form of customs unions.

Customs unions are by definition discriminatory. They mean a lowering of tariffs within the union and an establishing of a joint outer tariff wall. They combine free trade with protection.

Regional trade grouping or economic integration can take several forms representing different degrees of integration namely, free trade area, and customs union, and common market, economic union and complete economic integration.

A free trade area abolishes or decreases tariffs and other trade barriers within the constituent countries but each member country can impose its own tariffs on imports from non-members. When a free trade area agrees to have common tariffs on imports from non- members, then it is a customs union. When a customs union reaches agreement on removal of factor immobility within the union, then it is a common market.

When a common market reaches agreement on coordination of national economic policies of the members, then it is an economic union. Finally, the complete economic integration involves the unification of monetary, fiscal, social and counter cyclical policies and the setting up of a supra-national authority whose decisions are binding for the member countries.

In tariff theory, there are two types of discrimination, namely, the commodity discrimination and the country discrimination. The commodity discrimination is one where different tariff rates are applied to different commodities and the country discrimination is one where different tariff rates are applied to the same commodity according to its country of origin. The customs union theory deals with problems raised by the latter type of discrimination.

According to R.G. Lipsey, "The theory of customs unions may be defined as that branch of tariff theory which deals with the effects of geographically discriminatory changes in trade barriers". The theoretical considerations which we are concerned here apply to customs unions, a grouping which we have defined in terms of its tariff policy.

The theory has being confined mainly to a study of the effects of customs union on welfare gains and losses which may arise from a number of different sources:

(i) The specialization of production according to comparative advantage which is the basis of the classical case for gains from trade;

(ii) Economies of scale;

(iii) Changes in the terms of trade;

(iv) Forced changes in efficiency due to increased foreign competition and

(v) A change in the rate of economic growth.

The conclusion of the earliest customs union theory may be summarized as follows. In the beginning customs unions have been viewed favorably. The reasoning was free trade maximizes world welfare; a customs union reduces tariffs and is therefore a movement towards free trade; a customs union will, therefore, increase world welfare even if it does not lead to world-welfare maximization.

In his pioneering study, the Customs Union Issues, Jacob Viner showed this argument to be incorrect. He introduced the new familiar concepts of "trade creations" and "trade diversion".

Trade Creation and trade diversion:

Let us discuss the concepts of trade creation and trade diversion through the following example.

Production cost of commodity (X) in three countries.

Country	A	B	C
Production cost	Rs. 50	Rs. 40	Rs. 30

Assume that the transport costs among the countries are negligible and assume that each country can produce good (X) at a constant cost. That is, assume that the prices indicated in the table are constant regardless of the level of output.

If country A has a tariff of 100% percent on (X), there will be no imports of the good, but the domestic producers will dominate the home market. If A forms a customs union with either country (IS) or country (C), she will be better off; if the union is with (IS) she will get a unit of commodity (X) at an opportunity cost of Rs. 40 worth of exports instead of at the cost of Rs. 50 worth of other goods entailed by domestic production. This is an example of "trade creation".

If (A) has been levying a somewhat lower tariff, say 50% percent and it was non-discriminatory, she would have imported the good from the lower cost source, country (C), and the price in (A's) home market would be Rs. 45. Let us now assume that (A) and (B) form a customs union. (A) will then instead, import (X) from (B), and the price in (A's) market will be Rs. 40. Import will be switched from the low-cost supplier (C) to the high-cost supplier (B). This is an example "trade diversion" and since it entails a movement from lower to higher real cost sources of supply, it represents a movement from a more to less efficient allocation of resources. Trade diversion will lead to a lowering of welfare as it entails a less efficient allocation of resources.

This analysis assumes that the countries involved are fully employed both before and after the formation of the customs union. In this sense the analysis is of neoclassical type. This being the case, it is natural to let the analysis primarily be concerned with the effects on the allocation of resources and the welfare implications of the effects.

This kind of analysis gives rise to three possibilities. First, neither of the two countries forming the union produces the good in question. The customs union would then be of no significance as both countries would import the good from a third country just as they did before forming the union. Second, one of the countries, forming the union produces the good inefficiently that is, is not the lowest cost available source of supply.

The union partner would then import from the cheaper source and there would be a case of trade diversion. Third, both countries forming the customs union produce the good, in which case one of the countries will then be secured for the more efficient industry and there will be trade creation. This analysis suggests that if a customs union primarily leads to trade creation, it will lead to an increase in welfare; and if it primarily gives rise to trade diversion it will lead to a lowering in the world's welfare. In this case, it will certainly lead to a lowering in the welfare of the third country (rest of the world). Whether it will also lead to a lowering in the welfare of the countries forming the customs union is less certain.

The implication of this analysis is that customs unions will lead to detrimental effects if the countries are complementary in the list of goods they produce. If, on the other hand, the group of commodities that both countries produce under tariff protection is large, the scope for positive welfare effects is large.

The following figures illustrate these facts:

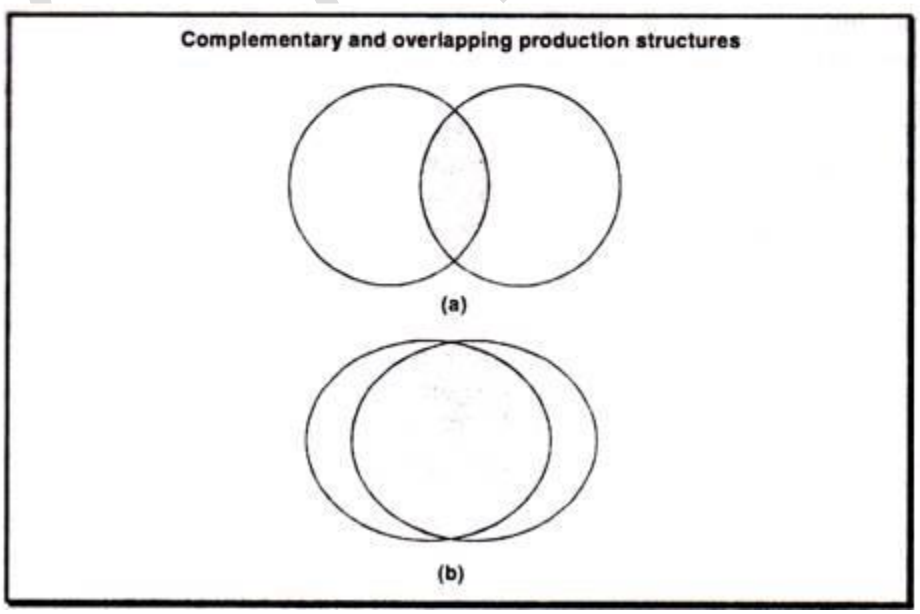


Figure (A) illustrates a situation where the two countries are primarily complementary. The area where the two economies overlap shown by the shaded union of (A) and (B), is small. Figure (B) shows a situation where the two economies are primarily competitive. The area of overlapping production, shown by the shaded union of (A) and (B) is large. Intuitively one might think that an agricultural country ought to form an union with an industrial country. This is not the case.

Agricultural countries should form customs union with each other, and the industrial countries should form an union with another industrial country. The scope for trade creation is then largest and so is the scope for an improved allocation of resources and an increase in welfare. We can also observe that the larger the cost differentials between the countries in the union on the goods they produce before the union, the larger the scope for gains.

Viner assumed that:

(i) There are no possibilities of substitution in consumption;

(ii) That all price elasticity's of demand are equal to zero;

(iii) On the supply side, the supposed the supply elasticities to be infinitely large, so that all products are produced under constant returns to scale.

It is easy to understand why Viner chose these assumptions. If goods are consumed in constant proportions irrespective of prices and if costs are constant, then the only interesting thing left to study is the shifts in production between countries as given by trade creation and trade diversion. The trade diversion for instance, will always cause a lowering of welfare.

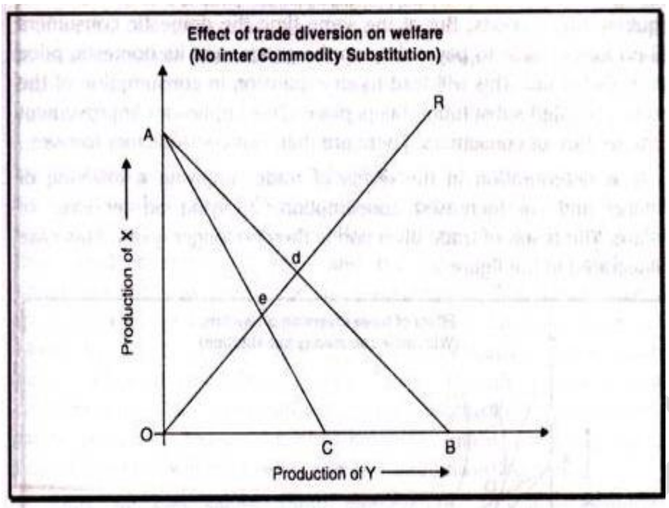


Fig. 1.

Country A is completely specialized in production good (X) and produces at point (A) on the X axis. It exchanges (X) for (Y) on the world market at the best terms of trade possible. They are given by the line AB. Consumers in the country consume the two goods in constant proportion given by the ray OR from the origin. The point of consumption is then at (d).

A now forms a customs union with C. This leads to trade diversion. Country A is still completely specialized in production (X) which it exchanges for (Y) from C. Because of the customs union, A's terms of trade deteriorate. The new terms of trade are given by the line AC. The country still consumes along the ray OR and consumption now will be at point (e). This point is clearly inferior to (d) as it represents a smaller amount of both goods.

This analysis shows that, on the Vinerian assumption of no substitution in consumption, trade diversion will necessarily lower A s welfare. But Viner's assumptions are very strong and quite unrealistic. A customs union will normally lead to a change in all relative prices. Then, substitution will take place. This is what would normally be expected. Now we will look into some of the effects that substitution in consumption might give rise to.

Inter-country and Inter-commodity Substitution:

If a country enters a customs union and trade diversion follows on some goods it means that the country will have to pay a higher price in acquiring these goods. But at the same time the domestic consumers will no longer have to pay a duty on the goods, and its domestic price will probably fall. This will lead to an expansion in consumption of the goods, provided substitution takes place. This implies an improvement in the welfare of consumers.

There are then two contradictory forces:

(i) A deterioration in the terms of trade, implying a lowering of welfare; and

(ii) Increased consumption, implying an increase of welfare.

The result of trade diversion is then no longer given. This case is illustrated in the figure 2.

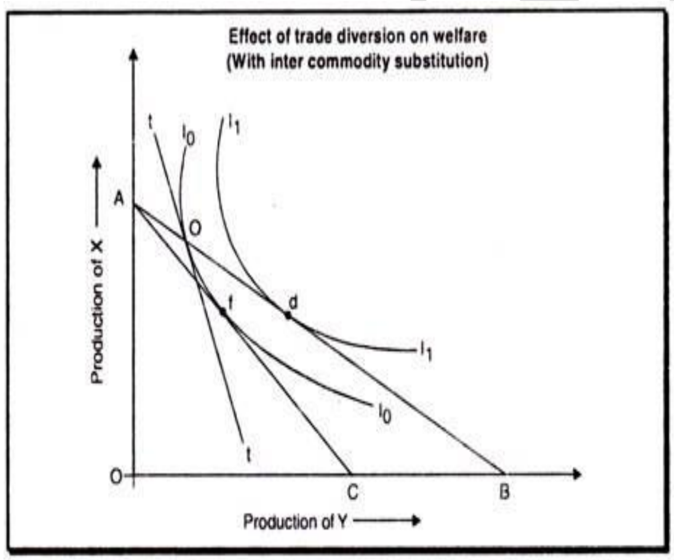


Fig. 2.

Country (A) is completely specialized in the production of good (X) and produces at point (A) on the X-axis. Before the union it imports good (Y) from the cheapest possible source country (B), at the terms of trade AB. If free trade were permitted, consumption would be at point (d) where an indifference curve 1, 1, is tangent to price line AB. Plow the country prefers to have a steep duty on (Y), and the domestic price ratio is indicated by price line (tt). The tariff leads to a fall in consumption of (Y) which is substituted by (X) and to a lowering in consumer's welfare. The terms of trade AB are assumed not to have been affected by the tariff.

Country (A) now forms a customs union with (C). This leads to trade diversion and to a worsening of (A's) terms of trade. The country will produce at (A) and exchanges (X) for (Y). The new terms of trade are given by line (AC). This need not necessarily lead to a lowering in welfare for consumers, because the price ratio (AC) will now be ruling in (A's) domestic market and (Y) is now cheaper than at the tariff-inclusive price ratio (tt). (Y) will therefore be substituted for (X) in consumption and consumption will move to point (f). Point (f) is on the same indifference curve as (C). Hence consumers are as well off after the customs union as before.

This shows that a customs union, even though it leads to trade diversion, could result in consumers being as well off as before. If the deterioration in terms of trade had been less than what is shown by (AC) and the new price line had been somewhere in between AB and AC, the customs union would have led to an increase in consumers' welfare and would have put them on a higher indifference curve than (I_oI_o). Then the customs union would have increased consumers' welfare even though it was a trade diverting kind. This demonstrates that if substitution in consumption takes place, it implies that a customs union can lead to an improvement in welfare even if it is of a trade diverting nature.

Thus we can speak about inter-country and inter-commodity substitution. Inter-country substitution is Viner's trade diversion and trade creation. Inter-commodity substitution is the usual substitution that takes place between commodities, both on the supply and the demand side, because of changes in relative prices. A customs union will give rise to both kinds of substitution. If both kinds are taken into account, the situation becomes more complex and the possibility of drawing inferences becomes more limited.

A customs union has both free trade side and a protectionist side. The welfare effects of a union depend on which is stronger. We have now seen some of the factors that are important when assessing the economic gains and losses of a customs union. The gains are primarily connected with trade creation, the losses with trade diversion. But how are these gains and losses to be measured? Here the height of the tariffs comes in as an important factor.

The Height of Tariffs and Tariff Removals:

In a competitive world the supply price of a good indicates the cost (marginal) to the producer and thus the opportunity cost, and the demand price indicates the utility of the good to the consumer. If no tariffs, taxes or other distortions exist, the supply price of a good will is the same as the demand price. If taxes or tariffs exist, this is no longer the use. Suppose there is a 50 percent tax on a product: if the cost of production of the good is Rs. 2, then the producer of the good will get Rs. 2 for it, but consumer will have to pay Rs. 3 for it.

Since the producer is living in a competitive world, it means that the last unit of the product must be worth Rs. 2 to him that it must cost Rs. 2 worth of resources to produce. Similarly, since the consumer is willing to pay Rs. 3 for a unit of goods, it means that it must be worth Rs. 3 to him. A discrepancy in utility for producers and consumers thus exists, and it trade in the product could be increased, this would lead to an increase in welfare.

A tax or tariff has completely analogous effect in this respect, and we can illustrate the effect of a tariff in a geometric fashion.

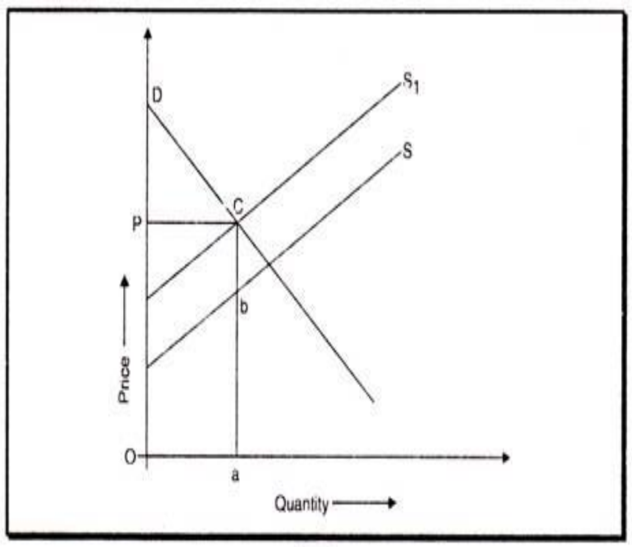


Fig. 3.

A tariff, or a tax, can be thought of as shifting the supply curve to the left. The pre-tariff curve is (S) and the tariff-inclusive supply curve is (S^1). Equilibrium is established at (C), with (p) being the price and Oa the quantity consumed. The tariff rate in the figure is Cb/ba percent, and the supply price differs from the demand price by this amount. An increase in trade of this good would, on the margin, mean an increase in welfare of an amount equal to (cb).

This type of analysis implies that the higher the initial tariffs between the countries forming the customs union, the larger the scope for gain. Conversely, the lower the tariffs with the outside world, the lower should be losses due to trade diversion.

When we take the heights of tariffs into account we can no longer try to estimate gains and losses by simply taking trade creation and trade diversion at face value. We also have to weigh, the values of trade created and diverted with the heights of the tariffs involved.

The Dynamic Effects:

So far, the whole discussion of the effects of customs unions has been in static terms. Many of the interesting influences around which controversy centre's still, however, lie outside the formal analysis; for they are concerned with the effects of customs unions both upon constituent countries and upon the world at large, overtime.

These dynamic effects are not amenable to rigorous analysis and theory is not of much help in discussing them, but they are important, perhaps more important than the static concepts of trade creation and trade diversion. There is widespread disagreement about the significance and strengths of dynamic influences.

Four dynamic effects come up for attention in the literature.

They are:

(i) The stimulus imparted to countries in the union by competition;

(ii) The probable acceleration of technological change;

(iii) The stimulus given to investment; and

(iv) The economies of scale which union makes possible for industries in participant countries.

An important argument of a dynamic character is that a customs union will lead to enforced competition. This argument has been applied to the European Economic Community. As tariff fall away between union members, monopolies and cartels within individual countries become exposed to pressure in their domestic markets from firms elsewhere in the union.

Inefficient and un-enterprising firms and firms below optimum size are similarly exposed. The result will be a restructuring of industry for survival or for wider market penetration with beneficial effects on costs and prices. Scitovsky has argued that this competitive effect has been an important one in the European Economic Community.

A second view which favours customs unions is that they will speed economic growth, since the enlargement of the market will encourage innovation and technological change. As the market grows so the optimum size of firms will increase and additional resources be deployed into research and development. Whether this will result in a faster rate of innovation is of course problematic.

There is little empirical evidence to show that the rate of technical innovation in large firms exceeds that in small firms. The most we can say is that the potential for innovation is there and that wide markets and keen competition provide a favorable climate for it.

It may be expected that, within the union, investment will be stimulated by wider market opportunities, by changes in prices, and by increase of competition. The total impact upon investment is hard to estimate, since it will be compounded of a number of influences, some favourable, some less so. Besides domestic investment, union countries may experience a growth in investment from abroad, foreign firms with plants already within the union may expand or regroup these to meet the new circumstances created by the union.

Other institutional aspects which could be important are those connected with increased factor movements and with rights to establish businesses within the union. Movements of labour and capital could increase the productivity of the factors in question and foster growth.

A greater freedom in establishment rights would perhaps lead not only to a greater personal freedom and increased well-being, but also to a faster spread of knowledge and thereby to faster growth. Factors such as these could be important.

It was widely argued during the period preceding the treaty of Rome that the growth of industry in the United States and the high per capita income in that country sprang in great part from the huge market which American industry has served and the economies of scale which this has made possible. Great would be the advantages for European industries when a market of millions of people was provided within the community.

Within the union, industrial specialization will take place that as a result unit costs will fall with full utilization of plant, long production runs and growing expertise of labour and management and that further economies will be made possible by scientifically planning and locating such costly basic industries as steel, base metals and power supply.

Some Practical Implications:

Let us summarize some of the main results of the theory of customs unions.

They are:

(i) When a union is formed both trade creation and trade diversion will take place. The higher the elasticity of demand and supply for the goods that will come into trade between union members after elimination of the tariff the more will be the trade creation.

(ii) The more the foreign trade of union members were with other union members before the union was formed, the more likely it is that the union will raise welfare.

(iii) The higher the pre-union tariffs between the members of the union, the greater will be the trade creation once the union is formed and the tariffs are removed.

(iv) The lower the level of the common tariff of a union the less trade diversion the union will cause.

(v) Trade creation and greater efficiency in resource use will result from a customs union between countries which are rivals in trade than between countries whose goods are complementary.

It would appear on theoretical grounds that the European Common Market, tightly integrated geographically as it is in the centre of the trading world, has a much stronger potential for reaping the advantages of union than have the other free-trade areas, particularly those in the developing world.

COMMON MARKET

A common market represents a major step towards significant economic integration. In addition to containing the provisions of a customs union, a common market (CM) removes all barriers to the mobility of people, capital and other resources within the area in question, as well as eliminating non-tariff barriers to trade, such as the regulatory treatment of product standards.

Establishing a common market typically requires significant policy harmonization in a number of areas. Free movement of labour, for example, necessitates agreement on worker qualifications and certifications. A common market is also typically associated – whether by design or consequence – with a broad convergence of fiscal and monetary policies due to the increased economic interdependence within the region and the effect that one member country's policies can have on other member countries. This necessarily places more severe limitations on member countries' ability to pursue independent economic policies.

The principal advantage of establishing a common market is the expected gains in economic efficiency. With unfettered mobility, labour and capital can more easily respond to economic signals within the common market, resulting in a more efficient allocation of resources

Trade creation & diversion

Trade agreements in the international economy

Trade agreements and trade liberalization are two essential components in the drive to increase the rate of growth of world trade.

o Trade agreements can involve two countries reducing tariffs on each other's goods, or perhaps reducing bureaucracy by simplifying import/export procedures.

o Trade liberalisation might involve creating free-trade areas. This creates larger markets, greater access to raw materials, and more competition. The happy ending should be lower unit costs, since firms are able to gain economies of scale. From the consumers' point of view, lower prices and greater choice should make them happy too. Briefly now we consider the emergence of regional trading agreements between countries.

Growth of Regional Trade Agreement: An important feature of international trade arrangements between countries over the last two decades has been a significant expansion of regional trade agreements (RTAs) across the global economy. Some of these agreements are simply free-trade agreements which involve a reduction in current tariff and non-tariff import controls so as to liberalise trade in goods and services between countries. The most sophisticated RTAs go beyond traditional trade policy mechanisms, to include regional rules on flows of investment, co-ordination of competition policies, agreements on environmental policies and the free movement of labour.

Examples of regional trade agreements: o The European Union (EU) – a customs union, a single market and now with a single currency o The European Free Trade Area (EFTA) o The North American Free Trade Agreement (NAFTA) – created in 1994 o Mercosur - a customs union between Brazil, Argentina, Uruguay, Paraguay and Venezuela o The Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA) o The Common Market of Eastern and Southern Africa (COMESA) o The South Asian Free Trade Area (SAFTA) created in January 2006 and containing countries such as India and Pakistan.

Economic Integration between Countries: There are many different types of economic integration between countries and these are summarized below. A free trade area is a fairly loose form of integration where countries simply agree to remove tariff and non-tariff barriers between them to promote free trade in goods and services. The North American Free Trade Area (NAFTA) is a good example of this as is the European Free Trade Area(EFTA). ASEAN (Association of South East Nations), the Andean Pact, and Mercosur are other examples.

Customs Union The EU is a customs union. A customs union comprises two (or more) countries which agree to: 1. Abolish tariffs and quotas between member nations to encourage free movement of goods and services. Goods and services that originate in the EU circulate between Member States duty-free. However these products might be subject to other charges such as excise duty and VAT. 2. Adopt a common external tariff (CET) on imports from non-members countries. Thus, in the case of the EU, the tariff imposed on, say, imports of Japanese TV sets will be the same in the UK as in any other member country. The important point about a common external tariff is that 1.it prevents individual countries imposing their own unilateral tariffs on different products that differ from other nations in the customs union.

2. Preferential tariff rates apply to preferential or free-trade agreements which the EU has entered into with third countries or groupings of third countries.

3. The EU, as well as all its member states are a member of the World Trade Organisation and, officially at least, subscribes to its free trade ethos. The EU certainly argues in principle for more free trade, but mainly in areas where free trade is to the advantage of the EU! For example, the EU is ready to use the WTO appeals mechanism in its frequent disputes with the USA (the recent battle over the introduction of US steel tariffs is a good example to quote).

4.A customs union shares the revenue from the CET in a pre-determined way – in this case the revenue goes into the main EU budget fund. In 2003, 80% of total EU expenditure goes on agricultural spending and cohesion funds. We shall return to this when we consider agricultural policy and regional policy.

5. The EU receives its revenues from customs duties from the common tariff, agricultural levies and countries paying 1% of their VAT base. Payments are also made through contributions made by member states based on their national incomes. Thus relatively poorer countries pay less into the EU and tend to be net recipients of EU finances.

6. A single market represents a deeper form of integration than a customs union. It involves the free movement of goods and services, capital and labour and the concept are broadened to encompass economic policy harmonisation for example in the areas of health and safety legislation and monopoly & competition policy. Deeper economic integration requires some degree of political integration, which also requires shared aims and values between nations.8. The economic effects of the creation and development of a customs union can be analysed both in the short term and the long term. We make an important distinction between trade creation and trade diversion effects Trade Creation This involves a shift in domestic consumer spending from a higher cost domestic source to a lower cost partner source within the EU, as a result of the abolition tariffs on intra-union trade. So for example UK households may switch their spending on car and home insurance away from a higher-priced UK supplier towards a French insurance company operating in the UK market. Similarly, Western European car manufacturers may be able to find and then benefit from a cheaper source of glass or rubber for tyres from other countries within the customs union than if they were reliant on domestic supply sources with trade restrictions in place. Trade creation should stimulate an increase in intra-EU trade within the customs union and should, in theory, lead to an improvement in the efficient allocation of scarce resources and gains in consumer and producer welfare.

Trade Diversion

Trade diversion is best described as a shift in domestic consumer spending from a lower cost world source to a higher cost partner source (e.g. from another country within the EU-27) as a result of thee limitation of tariffs on imports from the partner. The common external tariff on many goods and services coming into the EU makes imports more expensive. This can lead to higher costs for producers and higher prices for consumers if previously they had access to a lower cost / lower price supply from a non-EU country. The diagram next illustrates the potential welfare consequences of imposing an import tariff on goods and services coming into the European Union. In general, protectionism in the forms of an import tariff results in a deadweight social loss of welfare. Only short term protectionist measures, like those to protect infant industries, can be defended robustly in terms of efficiency. The common external tariff will have resulted in some dead weight social loss if it has in total raised tariffs between EU countries and those outside the EU. The overall effect of a customs union on the economic welfare of citizens in a country depends on whether the customs union creates effects that are mainly trade creating or trade diverting.

POSSIBLE QUESTIONS

PART - B

1. What is International Economics?
2. What is Customs Union?
3. Write a short note on Inter-regional trade and International trade.
4. What do you mean by International trade?
5. What do you mean by economic integration?
6. What is NAFTA?
7. What is Common Market?
8. Define economic integration.
9. State different levels of economic integration.
10. List any six advantages of international trade
11. State the current economic problems.

PART - C

1. Discuss the current international economic problems.
2. Explain briefly the theory of 'Customs Union'
3. "International trade should be regarded as a special case of inter-regional trade or perhaps rather inter-local trade" Examine this statement fully.
4. Discuss the problems of Economic Integration and measures to encourage economic integration among developing countries.
5. Define International Economics. Describe its scope.
6. What is NAFTA? Explain the effects of NAFTA on America and Mexico.
7. Explain the scope and importance of international trade.
8. Explain the trade creation and trade diversion of effects of customs union.

PART - D

Factors facilitating foreign trade and economic development go hand in hand. Establish the fact behind this statement by focusing the trend prevailing in your country.

Karpagam Academy of Higher Education
Department of Management
International Economics- 17MBAPI401B
Unit I
Multiple Choice Questions - Each Question Carries ONE Mark

S.No.	Questions	Option 1	Option 2	Option 3	Option 4	Answers
1	A primary reason why nations conduct international trade is because:	Some nations prefer to produce one thing while others produce another	Resources are not equally distributed to all trading nations	Trade enhances opportunities to accumulate profits	Interest rates are not identical in all trading nations	Resources are not equally distributed to all trading nations
2	International trade in goods and services is sometimes used as a substitute for all of the following except	International movements of capital.	International movements of labor.	International movements of technology	Domestic production of different goods and services	Domestic production of different goods and services
3	The movement to free international trade is most likely to generate short-term unemployment in which industries	Industries in which there are neither imports nor exports	Import-competing industries.	Industries that sell to domestic and foreign buyers	Industries that sell to only foreign buyers	Import-competing industries.
4	International trade is based on the idea that:	Exports should exceed imports	Imports should exceed exports	Resources are more mobile internationally than are goods	Resources are less mobile internationally than are goods	Resources are less mobile internationally than are goods
5	International trade in goods and services tends to:	Increase all domestic costs and prices	Keep all domestic costs and prices at the same level	Lessen the amount of competition facing home manufacturers	Increase the amount of competition facing home manufacturers	Increase the amount of competition facing home manufacturers
6	A business that deals with more than two nations is know as ___________________	Modern Business	Business.	Domestic trade.	International Business	International Business

7	_____________ is the traditional mode of international business.	Importing.	Exporting	Franchising.	Licensing.	Exporting
8	Downloading goods or services from foreign countries for the purpose of manufacturing goods and service can be termed as	Importing.	Exporting.	Franchising.	Licensing.	Importing.
9	Companies with long term substantial interest in the foreign market normally establish_____________.	joint ventures.	mergers.	contract manufacturing	fully owned manufacturing facilities.	fully owned manufacturing facilities.
10	Implementing manufacturing facilities in host country is called as _____________.	mergers	contract manufacturing	management contract.	fully owned manufacturing facilities.	fully owned manufacturing facilities.
11	___________ effects internationalization either in positive or negative aspects	Product life cycle.	Government Policies & Regulations.	Domestic market constraints	Counter competition.	Government Policies & Regulations.
12	The business activity that crosses national boundaries is known as ______________.	national business.	international business.	commercial business.	huge business.	international business.
13	When did India introduce the new Economic Policy?	1986	1991	1992	1996	1991
14	The simplest sense of business activity that transcends national boundaries is known as	foreign trade.	international Business	private Business	government Business.	international Business
15	Expand ITA	Industries and Trade Association	Internal and Trade Association	International Trade Association	Institution and trade Association	Industries and Trade Association
16	The growth of global economy is very essential for healthy growth of an international	Trade and export	import and export	trade and export	imports.	Trade and export
17	When did India introduce new trade policy?	1990	1991	1992	1993	1991
18	FTP refers to _______________.	Free Trade Policy.	Foreign Trade Policy.	Fees Trade Policy.	Fright Trade Policy.	Foreign Trade Policy

19	The goals of international marketing are to _______________.	create and retain customers in global markets	gain market share and increase profit.	expand business activities abroad.	eliminate competition in international markets.	create and retain customers in global markets.
20	The work of an international marketer is mainly concerned with _____________	transferring a marketing mix to enter a market in another country	translating product instructions and advertising messages.	adapting a marketing mix to enter a market in another country	establishing global brands	adapting a marketing mix to enter a market in another country.
21	A firm doing business abroad has to consider the relevant ____________ of the foreign countries	laws and regulations	trade practices.	environment	all the above.	laws and regulations
22	Which of the following is international trade:	Trade between provinces	Trade between regions	Trade between countries	(b) and (c) of above	Trade between countries
23	All are advantages of foreign trade except	People get foreign exchange	Nations compete	Cheaper goods	Optimum utilisation of country's resources	People get foreign exchange
24	International trade is possible primarily through:	Generalization in production of all goods	Specialization in production of one good	Specialization in production of a few goods	All of the above	Specialization in production of a few goods
25	A country that does not trade with other countries is called:	Developed economy	Closed economy	Independent economy	None of the above	Closed economy
26	__________is the exchange of goods and services between the two countries, across their international borders	Foreign Trade	Domestic Trade	Illegal Trade	Future Market	Foreign Trade
27	In the course of international trade	Capital moves truly among nations	Labour moves truly among nations	Both moves truly among nations	Labour moves less truly than capital.	Labour moves less truly than capital.
28	Expand NAFTA	National Agreement for Free Trade Agreement.	North American Free Trade Agreement	National Arrangement for Free Trade Agreement	North American Free Tariff Agreement	North American Free Trade Agreement

29	International trade is based on the notion that:	Different currencies are an obstacle to international trade	Goods are more mobile internationally than are resources	Resources are more mobile internationally that are goods	A country's exports should always exceeds its imports	Goods are more mobile internationally than are resources
30	The responsibility for the administration of foreign trade is hold by ___________	Director General Foreign Trade	Director Director Generals of Foreign Trade	Joint Deputy Generals of Foreign Trade	Government of India.	Director General Foreign Trade.
31	Economic growth occurs because	labor forces increase	capital stocks increase	new inventions increase productivity	all of the above	all of the above
32	India is part of……………..	European Union	NAFTA	SAARC	CER	SAARC
33	Several levels of economic integration are possible. Three such levels from the least integrated to the most integrated are…………………..	free trade area, customs union, common market	customs union, political union, economic union	free trade area, political union, common market	common market, customs union, political union	free trade area, customs union, common market
34	Regional economic integration can be seen as an attempt to achieve gains from……………….. beyond those attainable under international agreements such as the WTO.	common currencies	region-specific tariffs	the free flow of trade and investment	gains from common access to intellectual property	the free flow of trade and investment
35	Regional economic integration, for example, the EU, offers significant opportunities to US businesses including…………	non-EU companies no longer need to set up subsidiaries in EU countries	companies can realize significant cost economies by centralizing operations where factor costs and skills are optimal	it makes no difference where in the EU one locates an operation since the costs are the same throughout	cultural differences and national consumer preferences are now irrelevant	companies can realize significant cost economies by centralizing operations where factor costs and skills are optimal

36	Regional economic integration presents potentially significant threats to business outside the area, including…………….	long-term improvements in the competitive positions of firms inside the areas.	the end of a “fortress” mentality means other firms outside the area will be able to enter the areas more easily to compete with existing area firms	the end to efforts to rationalize production and reduce costs	the imposition of US standards, recognized as a pioneer in regional economic integration, which means US firms will not be able to get around the legal barriers	the end to efforts to rationalize production and reduce costs
37	The NAFTA is a:	monetary union	free trade area	common market	customs union	free trade area
38	Members of the EU find that ―trade creation‖ is fostered when their economies are:	highly competitive	highly noncompetitive	geographically distant	small in economic importance	highly competitive
39	The European Union has achieved all of the following except:	adopted a common fiscal policy for member nations	established a common system of agricultural price supports	disbanded all tariffs between its member countries	levied common tariffs on products imported from nonmembers	adopted a common fiscal policy for member nations
40	The European Union is an example of a/an	customs union	economic union	common market	free trade area	common market
41	The North American Free Trade Agreement (NAFTA)………	set up a common trading area for all states in the upper Midwest and New England	created the world's largest free trade zone	includes only Canada and the United States	includes only Canada and Mexico	created the world's largest free trade zone
42	How has NAFTA affected Mexico?	There is increased confidence on the part of foreign firms to invest in Mexico.	Reduced economic advantage of Mexican labor over its American counterpart	Increased surplus of more than $2 billion in farm trade with America	Reduced farm subsidies to improve the efficiency of agricultural exports	There is increased confidence on the part of foreign firms to invest in Mexico.

43	The implementation of a common market involves all of the following except:	a. elimination of trade restrictions among member countries	a common tax system and monetary union	c. prohibition of restrictions on factor movements	a common tariff levied in imports from nonmembers	a common tax system and monetary union
44	Which of the following is not a preferential trading arrangement?	EU	NAFTA	OECD	Anti-dumping duty	OECD
45	European Union was established in………..	1995	1985	1993	1983	1993
46	Which of the following is not a key quality of an international organization?	voluntary cooperation	shared interests	communal management	sovereignty	sovereignty
47	In most cases, support by states for regionalism is motivated primarily by………..	the desire for economic cooperation	the desire for political unity	the desire for social cohesion	the desire for shared military protection	the desire for economic cooperation
48	SAFTA means………….	South Asian Association for Regional Co-operation	South Asian Association for Regional Culture	South Asian Association for Regional Class	South Asian Free Trade Agreement	South Asian Free Trade Agreement
49	The instrument involved in SAFTA……..	increase the level of trade	economic cooperation	medium and long term contracts	Institutional Arrangements	Institutional Arrangements
50	How is governance best defined?	the rules and norms that lie at the basis of a system of government	an arrangement in which power is shared among groups in divided societies	an arrangement by which decisions are made without the existence of formal institutions of government	an administrative system in which power is shared and distributed horizontally and vertically among different levels of government	the rules and norms that lie at the basis of a system of government
51	The main objective of the agreement is to promote……	free trade	competiton	meet demand	supply money	competiton
52	A positive, dynamic effect of economic integration is illustrated by	trade diversion effect	increased monopoly power of firms	decreased customs costs	economy-of-scale effect	economy-of-scale effect

53	_____________ means selling the home countrys goods service in foreign country.	Marketing	Sales	Export	Import.	Export.
54	International trade and domestic trade differ because of:	Trade restrictions	Immobility of factors	Different government policies	All of the above	All of the above
55	Assume that the formation of a customs union turns out to include the lowest-cost world producer of the product in question. Which effect could not occur for the participating countries?	Trade creation–production effect	Trade creation–consumption effect	Trade diversion	Scale economies and competition	Trade diversion
56	Which of the following conditions lead to high trade creation?	Transport costs are high	The size of the common market is small	Member countries in the common market are at different levels of economic development	The pre-union tariffs of member countries were high	The pre-union tariffs of member countries were high
57	Customs union theory reasons that the formation of a customs union will decrease members' real welfare when the:	Trade diversion effect exceeds the trade creation effect	Trade production effect exceeds the trade consumption effect	Trade consumption effect exceeds the trade production effect	Trade creation effect exceeds the trade diversion effect	Trade diversion effect exceeds the trade creation effect
58	When imports from a higher-cost supplier within a customs union replace imports from a lower cost supplier outside the custom union, there exists	trade creation	trade diversion	dynamic welfare effects	comprehensive welfare effects	trade diversion
59	_________ is said to exist when the formation of a regional trading group leads to an expansion oftrade above pregroup levels.	trade creation	trade diversion	trade exclusion	trade distortion	trade creation

60	________ is said to exist when the formation of a regional trading group leads to the reduction of trade with nonmember countries in favor of member countries.	trade creation	trade diversion	trade exclusion	trade distortion	trade diversion

Theories of International Trade

SYLLABUS

Theories of International Trade: Theory of Absolute Cost Advantage, Theory of Comparative Cost Advantage. Intra - Industry Trade, Gains from trade, Measurement of gains, static and dynamic gains. Terms of trade – Importance & Types, Determinant's of Terms of trade, Causes of unfavorable terms of trade to less developed countries

Theories of International Trade

According to the classical theory of international trade, every country will produce their commodities for the production of which it is most suited in terms of its natural endowments climate quality of soil, means of transport, capital, etc. It will produce these commodities in excess of its own requirement and will exchange the surplus with the imports of goods from other countries for the production of which it is not well suited or which it cannot produce at all. Thus all countries produce and export these commodities in which they have cost advantages and import those commodities in which they have cost disadvantages.

Types of Cost Difference in Production

Economists speak about three types of cost difference in production, they are

1. Absolute cost difference,
2. Equal cost difference, and
3. Comparative cost difference.

1. Absolute Cost Differences

Adam Smith in his book '*Wealth of Nation*' argued that international trade is advantageous for all the participating countries only if they enjoy absolute differences in the cost of production of the commodity which they specialise. As in the case of individuals where each specialises in the production of that commodity in which he has an absolutely superiority in terms of cost, so also each country specialises in production of goods based on absolute advantage.

The principle of absolute difference in cost can be explained with the help of table given below. Let us assume that we have 2 countries, I and II specializing in the production of X and Y.

One Day Labour Produces

Country	Commodity X (in units)	Commodity Y (in units)	Internal Exchange Rate	
			X	Y
I	20	10	2	1
II	10	20	1	2

In country I, one day's labour produces 20 x or 10y. The internal exchange rate is 2 : 1. In country II, one day's labour produce 10x or 20y which gives us the domestic exchange rate of 1 : 2. Country I has the absolute advantage in the production of X (as 20 > 10) and country II in Y (as 10 < 20). If these countries enter into trade with the international exchange of 1 : 1, both countries stand to benefit. Country I will have 1y for 1x as against $^1/_{2y}$ for 1x within the country. Similarly country II will have 1x for 1y as against $^1/_{2x}$ for 1y within the country.

Based on this example, according to Adam Smith, it can be pointed out that international trade to be beneficial; each country must enjoy absolute difference in cost of production.

2. Equal Difference in Cost

Adam Smith, in order to strengthen his argument in favour of absolute difference in cost pointed out that trade is not possible if countries operate under equal difference in cost instead of absolute difference.

One Day Labour Produces

Country	Commodity X (in units)	Commodity Y (in units)	Internal Exchange Rate	
			X	Y
I	20	10	2	1
II	10	5	2	1

The above table gives us the internal exchange rate 2x : 1y in both countries. Since the exchange ratio between X and Y in both countries is the same; none of them will benefit by entering into international trade.

Based on this example, according to Adam Smith, for international trade to be beneficial countries must enjoy absolute difference in cost. Trade would not take place when the difference in cost is equal.

3. Comparative Difference in Cost

David Ricardo agreed that absolute difference in cost gives a clear reason for trade to take place. He, however, went further to argue that even that the country has absolute advantage in the production of both commodities it is beneficial for that country to specialise in the production of that commodity in which it has a greater comparative advantage. The other country can be left to specialise in the production of that commodity in which it has less comparative advantage. According to Ricardo the essence for international trade is not the absolute difference in cost but comparative difference in cost.

Adam Smith's Theory of Absolute Advantage

The mercantilist economic theory, which was widely followed between the 16th and the 18th century, came under a lot of criticism with the emergence of economists like John Locke and David Hume. Mercantilism advocated a national economic policy designed to maximize the nation's trade and its gold and money reserves. Mercantilism gained influence due to the emergence of colonial powers such as Britain and Portugal, before Adam Smith, and later Daniel Ricardo, both staunch critics of the concept, came up with their own theories to counter mercantilism.

Smith was the first economist to bring up the concept of absolute advantage, and his arguments regarding the same supported his theories for a laissez-faire state. In the Wealth of Nations, Smith first points out through opportunity costs that regulations favoring one industry take away resources from another industry, where they might have been more advantageously employed.

Secondly, he applies the opportunity cost principle to individuals in a society, using the particular example of a shoemaker not using the shoes he made himself because that would be a waste of his productive resources and he would rather purchase shoes made efficiently by some other producer. Each individual thus specializes in the production of goods and services in which he or she has some sort of an advantage.

Thirdly, Smith applies the same principles of opportunity costs and specialization to international economic policy, and the principle of international trade. He explains that it is better to import goods from abroad where they can be manufactured more efficiently because this allows the importing country to put its resources on its own most productive and efficient industries. Smith thus emphasizes that a difference in technology between nations is the primary determinant of international trade flows around the globe.

Adam Smith's Theory of Absolute Differences in Cost

Adam Smith said that trade between two nations is based on **absolute advantage**. When one nation is more efficient than another in the production of one commodity but is less efficient than the other nation in producing a second commodity, then both nations can gain by each specializing in the production of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage.

