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INTERNATIONAL ECONOMICS

Fifth Edition

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Fifth Edition

Francis Cherunilam

*Director, Albertian Institute of Management
Cochin*



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To
The Invisible Hand

Preface to the Fifth Edition

The field of international Economics is very dynamic, characterised as it is by almost continuous changes in many variables which shape the structure and nature of the global economy and set the trends.

This book has been revised to incorporate the significant changes and trends since the publication of the last edition about two years ago.

The salient features of the current edition are:

- Updating of statistics throughout the text
- Incorporation of several new statistical tables and diagrams
- Significant modification of the chapter on *Global Trade*, capturing the emerging trends in trade flows.
- Addition of a section on *Exchange Rate Policies and Trends in respect of the Rupee since 1957* with special focus on the recent trends in the external value of Rupee and its implications, in Chapter 18.
- Modification of the section on *Capital Account Convertibility* of Indian Rupee in the light of Report of the Tarapore Committee Report II in Chapter 18.
- Incorporation of a section on *Foreign Exchange Reserves of India* in Chapter 19.
- Modification of Chapter 21 incorporating the emerging trends in international capital flows.
- Modification of the Chapter on trade and BOP of India so as to reflect the emerging trends.

These modifications and revisions make this book more contemporary and useful.

The author is very grateful to the management and the teaching and non-teaching staff of the Albertian Institute of Management and St. Albert's College, Cochin, and McGraw-Hill Education, particularly to Tapas Maji, Biju Kumar and Hemant Jha for all their help and encouragement.

Dr FRANCIS CHERUNILAM

Preface to the First Edition

International economics is one of the most important branches of the dynamic discipline of economics. The subject becomes complex and therefore interesting because of the conjuncture of economic factors, international politics, socio-demographic overtones and geo-physical factors. Despite conflicting national interests and even rivalries in many cases, economic transactions of one or other type, directly or indirectly, between nations, have become almost inevitable because in today's dynamic world no nation can be self-sufficient or self-reliant in all respects.

Due to the conflicting national interests, couched in socio-political and economic factors, international economic relations, are often far from cordial and healthy. The problems plaguing the East–West and North–South economic relations are well known. Yet they defy lasting solutions due to conflicting interests, unequal bargaining strengths, preponderance of politics over economics, and so on.

It is obvious that the developing countries lose in international bargaining vis-a-vis the developing countries. The international institutions, by and large, have failed to accord a fair treatment to the poor economies. Institutions and forums which were expected to take particular care of the needs of the developing countries, too, have failed to make any major contribution. It is no wonder, therefore, that the international economic gap has been widening alarmingly.

Despite the fact that many renowned economists such as Milton Friedman strongly advocate free trade, protectionism is increasing. Even a country like the United States, which was once seen a champion of free enterprise and free trade, is increasing protectionism. Some recent developments in the trade relations between the US and Japan are interesting manifestations of emerging international economic trends.

The study of economics is incomplete without an understanding of international economy. It is, therefore, quite natural that this subject is an integral part of the undergraduate and postgraduate courses in economics in almost all universities. There is, however, a dearth of good textbooks on this subject by Indian authors. This book aims to serve as a concise and comprehensive textbook for postgraduate students of international economics. While giving an analytical and critical account of theories and issues, care has been taken to treat the subject matter systematically and lucidly so that an average student can easily understand it.

This work has been made possible by the encouragement and assistance of a number of people. In this context, I must particularly mention the name of Prof M Madaiah, Chairman, Department of Postgraduate Studies and Research in Economics and Cooperation, who helped me not by providing valuable guidance on a number of occasions but also by supplying a lot of valuable reference material from his personal collection. I am indebted to my friend Dr S Udayashankar, Reader, Department of Economics, St Aloysius College, Mangalore, who gladly permitted me to quote at any length from his thesis entitled “New International Economic Order and Less Developed Countries with Particular Reference to India”. My thanks are due to Mr V Rangachari for impeccably typing the manuscript and to Mr B S Ragavendra Rao, cartographer, Department of Postgraduate Studies and Research in Geography, University of Mysore, who has drawn the neat diagrams for this book. I take this opportunity to express my gratitude to the staff of the Mysore University Library, particularly to Mr K S Rangaswamy, Mysore University Undergraduate

Library, Library of the Institute of Correspondence Course and Continuing Education, Mysore, and the Library of the Administrative Training Institute, Mysore. I would also like to acknowledge my gratitude to the faculty members of the School of Management Studies and the Department of Applied Economics, Cochin University of Science and Technology, and the staff of the libraries of the School of Management Studies and the Department of Applied Economics. Finally, I am very grateful to Tata McGraw-Hill Publishing Company for the interest they have evinced in this work and for the guidance and assistance rendered by them for its completion.

Dr FRANCIS CHERUNILAM

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PART ONE

International Economics and the Global Economy

1

CHAPTERS

- ❖ Introduction
- ❖ International Economic Gap and NIEO
- ❖ Global Trade
- ❖ Globalisation

CHAPTER I

1

Introduction

LEARNING OBJECTIVES

- ☐ To understand the meaning, nature and scope of international economics.
- ☐ To get a broad picture of the global economy.
- ☐ To know the common characteristics of developed and developing economies.
- ☐ To get an idea of the factors promoting global economic integration.
- ☐ To examine the position of India in the emerging global economy.

MEANING, NATURE AND SCOPE OF INTERNATIONAL ECONOMICS

International Economics deals with those international forces which influence the domestic economic conditions as well as those which shape the economic relationship between countries, world economic integration and transition. The scope of the subject is very broad and the elements very intricate.

International economics deals with the economic interdependence among countries and includes the effects of such interdependence and the factors which affect it.

International economics, which emerged as a 'specialistic' field of economics long ago, has developed in depth and width over time by a lot of theoretical, empirical and descriptive contributions.

The need for development of this distinct branch of economics was justified by a number of important factors. Economic activities between countries are made different from those within the countries by the fact that factors of production are generally less mobile between countries than within the country. In fact, the international trade theories have been based on the traditional assumption that factors of production are perfectly mobile within the country and completely immobile between countries. Simultaneously, it is assumed that goods are perfectly mobile both within and between countries but for government restrictions in some cases. Indeed, the impact of different types of government restrictions on trade, production, consumption and income distribution is an important area of study in international economics.

Theoretical and Descriptive International Economics

Like many other disciplines, international economics also has two distinct parts—theoretical and descriptive.

International Economics consists of theoretical and descriptive parts.

Theoretical International Economics The “theoretical part tries to go beyond the phenomena to seek general principles and logical frameworks which can serve as a guide to the understanding of

Theoretical International Economics has two components, viz., pure and monetary theories.

actual events (so as, possibly, to influence them through policy interventions). Like any economic theory, it uses for this purpose abstractions and models, often expressed in mathematical form. The theoretical part can be further divided... into pure and monetary theory, each containing aspects of both positive and normative economics, although these aspects are strictly intertwined in our discipline".¹

The theoretical part of international economics may be divided into pure theory of international trade and international monetary economics.

The *pure theory of international trade*, which has a micro-economic nature, covers a very wide area. The pure theory encompasses mainly the following:

- The bases or causes of trade and the pattern of trade.
- Effect of trade on production, consumption and distribution of income.
- Effect of trade on relative factor prices and product prices.
- Gains from trade and distribution of the gains.
- Effect of trade barriers on trade, factor and product prices and income distribution.
- Effect of trade on economic growth and vice versa.

The *international monetary theory*, which is of a macro economic nature, deals with matters pertaining to balance of payments and international monetary system. It covers areas such as causes and methods of correcting balance of payments disequilibria, exchange rate determination, international liquidity, relationship between balance of payments position and other macro-economic variables etc.

Descriptive International Economics The descriptive part is concerned with the description of international economic transactions just as they happen and of the institutional (including the policy) environment in which they take place. This covers international trade flow of goods and services, flow of international financial and other resources, international organisations like IMF, World Bank, Regional Development Banks, WTO, UNCTAD etc. international economic agreements (including trade blocs) and so on.

Descriptive International Economics explains international economic transactions and the relevant institutional environment.

International trade is only one, albeit important, part of international economics.

Business strategies, particularly of the large corporations, such as multinational investments, production sharing and global sourcing, joint venturing and other alliances etc. have been increasingly fostering world economic integration and transnationalisation. These forces will gather more momentum in the future. However, the literature on international economics does not appear to be giving due importance to the role of business strategies in shaping the world economic transition.

This chapter provides a short description of some of the important characteristics and trends of global economy and India's position in it.

FEATURES OF GLOBAL ECONOMY

The global economy is made up of a large number of politically independent nations which have different types and degree of interdependencies and very diverse economic characteristics between and within them. According to the World Bank's annual publication *World Development Report* (WDR) 2006, there were 209 economies in the world with a population of 30,000 or more each. These countries are often classified into different categories on the basis of per capita income (i.e. the average annual income per person) level and other development indicators.

Categories of Economies

Low, High and Middle Income Economies On the basis of the per capita income, countries are broadly classified as low income, middle income and high income economies.

There are four income classes of nations.

Low Income Economies (LIC) are economies with very low level of per capita income. All economies with per capita GNI of \$875 or less in 2005 are regarded as low income economies. There were 54 low income economies in 2005.