This process helps in utilizing the resources in the most efficient way and the output of both products will rise.

Assumptions of the Absolute Advantage Theory

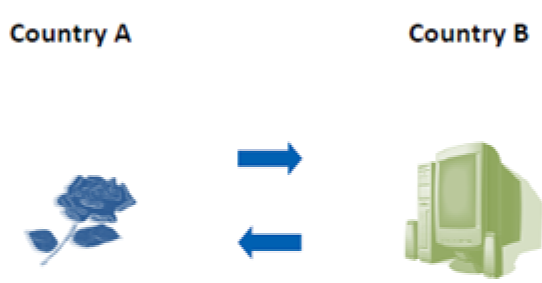
- Smith assumed that the costs of the commodities were computed by the relative amounts of labor required in their respective production processes.
- He assumed that labor was mobile within a country but immobile between countries.
- He took into consideration a two-country and two-commodity framework for his analysis.
- He implicitly assumed that any trade between the two countries considered would take place if each of the two countries has an absolutely lower cost in the production of one of the commodities.

Advantages

- **Absolute Cost Advantage:** This results from the specialization of labor proposed by Smith in his theory. Specialization of labor, or division of labor, results in a significantly higher productivity per unit of labor, and in turn, a lower cost of production. Smith also used the concept of "Economies of Scale" to explain the lowering of production costs, as a higher output due to labor diversification would significantly reduce production cost.
- **Natural Advantage:** A country would produce those goods that are naturally favoring its climatic environment. The type of goods produced would also depend on the availability of natural resources. The presence of lots of natural resources would significantly provide an advantage to such a country while producing the goods.
- **Acquired Advantage:** This includes advantages in technology and level of skill development.

Example

Suppose country A is better than country B in producing roses, and country B is better than country A in producing computers. This is because country A can produce more roses than Country B with the same number of employees per hour (read resources), while country B can produce more computers than country A under the same conditions. Then, it will be an obvious case that each country will specialize in the product that it can produce most efficiently and then trade their products: country A will export roses and import computers from B, while country B will export computers and import roses from A.



Under these circumstances, both countries would gain if each specialized in the production of product of its absolute advantage and traded with the other country. *As a result both the products would be produced and consumed in more quantities and both the nations would benefit.*

This means that the theory of Adam Smith refutes the assumption that one nation could benefit only at the expense of another nation *Adam Smith believed that all nations would gain from free trade and strongly advocated a policy of laissez-faire i.e. free trade.*

Criticism of Absolute Advantage Theory

Adam Smith's theory could not explain *why the trade takes place even when one of the trading countries* ***does not have absolute cost advantage*** in both the commodities compared to the other country. Absolute cost advantage theory can explain only a very small part of world trade such as trade between tropical zone and temperate zone or between developed countries and developing countries. Most of the world trade is between developed countries that are similar with respect to their resources and development which is not explained by absolute cost advantage.

Comparative Costs Theory:

Ricardo's Theory of Comparative Advantage

David Ricardo stated a theory that other things being equal a country tends to specialise in and exports those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. Similarly the country's imports will be of goods having relatively less comparative cost advantage or greater disadvantage.

The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labour and specialization in production. Due to differences in climate, natural resources, geographical situation and efficiency of labour, a country can produce one commodity at a lower cost than the other.

In this way, each country specializes in the production of that commodity in which its comparative cost of production is the least. Therefore, when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high.

This is the basis of international trade, according to Ricardo. It follows that each country will specialise in the production of those commodities in which it has greater comparative advantage or least comparative disadvantage. Thus a country will export those commodities in which its comparative advantage is the greatest, and import those commodities in which its comparative disadvantage is the least.

Assumptions of the Theory:

The Ricardian doctrine of comparative advantage is based on the following assumptions:

(1) There are only two countries, say A and B.

(2) They produce the same two commodities, X and Y.

(3) Tastes are similar in both countries.

(4) Labour is the only factor of production.

(5) All labour units are homogeneous.

(6) The supply of labour is unchanged.

(7) Prices of the two commodities are determined by labour cost, i.e.. the number of labour-units employed to produce each.

(8) Commodities are produced under the law of constant costs or returns.

(9) Trade between the two countries takes place on the basis of the barter system.

(10) Technological knowledge is unchanged.

(11) Factors of production are perfectly mobile within each country but are perfectly immobile between the two countries.

(12) There is free trade between the two countries, there being no trade barriers or restrictions in the movement of commodities.

(13) No transport costs are involved in carrying trade between the two countries.

(14) All factors of production are fully employed in both the countries.

(15) The international market is perfect so that the exchange ratio for the two commodities is the same.

Cost Differences:

Given these assumptions, the theory of comparative costs is explained by taking three types of differences in costs: absolute, equal and comparative.

(1) Absolute Differences in Costs:

There may be absolute differences in costs when one country produces a commodity at an absolute lower cost of production than the other.

The absolute cost differences are illustrated in Table

Table Absolute Differences in Costs:

The table reveals that country A can produce 10 X or 5F with one unit of labour and country B can produce 5X or 10K with one unit of labour

Country	Commodity X	Commodity Y
A	10	5
B	5	10

In this case, country A has an absolute advantage in the production of X (for 10 X is greater than 5 X), and country B has an absolute advantage in the production of Y (for 10 Y is greater than 5 Y).

This can be expressed as 10X of A/5X of B > 1 > 5 Y of A/10Y of B.

Trade between the two countries will benefit both, as shown in Table

Country	**Production before trade**	**Production after trade**	**Gains from trade**
Commodity	(1)	(2)	(2-1)
	XY	XY	XY
A	105	20-	+10-5
B	510	-20	-5+10

Table reveals that before trade both countries produce only 15 units arch of the two commodities by applying one labour-unit on each commodity. If A were to specialise in producing commodity X and use both units of labour on it, its total production will be 20 units of X. Similarly, if B were to specialise in the production of Y alone, its total production will be 20 units of Y. The combined gain to both countries from trade will be 5 units of X and Y.

Figure illustrates absolute differences in costs with the help of production possibility curves. Y_A X_A is the production possibility curve of country A which shows that it can produce either OX_A of commodity X or OY_A of commodity Y. Similarly, country B can produce OX_B of commodity X or $0Y_B$ of commodity Y. The figure also reveals that A has an absolute advantage in the production of commodity X ($OX_A > OX_B$), and country B has an absolute advantage in the production of commodity Y($OY_B > OY_A$).

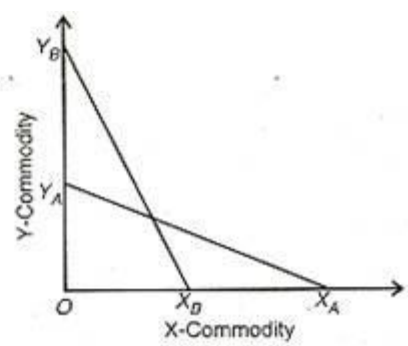


FIG. 78.1

Adam Smith based his theory of international trade on absolute differences in costs between two countries. But this basis of trade is not realistic because we find that there are many underdeveloped countries which do not possess absolute advantage in the production of commodities, and yet they have trade relations with other countries. Ricardo, therefore, emphasised comparative differences in costs.

(2) Equal Differences in Costs:

Equal differences in cost arise when two commodities are produced in both countries at the same cost difference. Suppose country A can produce 10 X or 5 Y and country B can produce 8 X or 4 Y.

In this case, with one unit of labour country A can produce either 10 X or 5 Y, and the cost ratio between A" and Y is 2:1. In country B, one unit of labour can produce either 8X or 4Y, and the cost ratio between the two commodities is 2: 1.

Thus the cost of producing X in terms of Y is the same in both countries. This can be expressed as 10X of A/ 8X of B = 5Y of A/4Yof B = 1

When cost differences are equal, no country stands to gain from trade. Hence international trade is not possible.

(3) Comparative Differences in Costs:

Comparative differences in cost occur when one country has an absolute advantage in the production of both commodities, but a comparative advantage in the production of one commodity than in the other. The comparative cost differences are illustrated in Table below.

Table Comparative Differences in costs:

Country	Commodity X	Commodity Y
A	10	10
B	6	8

The table reveals that country A can produce 10X or 10Y, and country B can produce 6X or 8X.

In this case, country A has an absolute advantage in the production of both X and Y, but a comparative advantage in the production of X. Country B is at an absolute disadvantage in the production of both commodities but its least comparative disadvantage is in the production of Y. This can be seen from the fact that before trade the domestic cost ratio of X and Y in country A is 10: 10 (or 1:1), while in country B, it is 6:8 (or 3:4). If they were to enter into trade, country A's advantage over country B in the production of commodity X is 10X of A / 6X of B or 5/3, and in the production of Y, it is 10Y of A/8Y of B or 5/4. Since 5/3 is greater than 5/4, A's advantage is greater in the production of commodity X, A will find cheaper to import commodity Y from country B in exchange for it's X.

Similarly, we can know the comparative disadvantage of country B in the production of both commodities. In the case of commodity X, country B's position is 6X of B/10X of A or 3/5. In the case of commodity Y, it is 8Y of B/10Y of A or 4/5.

Since 4/5 is greater than 3/5, B has least comparative disadvantage in the production of Y. It will trade its Y for X of country A.

In other words, country A has a comparative advantage in the production of commodity A', and B has least comparative disadvantage in the production of Y. Thus, trade is beneficial for both countries. The comparative advantage position of both countries is illustrated in Figure below.

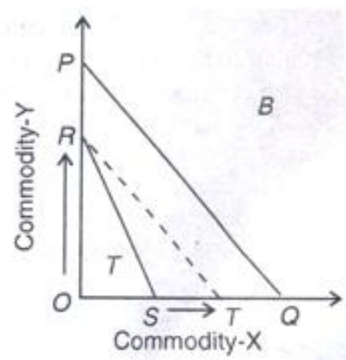


Fig. 78.2

Let PQ be the production possibility curve of country A and RS of country B. The curve PQ shows that country A has an absolute advantage in the production of both commodities X and Y respectively over country B. This is due to the fact that the production possibility curves RS of country B lies below the production possibility curve PQ of country A. Country B produces OR units of commodity Y and OS units of commodity X.

To show comparative advantage position in trade, draw a line RT parallel to line PQ. Now country A has a comparative advantage in the production of commodity X only because it exports OT (> OS) units relatively to country B. On the other hand, country B has a comparative disadvantage in the production of commodity Y only. This is because, if it gives up resources required to produce OS units of X, it would be able to produce commodity Y by an amount less than OR. Thus country A has a comparative advantage in the production of commodity X, and country B has a comparative disadvantage in the production of commodity Y.

Criticisms:

The principle of comparative advantage has been the very basis of international trade for over a century until after the First World War. Since then critics have been able only to modify and amplify it. As rightly pointed out by Professor Samuelson, "If theories, like girls, could win beauty contests, comparative advantage would certainly rate high in that it is an elegantly logical structure."

But the theory is not free from some defects. In particular, it has been criticised by Bertin Ohlin and Frank D. Graham. We discuss some of the important criticisms as under.

(1) Unrealistic Assumption of Labour Cost:

The most severe criticism of the comparative advantage doctrine is that it is based on the labour theory of value. In calculating production costs, it takes only labour costs and neglects non-labour costs involved in the production of commodities. This is highly unrealistic be- cause it is money costs and not labour costs that are the basis of national and international transactions of goods.

Further, the labour cost theory is based on the assumption of homogeneous labour. This is again unrealistic because labour is heterogeneous—of different kinds and grades, some specific or specialised, and other non-specific or general.

(2) No Similar Tastes:

The assumption of similar tastes is unrealistic because tastes differ with different income brackets in a country. Moreover, they also change with the growth of an economy and with the development of its trade relations with other countries.

(3) Static Assumption of Fixed Proportions:

The theory of comparative costs is based on the assumption that labour is used in the same fixed proportions in the production of all commodities. This is essentially a static analysis and hence unrealistic. As a matter of fact labour is used in varying proportions in the production of commodities. For instance, less labour is used per unit of capital in the production of steel than in the production of textiles. Moreover, some substitution of labour for capital is always possible in production.

(4) Unrealistic Assumption of Constant Costs:

The theory is based on another weak assumption that an increase of output due to international specialisation is followed by constant costs. But the fact is that there are either increasing costs or diminishing costs. If the large scale of production reduces costs, the comparative advantage will be increased. On the other hand, if increased output is the result of increased cost of production the comparative advantage will be reduced, and in some cases it may even disappear.

(5) Ignores Transport Costs:

Ricardo ignores transport costs in determining comparative advantage in trade. This is highly unrealistic because transport costs play an important role in determining the pattern of world trade. Like economies of scale, it is an independent factor of production. For instance, high transport costs may nullify the comparative advantage and the gain from international trade.

(6) Factors not fully Mobile Internally:

The doctrine assumes that factors of production are perfectly mobile internally and wholly immobile internationally. This is not realistic because even within a country factors do not move freely from one industry to another or from one region to another.. The greater the degree of specialisation in an industry, the less is the factor mobility from one industry to another. Thus factor mobility influences costs and hence the pattern of international trade.

(7) Two-Country Two-Commodity Model is Unrealistic:

The Ricardian model is related to trade between two countries on the basis of two commodities. This is again unrealistic because, in actuality, international trade is among countries trading many commodities.

(8) Unrealistic Assumption of Free Trade:

Another serious weakness of the doctrine is that it assumes perfect and free world trade. But, in reality, world trade is not free. Every country applies restrictions on the free movement of goods to and from other countries. Thus tariffs and other trade restrictions affect world imports and exports. Moreover, products are not homogeneous but differentiated. By neglecting these aspects, the Ricardian theory becomes unrealistic.

(9) Unrealistic Assumption of Full Employment:

Like all classical theories, the theory of comparative advantage is based on the assumption of full employment. This assumption also makes the theory static. Keynes falsified the assumption of full employment and proved the existence of underemployment in an economy. Thus the assumption of full employment makes the theory unrealistic.

(10) Self-Interest Hinders its Operation:

The doctrine does not operate if a country having a comparative disadvantage does not wish to import a commodity from the other country due to strategic, military or development considerations. Thus often self-interest stands in the operation of the theory of comparative costs.

(11) Neglects the Role of Technology:

The theory neglects the role of technological innovations in international trade. This is unrealistic because technological changes help in increasing the supply of goods not only for the domestic market but also for the international market. World trade has gained much from innovations and research and development (R & D).

(12) One-Sided Theory:

The Ricardian theory is one-sided because it considers only the supply side of international trade and neglects the demand side. In the words of Professor Ohlin, "It is, indeed, nothing more than an abbreviated account of the conditions of supply."

(13) Impossibility of Complete Specialisation:

Professor Frank Graham has pointed out that complete specialisation will be impossible on the basis of comparative advantage in producing commodities entering into international trade. He explains two cases in support of his argument: one, relating to a big country and a small country; and two, relating to a commodity of high value and low value.

To take the first case, suppose there are two countries which enter into trade on the basis of comparative advantage, of these, one is big and the other is small. The small country will be able to specialise completely as it can dispose of its surplus commodity to the bigger one. But the big country will not be able to specialise fully because (a) being big, the small country will not be in a position to meet its requirements fully, and (b) if it specialises completely in a particular commodity its surplus will be so large that the smaller country will not be able to import the whole of it.

In the second case of commodities having incomparable value, the country producing in high-value commodity will be able to specialise while that producing in low-value commodity will not be able to do the same. This is because the former country will be in a position to have a larger gain than the latter country. Thus, according to Graham, "The classical conclusion of complete specialisation between two countries can hold ground only … by assuming trade between two countries of equal opportunity, consumption value and between two countries of approximately equal economic performance."

(14) A Clumsy and Dangerous Tool:

Professor Ohlin has criticised the classical theory of international trade on the following grounds (i) The principle of comparative advantage is not applicable to international trade alone, rather it is applicable to all trade. To Ohlin, "International trade is but a special case of inter-local or interregional trade." Thus there is little difference between internal trade and international trade, (ii) Factors are immobile not only internationally but also within different regions. This is proved by the fact that wages and interest rates differ in different regions of the same country. Further labour and capital can also move between countries in a limited way, as they do within a region, (iii) It is a two-country two- commodity model based on the labour theory of value which is sought to be applied to actual conditions involving many countries and many commodities. He, therefore, regards the theory of comparative advantage as cumbersome, unrealistic, and as a clumsy and dangerous tool of analysis. As an alternative, Ohlin has propounded a new theory which is known as the Modern theory of International Trade.

(15) Incomplete Theory:

It is an incomplete theory. It simply explains how two countries gain from international trade. But it fails to show how the gains from trade are distributed between the two countries.

Conclusion:

Despite these weaknesses, the theory has stood the test of the times. Its basic structure has remained intact, even though many refinements have been made over it. To conclude with Professor Samuelson, "Yet for all its over simplifications, the theory of comparative advantages has in it a most important glimpse of truth. Political economy has found few more pregnant principles. A nation that neglects comparative advantage may have to pay a heavy price in terms of living standards and potential rates of growth."

Static gains from trade

The following are the static gains from trade:

1. Maximisation of Production:

According to the classical economists, the gains from trade result from the advantages of division of labour and specialisation both at the national and international levels.

Given the resources and technology in a country, it is specialisation in production 0Π the basis of comparative advantage and trading which enables each country to exchange its goods for the goods of another country. Thus it reaps greater gain than without trade. Each country exports those goods which it produces cheaper in exchange for what other countries produce at a lower cost. According to

Ricardo, "The gain from trade consisted in the saving of cost resulting from obtaining the imported goods through trade instead of domestic production." Thus trade maximises production.

2. Increase in Welfare:

As a result of international division of labour and specialisation, the production of goods increases in the trading country. As a result, the consumption of goods increases and so does the welfare of the people. As pointed out by Ricardo, "The extension of international trade very powerfully contributes to increase the mass of commodities and, therefore, the sum of enjoyments."

3. Increase in National Income:

When a country gains from international specialisation and exchange of goods in trade, there is increase in its national income. This, in turn, raises its level of output and growth rate of the economy.

4. Vent for Surplus:

The gain from trade also arises from the existence of idle land, labour, and other resources in a country before it enters into international trade. With its opening (vent) to world markets, its resources are used to produce a surplus of goods which would otherwise remain unsold. This is Adam Smith's vent for surplus gain from trade.

Dynamic Gains:

The following are the dynamic gains from trade:

1. Efficient Employment of Resources:

The direct dynamic gains from foreign trade are that comparative advantage leads to a more efficient employment of the productive resources of the world.

2. Widens-the Market:

The major indirect dynamic gain from trade is that it widens the size of the market. By enlarging the size of the market and scope of specialisation, international trade makes a greater use of machines, encourages inventions and innovations, raises labour productivity, lowers costs and leads to faster growth.

3. Development of Other Activities:

When a country starts producing goods for export and importing goods for domestic consumption, other economic activities also develop. There is expansion of infrastructure facilities in power, and building highways, bridges, fly-overs, etc. Shopping and housing complexes are built along with industrial centres. The primary sector develops into business sector for export of raw materials and for domestic use. Tertiary sector expands in the form of banks, communications, insurance, etc.

4. Increase in Investments:

Foreign trade encourages the setting up of new units for assembling and production of variety of goods. Supplementary and ancillary units are established. Production for exports leads to backward and forward linkages in developing other activities referred to above. All these increase autonomous and induced investments in the country.

The two types of gains are: (1) Static Gains, and (2) Dynamic Gains.

Static Gains from Trade:

The static gains from trade are measured by the increase in the utility or level of welfare when there is opening of trade between the countries. Note that in modern economics increase in utility or welfare is measured through indifference curves. When as a result of foreign trade, a country moves from a lower indifference curve to a higher one, it implies that the welfare of the people has increased.

To show the static gains from trade, let us take an example. Suppose two commodities cloth and wheat are produced in two countries, India and U.S.A., before they enter into trade. Their production possibility and indifference curves are shown in Figures 23.8 and 23.9. It will be seen from Fig. 23.8 that before trade India would be in equilibrium at point F (i.e. produc-ing and consuming at point F) where the price line pp' is tangent to both production possibility curve AB and indifference curve IC1.

The slope of the price line pp' shows the price-ratio (or cost ratio) of the two commodities in India. India can gain if international price-ratio (terms of trade) is different from the domestic price-ratio represented by pp'. Suppose the terms of trade settled are such that we get tt as the terms of trade line showing the price ratio at which goods can be ex-changed between India and the U.S.A

India would produce at point R at which the terms of trade line tt are tangent to her production possibility curve. It will be seen from Fig. 23.8 that at point R, India will produce more of cloth in which it has comparative advantage and less of wheat than at F. Though India will produce at point R on his production possibility curve, where the terms of trade line tt are tangent to her production possibility curve AB it will not consume the quantities of wheat and cloth repre-sented by the point R.

Given the new price-ratio represented by the terms of trade line tt the con-sumption of the goods will depend upon the pattern of demand of the country. To incorporate this factor we have drawn social indifference curves IC1 IC2 of the country. These social indifference curves represent the demands for the two goods, or, in other words, the scale of preferences be-tween the two goods of the society.

Gain from Trade: India

It will be seen from figure that the terms of trade line tt is tangent to the social indifference curve IC2 of India at point S. Therefore, after trade India will consume the quantities of cloth and wheat as represented by point S. It is therefore clear that as a result of specialisation and trade India has been able to shift from point F on indifference curve IC1 to the point S on higher indifference curve IC2.

This is the gain obtained from specialisation and trade and implies that trade enables a country to increase her consumption beyond her production possibility curve. (It will be seen that point S lies beyond the production possibility curve AB of India).

It is also worth noting that when specialisation and trade occur, the quantities of the two goods consumed by a country will differ from the quantities of the two goods produced by her. In Fig. 23.8 whereas India produces the quantities of two goods represented by point R, it will consume the quantities of the two goods represented by the point 5. The difference arises due to exports and imports of goods. In Fig while India will export MR quantity of cloth it will import MS quantity of wheat.

Now consider the position of U.S.A. which is depicted in fig given its factor endow-ments CD is the production possibility curve between wheat and cloth of the U.S.A. It is evident from the production possibility curve CD that the factor endowments of the USA are more favourable for the production of wheat.

It will also be seen from fig that before trade the U.S.A. will produce and consume at point E on her production possibility curve CD where the domestic price ratio line pp and indifference curve IC1 are tangent to it. The USA will gain from trade if it can sell at a different price ratio from pp. Suppose the terms of trade line is tt.

With this term of trade line tt the U.S.A. will produce at point G on her production possibility curve CD. She will now produce more of wheat in which she has comparative advantage and less of cloth than before. On the other hand, given the price ratio as represented by the terms of trade line tt the USA will consume the quantities of the two goods given by the point H where the terms of trade line tangent to her indifference curve lC2 is.

It is therefore clear that the specialisation and consequently trade with India has enabled the U.S.A. to shift from her lower indifference curve IC1 to her higher indifference curve IC2. This is the gain which she obtains from trade. By comparing the production and consumption points of the U.S.A. it will be observed that the U.S.A. will export NG amount of wheat and import NH amount of cloth.

It is worth remembering that while in case of constant opportunity cost, each country attains complete specialisation, that is, it produces one of the two goods after trade, in case of increasing opportunity cost specialisation is not complete. In case of increasing opportunity cost, a country produces only a relatively large amount of the good in which it has comparative advantage.

Measurement of gains from trade

1. The Classical Method: Jacob Viner points out that the classical economists followed three different methods or criteria for measuring the gains from international trade: (1) differences in comparative costs; (2) increase in the level of national income; and (3) the terms of trade.

But they often intermixed these methods without specifying them clearly. We discuss them as under.

Ricardo's Approach:

To take Ricardo's approach first, a country will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high. "The country thus economizes in the use of its resources, obtaining for a given amount thereof a larger total income than if it attempted to produce everything itself."

Prof. Ronald Findlay in his Trade and Specialisation (1970) has explained Ricardo's approach to the gains from international trade in terms of Fig below In the pre-trade situation, AB is the production possibility curve of a country which produces two commodities X and Y, given the quantity of labour input. On AS, the country is in equilibrium at point E.

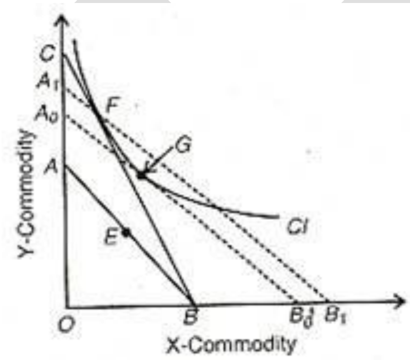


Fig. 80.1

After it enters into trade, its international price ratio is given by the slope of the line CB. Suppose that it is in equilibrium at point F on the line CB. If the quantities of X and Y represented by the combination at F are to be produced domestically, the quantity of labour input will have to increase sufficiently to shift the domestic production possibility curve up from AB to A_1B_1 The gains from trade will thus be measured by BB_1/OB.

But Malthus criticised Ricardo for greatly over-estimating the gains from trade. In terms of Fig, Malthus's view is that with the shifting of the domestic production possibility curve to A_1B_1 F would not be the equilibrium point. Relative prices along A_1B_1 would not be more favourable to the exported commodity X than along CB, so that consumer will prefer a point to the right of F on A_1B_1, rather than F itself. Hence the gains from trading along CB cannot be measured by an increase of labour input in the ratio BB_1/OB. This is because the change to the right of F on A_1B_1 is preferable to that on CB.

Prof. Ronald Findlay has modified the Ricardo measure of the gains from trade using the community indifference curve Cl. If the labour input is increased sufficiently to push the production possibility curve to A_0B_0 instead of to A_1B_1 the point G on the CI curve will make each individual as better as he is at the free trade point F. The gains from trade would, therefore, be equal to BBJOB instead of the larger BB_1IOB. This measure satisfies Malthus's criticism of Ricardo.

Mill's Approach:

J.S. Mill analysed the gains as well as the distribution of the gains from international trade in terms of his theory of reciprocal demand. According to Mill, it is reciprocal demand that determines terms of trade which, in turn, determine the distribution of gains from trade of each country. The term 'terms of trade' refers to the barter terms of trade between the two countries i.e., the ratio of the quantity of imports for a given quantity of exports of a country.

To take an example, in country A, 2 units of labour produce 10 units of X and 10 units of Y, while in country B the same labour produces 6X and 8K. The domestic exchange ratio (or domestic terms of trade) in country A is IX = 1 Y, and in country B, IX = 1.33У. This means that one unit of X can be exchanged with one unit of Y in country A or 1.33 units of Y in country B. Thus the terms of trade between the two countries will lie between 1X or 1Y or 1.33 Y.

However, the actual exchange ratio will depend upon reciprocal demand, i.e., "the relative strength and elasticity of demand of the two trading countries for each other's product in terms of their own product." If A's demand for commodity Y is more intense (inelastic), then the terms of trade will be nearer IX = IK. The terms of trade will move in favour of B and against country A. B will gain more and A less. On the other hand, if A's demand for commodity Y is less intense (more elastic), then the terms of trade will be nearer IX = 1.33K. The terms of trade will move in favour of A and against B. A will gain more and B less.

The distribution of gains from trade is explained in terms of the Marshall-Edge worth offer curves in fig . OA is the offer curve of country A, and OB of country B. OP and OQ are the domestic constant cost ratios of producing o X and Y in country A and B respectively. These rays are, in fact, the limits within which the terms of trade between the two countries lie. However, the actual terms of trade are settled at E the point of inter-section of OA and OB.

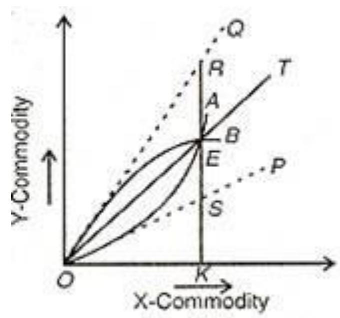


Fig. 80.2

The line OT represents equilibrium terms of trade at E.

The cost ratio within country A is KS units of Y: OK units of X. But it gets KE units of Y through trade. SE units of Y are, therefore, its gain. The cost ratio within country B is KR units of Y: OK units of X. But it imports OK units of X from country A in exchange for only KE units of Y. EP units of Y is its gain. Thus both countries gain by entering into trade.

2. The Modern Approach:

In modern trade theory, the gains from international trade are clearly differentiated between the gain from exchange and the gain from specialisation. The analysis is explained in terms of the general equilibrium of a closed economy by taking demand and supply. It is characterised by the tangency of a community indifference curve with the transformation curve, and the equality of the marginal rates of substitution between commodities in consumption and production with the domestic terms of trade or commodity price ratio. “The introduction of international trade permits the realisation of a gain from exchange and gain from specialisation. When equilibrium is established and these gains are maximised, the new marginal rate of transformation in production and the new marginal rate of substitution in consumption are equal to the international price ratio or terms of trade.” Thus both producers and consumers gain from international trade by producing and consuming more than the pre-trade level.

Figure below explains the gains from inter-national trade. AB is the transformation curve representing the supply side and CI_0 is the community indifference curve representing the demand side of an economy. The closed economy (no trade) equilibrium is shown by point E where the AB and CI_0 curves are tangent to each other and both equal the domestic terms of trade or commodity price ratio (line) P.

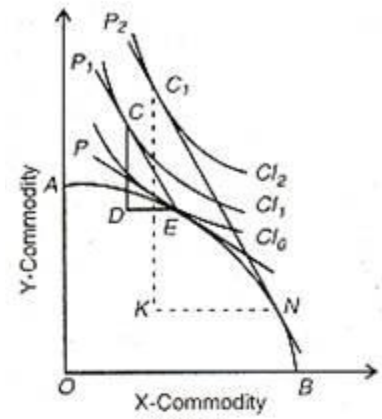


Fig. 80.3

With the introduction of international (or free) trade, the international price ratio (terms of trade) will be different from the domestic price ratio (terms of trade). It is shown as P_1 and is steeper than the domestic price ratio P. It means that the price of commodity X has increased in relation to commodity Y in the world market. At the X-Commodity international price line P_1 the consumers move to point C on a higher figure community indifference curve CI_0 from point E on the CI_0 curve. This movement from E to C measures the gain from exchange or consumption gain with no change in production.

Since the price of X has increased in the world market, producers increase its production and decrease that of Y. This leads to movement along the transformation curve from point E to N where a new international price line P, is tangent to the AB curve. In other words, at N the marginal rate of transformation in production equals the international price ratio. The new world terms of trade ratio P_2 is the same as P_1 because it is parallel to P_1. At N the country exports KN of X in exchange for KC_X imports of Y.

As a result of increased specialisation in the production of X, there is a shift in consumption from point C on the CI_1 curve to point C_1 on the CI_1 curve, where consumers consume larger quantities of both X and Y. This movement from C to C_1 measures the gain from specialisation in production or production gain. At C, the marginal rate of substitution and the international price ratio are equal. Hence the gains from international trade are maximised at points N and C, because the marginal rate of transformation in production and the marginal rate of substitution in consumption are equal to the international price ratio P_2. The total gain from free trade is the sum of the consumption and production gains and is shown as improvement in welfare from CI_0 to CI_2.

Increase in National Income. This analysis also explains the increase in the real income and hence the gains from trade. Point N on the price line P_2 corresponds to a higher real income than the pre-trade point E at the price line P. This is because at the new price line P_2 there are production and consumption gains to the country after trade.

Terms of trade

The commodity or net barter terms of trade is the ratio between the price of a country's export goods and import goods. Symbolically, it can be expressed as:

$Tc = Px/Pm$

Where, Tc stands for the commodity terms of trade, P for price, the subscript x for exports and m for imports.

To measure changes in the commodity terms of trade over a period, the ratio of the change in export prices to the change in import prices is taken. Then the formula for the commodity terms of trade is

$$Tc = Px_1/Px_0 \; / \; Pm_1/Pm_0$$

Where the subscripts 0 and 1 indicate the base and end periods.

Taking 2001 as the base year and expressing India's both export prices and import prices as 100, if we find that by the end of 2011 its index of export prices had fallen to 90 and the index of import prices had risen to 110. The terms of trade had changed as follows:

Tc = 90/100 / 110/100 = 81.82

It implies that India's terms of trade declined by about 18 per cent in 2011 as compared with 2001, thereby showing worsening of its terms of trade.

If the index of export prices had risen to 180 and that of import prices to 150, then the terms of trade would be 120. This implies an improvement in the terms of trade by 20 per cent in 2011 over 2001.

The concept of the commodity or net barter terms of trade has been used by economists to measure the gain from international trade. The terms of trade, as determined by the offer curves in the Mill-Marshall analysis, are related to the commodity terms of trade.

Limitations:

Despite its use as a device for measuring the direction of movement of the gains from trade, this concept has important limitations.

1. Problems of Index Numbers:

Usual problems associated with index number in terms of coverage, base year and method of calculation arise.

2. Change in Quality of Product:

The commodity terms of trade are based on the index numbers of export and import prices. But they do not take into account changes taking place in the quality and composition of goods entering into trade between two countries. At best, commodity terms of trade index shows changes in the relative prices of goods exported and imported in the base year. Thus the net barter terms of trade fail to account for large change in the quality of goods that are taking place in the world, as also new goods that are constantly entering in international trade.

3. Problem of Selection of Period: Problem arises in selecting the period over which the terms of trade are studied and compared. If the period is too short, no meaningful change may be found between the base date and the present. On the other hand, if the period is too long, the structure of the country's trade might have changed and the export and import commodity content may not be comparable between the two dates.

4. Causes of Changes in Prices:

Another serious difficulty in the commodity terms of trade is that it simply shows changes in export and import prices and not how such prices change. As a matter of fact, there is much qualitative difference when a change in the commodity terms of trade index is caused by a change in export prices relative to import prices as a result of changes in demand for exports abroad, and ways or productivity at home. For instance, the commodity terms of trade index may change by a rise in export prices relative to import prices due to strong demand for exports abroad and wage inflation at home. The commodity terms of trade index does not take into account the effects of such factors.

5. Neglect of Import Capacity:

The concept of the commodity terms of trade throws no light on the "capacity to import" of a country. Suppose there is a fall in the commodity terms of trade in India. It means that a given quantity of Indian exports will buy a smaller quantity of imports than before.

Along with this trend, the volume of Indian exports also rises, may be as a consequence of the fall in the prices of exports. Operating simultaneously, these two trends may keep India's capacity to import unchanged or even improve it. Thus the commodity terms of trade fails to take into account a country's capacity to import.

6. Ignores Productive Capacity:

The commodity terms of trade also ignores a change in the productive efficiency of a country. Suppose the productive efficiency of a country increases. It will lead to a fall in the cost of production and in the prices of its export goods.

The fall in the prices of export goods will be reflected in the worsening of its commodity terms of trade. But, in reality, the country will not be worse off than before. Even though a given value of exports will exchange for less imports, the country will be better off. This is because a given volume of exports can now be produced with lesser resources, and the real cost of imports, in terms of resources used in exports, remains unchanged.

7. Not Helpful in Balance of Payment Disequilibrium:

The concept of commodity terms of trade is valid if the balance of payments of a country includes only the export and imports of goods and services, and the balance of payments balances in the base and the given years. If the balance of payments also includes unilateral payments or unrequired exports and or/imports, such as gifts, remittances from and to the other country, etc., leading to disequilibrium in the balance of payments, the commodity terms of trade is not helpful in measuring the gains from trade.

8. Ignores Gains from Trade:

The concept of commodity terms of trade fails to explain the distribution of gains from trade between a developed and under-developed country. If the export price index of an underdeveloped country rises more than its import price index, it means an improvement in its terms of trade. But if there is an equivalent rise in profits of foreign investments, there may not be any gain from trade.

To overcome this last difficulty, Taussig introduced the concept of the gross barter terms of trade

The gross barter terms of trade are the ratio between the quantities of a country's imports and exports. Symbolically, Tg = Qm/Qx, where Tg stands for the gross terms of trade, Qm for quantities of Imports and Qx for quantities of exports. The higher ratio between quantities of imports and exports, the better is the gross terms of trade. A larger quantity of imports can be had for the same volume of exports.

To measure changes in the gross barter terms of trade over a period, the index number of the quantities of imports and exports in base period and the end period are related to each other. The formula for this is:

Tg = Qm1/Qm0 / Qx1/Qx0

Taking 2001 as the base year and expressing India's both quantities of imports and exports as 100, if we find that the index of quantity imports had risen to 160 and that of quantity exports to 120 in 2011, then the gross barter of trade had changed as follows:

Tg = 160/100 / 120/100

It implies that there was an improvement in the gross barter terms of trade of India by 33 per cent in 2011 as compared with 2001.

If the quantity of import index had risen by 130 and that of quantity exports by 180, then the gross barter terms of trade would be 72.22.

Tg = 130/100 / 180/100

This implies deterioration in the terms of trade by 18 per cent in 2011 over 2001.

When the net barter terms of trade (Γ) equal the gross barter terms of trade (Γ), the country has balance of trade equilibrium. It shows that total receipts from exports of goods equal total payments for import goods.

Numerically:

$$Px \times Qx = Pm \times Qm$$

$$\text{or } Px / Pm = Qm/Qx$$

$$\text{or } Tc = Tg$$

Criticisms:

The concept of gross barter terms of trade has been criticised by economists on the following grounds:

1. Aggregating Goods, Services and Capital Transactions:

The concept of gross barter terms of trade has been criticised for lumping together all types of goods and capital payments and receipts as one category in the index numbers of exports and imports. No units are applicable equally to rice and to steel, or to export (or import) of capital and the payment (or receipt) of a grant. It is therefore, not possible to distinguish between the various types of transactions which are lumped together in the index. Haberler, Viner and other economists have, therefore, dismissed this concept as unreal and impracticable as a statistical measure.

2. Ignores Factor Productivity:

This concept ignores the effect of improvement in factor productivity on the terms of trade of a country. A country may have unfavourable gross barter terms of trade due to increase; in factor productivity in the export sector. This increased factor productivity, in turn, reflects the gain for the exporting country.

3. Neglects Balance of Payments:

The concept of gross barter terms of trade relates to the trade balance and ignores the influence of international capital receipts and payments of a trading country.

4. Ignores Improvements in Production:

This concept measures the terms of trade in terms of physical quantities of exports and imports but ignores qualitative improvements in the production of exportable and importable goods.

5. Not True Index of Welfare:

An improvement in gross barter terms of trade is regarded as an index of a higher level of welfare from trade. For the country exchanges more importable goods for its exportable goods. But this may not be true if tastes, preferences and habits of the people change so that the country needs less importable which yield greater satisfaction to the people. It will lead to unfavourable gross barter terms of trade but improve welfare.

Conclusion: Due to the above noted limitations, Viner uses only the concept of net barter terms of trade while other writers use only the export-import price ratio as the commodity terms of trade. So this concept has been discarded by economists.

Income terms of trade: The income terms of trade is the net barter terms of trade of a country multiplied by its export volume index. It can be expressed as

Ty = Tc.Qx = Px.Qx/Pm = Index of Export Prices x Export Quantity/Index of Import Prices

Where, Ty is the income terms of trade, Tc the commodity terms of trade and Qx the export volume index.

A.H. Imlah calculates this index by dividing the index of the value of exports by an index of the price of imports. He calls it the "Export Gain from Trade Index."

Taking 2001 as the base year, if

Px = 140, Pm = 70 and Qx = 80 in 1981, then

Py = 140 x 80/70 = 160

It implies that there is improvement in the income terms of trade by 60 per cent in 2011 as compared with 2001.

If in 2011, Pi = 80, Pm =160 and Qx =120, then

Py = 80 x 120 / 120 = 60

It implies that the income terms of trade have deteriorated by 40 per cent in 2011 as compared with 2001.

A rise in the index of income terms of trade implies that a country can import more goods in exchange for its exports. A country's income terms of trade may improve but its commodity terms of trade may deteriorate. Taking the import prices to be constant, if export prices fall, there will be an increase in the sales and value of exports. Thus while the income terms of trade might have improved, the commodity terms of trade might have deteriorated.

The income terms of trade is called the capacity to import. In the long-run, the total value of exports of a country must equal to its total value of imports, i.e., Px. Qx = Pm.Qm or Px.Qx/Pm = Qm. Thus Px.Qx/ Pm determine Qm which is the total volume that a country can import. The capacity to import of a country may increase if other things remain the same (i) the price of exports (Px) rises, or (if) the price of imports {Pm) falls, or (Hi) the volume of its exports (Qx) rises. Thus the concept of the income terms of trade is of much practical value for developing countries having low capacity to import.

Criticisms:

The concept of income terms of trade has been criticised on the following counts:

1. Fails to Measure Gain or Loss from Trade:

The index of income terms of trade fails to measure precisely the gain or loss from international trade. When the capacity to import of a country increases, it simply means that it is also exporting more than before. In fact, exports include the real resources of a country which can be used domestically to improve the living standard of its people.

2. Not Related to Total Capacity to Import:

The income terms of trade index is related to the export based capacity to import and not to the total capacity to import of a country which also includes its foreign exchange receipts. For example, if the income terms of trade index of a country have deteriorated but its foreign exchange receipts have risen, its capacity to import has actually increased, even though the index shows deterioration.

3. Inferior to Commodity Terms of Trade:

Since the index of income terms of trade is based on commodity terms of trade and leads to contradictory results, the concept of the commodity terms of trade is usually used in preference to the income terms of trade concept for measuring the gain from international trade.

Single Factoral Terms of Trade:

The concept of commodity terms of trade does not take account of productivity changes in export industries. Prof. Viner had developed the concept of single factoral terms of trade which allows changes in the domestic export sector. It is calculated by multiplying the commodity terms of trade index by an index of productivity changes in domestic export industries. It can be expressed as:

$$Ts = Tc.Fx = Px.Fx/Pm$$

Where Ts is the single factoral terms of trade, Tc is the commodity terms of trade, and Fx is the productivity index of export industries.

It shows that a country's factoral terms of trade improve as productivity improves in its export industries. If the productivity of a country's exports industries increases, its factoral terms of trade may improve even though its commodity terms of trade may deteriorate. For example, the prices of its exports may fall relatively to its import prices as a result of increase in the productivity of the export industries of a country. The commodity terms of trade will deteriorate but its factoral terms of trade will show an improvement.

Limitations:

This index is not free from certain limitations. It is difficult to obtain the necessary data to compute a productivity index. Further, the single factoral terms of trade do not take into account the potential domestic cost of production of imports industries in the other country. To overcome this weakness, Viner formulated the double factoral terms of trade.

Double Factoral Terms of Trade:

The double factoral terms of trade take into account productivity changes both in the domestic export sector and the foreign export sector producing the country's imports. The index measuring the double factoral terms of trade can be expressed as

$$Td = Tc. Fx/Fm = Px/Fm . Fx/Fm$$

Where Td is the double factoral terms of trade, Px/Pm is the commodity terms of trade, Fx is the export productivity index, and Fm is the import productivity index.

It helps in measuring the change in the rate of exchange of a country as a result of the change in the productive efficiency of domestic factors manufacturing exports and that of foreign factors manufacturing imports for that country. A rise in the index of double factoral terms of trade of a country means that the productive efficiency of the factors producing exports has increased relatively to the factors producing imports in the other country.

Criticisms:

1. Not Possible to Construct a Double Factoral Terms of Trade Index:

In practice, however, it is not possible to calculate an index of double factoral terms of trade of a country because it involves measuring and comparing productivity changes in the import industries of the other country with that of the domestic export industries.

2. Required Quantity of Productive Factors not Important:

Moreover, the important thing is the quantity of commodities that can be imported with a given quantity of exports rather than the quantity of productive factors required in a foreign country to produce its imports.

3. No Difference between the Double Factoral Terms of Trade and the Commodity Terms of Trade:

Again, if there are constant returns to scale in manufacturing and no transport costs are involved, there is no difference between the double factoral terms of trade and the commodity terms of trade of a country.

4. Single Factoral Terms of Trade is more Relevant Concept:

According to Kindleberger, "The single factoral terms of trade is a much more relevant concept than the double factoral. We are interested in what our factor can earn in goods, not what factor services can command in the services of foreign factors. Related to productivity abroad moreover, is a question of the quality of the goods imported."

Factors influencing terms of trade

Terms of trade are influenced by a number of factors. Important among them are given below:

1. Elasticity of Demand: The elasticity of demand for exports and imports of a country influence its terms of trade. If the demand for a country's exports is less elastic as compared to her imports, the terms of trade will tend to be favourable because the exports can command higher price than imports.

On the other hand, if the demand for imports is less elastic than that for exports, the terms of trade will be unfavourable.

2. Elasticity of Supply:

The nature of elasticity of supply also significantly influence the country's terms of trade. If the supply of a country's exports is more elastic than the imports, the terms of trade will tend to be favourable.

3. Nature of Goods:

If a country is producing and exporting only primary goods, and importing manufactured goods, the terms of trade will be unfavourable.

4. Economic Development:

The economic development has two types of effects: (a) The demand effect: It refers to the increase in demand for imports as a result of increase in income associated with economic development, (b) The supply effect: It refers to the increase in supply of import substitutes or import competing goods. The net effect of economic development depends upon the extent of these two effects.

5. Rate of Exchange:

Changes in the rate of exchange of a country's currency also affect its terms of trade. If a country's currency appreciates, its terms of trade will improve because a rise in the value of the currency causes an increase in the export prices and decrease in the import prices.

6. Tariff Policy:

Tariffs and quotas also influence the terms of trade. These measures, if not retaliated by other countries, improve a country's terms of trade by restricting imports.

7. Size of Population:

An overpopulated country will have larger demand for imports. As a result, the terms of trade will tend to be unfavourable in this case relative to the under populated or optimally populated country.

8. Size of Country:

A larger country will tend to have less favourable terms of trade as compared to a smaller country. This is because the smaller country can reap the gains of economies of scale enjoyed by the larger one in the international trade.

9. Degree of Competition:

If a country enjoys monopoly power in case of its exports and there are many alternative sources of supply of its imports, then it will have favourable terms of trade.

Determinants of the Terms of Trade

The terms of trade ultimately decided on by the two trading farmers will depend on a variety of different and distinct factors. Next we describe many of these factors.

Preferences

The strength of each farmer's desire for the other product will influence how much he is willing to give up obtaining the other product. Economists assume that most products exhibit diminishing marginal utility. This means that the tenth orange consumed by Farmer Smith adds less utility than the first orange he consumes. In effect, we expect people to get tired of eating too many oranges. Since for most people the tenth orange consumed will be worth less than the first apple consumed, Farmer Smith would be willing to trade at least one orange for one apple. As long as the same assumption holds for Farmer Jones, the tenth apple for him will be worth less than the first orange, and he will be willing to trade at least one for one. How many more oranges might trade for how many more apples will depend on how much utility each farmer gets from successive units of both products: in other words, it depends on the farmers' preferences.

Uncertainty

In this situation, each farmer is unlikely to have well-defined preferences. Farmer Smith may never have tasted an apple, and Farmer Jones may never have tasted an orange. One simple way to resolve this uncertainty is for the farmers to offer free samples of their products before an exchange is agreed on. Without a sample, the farmers would have to base their exchanges on their expectations of how they will enjoy the other product. Free samples, on the other hand, can be risky. Suppose a sample of oranges is provided and Farmer Jones learns that he hates the taste of oranges. He might decide not to trade at all.

To overcome uncertainty in individual preferences, many consumer products are offered in sample sizes to help some consumers recognize that they do have a preference for the product. This is why many supermarkets offer free samples in their aisles and why drink companies sometimes give away free bottles of their products.

Scarcity

The relative quantities of the two goods available for trade will affect the terms of trade. If Farmer Smith came to the market with one hundred oranges to Farmer Jones's ten apples, then the terms of trade would likely be different than if the farmers came to the market with an equal number. Similarly, if the farmers came to the market with ten oranges and ten apples, respectively, but recognized that they had an entire orchard of apples and an entire grove of oranges waiting back at home, then the farmers would be more likely to give up a larger amount of their product in exchange.

Size

The sizes of the apples and oranges are likely to influence the terms of trade. One would certainly expect that Farmer Smith would get more apples for each orange if the oranges were the size of grapefruits and the apples the size of golf balls than if the reverse were true.

Quality

The quality of the fruits will influence the terms of trade. Suppose the apples are sweet and the oranges are sour. Suppose the apples are filled with worm holes. Suppose the oranges are green rather than orange. Or consider the vitamin, mineral, and calorie contents of each of the fruits. Quality could also be assessed by the variety of uses for each product. For example, apples can be eaten raw, turned into applesauce, squeezed into juice, made into pies, or covered with caramel.

Effort

Although a pure exchange model assumes that no production takes place, imagine momentarily that some effort is required to harvest the fruit. What if apples grew at the top of tall trees that required a precarious climb? What if predatory wolves lived in the orange grove? Surely these farmers would want to take these factors into account when deciding the terms for exchange. Of course, this factor is related to scarcity. The more difficult it is to produce something, the scarcer that item will be.

Persuasion

The art of persuasion can play an important role in determining the terms of trade. Each farmer has an incentive to embellish the quality and goodness of his product and perhaps diminish the perception of quality of the other product. Farmer Smith might emphasize the high quantities of vitamin C found in oranges while noting that apples are relatively vitamin deficient. He might argue that oranges are consumed by beautiful movie stars who drive fast cars, while apples are the food of peasants. He might also underemphasize his own desire for apples. The more persuasive Farmer Smith is, the more likely he is to get a better deal in exchange. Note that the farmer's statements need not be truthful as long as the other farmer is uncertain about the quality of the other product. In this case, differences in the persuasive abilities of the two farmers can affect the final terms of trade.

Expectations of Utility

Decisions about how much to trade are based on the utility one expects to obtain upon consuming the good. The utility one ultimately receives may be less. Indeed, in some cases the value of what one receives may be less than the value of what one gives up. However, this outcome will arise only if expectations are not realized.

For example, a person may choose to voluntarily pay $10 to see a movie that has just been released. Perhaps the person has read some reviews of the movie or has heard from friends that the movie is very good. Based on prior evaluation, the person decides that the movie is worth at least $10. However, suppose this person winds up hating the movie and feels like it was a complete waste of time. In hindsight, with perfect knowledge about his own preferences for the movie, he might believe it is only worth $5 or maybe just $2, in which case he is clearly worse off after having paid $10 to see the movie. This is one reason individuals may lose from trade, but it can only occur if information is imperfect.

Expectations of a Future Relationship

If the farmers expect that the current transaction will not be repeated in the future, then there is a potential for the farmers to misrepresent their products to each other. Persuasion may take the form of outright lies if the farmers do not expect to meet again. Consider the traveling medicine man portrayed in U.S. Western movies. He passes through town with a variety of elixirs and promises that each will surely cure your ailment and possibly do much more. Of course, chances are good that the elixirs are little more than colored water with some alcohol and are unlikely to cure anything. But this type of con game is more likely when only one transaction is expected. However, if the transaction is hoped to be the first of many to come, then untruthful embellishments will be less likely.

Government Policies

If a taxman stands ready to collect a tax based on the amounts traded between the two farmers, this is likely to affect the terms of trade. Also, if laws impose penalties for misrepresentation of a product, then this will also affect the farmers' behavior in determining the terms of trade.

Morality

Imagine that Farmer Smith was raised to always tell the truth, while Farmer Jones missed those lessons during his upbringing. In this case, Farmer Jones might be more likely to misrepresent his apples in order to extract a more favorable terms of trade.

Coercion

Finally, the terms of trade can also be affected by coercion. If Farmer Jones threatens Farmer Smith with bodily injury, he might be able to force an exchange that Farmer Smith would never agree to voluntarily. At the extreme, he could demand all of Farmer Smith's oranges and not give up any apples in exchange. Of course, once coercion enters a transaction, it may no longer be valid to call it trade—it would be more accurate to call it theft.

Summary

Notice that many of these determinants relate to good business practices and ethical behavior. Business schools have classes in marketing and product promotion, sales advertising, and quality control, all of which can be thought of as ways to improve the terms of trade for the product the business is selling. Ethics teaches one to be truthful and to represent one's products honestly. It also teaches one not to steal or use force to obtain what one desires.

How all these factors play into the matter ultimately influences what the terms of trade will be between products. As such, this simple model of trade can be embellished into a fairly complex model of trade. That some terms of trade will arise is simple to explain. But what precisely will be the terms of trade involves a complex mixture of factors.

Reasons for the Unfavourable Terms of Trade of Underdeveloped Countries

In comparison to advanced countries, underdeveloped countries have, usually, unfavorable terms of trade. The reasons for this tendency are not far to seek. The following causes are responsible for such a phenomenon:

1. High Cost-ratios:

As compared to advanced countries, underdeveloped countries have high cost-ratios on account of the low productivity of factors of production.

2. Backward Technology:

Underdeveloped countries are in a backward state of technology; hence, their relative productivity is low, so the cost of production and domestic price-structure is relatively high. This puts the poor country at a disadvantageous bargaining position; consequently the terms of trade are settled in favour of the advanced country.

3. Primary Products:

Underdeveloped countries are usually agrarian economics. Their exports consist of primary products and imports consist of capital goods. Again in these countries agricultural production is very much prone to the operation of the law of diminishing returns due to lack of mechanisation and agricultural reforms.

On the other hand, industrial production in advanced countries is subject to the law of increasing returns due to improved and changing technology. Thus, terms of trade between the exchange of primary products and industrial products are always settled in favour of the latter and against the former.

Usually, the pattern of production and trade in developed (DCs) and less development countries (LDCs) indicate that the demand of the DCs for primary product imports from LDCs is inelastic. Moreover, the supply of primary products by the LDCs also tends to be inelastic. With low desires of elasticity's of demand and supply, the equilibrium terms of trade is determined unfavourably in the case of LDCs.

4. High Population Growth:

Most of the underdeveloped countries are over-populated and their growth rate is also high. Consequently, there is a high internal demand for the goods produced in general which causes low exportable surplus with these countries.

Again, the relative import demand of these countries is also high and inelastic. This causes their terms of trade to deteriorate.

5. Greater Dependency:

Poor countries are greatly dependent for their capital goods requirement and other needs on the advanced countries. They have no other alternative in view of the absence of import substitution. While, advanced countries are least dependent on the poor countries as they are capable of producing import substitutes. Hence, poor countries have always weak bargaining power, so they have to accept even terms of trade which are very much against their interest.

6. Lack of Adaptability:

Advanced countries can quickly adapt the production of such goods which are high in demand and whose prices are rising faster than the goods whose prices remain steady or declining. Underdeveloped countries lack such adaptability on account of their primary production, backward state of technology, market imperfections, immobility of factors of production and the over-all rigidity of their economy as a whole.

As such, the terms of trade of underdeveloped" countries tend to deteriorate when inflation starts in manufactured goods at a faster rate, while the world prices of agrarian output remain more or less steady.

The following are the main reasons for unfavorable and declining terms of trade of less developed countries:

1. Prebisch's Arguments:

Prebisch has given the following arguments explaining the declining tendency of terms of trade of the less developed countries.

(i) Nature of Product:

The less developed countries are mainly primary producing countries. Their exports mostly include primary products and their imports include capital goods. On the contrary, the developed countries produce and export manufactured goods.

The terms of trade between the primary products and manufactured products are generally determined against the former and in favour of the latter.

(ii) Effect of Technical Progress:

Prebisch has argued that industrial countries keep the whole benefit of their technical progress, whereas the primary producing countries transfer a part of the fruits from their own technical progress to the industrial nations.

According to him, money incomes and prices have risen more rapidly than productivity in industrial countries, whereas in the primary producing countries, the gains in productivity have been distributed in the form of price reductions. This has led to the deterioration of terms of trade of the primary producing countries.

(iii) Different Market Conditions:

Export prices in the industrial countries do not fall as a result of technical progress because (a) the manufacturers operate under monopolistic conditions in the product market; and (b) they do not operate under competitive conditions in the factor market, i.e., labour market is dominated by trade unions.

Thus, the benefit of the improved technology is not transferred to the consumers in poor countries. The producers in the poor countries, on the other hand operate under competitive conditions both domestically and internationally.

Thus, as a result of technical progress in these countries, prices fall and the benefits flow to the consumers in the rich countries.

(iv) Price Movements through Business Cycles

Prebisch attributes the contrasting behaviour of prices in the industrial and primary producing countries to the different movements of primary product prices and industrial prices over successive business cycles.

The prices of primary products have risen sharply in the prosperous periods and have fallen in the downswing of the business cycle.

In contrast, although manufacturing prices have risen in the upswing of the cycle, these have not fallen so much in the depression because of the rigidity of industrial wages and price inflexibility due to monopolistic conditions.

Thus, over successive cycles, the gap between the prices of the two groups of commodities has widened, and the primary producing countries have suffered an unfavourable movement in their terms of trade.

(v) Disparity in Demand:

Declining terms of trade of the less developed countries is also due to long-term disparity in the demand for manufactures and primary products.

In the industrial countries, the income elasticity of demand for primary products is inelastic (i.e., less than one), while in the poor countries, the income elasticity of demand for manufactured goods is more elastic (exceeds one).

This is because of two reasons: (a) Due to the operation of Engel's law, as incomes rise, the proportion of expenditure on food declines.

Thus, the demand for food increases less rapidly than the rise in income, (b) The demand for raw materials is restricted by competition from synthetic or man-made substitutes.

2. Other Reasons:

Some other causes of adverse terms of trade of the less developed countries are as follows:

(i) Backward Technology:

The less developed countries use backward technology as compared to the developed countries. As a result their relative productivity is low, cost ratios are high, and price structure is also relatively high. This leads to the adverse terms of trade for the poor country, placing it at a disadvantageous bargaining position.

(ii) High Population Growth

Most of the less developed countries experience overpopulation and high population growth. As a result, there is high internal demand for the goods and low exportable surplus. Moreover, the import demand of these countries is highly inelastic. This causes their terms of trade to fall.

(iii) Lack of Import Substitutes:

Poor countries are greatly dependant on the advanced countries for their imports and have not developed import substitutes. On the other hand, the advanced countries are not so much dependant on the poor countries because they are capable of producing import substitutes. Thus, the poor countries have weak bargaining position in the international trade.

(iv) Lack of Adaptability:

Unlike, the advanced countries, the less developed countries cannot quickly adapt their supply of goods which are high in demand and whose prices are rising. The reasons for this are: backward technology, market imperfections, immobility of factors of production, etc.

Thus, the terms of trade of less developed countries tend to deteriorate and these countries fail to reap gains by increasing their supplies of exports during inflation.

PART A

1. Define comparative advantage.

2. Define absolute advantage.

3. State the assumptions of comparative cost theory.

4. State the assumptions of absolute cost theory.

5. Give the meaning of Intra – Industry trade

6. List the determinants of trade.
7. What is Net Barter Terms of Trade?
8. Define Opportunity cost.
9. What is Gross Barter Terms of Trade?

10. What is an income term of trade?

11. What is a utility term of trade?

12. Define gains from trade.

13. What is static gain?

14. What is dynamic gain?

PART –B

1. “Difference in comparative costs accounts for the existence of foreign trade and determines its composition and magnitude” Discuss.

2. Bring out the role of terms of trade in economic development.

3. Explain the Adam Smith’s absolute cost advantage theory of international trade.

4. Name different kinds of terms of trade. Which of these concepts is most helpful in indicating ‘gains from trade’ and why?

5. Explain the causes and significance of the intra-industry trade.

6. Explain the static and dynamic gains from trade.

7. Explain the modern method to measure the gains from international trade.

8. Discuss the causes for unfavourable terms of trade of less developed countries.

PART – D

By the early 1990s, Italian firms were by far the world leader in the production and export of ceramic roofing and flooring tiles, accounting for over 30% of world production and 60% of world exports.
The rise to global preeminence of the Italian tile industry was based on the superior mechanical and aesthetic qualities of Italian tiles. One reason for the high domestic demand was Italy’s Mediterranean climate (ceramic tiles were cool to touch in warm weather). There was also a tradition in Italy for using natural stone materials for flooring as opposed to carpeting a wood.
As a result of booming demand, the number of ceramic tile firms in the Sassuolo region of the Italy grew rapidly. Rivalry between firms was intense. They had to compete vigorously against each other to get access to retail outlets. Retailers demanded high quality, low cost and aesthetically pleasing tiles. Firms constantly sought to gain an edge against each other in technology, design and distributions. Innovations were usually known within a matter of week and quickly copied by rivals.
Firms seeking a leadership position, whether in technology or productive efficiency or design, had to constantly improve their processes and turnover their product line to stay ahead of rivals. One result

of competitive process among equipment suppliers in the Sassoulo region was the development of a number of important process innovations that significantly lowered the energy and labour costs of manufacturing ceramic tiles.

The long post war boom in domestic demand was losing steam and excess capacity was beginning to develop among Italian tile firms. They responded to this problem by seeking international markets for their products, with advantages based on higher productivity, lower costs, better design and the Italian regulation for style, against their nearest competitors-the Spanish.

Question

1. To what extent does the theory of comparative advantage explain the rise of Italian tile firms globally?

Karpagam Academy of Higher Education

Department of Management

International Economics- 17MBAPI401B

Unit II

Multiple Choice Questions - Each Question Carries ONE Mark

S.No.	Questions	Option 1	Option 2	Option 3	Option 4	Answers
1	Theory of comparative advantage was presented by:	Adam Smith	Ricardo	Hicks	Marshall	Ricardo
2	According to the classical theory of international trade:	Only countries with low wages will export	Only countries with high wages will import	Countries with high wages will have higher prices	All the above are false	All the above are false
3	In the classical model of Ricardo, the direction of trade is determined by:	absolute advantage	comparative advantage	physical advantage	No advantage	comparative advantage
4	Absolute advantage is determined by:	actual differences in labor productivity between countries	relative differences in labor productivity between countries	Maximum differences in labor productivity between countries	accurate differences in labor productivity between countries	actual differences in labor productivity between countries
5	Comparative advantage is determined by:	actual differences in labor productivity between countries	relative differences in labor productivity between countries	Minimum differences in labor productivity between countries	absolute differences in labor productivity between countries	relative differences in labor productivity between countries
6	According to the theory of comparative advantage, which of the following is not a reason why countries trade?	Comparative advantage.	Costs are higher in one country than in another.	Prices are lower in one country than in another	Exports give a country a political advantage over other countries that export less.	Exports give a country a political advantage over other countries that export less.

7	According to the theory of comparative advantage, a country will export a good only if	It can produce it using less labor than other countries.	Its productivity is higher in producing the good than the productivity of other countries in producing it.	Its wage rate in producing the good is lower than in other countries.	Its cost of producing the good, relative to other goods, is at least as low as in other countries	Its cost of producing the good, relative to other goods, is at least as low as in other countries
8	According to the theory of comparative advantage, countries gain from trade because	Trade makes firms behave more competitively, reducing their market power.	All firms can take advantage of cheap labor.	Output per worker in each firm increases.	World output can rise when each country specializes in what its does relatively best	World output can rise when each country specializes in what its does relatively best
9	Scholars at MIT recently tested the theory of comparative advantage. One problem with doing this is that	The theory was never meant to apply after the 19th century.	One cannot observe productivity in industries that are not producing.	Countries keep their data on international trade secret.	The theory is only valid if the world really only produces two goods.	One cannot observe productivity in industries that are not producing.
10	The principle of comparative advantage states that:	each country will benefit if it specializes in the production and export of those goods that it can produce at relatively low cost	each country will benefit if it produces everything by itself.	each country will benefit if it produces only one good and imports everything else.	none of the above.	each country will benefit if it specializes in the production and export of those goods that it can produce at relatively low cost
11	Which is NOT an advantage of international trade:	Export of surplus production	Import of defence material	Dependence on foreign countries	Availability of cheap raw materials	Dependence on foreign countries
12	The theory explaining trade between two countries is called:	Comparative advantage	Comparative bargain	Comparative trade	Comparative returns	Comparative advantage
13	The theory explaining trade between two countries is called:	Comparative disadvantage theory	Comparative cost theory	Comparative trade theory	None of the above	Comparative cost theory

14	Trade between two countries can be useful if cost ratios of goods are:	Equal	Different	Undetermined	Decreasing	Different
15	Modern theory of international trade is based n the views of:	Robbins and Ricardo	Adam Smith and Marshall	Heckcsher and Ohlin	Saleem and Kareem	Heckcsher and Ohlin
16	International trade forces domestic firms to become more competitive in	The introduction of new products	Product design and quality	Product price	All of the above	All of the above
17	A main advantage of specialization results from:	Economics of large scale production	The specializing country behaving as a monopoly	Smaller production runs resulting in lower unit costs.	High wages paid to foreign workers	Economics of large scale production
18	David Ricardo presented the theory of international trade called:	Theory of absolute advantage	Theory of comparative advantage	Theory of equal advantage	Theory of total advantage	Theory of comparative advantage
19	Development in international law is process. What does this process promote?	Mainly human development	Mainly economic development	Mainly social development	Mainly political development	Mainly economic development
20	Arguments for free trade are sometimes disregarded by politicians because:	Maximizing domestic efficiency is not considered important	Maximizing consumer welfare may not be a chief priority	There exist sound economic reasons for keeping one's economy isolated from other economies	Economists tend to favor highly protected domestic markets	Maximizing consumer welfare may not be a chief priority
21	The earliest statement of the principle of comparative advantage is associated with:	Adam Smith	David Ricardo	Eli Heckscher	Bertil Ohlin	David Ricardo
22	If the international terms of trade settle at a level that is between each country's opportunity cost	There is no basis for gainful trade for either country	Both countries gain from trade	Only one country gains from trade	One country gains and the other country loses from trade	Both countries gain from trade
23	The classical trade theories of Smith and Ricardo predict that	Countries will completely specialize in the production of export goods.	Considerable trade will occur between countries with different levels of technology	Small countries could obtain all of the gains from trade when trading with large countries	All of the above	All of the above

24	A feasible effect of international trade is that a (an):	Monopoly in the home market becomes an oligopoly in the world market	Oligopoly in the home market becomes a monopoly in the world market	Purely competitive firm in the home market becomes an oligopolist	Purely competitive firm in the home market becomes a monopolist	Monopoly in the home market becomes an oligopoly in the world market
25	A Company doing international business enters into contract with firms in foreign countries to manufacture or assemble the products or services is called	Licensing.	Franchising.	Turnkey project.	Contract manufacturing.	Contract manufacturing.
26	constructions, Railway track constructions, Airport maintenance is the example for ___________.	management contract	construction activities	contract manufacturing.	turnkey project.	turnkey project.
27	Ownership and Management getting shared between a foreign firm and local firm is called as	management contract	acquisition.	merger.	joint venture	joint venture
28	Taking over of the majority share of a company with all the right to operate the business is called as	amalgamation.	joint venture	merger.	acquisition	acquisition
29	Polycentrism is ___________ orientation.	home country	host country.	regional.	world.	host country.
30	Regiocentrism is __________ orientation	home country.	host country.	regional.	world.	regional.
31	Geocentrism is _________ orientation.	home country.	host country.	regional.	global	global
32	Trade between two countries takes place when:	Cost ratios of commodities are equal	Cost ratios of commodities are different	Cost ratios of commodities are high	Cost ratios of commodities are low	Cost ratios of commodities are different

33	Trade may give rise to frustrations among some people within many given countries because	The country does not gain from trade	Some people gain while others lose, and the loses are not compensated	Trade benefits only the rich and so the rich	None of the above	Some people gain while others lose, and the loses are not compensated
34	The comparative advantage model of Ricardo was based on	intraindustry specialization and trade	interindustry specialization and trade	demand conditions underlying specialization and trade	income conditions underlying specialization and trade	interindustry specialization and trade
35	The gains from international trade are closely related to:	The labor theory of value	How much the autarky price differs from international terms of trade change	The fact that a country must lose from trade.	All of the above	How much the autarky price differs from international terms of trade change
36	Two countries can gain from foreign trade if:	Cost ratios are different	Tariff rates are different	Price ratios are different	(a) and (c) of above	(a) and (c) of above
37	The factor endowment model of international trade was developed by	Adam Smith	David Ricardo	John Stuart Mill	Eli Heckscher and Bertil Ohlin	Eli Heckscher and Bertil Ohlin
38	The product cycle theory of trade is essentially a	static, short run trade theory	dynamic, long run trade theory	zero-sum theory of trade	negative-sum theory of trade	dynamic, long run trade theory
39	If tastes are identical between countries, then comparative advantage is determined by:	supply conditions only.	demand conditions only.	supply and demand conditions	can’t tell without more information.	supply conditions only.
40	The terms of trade is given by the prices	Paid for all goods exported by the home country.	Received for all goods exported by the home country.	Received for exports and paid for imports.	Of primary products as opposed to manufactured products	Received for exports and paid for imports.
41	Dynamic gains from trade could result from	The stimulus of additional investment spending as markets open	Economies of large scale production as markets open	Additional competition made possible by the opening of markets	All of the above	All of the above

42	All of the following are trade problems of developing countries except	unstable export markets	improving terms of trade	limited access to the markets of industrial countries	highly elastic demand curves for their products	improving terms of trade
43	Intra-industry trade theory	explains why the United States might export autos and import clothing	explains why the United States might export and import differentiated versions of the same product	assumes that transport costs are very low or do not exist	dignores seasonal considerations for agricultural goods	explains why the United States might export and import differentiated versions of the same product
44	Intra-industry trade (IIT) is	the result of nations following their comparative advantage.	the result of capital-intensive nations trading with labor-intensive nations.	trade among the various firms of a single industry in one country.	two-way international trade in very similar products.	two-way international trade in very similar products.
45	Intra industry trade can be explained by all of the following except	high transportation costs as a proportion of product value	different growing seasons of the year for agricultural products	product differentiation for goods such as automobiles	high per capita incomes in exporting countries	high per capita incomes in exporting countries
46	Intra-industry trade is more likely to occur between	rich and poor countries	countries with high and similar income levels	developing countries	developed and developing countries	countries with high and similar income levels
47	Terms of trade of developing countries are generally unfavourable because:	They export primary goods	They export few goods	They import value added goods	(a) and (b) of above	(a) and (b) of above
48	Terms of trade of a country show:	They export primary goods	They import value added goods	They export few goods	(a) and (b) of above	(a) and (b) of above
49	Terms of trade of a country show:	Ratio of goods exported and imported	Ratio of import duties	Ratio of prices of exports and imports	.(a) and (c) of above	Ratio of prices of exports and imports
50	The ratio of export prices to import prices is called:	a.the terms of trade.	.the price ratio.	the tariff level.	the size of the quota.	the terms of trade.

51	Terms of trade of developing countries are generally unfavourable because:	They export primary goods	They import value added goods	They export few goods	(a) and (b) of above	(a) and (b) of above
52	Term of trade of a country show	Ratio of goods exported and imported	Ratio of import duties	Ratio of prices of exports and imports	(a) and (c) of above	Ratio of prices of exports and imports
53	"Terms of trade" between two countries refer to a ratio of:	Export prices to import prices	Currency values	Exports to imports	Balance of trade to balance of payments	Export prices to import prices
54	Ratio of export prices to import prices is_______ terms of trade	Net barter terms of trade	Gross barter terms of trade	Income terms of trade	Utility terms of trade	Net barter terms of trade
55	Ratio of physical quantities of imports to the total physical quantities of exports	Gross barter terms of trade	Net barter terms of trade	Utility terms of trade	Income terms of trade	Gross barter terms of trade
56	Indices of export and import prices and quantity index of exports	Utility terms of trade	Income terms of trade	Real cost terms of trade	Double factoral terms of trade	Income terms of trade
57	Factors affecting terms of trade	Reciprocal demand	tariff	changes in technology	All of the above	All of the above
58	The economic growth involves a rise in ________ or income of a country over a period of time	real national product	Gross domestic product	Income	Cost	Real national product
59	_______ is determined by the difference in the price ratio of the two commodities X and Y in the two countries	Actual gain from trade	Potential gain from trade	Total gain from trade	Minimum gain from trade	Actual gain from trade
60	________ is determined technically on the basis of the difference in domestic cost ratios of producing two commodities	Actual gain from trade	Potential gain from trade	Total gain from trade	Minimum gain from trade	Potential gain from trade

UNIT-III - Trade Policy and Exchange Rate

SYLLABUS

Trade policy & Exchange Rate: Free trade policy - Case for and against, Protections – Case for and against, Types of Tariffs and Quotas, Determination of Exchange rate, Fixed & Flexible Exchange Rate- Merits & Demerits.

FREE TRADE

Free trade may be defined as a policy of a government which does not discriminate against imports or interfere with trade by applying tariffs (to imports) or subsidies (to exports). In other words it is the unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas. Free trade enables nations to focus on their core competitive advantages, thereby maximizing economic output and fostering income growth for their citizens. The idea that free trade is welfare enhancing is one of the most fundamental doctrines in modern economics dating back at least to Adam Smith (1776) and David Ricardo (1816). But the policy of free trade has been in controversy all the time because the countries were not taking choice between free trade and autarky (no trade). They always choose one policy from among a spectrum of free trade regimes with varying degrees of liberalization.

Here are some arguments which are placed in favour of the free trade regime.

1. The theory of comparative advantage

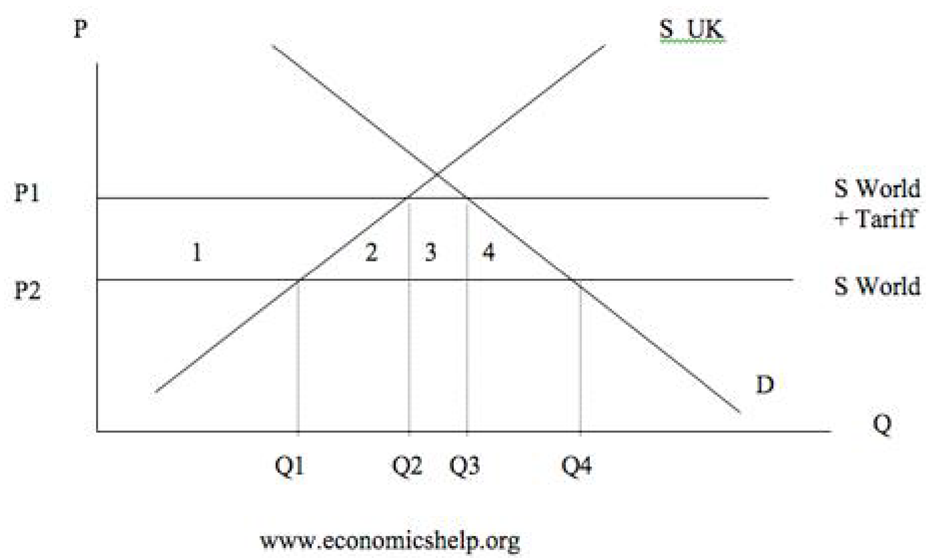
This explains that by specializing and trading goods in which countries have a lower opportunity cost or greater comparative advantage, there can be an increase in economic welfare for all countries. Free trade enables countries to specialize in those goods where they have a comparative advantage. Free trade in lines of comparative advantage is expected to mutually benefit the countries engaged in free trade.

2. Trade as a vent for surplus.

Trade is identified as a vent for surplus output of an economy. The dictum is related to Adam smith who identified the importance of division of labour. Smith also maintained that the division of labour is limited by the size of the market. Hence division of labour is expected to raise the domestic production. A deficiency in Aggregate demand may reduce the domestic prices. Here trade can act as a vent for surplus production brought forth through technology and division of labour. Free trade is expected to smoothen this process.

3. Reducing Tariff barriers leads to trade creation

Trade creation occurs when consumption switches from high cost producers to low cost producers. Reducing the tariff barriers with an objective to bring about free trade in an economy may help countries for trade creation. The following diagram explains the above idea.



- The removal of tariffs leads to lower prices for consumers and an increase in consumer Surplus of areas 1 + 2 + 3 + 4
- Imports will increase from Q3-Q2 to Q4-Q1
- The government will lose tax revenue of area 3
- Domestic firms producing this good will sell less and lose producer surplus equal to area 1
- However overall there will be an increase in economic welfare of **2+4** (1+2+3+4 – (1+3)
- The magnitude of this increase depends upon the elasticity of supply and demand. If demand elastic consumers will have a big increase in welfare

4. Economies of Scale.

If countries can specialize in certain goods they can benefit from economies of scale and lower average costs. Economies of scale refer to the capacity of firms to change their output more than proportionately to changes in inputs. This is especially true in industries with high fixed costs or that require high levels of investment. The benefits of economies of scale will ultimately lead to lower prices for consumers. Lowering of trade restrictions enhances this outcome.

5. Increased Competition.

With more trade domestic firms will face more competition from abroad. As a result of this there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.

6. Trade is an engine of growth.

World trade has increased by an average of 7% since the 1945, causing this to be one of the big contributors to economic growth.

7. Make use of surplus raw materials

Middle Eastern counties such as Qatar are very rich in reserves of oil but without trade there would be not much benefit in having so much oil. Japan on the other hand has very few raw material without trade it would be very poor.

8. Tariffs encourage inefficiency

If an economy protects its domestic industry by increasing tariffs industries may not have any incentives to cut costs. Trade liberalization is often justified in terms of the efficient market outcome and efficient price fixation through a competitive price fixing mechanism.

Arguments against Free Trade

1. **Infant Industry Argument:** Governments are sometimes urged to support the development of infant industries, protecting home industries in their early stages, usually through subsidies or tariffs. Subsidies may be indirect, as in when import duties are imposed or some prohibition against the import of a raw or finished material is imposed.

If developing countries have industries that are relatively new, then at the moment these industries would struggle against international competition. However if they invested in the industry then in the future they may be able to gain Comparative Advantage.

2. The Senile industry argument: If industries are declining and inefficient they may require large investment to make them efficient again. Protection for these industries would act as an incentive to for firms to invest and reinvent themselves. However protectionism could also be an excuse for protecting inefficient firms

3. **To diversify the economy:** Many developing countries rely on producing primary products in which they currently have a comparative advantage. However relying on agricultural products has several disadvantages. One of the most important determinants of Agricultural Prices is the environmental factors. Hence they can fluctuate with climatic changes. Agricultural commodities have a low income and price elasticity of demand. Therefore with proportionate rise in economic growth will lead to less than proportionate rise in demand. Agricultural commodities have relatively low price elasticity of supply. A proportionate rise in prices will lead to less than proportionate rise in supply of agricultural commodities. This is because of the time lag involved in the production of agricultural goods. This is given by the fact that the production of agricultural goods at time ***t*** is determined by the prices prevailing in time'*t*-***1'.***

4. **Raise revenue for the govt:** Import taxes and tariffs can be used to raise money for the government.

5. Help the Balance of Payments: Reducing imports can help the current account. However in the long term this is likely to lead to retaliation

6. **Cultural Identity:** This is not really an economic argument but more political and cultural. Many countries wish to protect their countries from what they see as an Americanization or commercialization of their countries

7. **Protection against dumping:** The EU sold a lot of its food surplus from the CAP at very low prices on the world market. This caused problems for world farmers because they saw a big fall in their market prices

8. **Environmental:** It is argued that free trade can harm the environment because Developing countries may use up natural reserves of raw materials to produce exportable commodities. Also countries with strict pollution controls may find consumers import the goods from other countries where legislation is lax and pollution allowed.

Trade Restrictions

Restrictions on international movement of goods and services can be divided into tariff barriers and non tariff barriers. A **tariff** is a tax put on goods imported from abroad. The effect of a tariff is to raise the price of the imported product. It helps domestic producers of similar products to sell them at higher prices. The money received from the tariff is collected by the domestic government. An import tariff is a duty on Import commodities and an export tariff is a duty on export commodities. Tariffs can be ***ad valoram*** specific or compound. An *ad valorem* tariff is expressed as a fixed percentage of the value of the traded commodity. For example if the US government decides to levy a 10% ***ad valoram*** duty on the $100 worth bicycles that the US imports from India, the imported will have to pay $ 10 for each bicycle that he imports from India. The specific tariff is expressed as a fixed sum per physical unit of the traded commodity.

Here if the specific duty is specified as $5 then the customs officials have to collect $5 for each bicycle that is imported to us from India irrespective of its price. A compound tariff is the combination of the *ad valorem* and specific tariffs. Finally a compound duty of $15 on the bicycle imported to US will lead the customs officials to collect $5 as the specific part of the compound duty and $10 - that is10 % if each $100 worth bicycle - as the *ad valorem* part of the compound duty.
Besides these classifications tariffs can be classified as protective and revenue tariffs.
Protective tariffs are put in place specifically to make foreign good more expensive to protect domestic industries from competition. **Revenue tariffs** are put in place to raise money for the government. It all depends on the intention of the government that implements the tariff.

Tariff

Tariff refers to duty (tax) imposed on imports and exports. Levying duty and changing duty structure are common on imports. So tariff popularly refers to import duty. Tariff is levied to regulate imports. Tariff increases price of the imported goods and imports become expensive. Tariff is raised for the purpose of primarily protecting domestic industries and to increase revenue of the Government.

Tariff reduces the volume of International trade and prevents the countries from getting gains from trade. Tariff barrier reduces International business relations between countries and it is treated as obstacle in the International trade.

Tariff is classified into three types. They are *specific duty*, *ad valorem duty* and *compound duty*. Recently Government introduced special additional duty.

Specific duty is a percentage of tariffs levied on the value of imports.

Ad valorem duty will be more or less equivalent to the excise duty, levied if the imported goods are produced locally.

Compound duty is a tariff consisting of both a specific and *ad valorem* duty.

Anti-dumping duty is also one of the tariff barriers. This duty is levied to protect the domestic industries from foreign competition. Anti-dumping duty is common not only in developing countries but also in developed countries. Recently India imposed antidumping duty for the import of steel, because domestic steel prices are higher than the imported steel. In this situation, imported steel will be dumped into Indian market and domestic steel industries will be affected. So anti-dumping duty is levied on steel import to protect domestic industries.

This duty reduces the volume of International trade. European Union has also levied anti dumping duty on textile goods imported from India. Developed countries have no exception in levying anti-dumping duty. Robert Cohen, in his paper 'Grumbling over GATT' published in New York Times, September 1, 1993 has stated that "tariffs continue to be one of the most commonly used barriers to trade, despite the fact that they often hurt low-income consumers and have limited, if any, impact on upper-income purchasers."

Tariff Policy Arguments

Terms of Trade Argument

Imposition of tariff on imports increases the rate at which the country's exports are exchanged for imports. Tariff improves the terms of trade.

Bargaining Argument

A tariff import throws light on negotiations in the international trade. Foreign trade is based on the reciprocal basis. The tariff structure may induce the countries to provide reciprocal concessions to each other.

Anti-Dumping Argument

Dumping will affect the market potentials of the domestic industries. It means selling foreign products at a price less than the price of the domestic industries. To protect and support the indigenous industry anti-dumping duty is levied. This duty will make the foreign goods costlier than the goods produced by the indigenous industry. Thus indigenous industry is protected.

Diversification Argument

The indigenous industry should be diversified to achieve a balanced growth of economy. All the sectors (Agriculture, Industry, Services) of the economy should be developed side by side and the development should go hand in hand. Diversification will contribute to the growth of the indigenous sector.

Infant Industry Argument

Indigenous industries which are at infant stage should be protected from the foreign competition. Industries at infant stage cannot compete with the global competition. Protection should continue till such indigenous industries reaching the growth stage. Protection to the infant industries will contribute to their expansion and reduce the costs and prices, which in turn, advantageous to the industries using the products/services of the protected industries. The industries started in the backward regions are permitted to avail tax holiday and other incentives.

Key Industries Argument

It is the responsibility of the Government to support and protect the key sectors of the economy. Keeping the key industries (agriculture, steel, heavy industries etc) under protective tariff regime is one of the basic objectives of the trade policy.

Employment Argument

The tariff protection will reduce import of manufactured goods and increase the production of the domestic indigenous industries. It is assumed that the tariff protection will contribute to the growth of the indigenous industries. Prof. Haberler has analysed the effects of tariffs on the various types of unemployment. Technological unemployment can be removed by imposing a new tariff duty of imports only in the case of one industry, but not in the case of the entire industrial structure of the economy.

Balance of Trade Argument

The country will have to impose tariff to achieve surplus of exports over imports. Keynes has stated that excess of exports over imports raises employment and income in the country through the expansion of the export sector and the decline in imports by imposing tariffs. Increase in income will increase the availability of funds and will reduce interest rate and encourage investment. The increased investment will help the indigenous industries for growth and development.

Pauper Labour Management

Goods produced by the low wage countries will be cheaper than the goods produced by the high wage countries. If India becomes a high wage country, imports from the low wage countries will affect the indigenous industries. In this situation, tariff protection will protect and support the indigenous sectors.

Keeping Money at Home Argument

When we import goods from the foreign countries we get goods and the foreign countries will receive money. When we purchase manufactured goods from the domestic market we get both the goods and the money. Protected tariff will curtail import and force to buy from the domestic market and the indigenous sector will grow. The growth of indigenous sector will expand the domestic market. When the domestic market is under expansion in the protected tariff regime, the indigenous sector should improve its efficiency to reduce costs of production. Indigenous sector should not pass on the cost of inefficiency to the consumers.

Expanding Home Market Argument

If the imported goods are cheaper than the domestic goods, imported goods will occupy the domestic market and indigenous industries will be affected. In order to protect the indigenous industries, high import duty is imposed on imports. Naturally the home market could be expanded

Equalization of Costs of Production Argument

If the cost of production of indigenous industry is higher than that of imported goods adding tariff to the imported goods makes its cost either equal or higher than the cost of domestic product. Then people will hesitate to buy the foreign product. Thus all these reasons/arguments in support of tariffs indicate how it could be used as a policy instrument to improve our commercial transactions.

From the above discussions, it is revealed that the protected tariff is one of the policies to be taken to support and protect the indigenous industries. Tariff policy is a viable alternative to protect the indigenous industries.

Tariff Schedule

Classification

The Indian classification on tariff items follows the Harmonized Commodity Description and Coding System (Harmonized System or HS). India has fully adopted HS through the Customs Tariff Amendment Act, 1985. There has been some modification of HS as appropriate to the Indian environment concerning excise taxes.

Difference between Fixed vs. Flexible Exchange Rate System

There may be variety of exchange rate systems (types) in the foreign exchange market. Its two broad types or systems are Fixed Exchange Rate and Flexible Exchange Rate as explained below.