[Gross national income (GNI—formerly gross national product or GNP), the broadest measure of national income, measures the total value added from domestic and foreign sources claimed by residents. GNI comprises gross domestic product (GDP) plus net receipts of primary income from foreign sources.]

High Income Economies (HIC) are countries with very high per capita income. Those with a per capita GNI of \$10,726 or above in 2005 fall in the category of high income economies. In 2005, there were 57 high income economies. There are mainly two categories of high income economies—industrial economies and oil exporters. Industrial economies are developed economies.

Middle Income Economies (MIC) are those falling in between the low income economies and high income economies.

Middle income economies are subdivided into *lower middle income* (those with per capita GNI between \$876 and \$3,465 in 2004) and *upper middle income* (\$3,466–\$10,725) economies (UMC). In 2004, there were 98 middle income economies. Large majority of them were lower middle income economies.

Table 1.1 Some Economic Comparisons, 2005

Country/ Region	GNI		GNI (PPP)		GNI Per capita (Dollars)	GNI (PPP) Per capita (Dollars)
	\$ billion	Rank	\$ billion	Rank		
USA	12,969.6	1	12,438	1	43,740	41,950
Japan	4,988.2	2	4,019	3	38,980	31,410
Germany	2,852.3	3	2,409	5	34,580	29,210
China	2,263.8	4	8,610	2	1,740	6,600
U K	2,263.7	5	1,968	6	37,600	32,690
France	2,177.7	6	1,855	7	34,810	30,540
Italy	1,724.9	7	1,657	8	30,010	28,840
Spain	1,100.1	8	1,120	10	25,360	25,820
Canada	1,051.9	9	1,040	11	32,600	32,220
India	793.0	10	3,787	4	720	3,460
Mexico	753.4	11	1,034	12	7,310	10,030
Brazil	644.1	12	1,534	9	3,460	8,230
World	44,983.3	—	60,644	—	6,987	9,420
High Income Countries	35,528.8	—	32,893	—	35,131	32,524
Middle Income Countries	8,113.1	—	22,115	—	2,640	7,195
Low Income Countries	1,363.9	—	5,849	—	580	2,486

Source: World Bank, *World Development Report 2007*.

International comparisons of GNI and per capita income in a nominal currency unit (say US dollar) do not reflect a realistic picture because the purchasing power of the national currencies vary. Further, exchange rate changes would give a misleading picture of the economic position of the country when

Purchasing power parity is a better measure for certain international comparisons.

the income is converted into dollar from the national currency. For example, if the national currency has depreciated against the dollar at a rate higher than the GNI growth rate, when the GNI is converted into dollar, it will show a decline even though the GNI has actually increased in terms of the national currency. To overcome such problems, it has become a common practice to estimate the gross national income (GNI) and per capita income at *purchasing power parity* (PPP) too. For example, in 2005, the per capita GNI of India was estimated at \$720; in PPP terms it was estimated at \$3,460. What it means is that a bundle of goods which costs \$720 in India will cost \$3,460 in the US. In other words, \$720 in India is equivalent to \$3460 in USA. In 2005, India's PPP GNI was \$3,787 while it was \$793 in nominal dollars. Although Norway had the highest per capita GNI in 2005 (\$59,590), its PPP GNI (\$40,420) was lower than that of the US (\$41,950).

The geographical distribution of the economies presents an interesting picture. Most of the low income economies are in Sub-Saharan Africa (consisting of Eastern and Southern Africa and West Africa), Asia, Eastern Europe and Central Asia. The middle income economies are spread in all major regions of the world. Most of the high income economies are in Europe and Central Asia, Americas, East Asia and Pacific, and the Middle East. Sub-Saharan Africa, North Africa and South Asia hardly have any high income economy while East and Southern Africa, Eastern Europe and Central Asia had just a few.

The low income economies are sometimes referred to as the third world (the high income and middle income economies representing the first and second worlds).

Developing and Developed Economies

Developing and developed economies/countries are often used terms. The use of these terms is convenient; it is not, however, intended to imply that all economies in the group of developing are experiencing similar development or that other economies have reached a preferred or final stage of development.

Low income and middle income economies are developing economies. It may be noted that the term third world does not cover all developing economies—it covers only the low income economies. The developed economies as a group are sometimes referred to as the *North* as they, with some exceptions such as Australia and New Zealand, are in the northern hemisphere and the developing economies are referred to as the *South* as most of them are in the southern hemisphere.

Classification by income does not necessarily reflect development status. In the group of high income economies, the industrial economies are developed economies; but all the high income economies are not developed economies (for example, countries such as Kuwait and UAE, though high income economies, are regarded as developing economies). Besides income, some other criteria such as the sectoral distribution of the income and employment generation, social development indicators etc. are applied to consider whether an economy is a developed or developing one.

According to the *Human Development Report 2007*, there were 137 developing countries or areas. Besides, 28 countries or areas in the Central and Eastern Europe and the Commonwealth of Independent States (CIS) are also developing economies.

Sometimes the terms less developed countries (LDCs) and more developed countries (MDCs) are used to refer to the developing and developed countries. The use of the term underdeveloped to refer to the developing countries is also common.

The United Nations Economic and Social Council has identified a special category of low income economies known as the least developed countries (LDCs—as the same short form is used for both the less developed and least developed countries it could sometimes create confusion). A number of criteria are used as the basis for the identification such as a very low GNP per capita, low levels of human development (a combined health, nutrition and education index) and economic vulnerability (a composite index based on indicators of instability, inadequate diversification and the handicap of small size). According to the *Human Development Report 2007*, there were 50 least developed countries or areas, including Bangladesh, Bhutan, Nepal, Maldives, Mali, Uganda, Myanmar, Sudan, Zambia, Zimbabwe and Yemen. The least developed countries are home to about 10 per cent of the world's population.

Newly Industrialising Economies The newly industrialising economies are those developing economies which have been experiencing rapid industrialisation such as Hong Kong, South Korea, Singapore and Taiwan (i.e. Taipei, China)—the Asian Tigers. Some publications use the term newly industrialised (instead of industrialising) to refer to them. They are also referred to as emerging market economies (EMEs). Now, Peoples' Republic of China is regarded as a newly industrialising economy.

Over a long period, the newly industrialising economies have shown a very high growth rate of economy and per capita income. They have also been presenting very impressive export performance.

Transition Economies The term transition economies refers to those economies which are in a transition from the centralised economic system to the market economy. The transition economies, thus, are the former communist/socialist economies like erstwhile USSR, (i.e. the present CIS) and East European countries which are undergoing an economic (system) transition. They also represent a transition from authoritarianism to democracy.

CHARACTERISTICS OF DEVELOPED ECONOMIES

As indicated earlier, income is not the only criterion to consider a country as developed. There is indeed some important difference between economic growth and development. An increase in income is an indication of economic growth. Economic development, besides growth, has some qualitative dimensions too, such as the distribution of income, standard of living, composition of output, characteristics of working conditions and over all improvement in economic welfare.

Kindleberger and Herrick observe: "Economic development is generally defined to include improvements in material welfare, especially for persons with the lowest incomes, the eradication of mass poverty with its correlates of illiteracy and disease and early death, changes in the composition of inputs and outputs that generally include shifts in the underlying structure of production away from agricultural towards industrial activities, the organisation of the economy in such a way that productive employment is general among the working age population rather than the situation of a privileged minority, and the correspondingly greater participation of broadly based groups in making decisions about the directions, economic and otherwise, in which they should move to improve their welfare."²

Developed economies are characterised by high per capita income, well developed social infrastructure and widespread use of modern technology and amenities.

Amartya Sen has added certain human rights to the dimensions of development. According to him, development requires the removal of major sources of unfreedom: poverty as well as tyranny, poor

economic opportunities as well as systemic social deprivation, neglect of public facilities as well as intolerance or over-activity of repressive states. Despite unprecedented increases in overall opulence, the contemporary world denies elementary freedom to vast numbers—perhaps even the majority—of people.³

The UNCTAD in its annual publication *Human Development Report* uses some composite indices, like human development index (HDI), human poverty index (HPI), and gender related development index (GDI) to indicate the level of welfare or deprivation in an economy. Definition of these terms are given in the *Annexure* to this chapter.

It is interesting to note that in a number of cases, countries which have the same HDI value have substantially different per capita income levels. For example, Luxembourg and Ireland have fairly similar HDI value (about 0.9—the maximum is 1.0) but their per capita incomes differ substantially. This clearly indicates that income alone is not a satisfactory indicator of the economic and social welfare. It may also be noted that the Indian State of Kerala has a fairly high HDI although its per capita income is nothing to be proud of compared to other states of India, let alone other countries.

Besides the income and social dimensions, there are a number of common characteristics of developed economies. For example, widespread use of modern and sophisticated technology; continuous innovations; fast diffusion of new ideas and technologies; low share of the primary sector and dominance of the tertiary (service) sector and secondary (mostly manufacturing) sector in the income and employment generation; market friendly economic policies; comparatively open trade and investment policies; democratic rights; competition and consumer choice etc.

Although the developed countries are characterised by general affluence, they are marred by patches of poverty. It may, however, be noted that the definition of basic necessities of life or poverty in a developed country may be different from that in a developing country.