In between these two extreme rates, there are some hybrid systems like Crawling Peg, Managed Floating.

Broadly when government decides the conversion rate, it is called fixed exchange rate. On the other hand, when market forces determine the rate, it is called floating exchange rate.

(a) Fixed Exchange Rate System:

Fixed exchange rate is the rate which is officially fixed by the government or monetary authority and not determined by market forces. Only a very small deviation from this fixed value is possible. In this system, foreign central banks stand ready to buy and sell their currencies at a fixed price. A typical kind of this system was used under Gold Standard System in which each country committed itself to convert freely its currency into gold at a fixed price.

In other words, value of each currency was defined in terms of gold and, therefore, exchange rate was fixed according to the gold value of currencies that have to be exchanged. This was called mint par value of exchange. Later on Fixed Exchange Rate System prevailed in the world under an agreement reached in July 1994.

The advantages and disadvantages of this system are as under:

Merits:

(i) It ensures stability in exchange rate which encourages foreign trade, (ii) It contributes to the coordination of macro policies of countries in an interdependent world economy, (iii) Fixed exchange rate ensures that major economic disturbances in the member countries do not occur, (iv) It prevents capital outflow, (v) Fixed exchange rates are more conducive to expansion of world trade because it prevents risk and uncertainty in transactions, (vi) It prevents speculation in foreign exchange market.

Demerits:

(i) Fear of devaluation. In a situation of excess demand, central bank uses its reserves to maintain foreign exchange rate. But when reserves are exhausted and excess demand still persists, government is compelled to devalue domestic currency. If speculators believe that exchange rate cannot be held for long, they buy foreign exchange in massive amount causing deficit in balance of payment. This may lead to larger devaluation. This is the main flaw or demerit of fixed exchange rate system, (ii) Benefits of free markets are deprived; (iii) There is always possibility of under-valuation or over-valuation.

(b) Flexible (Floating) Exchange Rate System:

The system of exchange rate in which rate of exchange is determined by forces of demand and supply of foreign exchange market is called Flexible Exchange Rate System. Here, value of currency is allowed to fluctuate or adjust freely according to change in demand and supply of foreign exchange.

There is no official intervention in foreign exchange market. Under this system, the central bank, without intervention, allows the exchange rate to adjust so as to equate the supply and demand for foreign currency In India, it is flexible exchange rate which is being determined. The foreign exchange market is busy at all times by changes in the exchange rate. Advantages and disadvantages of this system are listed below:

Merits:

(i) Deficit or surplus in BOP is automatically corrected, (ii) There is no need for government to hold any foreign exchange reserve, (iii) It helps in optimum resource allocation, (iv) It frees the government from problem of BOP

Demerits:

(i) It encourages speculation leading to fluctuations in foreign exchange rate, (ii) Wide fluctuation in exchange rate hampers foreign trade and capital movement between countries, (iii) It generates inflationary pressure when prices of imports go up due to depreciation of currency.

Managed Floating:

This refers to a system of gradual adjustments in the exchange rate deliberately made by a central bank to influence the value of its own currency in relation to other currencies. This is done to save its own currency from short-term volatility in exchange rate caused by economic shocks and speculation. Thus, central bank intervenes to smoothen out ups and downs in the exchange rate of home currency to its own advantage.

When central bank manipulates floating exchange rate to disadvantage of other countries, it is termed as dirty floating. However, central banks have no fixed times for intervention but have a set of rules and guidelines for this purpose.

(c) Distinction between Fixed Exchange Rate and Flexible Exchange Rate [AOS; D09]:

Fixed exchange rate is the rate which is officially fixed in terms of gold or any other currency by the government. It does not change with change in demand and supply of foreign currency. As against it, flexible exchange rate is the rate which, like price of a commodity, is determined by forces of demand and supply in the foreign exchange market. It changes according to change in demand and supply of foreign currency. There is no government intervention.

A fixed exchange rate system e.g. a currency peg either as part of a currency board system or membership of the ERM II for countries intending to join the Euro

The main arguments for adopting a fixed exchange rate system are as follows:

1. **Trade and Investment**: Currency stability can promote trade and capital investment because of less currency risk. Overseas investors will be more certain and confident that the returns from their investments will not be destroyed by sudden fluctuations in the value of a currency.
2. **Some flexibility permitted**: Some adjustment to the fixed currency parity is possible if the case becomes unstoppable (i.e. the occasional devaluation or revaluation of the currency if agreement can be reached with other countries). Some countries are tempted to engage in competitive devaluations and this threatens the outbreak of “currency wars".

3. **Reductions in the costs of currency hedging**: Businesses have to spend less on currency hedging if they know that the currency will maintain a stable value in the foreign exchange markets.

4. **Disciplines on domestic producers**: A stable currency acts as a discipline on producers to keep costs and prices down and may encourage attempts to raise productivity and focus on research and innovation. In the long run, with a fixed exchange rate, one country's inflation must fall into line with another (and thus put competitive pressures on prices and real wages)

5. **Reinforcing gains in comparative advantage**: If one country has a fixed exchange rate with another, then differences in relative unit labour costs will be reflected in the growth of exports and imports. Consider the example of China and the United States. For several years China pegged the Yuan against the dollar. Until July 2005 the exchange rate was fully fixed; since then the Chinese have allowed only a gradual depreciation of the dollar against the Yuan. Most estimates indicate that the Chinese currency is persistently undervalued against the dollar. This makes Chinese products cheaper and has led to numerous calls from US manufacturers for the Chinese to be persuaded to switch to a floating exchange rate or to adjust their currency by appreciating against the dollar.

THEORIES OF RATE OF EXCHANGE

Every country has a currency different from others. There is no common medium of exchange. It is this feature that distinguishes international trade from domestic. Suppose the imports and exports of a country are equal, the demand for foreign currency and its supply conversely, the supply of home currency and the demand for it will be equal. The exchange will be at par. If the supply of foreign money is greater than the demand it will fall below par and the home currency will appreciate. On the other hand, when the home currency is in great supply, there will be more demand for the foreign currency. This will appreciate in value and rise above par.

Economists have propounded the following four theories in connection with determination of rate of exchange:

1. Mint par theory

2. Purchasing power parity theory

3. Balance of payments or equilibrium theory and

4. Foreign exchange theory

Mint par theory

Mint par indicates the parity of mints or coins. It means that the rate of exchange depends upon the quality of the contents of currencies. It is the exact equivalent of the standard coins of one country expressed in terms of standard coins of another country having the same metallic standards the equivalent being determined by a comparison of the quantity and fineness of the metal contained in standard coins as fixed by law. A nation’s currency is said to be fully on the gold standard if the Government:

1. Buys and sells gold in unlimited quantity at an official fixed price.

2. Permits unrestricted gold movements into and out of the country.

In short, an individual who holds domestic currency knows in advance how much gold he can obtain in exchange for it and how much foreign currency this gold will buy when exported to another country. Under these circumstances, the foreign exchange rate between two gold standard countries’ currencies will fluctuate within the narrow limits around the fixed mint par. But mint par is meant that the exchange rate is determined on the weight-to-weight bases of the metallic contents of the two currency units, allowance being given to the purity of the metallic content. The mint parity theory of foreign exchange rate is applicable only when the countries are on the same metallic standards. This, t can be no fixed mint par between gold and silver standard country.

Purchasing power parity theory

This theory was developed after the break down of the gold standard post World War I. The equilibrium rate of foreign exchange between two inconvertible currencies in determined by the ratio between their purchasing powers. Before the first World War, all the major countries of Europe were on the gold standard. The rate of exchange used to be governed by gold points. But after the I World

War, all the countries abandoned the gold standard and adopted inconvertible paper currency standards in its place.

The rate of foreign exchange tends to be stabilized at a point at which there is equality between the respective purchasing powers of the 2 countries. For eg; say America and England where the goods purchased for 500 $ in America is equal to 100 pounds in England. In such a situation, the purchasing power of 500 US $ is equal to that of 100 English pounds which is another way of saying that US $500 = 100, or US $5=1 pound. If and when the rate of foreign exchange deviates from this nor, economic forces of equilibrium will come into operation and will bring the exchange rate to this norm. The price level in countries remain unchanged but when foreign exchange rate moves to 1=$5.5, it means that the purchasing power of the pound sterling in terms of the American dollars has risen. People owing Pounds will convert them into dollars at this rate of exchange, purchase goods in America for 5$ which in England cost 1 pound sterling and earn half dollar more. This tendency on the part of British people so to convert their pound sterling into dollars will increase, the demand for dollar in England, while the supply of dollar in England will decrease because British exports to America will fall consequently the sterling price of dollar will increase until it reaches the purchasing power par, i.e. 1=US $5. On the other hand, of the prices in England rose by 100 percent those on America remaining unaltered, the dollar value of the English currency will be halved and consequently one sterling would be equal to 2.5 $. This is because 2 unite of English currency will purchase the same amount of commodities in England, as did one unit before. If on the other hand, the prices doubled in both the countries, there would be no exchange in the purchasing power parity rate of foreign exchange, this , in brief is the purchasing power parity theory of foreign exchange rate determination.

The change in the purchasing power of currency will be reflected in the exchange rate.

Equilibrium Exchange Rate (ER) =Er X Pd / Pf Where;

ER = Equilibrium Exchange Rate

Er = Exchange Rate in the Reference period

Pd = Domestic Price Index

Pf = Foreign currencies price index

Balance of payments theory

According to this approach, foreign exchange rate is determined by independent factors no related to international price levels, and the quantity of money has asserted by the purchasing power parity theory. According to this theory, an adverse balance of payment, lead to the fall or depreciation of the rate of foreign exchange while a favourable balance of payments, by strengthening the foreign exchange, causes an appreciation of the rate of foreign exchange. When the balance of payments is adverse, it indicates a situation in which a demand for foreign exchange exceeds its supply at a given rate of exchange consequently, its price in terms of domestic currency must rise i.e., the external value of the domestic currency must depreciate. Conversely, if the balance of payment is favourable it means that there is a greater demand for domestic currency in the foreign exchange market that can be met by the available supply at any given rate of foreign exchange. Consequently, the price of domestic currency in terms of foreign currency rises i.e., the rate of exchange moves in favour of home currency, a unit of home currency begins to command larger units of the foreign currency than before.

Balance of Payment theory, also known as the Demand and Supply theory and the general equilibrium theory of exchange rate holds that the foreign exchange rate, under free market conditions is determined by the conditions of demand and supply in the foreign exchange market.

According to this theory, the price of a commodity that is , exchange rate is determined just like the price of any commodity is determined by the free play of the force of demand and supply.

“When the Balance of Payment is equilibrium, the demand and supply for the currency are equal. But when there is a deficit in the balance of payments, supply of the currency exceeds its demand and causes a fall in the external value of the currency. When there is a surplus, demand exceeds supply and causes a rise in the external value of the currency.”

DEALINGS ON THE FOREIGN EXCHANGE MARKET: SPOT AND FORWARD EXCHANGE.

The term Spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange currency on the spot. In practice, the settlement takes place within two days in most markets.

The forward transaction is an agreement between two parties, requiring the delivery at the some specified future dates of a specified amount of foreign currency by one of the parties, against payment in domestic currency by the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the 'Forward Exchange Rate" and the market for forward transaction are known as "Forward Market".

Forward Exchange Rate: - The rate quoted in terms of price of one country to another.

The forward exchange rate may be at Par, Discount, and Premium.

At Par: - If the forward exchange rate quoted is exactly equivalent to the spot rate at the time of making the contract, the forward exchange rate is said to be at Par.

At Premium: - The forward rate of currency, say the dollar is said to be at premium with respect to the spot rate when one dollar buys more units of another currency, say rupee in the forward than in the spot market.

At Discount: - The forward rate for a currency, say the dollar, is said to be at discount with respect to the spot rate when one dollar buys fewer rupees in the forward.

PART – B

1. What is Free trade?

2. What is Protection?

3. Define tariff.

4. Distinguish between free trade and protection.

5. Write the various types of tariffs.

6. Define quota.

7. What is exchange rate?

8. What is foreign exchange market?

9. What is fixed exchange rate?

10. What is flexible exchange rate?

11. Distinguish between fixed and flexible exchange rates.

12. What is an equilibrium rate of exchange?

13. What are the determinants of exchange rate?

PART – C

1. Give the arguments for and against free trade.

2. Examine the factors influencing the foreign exchange rates.

4. Explain clearly the different classification related to tariffs.

5. Explain the flexible exchange rates. What are the arguments for and against flexible exchange rates?

6. Examine the infant industry argument for protection as a means to industrialisation of developing countries.

7. Define the rate of exchange. How is the equilibrium rate of exchange determined?

8. Explain clearly the effects of import quotas for the importing country.

PART – D

In nineties the Government of India sowed the seeds for free trade. Before that India favoured protectionism. Why there was a change in the attitude? Who are all the beneficiaries/losers due to the change in the attitude?

Karpagam Academy of Higher Education
Department of Management
International Economics- 17MBAPI401B
Unit III
Multiple Choice Questions - Each Question Carries ONE Mark

S.No.	Questions	Option 1	Option 2	Option 3	Option 4	Answers
1	If a nation has an open economy it means that the nation:	Allows private ownership of capital	Has flexible exchange rates	Has fixed exchange rates	Conducts trade with other countries	Conducts trade with other countries
2	Increased foreign competition tend to	Intensify inflationary pressure at home	Induce falling output per worker-hour for domestic workers	Place constraints on the wages of domestic workers	Increase profits of domestic import-competing industries	Place constraints on the wages of domestic workers
3	Recent pressures for protectionism in the United States have been motivated by all of the following except	U.S. firms shipping component production overseas	High profit levels for American corporations	Sluggish rates of productivity growth in the United States	High unemployment rates among American workers	High profit levels for American corporations
4	A sudden shift from import tariffs to free trade may induce short-term unemployment in:	Import-competing industries	Industries that are only exporters	Industries that sell domestically as well as export	Industries that neither import nor export	Import-competing industries
5	A tariff is ____________.	either imports or exports.	a tax on exports only	a tax on imports only.	a luxury tax.	either imports or exports
6	To be effective, an import quota must ____________.	reduce the price and increase the quantity of imports.	set the price of the imported good higher than the domestic equilibrium price	restrict imports to less than would be imported under free trade.	restrict imports to less than exports in trade with that particular country	restrict imports to less than would be imported under free trade.

7	__________ refers to the compulsions of the domestic market such as saturation of the market, which prompt companies to internationalize.	Competitions	Push factors	Pull factors.	Market situation	Push factors.
8	Most of the push factors are ____________ reasons	motivating	result-oriented.	reactive.	pro-active	reactive.
9	The best way to manage the product life cycle of a product is by doing ________________	competition.	international business	monetary policy	proper planning	international business
10	Ethnocentrism is pre-dominantly a _____________ country orientation	home	host.	regional.	world.	home
11	A Most Favored nation status doesnt necessarily refers to_____________.	same and equal economic treatment	nondiscriminatory treatment	same tariff rates applicable.	uniform civil code.	uniform civil code.
12	The basic objective of export Promotion Council is to promote and develop the exports of the	particular products of country.	only attractive projects of the country	only services industry products of the country.	overall exports of the country	overall exports of the country
13	Exports and Imports come under the purview of _____________.	Ministry of Finance.	Ministry of Commerce	Ministry of External Affairs	Ministry of Home Affairs.	Ministry of Commerce
14	Which one of the following systems occurred first in the history of international banking?	Post Britton Woods	European Monetary Union	Gold Standard.	Gold Exchange Standard	Post Britton Woods.
15	A specific amount of money levied on each unit of a product brought into the country is a	fixed tariff.	protective tariff.	duty free tariff.	value added tariff.	fixed tariff
16	The Indian Institute of Foreign Trade was setup as __________, registered under the societies registration act	an autonomous body.	public sector undertaking	subsidiary body.	deemed university.	an autonomous body.

17	Expand ITPO	Indian Tariff Promotion Organization	Indian Tender Promotion Organization.	Indian Trade Promotion Organization	International Trade Promotion Organization.	Indian Trade Promotion Organization
18	Until the early 1990s, India followed _________.	advanced import practices.	a highly restrictive trade policy.	indiscriminative trade strategy	advance export practices.	a highly restrictive trade policy.
19	Quantitative restrictions refer to limit set by countries to curb ______________.	imports.	exports.	imports & exports	none of the above	imports & exports
20	If Japan and Pakistan start free trade, difference in wages in two countries will:	Increase	Decrease	No effect	Double	Decrease
21	Foreign trade creates among countries:	Conflicts	Cooperation	Hatred	Both (a) & (b)	Cooperation
22	A tariff:	Increases the volume of trade	Reduces the volume of trade	Has no effect on volume of trade	(a) and (c) of above	Reduces the volume of trade
23	A tariff is:	A restriction on the number of export firms	Limit on the amount of imported goods	Tax and imports	(b) and (c) of above	Tax and imports
24	Dumping refers to:	Buying goods at low prices abroad and selling at higher prices locally	Expensive goods selling for low prices	Reducing tariffs	Sale of goods abroad at low a price, below their cost and price in home market	Sale of goods abroad at low a price, below their cost and price in home market
25	In a free trade world in which no restrictions exist, international trade will lead to:	Reduced real living standard	Decreased efficiency	Increased efficiency	Reduced real GDP	Increased efficiency
26	What would encourage trade between two countries:	Different tax system	Frontier checks	National currencies	Reduced tariffs	Reduced tariffs
27	It is drawback of free trade:	Prices of local goods rise	Government looses income from custom duties	National resources are underutilized	(a) and (b) of above	Government looses income from custom duties
28	Policy of Protection in trade:	Facilitates trade	Protects foreign producers	Protects local producers	Protects exporters	Protects local producers

29	In an efficient foreign exchange rate market, an unexpected increase in domestic money supply growth can lead to	an immediate appreciation of a currency	an immediate depreciation of a currency	an immediate decrease in direct foreign investment	none of the above	
30	The foreign Trade (Regulation) Rules was passed in the year	1991	1992	1993	1994	1993
31	The apex body of the Foreign Trade is	The Central Government	The State Government	The Ministry of Commerce	All the above	The Ministry of Commerce
32	The tenure of the Foreign Trade policy is	3 yrs	5 yrs	1 yr	7 yrs	5 yrs
33	How many chapters are there in The Foreign Trade (Development and Regulation) Act, 1992	5	4	6	7	6
34	What does CCIE stand for?.	Chief Controller of Imports and Exports	Central Cottage Industries Exports	Control on Cotton Imports and Exports	Commissioner of Central Imports and Exports	Chief Controller of Imports and Exports
35	Foreign Exchange Regulation Act was replaced with The Foreign Exchange Management act in the year	1973	1991	1995	1999	1999
36	Transfer of assets of a foreign firm to a domestic firm effected by the government with payment of compensation is	Expropriation	Appropriation	Confiscation	Domestication.	Expropriation
37	Trade in services includes which of the following?	textiles	Computer hardware	Weapons	Insurance	Insurance
38	Foreign exchange transactions involve monetary transactions	among residents of the same country	between residents of two countries only	between residents of two or more countries	among residents of at least three countries	between residents of two or more countries

39	Which of the following statements is true	Foreign exchange leads to foreign trade	Foreign trade leads to foreign exchange	No foreign exchange is involved in foreign trade	There is no link between foreign trade and foreign exchange	Foreign trade leads to foreign exchange
40	Where rates are not fixed for any product, it can be claimed under _____ that needs to be fixed on case -to - case basis	Brand rate	Flexibe rate	Free rate	Consumption rate	Brand rate
41	Foreign Trade (Development and Regulation) Act was passed in the year	1991	1992	1993	1994	1992
42	Who may appoint any person to be the Director General of Foreign Trade under FTDR act ?	State Govt	Central Govt.	President	Export promotion Councils	Central Govt.
43	The licence that is transferable is	Export licence	Advance licence	DEPB licence	REP licence	DEPB licence
44	Monetary policy is powerless under pegged exchanges rates where we have:	purchasing power parity	perfect capital mobility	fixed exchange rates	restrictive fiscal policy	perfect capital mobility
45	An increase in the demand for rupee will cause rupee to:	devalue	depreciate	appreciate	fall	appreciate
46	An exchange rate is the:	amount of foreign currency that can be bought	price of one currency on the international market	price of one currency against another currency	amount other countries are willing to pay for your currency	price of one currency against another currency
47	Flexible exchange rate is based on the concept of	Demand theory	Supply theory	Price theory	Both a and b	Both a and b
48	Quotas are government imposed limits on the ________ of goods trade between countries.	prices	quantity	revenue	costs	quantity
49	________ are quotas that lead to a complete abolishment of trade.	embargoes	voluntary export restraints	nontariff barriers	orderly marketing agreements	embargoes
50	Similar to import tariffs, import quotas tend to result in	higher prices and reduced imports	increased government revenue	increased consumer surplus	decreased producer surplus	higher prices and reduced imports

51	A tariff-rate quota is essentially a	two-tier tariff applied to a country's imports	three-tier tariff applied to a country's imports	two-tier quota applied to a country's exports	three-tier quota applied to a country's exports	two-tier tariff applied to a country's imports
52	A(n) __________ is an example of a quota where foreigners hold quota licenses.	export quota	embargo	auction quota	tariff quota	export quota
53	When the Exchange rate of a country is lowered to help trade we say the currency has been:	politically adjusted	revalued	realigned	devalued	devalued
54	Where the government constant intervenes into the Forex market, buying and selling its currency, we can the country's exchange rate is:	.floating	pegged to the dollar	pegged to the dollar	pegged to the gold standard	.fixed
55	Where supply and demand are allowed to determine a country's exchange rate, we say we have exchange rate is:	.floating	fixed	pegged to the dollar	pegged to the gold standard	floating
56	The ________ is the relative price of domestic and foreign goods, when measured in a common currency:	real exchange rate	exchange rate	exchange rate ratio	Forex	real exchange rate
57	Fixed exchange rate can survive in an economy if there is	Government intervention	Free market economy	Socialistic economy	None of the above	Free market economy
58	Spot and forward market are intimately linked together by	Interest arbitrage	Hedging	Speculation	.Inflation	Speculation
59	Speculation in exchange market is possible if market is operating under	Free exchange rate	Gold standard	Silver standard	Fixed exchange rate	Free exchange rate
60	Floating exchange rate became common in	1950s	1960s	1970s	1980s	.1970s

Balance of Trade and Balance of Payments

SYLLABUS

Balance of trade and Balance of payments: Concepts and Components - Equilibrium and Disequilibrium in Balance of Payments; Causes and Consequences, Measures to correct deficit in the Balance of Payments. International Monetary System, Devaluation: Merits, Demerits and Limitations, Foreign Trade Multiplier; Concept and Limitations, IMF, World Bank – Objectives, Functions & Performance.

Balance of Trade:

Meaning

It is the difference between the money value of exports and imports of material goods [called visible items or merchandise) during a year.

The difference between values of exports and imports is called Balance of trade or Trade balance. Remember export means sending goods abroad to earn foreign exchange whereas imports means buying goods from abroad and pay in foreign exchange. Exports are considered as income and imports as expenditure. It includes only visible items and does not consider exchange of services.

Examples of visible items are clothes, shoes, machines, etc. Clearly, the two transactions which determine BOT are exports and imports of goods. **Exports and imports of services (invisible items like shipping, insurance, banking, payment of dividend and interest, expenditure by tourists, etc.) are not included.**

Surplus or Deficit BOT:

Balance of trade may be in surplus or in deficit or in equilibrium. If value of exports of visible items is more than the value of imports of visible items, balance of trade is said to the positive or favourable. Thus, BOT shows a surplus. In case the value of exports is less than the value of imports, the balance of trade is said to be negative or adverse or unfavourable.

Then BOT is called in deficit. In case value of exports equals its imports, BOT is said to be balanced or in equilibrium..This country exported goods worth Rs 550 crore and imported goods worth Rs 800 crore. It had a deficit in its balance of trade of Rs 250 crore.

Balance of Trade = 550-800 = Rs -250

Even though the country had a deficit in its balance of trade, this might be offset by items on other accounts especially by capital account. Balance of trade (merchandise) provides substantial account of payments emerging from international transactions but it does not reflect a complete picture of all the payments due to the country and the payments due from the country. For that it requires Balance of Payment Account. Mind, balance of visible items in BOP account is called BOT.

The balance of trade compares the value of a country's exports of goods and services against its imports. When exports are greater than imports, a trade surplus, Most nations view that as a favorable trade balance. The opposite, when the value of imports outweighs the value of exports, is a trade deficit. Countries usually regard that as an unfavorable trade balance.

To determine whether a country truly has a favorable trade balance, it must answer three questions.

First, where is the country is in its business cycle? Second, how long has the deficit or surplus been ongoing? Third, what are the reasons behind it?

The balance of trade is the most significant component of the current account. Which measures a country's net income earned on international assets.

It also includes all payments across borders. The trade balance is the easiest to measure. That's because all goods and many services must pass through the customs office.

The current account is itself part of a country's balance of payments, which measures all international transactions.

Favorable Trade Balance

Countries try to create trade policies that encourage a trade surplus. They consider a surplus a favorable trade balance because it's like making a profit as a country. Nations prefer to sell more and receive more capital for their residents. It translates into a higher standard of living. Their companies also gain a competitive advantage in expertise by producing all the exports. They hire more workers, reducing unemployment and generating more income.

To maintain this favorable trade balance, leaders often resort to trade protectionism. They protect domestic industries by levying tariffs, quotas or subsidies on imports. That doesn't work for long. Soon other countries retaliate with their protectionist measures.

Sometimes a trade deficit is the more favorable balance of trade. It depends on where the country is in its business cycle.

But many of its imports are raw materials that it converts into finished goods and then exports. That gives it a competitive advantage in manufacturing and finance. It creates a higher standard of living. Canada's slight trade deficit is a result of its economic growth. Its residents enjoy a better lifestyle afforded by diverse imports.

Unfavorable Trade Balance

Most of the time, trade deficits are an unfavorable balance of trade.

As a rule, countries with trade deficits export raw materials. They import a lot of consumer products. Their domestic businesses don't gain the experience needed to make value-added products. Their economies become dependent on global commodity prices. Such a strategy also depletes their natural resources in the long run.

Once in a while, a trade surplus is an unfavorable trade balance. China and Japan have both become dependent on exports to drive economic growth. They must purchase significant amounts of U.S. Treasury's to keep the dollar's value high and the value of their currencies low. That's how they keep their exports competitively priced and maintain their trade surplus. But this export-driven strategy means they rely on U.S. customers and U.S. foreign policy. In addition, their domestic market is weak. Chinese and Japanese citizens must save to provide for their old age, since the governments don't have strong social services.

Balance of Payment:

It is the difference between a nation's total payments to foreign countries and its total receipts from them. In other words, it is a systematic record of a country's receipts and payments in international economic transactions in a specific period of time.

Since BOP takes into account exchange of both visible and invisible items, therefore, it represents a wider and better picture of a country's international transactions than balance of trade. Each transaction is entered on the credit and debit side of the balance sheet.

Main items (or components) on credit side:

They are:

(i) Exports of Goods (visible exports) (ii) Exports of Services [invisible exports) (iii) Unrequited Receipts [unilateral transfers) and (iv) Capital Receipts.

Similar items are shown on debit side. They are:

(i) Imports of Goods, (ii) Imports of Services, (iii) Unrequited Payments and (iv) Capital Payments. All these items have been discussed in detail in the preceding clearly, the balance of payment is an application of double entry book-keeping with the result that debits and credits will always balance. In other words, balance of payment will always be in equilibrium.

(c) Comparison:
Balance of payment is a wider concept as compared to balance of trade which is just one of the four components of the former. The other three components of balance of payment are export/import of services, unilateral receipts/payments and capital receipts/payments.

BOT does not include any of these three components. Therefore, BOP represents a better picture of a country's economic transactions with the rest of the world than the Balance of Trade. Both are compared below.

What is the balance of payments?

The **balance of payments** (BOP) records all financial transactions made between consumers, businesses and the government in one country with others

- Inflows of foreign currency are counted as a positive entry (e.g. exports sold overseas)
- Outflows of foreign currency are counted as a negative entry (e.g. imported goods and services)

A balance of payments **deficit** means the country imports more goods, services and capital than it exports. It must borrow from other countries to pay for its imports. In the short-term, that fuels the country's economic growth. It's like taking out a school loan to pay for education. In the long-term, the country becomes a net consumer, not a producer, of the world's economic output. It will have to go into debt to pay for consumption instead of investing in future growth. If the deficit continues long enough, the country may have to sell off its assets to pay its creditors. These assets include natural resources, land and commodities,

A balance of payments **surplus** means the country exports more than it imports. Its government and residents are savers. They provide enough capital to pay for all domestic production. They might even lend outside the country.

A surplus boosts economic growth in the short term. That's because it's lending money to countries that buy its products. That boosts its factories, allowing them to hire more people.

In the long run, the country becomes too dependent on export-driven growth. It must encourage its residents to spend more. A larger domestic market will protect the country from exchange rate fluctuations. It also allows its companies to develop goods and services by using its own people as a test market.

Basic structure of the balance of payments accounts/BOP Components

The balance of payments has three components. They are the financial account, the capital account and the current account. The financial account describes the change in international ownership of assets. The capital account includes any financial transactions that don't affect economic output. The current account measures international trade, the net income on investments and direct payments. Here are the balance of payments components and how they work together.

Current Account

1. Balance of trade in goods
2. Balance of trade in services
3. Net primary income (this includes incomes from interest, profits, dividends generated from foreign investment and also migrant remittances i.e. payments from people living and working overseas)
4. Net secondary income (this includes (for the UK) our annual contributions to EU, spending military aid, overseas development aid etc.)

   The current account measures a country's trade balance plus the effects of net income and direct payments. When the activities of a country's people provide enough income and savings to fund all their purchases, business activity and government infrastructure spending, then the current account is in balance.

Capital account

- Sale/transfer of patents, copyrights, franchises, leases and other transferable contracts, and goodwill
- Transfers of ownership of fixed assets

The capital account measures financial transactions that don't affect a country's income, production or savings. For example, it records international transfers of drilling rights, trademarks and copyrights. Many capital account transactions happen infrequently, such as cross-border insurance payments. The capital account is the smallest component of the balance of payments.

Financial Account

This includes transactions that result in a change of ownership of financial assets and liabilities between UK residents and non-residents

- Net balance of foreign direct investment flows (FDI)
- Net balance of portfolio flows (e.g. inflows and outflows of debt and equity)
- Balance of banking flows (e.g. hot money flowing in/out of banking system)

The financial account measures 1) changes in domestic ownership of foreign assets and 2) foreign ownership of domestic assets. If foreign ownership increases more than domestic ownership does, it creates a deficit in the financial account. This means the country is selling off its assets, like gold, commodities and corporate stocks, faster than it is acquiring foreign assets.

Balancing item (estimated errors & omissions)

Changes to the value of reserves of gold and foreign currency

Overall balance of payments = zero

Current account deficit

A current account deficit is when a country's residents spend more on imports than they save. To fund the deficit, other countries lend to, or invest in, the deficit country's businesses. The lender country is usually willing to pay for the deficit because its businesses profit from exports to the deficit country. In the short run, the current account deficit is a win/win for both nations.

But if the current account deficit continues for a long time, it will slow economic growth. Why? The foreign lenders will begin to wonder whether they will get an adequate return on their investment. If demand falls off, the value of the borrower country's currency may also decline. This leads to inflation as import prices rise. It also creates higher interest rates as the government must pay higher yields on its bonds.

Current account: Trade balance

The trade balance measures a country's imports and exports. This is the largest component of the current account, which is itself the largest component of the balance of payments. Most countries try to avoid a trade deficit, but it's a good thing for emerging market countries. It's helps them grow faster than they could if they maintained a surplus.

Current account: Trade deficit

Definition: A trade deficit is when a country imports more than it exports. It is also called a negative balance of trade. It is one way of measuring international trade. To calculate the trade deficit, subtract the total value of exports from the total value of imports.

What Causes a Trade Deficit?

A trade deficit occurs when a country does not produce all it needs. Most nations must borrow from foreign states to pay for the imports.

A trade deficit results when a country's imports more than it exports. Imports are any goods and services produced in a foreign country, even if produced overseas by a domestic company.

Therefore, a trade deficit can occur even if all the imports are being sold by, and sending profit to, a domestic firm. With the rise of multinational corporations, and job outsourcing, trade deficits are on the rise.

Causes and Measures of Disequilibrium

Overall account of BOP is always in equilibrium. This balance or equilibrium is only in accounting sense because deficit or surplus is restored with the help of capital account.

In fact, when we talk of disequilibrium, it refers to current account of balance of payment. If autonomous receipts are less than autonomous payments, the balance of payment is in deficit reflecting disequilibrium in balance of payment.

There are several factors which cause disequilibrium in the BOP indicating either surplus or deficit.

Such causes for disequilibrium in BOP are listed below:

Economic Factors:

(a) Imbalance between exports and imports. (It is the main cause of disequilibrium in BOR), (b) Large scale development expenditure which causes large imports, (c) High domestic prices which lead to imports, (d) Cyclical fluctuations (like recession or depression) in general business activity, (e) New sources of supply and new substitutes.

Population Growth

Most countries experience an increase in the population and in some like India and China the population is not only large but increases at a faster rate. To meet their needs, imports become essential and the quantity of imports may increase as population increases.

Development Programmes

Developing countries which have embarked upon planned development programmes require to import capital goods, some raw materials which are not available at home and highly skilled and specialized manpower. Since development is a continuous process, imports of these items continue for the long time landing these countries in a balance of payment deficit.

Demonstration Effect

When the people in the less developed countries imitate the consumption pattern of the people in the developed countries, their import will increase. Their export may remain constant or decline causing disequilibrium in the balance of payments.

Natural Factors

Natural calamities such as the failure of rains or the coming floods may easily cause disequilibrium in the balance of payments by adversely affecting agriculture and industrial production in the country. The exports may decline while the imports may go up causing a discrepancy in the country's balance of payments.

Cyclical Fluctuations

Business fluctuations introduced by the operations of the trade cycles may also cause disequilibrium in the country's balance of payments. For example, if there occurs a business recession in foreign countries, it may easily cause a fall in the exports and exchange earning of the country concerned, resulting in a disequilibrium in the balance of payments.

Inflation

An increase in income and price level owing to rapid economic development in developing countries, will increase imports and reduce exports causing a deficit in balance of payments.

Poor Marketing Strategies

The superior marketing of the developed countries have increased their surplus. The poor marketing facilities of the developing countries have pushed them into huge deficits.

Flight of Capital

Due to speculative reasons, countries may lose foreign exchange or gold stocks People in developing countries may also shift their capital to developed countries to safeguard against political uncertainties. These capital movements adversely affect the balance of payments position.

Globalisation

Due to globalisation there has been more liberal and open atmosphere for international movement of goods, services and capital. Competition has been increased due to the globalisation of international economic relations. The emerging new global economic order has brought in certain problems for some countries which have resulted in the balance of payments disequilibrium.

Political Factors:
Experience shows that political instability and disturbances cause large capital outflows and hinder Inflows of foreign capital.

Social Factors:

(a) Changes in fashions, tastes and preferences of the people bring disequilibrium in BOP by influencing imports and exports; (b) High population growth in poor countries adversely affects their BOP because it increases the needs of the countries for imports and decreases their capacity to export.

Measures to correct disequilibrium in BOP:

Sustained or prolonged deficit has to be settled by short term loans or depletion of capital reserve of foreign exchange and gold

Following remedial measures are recommended:

(i) Export promotion:

Exports should be encouraged by granting various bounties to manufacturers and exporters. At the same time, imports should be discouraged by undertaking import substitution and imposing reasonable tariffs.

(ii) Import substitution

Restrictions and Import Substitution are other measures of correcting disequilibrium.

(iii) Reducing inflation:

Inflation (continuous rise in prices) discourages exports and encourages imports. Therefore, government should check inflation and lower the prices in the country.

(iv) Exchange control:

Government should control foreign exchange by ordering all exporters to surrender their foreign exchange to the central bank and then ration out among licensed importers.

(v) Devaluation of domestic currency:

It means fall in the external (exchange) value of domestic currency in terms of a unit of foreign exchange which makes domestic goods cheaper for the foreigners. Devaluation is done by a government order when a country has adopted a fixed exchange rate system. Care should be taken that devaluation should not cause rise in internal price level.

(vi) Depreciation:

Like devaluation, depreciation leads to fall in external purchasing power of home currency. Depreciation occurs in a free market system wherein demand for foreign exchange far exceeds the supply of foreign exchange in foreign exchange market of a country (Mind, devaluation is done in fixed exchange rate system.

Monetary Measures for Correcting the BOP

The monetary methods for correcting disequilibrium in the balance of payment are as follows :-

1. Deflation

Deflation means falling prices. Deflation has been used as a measure to correct deficit disequilibrium. A country faces deficit when its imports exceeds exports.

Deflation is brought through monetary measures like bank rate policy, open market operations, etc or through fiscal measures like higher taxation, reduction in public expenditure, etc. Deflation would make our items cheaper in foreign market resulting a rise in our exports. At the same time the demands for imports fall due to higher taxation and reduced income. This would built a favourable atmosphere in the balance of payment position. However Deflation can be successful when the exchange rate remains fixed.

2. Exchange Depreciation

Exchange depreciation means decline in the rate of exchange of domestic currency in terms of foreign currency. This device implies that a country has adopted a flexible exchange rate policy.

Suppose the rate of exchange between Indian rupee and US dollar is $1 = Rs. 40. If India experiences an adverse balance of payments with regard to U.S.A, the Indian demand for US dollar will rise. The price of dollar in terms of rupee will rise. Hence, dollar will appreciate in external value and rupee will depreciate in external value. The new rate of exchange may be say $1 = Rs. 50. This means 25% exchange depreciation of the Indian currency. Exchange depreciation will stimulate exports and reduce imports because exports will become cheaper and imports costlier. Hence, a favourable balance of payments would emerge to pay off the deficit.

Limitations of Exchange Depreciation:-

Exchange depreciation will be successful only if there is no retaliatory exchange depreciation by other countries.

It is not suitable to a country desiring a fixed exchange rate system.

Exchange depreciation raises the prices of imports and reduces the prices of exports. So the terms of trade will become unfavourable for the country adopting it.

It increases uncertainty & risks involved in foreign trade.

It may result in hyper-inflation causing further deficit in balance of payments.

3. Devaluation

Devaluation refers to deliberate attempt made by monetary authorities to bring down the value of home currency against foreign currency. While depreciation is a spontaneous fall due to interactions of market forces, devaluation is official act enforced by the monetary authority. Generally the international monetary fund advocates the policy of devaluation as a corrective measure of disequilibrium for the countries facing adverse balance of payment position. When India's balance of payment worsened in 1991, IMF suggested devaluation.

Accordingly, the value of Indian currency has been reduced by 18 to 20% in terms of various currencies. The 1991 devaluation brought the desired effect. The very next year the import declined while exports picked up.

When devaluation is effected, the value of home currency goes down against foreign currency, Let us suppose the exchange rate remains $1 = Rs. 10 before devaluation. Let us suppose, devaluation takes place which reduces the value of home currency and now the exchange rate becomes $1 = Rs. 20. After such a change our goods becomes cheap in foreign market. This is because, after devaluation, dollar is exchanged for more Indian currencies which push up the demand for exports. At the same time, imports become costlier as Indians have to pay more currencies to obtain one dollar. Thus demand for imports is reduced.

Generally devaluation is resorted to where there is serious adverse balance of payment problem.

Limitations of Devaluation:-

- Devaluation is successful only when other country does not retaliate the same. If both the countries go for the same, the effect is nil.
- Devaluation is successful only when the demand for exports and imports is elastic. In case it is inelastic, it may turn the situation worse.
- Devaluation, though helps correcting disequilibrium, is considered to be a weakness for the country.
- Devaluation may bring inflation in the following conditions :-
- Devaluation brings the imports down, When imports are reduced, the domestic supply of such goods must be increased to the same extent. If not, scarcity of such goods unleash inflationary trends.
- A growing country like India is capital thirsty. Due to non availability of capital goods in India, we have no option but to continue imports at higher costs. This will force the industries depending upon capital goods to push up their prices.
- When demand for our export rises, more and more goods produced in a country would go for exports and thus creating shortage of such goods at the domestic level. This results in rising prices and inflation.
- Devaluation may not be effective if the deficit arises due to cyclical or structural changes.

4. Exchange Control

It is an extreme step taken by the monetary authority to enjoy complete control over the exchange dealings. Under such a measure, the central bank directs all exporters to surrender their foreign exchange to the central authority. Thus it leads to concentration of exchange reserves in the hands of central authority. At the same time, the supply of foreign exchange is restricted only for essential goods. It can only help controlling situation from turning worse. In short it is only a temporary measure and not permanent remedy.

Non-Monetary Measures for Correcting the BOP

A deficit country along with Monetary measures may adopt the following non-monetary measures too which will either restrict imports or promote exports.

1. Tariffs

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes. Non-essential imports can be drastically reduced by imposing a very high rate of tariff.

Drawbacks of Tariffs:-

- Tariffs bring equilibrium by reducing the volume of trade.
- Tariffs obstruct the expansion of world trade and prosperity.
- Tariffs need not necessarily reduce imports. Hence the effects of tariff on the balance of payment position are uncertain.
- Tariffs seek to establish equilibrium without removing the root causes of disequilibrium.
- A new or a higher tariff may aggravate the disequilibrium in the balance of payments of a country already having a surplus.
- Tariffs to be successful require an efficient & honest administration which unfortunately is difficult to have in most of the countries. Corruption among the administrative staff will render tariffs ineffective.

2. Quotas

Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

Types of Quotas:

- The tariff or custom quota,
- The unilateral quota,

- The bilateral quota,
- The mixing quota, and
- Import licensing.

Merits of Quotas:-

- Quotas are more effective than tariffs as they are certain.
- They are easy to implement.
- They are more effective even when demand is inelastic, as no imports are possible above the quotas.
- More flexible than tariffs as they are subject to administrative decision. Tariffs on the other hand are subject to legislative sanction.

Demerits of Quotas :-

- They are not long-run solution as they do not tackle the real cause for disequilibrium.
- Under the WTO quotas are discouraged.
- Implement of quotas is open invitation to corruption.

3. Export Promotion

The government can adopt export promotion measures to correct disequilibrium in the balance of payments. This includes substitutes, tax concessions to exporters, marketing facilities, credit and incentives to exporters, etc.

The government may also help to promote export through exhibition, trade fairs; conducting marketing research & by providing the required administrative and diplomatic help to tap the potential markets.

4. Import Substitution

A country may resort to import substitution to reduce the volume of imports and make it self-reliant. Fiscal and monetary measures may be adopted to encourage industries producing import substitutes. Industries which produce import substitutes require special attention in the form of various concessions, which include tax concession, technical assistance, subsidies, providing scarce inputs, etc.