CHARACTERISTICS OF DEVELOPING ECONOMIES

Low income is just an indication of deprivation. It prevents access to even basic necessities, not only better and modern amenities.

Further, in developing economies the inequality in the distribution of income is very high and, as a result, a large proportion of the population lives in abject poverty. Although many countries have achieved considerable reduction in poverty, the incidence of poverty is still very high in many countries.

Dimensions of Poverty

The magnitude of global poverty is indeed alarming. What follows is an account of the dimensions of poverty, adapted from the World Bank's *World Development Report 2000–2001*.

Almost half of the world's people live on less than \$2 a day and about a fifth live on less than \$1 a day.

Poverty has several dimensions and manifestations.

In rich countries fewer than one child in 100 does not reach its fifth birthday, while in the poorest countries as many as a fifth of children do not. And while in rich countries fewer than five per cent of all children under five are malnourished, in poor countries as many as 30 per cent are.

The development experience in different parts of the world has been very diverse. In East Asia the number of people living on less than \$1 a day fell from around 420 million to around 280 million between 1987 and 1998—even after the setbacks of the financial crisis. Yet in Latin America, South

Asia and Sub-Saharan Africa the numbers of poor people have been rising. In the countries of Europe and Central Asia the number of people living on less than \$1 a day rose more than twenty fold. There have also been major advances and serious setbacks in crucial non-income measures of poverty. India has seen marked progress in girls attending school, and in the educationally most advanced state, Kerala, life expectancy is greater than in other places with many times the level of income (such as Washington, D.C.).

Social development indicators present a very highly divergent picture across the world. Experiences are also vastly different at sub-national levels and for ethnic minorities and women. Inequalities also exist across different ethnic groups in many countries. In some African countries infant mortality rates are lower among politically powerful ethnic groups, and in Latin American countries indigenous groups often have less than three-quarters the schooling on average of non-indigenous groups. And women continue to be more disadvantaged than men. In South Asia, women have only about half as many years of education as men, and female enrollment rates at the secondary level are only two-thirds the male rates.

One route for investigating the causes of poverty is to examine the dimensions highlighted by poor people which include the following:

- Lack of income and assets to attain basic necessities—food, shelter, clothing, and acceptable levels of health and education.
- Sense of voicelessness and powerlessness in the institutions of state and society.
- Vulnerability to adverse shocks, linked to an inability to cope with them.

To understand the determinants of poverty in all its dimensions, it helps to think in terms of people's assets, the returns to (or productivity of) these assets, and the volatility of returns. These assets are of several kinds:

- *Human assets*, such as the capacity for basic labour, skills, and good health.
- *Natural assets*, such as land.
- *Physical assets*, such as access to infrastructure.
- *Financial assets*, such as savings and access to credit.
- *Social assets*, such as networks of contacts and reciprocal obligations that can be called on in time of need, and political influence over resources.

The returns to these assets depend on access to markets and all the global, national, and local influences on returns in these markets. But returns depend not just on the behaviour of markets, but also on the performance of institutions of state and society. Underlying asset ownership and returns to assets are not only economic but also fundamental political and social forces. Access to assets depends on a legal structure that defines and enforces private property rights or on customary norms that define common property resources. Access may also be affected by implicit or explicit discrimination on the basis of gender, ethnicity, race, or social status. Both access to assets and returns to assets are affected by public policy and state interventions, which are shaped by the political influence of different groups. Also important is the volatility of returns, which results from market fluctuations, weather conditions, and, in some societies, turbulent political conditions. Volatility affects not only returns, but also the value of assets, as shocks undermine health, destroy natural and physical assets, or deplete savings.

Poor people consistently emphasise the centrality of work to improving their lives. A country's overall wealth is an important influence on this: as countries grow richer, so on average do poor people in those countries, with the main mechanism being better-paid work.

With economic growth, income poverty falls; with economic contraction, income poverty rises. Some countries in East Asia sustained per capita GDP growth rates of 4–5 per cent over four decades, with massive improvements in living standards and in health and education for poor people and for everyone else. Other countries, most in Africa, registered negative growth or no growth at all over the same period, delivering no improvements even in average living standards.

While economic growth is systematically associated with poverty reduction, the rate at which growth translates into lower poverty depends on the initial level of inequality in the distribution of income and how that distribution changes over time. Growth—and its effectiveness in reducing poverty—also depends on sound and stable governance. So confronting socio-economic inequalities and building sound institutions can be important both for providing a socially sustainable basis for overall growth and for ensuring that poor people gain substantially from that growth.⁴

Developing countries rank very low in human development index (HDI). With an HDI value of 0.595, India ranked 127 among the 177 nations for which the index was calculated for 2002. India's HDI value is lower than the average for the developing countries (0.663). India falls within the category of medium human development countries. The developing countries present a very poor picture in respect of HPI also.

Following are some more dimensions of poverty and common features of the developing countries as listed down by Harvey Leibenstein⁵ (The characteristics have been reproduced here with a little modification necessitated by the change of time. Leibenstein's work was published in 1957.)

Economic

(a) General Characteristics

1. A very high proportion of the population in agriculture. Even now about 70 per cent of the population of India depends on agriculture although agriculture now contributes only little over one-fifth of the GDP.
2. "Absolute over-population" in agriculture; that is, it would be possible to reduce the number of workers in agriculture and still obtain the same total output.
3. Evidence of considerable "disguised unemployment" and a lack of employment opportunities outside agriculture.
4. Very little capital per head.
5. Low income per head and, as its consequence, existence near the "subsistence" level.
6. Practically zero savings for the large mass of the people.
7. Whatever savings do exist are usually achieved by a landholding class whose values are not conducive to investment in industry or commerce. However, as the economy develops savings of other classes grow in importance.
8. The primary industries, such as agriculture, forestry and mining, are usually the residual employment categories.
9. The output in agriculture is made up mostly of cereals and primary raw materials, with relatively low output of protein foods.
10. Major proportion of expenditures on food and necessities.
11. Export of foodstuff and raw materials. However, manufacture now account for nearly three-fourth of India's total merchandise exports. This is a common trend in respect of developing countries.

Developing economies are characterised by high dependence on primary sector, low savings and investments, low household incomes and poor living conditions.

12. Low volume of trade per capita. In the recent decades the volume of trade of many developing countries has, however, increased substantially.
13. Poor credit and marketing facilities.
14. Poor housing.

(b) Characteristics in Agriculture

1. Although there is low capitalisation on the land, there is simultaneously an uneconomic use of whatever capital exists due to the small size of holdings and the existence of exceedingly small plots.
2. The level of agrarian techniques is exceedingly low and tools and equipment are limited and primitive in nature.
3. Even where there are big landowners, the openings for modernised agricultural production for sale are limited by difficulties of transport and the absence of an efficient demand in the local market. It is significant that in many backward countries a modernised type of agriculture is confined to production for sale in foreign markets.
4. There is an inability of small landholders and peasants to weather even a short-term crisis, and as a consequence, attempts are made to get the highest possible yields from the soil, which leads to soil depletion.
5. There is a widespread prevalence of high indebtedness relative to assets and income.
6. The methods of production for the domestic market are generally old fashioned and inefficient, leaving little surplus for marketing. This is usually true irrespective of whether or not the cultivator owns the land, has tenancy rights, or is a sharecropper.
7. A most pervasive aspect is a feeling of land hunger due to the exceedingly small size of holdings and small diversified plots, the reason for this is that holdings are continually subdivided as the population on the land increases.

Agricultural sector of developing countries has many handicaps.

Demographic

1. High fertility rates. As a consequence, the population growth rate in countries like India is still very high.
2. High mortality rates and low expectation of life at birth. Although the life expectancy in India has significantly increased over time, it is still very low even in comparison with several other developing countries.
3. Inadequate nutrition and dietary deficiencies. A very large number of people continue to be below the poverty line.
4. Rudimentary hygiene, public health and sanitation.
5. Rural overcrowding.

High birth and death rates, fast population growth, and poor health and sanitation are common to developing countries.

Cultural and Political

1. Rudimentary education and usually a high degree of illiteracy. Although the literacy rate in India has increased from about 18 per cent in 1951 to 65 per cent in 2001, it is much below than in several other developing countries. The literacy rate among females was only 54 per cent in 2001.

Cultural and political factors are also responsible for the socio-economic backwardness of developing nations.

2. Extensive prevalence of child labour.
3. Inferiority of women's status and position.
4. Traditionally determined behaviour for the bulk of the populace.

Technological and Miscellaneous

1. Low yields per acre.

Developing countries are technologically backward.

2. Inadequate and crude communication and transportation facilities, especially in the rural areas.
3. Existence of crude technology in many spheres.

Benjamin Higgins points out⁶ that the developing countries are characterised by the existence of what he calls *vicious circle* where each characteristic has a hen-and-egg nature that makes it impossible to separate causes from effects. The factors act and react upon each other creating a vicious circle and perpetuating the problem. For example, poverty is the cause and consequence of poverty and vice versa. Because of poverty the savings are very low and consequently the investment is also low. Because of low investment income generation is low, thus creating a vicious circle.