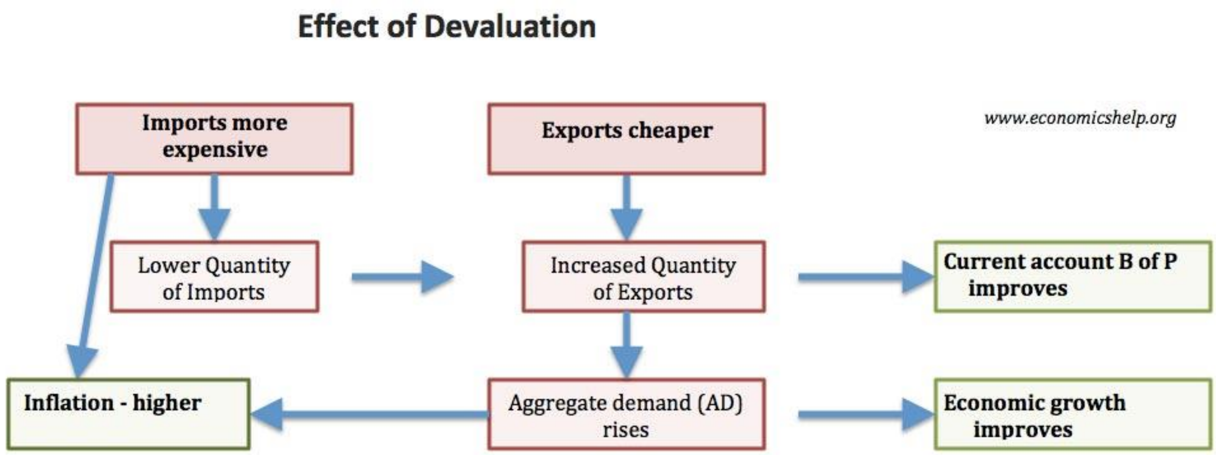
Non-monetary methods are more effective than monetary methods and are normally applicable in correcting an adverse balance of payments.

Drawbacks of Import Substitution

- Industries may lose the spirit of competitiveness.
- Domestic industries enjoying various incentives will develop vested interests and ask for such concessions all the time.
- Deliberate promotion of import substitute industries go against the principle of comparative advantage.

A devaluation means there is a fall in the value of a currency. A devaluation in the Pound means £1 is worth less compared to other foreign currencies. (e.g. Jan 2016. £1= $1.50 – July 2016 – £1=$1.28)

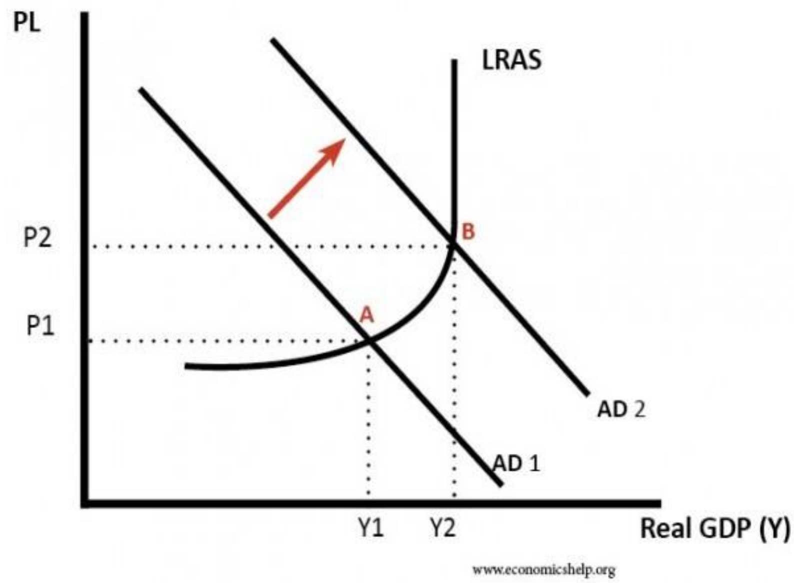
Planned or market forced reduction in the value of a currency's exchange value. Devaluation may improve a country's balance of payments situation by boosting exports and reducing imports, but it worsens inflation for imported goods or those having significant import content. Opposite of revaluation.



1. **Exports cheaper**. A devaluation of the exchange rate will make exports more competitive and appear cheaper to foreigners. This will increase demand for exports. Also, after a devaluation, UK assets become more attractive; for example, a devaluation in the Pound can make UK property appear cheaper to foreigners.

2. **Imports more expensive.** A devaluation means imports, such as petrol, food and raw materials will become more expensive. This will reduce demand for imports. It may also encourage British tourists to take a holiday in the UK, rather than US – which now appears more expensive.

3. **Increased aggregate demand (AD)**. A devaluation could cause higher economic growth. Part of AD is (X-M) therefore higher exports and lower imports should increase AD (assuming demand is relatively elastic). In normal circumstances, higher AD is likely to cause higher real GDP and inflation.



4. **Inflation** is likely to occur following a devaluation because:

- Imports are more expensive – causing cost push inflation.
- AD is increasing causing demand pull inflation
- With exports becoming cheaper, manufacturers may have less incentive to cut costs and become more efficient. Therefore over time, costs may increase.

5. **Improvement in the current account**. With exports more competitive and imports more expensive, we should see higher exports and lower imports, which will reduce the current account deficit. In 2016, the UK had a near record current account deficit, so a devaluation is necessary to reduce the size of the deficit.

6. Wages. A devaluation in the Pound makes the UK less attractive for foreign workers. For example, with fall in the value of the Pound, migrant workers from Eastern Europe may prefer to work in

Germany than the UK. In the UK food manufacturing industry, more than 30% of workers are from the EU. UK firms may have to push up wages to keep foreign labour. Similarly, it becomes more attractive for British workers to get a job in the US because a dollar wage will go further. (FT – migrants become more picky about UK jobs)

7. Falling real wages. In a period of stagnant wage growth, devaluation can cause a fall in real wages. This is because devaluation causes inflation, but if the inflation rate is higher than wage increases, then real wages will fall.

Evaluation of devaluation

The effect of devaluation depends on:

1. Elasticity of demand for exports and imports. If demand is price inelastic, then a fall in the price of exports will lead to only a small rise in quantity. Therefore, the value of exports may actually fall. An improvement in the current account on the balance of payments depends upon the Marshall Lerner condition and the elasticity of demand for exports and imports

- If PEDx + PEDm > 1 then a devaluation will improve the current account
- The impact of devaluation may take time to influence the economy. In the short term, demand may be inelastic, but over time demand may become more price elastic and have a bigger effect.

2. State of the global economy. If the global economy is in recession, then a devaluation may be insufficient to boost export demand. If growth is strong, then there will be a greater increase in demand. However, in a boom, devaluation is likely to exacerbate inflation.

3. Inflation. The effect on inflation will depend on other factors such as:

- Spare capacity in the economy. E.g. in a recession, a devaluation is unlikely to cause inflation.
- Do firms pass increased import costs onto consumers? Firms may reduce their profit margins, at least in the short run.
- Import prices are not the only determinant of inflation. Other factors affecting inflation such as wage increases may be important.

4. It depends on why the currency is being devalued. If it is due to a loss of competitiveness, then a devaluation can help to restore competitiveness and economic growth. If the devaluation is aiming to meet a certain exchange rate target, it may be inappropriate for the economy.

Winners and losers from Devaluation

Devaluation / depreciation

Winners	Losers
• Exporters • Domestic tourist industry • Workers gaining jobs in export industry • Economic growth might increase • Current account deficit should improve	• Consumers who buy imports • Residents who holiday abroad • Firms who buy imported raw materials • Those on fixed incomes/wages who see inflation rise faster • Foreign exporters/tourist industry

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Foreign Trade Multiplier

Meaning:

The foreign trade multiplier, also known as the export multiplier, operates like the investment multiplier of Keynes. **It may be defined as the amount by which the national income of a country 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 export industries. These, in turn, create demand for goods. But this is dependent upon their marginal propensity to save (MPS) and the marginal propensity to import (MPM). The smaller these two marginal propensities are, the larger will be the value of the multiplier, and vice versa.

Working

The foreign trade multiplier process can be explained like this. Suppose the exports of the country increase. To begin with, the exporters will sell their products to foreign countries and receive more income. In order to meet the foreign demand, they will engage more factors of production to produce more.

This will raise the income of the owners of factors of production. This process will continue and the national income increases by the value of the multiplier. The value of the multiplier depends on the value of MPS and MPM, there being an inverse relation between the two propensities and the export multiplier.

The foreign trade multiplier can be derived algebraically as follows:

The national income identity in an open economy is

$$Y = C + I + X – M$$

Where Y is national income, C is national consumption, I is total investment, X is exports and M is imports.

The above relationship can be solved as:

$$Y-C = 1 + X-M$$

$$\text{or } S = I+X-M \ (S=Y-C)$$

$$S + M = I + X$$

Thus at equilibrium levels of income the sum of savings and imports (S+M) must equal the sum of investment and export (1+X).

In an open economy the investment component (I) is divided into domestic investment (Id) and foreign investment (If)

$$I=S$$

$$Id + If = S\ldots (1)$$

Foreign investment (If) is the difference between exports and imports of goods and services.

$$If =X-M\ldots. (2)$$

Substituting (2) into (1), we have

$$l_d + X-M – S$$

$$\text{or } I_d + X = S+M$$

Which is the equilibrium condition of national income in an open economy. The foreign trade multiplier coefficient (K_f) is equal to

$$K_f = \Delta Y/\Delta X$$

$$\text{And } \Delta X = \Delta S + \Delta M$$

Dividing both sides by ΔY, we get

$$\frac{\Delta X}{\Delta Y} = \frac{\Delta S + \Delta M}{\Delta Y}$$

or

$$\frac{\Delta Y}{\Delta X} = \frac{\Delta Y}{\Delta S + \Delta M}$$

or

$$K_f = \frac{\Delta Y}{\Delta S + \Delta M} \qquad \left(\because K_f = \frac{\Delta Y}{\Delta X}\right)$$

$$K_f = \frac{1}{\frac{\Delta S}{\Delta Y} + \frac{\Delta M}{\Delta Y}} \qquad (\because \text{ Dividing by } \Delta Y)$$

Hence

$$K_f = \frac{1}{MPS + MPM} \qquad \left(\begin{matrix} \because MPS = \Delta S / \Delta Y \\ \because MPM = \Delta M / \Delta Y \end{matrix}\right)$$

Let us understand it with the help of an example.
Suppose MPS=0.3, MPM = 0.2 and ΔX (increase in exports) = Rs. 1000 crores, we get

$$K_f = \frac{\Delta Y}{\Delta X} = \frac{1}{MPS + MPM}$$

or

$$\Delta Y = \frac{1}{MPS + MPM} \Delta X$$

$$= \frac{1}{0.3 + 0.2} \times 1000 = \text{Rs. 2000 crores}$$

It shows that an increase in exports by Rs. 1000 crores has raised national income through the foreign trade multiplier by Rs. 2000 crores, given the values of MPS and MPM.

Assumptions:

The foreign trade multiplier is based on the following assumptions:

1. There is full employment in the domestic economy.

2. There is direct link between domestic and foreign country in exporting and importing goods.

3. The country is small with no foreign repercussion effects.

4. It is on a fixed exchange rate system.

5. The multiplier is based on instantaneous process without time lags.

6. There is no accelerator.

7. There are no tariff barriers and exchange controls.

8. Domestic investment (I_d) remains constant.

9. Government expenditure is constant.

10. The analysis is applicable to only two countries.

Diagrammatic Explanation:

Given these assumptions, the equilibrium level in the economy is shown in Figure 1, where S(Y) is the saving function and (S+M) Y is the saving plus import function. l_d represents domestic investment and $l_d + X$, domestic investment plus exports. (S+M) Y and I_d+ X functions determine the equilibrium level of national income OY at point E, where savings equal domestic investment and exports equal imports.

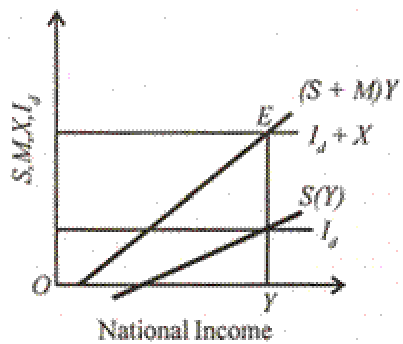


Fig. 1

If there is a shift in the I_d + X function due to an increase in exports, the national income will increase from OY to OY_1 as shown in Figure 2. This increase in income is due to the multiplier effect, i.e. $\Delta Y = K_f \Delta X$. The exports will exceed imports by sd, the amount by which savings will exceed domestic investment. The new equilibrium level of income will be OY_1. It is a case of positive foreign investment.

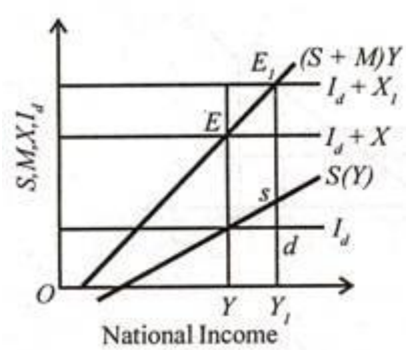


Fig. 2

If there is a fall in exports, the export function will shift downward to $I_d + X_1$ as shown in Figure 3. In this case imports would exceed exports and domestic investment would exceed savings by ds. The level of national income is reduced from OY to OY_1. This is the reverse operation of the foreign trade multiplier.

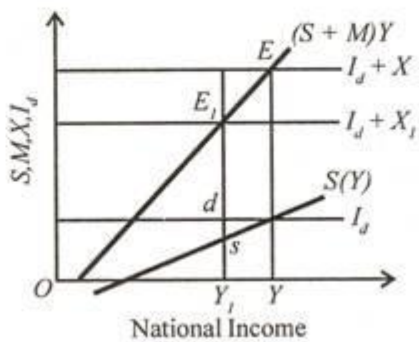


Fig. 3

Foreign Repercussion or Backwash Effect:

The above analysis of the simple foreign trade multiplier has been studied in the case of one small country. But, in reality, countries are linked to each other indirectly also. A country’s exports or imports affect the national income of the other country which, in turn, affects the foreign trade and national income of the first country.

This is known as the Foreign Repercussion or Backwash or Feedback Effect. The smaller the country is in relation to other trading partner, the negligible is the foreign repercussion. But the foreign repercussion will be high in the case of a large country because a change in the national income of such a country will have significant foreign repercussions or backwash effects.

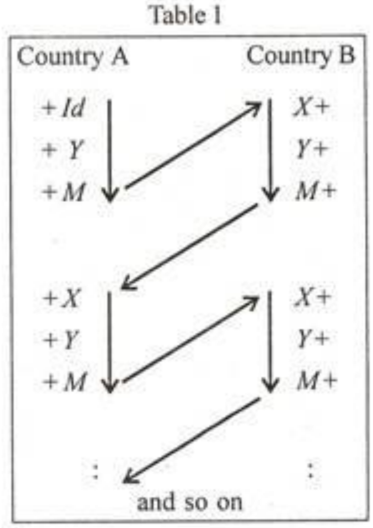
Assuming two large countries A and B where A’s imports are B’s exports and vice versa. An increase in A’s domestic investment will cause a multiplier increase in its income. This will increase its imports. This increase in A’s imports will be increase in B’s exports which will increase income in B through B’s foreign trade multiplier.

Now the increase in B's income will bring an increase in its imports from country A which will induce a second round increase in A's income, and so on. This is explained in Table 1. When autonomous domestic investment (I_d) increases in country A, its national income increase (+Y).

It induces country A to import more from country B. This increases the demand for country B's exports (X+). Consequently, the national income in country B increases (Y+). Now this country imports more (M+) from country A.

As the demand for country A's exports increases (+X), its national income (+Y) increases further and this country imports more (+M) from B country. This process will continue in smaller rounds. These are the foreign repercussions or the backwash effects for country A which will peter out and dampen the effects of increase in the original autonomous domestic investment (I_d) in country A.

Table 1



The stages of foreign repercussions shown in the above table are explained in Figure 4 Panel I, II and III. In stage I, domestic investment in country A increases form I_d to I_{d1} in Panel I. This leads to an upward shift in the I_d+ X curve to I_{d1} + X. As a result, the new equilibrium point is at E_1which shows an increase in the national income from OY to OY_1. As the national income increases, the demand for imports from country B also increases.

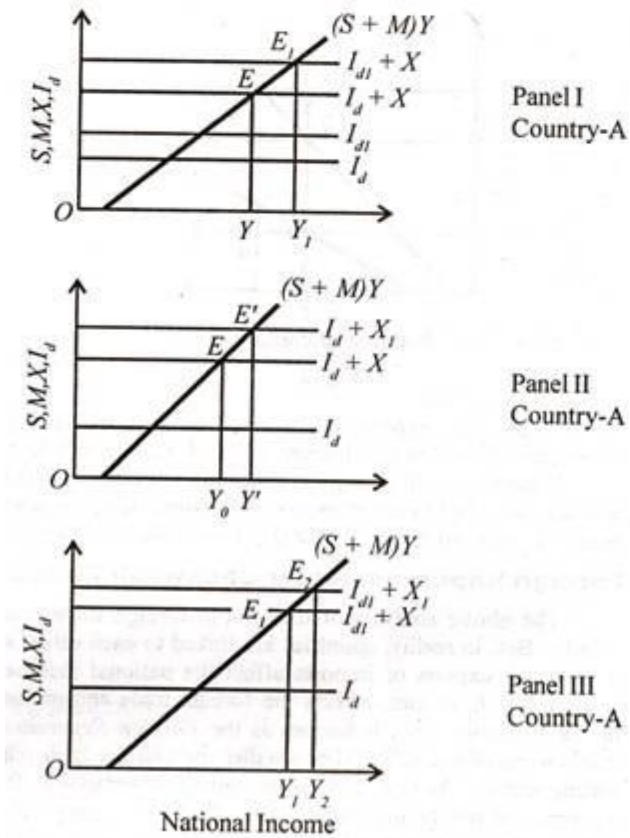


Fig. 4

This means increase in the exports of country B. This is shown in Panel II when the l_d + X curve of country B shifts upward as $I_d + X_1$. Consequently, the national income in country B increases from OY_0 to OY' at the higher equilibrium level E'.

As country B's income increases, its demand for imports from country A also increases. This, in turn, leads to the backwash effect in the form of increase in the demand for exports of country A. This is shown in Panel III where the l_{d1} + X curve (of Panel I) further shifts upwards to $I_{d1} + X_1$and consequently the national income increases further from OY_1 to OY_2.

This shows how the foreign repercussions in one country affect its own national income and that of the other country which, in turn, again affects in own national income through the backwash effects with greater force.

Implications of Foreign Repercussion:

The following are the implications of foreign repercussion effects:

1. The foreign repercussion effects suggest a mechanism for the transmission of income disturbances between trading countries. If a country is small, it will be affected by change in income of other countries that will alter the demand for its exports. But it will not be able to transmit its own income disturbances to the latter.

If a country is large, it may transmit its own income disturbances to other countries and, in turn, be affected by income disturbances in them. It implies that a boom or slump in one country has repercussion on the incomes of other countries. Thus swings in business cycles are likely to be internationally contagious, as happened in the 1930s and 2008.

2. The repercussion effects also suggest that since the backwash effects ultimately peter out, automatic income changes cannot eliminate completely the current account BOP deficit or surplus produced by an automatic disturbance.

3. The policy implications of the backwash effects suggest that export promotion policies raise national income in the trading partners at a lower rate than by an increase in domestic investment. The export promotion measures raise national income via the simple foreign trade multiplier, whereas increase in domestic investment policies raise national income many times in multiplier rounds via the repercussion effects.

Criticisms of Foreign Trade Multiplier:

The two models of the foreign trade multiplier presented above are based on certain assumptions which make the analysis unrealistic.

1. Exports and Investment not Independent: The analysis of simple foreign trade multiplier is based on the assumption that exports and investment (both domestic and foreign) are independent of changes in the level of national income. But, in reality, this is not so. A rise in exports does not always lead to increase in national income. On the contrary, certain imports, of say capital goods, have the effect of increasing national income.

2. Legless Analysis:

The foreign trade multiplier is assumed to be an instantaneous process whereby it provides the final results. Thus it involves no lags and is unrealistic.

3. Full Employment not Realistic:

The analysis is based on the assumption of a fully employed economy. But there is less than full employment in every economy. Thus the foreign trade multiplier does not find clear expression in an economy with less than full employment.

4. Not Applicable to More than two Countries:

The whole analysis is applicable to a two-country model. If there are more than two countries, it becomes complicated to analyse and interpret the foreign repercussions of this theory.

5. Neglects Trade Restrictions:

The foreign trade multiplier assumes that there are no tariff barriers and exchange controls. In reality, such trade restrictions exist which restrict the operations of the foreign trade multiplier.

6. Neglects Monetary-Fiscal Measures:

This analysis is based on the unrealistic assumption that the government expenditure is constant. But governments always interfere through monetary and fiscal policies which affect exports, imports and national income. Despite these shortcomings, the foreign trade multiplier is a powerful tool of economic analysis which helps in formulating policy measures.

International Monetary Fund (IMF)

Origin of IMF:

The origin of the IMF goes back to the days of international chaos of the 1930s. During the Second World War, plans for the construction of an international institution for the establishment of monetary order were taken up.

At the Bretton Woods Conference held in July 1944, delegates from 44 non-communist countries negotiated an agreement on the structure and operation of the international monetary system.

The Articles of Agreement of the IMF provided the basis of the international monetary system. The IMF com-menced financial operations on 1 March 1947, though it came into official existence on 27 December 1945, when 29 countries signed its Articles of Agreement (its charter). Today (May 2012), the IMF has near-global membership of 188 member countries. Virtually, the entire world belongs to the IMF. India is one of the founder- members of the Fund.

Objectives:

Article 1 of the Articles of Agreement (AGA) spell out 6 purposes for which the IMF was set up.

These are:

I. To promote international monetary coope-ration through a permanent institution which provides the machinery for consolation and collaboration on international monetary problems.

II. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objective of economic policy.

III. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

IV. To assist in the establishment of a multila-teral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

V. To give confidence to members by making the general resources of the Fund tempo-rarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments, without resor-ting to measures destructive of national or international prosperity.

VI. In accordance with the above, to shorten the duration and lessen the degree of dis-equilibrium in the international balance of payments of members.

Major Functions of International Monetary Fund

The following points highlight the twelve major functions of International Monetary Fund (IMF).

They are: 1. Fixation of par value of currencies in terms of Gold or Dollar 2. Alternation of limit within par value 3. Loans of foreign currency 4. Drawing Rights 5. Stand by Arrangements and Others.

Function 1. Fixation of Par Value of Currencies in terms of Gold or Dollar:

Every member country has to declare the par value of her currency in terms of US Dollars or in gold.

The main objective of IMF is to maintain stability in exchange rates of the member countries.

In fact, the IMF fixes the maximum or minimum limit of the par values of various countries.

Function 2. Alternation of Limit within Par Value:

There is over rigidity in the par values of the currencies of different countries. If Fund finds that there is fundamental disequilibrium in the balance of payments of a country, it can change the par values of its currency, A country is allowed to alter its basic par value within well defined limits i.e. upto 10 per cent after making her intention known to the Fund.

Under certain circumstances, the Fund itself can make proportionate alterations in par values of all the member countries.

Function 3: Loans of Foreign Currency

The Fund realises that a stable exchange is very essential for the proper growth and expansion of the free world trade. Therefore, it take-s steps to check the fluctuations in the par values by eliminating the disequilibrium in the balance of payment of the member countries.

A member country can buy foreign currency from the Fund to tide over her temporary balance of payments deficit. The Fund sells currencies to members against their subscriptions for short period to enable them to remove the difficulties of the balance of payment.

Function 4. Drawing Rights:

A member country during hardships of the balance of payments can buy the required foreign currency from the Fund by offering more of its own currency over and above its original subscription. The Fund provides both maximum and normal limits of financial assistance for a short period. A member country can request for any currency under the credit line of 25 per cent of its quota in one year.

This is known as gold tranche or reserve tranche drawing. But the full amount drawn under these drawings should not exceed by 200 per cent of the Fund's holdings of a country's currency quota. The member countries do not borrow more than 150 per cent of quota, because any further borrowing in subject to increasing interference by the Fund.

Function 5. Stand by Arrangements:

Under the agreement of the Fund guarantee is given to provide a specific sum of money for a given period of time to a member country. Normally, the satisfaction as to the legitimacy and purpose of drawing is considered before a standby is granted. Since the standby is a part of the quota, it forms a part of the total drawing power.

Function 6. Liquidity of Fund's Resources:

If the borrowing countries are buying the currency of other countries, the Fund may accommodate such currencies as are not demanded. In fact, the Fund will not be able to act as a reserve Fund. Thus, it becomes necessary that the Fund should keep its resources in a liquid form so that the borrowing country may repurchase of domestic currency.

There are certain rules to maintain the liquidity of resources such as:

(i) Any member country can buy the currency of any other member country by depositing gold in the Fund.

(ii) If the currency of a country with the Fund exceeds its quota, then that country can purchase its own currency in exchange for gold.

(iii) Every country, under special circumstances, can buy a part of its own currency from the Fund in exchange for gold or other currency.

Function 7. Currency in Short Supply:

It is possible that a country's currency may be in short supply. Short supply of a currency in foreign exchange market indicates a favourable balance of payment. If the Fund finds that a particular member country is having a surplus in its balance of payment and its supply of currency is inadequate relative to demand, the Fund may ask the surplus country to revalue its currency.

On the contrary when the Fund declares a particular currency as scarce, the member country revalues the currency, thus, raising costs and prices. This would increase its imports and the Fund can operate its operations more effectively.

Function 8. Position of Gold in Fund's Scheme:

Under the Fund's scheme, status was given to gold as every member country has to deposit in gold the Fund upto 25 percent of its quota or 10 per cent of its gold holdings. Under the agreement of the Fund, the par values of currencies of members are expressed in terms of gold, SDR and the US Dollars. In Fund's scheme, gold had been retained as a basis of determination of the par values of member's currencies.

A member can deal with the Fund "only through its treasury, central bank, stabilisation fund or other similar agency". An alteration in par value is permitted only within limits. If the fund is short of any particular currency, it can purchase the same for gold. The value of gold has been fixed by the Fund at 35 dollars per five ounce.

According to Prof. Williams, Fund's Planning is akin to gold standard. But according to Lord Keynes, Under Fund's planning; a system has been created, by means of international agreement, that is far removed from the old political gold standard system.

It is so because:

(a) It is not based on gold currency as was gold standard.

(b) Under Fund's planning, value of the currency is not fixed in terms of gold forever.

(c) Under gold standard, gold occupied the position of a master but under Fund's planning it is given the place of a servant. By virtue of the amendments made in the regulations of the Fund, since 1976 gold has no place in Fund's planning.

Function 9. A Central Bank's Bank:

IMF may be described as a bank of Central Banks of different countries. It collects the resources of the various Central Banks in the same way in which a country's Central Bank collects cash reserves of all commercial banks in a country.

Function 10. Facilities during the Transition Period:

The Fund gets all the exchange control removed so that the world trade may flourish smoothly. During the transitional period, the Fund has empowered the member countries to impose such restrictions on imports and foreign exchanges according to its necessity.

As the transitional period is over, member countries are supposed to remove the restrictions imposed on international trade and foreign exchanges. Therefore, the member countries can continue with their control to the desirability of the Fund.

Function 11. Training:

The Fund also imparts training to the representatives of member-countries. This training is imported to the senior officers of the central banks and Finance Departments.

Function 12. Facilities during Emergency:

Although IMF is opposed to any sort of controls either on foreign exchange or foreign trade. Still member-countries have been given the right to resort to these controls during emergency in the hope that they will lift it as early as the situation warranted.

Its main elements are:

(i) Application of the principles of market economy;

(ii) Opening up of the economy by removing all barriers of trade; and

(iii) Prevention of deflation.

The Fund provides financial assistance. It includes credits and loans to member countries with balance of payments problems to support policies of adjustment and reform. It makes its financial resources available to member countries through a variety of financial facilities.

It also provides concessional assistance under its poverty reduction and growth facility and debt relief initiatives. It provides fund to combat money- laundering and terrorism in view of the attack on the World Trade Centre of the USA on 11 September 2001.

In addition, technical assistance is also given by the Fund. Technical assistance consists of expertise and support provided by the IMF to its members in several broad areas : the design and implementation of fiscal and monetary policy; institution-building, the handling and accounting of transactions with the IMF; the collection and retirement of statistical data and training of officials.

Maintenance of stable exchange rate is another important function of the IMF. It prohibits multiple exchange rates.

It is to be remembered that unlike the World Bank, the IMF is not a development agency. Instead of providing development aid, it provides financial support to tide over BOP difficulties to its members.

Organisation and Management of the IMF:

Like many international organisations, the IMF is run by a Board of Governors, an Executive Board and an international staff. Every member country delegates a representative (usually heads of central banks or ministers of finance) to the Board of Governors—the top link of the chain of command. It meets once a year and takes decision on fundamental matters such as electing new members or changing quotas.

The Executive Board is entrusted to the management of day-to-day policy decisions. The Board comprises 24 executive directors who supervise the implementation of policies set by the member governments through the Board of Governors.

The IMF is headed by the Managing Director who is elected by the Executive Board for a 5 year term of office.

Rights and obligations, i.e., the balance of Powers in the Fund is determined by a system of quotas. Quotas are decided by a vote of the Board of Governors. Quotas or subscriptions roughly reflect the importance of members in the world economy. It is the quota on which payment obligation, credit facilities, and voting rights of members are determined.

Financial Structure of the IMF:

The capital or the resources of the Fund come from two sources:

(i) Subscription or quota of the member nations, and

(ii) Borrowings.

Each member country is required to subscribe an amount equivalent to its quota. It is the quota on which payment obligations, credit facilities, and voting right of members are determined. As soon as a country joins the Fund, it is assigned a quota which is expressed in Special Drawing Rights (SDRs). At the time of formation of the IMF, the quota of each member was made up of 25 p.c. in gold or 10 p.c. of its net official holdings of gold and US dollars (whichever was less). Now this has been revised.

The capital subscriptions or quota is now made up of 25 p.c. of its quota in SDRs or widely accepted currencies (such as the US dollar, euro, the yen or the pound sterling) instead of gold and 75 p.c. in country's own currency. The size of the Fund equals the sum of the subscriptions of members. Total quotas at the end-August 2008 were SDR 217.4 billion (about $341 billion).

The Fund is authorised to borrow in special circumstances if its own resources prove to be insufficient. It sells gold to member countries to replenish currency holdings. It is entitled to borrow even from international capital market. Though the Articles of Agreement permit the Fund to borrow from the private capital market, till today no such use has been made by the IMF.

Special Drawing Rights (SDRs):

The Special Drawing Rights (SDRs) as an international reserve asset or reserve money in the international monetary system was established in 1969 with the objective of alleviating the problem of international liquidity. The IMF has two accounts of operation—the General Account and the Special Drawing Account.

The former account uses national currencies to conduct all business of the fund, while the second account is transacted by the SDRs. The SDR is defined as a composite of five currencies—the Dollar, Mark, Franc, Yen and Pound. The SDRs are allocated to the member countries in proportion to their quota subscriptions. Only the IMF members can participate in SDR facility.

SDRs being costless, often called paper gold, is just a book entry in the Special Drawing Account of the IMF. Whenever such paper gold is allocated, it gets a credit entry in the name of the participating countries in the said account. It is to be noted that SDRs, once allocated to a member, are owned by it and operated by it to overcome BOP deficits. Since its inception, there have been only four allocation to SDRs—the first in 1970, and the last in 2008-09—mainly to the developing countries.

Instruments of IMF Lending and Loan Conditionality:

The IMF Articles of Agreement clearly state that the resources of the Fund are to be used to give temporary assistance to members in financing BOP deficit on current account. Of course, the financial assistance provided by the Fund is loan. The following technique is employed: If a country calls on the Fund it buys foreign currencies from the IMF in return for the equivalent in the domestic currency.

This, in legal and technical terms, is called a ‘drawing’ on the Fund. The technique, therefore, suggests that the IMF does not lend, but sells the required currency to the members on certain terms. This unique financial structure of the Fund clearly suggests that the Fund’s resources cannot be lent for long time. It is meant to cover short run gaps in BOP.

The IMF’s unique financial structure does not allow any member to enjoy financial assistance over a long time period. The total amount that a country is entitled to draw is determined by the amount of its quota. A member is entitled to draw an amount not exceeding 25 p.c. of its quota. The first 25 p.c.

called the ‘gold tranche’ (‘tranche’ a French Word meaning slice) or ‘reserve tranche’ can easily be drawn by countries with BOP problems.

This 25 p.c. of the quota is the members’ owned reserves and therefore no conditions are attached to such drawings. This may be called ‘ordinary, drawing rights; even the Fund cannot deny its use. However, no interest for the first credit tranche is required to be paid though such drawings are subject to repayment within 3-5 years period.

The ‘credit tranche’ of 100 p.c. each equaling 25 p.c. of a member’s quota are also available subject to the IMF approval and hence, ‘conditional’.

Originally, it was possible to borrow equal to 125 p.c. of one’s quota. At present, borrowing limit has been raised to 450 p.c. of one’s quota which must be redeemed within five years.

Borrowing methods used by the Fund are:

(i) Stand-by Arrangements:

This method of borrowing has become the most normal form of assistance by the Fund. Under this form of borrowing, a member state obtains the assurance of the Fund that, usually over 12-18 months, requests for drawings of foreign exchange (i.e., to meet short- term BOP problems) up to a certain amount will be allowed if the country concerned wishes.

However, the stand-by arrangements can be extended up to 3 years while repayments are required to be made within 3-5 years of each drawing. The term “stand-by” here means that, subject to conditionality, a member has a right to draw the money made available, if needed. In most cases, the member does, in fact, draw.

(ii) Extended Fund Facility (EFF):

Stand-by arrangements to stabilise a member’s BOP run usually for a period of 12-18 months. Developing countries suffer from chronic BOP problems which could not be remedied in the short run. Such protracted BOP difficulties experienced by the LDCs were the result of structural imbalances in production and trade. It then necessitated an adjustment programme and redemption scheme of longer duration.

In the 1970s, the Fund recognised this idea and built up the EFF in 1974. The EFF is designed to provide assistance to members to meet their BOP deficits for longer period (3-4 years) and in amounts larger in relation to their quotas. Repayment provisions of EFF cover a period of 4-10 years. However, conditions for granting loans are very stringent.

(iii) Compensatory Financing Facility (CFF):

Apart from the ordinary drawing rights, there are some 'special finances' windows to assist the developing countries to tide over BOP difficulties. CFF, introduced in 1963, is one such special drawing provision. Its name was changed to Compensatory and Contingency Financing Facility (CCFF) in 1980, but the 'contingency' was dropped in 2000. Under it, members were allowed to draw up to 25 p.c. of its quota when CFF was introduced.

It can now draw up to 45 p.c. Since the mid- 1990s, this has been the least-used facility.

(iv) Structural Adjustment Facility (SAF) and the Enhanced SAF (ESAF):

In 1986 a new facility—the SAF—was introduced for the benefit of low income countries. It was increasingly realised that the so-called stringent and inflexible credit arrangements were too inadequate to cope with the growing debt problems of the poorest members of the Fund. In view of this, SAF was introduced which stood quite apart from the monetary character of the Fund.

Under it, credit facilities for economic reform programmes are available at a low interest rate of 0.5 p. c compared to 6 p.c. for most Fund facilities. Loans are for 10 years with a grace period of five and a half years. LDCs facing protracted BOP problems can get assistance under SAF provided they agree to undertake medium-term structural adjustment programmes to foster economic growth and improve BOP conditions. An extended version of SAF—ESAF—was introduced in 1987. The ESAF has been replaced by a new facility, called Poverty Reduction and Growth Facility in 1999.

What emerges from the structural adjustment facility is that the IMF's loan is now available to member countries in support of policy programmes. It now insists on the supply side policy 'as a condition' for assistance, in addition to loans meant for short-term BOP difficulties.

(v) Poverty Reduction and Growth Facility (PRGF):

The PRGF that replaced the ESAF in November 1999 provides concessional lending to help the poorest member countries with the aim of making poverty reduction and economic growth —the central objectives of policy programmes. Under this facility, low-income member countries are eligible to borrow up to 140 p.c. of its quota for a 3-year period. Rate of interest that is charged is only 0.5 p. c and repayment period covers 5 1/2-10 years, after disbursement of such facility. However, financial assistance under this facility is, of course, 'conditional'.

(vi) Supplemental Reserve Facility (SRF):

This instrument provides additional short-term financing to member countries facing exceptional BOP difficulties because of a sudden and disruptive loss of market confidence reflected in capital outflows of countries concerned. Consequent upon the eruption of East Asian financial crisis, the SRF was introduced in 1997.

Till date (March, 2012), the top three largest borrowing nations are Greece, Portugal and Ireland from the IMF.

Strings of Conditionality:

It is to be remembered here that the IMF lending is conditional. Further, the IMF lending is temporary ranging from 1 year to 3 years. Repayment period varies from country to country and from one facility to another. Repayment under PRGF for low income countries is 10 years with a 5 1/2 year grace period on principal payments.

The IMF may be viewed as both a financing and an adjustment-oriented international institution for the benefit of its members. The distinguishing features of the Fund loans are their cost and certain macroeconomic policy conditions. These conditionality requirements range from rather general commitments to cooperate with the IMF in setting policies to formulating a specific, quantified plan for monetary, trade, and fiscal policies.

The IMF practice of tying loans to conditions reflects the dominant influence of the capitalist world. The strings of conditionality's as well as the policy of sanctions that came to the fore in the early 1960s made this international organisation the most controversial institution. This is because of the fact that the conditions set by the Fund cannot constitute a standard solution for deficit countries to the Fund's finances. By attaching conditions to credit facilities, the Fund has assumed the role of a 'neo-colonist'. Some say that the IMF has been acting as 'a rubber stamp for the desires of the US administration'.

The conditionality is always intended to restore internal and external balance and price stability. While formulating specific performance criteria (often referred to as 'conditional loans' that is, 'at the point of a gun'), the Fund prepares 'stabilization' programme and 'adjustment' programme which member states will be required to adopt to tackle macroeconomic instability.

The programme design involves monetary and fiscal policy measures so that structural adjustment (i.e., reforms aimed at changing the structure of both production and consumption) takes place. Stabilisation is generally regarded as a precondition of structural adjustment policies'.

Thus, stabilisation and structural programmes not only includes monetary and fiscal policies but also exchange rate policy (i.e., devaluation), liberalisation or deregulation, privatisation, reforming institutions to carry governments' new role, freeing markets to determine prices, reforming the labour sector. Almost all stabilisation programmes intend to curb effective demand.

Working of the IMF:

There are two phases in the working of the IMF over the last 65 years. The first phase covers the period late 1940s (i.e., 1947) to 1971. This phase is popularly known as the 'Bretton Woods System'. The IMF system or the Bretton Woods System provides for exchange rate stability in the short run but allowed for the possibility of exchange rate adjustment when a country experienced 'fundamental' disequilibrium in its BOP accounts. Thus, the pegged exchange rate was adjusted in accordance with the IMF. Hence the name 'adjustable peg system'.

As the system was the source of some major problems, it was abandoned in 1971 and more flexibility was introduced in the monetary system. In other words, the demise of the Bretton Woods System made room for the floating exchange rate regime, requiring changes in the role of the IMF. After prolonged negotiations (1973-78), the IMF started its second-leg journey in 1978.

The decade of the 1970s saw massive borrowing by the developing countries. It rose to $600 billion by 1982. Meanwhile, the rise in interest rates in the USA from 1979 and the appreciation of dollar caused tremendous difficulties to the developing countries in servicing their debts. On the other hand, the switch to the floating exchange rate system coincided with the deteriorating economic conditions in the industrialised countries.

Debt crisis that emerged in many developing countries had a dramatic effect. Mexico a Latin American country announced its failure to honour debt obligations. The IMF now played a crucial role to put the international financial system in order. It came in for mobilisation of additional financial resources so as to reduce the debt burden. As a result of this and other related measures, many countries regained access to the international banks and creditors and the severity of the debt problem moderated considerably in Latin America in the early 1990s.

With the breakup of the Soviet Union in 1989, a new category of countries, especially the erstwhile communist countries, joined the IMF. The IMF now came forward to assist countries undergoing transition from a centrally planned economy to a market-oriented economy. Privatisation is indeed a crucial element of the transition process. That is why the IMF is providing financial assistance and technical support for the development of sound economic management and the privatisation of state enterprises.

In 1997, the East Asian financial crisis began when the currencies of the ‘Asian tiger’ economies (South Korea, Singapore, Hong Kong, Taiwan) plummeted, and the stock market crashed. Rescue packages were launched by the IMF under strong authority conditions.

Achievements:

From this balance sheet of the working of the IMF, we are now in a position to evaluate its performance over the last 65 years or so. First, we state the achievements of the Fund.

The IMF acts both as a financing and an adjustment-oriented international institution for the benefit of its members It has been providing financial assistance to the deficit countries to meet their temporary disequilibrium in BOP.

The Fund aims at promoting exchange rate stability. In its early phase, the Fund made arrangements of avoidance of competitive exchange depreciation.

It has made an attempt to solve the problem of international liquidity. To create international liquidity. Special Drawing Rights (SDRs)—an artificial currency—were created in 1969 as foreign exchange reserves to benefit the developing countries in particular. SDR allocations are made to member countries to finance the BOP deficits.

It is an institution through which consultation in monetary affairs takes place in an on-going way. It acts as a forum for discussions of the economic, fiscal and financial policies of member countries, keeping the BOP problems in mind. Previously, the poorest developing countries did not receive adequate treatment from the Fund. But from 1980s onwards—when the debt crisis broke out in poor countries—the Fund decided to divert its financial resources to these countries.

In 1980s, centrally planned economies were not hitherto members of the Fund. With the collapse of the Soviet Union in 1989, ex-communist countries became members of the Fund and the Fund is providing assistance to these countries so as to instill, the principles of market economy. It has decided to finance resources to combat terrorism and money-laundering.

Finally, the IMF has assisted its members in the formulation of appropriate monetary, fiscal, and trade policies.

Failures:

Despite these achievements, its failures are glaring. In other words, its success is, on the whole, limited. There are some serious charges against this institution that cannot escape attention.

These are:

The Fund provides short-term finance to its members to tackle BOP disequilibrium. For this purpose, it adopted an adjustable peg system in the first phase of its life. But it failed to establish a stable exchange rate. Its role in controlling the competitive exchange depreciation policies adopted by the members was subject to serious scrutiny, although it was created to avoid devaluation as a BOP measure as much as possible.

Truly speaking, the IMF is incapable of taking independent policy decisions. It complies with the 'order' of the superpowers. Further, it has minimal influence over the policy decisions of the major industrial powers. In these cases, its mandate to exercise 'firm surveillance' over some influential members or superpowers is virtually meaningless—it has no influence over the US deficits or European interest rates.

Secondly, the Fund imposes conditions on the poor countries while sanctioning loans. Now, it is ignoring its central concern—exchange rate management and the BOP problems. It is now championing the issue of 'market principle'. It suggests poor developing countries to cut expenditure-borrowing-subsidy, raise prices of state enterprises, privatisation of state-owned enterprises, etc. If such measures—most popularly known as structural adjustment programmes—are adopted only then the IMF credit would follow. It is said that the third world debt crisis is due to the Fund policies and working.