As Higgins very aptly puts it, "Being underdeveloped in the technical sense means nothing in terms of the level of civilisation, culture, or spiritual values. It might be a good idea to organise a "reverse technical assistance programme" with experts from the so-called underdeveloped countries being sent to the West to teach us some of their arts and skills. Mechanics in some Asian countries have much to teach those of the West, who can only replace damaged or worn parts with new ones and do not really know how to fix things as Asians do."⁷

REGION STATES

It is very common to consider a nation as an economic unit. There may, however, be vast differences in the economic conditions and other factors relevant to business between the different regions of a country, particularly if the country is geographically vast and culturally diverse. For example, different regions of India shows significant diversities. Even different parts of the same state are dissimilar in several respects.

When the different regions of a national economy show great diversity, it may not be appropriate to regard it as a single economic unit. Kenichi Ohmae, well known Japanese management expert and

Substantial economic diversity between regions of a country makes the concept of region state very relevant.

renowned author, argues that "nation states are no longer meaningful units in which to think about economic activity. In a borderless world, they combine things at the wrong level of aggregation".⁸ Ohmae points out that in a borderless economy, the units that do make sense are region-

states, i.e. geographical units which are natural economic zones. They may or may not fall within the boundaries of a particular nation.⁹

The concept of Region State which Ohmae suggested in his *The Borderless World* has been elaborated in *The End of the Nation State: The Rise of Regional Economies*.¹⁰ He points out that the economies of nation states are not monolithic. In the real world there is no such thing as an average Italy or France or Japan or United States. For managers, such statistics are useless statistical abstractions—and misleading abstractions at that. In other words, in the borderless world, the boundaries that make sense exactly at the bottom are the natural business units—the sufficient, correctly sized and scaled aggregations of people and activities—through which to tap into the economy. One way to consider this is to observe the flows of what he calls the four "I"s: Investment; industry; information technology and individual consumers.

Investment is no longer geographically constrained. Now, wherever you sit in the world, if the opportunity is attractive, the money will come in. *Industry* is also far more global in orientation than it was a decade ago. The strategies of modern MNCs are no longer shaped and conditioned by reasons of the state but rather by the desire—and the need—to serve attractive markets wherever they exist and to tap attractive pools of resources wherever they sit. The movement of both investment and industry has been greatly facilitated by *information technology* which now makes it possible for a company to operate in various parts of the world without having to build up an entire business system in each of the countries where it has a presence. Finally, *individual consumers* have also become more global in orientation. With better information about lifestyles around the globe, they are much less likely to want to buy—and much less conditioned by government injunctions to buy—from any particular source merely because of their national associations. Consumers increasingly want the best and the cheapest products, no matter where they come from.

Ohmae suggests that taken together, the mobility of these four “I”s makes it possible for viable economic units in any part of the world to pull in whatever is needed for development. They need not look for pools of resources close to home. Nor do they need to rely on the formal efforts of governments to attract resources from elsewhere and funnel them to the ultimate users. This makes the traditional “middleman” function of nation states—and of their governments—largely unnecessary. If allowed, global solutions will flow to where they are needed without the intervention of nation states.

There is a growing recognition of the implications of the regional differences. For example, Ohmae has proposed breaking up homogeneous Japan into nine or 10 autonomous regions. Ichiro Ozawa, a prominent politician, has advocated the breaking up of Japan into 300 autonomous regions in order to radically decentralise power and authority. He has suggested each region to govern itself. China has 56 different nationalities. Five of China’s 30 provinces are autonomous. Naisbitt states that it is not hard to imagine that sometime in the 21st century China could become a confederation of dozens of regions or countries held together by economic self-interest. He also observes that, the old Soviet Union which was made up of 104 officially recognised ethnic groups, is on its way to eventually becoming perhaps as many as 60 or 70 countries. Naisbitt, who forecasts that the number of countries would go up to nearly a thousand by the middle of the present century, argues that the countries will become more irrelevant and the shift will be to numerous “host” of web networks that are all tied together.¹¹

A number of nations of today would splinter into many.

THE GROWING ECONOMIC POWER OF DEVELOPING COUNTRIES

Although the international economic gap is widening in several areas, the developing economies are doing well in some respect. For a long time now, the economic growth rate and the export growth rate of the developing economies, for instance, have been significantly higher than those of the developed economies and this trend is expected to continue in the future. We must, however, realise that the overall good performance of the developing countries has been mainly because of the impressive performance of a small number of them. The performance of a large number of developing countries is poor.

The share of developing countries in global income and trade has been growing.

There are four developing countries among the 12 largest economies of the world. GNP measured at PPP, China is the second and India the fourth largest economies.

It is expected that the global economic share of the developing countries will increase and they will play an increasingly important role in international business. Developing country firms are making

inroads into developed country markets and a number of developing economies have trade surplus with developed countries. A number of developing countries are now among the major exporters of the world. Some developing countries, including India, also have large foreign exchange reserves.

The developing countries are expected to grow faster than the developed ones in future. This does not mean that all the developing countries will grow at high rates. While East Asia and South Asia are estimated to grow very fast. In 2006, developing economies accounted for 41 per cent of the global GDP, up from 36 per cent in 2000.

The developing countries' share of the world output is estimated to increase significantly over time.

Encouraged by liberalisation, the FDI and portfolio investment flows to the developing countries have been increasing. As more developing countries open their markets and improve their growth prospects, and as the globalisation of corporate production and distribution strategies continue, this flow is likely to rise further. The increasing attractiveness of the developing country capital markets is also reflected in their faster market capitalisation. All these indicate the growing importance of developing countries in the globalising world economy. No wonder, they are receiving increasing attention by MNCs and investment inflows to them have been surging.

As we shall see in Chapter 3, the share of the developing countries in the global trade has been increasing and there are several of them among the top trading nations.

FACTORS PROMOTING GLOBAL ECONOMIC INTEGRATION

There are a number of factors which promote global economic integration. Some of these are described below.

International Trade Trade is one of the powerful forces of economic integration. For a long time now, international trade has been growing much faster than the growth in output.

Trade is a major driver of global economic integration.

The global trade integration (i.e. the excess of international trade over output growth) has been very significant for quite some time now. In the last two decades of the twentieth century, world trade has grown twice as fast as world GDP (six per cent versus three per cent).

Indeed, developing countries today are much more globally integrated by trade, i.e. they are more trade intensive than the developed countries as is evident from their foreign trade-GNP ratios (the value of foreign trade—exports and imports—expressed as a percentage of the GNP). By the beginning of the 1990s, the developing countries overtook the developed countries in the trade-GNP ratio and today it is substantially higher for developing countries than for the developed ones. (Also see the sub-section *Trends in Trade and Trade-GDP Ratio* under *Merchandise Trade* in Chapter 3.)

Exports of developing countries have also been growing faster than those of the developed countries.

Production Sharing/Global Sourcing The world economic integration is encouraged by the growing trend of global sourcing or production sharing elaborated in the chapter on *Global Trade*.

Production sharing, a term introduced by Peter Ducker, refers to the practice of carrying out different stages of manufacturing a product in several countries.

Such production sharing has become quite common in many industries including the fields of high technology and sophisticated products. The technical development and designing may be done in one country, the various components may be manufactured in other countries, assembling may be done in

some other countries and the product may be marketed globally. For example, the parts and components of a motor car finally assembled in the US or a European country are obtained from a large number of suppliers in different countries. In short, what is marketed as an American car or German car is not purely American or German but really transnational. Most of the parts and components of the IBM personal computer sold in the US are manufactured abroad. According to the data given in one report,¹² nearly three-fourths of the total manufacturing costs of the IBM PC were accounted for by parts and components manufactured overseas. US owned overseas plants supplied more than one-third of these foreign parts and components. Ducker points out that the only thing really made in Japan of an electronic calculator, carrying the label 'made in Japan', is the label!

The business strategy of production sharing fosters global economic integration.

Ducker argues that the practice of production sharing will be "... the most important form of economic integration, needed by developed and developing countries alike. In production sharing the resources of the developing countries... their abundant labour for traditional jobs... are brought together with the resources of the developed countries ... their management, their technology, their educated people, their markets and purchasing power".¹³

Ducker further argues that production sharing is the best hope—perhaps the only hope—for most of the developing countries to survive without catastrophe of the explosive expansion of working-age people in search of a job.¹⁴ Developing countries can, of course, benefit immensely by production sharing. But to argue that it is the only hope is to grossly underestimate the potential of the developing countries. Further, Ducker does not appear to have paid sufficient attention to the fact that substantial production sharing takes place between advanced economies. Further, many developed country firms are able to maintain competitiveness because of the production sharing which enables them to reduce cost and derive other advantages.

International Investment and Production International investment and the resultant international production are the most dominant drivers of international business and economic integration.

Both foreign direct investment (FDI) and portfolio investments have risen substantially. Although the lion's share of the investment flows still takes place between the developed countries, the capital flows to the developing countries have increased very substantially in the last one decade or so.