Thirdly, the Fund has failed to eliminate foreign exchange restrictions imposed by its members that hamper the growth of trade.

In view of these, the developing countries are blaming the IMF for their economic malaise. It is said that the IMF has outlived its mission and the time has come for it to go into oblivion. Sixty- five years is long enough!

Role of IMF in Economic Development of LDCs:

Being a central institution of international monetary system, the IMF works for global prosperity by promoting a balanced expansion of world trade. The IMF not only operates as a BOP adjustment institution but also a BOP financing institution.

The IMF system provides for exchange rate stability in the short run but allows for exchange rate adjustment if a country faces 'fundamental' disequilibrium in its BOP accounts. Hence the name 'adjustable peg system' that lasted till 1971 since its birth. Till the mid-60s of the 20th century, some progress had been achieved in the direction of international cooperation and compliance with the Fund's Articles of Agreement.

Continuous drop in its gold reserves and chronic BOP deficits resulting in a crisis of confidence of dollar forced the USA to abandon the convertibility of dollars into gold in 1971. This is called breakdown of the Bretton Woods System that seriously raised questions about the role of the IMF in the provisioning of international finance. Floating exchange rate system thus introduced caused severe hardships to the LDCs. Meanwhile, many LDCs faced serious BOP deficits because of a world recession, the first oil shock in the form of ricocheting fuel prices, and a falling exports of LDCs.

Earlier, that is before 1971, the bulk of the Fund's resources was used to maintain the value of currencies of the developed world. The Fund had been also marginalised by the actions of the G-7 and regional trading blocks. However, with the change in the exchange rate system, the role of the IMF also underwent a change.

It shifted its focus of attention to the developing countries in the late 1970s. In the 1980s, it became more generous in providing resources to the countries in difficulty. Since then, both the IMF and the World Bank have been helping ex-communist countries to build a market economy, though the IMF was created primarily as an institution for the promotion of international monetary stability. The founding fathers of the Fund expected that it would poke its nose in the affairs of the LDCs and, lately, of the former communist countries.

Today, the Fund is being labelled as an 'anti- developmental' institution, as far as structural adjustment lending is concerned. The IMF now serves the needs of global finance instead of the needs of global stability. The use of conditionality and the direct 'surveillance' on macroeconomic policy by the Fund is suggestive of increasing involvement in the LDCs' development process.

Drawings from the EFF, SRF, PRGF, etc., are available if the member countries agree to a stabilization programme. The IMF focuses mainly on a country's macroeconomic stability as well as structural adjustment programme that influences its macroeconomic performance. Conditionality's are attached when member countries opt for drawings from the above noted sources of the Fund.

Structural adjustment programmes (that includes not only stabilisation programmes associated with monetary and fiscal policy measures, but also trade liberalisation, privatisation, globalisation, freeing markets to determine prices, reforming institutions, to carry government's new role, and so on) are said to be preconditions for securing Bank-Fund loans. Its adverse impacts on the LDCs are varied and numerous.

First, SAP was justified as necessary to the LDC world as it would enable them to repay their debt to banks of advanced countries. By the late 1980s, more than 70 LDCs had to swallow the SAP medicine. But its impact on growth of these countries was negative. As many as 77 p.c. of countries saw the most significant decline in their per capita incomes. In Latin America, during the 1960s and 1970s, income grew by 75 p.c. when these economies were relatively closed, but during the 1980s, income grew by 61 p.c. only. Average incomes in sub-Saharan Africa actually contracted.

Latest research data (2006) for 98 countries during 1970-2000 revealed a negative impact of the IMF programmes on the per capita income growth of 1.7 p.c. p.a. Another study (1991) of 40 countries showed negligible growth in GDP, marginal increase in export growth and the BOP situation and a decline in investment. The IMF aims at tackling BOP disequilibrium but does little to learn the root causes of such disequilibrium.

Secondly, the costs of adjusting to greater openness of the LDC economy are shouldered mainly by the poor. The Fund recommends privatisation so as to offset government failure. It is said that the government-run enterprises are inefficient. Bureaucracies are corrupt. Thus by ‘freeing the markets’, competitive efficiency could be improved. But the costs of such adjustment programmes are expensive. Indeed, globalisation has triggered both poverty and inequality. Today’s world see the **“billionaires of capitalists”** and the exponential growth of poverty-stricken, malnourished people.

In compliance with the IMF demand, in Argentina during 1976-87, employment in public administration was down by 11.5 p.c. and in State enterprises by 18.9 p.c. In India, during the stabilisation period 1991-99, growth rates in employment in the organised sector declined form 1.44 p.c. to 0.84 p.c. and further to -0.31 p.c. during 1994-2006. The inevitable consequence of this is the rise in the number of unemployed and poor people. **“In the eyes of some, the acronym IMF stands for (I)inflation, (M)isery and (F)amine!”** (A.P Thirlwall).

Again, the IMF introduced economic shock therapy measures in command economies. All these comprised the introduction of capitalism in Russia and other former Soviet-bloc countries and hence a shift from the state-led development to market-led development.

Thirdly, Joseph Stiglitz has accused the IMF of promoting an agenda of 'market fundamentalism' thereby injuring the country's social fabric. The Fund emphasises fiscal discipline—cuts in government expenditures and subsidies—so as to pursue a free market economy philosophy. But because of cuts in government expenditures and various subsidies on basic necessities and a rise in the price of public services, vulnerable people bore the major brunt.

Following cuts in subsidies on food products, milk prices in Chile went up by 400 p.c., bread by 367 p.c., potatoes by 850 p.c. and carrot by 1.589 p.c. in 1975—the average rate of inflation there was 340 p.c. Many LDCs saw their indicators of standard of living—infant mortality, life expectancy, adult literacy, primary school enrolment, per capita calorie supply, etc. — falling to an unimaginable proportion. The Fund is unresponsive to **"adjustment with a human face".**

Fourthly, structural adjustment conditionality is often criticised for the third world debt crisis. Borrowing-dependent third world countries in the 1970s and 1980s went for private commercial bank loans—thereby causing accumulation of external debt and ballooning of debt service payments. Faced with this crisis, many of the LDC countries approached the IMF for borrowing to avert the risk of default.

It then invented the structural adjustment lending, provided conditionality's imposed by the Fund-World Bank are respected by the borrowing nations. This debt burden also caused severe BOP crises in many countries. The Fund- Bank do not find incentives to close exchange gap; rather they decapitalise LDCs.

Finally, the Fund often brings political and social unrest. Many of the policy measures suggested by the Fund (e.g., subsidy cut, labour retrenchment, golden handshake, etc.) caused widespread strikes, riots, etc., in many countries. Actually, finding no other alternatives, these countries had to swallow the bitter painful SAP medicine.

One author has remarked that the Fund has overthrown more governments than the military'! Social unrest consequent upon strict conditionality's brought more chaos, rather than solution. Argentina faced military takeover in 1976, Brazil in 1964, Chile and Uruguay in 1973, Turkey in 1960, 1971, and 1980. Military coups do not deserve the name 'stabilisation' and 'structural adjustment', in any case.

World Bank (WB)

Origin:

The World Bank (WB) was originally created as the International Bank for Reconstruction and Development (IBRD) in 1944 along with its twin, the IMF. Together they came to be known as the 'Bretton Woods' twin sisters'. When it was set up it was decided that this international bank would assist in the economic reconstruction of the World War II-damaged European economies. In early 1946 this international bank launched its carrier as the multilateral development bank and since then the IBRD came to be known as the World Bank. Its headquarters is located in Washington, opposite the IMF building, and it lies as the next door neighbour of the White House.

Functions:

Being twin sisters, membership in the IMF is a prerequisite for membership in World Bank (188 countries in May, 2012).

The Bank performs the following functions:

I. To assist in the construction and develop-ment of the territories of its members by facilitating investment of capital for productive purposes, including the 'restoration of economies destroyed or disrupted by war', and the encouragement of the "development" of productive facilities and resources in less developed countries.

II. To promote private investment and long run balanced growth of international trade and BOP equilibrium by means of guarantees or partici-pation in international loans and investments.

III. To arrange loans made or guaranteed by it. so that more useful and urgent projects receive preference.

IV. To provide finance to projects from its own capital, funds raised by it and by participating with other members.

In addition, the Bank provides advice and expertise. It now puts more emphasis on institutional technical assistance and infrastructure assistance. Over the years, it has been able to generate and disseminate policy relevant knowledge. Today, it has been concentrating more on this asset rather than financial resources. This organisation is now called the 'knowledge bank'.

Objectives:

The purposes and objectives are constantly changing. For instance, in the early years, the Bank's investment concentrated on infrastructural build-up like power, transport, communications and irrigation. During the late 1960s and 1970s, the Bank went on financing agricultural projects more actively—particularly in the promotion of cash crops. However, in the 1980s, agricultural lending declined drastically.

Meanwhile, the WB decided to put emphasis on the alleviation of poverty in less developed countries in the late 1960s and 1970s. During Robert McNamara's Presidency (1968-81), the WB made a radical change in emphasis—the reduction of rural poverty as well as urban poverty. Since then all the Presidents reiterated the commitment to fight poverty, enhance growth with sustainability.

It also introduced structural adjustment programmes (SAPs) in developing countries so that not only macroeconomic stability can be attained but also structural reforms aimed at accelerating growth can be undertaken. It has shifted its emphasis from the financing on specific projects towards non-project linked programmes. It works in developing economies with the focus of helping the poorest people and the poorest countries.

For all its clients, the Bank emphasises the need for:

(i) Investing in people, particularly through basic health and education;

(ii) Focusing on social development, gover-nance and institution-building as the major elements of poverty alleviation;

(iii) Strengthening the ability of the govern-ments to deliver quality services with greater efficiency and transparency;

(iv) Protecting the environment;

(v) Supporting and encouraging private business development and long-term planning.

Through its loans, policy advice, and technical assistance, the WB supports a broad range of programmes aimed at reducing poverty and improving living standards in the developing world including the achievement of the Millennium Development Goals (MDGs) by helping countries develop an environment for investment, jobs, and sustainable growth. The WB works with govern-ment agencies, non-governmental organisations (NGOs), and the private sector to formulate various assistance strategies.

A Critical Evaluation of the World Bank Activities:

The WB offers two basic types of loans investment loans for the support of economic and social development projects, and development policy loans to support countries' policy and institutional reforms. The WB grants loans only to the developing countries (and not all the 188 members) annually at nearly $ 20 billion a year usually for a period of 15 to 20 years for the purpose of building roads, dams, and other physical capital that contribute to their economic develop-ment. Its lending rate is somewhat low and is fixed every six months.

The Bank offers hard currency loans. It accepts hard currency at the time of repayment. The Bank functions as an agent on the international capital markets for countries which are unable to obtain sufficient loans on concessional terms.

Its loan provisions are:

(i) Project loans,

(ii) Sectoral loans, and

(iii) Struc-tural adjustments loans (SALs).

The Bank provided $ 24.7 billion loans in the fiscal year 2008, with Africa receiving 23 p.c. of the total; Latin America and the Caribbean 19 p.c.; East Asia and Pacific 18 p.c.; South Asia 17 p.c.; Europe and Central Asia 17.4 p.c.; and Middle East and North Africa 6 p.c. With Bank support—both lending and advice—governments are refor-ming their economies and strengthening the entire financial and banking systems.

The World Bank has made remarkable success in achieving its basic objectives over the last 65 years or so. Its concern for developing countries deserves special attention. It has taken up various poverty-reduction strategies and poverty-focused lending. Bank programmes give high priority to sustainable, social and human development and strengthened economic management.

Latin American experience suggest that, during the 1980s and 1990s, inflation rate declined in Mexico, Panama, Costa Rica, Bolivia, Argentina, except Brazil. Further, because of trade liberalisation programme, the share of exports to GDP in these countries rose to 21.3 p.c. in 1993 from 14 p.c. in 1980. Still then, the modus operandi of the Bank has come in for sharp criticisms.

One of the serious charges against the WB loan is its structural adjustment lending or policy- based lending. The essence of SAL is loans disbursed in exchange for policy reforms like trade liberalisation, privatisation, financial sector reforms, tax reforms, etc. But various studies have shown that SALs have failed miserably in estab-lishing a basis for healthy economic and social development in debtor countries.

In most of the developing countries, average incomes, invest-ment, import, etc., have fallen drastically. Unem-ployment and inflation have become major problems. Number of people living below the poverty line does not show any declining trend in these countries. On the contrary, global poverty has increased and its activities are alleged to be detrimental to the environment, public health, and cultural diversity. It seems two institutions now need urgent reforms.

Among the developing countries, the Latin American experience is too hard to digest. After the adoption of SAPs, average incomes fell by 10 p. c. and investment declined from 23 p. c to 16 p.c. of national income during the 1980s. According to a WB estimate, the poverty ratio increased marginally from 15.53 p.c.. to 15.67 p.c. and the number of poor people rose from nearly 64 million to 78 million. Many of the Latin American countries experienced the process of deindustrialisation—causing a massive increase in the number of unemployed. Import liberalisation policy resulted in an Increase in imports of stable food like rice, com, etc. These costly imports lowered the living standards of masses. The case of sub- Saharan Africa is worst where nearly all children under-5 are malnourished.

A final word about the social and environ-mental damage caused by the WB project lending is a matter of grave concern. The 'Sobradinho Dam' in Brazil displaced quite a good number of poor families from their homes and livelihoods, but they had never been compensated.

The 'Singrauli Super Thermal Power Plant' in central India resulted in a massive displacement of the local population from their places—about 49,000 in 1994. During a visit of a WB study team in the Singrauli region in 1993, a number of houses in Nimidam were bulldozed and ousters were forced to move without adequate arrangement.

The gigantic investment in this project has resulted in a variety of problems in the area: severe air pollu-tion from coal and ash dust leading to high rates of pulmonary diseases, unemployment, inadequate compensation, inadequate housing, pollution of drinking water, etc. Thus adjustment with a human face' has come under strict scrutiny.

It is also said that the World Bank is an instrument that serves the interests of the USA as well as the Western countries. Its functioning lacks transparency.

Thus, the World Bank has not come up to the expectations of many of the developing countries.

PART – B

1. What is balance of trade?

2. What is Balance of payments?

3. Distinguish between balance of trade and balance of payments.

4. What is current account?'

5. What is Capital account?

6. What are visible and non-visible items?

7. What do you mean by disequilibrium in the balance of payments?

8. List out the causes of disequilibrium in the balance of payments.

9. State the measures to correct the disequilibrium in the balance of payments.

10. What is International Monetary system?

11. What is Bretton Wood system?

12. What is gold standard?

13.What is devaluation?

14.List the effects of devaluation.

15. List the objectives of IMF.

16. Write a short note on foreign trade multiplier.

17. State the objectives of the World Bank

18. List the functions of World Bank.

PART – C

1. Discuss the important methods to correct balance of payment disequilibrium.

2. IMF is a key to economic development of all countries in the World – Discuss.

3. Explain the working and limitations of foreign trade multiplier.

4. Discuss devaluation as a measure for removing BOP deficit. What are the conditions for its success?

5. Explain the structure of balance of payments accounts in the case of India.

6. Discuss the objectives and functions of World Bank.

7. What is the present monetary system? What are its shortcomings?

8. Explain briefly the contributions made by the World Bank for the economic development of India.

PART – D

Stylo Garments, one of the Pakistan's largest exporters of ready-made garments was recently hurt by the quota allocations imposed by the U.S. Because the U.S. was the firms largest customer, its sales decreased by 40%. In order to counter balance this drastic sales drop Mr.Khan, the Company's Chairman, decided to enter the EEC market. The problem was that this market was highly fragmented, thus only a large number of relatively small orders were available.

Question

Q1. Evaluate the Pros and Cons of several alternatives that Mr.Khan might consider.

Karpagam Academy of Higher Education
Department of Management
International Economics- 17MBAPI401B
Unit IV
Multiple Choice Questions - Each Question Carries ONE Mark

S. No.	Questions	Option A	Option B	Option C	Option D	Answers
1	The "balance of trade" is a record of	exports and imports of financial assets	the current account plus capital account	the net export of goods and services	the value of merchandise exports minus imports	the value of merchandise exports minus imports
2	The balance of trade can only worsen if income _________ relative to absorption.	increases	decreases	does not change	none of the above	decreases
3	Balance of payments means:	The balance of receipts and payments of all banks	The balance of receipts and payments of State Bank	The balance of receipts and payments of foreign exchange by a country	The balance of govt. receipts and payments	The balance of receipts and payments of foreign exchange by a country
4	The difference between a country's balance of payments and its balance of international indebtedness	is equal to official reserve transactions	occurs because of foreign exchange fluctuations	reflects statistical discrepancies	reflects the difference between flow and stock concepts	reflects the difference between flow and stock concepts
5	Increased foreign competition tend to	Intensify inflationary pressure at home	Induce falling output per worker-hour for domestic workers	Place constraints on the wages of domestic workers	Increase profits of domestic import-competing industries	Place constraints on the wages of domestic workers
6	The trade balance is often a major determinant of the ___________ of a country	standard of living of the people	development.	trade policy	balance of payment	balance of payment

7	Trade deficit has often caused ___________ deficits for India	foreign exchange	export	import.	balance of payment.	balance of payment.
8	Which one of the following is not a Current account transaction?	imports payable	export receivable	insurance	divident	insurance
9	__________ is one of the simplest ways of remedying the balance of payment problems	Import restriction	Export restriction.	Trade control.	Exchange control.	Import restriction
10	Rich countries have deficit in their balance of payments:	Sometimes	Never	Alternate years	Always	Sometimes
11	Free traders maintain that an open economy is advantageous in that it provides all of the following except	Increased competition for world producers	A wider selection of products for consumers	The utilization of the most efficient production methods	Relatively high wages levels for all domestic workers	Relatively high wages levels for all domestic workers
12	International trade tends to cause welfare losses to at least some groups in a country	The less mobile the country's resources	The more mobile the country's resources	The lower the country's initial living standard	The higher the country's initial living standard	The less mobile the country's resources
13	The real income of domestic producers and consumers can be increased by:	Technological progress, but not international trade	International trade, but not technological progress	Technological progress and international trade	Neither technological progress nor international trade	Technological progress and international trade
14	Technological improvements are similar to international trade since they both:	Provide benefits for all producers and consumers	Increase the nation's aggregate income	Reduce unemployment for all domestic workers	Ensure that industries can operate at less than full capacity	Increase the nation's aggregate income
15	A reduced share of the world export market for the United States would be attributed to:	Decreased productivity in U.S. manufacturing	High incomes of American households	Relatively low interest rates in the United States	High levels of investment by American corporations	Decreased productivity in U.S. manufacturing

16	_____________ are those forces of attraction which take the business to the foreign markets	Competitive forces.	Push factors	Internationalization	Pull factors.	Pull factors.
17	The term __________ refers to the increase in purchase behavior of a customer or consumer seeing that a particular company occupies major part of sale in foreign country	obsolescence.	customer taste	swipe off	spin-off.	spin-off.
18	A product has ___________ kinds of utility	3	4	2	5	4
19	A strategy that is successful in one market may not be successful in another, where the ___________ is very different	strategy	competition.	business environment.	government policies.	government policies.
20	Which one of the following is a method for an exporter to get a contract?	Performa invoice	Purchase order	Sales contract.	All the above.	All the above.
21	When the exporter, expects the importer, to make the payment immediately upon the draft being presented to him is called as _____________.	sight draft	usance draft	demand draft.	pay note.	sight draft
22	Which one of the following is not a Current account transaction?	Imports payable	Exports receivable.	Insurance	Dividend	Insurance
23	Payment by documentary credit includes _____________.	post dated cheque	letter of credit	none of these	contract of the business	letter of credit
24	FOB means __________________	Foreign Oil Board.	Foreign Online Board.	Free On Board	Foreign Order Board	Free On Board
25	DEPB means _______________	Duty entitlement Pass Book Scheme.	Duty essential Pass Book Scheme.	Duty entitled Program Book Scheme	Duty Embedded Pass Book Scheme	Duty entitlement Pass Book Scheme
26	____________ in export business assumes greater significance as many parties are involved in single transaction	Taxation.	Documentation	Marketing	Banking.	Documentation.

27	IMF refers to _____________.	International Monetary Focus	International Monetary Force.	International Monetary Fund.	Interdependent Monetary Force	International Monetary Fund.
28	The role of the IMF is ______________	It controls the budgets of national governments.	It acts as a forum for international economics	It observes world exchange rates, balance of payments and multilateral payments.	It seeks to promote free international trade.	It observes world exchange rates, balance of payments and multilateral payments.
29	What is the IMFs primary objective?	The overall promotion of world trade	The fixation of the value of world currencies	The promotion of free trade	The promotion of its policies in certain countries around the world	The overall promotion of world trade
30	How does the IMF meet its primary objective	By promoting free international trade.	By overseeing the balance of payments, acting as a forum of world negotiation and regulating world exchange rates	By acting as an arbitrator for the dispute settlement of world trade matters	By aligning its primary objective with the monetary objectives of national governments	By overseeing the balance of payments, acting as a forum of world negotiation and regulating world exchange rates
31	Where the government constant intervenes into the Forex market, buying and selling its currency, we can the country’s exchange rate is:	floating	fixed	pegged to the dollar	pegged to the gold standard	fixed
32	When the Exchange rate of a country is lowered to help trade we say the currency has been	politically adjusted	Revalued	realigned	devalued	devalued

33	Where supply and demand are allowed to determine a country’s exchange rate, we say we have exchange rate is:	floating	fixed	pegged to the dollar	pegged to the gold standard	floating
34	________ records all international purchases and sales of financial assets:	balance of payment	capital account	Financial account	current account	Financial account
35	The ________ is the relative price of domestic and foreign goods, when measured in a common currency	real exchange rate	exchange rate	exchange rate ratio	Forex	real exchange rate
36	Where a positive interest differential must be offset by an expected exchange rate fall of equal magnitude, this called:	the interest parity condition	real rate of international interest rates	purchasing power parity	perfect capital mobility	the interest parity condition
37	Relatively high rates of domestic inflation are often mirrored by high interest rates. High interest rates will lead to:	a devaluation of the currency	no effect on imports or exports	to a fall in imports	to a fall in exports	to a fall in exports
38	Imported cars from Germany and France, will show up in the balance of payments accounts under the heading:	current account	visible trade	imports	invisible trade	visible trade
39	The exporting of financial services to Europe by the UK will show up in the balance of payments accounts under the heading:	current account	visible trade	imports	invisible trade	invisible trade
40	Govt. policy about exports and imports is called:	Monetary policy	Fiscal policy	Commercial policy	Finance policy	Commercial policy
41	Gold standard means:	Currency of the country is made of gold	Paper currency is not used	Currency of the country is freely convertible into gold	(a) and (c) of above	(a) and (c) of above
42	In a free trade world in which no restrictions exist, international trade will lead to:	Reduced real living standard	Decreased efficiency	Increased efficiency	Reduced real GDP	Increased efficiency

43	Gold standard was suspended at the time of	First world war	Great Depression of 1930s	Second world war	Oil crisis of 1970s	First world war
44	Under gold standard equilibrium in balance of payment takes place through	Change in exchange rate	Tariff	Canalisation	Flow of good	Flow of good
45	Under gold standard a country with deficit will have	Outflow of foreign exchange	Outflow	Inflow off gold	Inflow of foreign exchange	Outflow
46	In which year did the nations gathered at Bretton Woods?	1942	1943	1944	1945	1944
47	Bretton Woods system introduced	Fixed Exchange Rate	Adjustable Peg System	Crawling Peg System	Free Exchange Rates	Adjustable Peg System
48	Terms of trade of a country:	Mean the trade agreement between trading countries	Is another name of exchange ratio of two currencies	Show the ratio between total export earnings and import bill of a country	Are determined by the price index of export and import goods	Are determined by the price index of export and import goods
49	This is an advantage of foreign trade:	We can preserve our natural resources	New technology comes to the country	People need not go abroad	We can get foreign currencies	New technology comes to the country
50	This is NOT an advantage of foreign trade:	We can get gold from abroad	New technology comes to the country	We can import goods which are in short supply in Pakistan	We can made best use of natural resources	We can get gold from abroad
51	Foreign trade:	Increases employment opportunities	Increases international mobility of labour	Increases competition	All of the above	All of the above

52	Foreign trade	Benefits developed countries	Benefits underdeveloped countries	Benefits democratic countries	Benefits all countries	Benefits all countries
53	Foreign trade has the advantage:	Trading countries get foreign exchange	Can import scarce raw materials	Can import machinery and technology	(b) and (c) of above	(b) and (c) of above
54	In foreign trade, Protection policy means:	Restrictions on exports	Restriction on transfer of foreign exchange	Restrictions on imports	All of the above	Restrictions on imports
55	If a country decreases the external value of its currency, it will affect	Volume of exports	Volume of imports	General price level	All of the above	All of the above
56	When an economy is fully employed, the main favourable effect of devaluation on the balance of payment is through________	Decrease in absorption	Increase in imports	Decrease in exports	Change in real national income	Decrease in absorption
57	The devaluation by a country which has some unemployed resources will have a positive effect on trade balances provided the propensity to absorb is	Infinity	Less than one	Greater than one	Zero	Less than one
58	Increase in budget deficit leads to	Improvement in BOP	Deterioration in BOP	No effect on BOP	Either b or c	Deterioration in BOP
59	World Bank came into existence on:	July, 1946	July, 1945	July, 1944	July, 1966	July, 1944
60	The trade bodies in India is established by ______________	government of India.	trade authorities	government of TamilNadu.	commodity boards	government of India.

Foreign Trade

SYLLABUS

Foreign Trade in India, Recent changes in the composition and direction of foreign trade - Causes and Effects of persistent deficit in the Balance of Payments - Measures adopted by the Government to correct the deficit after 1991 - WTO & India Export Promotion measures, Partial and Full convertibility of Indian Rupees, Export Promotion – Contribution of SEZ Foreign Trade policy 2009, Role of Multinational Corporations in India.

Introduction to India's Foreign Trade

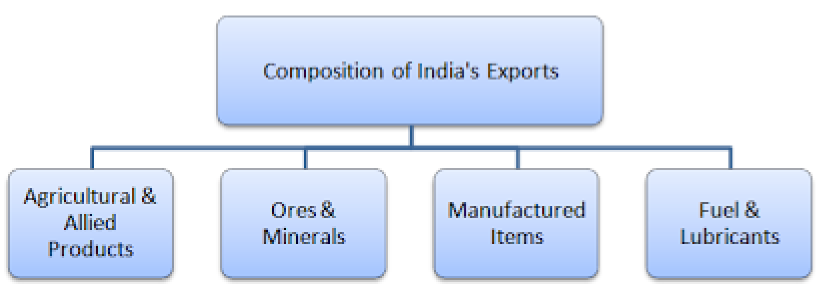
Foreign Trade is one of the significant macro fundamental variables of an economy. India till recently was predominantly a primary goods exporting and mainly an industrial goods importing country.

In 1950s, India's share in the world trade was 1.78% which was decline to 0.59% in 1990 and continues to remain around 0.60% till now. India's share in world exports was 0.8% in 2006.

Composition of India's Exports

Britishers strongly believed that India was a country well suited to supply raw materials and other primary goods and a good market place for British manufacturers. So at the time of our independence our exports were predominantly of primary goods and imports were of manufacturers. At the time of independence agricultural commodities and light manufactured consumer goods dominated India's export basket. During the post independence period India's composition of exports changed.

Now exports of India's are broadly classified into following four categories.



The composition of India's export can be summarised as follows:-

1. Agricultural and Allied Products

The share of agriculture items in the total exports of India has declined between 1990-91 to 2005-06. The share of agriculture exports was 19.5% in 1990-91. It came down to about 10.2% in 2005-06.

The top items of agriculture exports include:-

1. Fish Products,
2. Rice,
3. Oil Cakes,
4. Fruits and Vegetables

The most important export item in 'Agriculture and Allied products' group over the period 1991-92 to 2005-06 has been 'Fish and Fish Preparations'. From $ 585 million in 1991-92 export earnings from fish and fish preparations rose to $ 1,589 million in 2005-06. However, in percentage terms, their share fell slightly from 3.3 percent in 1991-92 to 1.5 percent in 2005-06.

As far as agricultural exports are concerned, a significant development during the period since 1991 has been the considerable exports of rice in certain year. In fact, exports of rice were as high as $ 1,366 million in 1995-96 which was 4.3 percent of total export earning in that year. In 2005-06, exports of rice were worth $ 1,405 million which was 1.4 percent of total export earning in that year.

2. Ores and Minerals

The overall export performance of ores and minerals is not satisfactory. In percentage terms, the export performance of ores and mineral has increased from 4.4% in 199091 to 5.2% in 2005-06.

A major share of ores and minerals exports comes from the export of iron ore.

3. Manufactured Goods

The share of manufactured items in the total export earnings of India is on the increase. In 1990-91, the share of manufactured items in the total export earnings was about 73% of the total export earnings.

In 2005-06, the share of manufactured items in the total export earnings of India remained stagnant at 72%.

The top manufactured export items include:-

1. Engineering Goods,
2. Gems and Jewellery,
3. Chemicals and Allied products, and
4. Readymade Garments

The export of engineering goods increased from $ 2,234 millions in 1991-92 to $ 21,315 million in 2005-06. In percentage terms the share of engineering goods rose from 12.5% in 1991-92 to 20.7% in 2005-06. Over the period 1991-92 to 2002-03, engineering goods occupied the second position in India's export earnings after gems and jewellery. However, thereafter engineering goods have occupied the first place. In 2005-06 they contributed 20.7% (i.e. one-fifth) of total export earnings.

For most of the period since 1991, largest export earnings came from the exports of gems and jewellery. The share of gems and jewellery in India's total export was 15.3% in 1991-92 and 15.1% in 2005-06. However, gems and jewellery industry is a highly import intensive industry requiring large amount of imports of pearls and precious stones.

Exports of chemicals and allied products rose significantly from $ 1,583 million in 1991-92 to $ 11,935 million in 2005-06. In percentage terms, their share stood at 11.6% in 2005-06 and they occupied the third place in India's export earnings in this year.

In percentage terms, readymade garments maintained an almost constant share all through the period since 1991. They contributed 12.3% of export earnings in 1991-92 and 12.5% of export earnings in 2000-01. In 2003-04, their share fell to 9.8% and in 2005-06 to 8.3%.

4. Mineral Fuel and Lubricants

There has been an improvement in the export of mineral fuels and lubricants both in terms of value and in terms of percentage. In percentage terms, its share has increased from less than 2.9% in 1990-91 to 11.5% in 2005-06.

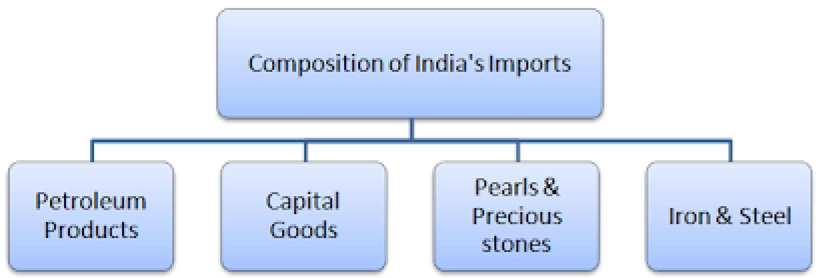
Some other facts regarding structural change in India's export since 1991 are as follows :-

1. There is indication that during 1990s, some of Indian exports have moved upwards in value addition chain whereby instead of exporting raw materials, the country has switched over to export of processed goods.
2. There were significant compositional shift within the major manufactured product groups such as engineering. goods, chemicals and allied products, etc.

Composition of India's Imports

In 1947-48 the main items of India's imports were machineries, oil, grains, cotton, cutlery, hardware implements, chemicals, etc. They constituted 70% of India's imports. After that due to the emphasis on industrialisation during the second 5-Year plan necessitated the imports of capital goods.

Now imports of India's are broadly classified into following four categories.



The composition of India's imports can be summarised as follows:-

1. Petroleum Products

Imports of petroleum oil and lubricants rose significantly from $ 5364 million in 199192 to $ 43,963 million i.e. more than eight times.

Due to high price of crude oil, the POL imports jumped to $ 15,650 million in 2000-01. In 1990-91, petroleum products accounted for nearly 25% of total imports of India. In 2005-06, it has further increased to nearly 31% of the total import bill of India.

2. Capital Goods

The imports of capital goods were $ 3,610 million in 1991-92. In 1995-96 due to sharp rise in non-electrical machinery imports, the imports of capital goods jumped upto $ 8,458 million. However due to slowing domestic demand imports of capital goods fell subsequently. The capital goods and related items were 24.1% of the total imports of India in 1990-91, which has come down slightly in 2005-06 to about 22.3%.

3. Pearls and Precious Stones

To meet the requirements of the gems & jewellery industry pearls and precious stones are imported in large quantities. In 1990-91, the share of pearls and precious stones was 8.7% which has reduced in percentage terms to 6.4% in 2005-06.

4. Iron and Steel

The imports of iron and steel have declined over the years in percentage terms. In 1990-91, the share of iron and steel imports was 5%, which has come down to 3% in 2005-06. This is because; a good amount of iron ore is now extracted in India which has reduced imports.

5. Fertilizers

Import of fertilizers in 1991-92 stood at $ 954 million. In 2003-04 expenditure on import of fertilizers was $ 635 million.

The imports of fertilizers have declined, which indicates less dependence of India on imported fertilizers. The share in total imports of fertilizers was 4.1% in 1990-91, which came down to 1.5% in 2005-06.

Conclusion on India's Foreign Trade

Composition of India's foreign trade has undergone a positive change. It is a remarkable achievement that India has transformed itself from a predominantly primary goods exporting country into a non-primary goods exporting country. Under import too India's dependence on food grains and capital goods has declined.

The trend indicates structural transformation of Indian economy.

Prior to 1947, India's trade was a typical colonial trade, in which we used to supply raw materials to our colonial master and imported the manufactured goods. So, naturally the industrialization at home was not permitted. The indigenous handicrafts suffered because of the competition from the British manufactured products as well as British traders located in India as well as abroad.

The colonial pattern of trade was to be changed after independence.

- The first major challenge was the increase in the production capacity of the country. So, this led to import of the heavy plants and machinery which was called the "developmental Imports".
- To maintain the productive capacity of the country, the objects such as machines were imported and this was called "maintenance imports".

The above two similar kinds of imports were vital for a developing country like ours which just embarked on the path of the economic development.

Apart from that, India needed to import lots of food grains in the beginning. Since, the food grain production in the country was so less to fulfill needs. The import of food grains was also necessary to contain the inflation in these consumer goods.

India when became independent was heavily dependent upon the imports. The higher imports and negligible exports mean a **pressure on the balance of trade**. The result is pressure on the economy.

So, there was need to encourage the exports. ***The imports were inelastic***, and to fight with the pressure of the foreign debt, the country needed to boost its exports.

Balance of Trade

Balance of Trade is the difference between the monetary value of exports and imports of output in an economy over a certain period. A positive balance is known as a trade surplus if it consists of exporting more than is imported; it is also known as favourable trade balance. A negative balance is referred to as a trade deficit.

Factors that can affect the balance of trade include:

- The cost of production (Land, Labour, Capital, Taxes, Incentives, etc.) in the exporting and importing countries
- The cost and availability of raw materials, intermediate goods and other inputs;
- Exchange rate movements;
- Multilateral, bilateral and unilateral taxes or restrictions on trade;
- Non-tariff barriers such as environmental, health or safety standards;
- The availability of adequate foreign exchange with which to pay for imports; and
- Prices of goods manufactured at home (influenced by the responsiveness of supply)
- The stage in business cycle such as recession, boom, stagnation etc.

Historical Trends in Trade Balance

In 1949-50, India's exports were worth Rs. 485 Crore and the imports were worth Rs. 617 Crore. Thus, the country started with negative trade balance of Rs. 132 Crore. Both exports and imports increased and the trade deficit also increased. India has a continuous trade deficit except only two years viz. 1972-73 & 1976-77 in which there were more exports than imports and a positive trade balance.

Post liberalization, the devaluation of Rupee and convertibility of Indian Rupee in current account tried to create a favourable environment but in the subsequent years, the trade deficit increased.

India's Merchandise Trade: Key Facts

During the current financial year (April-January), India's total export was $217.7 billion while total import during the same period was $324.5 billion. In 2015-16, both imports and exports have *been* on declining trend mainly due to global slowdown. The trade deficit stands at $106.8 billion. Some important current facts are as follows:

- The merchandise trade (trade in commodities) had a 13.9% share in India's GDP in 1991-92. It stood at 27% in 2004-05, and further went up to 41% in 2013-14. In 2014-15, merchandise trade is 37.1% of GDP.

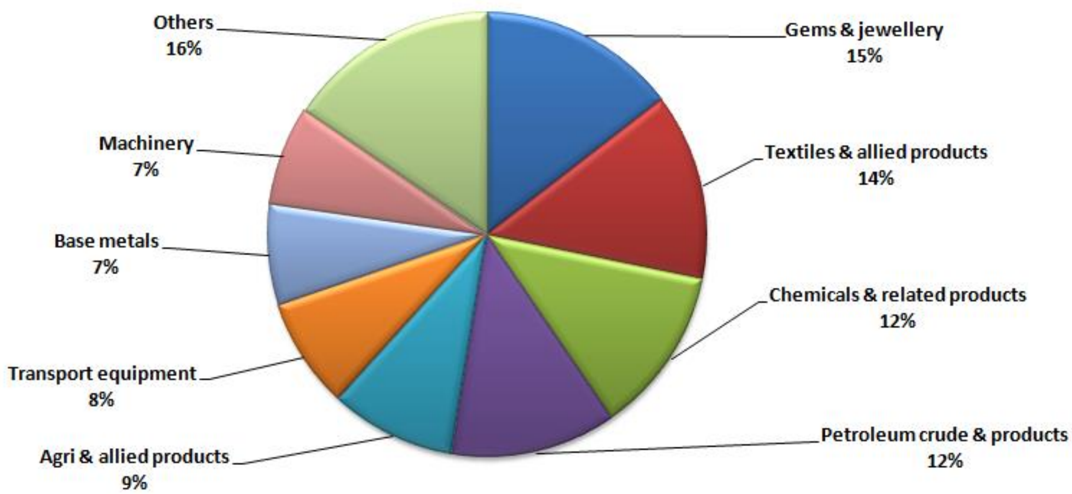
- In 2013, India's exports share in world merchandise exports was 1.7 per cent. The objective of taking it to a respectable figure of at least 4% of world trade in next five years still seems to be a distant dream. We note here that China's share in world trade is around 11%.
- Gujarat and Maharashtra are two export dominating states of India.
- China and UAE are India's largest trade partners.

Composition of India's merchandise export Basket

The merchandise exports of India are broadly classified into four categories viz. manufactured goods, Ores & minerals, Farm Products, Crude Oil and Petroleum products. We note here that manufactured goods are backbone of India's Merchandise exports. In Merchandise exports too, the share of Gems and Jewellery is maximum.

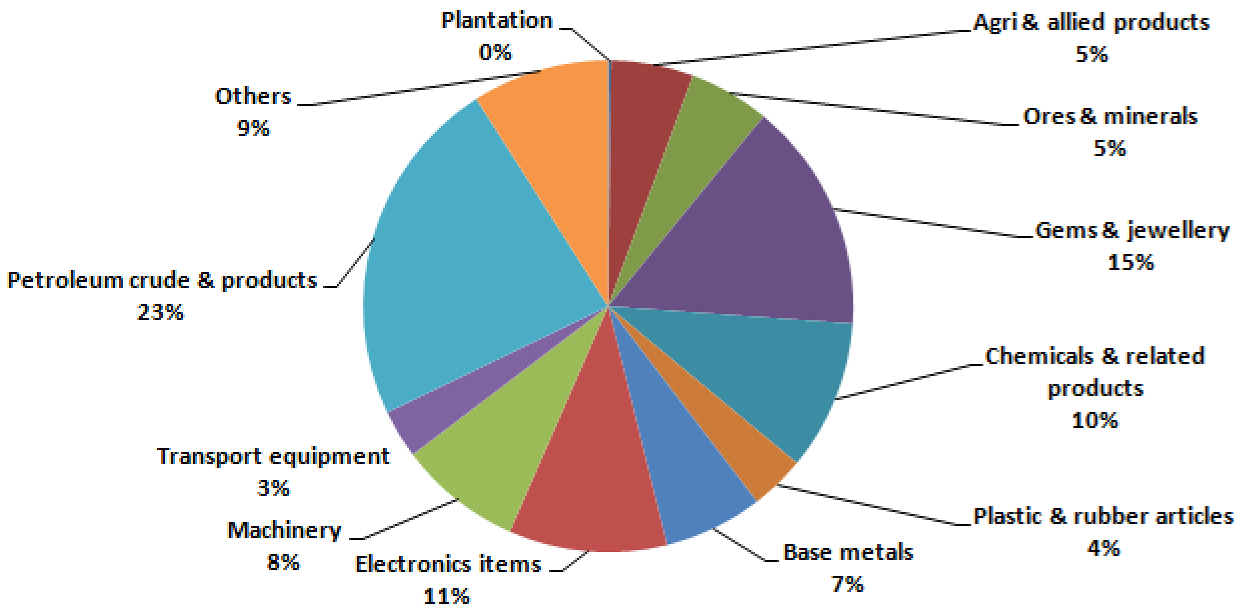
India's Merchandise Imports Basket

Around one fourth of India's imports are POL (Petrol, Oil and Lubricants) products. Food is a small fraction in the imports and out of the total 3.5%, 2% is occupied by vegetable oils



Composition of India's Export Basket 2015-16

which are India's largest agricultural import item.



India's Merchandise Import Basket April - December 2015 {Source Economic Survey 2015-16}

WTO: The World Trade Organisation

Introduction:

The establishment of the World Trade Organisation (WTO) as the successor to, the GATT on 1 January 1995 under the Marrakesh Agreement places the global trading system on a firm constitutional footing with the evolution of international economic legislation resulted through the Uruguay Round of GATT negotiations.

A remarkable feature of the Uruguay Round was that it paved the way for further liberalisation of international trade with the fundamental shift from the negotiation approach to the institutional framework envisaged through transition from GATT to WTO Agreement.

The GATT 1947 and the WTO co-existed for the transitional period of one year in 1994. In January 1995, however, the WTO completely replaced the GATT. The membership of the WTO increased from 77 in 1995 to 127 by the end of 1996.

Features of the WTO:

The distinctive features of the WTO are:

i. Unlike the GATT, it is a legal entity.

ii. Unlike the International Monetary Fund (IMF) and the World Bank (WB) it is not an agent of the United Nations.

iii. Unlike the IMF and the World Bank, there is no weighted voting, but all the WTO members have equal rights.

iv. Unlike the GATT, the agreements under the WTO are permanent and binding to the member countries.

v. Unlike the GATT, the WTO dispute settlement system is based not on dilatory but automatic mechanism. It is also quicker and binding on the members. As such, the WTO is a powerful body.

vi. Unlike the GATT, the WTOs approach is rule- based and time-bound.

vii. Unlike the GATT, the WTOs have a wider coverage. It covers trade in goods as well as services.

viii. Unlike the GATT, the WTOs have a focus on trade-related aspects of intellectual property rights and several other issues of agreements.

ix. Above all, the WTO is a huge organisational body with a large secretariat.

Structure of the WTO

The organisational structure of the WTO is outlined in the Chart

The Ministerial Conference (MC) is at the top of the structural organisation of the WTO. It is the supreme governing body which takes ultimate decisions on all matters. It is constituted by representatives of (usually, Ministers of Trade) all the member countries.

The General Council (GC) is composed of the representatives of all the members. It is the real engine of the WTO which acts on behalf of the MC. It also acts as the Dispute Settlement Body as well as the Trade Policy Review Body.

There are three councils, viz.: the Council for Trade in Services and the Council for Trade-Related Aspects of Intellectual Property Rights (TRIPS) operating under the GC. These councils with their subsidiary bodies carry out their specific responsibilities

Further, there are three committees, viz., the Committee on Trade and Development (CTD), the Committee on Balance of Payments Restrictions (CBOPR), and the Committee on Budget, Finance and Administration (CF A) which execute the functions assigned to them by e WTO Agreement and the GC.

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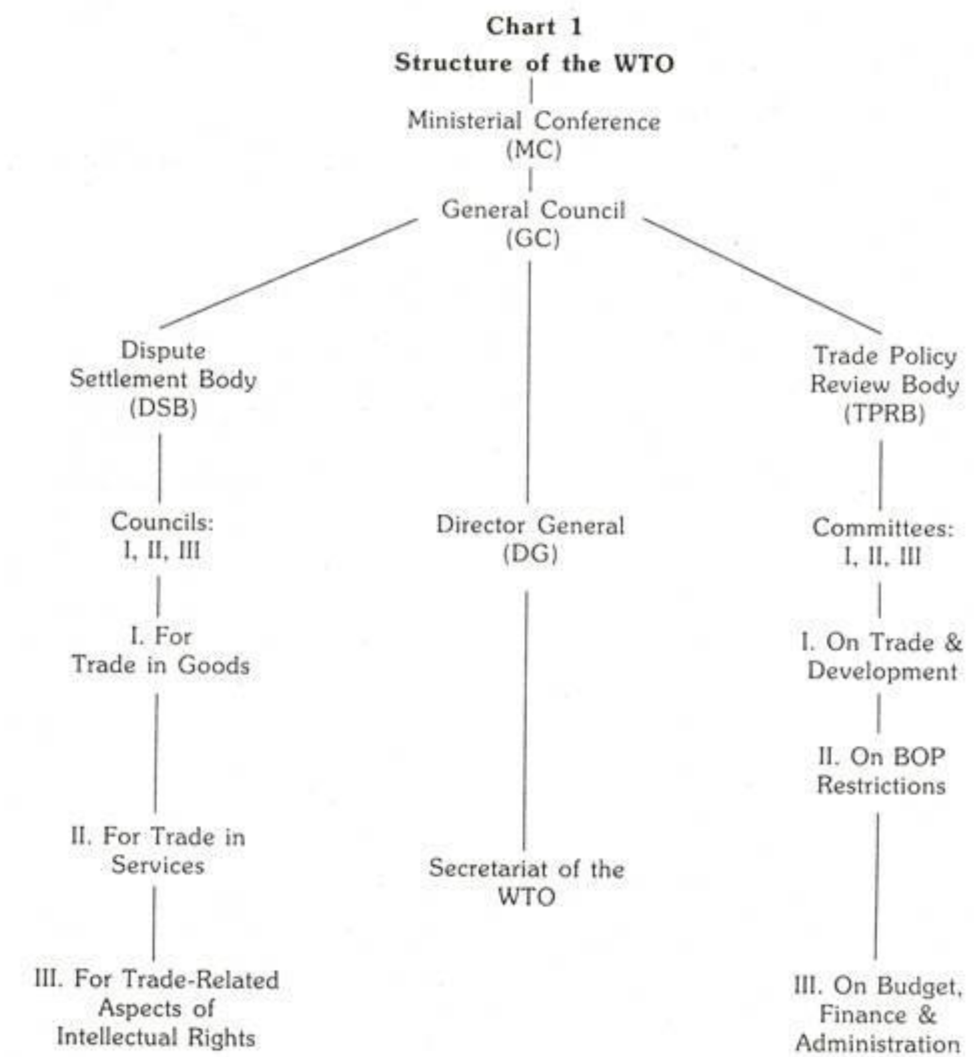

The administration of the WTO is conducted by the Secretariat which is headed by the Director General (DG) appointed by the MC for the tenure of four years. He is assisted by the four Deputy Directors from different member countries. The annual budget estimates and financial statement of the WTO are presented by the DG to the CBFA for review and recommendations for the final approval by the GC.

Objectives of the WTO:

The purposes and objectives of the WTO are spelled out in the preamble to the Marrakesh Agreement.

In a nutshell, these are:

1. To ensure the reduction of tariffs and other barriers to trade.

2. To eliminate discriminatory treatment in international trade relations.

3. To facilitate higher standards of living, full employment, a growing volume of real income and effective demand, and an increase in production and trade in goods and services of the member nations.

4. To make positive effect, which ensures developing countries, especially the least developed secure a level of share in the growth of international trade that reflects the needs of their economic development.

5. To facilitate the optimal use of the world's resources for sustainable development.

6. To promote an integrated, more viable and durable trading system incorporating all the resolutions of the Uruguay Round's multilateral trade negotiations.

Above all, to ensure that linkages trade policies, environmental policies with sustainable growth and development are taken care of by the member countries in evolving a new economic order.

Functions of the WTO:

The WTO consisting a multi-faced normative framework: comprising institutional substantive and implementation aspects.

The major functions of the WTO are as follows:

1. To lay-down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.

2. To provide the institutional framework for the administration of the substantive code this encompasses a spectrum of norms governing the conduct of member countries in the arena of global trade.

3. To provide an integrated structure of the administration, thus, to facilitate the implementation, administration and fulfillment of the objectives of the WTO Agreement and other Multilateral Trade Agreements.

4. To ensure the implementation of the substantive code.

5. To act as a forum for the negotiation of further trade liberalisation.

6. To cooperate with the IMF and WB and its associates for establishing a coherence in trade policy-making.

7. To settle the trade-related disputes.

WTO Agreements:

The WTO's rule and the agreements are the result of negotiations between the members. The current sets were the outcome to the 1986-93 Uruguay Round negotiations which included a major revision of the original General Agreement on Tariffs and Trade (GATT).

GATT is now the WTO's principal rule-book for trade in goods. The Uruguay Round also created new rules for dealing with trade in services, relevant aspects of intellectual property, dispute settlement and trade policy reviews.

The complete set runs to some 30,000 pages consisting of about 30 agreements and separate commitments (called schedules) made by individual members in specific areas such as, lower customs duty rates and services market-opening.

Through these agreements, WTO members operate a non-discriminatory trading system that spells out their rights and their obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other countries' markets. Each country promises to do the same for imports into its own market. The system also gives developing countries some flexibility in implementing their commitments.

(a) Goods:

It all began with trade in goods. From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important, rules, particularly non-discriminations since 1995, the updated GATT has become the WTO s umbrella agreement for trade in goods.

It has annexes dealing with specific sectors such as, agriculture and textiles and with specific issues such as, state trading, product standards, subsidies and action taken against dumping.

(b) Services:

Banks, insurance firms, telecommunication companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of free and fair that originally only applied to trade in goods.

These principles appear in the new General Agreement on Trade in Services (GATS). WTO members have also made individual commitments under GATS stating which of their services sectors, they are willing to open for foreign competition and how open those markets are.

(c) Intellectual Property:

The WTO's intellectual property agreement amounts to rules for trade and investment in ideas and creativity. The rules state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout designs and undisclosed information such as trade secrets "intellectual property" should be protected when trade is involved.

(d) Dispute Settlement:

The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore, for ensuring that trade flows smoothly.

Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgments by specially appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

The system encourages countries to settle their differences through consultation. Failing that, they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of the ruling by a panel of experts and the chance to appeal the ruling on legal grounds.

Confidence in the system is borne out by the number of cases brought to the WTO, around 300 cases in eight years compared to the 300 disputes dealt with during the entire life of GATT (1947-94).

(e) Policy Review:

The Trade Policy Review Mechanism's purpose is to improve transparency, to create a greater understanding of the policies that countries are adopting and to assess their impact. Many members also see the reviews as constructive feedback on their policies.

All WTO members must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO Secretariat.

Export Assistance and Promotional Measures

Export assistance is provide from the entry level organizations to large business houses through different organizations such as Export promotion councils, commodity boards etc.. Exports and imports are free unless regulated. Generally there are various bottlenecks that are faced by exporters in actual trade. The following steps were taken in the latest policy to enhancement of export trade. Exports and Imports free unless regulated. Exports and Imports shall be free, except in cases where they regulated by the provisions of this Policy or any other law for the time being in force. The item wise export and import policy shall be, as specified in ITC(HS) published and notified by Director General of Foreign Trade, as amended from time to time.

Export Promotion Councils/ Commodity Boards

The basic objective of Export Promotion Councils is to promote and develop the exports of the country. Each Council is responsible for the promotion of a particular group of products, projects and services.

Registration-cum-Membership Certificate (RCMC)

Any person, applying for

(i) A license/ certificate/ permission to import/ export, [except items listed as restricted items in Import Tariff Code (ITC)] or

(ii) Any other benefit or concession under this policy shall be required to furnish Registration-cum-Membership Certificate (RCMC) granted by the competent authority unless specifically exempted under the Policy. An exporter desiring to obtain a Registration-cum-Membership Certificate (RCMC) shall declare his main line of business in the application, which shall be made to the Export Promotion Council (EPC) relating to that line of business. However, a status holder has the option to obtain RCMC from Federation of Indian Exporters Organization (FIEO).

Example

Exporters of Drugs & Pharmaceuticals shall obtain RCMC from Pharmexcil only.

Further, exporters of minor forest produce and their value added products shall obtain RCMC from Shellac Export Promotion Council. The service exporters (except software service exporters) shall be required to obtain RCMC from FIEO. In addition, an exporter has the option to obtain an RCMC from FIEO or any other relevant EPC if the products exported by him relate to those EPC's.

Validity Period of RCMC

The RCMC shall be deemed to be valid from 1st April of the licensing year in which it was issued and shall be valid for five years ending 31st March of the licensing year, unless otherwise specified.

Directives of DGFT

The Director General of Foreign Trade may direct any registering authority to register or de-register an exporter or otherwise issue such other directions to them consistent with and in order to implement the provisions of the Act, the Rules and Orders made there under, the Policy or this Handbook.

Infrastructure Initiatives

Assistance to States for Infrastructure Development of Exports (ASIDE)

The State Governments shall be encouraged to participate in promoting exports from their respective States. For this purpose, Department of Commerce has formulated a scheme called ASIDE. Suitable provision has been made in the Annual Plan of the Department of Commerce for allocation of funds to the States on the twin criteria of gross exports and the rate of growth of exports. The States shall utilise this amount for developing infrastructure such as roads, connecting production centers with the ports, setting up of Inland Container Depots and Container Freight Stations, creation of new State level export promotion industrial parks/zones, augmenting common facilities in the existing zones, equity participation in infrastructure projects, development of minor ports and jetties, assistance in setting up of common effluent treatment facilities, stabilizing power supply and any other activity as may be notified by Department of Commerce from time to time.

Identifying Towns of Export Excellence

A number of towns in specific geographical locations have emerged as dynamic industrial clusters contributing handsomely to India's exports. It is necessary to grant recognition to these industrial clusters with a view to maximizing their potential and enabling them to move higher in the value chain and tap new markets. Selected towns producing goods of ` 1000 crore or more will be notified as Towns of Exports Excellence on the basis of potential for growth in exports. However for the Towns of Export Excellence in the Handloom, Handicraft, Agriculture and Fisheries sector, the threshold limit would be ` 250 crores. Common service providers in these areas shall be entitled for the facility of the EPCG scheme. The recognized associations of units will be able to access the funds under the Market Access Initiative scheme for creating focused technological services. Further such areas will receive priority for assistance for rectifying identified critical infrastructure gaps from the ASIDE scheme.

Market Related Initiatives:

Market Access Initiative (MAI)

The Market Access Initiative (MAI) scheme is intended to provide financial assistance
for medium term export promotion efforts with a sharp focus on a country and product. The financial assistance is available for Export Promotion Councils, Industry and Trade Associations, Agencies of State Governments, Indian Commercial Missions abroad and other eligible entities as may be notified from time to time. A whole range of activities can be funded under the MAI scheme. These include market studies, setting up of showroom/ warehouse, sales promotion campaigns, international departmental stores, publicity campaigns, participation in international trade fairs, brand promotion, registration charges for pharmaceuticals and testing charges for engineering products etc. Each of these export promotion activities can receive financial assistance from the Government ranging from 25% to 100% of the total cost depending upon the activity and the implementing agency.

Marketing Development Assistance (MDA)

The Marketing Development Assistance (MDA) Scheme is intended to provide financial assistance for a range of export promotion activities implemented by export promotion councils, industry and trade associations on a regular basis every year. As per the revised MDA guidelines, assistance under MDA is available for exporters with annual export turnover upto ` 10 crores.

These include participation in Trade Fairs and Buyer Seller meets abroad or in India, export promotion seminars etc. Further, assistance for participation in Trade Fairs abroad and travel grant is available to such exporters if they travel to countries in one of the four Focus Areas, such as, Latin

America, Africa, CIS Region, ASEAN countries, Australia and New Zealand. For participation in trade fairs etc., in other areas financial assistance without travel grant is available.

Focus Market Scheme and Focus Product Scheme

Under the above schemes the exporter was allowed for claiming duty and shall submit the application within a period of six months from the end of the period of the application or within a period of six months of the date of realization of the last export covered by the said application, whichever is later.

Special Focus Initiatives

With a view to doubling our percentage share of global trade within 5 years and expanding employment opportunities, especially in semi urban and rural areas, certain special focus initiatives have been identified for the **agriculture, handlooms, handicraft, gems & jewellery, leather and Marine sectors.** Government of India making concerted efforts to promote exports in these sectors by specific sectoral strategies that shall be notified from time to time. **Vishesh Krishi and Gram Udyog Yojana (Special Agriculture and Village Industry Scheme)**

The objective of Vishesh Krishi and Gram Udyog Yojana (Erstwhile Vishesh Krishi Upaj Yojana) is to promote export of Fruits, Vegetables, Flowers, Minor Forest produce,Dairy, Poultry and their value added products, and Gram Udyog products by incentivizing exporters of such products.

Exports of Fruits, Vegetables, Flowers, Minor Forest Produce, Dairy, Poultry and their value added products shall be entitled for duty credit scrip equivalent to 5% of the FOB value of exports. Gram Udyog products as listed in Appendix 37A of the Handbook of Procedures (Vol. I) shall be entitled for duty credit scrip equivalent to 5% of the FOB value of exports in respect of the exports made on or after 1st April 2006. The scrip and the items imported against it shall be freely transferable. Following exports shall not be taken into account for duty credit entitlement under the scheme:

(a) Export of imported goods covered under para 2.35 of the Foreign Trade Policy or exports made through transshipment.

(b) Deemed Exports.

(c) Exports made by SEZs units and EOUs units.

The Duty Credit may be used for import of inputs or goods, which are otherwise freely importable under ITC (HS) Classifications of Export and Import Items, Imports from a port other than the port of export shall be allowed under TRA facility as per the terms and conditions of the notification issued by Department of Revenue. Additional customs duty/excise duty paid in cash or through debit under Vishesh Krishi and Gram Udyog Yojana shall be **adjusted as CENVAT Credit or Duty Drawback** as per rules framed by the Department of Revenue.

Brand Promotion and Quality

The Central Government aims to encourage manufacturers and exporters to attain internationally accepted standards of quality for their products. The Central Government will extend support and assistance to Trade and Industry to launch a nationwide programme on quality awareness and to promote the concept of total quality management.

Trade Facilitation through EDI Initiatives

It is endeavor of the Government to work towards greater simplification, standardization and harmonization of trade documents using international best practices. As a step in this direction DGFT shall move towards an automated environment for electronic filing, retrieval and authentication of documents based on agreed protocols and message exchange with other community partners including Customs and Banks.

DGCI&S Commercial Trade Data

To enable the users to make commercial decisions in a more professional manner, DGCI&S trade data shall be made available with a minimum time lag in a query based structured format on a commercial criteria.

Fiscal Incentives to promote EDI Initiatives adoption

With a view to promote the use of Information Technology, DGFT will provide fiscal incentives to the user community. The following deductions in Application Fee would be admissible for applications signed digitally or/ and where application fee is paid electronically through EFT (electronic fund transfer).

S.NO	Mode of application	Fee deduction (as a % of normal application fee)
1	Digitally signed	25%
2	Application fee payment vide EFT	25%
3	Both digitally signed as well as use of EFT for payment of application fee	50%

The facility will reduce unnecessary physical interface with DGFT. It will enable faster processing, speedier communication of deficiencies, if any, and on-line availability of application processing status.

Trade Related Initiatives

Export Promotion Council for Services

Service exporters are required to register themselves with the Federation of Indian Exporters Organisation. However, software exporters shall register themselves with Electronic and Software Export Promotion Council. In order to give proper direction, guidance and encouragement to the Services Sector, an exclusive Export Promotion Council for Services shall be set up. The Services Export Promotion Council shall:

(i) Map opportunities for key services in key markets and develop strategic market access programmes for each component of the matrix.

(ii) Co-ordinate with sectoral players in undertaking intensive brand building and marketing programmes in target markets.

(iii) Make necessary interventions with regard to policies, procedures and bilateral/ multilateral issues, in co-ordination with recognised nodal bodies of the services industry.

Recognition of Star Export House

Merchant as well as Manufacturer Exporters, Service Providers, Export Oriented Units (EOUs) and Units located in Special Economic Zones (SEZs), Agri Export Zone (AEZ's), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio Technology Parks (BTPs) shall be eligible for applying for status as Star Export Houses. Plenty of advantages were provided to these houses. This topic will be discussed in the following lesson.

Test Houses

The Central Government will assist in the modernisation and upgradation of test houses and laboratories in order to bring them at par with international standards. **Grievance Redressal DGFT As A Facilitator Of Exports/ Imports** DGFT has a commitment to function as a facilitator of exports and imports. Our focus is on good governance, which depends on clean, transparent and accountable delivery systems.

Grievance Redressal Mechanism

In order to facilitate speedy redressal of grievances of trade and industry, a new grievance redressal mechanism has been put in place by a Government resolution. The Government is committed to resolving all outstanding problems and disputes pertaining to the past policy periods through the Grievance Redressal Committee for condoning delays, regularizing breaches by exporters in bonafide cases, resolving disputes over entitlements, granting extensions for utilization of licences etc.

Meeting Legal Expenses for Trade Related Matters

Financial assistance would be provided to deserving exporters on the recommendation of Export Promotion Councils for meeting the cost of legal expenses relating to trade related matters.

Currency Convertibility:

Currency Convertibility: Advantage, Benefits and Preconditions for Capital Account Convertibility!

For the rapid growth of world trade and capital flows between countries convertibility of a currency is desirable. Without free and unrestricted convertibility of currencies into foreign ex-change trade and capital flows between countries cannot take place smoothly.

Therefore, to achieve higher rate of economic growth and thereby to improve living standards through greater trade and capital flows, the need for convertibility of currencies of different nations has been greatly felt. Under Bretton Woods system fixed exchange rate system was adopted by various countries.

In order to maintain the exchange rate of their currencies in terms of dollar or gold various countries imposed several controls over the use of foreign exchange. This required some restrictions on the use of foreign exchange and its allocation among different uses, the currency of a nation was converted into foreign exchange on the basis of officially fixed exchange rate.

When Bretton Woods system collapsed in 1971, the various countries switched over to the floating foreign exchange rate system. Under the floating or flexible exchange rate system, exchange rates between different national currencies are allowed to the determined through market demand for and supply of them. However, various countries still imposed restrictions on the free convertibility of their currencies in view of their difficult balance of payment situation.

Meaning of Currency Convertibility:

Convertibility of a currency we mean currency of a country can be freely converted into foreign exchange at market determined rate of exchange that is, exchange rate as determined by demand for and supply of a currency.

For example, convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterlings etc.) can get them converted into rupees and vice-versa at the market deter-mined rate of exchange. Under convertibility of a currency there are authorised dealers of foreign exchange which constitute foreign exchange market.

The exporters and others who receive US dol-lars, Pound Sterlings etc. can go to these dealers which are generally banks and get their dollars exchanged for rupees at the market determined rates of exchange. Similarly, under currency convertibility, importers and other who require foreign exchange can go to these banks dealing in foreign exchange and get rupees converted into foreign exchange.

Current Account and Capital Account Convertibility of Currency:

A currency may be convertible on current account (that is, exports and imports of merchandise and invisibles) only. A currency may be convertible on both current and capital accounts. We have explained above the convertibility of a currency on current account only.

By capital account convertibility we mean that in respect of capital flows, that is, flows of portfolio capital, direct investment flows, flows of borrowed funds and dividends and interest pay-able on them, a currency is freely convertible into foreign exchange and vice-versa at market deter-mined exchange rate.

Thus, by convertibility of rupee on capital account means those who bring in foreign exchange for purchasing stocks, bonds in Indian stock markets or for direct investment in power projects, highways steel plants etc. can get them freely converted into rupees without taking any permission from the government.

Likewise, the dividends, capital gains, interest received on purchased stock, equity etc. profits earned on direct investment get the rupees converted into US dollars, Pound Sterlings at market determined exchange rate between these currencies and repatriate them.

Since capital convertibility is risky and makes foreign exchange rate more volatile, is intro-duced only some time after the introduction of convertibility on current account when exchange rate of currency of a country is relatively stable, deficit in balance of payments is well under control and enough foreign exchange reserves are available with the Central Bank.

Convertibility of Indian Rupee:

In the seventies and eighties many countries switched over to the free convertibility of their currencies into foreign exchange. By 1990, 70 countries of the world had introduced currency con-vertibility on current account; another 10 countries joined them in 1991.

As a part of new economic reforms initiated in 1991 rupee was made partly convertible from March 1992 under the "Liberalised Exchange Rate Management scheme in which 60 per cent of all receipts on current account (i.e., merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rate quoted by authorised dealers, while 40 per cent of them was to be surrendered to Reserve Bank of India at the officially fixed exchange rate.

These 40 per cent exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities. Thus, partial convertibil-ity of rupee on current account meant a dual exchange rate system.

This partial convertibility of rupee on current account was adopted so that essential imports could be made available at lower exchange rate to ensure that their prices do not rise much. Further, full convertibility of rupees at that stage was considered to be risky in view of large deficit in balance of payments on current account.

As even after partial convertibility of rupee foreign exchange value of rupee remained stable, full convertibility on current account was announced in the budget for 1993-94. From March 1993, rupee was made convertible for all trade in merchandise. In March' 1994, even indivisibles and remittances from abroad were allowed to be freely convertible into rupees at market determined exchange rate. However, on capital account rupee remained nonconvertible.

Advantages of Currency Convertibility:

Convertibility of a currency has several advantages which we discuss briefly:

1. Encouragement to exports:

An important advantage of currency convertibility is that it encourages exports by increasing their profitability. With convertibility profitability of exports increases because market foreign exchange rate is higher than the previous officially fixed exchange rate. This implies that from given exports, exporters can get more rupees against foreign exchange (e.g. US dollars) earned from exports. Currency convertibility especially encourages those exports which have low import-intensity.

2. Encouragement to import substitution:

Since free or market determined exchange rate is higher than the previous officially fixed exchange rate, imports become more expensive after convertibility of a currency. This discourages imports and gives boost to import substitution.

3. Incentive to send remittances from abroad:

Thirdly, rupee convertibility provided greater incentives to send remittances of foreign exchange by Indian workers living abroad and by NRI. Further, it makes illegal remittance such 'hawala money' and smuggling of gold less attractive.

4. A self – balancing mechanism:

Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

In this way, deficit in balance of payments get automatically corrected without intervention by the Government or its Central bank. The opposite happens when balance of payments is in surplus due to the under-valued exchange rate.

5. Specialisation in accordance with comparative advantage:

Another merit of currency convertibility ensures production pattern of different trading countries in accordance with their comparative advantage and resource endowment. It is only when there is currency convertibility that market exchange rate truly reflects the purchasing powers of their currencies which is based on the prices and costs of goods found in different countries.

Since prices in competitive environment reflect that prices of those goods are lower in which the country has a comparative advantage, this will encourages exports. On the other hand, a country will tend to import those goods in the produc-tion of which it has a comparative disadvantage. Thus, currency convertibility ensures specialisation and international trade on the basis of comparative advantage from which all countries derive benefit.

6. Integration of World Economy:

Finally, currency convertibility gives boost to the inte-gration of the world economy. As under currency convertibility there is easy access to foreign exchange, it greatly helps the growth of trade and capital flows between the countries. The expan-sion in trade and capital flows between countries will ensure rapid economic growth in the econo-mies of the world. In fact, currency convertibility is said to be a prerequisite for the success of globalisation.

Capital Account Convertibility of Rupee:

As explained above, under Capital Account Convertibility any Indian or Indian company is entitled to move freely from the Rupee to another currency to convert Indian financial assets into foreign financial assets and back, at an exchange rate fixed by the foreign exchange market and not by RBI.

In a way, capital account convertibility removes all the restrains on international flows on India's capital account. There is a basic difference between current account convertibility and capital account convertibility. In the case of current account convertibility, it is important to have a transaction – importing and exporting of goods, buying and selling of services, inward or outward remittances, etc. involving payment or receipt of one currency against another currency. In the case of capital account convertibility, a currency can be converted into any other currency without any transaction.

The Reserve Bank of India appointed in 1997 the Committee on Capital Account Convertibility with Mr. S.S. Tarapore, former Deputy Governor of RBI as its chairman. Tarapore Committee defined capital account convertibility as the freedom to convert local financial assets with foreign financial assets and vice-versa at market determined rates of exchange.

In simple language, capital account convertibility allows anyone to freely move from local currency into foreign currency and back. The purpose of capital convertibility is to give foreign investors an easy market to move in and move out and to send a strong message that Indian economy was strong enough and that India had sufficient forex reserves to meet any flight of capital from the country to any extent.

The Benefits of Capital Account Convertibility:

The Tarapore Committee mentioned the following benefits of capital account convertibility to India:

1. Availability of large funds to supplement domestic resources and thereby promote economic growth.

2. Improved access to international financial markets and reduction in cost of capital.

3. Incentive for Indians to acquire and hold international securities and assets, and

4. Improvement of the financial system in the context of global competition.

Accordingly, the Tarapore Committee recommended the adoption of capital account convertibil-ity.

Under the system of capital account convertibility proposed by this committee the following features are worth mentioning:

(a) Indian companies would be allowed to issue foreign currency denominated bonds to local investors, to invest in such bonds and deposits, to issue Global Deposit Receipts (GDRs) without RBI or Government approval to go in for external commercial borrowings within certain limits, etc.

(b) Indian residents would be permitted to have foreign currency denominated deposits with banks in India, to make financial capital transfers to other countries within certain limits, to take loans from non-relatives and others upto a ceiling of $ 1 million, etc.

(c) Indian banks would be allowed to borrow from overseas markets for short-term and long-term upto certain limits, to invest in overseas money markets, to accept deposits and extend loans denominated in foreign currency. Such facilities would be available to financial institutions and financial intermediaries also.

(d) All-India financial institutions which fulfill certain regulatory and prudential requirements would be allowed to participate in foreign exchange market along with authorised dealers (ADs) who are, at present, banks. In a later stage, certain select NBFCs would also be permitted to act as ADs in foreign exchange market.

(e) Banks and financial institutions would be allowed to operate in domestic and international markets and they would also be allowed to buy and sell gold freely and offer gold denominated deposits and loans.

Preconditions for Capital Account Convertibility:

The Tarapore Committee recommended that, before adopting capital account convertibility (CAC), India should fulfill three crucial pre-conditions:

(i) Fiscal deficit should be reduced to 3.5 per cent. The Government should also set up a Consolidated Sinking Fund (CSF) to reduce Government debt.

(ii) The Governments should fix the annual inflation target between 3 to 5 per cent. This was called mandated inflation target — and give foil freedom to RBI to use monetary weapons to achieve the inflation target.

(iii) The Indian financial sector should be strengthened. For this, interest rates should be folly deregulated, gross non-paying assets (NPAs) should be reduced to 5 per cent, the average effective CRR should be reduced to 3 per cent and weak banks should either be liquidated or be merged with other strong banks.

Apart from this thee essential pre-conditions, the Tarapore Committee also recommended that:

(a) RBI should have a monitoring exchange rate band of 5 per cent around Real Effective Exchange Rate (REER) and should intervene only when the RER is outside the band:

(b) The size of the current account deficit should be within manageable limits and the debt service ratio should be gradually reduced from the present 25 per cent to 20 per cent of the export earnings.

(c) To meet import and debt service payments, forex reserves should be adequate and range between $ 22 billion and $ 32 billion; and

(d) The Government should remove all restrictions on the movement of gold.

It was generally agreed that foil convertibility of the rupee, both on current account and capital account was a welcome measure and is necessary for closer integration of the Indian economy with the global economy.

The major difficulty with the Tarapore Committee recommendation was that it would like the current account convertibility to be achieved in a 3 year period – 1998 to 2000. The period was too short and the pre-conditions and the macroeconomic indicators could not be achieved in such short period.

Basically, the Committee failed to appreciate the political instability in the country at that time, and the complete absence of political will and vision to carry forward the process of economic reforms and economic liberalisation. The outbreak of Asian financial crisis at this time was also responsible for shelving the recommendation of Tarapore Committee.

Conclusion:

In a speech at RBI on March 18,2006, Prime Minister Dr. Manmohan Singh stated: "Given the changes that have taken place during the last two decades, there is merit in moving towards fuller capital account convertibility with a transparent framework… I will, therefore, request the Finance Minister and RBI to revisit the subject and come out with a roadmap based on current realities." Promptly, within two days RBI constituted the "Committee on Fuller Capital Account Convertibility" with S.S. Tarapore again as chairman. This Tarapore Committee submitted its report in September 2006 (more commonly called the Second Tarapore Report or II).

The second Tarapore Committee had drawn up a roadmap for 2011 as the target date for fuller capital convertibility of rupee and mentioned that the conditions were quite favourable.

These conditions were:

1. Strong fundamentals of the Indian economy

2 A good amount of foreign exchange reserves of $ 165 million that existed in 2006.

3. More liberalised use of foreign exchange already in place.

4. A financial system better geared to deal with external capital flows

The fuller capital convertibility of rupee seemed to be desirable at the end of 2006 when the committee submitted its report. However, economic events, especially global financial crisis of 2007-09, roughly about a sea change in the economic situation. The Indian economy would have been greatly affected by the global financial crisis if we had implemented the recommendations of Tarapore Committee recommendation. We could not have coped with the extent of capital outflows that took place during 2008-09.

Problems:

It may be noted that convertibility of currency can give rise to some problems.

Firstly, since market determined exchange rate is generally higher than the previous officially fixed exchange rate, prices of essential imports rise which may generate cost-push inflation in the economy.

Secondly, if current account convertibility is not properly managed and monitored, market exchange rate may lead to the depreciation of domestic currency. If a currency depreciates heavily, the confidence in it is shaken and no one will accept it in its transactions. As a result, trade and capital flows in the country are adversely affected.

Thirdly, convertibility of a currency sometimes makes it highly volatile. Further, operations by speculators make it more volatile. Further, operations by speculators make it more volatile and unstable. When due to speculative activity, a currency depreciates and confidence in it is shaken there is capital flight from the country as it happened in 1997-98 in case of South East Asian econo-mies such as Thailand, Malaysia, Indonesia, Singapore and South Korea.

This adversely affects economic growth of the economy. In the context of heavy depreciation of the currency not only there is capital flight but inflow of capital in the economy is discouraged as due to depreciation of the currency profitability of investment in an economy is adversely affected.

Special Economic Zones in India

A policy was introduced in the EXIM Policy effective from 1.4.2000 for setting up of Special Economic Zones in the country with a view to provide an internationally competitive and hassle free environment for exports. Units may be set up in SEZ for manufacture, of goods and rendering of services. All the import/export operations of the SEZ units will be on self-certification basis. The units in the zone have to be a net foreign exchange earner but they shall not be subjected to any pre-determined value addition or minimum export performance requirements. Sales in the Domestic Tariff Area by SEZ units shall be subject to payment of full Custom Duty and Import Policy in force.

The policy provides for setting up of SEZs in the public, private joint sector or by State Governments. It was also envisaged that some of the existing export processing zones would be converted into

Special Economic Zones. Accordingly, the Government has converted Export Processing zones located at Kandla and Surat (Gujara), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Madras (Tamilnadu), Visakhapatnam (Andhra Pradesh) and Noida (Uttar Pradesh) into a Special Economic Zones.

Policy for Development of Special Economic Zone

With a view to augmenting infrastructure facilities for export production it has been decided to permit the setting up of Special Economic Zones (SEZs) in the public, private, joint sector or by the State Governments. The minimum size of the Special Economic Zone shall not be less than 1000 hectares. Minimum area requirement shall, however, not be applicable to product-specific and port/air-port based SEZs. This measure is expected to promote self-contained areas supported by world-class infrastructure oriented towards export production.

Who Can Set Up?

Any private/public/joint sector or state government or its agencies can set up Special Economic Zone (SEZ).

How to Apply?

15 copies of application, indicating name and address of the applicant, status of the promoter along with a project report covering the following particulars may be submitted to the Chief Secretary of the state:

➢ Location of the proposed zone with details of existing infrastructure and that proposed to be established.

➢Its area, distance from the nearest sea port/airport/rail/road head etc.

➢Financial details, including investing proposed, mode of financing and viability of the project.

➢Details of foreign equity and repatriation of dividends etc., if any

➢Whether the zone will allow only certain specific industries or will be a multiple product zone. The state government shall, forward it along with their commitment to the following Department of Commerce, Government of India:

➢ That area incorporated in the proposed Special Economic Zone is free from environmental restrictions.

➢That water, electricity and other services would be provided as required.

➢That the units would be given full exemption in electricity duty and tax on sale of electricity for self generated and purchased power.

➢To allow generation, transmission and distribution of power within SEZ.

➢To exempt from state sales tax, octroi, mandi tax, turnover tax and any other duty/ cess or levies on the supply of goods from Domestic Tariff area to SEZ units.

➢ That for units inside the zone, the powers under the Industrial Disputes Act and other related labour Acts would be delegated to the Development Commissioner and that the units will be declared as a Public Utility Service under Industrial Disputes Act.

➢The single point clearances system and minimum inspections requirements under state law / rules would be provided. The proposal incorporating the commitments of the state government will be considered by an inter-Ministerial Committee in the Department of Commerce. On acceptance of the proposal, a letter of permission will be issued to the applicant.

Are There any Terms and Conditions?

➢Only units approved under SEZ scheme would be permitted to be located in SEZ.

➢The SEZ units shall abide by local laws, rules, regulations or bye-laws in regard to area planning, sewerage disposal, pollution control and the like. They shall also comply with industrial and labour laws as may be locally applicable.

➢ Such SEZ shall make security arrangement to fulfill all the requirements of the laws, rules and procedures applicable to such SEZ.

➢ The SEZ should have a minimum area of 1000 hectares and at least 25% of the area is to be earmarked for developing industrial area for setting up of units.

➢Minimum area of 1000 hectares will not be applicable to product specific and airport based SEZs.

➢ Wherever the SEZs are landlocked, an inland container depot (ICD) will be an integral part of SEZs.

Facilities to SEZ Developer

➢100% FDI allowed for; (a) townships with residential educational and recreational facilities on a case to case basis, (b) franchise for basic telephone service in SEZ.

➢ Income tax benefit under (80 1A) to developers for any block of 10 years in 15 years.

➢ Duty free import/domestic procurement of goods for development, operation and maintenance of SEZs.

➢Exemption from service tax.

➢Income of infrastructure capital fund/company from investment in SEZ exempt from investment in SEZ exempt from income tax.

➢Investment made by individuals etc. in a SEZ company also eligible for exemption u/s 88 of IT Act.

➢Developer permitted to transfer infrastructure facility for operation and maintenance.

➢Generation, transmission and distribution of power in SEZs allowed full freedom in allocation of space and built up area to approved SEZ units on commercial basis.

➢ Authorized to provide and maintain service like water, electricity, security, restaurants and recreation centres on commercial lines.

How to Set Up a Unit in SEZ?

For setting up a manufacturing, trading or service units in SEZ, 3 copies of project proposal in the format prescribed at Appendix 14-1A of the Handbook of Procedures, vol.1 to be submitted to the Development Commissioner of the SEZ.

What is the Approval Mechanism?

All approval to be given by the unit approval committee headed by the Development Commissioner, Clearance from the Department of Policy and Promotion / Board of Approvals, wherever required will be obtained by the Development Commissioner, before the Letter of intent is issued.

What is the Obligation of the Unit Under the Scheme?

➢ SEZ units have to achieve positive net foreign exchange earnings as per the formula given in paragraph appendix 14-11 (para 12.1) of Handbook of procedures, Vol.1. For this purpose, a legal undertaking is required to be executed by the unit with the Development Commissioner.

➢The units have to provide periodic reports to the Development Commissioner and zone customs as provided in Appendix 14-1F of the handbook of procedures, vol.1.

➢The units are also to execute a bond with the zone customs for their operation in the SEZ.

Facilities to SEZ Enterprises

Customs and Excise

➢ SEZ units may import or procure from the domestic sources, duty free, all their requirements of capital goods, raw materials, consumables, spares, packing materials, office equipment, DG sets etc. for implementation of their project in the zone without any license or specific approval.

➢ Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units.

➢ Goods imported/procured locally duty free could be utilized over the approval period of 5 years.

➢ Domestic sales by SEZ units will now be exempt from SAD.

Income Tax

➢ 100% income-tax exemption (10A) for first 5 years and 50% for 2 years thereafter.

Foreign Direct Investment

➢ 100% foreign direct investment is freely allowed in manufacturing sector in SEZ units under automatic route, except arms and ammunition, explosive, atomic substance, narcotics and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes, cigars and manufactured tobacco substitutes.

➢ No cap on foreign investments for SSI reserved items.

Off-Shore Banking (OBUs)

➢ Setting up of off-shore banking units allowed in SEZs.

➢ OBUs entitled for 100% income-tax exemption for 3 years & 50% for next 2 years.

Banking / External Commercial Borrowings

➢ External commercial borrowings by units up to $ 500 million a year allowed without any maturity restrictions.

➢ Freedom to bring in export proceeds without any time limit.

➢ Flexibility to keep 100% of export proceeds in EEFC account. Freedom to make overseas investment from it.

➢ Commodity hedging permitted.

➢ Exemption from interest rate surcharge on import finance.

➢ SEZ units allowed to 'write-off ' unrealized export bills.

➢ Exemption from interest rate surcharge on import finance.

General Sales Tax Act

➢ Exemption to sales made from Domestic Tariff Area to SEZ units.

Service Tax

➢ Exemption from service tax to SEZ units.

Environment

➢ SEZs permitted to have non-polluting industries in IT, and recreational facilities like golf courses, desalination plants, hotels and non-polluting service industries in the coastal regulation zone area.

➢ Exemption from public hearing under environment impact assessment notification.

Companies Act

➢ Enhanced limit of ` 2.4 crore per annum allowed for managerial remuneration.

➢ Regional office of Register of Companies in SEZs

➢ Exemption from requirement of domicile in India for 12 months prior to appointment as Director.

Drugs and Cosmetics

➢ Exemption from port restriction under Drugs & Cosmetics Rules.

Sub-Contracting / Contract Framing

➢ SEZ units may sub-contract part of production or production process through units in the Domestic Tariff Area or through other EOU/SEZ units.

➢ SEZ units may also sub-contract part of their production process abroad.

➢ Agriculture/Horticulture processing SEZ units allowed to provide inputs and equipments to contract farmers in DTA to promote production of goods as per the requirement of importing countries.

Are there any Relaxation in Labour Laws for SEZ Units?

The labour laws of the land will apply to all units inside the zone. However, the respective state governments may declare units within the SEZ as public utilities and may delegate the powers of the labour commissioner to the Development Commissioner of the SEZ.

Facilities for Domestic Suppliers to Special Economic Zone

➢ Supplies from Domestic Tariff Area (DTA) to SEZ to be treated as physical export. DTA supplier would be entitled to:

➢ Drawback/DEPB
➢ CST Exemption
➢ Exemption from state levies
➢ Discharge of EP if any on the suppliers
➢ Income-tax exemption under section 80-HHC

What is the Policy Frame for SEZs?

The policy frame work of SEZ units and SEZ developer is contained in the following:

➢ Chapter 7 of Export and Import policy
➢ Appendix 14-II of Handbook of Procedures, vol.1
➢ All relevant notifications and information is available at website www.sezindia.nic.in

Are Special Economic Zones Too Costly?

The logic of creating a special economic zone is to offer infrastructure and other facilities that cannot be provided quite so easily across the country as a whole. The objective is to create islands of world-class infrastructure to reduce the cost of doing business and make industry globally competitive. This would mean assured electricity availability at competitive rates, availability of capital at internationally benchmarked rates, good transport links to reduce shipment time and delays, and flexible labour laws. In India, SEZs are being developed by the private sector or public sector or through private-public partnership. Since SEZs require massive investments and have relatively longer gestation period, proper mix of stable SEZ policy coupled with fiscal benefits need to be extended to the zones.

The fiscal concession has made it possible for private players to look at SEZs as a profitable and new business opportunity. This has also helped provide infrastructure and other facilities to units in SEZs at substantially lower cost. Laying a kilometre of road costs ` 5 crore in our country, of which 30% goes to taxes. The exemption given to developer will ultimately percolate to units. In many states, industry pays as high as ` 7 for a unit of power where as all the large SEZs in the world provide electricity at ` 2. The removal of electricity duty will help in providing electricity at internationally benchmarked rates. Banks in SEZs are exempted from SLR and CRR requirements and also enjoy income tax concession. Thus the capital cost is lower for these banks which they will pass on to their customers. A narrow view is being taken by interpreting SEZs as a loss making venture from revenue point of view as it may lead to revenue loss of about ` 90,000 crore over a period of time. This fear is base-less as SEZs can be a pivot for attracting FDI both in manufacturing and retail trade. It can provide flexibility to global major players to tap the ASEAN and Gulf markets. It may be emphasised that no government should provide primacy to revenue considerations over employment, exports and infrastructure development. (Source: The Economic Times, 14th April, 2006).

SEZs may Become a Burden on Taxpayers

By offering privileged trading terms for export-oriented units, SEZs are expected to attract investment and foreign exchange, spur employment and boost the development of improved technologies and infrastructure. These zones are designated duty-free enclaves, and are deemed foreign territories for the purpose of trade operations, duties and tariffs. Indian SEZs have more than 800 units, employing 1 lakh people with export growth of 32% in 2004-05 (around ` 18,000 crore) covering sectors like gems and jewellery, textiles, software, leather and chemicals. Despite their appeal, many economists feel that SEZs attract investment only by offering distortionary incentives rather than building underlying competitive conditions. It is difficult to achieve 'comparative advantage' only by setting up SEZs. The success of any SEZ depends on conditions such as proper location, right kind of incentives, product specific policies, linkage between domestic sector and SEZ, financing issues and availability of sufficient trained human capital, etc. Along with the supply side conditions, identification of markets, multi-market strategy, brand development and so on are equally important for which strategies are quite independent of location of firms (inside or outside of SEZs).