International production, i.e. production under the common governance of transnational corporations (TNCs), is growing faster than other economic aggregates. As a *World Investment Report* (WIR) notes, international production by TNCs, with their large number of foreign affiliates and a plethora of inter-firm arrangements, spans virtually all countries and economic activities, rendering it a formidable force in today's world economy.¹⁵

The expansion of international production has been facilitated by virtually all countries through changes in their regulatory environments. Since early 1990s, a large number of regulatory changes have been introduced in national FDI regimes worldwide in the direction of creating a more favourable environment for foreign direct investment (FDI). Complementing and reinforcing the more welcoming national FDI regimes, the number of bilateral investment treaties—concluded increasingly also between developing countries—registered a more than 10-fold increase between 1980 and 2000 (from 181 to 1,941)¹⁶ and were about 2,500 in 2006.

The contribution of international investment to world economic integration has increased significantly.

Evidence on the expansion of international production over the past two decades abounds. Gross product associated with international production and foreign affiliate sales worldwide, two measures of

international production, increased faster than global GDP and global exports, respectively. Sales of foreign affiliates worldwide are now nearly twice as high as global exports, and the gross product associated with international production is about one-tenth of global GDP, compared with one-twentieth in 1982. The ratio of world FDI flows to global gross domestic capital formation at the beginning of this century was about 15 per cent, compared with two per cent two decades ago.¹⁷

As the WIR points out, the nature of international production is changing, responding to rapid technological change, intensified competition and economic liberalisation. Falling transportation and communication costs are allowing TNCs to integrate production and other corporate functions across countries in historically unprecedented ways. This process termed *as deep integration*, is giving rise to a *cohesive global production system*, with specialised activities located by TNCs in different countries linked by tight, long-lasting bonds. The system is unevenly spread across industries, countries and TNCs, but it is growing rapidly to span many of the most dynamic activities in the world. If it represents “best practice” in international economic activity—and this may be so, given the strong economic rationale behind its growth—then all countries have to come to grips with its dimensions and implications.¹⁸

The ascendance and deepening of international production has given rise to new policy challenges. The distribution of international production, and of the corresponding benefits associated with it, is one of the most important of these. Another challenge is posed by issues arising from the ability of TNCs to internalise cross-border transactions and bypass national controls and scrutiny. For example, TNCs can use transfer pricing on intra-firm trade to minimise their tax exposure, depriving host and home countries of tax revenues.¹⁹

Cross-border Mergers and Acquisitions A very significant aspect of the recent FDI surge is that it is triggered to a large extent by cross-border mergers and acquisitions (M&As). Over the past decade, most of the growth in international investment has been via cross-border M&As (including the acquisitions by foreign investors of state-owned enterprises) rather than greenfield investment.

Cross-border M&As foster internationalisation and oligopolisation of industries.

FDI resulting from cross-border majority-held M&As have been increasing much faster than the total FDI flows. Cross-border M&As of larger size have also increased in number and value.

As a WIR points out, one recent feature is that M&As among large or dominant TNCs, resulting in even larger TNCs, seem to impel other major TNCs to move towards restructuring or making similar deals with other TNCs. The pharmaceutical, automobile, telecommunications and financial industries are typical examples of industries in which such concentration can be observed. This trend significantly changes the industry structure. In the automobile industry, for example, the total number of major automobile makers may well decline to 5–10 by 2010, from the 1998 figure of 15. In the pharmaceutical industry, many markets are now controlled by a small number of firms. In both these industries, there has been a string of M&As.²⁰

The trend towards M&A is also accelerating the sale of non-core operations or affiliates by firms and the acquisition of similar operations from other firms (of divisions or affiliates, or firms that have similar businesses). This indicates a strategic shift by TNCs to focus on their core activities. Unlike in the 1980s, there were fewer deals among unrelated businesses. In addition to strategic considerations of firms, liberalisation and deregulation are the other main factors behind the dramatic increase in M&As in both developed and developing countries.²¹

Most M&As today appear to have strategic and economic rather than immediate financial motives. Also, most of the recent cross-border M&As are not hostile.

Economic Integration and Trade Pacts Economic integration at regional levels has been fostered by Regional Integration Agreements (RIAs)/ trade pacts which have been growing fast in number, depth and spread. Offshore investment policy and other multinational business strategies are significantly influenced by such regional groupings. (See chapter on *Economic Integration* for details.)

Transplants An important part of the recent international investment comprises transplant, i.e. transplanting production facilities in the foreign markets instead of exporting products manufactured in the home country. Japanese companies, for instance, have made such transplants in North America and Europe to overcome the problem of rising yen and growing protective barriers including the local content stipulation. Several Japanese auto firms—Honda, Mazda, Toyota, Mitsubishi, Isuzu and Fuji—have established overseas production facilities, either wholly owned or jointly with foreign big names such as General Motors and Chrysler. The transplants have helped the Japanese to expand their overseas market.

Suppliers tend to follow the original equipment by manufacturers in the relocation of production facilities. Besides the need to overcome the possibility of host country regulations like the local content stipulation, such moves are also promoted by the need to ensure the system of ‘just in time inventory’ i.e. arranging for the supply of materials for production in such a way that there is no need to maintain significant stock of them.

Business Strategies Besides the corporate strategies mentioned above (production sharing, international investment and production, and M&As), there are several strategies that tend to increase the global business and economic integration.

International licensing and franchising by which business gets linked and grows across the borders promote global business and economic integration.

International strategic alliance, a strategy which seeks to enhance the long-term competitive advantage of a company by forming alliance with its competitors, existing or potential, in critical areas instead of competing with each other, is another force which fosters international economic integration.

Also see the sub-section *Drivers of Globalisation* under *Globalisation of World Economy* in Chapter 4.

INDIA AND THE GLOBAL ECONOMY

India presents a mixed picture of strengths, prospects, weaknesses and problems. It is one of the largest economies of the world, but its per capita income is very low—in fact lower than the average for the developing economies. In the last half a century, while the Indian economy has grown fairly well—faster than the average growth of the developing countries—its growth has lagged behind the newly industrialising countries of South Asia.

Now, India is emerging as one of the largest markets in the world. It is indeed regarded as one of the growth markets of the future.

While the market for a number of products in the developed countries are saturating or declining, India presents an expanding market because of the following factors:

1. Existence of a large backlog of unsatisfied desires, like those for consumer durables.
2. Fast increase in population.
3. Rising income.
4. The communication revolution and changing social attitudes giving rise to a revolution of rising expectations and spurt in demand.

India is emerging as a powerhouse of the global economy.

Rising Population and Economic Growth

India is the second most populous nation in the world. However, as the population of India is growing much faster than that of China, in future the population of India could exceed that of China, although now China's population is about 30 per cent higher than that of India. China has nearly three times the land area of India, indicating that considering the geographical size the population problem is the most serious in India.

Although the population growth rate in India has significantly come down, the addition to the Indian population every year is more than or nearly equal to the total population of a number of countries. The annual addition to the Indian population is nearly equal to the combined total population of three developed nations, viz, Sweden, Norway and Denmark. In other words, in terms of the number of consumers, every year India is adding to itself a market as large as the above three markets put together. The Indian population which grew at an average annual rate of two per cent during 1975–1998, is projected to grow at the rate of 1.2 per cent during 1998–2015, resulting in a total population of over 120 crore in 2015. Chinese population is projected to grow at 0.7 per cent and reach more than 140 crore in 2015.

Table 1.2 Some Indicators of India's Position in the Global Economy

	<i>Share (Percentage)</i>	<i>Rank</i>
Population (2005)	17	2
GNI (2005)	1.8	10
GNI measured at PPP (2005)	6.2	4
Human Development Index (2005)	—	128
Export of goods (2006)	1.0	28
Import of goods (2006)	1.4	17
Export of services (2006)	2.7	10
Import of services (2006)	2.4	13
Foreign Direct Investment inflow (2006)	1.3	—

Source: Compiled /computed from different sources

The fast growing enormous size of the Indian population has given rise to a number of serious problems. The total population of only China and perhaps USA is larger than the total number of Indians below the poverty line. The number of unemployed in India is larger than the size of the labour force of many countries. The number of families in India without satisfactory housing is larger than the total number of households in many countries. To solve the basic problems, the additional employment opportunities to be created, the additional houses to be built, the additional number of people to be provided with health and sanitation facilities, water supply etc. during one Five Year Plan in India are more than what many nations have done over centuries. While all these highlight the gigantic challenge facing a poor nation, they also indicate the enormous investment and business potentials.

While it is true that the number of Indians below the poverty line is larger than the total population of many countries, it is also a fact that the total number of well-to-do Indians is larger than the total population of many countries. If one assumes that five per cent of the Indians are well off, their number will come

Fairly high growth rates of the economy and population make India an attractive market and investment destination.

to more than the total population of many of the developed countries. The size of the Indian middle class is larger than the total population of most of the countries.

Even if only a very small percentage of the Indian population can afford what may be called luxury goods according to the Indian standards, in absolute terms their number is significant. In several cases, their number is as large or larger than the total number of consumers in many of the developed countries.

According to the World Bank data, in 2005, India was the 11th largest economy in the world. In purchasing power parity terms, India was the fourth largest economy (see Table 1.1), and it is estimated that by the year 2030 it will be the third largest (after USA and China).

Considering countries with GDP of \$100 billion or more to be countries in the *Big League*, India was already in this league in the 1980s. Although India's share in the combined GDP of the League declined from 1.74 per cent in 1980 to 1.44 per cent in 1990, it is expected to rise in the next two decades and to reach 2.62 per cent in 2010 and more than four per cent in 2020, despite a substantial increase in the combined GDP of the Big League because of more countries entering the League. The number of countries in the League is projected to increase from 19 in 1980 to 42 in 2020.²²

Indian economy has grown faster than the world economy and the average of developing economies.

Although the growth rate of the Indian economy has been very poor in comparison with that of several East Asian countries, India is among the countries whose per capita income in the early 1990s was higher than ever before. Over much of the period since 1980 to early 1990s, economic decline or stagnation affected 100 countries, reducing the incomes of more than a quarter of the world's population. In 70 of these countries, average incomes in the early 1990s were less than they were in 1980 and in 43 countries less than they were in 1970.

Among the 48 low human development countries, India was the only country whose annual growth in per capita income was above 1.5 per cent during the period 1960–1993.

The long-term growth rate of the Indian economy has been substantially higher than the world average and higher than that of the average of developing countries, although it lagged far behind the East Asian economies. (See Table 1.3).

Table 1.3 Economic Performance of India: A Comparison

Region/ Country	Output Growth Rate (Annual Percentage Change)									GDP Per capita Annual Growth Rate (Percentage)	
	1975 to 1995	1991 to 2000	2001	2002	2003	2004	2005	2006	2007	1975 to 2005	1990 to 2005
World	3.0	2.9	1.5	1.8	2.6	4.1	3.4	4.0	3.4	1.4	1.5
Developing countries	3.9	5.0	2.6	3.8	5.1	7.1	6.5	6.9	6.4	2.5	3.1
India	4.8	6.0	5.0	4.0	7.1	8.5	9.2	9.2	8.5	3.4	4.2

Source: UNDP, *World Trade and Development Report 2007* and *Human Development Report 2000, 2003 and 2007*.

India is one of the largest producers of a number of products, both primary and manufactured. Some of the Indian companies are among the largest ones in their industries. The number of listed companies in

India is the leading producer of a number of products and many Indian companies are among the largest ones in the world.

India is second only to that of USA. However, in the case of many agricultural commodities, the productivity is very low in India. The output could be increased substantially by productivity improvements.

At the end of March 2004, India held the sixth largest stock of international reserve assets in the world, compared to 10th rank at the end of December 2001. In February 2003, the IMF designated India as a creditor country under its Financial Transaction Plan (FTP). Information regarding India's global trade is given in the chapter on *Global Trade*.

Economic Policy Liberalisation in India

Until June 1991, India followed a very restrictive economic policy characterised by exclusion of private sector from many important industries, monopoly or dominance of public sector in a number of important industries and sectors, entry and growth restrictions on private, particularly large, enterprises and limited role of and stringent restrictions on foreign capital and technology. The economic liberalisation ushered in 1991 changed the scenario very substantially.

Effects of Liberalisation With economic liberalisation in India, investment in the infrastructural and industrial sectors has increased substantially, industrial production has recorded good growth, competition has increased to the advantage of consumers, and export-GDP ratio and export intensity of companies (i.e. the ratio of export sales to total sales) have increased. Foreign investments, both portfolio and direct, have also increased substantially, and Indian companies are expanding foreign business with a new vigour.

Liberalisation has made Indian economy more vibrant and competitive.

Since the liberalisation there has been significant improvement in the foreign exchange reserves position as well.

The composition of financial inflows has also changed significantly. The proportion of the debt-creating flows has declined substantially, and the debt service ratio, although still very high, has shown a favourable change.

Features of Liberalisation The salient features of liberalisation are the following:

(a) *Abridgement of the role of public sector and expansion of the scope of private sector*

Until liberalisation, the development of 17 of the most important industries was exclusively reserved for the public sector, and in 12 of the remaining important industries the public sector was assigned a dominant role, the role of the private sector being a supplementary one. The scope of the private sector was, thus, limited. The new economic policy has substantially expanded the scope of the private sector by drastically bringing down the number of industries reserved for the public sector. Now, only four industries are reserved for the public sector

(b) *Removal of entry and growth restrictions*

There had been several entry and growth restrictions on the private sector under the licensing regulations and Monopolies and Restrictive Practices (MRTP) Act. A licence was required for establishing a new undertaking with investment above certain limit, or manufacture of a new item and for substantially expanding an existing undertaking. Besides, large undertakings (i.e. those with assets, including those of interconnected undertakings, of Rs 100 crore or more) and dominant undertakings (i.e. undertakings with a market share of 25 per cent or more) had to obtain a clearance under the MRTP Act, for substantial expansion, establishment of new undertaking and for takeovers and mergers and amalgamations.

The new policy has substantially reduced the entry and growth restrictions by delicensing all but a limited number of industries and scrapping the MRTP restrictions on growth.

(c) *Liberalisation of foreign investment*

Earlier, foreign investment required prior approval of the Government. Foreign equity was not allowed, normally, to exceed 40 per cent of the total.

The new policy has enormously expanded the scope of foreign investment. There is now automatic approval (i.e. no prior approval is required) for foreign investment up to specified limits in a large number of industries. For details see the chapter on *International Investment*.

(d) *Reform of trade policy*

The salient features of the trade policy reform are:

- (1) Exchange rate adjustment: To make the exchange rate more realistic and to encourage exports and discourage imports, the Rupee was devalued in 1991 and convertibility of the Rupee on current account was introduced later.
- (2) The role of subsidies in export promotion was substantially reduced by abolishing the cash compensatory support (CCS). The import entitlement scheme for exporters known as Replenishment Licence (REP), which was modified as *exim scrip*, was also withdrawn.
- (3) Liberalisation of imports by substantially eliminating licensing, quantitative restrictions and other regulatory controls. There has also been a considerable reduction in the import duties.
- (4) Procedural simplification.
- (5) Convertibility of the Rupee. As a first step towards free convertibility of rupee, a scheme of partial convertibility of the Rupee was introduced in March 1992. Accordingly, exporters got 40 per cent of the foreign exchange earnings converted into rupee at the official rate determined by the Reserve Bank of India. The remaining 60 per cent of the export earnings could be converted at the free market rate quoted by the authorised dealers. Full convertibility on trade account was introduced in 1994.

(e) *Capital market reforms*

The functioning of the stock exchanges had been characterised by many shortcomings with long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading. A number of measures have been taken to overcome these problems. The objectives of these measures, broadly, have been to provide for effective control of the stock exchange operations; increase the information flow and disclosures so as to enhance the transparency; protect the interests of investors; check insider trading; improve the operational efficiency of the stock exchanges, and to promote healthy development of the capital market.

Important measures of reform and development include the introduction of free pricing of capital issues; introduction of book building mechanism; introduction of electronic trading; measures to widen and deepen the capital market; improvement in the trading, clearing and settlement systems; promotion of dematerialisation; measures to reduce counterparty risk, introduction of circuit breakers/price bands; measures to increase information flow and to enhance the transparency of the companies; and, ushering in of fair trading practices, including prohibition of insider trading. These measures have had some positive impact on the volatility, liquidity and transaction cost. (For more details see recent edition of the author's *Business Environment*, Himalaya Publishing House.)

(f) *Second generation reforms*

The finance minister claimed that the Union Budget for 2001–2002 sought to herald the second generation of reforms. A major aspect of the

India's economic reform needs to be further broadened and deepened.

proposed second generation reforms is the reform of the legal environment. Many of the Indian laws are very old, a number of them enacted during the British regime, now calling for modifications.

Some legal reforms are required for internal liberalisation. For example, there were legal restrictions on the intra-regional movement of certain goods such as food grains, even as the imports were liberalised. An important area of reforms proposed to be addressed is labour laws. This is a politically very sensitive matter and how well it will be carried out is yet to be seen.

In short, the liberalisation commenced in 1991 and which still continues represents a new outlook, philosophy and development strategy. India, having joined the globalisation trend, should be expected to become more integrated with the global economy.

However, the regulatory and procedural environment of business in India is still very cumbersome compared to many other countries. According to a report by the World Bank (2004), starting a new business in India involves, on average, 11 procedures and 89 days, compared to the Asian average of nine procedures and 46 days. In a rich country, it takes only six procedures and 27 days. To close a business, it takes 10 years in India, at the end of which claimants can reclaim only 12.5 cents out of every dollar invested in the insolvent business, compared to the Asian average of 5.2 years and 21.4 cents. In the rich countries, it takes mere 1.7 years to shut shop and lenders can get back 72.1 cents out of every dollar put in.²³ In India, although the licence *raj* is, by and large, gone, the inspector *raj* survives.

More information on India's position in the global economy is available in the author's *International Business* (Prentice-Hall of India).

India's Future Prospects

The perception of experts about India's future is, generally, optimistic. There is common agreement, among individual scholars and international organisations, that India can emerge as a stronger economy.

India could be one of the fastest growing economies in future. According to one study she will grow faster than China.

For example, a recent Goldman Sachs study notes that "India has the potential to show the fastest growth over the next 30 and 50 years". This is deduced using a real growth rate of close to six per cent per year between now and 2040 and a slowdown to five per cent by 2050.