Many critics feel that SEZs could be the victim of 'allocative inefficiency'. As the policy inside the zone is quite attractive in terms of facilities and fiscal incentives, many investors may blindly relocate their operations inside the zone without giving due consideration to investment decisions in other areas. Hence, the incentives to firms may create a fiscal burden on the taxpayer and sometimes hurt environmental and labour standards. In addition, the direct and indirect cost of maintaining zone privileges lead to enclaves of prosperity and does not benefit the economy in the true sense. The success of SEZs depends on government's strategy to promote private sector-led growth. Active linkage programmes, adequate social and environmental safeguards, and private sector involvement in zone development and operation can go a long way in ensuring that the benefits of SEZs are maximised.

Brief Historic Perspective of Foreign Trade Policy

Necessity

Out of sheer necessity the Foreign Trade Policy (FTP) has been evolved over a period since independence. Policies are framed based on past experience and future needs and when circumstances change, new policies are evolved so that the problems faced could be sorted out and foreign Trade could become an effective source of national development.

Historic Perspective

The first active step was taken in 1970 in the form of a Export Policy Resolution.

The major events of chronological progress of the FTP, is indicated as follows:
1970: Export Policy Resolution passed in the Parliament.
1978: Export-Import and procedures by Alexander committee.
1980: Export strategies for eighties by Tandon committee.
1984: Trade Policies by Abid Hussain committee.
1985: EXIM Policy by Viswanath Pradap Singh Government. (3 year Policy)
1990-93: 3-year Import Export Policy.
1992-97: Export-Import Policy (to coincide with Plan period)
1997-02: EXIM Policies with major changes.
2002-02: EXIM Policies
2004-09: New Foreign Trade Policy (NFTP) was introduced due to change in Government.

Trade and Economic Policy

Until 1990's, India's Trade Policy was mostly influenced by the "Swadeshi" (self sufficiency) feelings and the "licence raj" system of restrictions on production and imports. A first generation of reforms (1991-1996) – aimed at, *inter alia*, liberalizing trade – led to a reduction of import tariffs, elimination of quantitative restrictions, exchange rate reforms and deregulation of industry resulting in yearly growth rates of around 7% (compared with 3% before the reforms).

A second generation of reforms was initiated in 1999 to address issues related to lack of competitiveness, poor infrastructure and overregulation. India has set the ambitious target of an annual 8% sustainable growth besides doubling the per capita income over 10 years. As you know, India is a member of all major multilateral economic for a, including the International Monetary Fund (IMF), the World Bank and the Asian Development Bank (ADB). India was founding member of both GATT and the World Trade Organisation (WTO). At regional level, India is member of SAARC, (South Asia Association of Regional Cooperation) of BIMSTEC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation) Bangkok Agreement. India has a free trade agreement with Singapore and with the other SAARC countries (SAFTA) and is in the process of negotiating one with Japan, South Korea, GCC and ASEAN. The details of the NFTP (2004-2009) would be discussed in the relevant unit of this paper. The major objective of the NFTP is to double India's share in world exports from the current 0.82% to nearly 2% by 2010. This provides the much needed boost to Indian exporters. This also reaffirms the fact that trade policy reforms forms the core of the country's economic reform. Within the broad framework of Foreign Trade Policy, **commercial Policy Instruments** are necessitated to protect indigenous industries as otherwise the indigenous supporting industries may be wiped out by the tornado of developed countries dumping of their products.

Need for Commercial Policy Instruments

Tariff and Non Tariff barriers

In order to protect our industries, we have to make use of the Commercial Policy Instruments (CPI). These policy instruments like levying import duty (tariff) as well as other tariffs and adapting other non-tariff barriers like quantitative restrictions enable us to safeguard our industries from these gigantic claws of the developed countries. It would be very difficult to compete with developed countries with their higher economic status and connected facilities, subsidies and encourage merit in increasing production and reducing their costs. If these products are permitted without restrictions and different forms of tariffs to their prices, our products may not find markers internally or externally. Under such international trading environment, there is need for developing countries to adopt commercial policy instruments to protect their own industries.

Multilateral Trading System

Understand the international trading environment, has become imperative for the entrepreneurs and the export managers in vie of the growing globalization, liberalization and competition in the world trade. The international trading environment consists of rule based multilateral trading system, trading blocks, trade agreements and trade policies of individual countries.

The multilateral trading system refers to the system that governs the trading among various countries. This system has been established over the years as a result of the international negotiations among the various countries. These negotiations provide the guidelines to member countries for the formulation of their policies governing international trade. Besides, the emergence of various trading blocks reflecting varying degrees of economic integration and bilateral trade agreements amongst the countries have had a profound impact on course of international trade flows and the state of competition at the global market place. The General Agreement on Tariffs and Trade (GATT) was established in 1948 and the WTO was established in 1955.

The Legal Framework

The Legal framework for the enforcement of the multilateral trading system consists of the following:

➢➢ Rules governing international trade

➢➢ Agreement on safeguard measures

➢➢ Agreements to deal with unfair trade practices namely, Agreements on anti dumping practices and Agreement on subsidies and countervailing measures. P.K Khurana has analysed the Legal framework further as depicted here:

Various Instruments

Commercial Policy Instruments are evolved over period and it is a continuous process. Its scope is vast and varied. Here we restrict our discussion on various instruments as follows:

➢➢ Tariffs and their different types

➢➢ Growth of quota system or quantitative restrictions (QRS) and its removal

➢➢ Antidumping / countervailing duties

➢➢ Technical standards

➢➢ Exchange control measures

➢➢ Other non-tariff measures

The Foreign Trade Policy of India (2009-2014)

On August 27, 2009, the commerce and industry minister, Anand Sharma, presented the five-year Foreign Trade Policy (FTP) for 2009-2014. Aiming to reverse contraction in exports for 10 consecutive months, the new FTP has several measures to ensure a healthy growth of foreign trade. The measures comprise fiscal concessions as well as relaxations in procedure.

The export target of $ 200 billion for 2010-11 means a growth of 15 per cent over the next two years. The FTP also envisages an overall medium- term objective of 25 per cent annual growth thereafter.

According to the minister, the three elements which were expected to help achieve the targets are: improvement in export-related infrastructure, reduction in transaction costs, and provision of full refund of all indirect taxes and levies.

Highlights:

Higher Support for Market and Product Diversification:

i. Incentive schemes have been expanded by way of addition of new products and markets.

ii. Twenty-six new markets have been added under Focus Market Scheme. These include 16 new markets in Latin America and 10 in Asia- Oceania.

iii. The incentive available under Focus Market Scheme (FMS) has been raised from 2.5 per cent to 3 per cent.

iv. The incentive available under Focus Product Scheme (FPS) has been raised from 1.25 per cent to 2 per cent.

v. A large number of products from various sectors have been included for benefits under FPS. These include engineering products (agricultural machinery, parts of trailers, sewing machines, hand tools, garden tools, musical instruments, clocks and watches, railway locomotives etc.), plastic (value added products), jute and sisal products, technical textiles, green technology products (wind mills, wind turbines, electric operated vehicles etc.), project goods, vegetable textiles and certain electronic items.

vi. Market Linked Focus Product Scheme (MLFPS) has been greatly expanded. Some major products include pharmaceuticals, synthetic textile fabrics, value added rubber products, value added plastic goods, textile made-up, knitted and crocheted fabrics, glass products, certain iron and steel products and certain articles of aluminium among others. Benefits to these products will be provided, if exports are made to 13 identified markets (Algeria, Egypt, Kenya, Nigeria, South Africa, Tanzania, Brazil, Mexico, Ukraine, Vietnam, Cambodia, Australia and New Zealand).

vii. MLFPS benefits also extended for export to additional new markets for certain products. These products include auto components, motor cars, bicycle and its parts, and apparels among others.

viii. Higher allocation for Market Development Assistance (MDA) and Market Access Initiative (MAI) schemes is being provided.

Technological Up-gradation:

i. To aid technological upgradation of India's export sector, EPCG Scheme at zero duty has been introduced. This scheme will be available for engineering and electronic products, basic chemicals and pharmaceuticals, apparels and textiles, plastics, handicrafts, chemicals and allied products and leather and leather products [subject to exclusions of current beneficiaries under Technological Upgradation Fund Schemes (TUFS), administered by Ministry of Textiles and beneficiaries of Status Holder Incentive Scheme in that particular year]. The scheme shall be in operation till March-end, 2011.

ii. 'Towns of Export Excellence' have been recognised: Jaipur, Srinagar and Anantnag for handicrafts; Kanpur, Dewas and Ambur for leather products; and Malihabad for horticultural products.

EPCG Scheme Relaxations:

i. To increase the life of existing plant and machinery, export obligation on import of spares, moulds, etc., under EPCG Scheme has been reduced to 50 per cent of the normal specific export obligation.

ii. Taking into account the decline in exports, the facility of Refixation of Annual Average Export Obligation for a particular financial year in which there is decline in exports from the country has been extended for the 5 year policy period 2009-14.

Support for Green Products and Products from North-East:

i. Focus Product Scheme benefit extended for export of 'green products'; and for exports of some products originating from the North-east.

Status Holders:

i. To accelerate exports and encourage technological upgradation, additional Duty Credit Scrips of 1 per cent of the FOB value of past exports shall be given to Status Holders. The duty credit scrips can be used for procurement of capital goods with Actual User condition. This facility shall be available for sectors of leather (excluding finished leather), textiles and jute, handicrafts, engineering (excluding iron and steel and non-ferrous metals in primary and intermediate form, automobiles and two wheelers, nuclear reactors and parts, and ships, boats and floating structures), plastics and basic chemicals (excluding pharma products) [subject to exclusions of current beneficiaries under Technological Upgradation Fund Schemes (TUFS)]. This facility shall be available upto March-end, 2011.

Stability / Continuity of the Foreign Trade Policy:

i. To impart stability to the policy regime, Duty Entitlement Passbook (DEPB) Scheme is extended beyond December 2009 till December 2010.

ii. Income Tax exemption to 100 per cent EOUs and to STPI units under Section 10B and 10A of Income Tax Act, has been extended for the financial year 2010-11 in the Budget 2009-10.

iii. The adjustment assistance scheme initiated in December 2008 to provide enhanced ECGC cover at 95 per cent, to the adversely affected sectors, is continued till March 2010.

Marine Sector:

i. Fisheries have been included in the sectors which are exempted from maintenance of average EO under EPCG Scheme, subject to the condition that fishing trawlers, boats, ships and other similar items shall not be allowed to be imported under this provision. This would provide a fillip to the marine sector which has been affected by the present downturn in exports.

ii. Additional flexibility under Target plus Scheme (TPS) / Duty Free Certificate of Entitlement (DFCE) Scheme for Status Holders has been given to marine sector.

Gems and Jewellery Sector:

i. To neutralise duty incidence on gold jewellery exports, it has now been decided to allow Duty Drawback on such exports.

ii. In an endeavour to make India a diamond international trading hub, it is planned to establish "Diamond Bourses".

iii. A new facility to allow import on consignment basis of cut and polished diamonds for the purpose of grading/certification purposes has been introduced.

iv. To promote export of gems and jewellery products, the value limits of personal carriage have been increased from US$ 2 million to US$ 5 million in case of participation in overseas exhibitions. The limit in case of personal carriage, as samples, for export promotion tours, has also been increased.

Agriculture Sector:

i. To reduce transaction and handling costs, a single window system to facilitate export of perishable agricultural produce has been introduced. The system will involve creation of multi-functional nodal agencies to be accredited by APEDA.

Leather Sector:

i. Leather sector shall be allowed re-export of unsold imported raw hides and skins and semi finished leather from public bonded ware houses, subject to payment of 50 per cent of the applicable export duty.

ii. Enhancement of FPS rate to 2 per cent, would also significantly benefit the leather sector.

Tea:

i. Minimum value addition under advance authorisation scheme for export of tea has been reduced from the existing 100 per cent to 50 per cent.

ii. DTA sale limit of instant tea by EOU units has been increased from the existing 30 per cent to 50 per cent.

iii. Export of tea has been covered under VKGUY Scheme benefits.

Pharmaceutical Sector:

i. Export obligation period for advance authorisations has been increased from the existing 6 months to 36 months, as is available for other products.

ii. Pharma sector extensively covered under MLFPS for countries in Africa and Latin America, and some countries in Oceania and Far East.

Handloom Sector:

i. To simplify claims under FPS, requirement of 'Handloom Mark' for availing benefits under FPS has been removed.

EOUs:

i. EOUs have been allowed to sell products manufactured by them in DTA upto a limit of 90 per cent instead of existing 75 per cent, without changing the criteria of 'similar goods', within the overall entitlement of 50 per cent for DTA sale.
ii. EOUs will now be allowed to procure finished goods for consolidation along with their manufactured goods, subject to certain safeguards.
iii. During this period of downturn, Board of Approvals (BOA) to consider extension of block period by one year for calculation of Net Foreign Exchange earnings of EOUs.
iv. EOUs will now be allowed CENVAT credit facility for the component of SAD and Education Cess on DTA sale.

Thrust to Value-Added Manufacturing:

i. To encourage value added manufactured export, a minimum 15 per cent value addition on imported inputs under Advance Authorisation Scheme has now been prescribed.
ii. Coverage of project exports and a large number of manufactured goods under FPS and MLFPS.

DEPB:

i. DEPB rate shall also include factoring of custom duty component on fuel where fuel is allowed as a consumable in Standard Input- Output Norms.

Flexibility Provided to Exporters:

i. Payment of customs duty for Export Obligation (EO) shortfall under Advance Authorisation / DFIA / EPCG Authorisation has been allowed by way of debit of duty credit scrips. Earlier the payment was allowed in cash only.
ii. Import of restricted items, as replenishment, shall now be allowed against transferred DFIAs, in line with the erstwhile DFRC scheme.
iii. Time limit of 60 days for re-import of exported gems and jewellery items for participation in exhibitions has been extended to 90 days in case of USA.
iv. Transit loss claims received from private approved insurance companies in India will now be allowed for the purpose of EO fulfillment under export promotion schemes. At present, the facility has been limited to public sector general insurance companies only.

Waiver of Incentives Recovery, on RBI Specific Write-off:

i. In cases, where RBI specifically writes off the export proceeds realisation, the incentives under the FTP shall now not be recovered from the exporters subject to certain conditions.

Simplification of Procedures:

i. To facilitate duty free import of samples by exporters, number of samples/pieces has been increased from the existing 15 to 50. Customs clearance of such samples shall be based on declarations given by the importers with regard to the limit of value and quantity of samples.
ii. Greater flexibility has been permitted to allow conversion of shipping bills from one export promotion scheme to other scheme. Customs shall now permit this conversion within three months, instead of the present limited period of only one month.

iii. To reduce transaction costs, dispatch of imported goods directly from the port to the site has been allowed under Advance Authorisation Scheme for deemed supplies. At present, the duty free imported goods could be taken only to the manufacturing unit of the authorisation holder or its supporting manufacturer.
iv. Disposal of manufacturing wastes/scrap will now be allowed after payment of applicable excise duty, even before fulfillment of export obligation under Advance Authorisation and EPCG Scheme.
v. Regional authorities have now been authorised to issue licences for import of sports weapons by 'renowned shooters', on the basis of NOC from the Ministry of Sports & Youth Affairs. Now there will be no need to approach DGFT(Hqrs.) in such cases.
vi. The procedure for issue of Free Sale Certificate has been simplified and the validity of the certificate has been increased from 1 year to 2 years. This will solve the problems faced by the medical devices industry.
vii. Automobile industry, having their own R&D establishment, would be allowed free import of reference fuels (petrol and diesel), upto a maximum of 5 K1 per annum, which are not manufactured in India.
viii. Acceding to the demand of trade and industry, the application and redemption forms under EPCG scheme have been simplified.

Reduction of Transaction Costs:

i. No fee shall now be charged for grant of incentives under the Schemes of FTP. Further, for all other authorisations/licence applications, maximum applicable fee is being reduced to Rs 100,000 from the existing Rs 1,50,000 (for manual applications) and Rs 50,000 from the existing Rs.75,000 (for EDI applications).
ii. To further EDI initiatives, Export Promotion Councils/ Commodity Boards have been advised to issue RCMC through a web-based online system.
iii. For EDI ports, with effect from December 2009, double verification of shipping bills by customs for any of the DGFT schemes shall be dispensed with.
iv. An Inter-Ministerial Committee will be formed to redress/ resolve problems/issues of exporters.

Directorate of Trade Remedy Measures:

i. To enable support to Indian industry and exporters in availing their rights through trade remedy instruments, a Directorate of Trade Remedy Measures shall be set up.

Analysis:

The salient features of the trend in trade balance are discussed below.

Increasing trade value:

The total trade value has risen from Rs 1,214 crore in 1950-51 to around Rs seven lakh crore in 2003-04. The fastest rise in trade value has taken place from mid- 1990s to mid-2000s due to a rise in quantity of exportable goods as well as a rise in the value of commodities.

The rise in value of trade suggests the significance of international trade vis-a-vis the Indian economy. As India's economy will be more diversified the value of trade will also increase. It is a matter of concern that, in spite of such a massive growth, India's share has remained very low in the context of world trade.

Larger growth of imports:

The value of India's imports has risen higher than the export value since 1951 due to rapid industrialisation, import of food-grains on a regular basis from 1958-59 to 1972-73 under PL 480 scheme in order to supplement domestic productions and maintain a minimum level of buffer stock.

Inflation in India has been controlled by increasing imports and supplying price sensitive commodities like cement, edible oils etc.

On the pretext of export promotion, imports have also been liberalised leading to imports of essential as well as non-essential goods.

Oil prices have been periodically increased by OPEC since 1973. This has added to our growing import bill.

Inadequate export growth:

The first 15 years of export stagnation in India occurred due to the predominance of agricultural commodities like tea, jute and cotton as export items. The demand for these items is always inelastic. Besides, our exportable items are not cost-effective.

After the rupee devaluation in 1966, the government entered into several agreements with socialist countries besides providing fiscal and cash incentives. Further, a number of export promotion councils and agencies were set up. All these factors led to a fairly rapid growth of exports in the 1970s. Despite this, our import bill has for all purposes always been higher than the export value because the majority of exportable commodities were primary goods; increasing domestic consumption left little surplus for export; export promotion measures like tax and other associated incentives were found to be inadequate; the developed countries like the USA resorted to greater tariff barriers against imports from developing countries; there has been a prolonged economic recession in most developed countries during the period; and the unit value of exportable goods rose much higher than the quantum index of exports.

Steps Required Of late, India has embarked on a path of diversifying exportable commodities to reduce its huge trade deficit. Hopefully the developed countries like the USA, UK, Germany and Japan will buy bulk commodities from India (their share is 37 per cent of the total exports). These well-off countries with high per capita income offer us excellent markets for pushing our products.

India needs to cultivate newer markets for some of the products like cotton and jute manufactures, particularly carpet backing, leather manufactures and non-traditional items such as marine products, pearls, precious stones etc. India has a great potential for augmenting exports in the field of software also. It is clear that export of value-added products and technologically advanced products holds the key to tilting the trade balance in favour of India.

Role of Multinational Corporations in the Indian Economy

Multi National Corporations (MNCs) are huge industrial organizations which extend their industrial and marketing operations through a network of their branches or their majority owned Foreign Affiliates (MOFAs). MNCs are also known as Transactional corporations (TNCs). Instead of aiming for maximization of their profits from one or two products, the MNCs operate in a number of fields and from this point of view, their business strategy extends over a number of products and over a number of countries.

(i) MNCs are playing a major role in the globalisation process.
(ii) More and more goods and services, investments and technology are moving between countries.
(iii) Most regions of the world are in closer contact with each other than a few decades back. As the new Leviathans of our time,

Multinational corporations are: Practically in every sphere of modern life, from policy making in regard to the environment and international security; from problems of identity and community; and from the future of work to the future of the nation state.

Arguments for MNCs (The positive role):

The MNCs play an important role in the economic development of underdeveloped countries.

1. Filling Savings Gap: The first important contribution of MNCs is its role in filling the resource gap between targeted or desired investment and domestically mobilized savings. For example, to achieve a 7% growth rate of national output if the required rate of saving is 21% but if the savings that can be domestically mobilised is only 16% then there is a 'saving gap' of 5%. If the country can fill this gap with foreign direct investments from the MNCs, it will be in a better position to achieve its target rate of economic growth.

2. Filling Trade Gap:

The second contribution relates to filling the foreign exchange or trade gap. An inflow of foreign capital can reduce or even remove the deficit in the balance of payments if the MNCs can generate a net positive flow of export earnings.

3. Filling Revenue Gap:

The third important role of MNCs is filling the gap between targeted governmental tax revenues and locally raised taxes. By taxing MNC profits, LDC governments are able to mobilize public financial resources for development projects.

4. Filling Management/Technological Gap: Fourthly, Multinationals not only provide financial resources but they also supply a "package" of needed resources including management experience, entrepreneurial abilities, and technological skills. These can be transferred to their local counterparts by means of training programs and the process of 'learning by doing'. Moreover, MNCs bring with them the most sophisticated technological knowledge about production processes while transferring modern machinery and equipment to capital poor LDCs. Such transfers of knowledge, skills, and technology are assumed to be both desirable and productive for the recipient country.

5. Other Beneficial Roles:

The MNCs also bring several other benefits to the host country.

(a) The domestic labour may benefit in the form of higher real wages.

(b) The consumers benefits by way of lower prices and better quality products.

(c) Investments by MNCs will also induce more domestic investment. For example, ancillary units can be set up to 'feed' the main industries of the MNCs

(d) MNCs expenditures on research and development (R&D), although limited is bound to benefit the host country. Apart from these there are indirect gains through the realization of external economies.

Arguments against MNCs (The negative role):

There are several arguments against MNCs which are discuss below.

1. Although MNCs provide capital, they may lower domestic savings and investment rates by stifling competition through exclusive production agreements with the host governments. MNCs often fail to reinvest much of their profits and also they may inhibit the expansion of indigenous firms.
2. Although the initial impact of MNC investment is to improve the foreign exchange position of the recipient nation, its long-run impact may reduce foreign exchange earnings on both current and capital accounts. The current account may deteriorate as a result of substantial importation of intermediate and capital goods while the capital account may worsen because of the overseas repatriation of profits, interest, royalties, etc.
3. While MNCs do contribute to public revenue in the form of corporate taxes, their contribution is considerably less than it should be as a result of liberal tax concessions, excessive investment allowances, subsidies and tariff protection provided by the host government.
4. The management, entrepreneurial skills, technology, and overseas contacts provided by the MNCs may have little impact on developing local skills and resources. In fact, the development of these local skills may be inhibited by the MNCs by stifling the growth of indigenous entrepreneurship as a result of the MNCs dominance of local markets.
5. MNCs' impact on development is very uneven. In many situations MNC activities reinforce dualistic economic structures and widen income inequalities. They tend to promote the interests of some few modern-sector workers only. They also divert resources away from the production of consumer goods by producing luxurious goods demanded by the local elites.
6. MNCs typically produce inappropriate products and stimulate inappropriate consumption patterns through advertising and their monopolistic market power. Production is done with capital-intensive technique which is not useful for labour surplus economies. This would aggravate the unemployment problem in the host country.
7. The behaviour pattern of MNCs reveals that they do not engage in R & D activities in underdeveloped countries. However, these LDCs have to bear the bulk of their costs.
8. MNCs often use their economic power to influence government policies in directions unfavorable to development. The host government has to provide them special economic and political concessions in the form of excessive protection, lower tax, subsidized inputs, cheap provision of factory sites. As a result, the private profits of MNCs may exceed social benefits.

9. Multinationals may damage the host countries by suppressing domestic entrepreneurship through their superior knowledge, worldwide contacts, and advertising skills. They drive out local competitors and inhibit the emergence of small-scale enterprises.

Role of MNCs in developing countries

MNCs have contributed significantly to the development of world economy at large. They have also served as an engine of growth in many host countries. Their importance in a developing country may be traced as follows:

1. MNCs help a developing host country by increasing investment, income and employment in its economy.
2. They contribute to the rapid process of development of the country through transfer of technology, finance and management.
3. MNCs promote professionalization management in the companies of the host countries.
4. MNCs help in promoting exports of the host country.
5. MNCs by producing certain required goods in the host country help in reducing its dependence on imports.
6. MNCs due to their wide network of productive activity equalise the cost of production in the global market.
7. Entry of MNCs in the host country makes its market more competitive and break the domestic monopolies.
8. MNCs accelerate the growth process in the host country through rapid industrialisation and allied activities.
9. The growth of MNCs creates a positive impact on the business environment in the host country.
10. MNCs are regarded as agents of modernisation and rapid growth.
11. MNCs are the vehicles for peace in the world. They help in developing cordial political relations among the countries of the world.
12. MNCs bring ideas and help in exchange of cultural values.
13. MNCs through their positive attitude and efforts work for the establishment of social welfare institutions and improvement of health facilities in the host countries.
14. Growth of MNCs help in improving the balance of payment status of the host country.
15. The MNCs integrate national and international markets. Their growth in these days has remarkably influenced economic, industrial, social environment and business conditions.

In short, through basically seeking maximisation of profits by using all types of resources and strategies of the global economy, eventually globalisation has become the main focus of their business. In this way, it has become a main propelling force behind the expansion of world economy at large.

Prior to 1991 Multinational companies did not play much role in the Indian economy. In the pre-reform period the Indian economy was dominated by public enterprises.

To prevent concentration of economic power industrial policy 1956 did not allow the private firms to grow in size beyond a point. By definition multinational companies were quite big and operate in several countries.

While multinational companies played a significant role in the promotion of growth and trade in South-East Asian countries they did not play much role in the Indian economy where import-substitution development strategy was followed. Since 1991 with the adoption of industrial policy of liberalisation and privatisation rote of private foreign capital has been recognized as important for rapid growth of the Indian economy.

Since source of bulk of foreign capital and investment are Multinational Corporation, they have been allowed to operate in the Indian economy subject to some regulations. The following are the important reasons for this change in policy towards multinational companies in the post-reform period.

Some of world's largest multinational corporations are given below:

World's Some Important Non-Financial Multinational Corporations

S.No.	*International Corporation*	*Parent Country*	*Industry of operation*
1.	General Electric	United States	Electronics
2.	Exxon Mobil Corporation	United States	Petroleum (exploring, refining and distributing)
3.	Royal Duch Shell Group	Netherland/UK	-do-
4.	General Motors	United States	Motor Vehicles
5.	Ford Motor Co.	United States	Motor Vehicles
6.	Toyata Motor Co.	Japan	Motor Vehicles
7.	IBM	United States	Computers
8.	BP	United Kingdom	Petroleum (Exp/Ref./Distt.)
9.	Nesle SA	Switzerland	Food/Beverages
10.	Nippon Oil Co.	Japan	Petroleum/Expl., Ref./Distt.
11.	Sieman AG	Germany	Electronics
12.	BMW AG	Germany	Motors Vehicles
13.	ABB	Switzerland	Electrical equipment
14.	Sony Corporation	Japan	Electronics
15.	Seagram	Canada	Food/Beverages
16.	Aventis	France	Pharmaceuticals/Chemicals
17.	Roche Group	Switzerland	Pharmaceuticals
18.	Honda Motor Co.	Japan	Motor Vehicles
19.	Phillips Electronics	Netherland	Electronics
20.	Hewlett-Packard	United States	Electronics/Computers

1. Promotion Foreign Investment:

In the recent years, external assistance to developing countries has been declining. This is because the donor developed countries have not been willing to part with a larger proportion of their GDP as assistance to developing countries. MNCs can bridge the gap between the requirements of foreign capital for increasing foreign investment in India.

The liberalized foreign investment pursued since 1991, allows MNCs to make investment in India subject to different ceilings fixed for different industries or projects. However, in some industries 100 per cent export-oriented units (EOUs) can be set up. It may be noted, like domestic investment, foreign investment has also a multiplier effect on income and employment in a country.

For example, the effect of Suzuki firm's investment in Maruti Udyog manufacturing cars is not confined to income and employment for the workers and employees of Maruti Udyog but goes beyond that. Many workers are employed in dealer firms who sell Maruti cars.

Moreover, many intermediate goods are supplied by Indian suppliers to Maruti Udyog and for this many workers are employed by them to manufacture various parts and components used in Maruti cars. Thus their incomes also go up by investment by a Japanese multinational in Maruti Udyog Limited in India.

2. Non-Debt Creating Capital inflows:

In pre-reform period in India when foreign direct investment by MNCs was discouraged, we relied heavily on external commercial borrowing (ECB) which was of debt-creating capital inflows. This raised the burden of external debt and debt service payments reached the alarming figure of 35 per cent of our current account receipts. This created doubts about our ability to fulfill our debt obligations and there was a flight of capital from

India and this resulted in balance of payments crisis in 1991. As direct foreign investment by multinational corporations represents non-debt creating capital inflows we can avoid the liability of debt-servicing payments. Moreover, the advantage of investment by MNCs lies in the fact that servicing of non-debt capital begins only when the MNC firm reaches the stage of making profits to repatriate Thus, MNCs can play an important role in reducing stress strains and on India’s balance of payments (BOP).

3. Technology Transfer:

Another important role of multinational corporations is that they transfer high sophisticated technology to developing countries which are essential for raising productivity of working class and enable us to start new productive ventures requiring high technology. Whenever, multinational firms set up their subsidiary production units or joint-venture units, they not only import new equipment and machinery embodying new technology but also skills and technical know-how to use the new equipment and machinery.

As a result, the Indian workers and engineers come to know of new superior technology and the way to use it. In India, the corporate sector spends only few resources on Research and Development (R&D). It is the giant multinational corporate firms (MNCs) which spend a lot on the development of new technologies can greatly benefit the developing countries by transferring the new technology developed by them. Therefore, MNCs can play an important role in the technological up-gradation of the Indian economy.

4. Promotion of Exports:

With extensive links all over the world and producing products efficiently and therefore with lower costs multinationals can play a significant role in promoting exports of a country in which they invest. For example, the rapid expansion in China’s exports in recent years is due to the large investment made by multinationals in various fields of Chinese industry.

Historically in India, multinationals made large investment in plantations whose products they exported. In recent years, Japanese automobile company Suzuki made a large investment in Maruti Udyog with a joint collaboration with Government of India. Maruti cars are not only being sold in the Indian domestic market but are exported in a large number to the foreign countries.

As a matter of fact until recently, when giving permission to a multinational firm for investment in India, Government granted the permission subject to the condition that the concerned multinational company would export the product so as to earn foreign exchange for India.

However, in case of Pepsi, a famous cold -drink multinational company, while for getting a product license in 1961 to produce Pepsi Cola in India it agreed to export a certain proportion of its product, but later it expressed its inability to do so. Instead, it ultimately agreed to export things other than what it produced such as tea.

5. Investment in Infrastructure:

With a large command over financial resources and their superior ability to raise resources both globally and inside India it is said that multinational corporations could invest in infrastructure such as power projects, modernisation of airports and posts, telecommunication.

The investment in infrastructure will give a boost to industrial growth and help in creating income and employment in the India economy. The external economies generated by investment in infrastructure by MNCs will therefore crowd in investment by the indigenous private sector and will therefore stimulate economic growth.

In view of above, even Common Minimum Programme of the present UPA government provides that foreign direct investment (FDI) will be encouraged and actively sought, especially in areas of (a) infrastructure, (b) high technology and (c) exports, and (d) where domestic assets and employment are created on a significant scale.

PART – B

1. What is foreign trade?

2. What is trade deficit?

3. List the measures adopted by government to correct disequilibrium in BOP.

4. Write about export promotion?
5. Write about import substitution?
6. Bring out the features of recent foreign trade policy of India.
7. What is rupee convertibility?
8. Write a note on full convertibility of rupee.
9. Write a note on partial convertibility of rupee.
10. What is special economic zone?
11. Give the facilities enjoyed by SEZ developers.

12. What is World Trade Organisation?

13. Give the objectives of WTO.
14. Mention the functions of WTO.

15. Give the causes for deficit in the balance of payments.

16. What is trade policy?

17.Bring out the features of recent trade policy.

18. What is Multi National Corporations?

19. Highlight the role of MNCs

PART – C

1. Examine the advantages of export promotion measures for a textile firm in international business.
2. Discuss why do MNCs like to indianise their operations? Give reasons.
3. Explain the measures adopted by the government to correct deficit in the BOP after 1991.
4. Discuss the setting up and the importance of SEZs.
5. Explain the concept of full convertibility of rupee.
6. Explain the export promotion measures of Government of India.
7. Discuss the implication of WTO agreement for Indian agriculture and industries.
8. Explain the mechanism of full convertibility of rupee.

PART- D

Indian consumer segment is broadly segregated into urban and rural markets, and is attracting marketers from across the world. The sector comprises of a huge middle class, relatively large affluent class and a small economically disadvantaged class, with spending anticipated to more than double by 2025. Each of the above segments makes for bigger population than the rest of the world, except China. Irrespective of what some commentators have said, Indian firms are successfully competing across entire value-chains spanning sectors. With more millionaires living in rural areas than in urban, companies are realizing the existence of huge untapped market. Appropriately several banking, FMCG, healthcare, automobile, consumer durable companies have launched innovative strategies and products tailored for them. Among these are the Unilevers, ITC, ICICI Bank, State Bank of India, P&G, LG, Samsung, Hero Honda, Maruti Suzuki, Tata Motors, etc. The transformation in India in the early years of the 21st century is remarkable! Wherever one goes, in remote villages or urban townships, one can see thousands of self-employed young men and women trying to learn more of the new skills for employability in modern-day complex businesses.

a. Explain the importance of consumerism in the context of international trade.

b. Considering the growth rate of Indian economy, Indian MNCs should concentrate on consolidating their operations at home instead of thinking of expanding in foreign markets. Highlight your views

c. Discuss the role of government with regard to trade policies to make India economically powerful.

Karpagam Academy of Higher Education
Department of Management
International Economics- 17MBAPI401B
Unit V
Multiple Choice Questions - Each Question Carries ONE Mark

S.No.	Questions	Option 1	Option 2	Option 3	Option 4	Answers
1	Which American industry has least been affected by import competition in recent years	Automobiles	Steel	Radios and TVs	Computer software	Computer software
2	The largest amount of trade with the United States in recent years has been conducted by:	Canada	Germany	Mexico	United Kingdom	Canada
3	For the United States, exports plus imports are about ______ of its gross national product:	5 percent	10 percent	25 percent	55 percent	25 percent
4	Major trading partners of the United States including all of the following countries except	Canada	Mexico	China	North Korea	North Korea
5	For the United States, automobiles are	Imported, but not exported	Exported, but not imported	Exported and imported	Neither imported not exported	Exported and imported
6	The most recent wave of globalization, which began in the 1980s, has emphasized the outsoursing of	services and white-collar jobs	manufacturing and blue-collar jobs	natural resource extraction and mining jobs	agriculture and farming jobs	services and white-collar jobs
7	Globalization of a business will be trigged by ____________ factors	2	3	4	5	2
8	____________ may be defined as the substitution of a domestic source of supply for a foreign source of supply	Swipe-off effect	Spin-off effect	Export Substitution	Import Substitution	Import Substitution
9	The emergence of global village has been facilitated by the ________ revolution.	regional	transportation.	business.	communication.	communication.
10	A global company can leverage its experience to expand it ____________.	resources	financial operations	global operations	competition.	global operations

11	As a part of W.T.O guidelines, Agreement on Agriculture doesnt consider	direct payments to farmers are permitted	indirect assistance and support to farmers including R & D support by govt. are not permitted.	domestic policies which directly effect on production and trade have to be cut back.	least developed countries do not need to make any cuts.	indirect assistance and support to farmers including R & D support by govt. are not permitted
12	The world trade organization was formed in the year ___________ with GATT as it basis.	1993	1994	1995	1996	1995
13	Which one of the following is not a cause but a consequence of Globalization?	Deregulation abroad.	Integration of Markets	Technology and know-how.	Greater institutionalization abroad.	Integration of Markets
14	When did the government introduced a new export / Import Policy?	1994	1993	1992	1990	1992
15	What is the percentage of Indias export trade in 1965 to 1966?	65 percentage	72 percentage	86 percentage	92 percentage	72 percentage
16	What is EO?	Export Online	Export Obligation	Export Oil refineries	Export Offer.	Export Obligation
17	___________ is the global body dealing with trade between nations	WTO	WHO.	GATT	FERA	WTO.
18	_____________ act was implemented to regulate foreign exchange and foreign securities dealings.	IEO	SERA	FERA.	GATT.	FERA
19	Export policy resolution in 1970 was______________.	human relation	marketing function	quality control.	promoting wealth.	quality control
20	The export policy resolution was started in the year ____________.	1966	1970	1982	1994	1970
21	Indias rank in export is ____________.	2	5	7	10	5

22	Expand ECGC	Export Credit Guarantee column	Export Credit Guarantee council.	Export credit Guarantee Corporation	None of these	Export credit Guarantee Corporation
23	Exports are generally classified into traditional product and _____________.	international product	non-traditional product	manufacturing products	cosmetic Products	cosmetic Products
24	_____________ is the process of earning money by selling products and services in foreign market.	Trade.	Export.	Import.	EXIM	Export.
25	With the globalization of markets, the tastes and preferences of consumers world-wide are	becoming similar to the tastes and preferences of American consumers	so different that they can be ignored by international organizations	being encouraged by multinational organizations to become increasingly similar.	converging upon a global norm	converging upon a global norm
26	Which of the following represents a company's effort to identify and categorize groups of customers according to common characteristics	Global positioning	Global targeting	Global market segmentation.	Global marketing research.	Global market segmentation
27	A global market leader is an organization which ________________.	has the monopoly over several foreign markets.	is ahead of the competition in terms of global innovation	is recognized as being ahead of the rest in terms of market share	has more than 50% global market share.	is ahead of the competition in terms of global innovation.
28	The foreign trade Development and Regulation Act 1992 has replaced the earlier _________.	Societies registration act.	Import & Export control Act 1947	Board of 962.	Export policy resolution, 1970.	Import & Export control Act 1947

29	Which of the following is a not export promotion measure?	Duty Drawback	Excise Exemption Facilities	Fiscal Benefit	Commodity Board	Commodity Board
30	Export Promotion council for Apparel is located in ______________.	Chennai.	Mumbai	Kolkatta.	New Delhi	New Delhi
31	Export promotion council for engineering goods is situated at ___________.	Chennai.	Kolkata.	Mumbai.	New Delhi.	Kolkata.
32	What is the underlying characteristic of the WTO?	It facilitates economic co-operation between different countries.	It resolves disputes between economic trade blocks	It facilitates the development of less developed countries	It acts as an umbrella institution that regulates the agreements concluded at the Uruguay round,	It acts as an umbrella institution that regulates the agreements concluded at the Uruguay round, the
33	The institution of Board of Trade was first constituted in ____________.	1961	1962	1963	1964	1962
34	The Projects & Equipment Corporation of India is a subsidiary body of ____________.	The Board of Trade.	Indian Council of Arbitration	Indian Institute of Foreign Trade.	State Trading Corporation.	State Trading Corporation.
35	Which one among the following is widely employed strategy of export promotion?	Export credit.	Market Development Assistance.	Production Assistance.	Export Incentives.	Export Incentives.
36	An export house is a registered exporter who satisfied certain criteria laid down in ____________.	the export promotion policy	the EXIM policy	the export trade policy.	the foreign trade policy.	the foreign trade policy.
37	Export orders or contracts normally stipulate that the buyer should open a ____________ in favour of exporter.	bank account	letter of credit	bill of lading	document of acceptance	letter of credit
38	Globalization is a challenge of the ___________.	sixties	seventies.	eighties.	nineties	nineties

39	LPG means __________.	Liberalization, Privatization and Globalization.	Leadership, Promotion and Goal Setting	Liberalization, Promotion and Globalization	Leadership, Privatization and Globalization.	Liberalization, Privatization and Globalization.
40	__________ has been fostered to a large extent of technological revolution	Liberalization	Privatization.	Globalization.	Modern exports	Globalization.
41	Global business encounters different ___________ in different countries across the world.	legal systems.	trade policies	fiscal policies.	business policies	legal systems.
42	Products meant by export are exempted from the imposition of __________	excise duty.	customs duty	sales tax.	port duty.	excise duty
43	Excise duty will be paid during _____________ stage	exporting.	manufacturing.	distributing	marketing.	manufacturing.
44	JDGFT means ______________.	Joint Deputy General of Foreign Trade	Joint Director General of Foreign Trade	Joint Deputy General of Frequent Trade.	Joint Director General of Frequent Trade	Joint Director General of Foreign Trade
45	Net exports equal:	Exports x Imports	Exports + Imports	Exports - Imports	Exports of services only	Exports - Imports
46	International trade disputes handled by the WTO under the auspices of the	International Court of Justice	Dispute Settlement Body	International Chamber of Commerce Arbitration Panel	World Court	World Court
47	Which Act replaced the earlier Act which used to be called as Import and Export (Control) Act 1947?	FTDR Act 1992	FTR Rules 1993	SEBI Act 1992	FEMA ACT 1999	FTDR Act 1992
48	EXIM policy is also called as	Foreign trade Policy	Export policy	Import policy	trade policy	Foreign trade Policy
49	Under which section of FTDR Act 1992 the central Govt. notifies the EXIM policy for a period of 5 years	2	3	4	5	5

50	The EXIM policy is updated every year on	31st December	31st March	30th September	1st April	31st March
51	When SEZ Act was passed?	2002	2003	2004	2005	2005
52	FDI limit in SEZs is	24%	51%	74%	100%	100%
53	In India, exports and imports are regulated by the-____	FTDR Act	RBI Act	SEBI Act	Companies Act	FTDR Act
54	______ refers to the policy measures adopted by a country with reference to its exports and imports.	EXIM policy	Economic policy	Fiscal policy	Monetary policy	EXIM policy
55	How many members are there in WTO at present?	152	154	159	162	159
56	An OBU set up in SEZ by a bank in India is subject to	No Capital Adequacy Norms	No prudential Accounting Norms	No CRR/SLR stipulation of RBI	No restrictions from Govt of India	No restrictions from Govt of India
57	Which round of international trade negotiations resulted in the creation of the World Trade organisation ?	Kennedy Round of 1964-1967	Tokyo Round of 1973-1979	Uruguay Round of 1986-1993	Doha Round of 2003-2007	Uruguay Round of 1986-1993
58	The institutional framework developed in 1947 to promote trade liberalization is known as	the WTO	the GATT	the IMF	the World Bank	the GATT
59	MNC means _______________.	Multi-National Competition	Multi-Nodel Corporation	Multi-National Corporation.	Multi-Nodel Competition	Multi-National Corporation.
60	The export proceeds shall be realized in	Any foreign currency	Non-convertible currency	Convertible currency	Home currency only	Convertible currency