With this growth rate, India would attain today's Korean standards of living by 2042 and Italy's by 2050. In terms of GDP in US dollars, the Indian economy would overtake UK in 20 years and Japan in 30 years. This is mainly attributed to a large base population.

According to the study, demographics have an important role to play in the way the world will change. India has the only population out of the BRICs (Brazil, Russia, India and China) that is expected to continue to grow throughout the next 50 years and so India has the potential to raise its US dollar income per capita to 35 times the current levels. India in the next few decades will be passing through a 'demographic dividend'. These are the decades when the economy will have the highest proportion of its population in the working age (15–60) and offer the maximum potential for employment and growth. The key assumption underlying the projections is that the BRICs maintain policies and develop institutions that are supportive of growth.²⁴ But, there is a catch in the above analysis. In a well-functioning economy, it is expected that labour demand would match labour supply and would lead to more jobs and output. But, there is no guarantee for this. In India, between 1993–94 and 1999–2000, the economy grew at around 6.7 per cent per year, but employment grew only one per cent per annum. The labour force during this period was growing at over two per cent per year and there was plenty of backlog of underemployment and unemployment. Thus, labour demand was growing much slower than labour supply.²⁵

SUMMARY

International Economics deals with the economic interdependence among countries and includes factors which affect as well as the effects of such interdependence.

The discipline International Economics consists of a theoretical part and a descriptive part. The theoretical part seeks general principles and logical frameworks which can serve as a guide to the understanding of actual events and it uses for this purpose abstractions and models. The theoretical part can be further divided into pure and monetary theories, each containing aspects of both *positive* and *normative* economics. The pure theory of international trade, which has a micro-economic nature, encompasses topics such as the bases of trade and the pattern of trade; effect of trade on production, consumption, and distribution of income; effect of trade on relative factor prices and product prices; gains from trade and the distribution of the gains; effect of trade barriers on trade, factor and product prices and income distribution; and, effect of trade on economic growth and vice versa. The international monetary theory, which is of a macro economic nature, deals with matters pertaining to balance of payments and international monetary system. The descriptive part is concerned with the description of international economic transactions just as they happen and of the institutional (including the policy) environment in which they take place.

The **global economy** is made up more than 200 politically independent nations which have different types and degree of interdependencies and very diverse economic characteristics between and within them. On the basis of per capita income, these countries are often classified into low, middle and high income economies.

The low income economies are sometimes referred to as the *third world* (the high income and middle income economies representing the *first* and *second* worlds). Low income and middle income economies are developing economies. Some of the high income economies also fall under the category of developing economies. The developed economies as a group are sometimes referred to as the *North* as they, with some exceptions like Australia and New Zealand, are in the northern hemisphere, and the developing economies are referred to as the *South* as most of them are in the southern hemisphere. Sometimes the terms *less developed* countries and *more developed* countries are used to refer to the developing and developed countries. The term *underdeveloped* also refers to the developing countries. There is a special category of low income economies known as the *least developed countries*, identified on the basis of criteria such as a very low GNP per capita, low levels of human development and economic vulnerability.

When the different regions of a national economy show great diversity, it may not be appropriate to regard it as a single economic unit. The concept of **region state**, therefore, is advocated.

Although the international economic gap is widening in several areas, a number of developing economies are doing well in some respects. For a long time now, the economic growth rate and the export growth rate of the developing economies, in general, have been significantly higher than those of the developed economies and this trend is expected to continue in the future. There are several developing countries among the largest economies of the world. It is expected that the global economic share of the developing countries will increase and they will play an increasingly important role in the global economy.

A number of factors tend to promote **global economic integration**. The important factors are international trade; global sourcing or production sharing; international investment and the resultant international production; cross-border M&As; regional groupings, integration and trade pacts; transplanting of production facilities in the foreign markets; and, certain corporate strategies which promote internationalisation.

India presents a mixed picture of strengths, prospects, weaknesses and problems vis-a-vis the global economy. It is one of the largest economies of the world, but its per capita income is very low—in fact lower than the average for the developing economies. In the last half a century, while the Indian economy has grown fairly well—faster than the average growth of the developing countries—the growth has lagged behind the newly industrialising countries of South Asia. India is emerging as one of the largest markets in the world. It is indeed regarded as one of the growth markets of the future. According to the World Bank data, in 2004, India was the 11th largest economy in the world. In purchasing power parity terms, India was the fourth largest economy and it is estimated that by the year 2030 it will be the third largest (i.e. only behind USA and China).

India, the second most populous nation in the world now, may overtake China in future as the population of India is growing much faster than that of China. Even if only a very small percentage of the Indian population can afford what may be called luxury goods according to the Indian standards, in absolute terms their number is significant. In several cases, their number is as large or larger than the total number of consumers in many of the developed countries.

Some of the Indian companies are among the largest ones in their industries. The number of listed companies in India is second only to that of the USA. The economic liberalisation ushered in 1991 and the continuing process of liberalisation are increasing India's integration with the global economy.

India, which is expected to be one of the fastest growing economies in the world in future, would significantly improve its position in the global economy.

Review Questions

1. Explain the nature and scope of International Economics.
2. Discuss the characteristics of developing countries.
3. Describe the salient features of developed countries.
4. Examine India's position in the global economy.
5. What are the salient features of economic reforms in India.
6. Give a brief account of the factors fostering global economic integration.
7. Write short notes on the following:
 - (a) Vicious circle of poverty
 - (b) Growing economic power of developing countries
 - (c) Dimensions of poverty in developing countries
 - (d) Classification of economies
 - (e) Production sharing

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- UNDP, *Trade and Development Report* (Annual publication).

Suggested Readings

Annexure 1.1

DEFINITIONS

Given below are the definitions of certain terms as given in the *Human Development Report*.

Human Poverty and Income Poverty Human poverty is defined by impoverishment in multiple dimensions—deprivations in a long and healthy life, in knowledge, in a decent standard of living, in participation. By contrast, income poverty is defined by deprivation in a single dimension—income—because it is believed either that this is the only impoverishment that matters or that any deprivation can be reduced to a common denominator. The concept of human poverty sees lack of adequate income as

an important factor in human deprivation, but not the only one. Nor, according to this concept, can all impoverishment be reduced to income. If income is not the sum total of human lives, lack of income cannot be the sum total of human deprivation.

Human Development Index (HDI) The HDI measures the average achievements in a country in three basic dimensions of human development—a long and healthy life, knowledge and a decent standard of living. A composite index, the HDI thus contains three variables—life expectancy at birth, educational attainment (adult literacy and the combined gross primary, secondary and tertiary enrolment ratio) and GDP per capita (PPP US \$). Income enters the HDI as a proxy for a decent standard of living and as a surrogate for all human choices not reflected in the other two dimensions.

Human Poverty Index (HPI) The HPI measures deprivations in human development. Thus, while the HDI measures the overall progress in a country in achieving human development, the HPI reflects the distribution of progress and measures the backlog of deprivations that still exists. The HPI is constructed for developing countries (HPI-1) and for industrialised countries (HPI-2). A separate index has been devised for industrialised countries because human deprivation varies with the social and economic conditions of a community, and to take advantage of the greater availability of data for these countries.

HPI-1 The HPI-1 measures deprivation in the same basic dimensions of human development as the HDI. The variables used are the percentage of people born today expected to die before age 40, the percentage of adults who are illiterate and deprivation in overall economic provisioning—public and private—reflected by the percentage of people without access to health services and safe water, and the percentage of underweight children.

HPI-2 The HPI-2 focuses on deprivation in the same three dimensions as the HPI-I and an additional one, social exclusion. The variables are the percentage of people born today expected to die before age 60, the percentage of people whose ability to read and write is not adequate to be functional, the proportion of people who are income poor (with disposable incomes of less than 50 per cent of the median disposable household income), and the proportion of the long-term unemployed (12 months or more).

Gender-Related Development Index (GDI) The GDI measures the achievements in the same dimensions and using the same variables as the HDI does, but takes into account inequality in achievement between women and men. The greater is the gender disparity in basic human development, the lower is a country's GDI compared with its HDI. The GDI is simply the HDI discounted, or adjusted downwards, for gender inequality.

Gender Empowerment Measure (GEM) The GEM indicates whether women are able to actively participate in economic and political life. It measures gender inequality in key areas of economic and political participation and decision-making. The GEM, focusing on women's opportunities in economic and political arenas, thus differs from the GDI, an indicator of gender inequality in basic capabilities.

CHAPTER 2

2

International Economic Gap and NIEO

LEARNING OBJECTIVES

- ☐ To get a broad picture of the magnitude of global economic disparity.
- ☐ To understand the reasons for the international economic gap.
- ☐ To examine the requirements of NIEO.
- ☐ To understand the meaning and scope of NIEO.
- ☐ To evaluate the progress towards NIEO.

INTERNATIONAL ECONOMIC GAP

The term *international economic gap* refers to the wide economic disparity between the developed and developing economies. As indicated in the preceding chapter, almost all important parameters of development and welfare indicate a yawning gap between the developed and developing economies. Even though human conditions have improved more in the past century than in the rest of history—global wealth, global connections, and technological capabilities have never been greater—the distribution of these global gains is extraordinarily unequal.

Economic disparity between developed and developing countries has been growing in several areas.

The average income in the richest 20 countries is 37 times the average in the poorest 20—a gap that has doubled in the past 40 years.¹ There is a general feeling that the present international economic order, which is biased against the developing economies, is one of the important reasons for it. There has, therefore, been a growing demand for a new economic order that will help remedy this problem.

Although the developing economies, on the whole, have been growing faster than the developed ones, there exists wide gap between these two categories of countries in many respects.

The widening or the persistence of the international economic gap has been caused by such factors as the differences in the growth rates, unequal access, population explosion in developing countries, and the negligence by the developed countries of the humanitarian needs of the developing countries, etc.

International economic gap has been caused by such factors as the differences in the growth rates, unequal access, population explosion in developing countries, the negligence by the developed countries of the humanitarian needs of the developing countries, etc.

The *Human Development Reports*, brought out annually by the UNDP, provide a number of indicators of this growing disparity. Some of them are reproduced below.

Table 2.1 Shares of Different Categories of Economies, 2005

(Percentage)

<i>Economy Group</i>	<i>Population</i>	<i>GNI</i>	<i>GNI Measured at PPP</i>
High Income	16	79	54
Middle Income	48	18	36
Low Income	37	3	10
Low and Middle Income	85	21	46
India	17	1.7	4

Source: Calculated from the data given by *World Development Report*, 2007.

In the three decades since 1960, the countries with the richest 20 per cent of the world population increased their share of global GNP from about 70 per cent to 83 per cent while countries with the poorest 20 per cent of the world population saw their share fall from 2.3 per cent to 1.4 per cent—a fall of nearly 40 per cent in their meager share compared to an increase in the lion's share of the richest countries by about 19 per cent. During this period, the income in the richest countries grew 2.7 times faster than in the poorest countries.

The income gap between the fifth of the world's people living in the richest countries and the fifth in the poorest was 74 to 1 in 1997, up from 60 to 1 in 1990 and 30 to 1 in 1960. In the nineteenth century, too, inequality grew rapidly during the last three decades, in an era of rapid global integration: the income gap between the top and bottom countries increased from 3 to 1 in 1820 to 7 to 1 in 1870 and 11 to 1 in 1913.

By the late 1990s, the fifth of the world's people living in the highest-income countries had:

- 86 per cent of world GDP—the bottom fifth had just one per cent.
- 82 per cent of world export markets—the bottom fifth had just one per cent.
- 68 per cent of foreign direct investment—the bottom fifth had just one per cent.
- 74 per cent of world telephone lines, today's basic means of communication—the bottom fifth had just 1.5 per cent.

Some have predicted convergence. Yet, the past decade has shown increasing concentration of income, resources and wealth among people, corporations and countries.

- OECD countries, with 19 per cent of the global population, have 71 per cent of global trade in goods and services, and about 60 per cent foreign direct investment. To make matters worse, a large chunk of the share of developing countries goes to the better off among them.
- The recent wave of mergers and acquisitions is concentrating industrial power in megacorporations—at the risk of eroding competition. By 1998 the top 10 companies in pesticides controlled 85 per cent of a \$31 billion global market—and the top 10 in telecommunications, 86 per cent of a \$262 billion market.
- About 91 per cent of all Internet users are in the developed countries.
- The world's 200 richest people more than doubled their net worth in the four years, 1994 to 1998, to more than \$1 trillion. The assets of the top three billionaires are more than the combined GNP of all least developed countries and their 600 million people.

- In 1993, just 10 countries accounted for 84 per cent of global research and development expenditures and controlled 95 per cent of the US patents of the past two decades. Moreover, more than 80 per cent of patents granted in developing countries belong to residents of industrial countries.

Further, the lion's share of the global commercial bank lending is for developed countries.

All these trends are not the inevitable consequences of global economic integration—but they have run ahead of global governance to share the benefits.

Within the group of the developing countries, there have been wide disparities in the per capita income levels, growth rates, share of trade, share of foreign investment and Official Development Assistance etc.

The developing countries suffer a lot due to unequal access to the global markets. The developing countries effectively paid an average interest rate of 17 per cent during the 1980s compared with four per cent paid by the industrial nations. The loss to the developing countries due to deterioration of the terms of trade is substantial. Further, according to a World Bank study, trade restrictions reduce developing countries' GNP by three per cent—an annual loss of \$75 billion. Global market restrictions and unequal partnership are estimated to cost the developing countries about \$500 billion—around 20 per cent of their GNP and more than six times of what they spend on human development priorities, such as basic education, primary health care, safe drinking water and elimination of malnutrition.²

According to the UN's *The Least Developed Countries 1999 Report*, "The 1990s have become for the LDCs the decade of increasing marginalisation, inequality, poverty and social exclusion. The violence and social tensions which afflict several LDCs are caused, in part at least, by increasing deprivation and inequality."³

A *Human Development Report*⁴ cautions that if global opportunities are not shared better, the failed growth of the last decades will continue. More than 80 countries still have per capita incomes lower than they were a decade ago. While 40 countries have sustained average per capita income growth of more than three per cent a year since 1990, 55 countries, mostly in Sub-Saharan Africa and Eastern Europe and the Commonwealth of Independent States (CIS), have had declining per capita incomes. Many people are also missing out on employment opportunities. The global labour market is increasingly integrated for the highly skilled—corporate executives, scientists, entertainers and the many others who form the global professional elite—with high mobility and wages. But the market for unskilled labour is highly restricted by national barriers. Inequality has been rising in many countries since the early 1980s.

While the North-South disparity in human development has been narrowing in a number of areas like life expectancy, adult literacy, nutrition, infant mortality, child mortality and access to safe water, it has been widening in areas like mean years of schooling, tertiary education enrolment ratio, scientists and technicians (per thousand people), expenditure on R&D, telephones and radios (per thousand people) etc.

The Participation Gap

As a UNDP report observes, just as inclusive democracy is needed to ensure minority participation at the national level, inclusive global democracy is needed in which all countries—small and weak as well as large and powerful—have a voice in decisions. Participation is needed as a matter of right to create a global economy with fair and just rules. Global economic policy-making occurs in a world of grossly unequal economic and political power. The playing field is not level when the "teams" have vastly different resources, expertise and negotiating power. Poor and small

Poor nations are unable to effectively participate in international organisations and negotiations.

countries can ill afford the high costs of participating in the WTO, for example. Fourteen of them have either a one-person delegation in Geneva or none at all. They lack access to well-researched legal and economic policy advice. They cannot afford top legal representation in dispute settlements. The community of states has an obligation to put in place procedures for greater participation and transparency in global decision-making. The WTO, for example, has been heavily criticised for its non-transparent and non-participatory decision-making, depending more on informal consensus than formal procedures. A major review of decision-making in international bodies should focus on two issues. One is the participation of small and weak countries in the processes of negotiation and dispute settlement. The second is the participation of civil society—including corporations, trade unions and global networks of NGOs—in a forum for open debate rather than in behind-the-scenes lobbying and on the-street demonstrations.⁵

NEW INTERNATIONAL ECONOMIC ORDER

As indicated in the beginning of this chapter, the feeling that the international economic order that was in vague hitherto has been a major reason for the miserable plight of the developing countries has led to the demand for a New International Economic Order.

Emergence of NIEO

The term *New International Economic Order (NIEO)* refers to a set of demands to ensure that the developing countries are accorded a fair, equal and, in some cases, a considerate deal in the international economic system. The demand for a NIEO implies, obviously, that the existing order is unfair.

A new international economic order is needed to ensure a fair and considerate deal for the developing economies.

The general feeling that the post Second World War international trading—monetary, financial, institutional, technological—and other resource transfer systems and development patterns have been prejudicial to the interests of the developing countries vis-a-vis the developed countries, and has led to the demand for a new international economic order (NIEO).

This issue has become very lively since May 1974, when the Sixth Special Session of the United Nations General Assembly adopted the famous Declaration on the Establishment of a New International Economic Order and Programme of Action, “...based on equity, sovereign equality, interdependence, common interest and cooperation among all States, irrespective of their economic and social systems, which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steadily accelerating economic and social development and peace and justice for present and future generations”.

The second resolution, adopted in the same session—the Programme of Action on the Establishment of a NIEO—spelt out specific measures to be carried out for the purpose of achieving the above ideal and for bringing about maximum possible “economic cooperation and understanding among all States, particularly between developed and developing countries, based on the principle of dignity and sovereign equality”.

These resolutions, together with the Charter of Economic Rights and Duties of States, adopted by the regular twenty-ninth Session of the UN General Assembly later in the same year, constitute the basic documents of the NIEO.

Scope of NIEO

The statements from the UN declarations given above indicate the ambitious objectives of NIEO and the broad areas it encompasses. However, in spite of the enormous popularity of this term and the avalanche of discussions on this issue, there is not yet a precise definition of the NIEO that is acceptable to all. Robert Cox, after a critical survey of the available literature on the NIEO, explains the concept at four 'levels':⁶

- The NIEO is a series of specific demands and considerations embodied in an impressive range and number of official documents adopted by international conferences.
- The NIEO is a negotiation process, broadly speaking, between countries of the North and South,⁷ taking place through a variety of institutions and forums in which wider or narrower ranges of functional and geographical interests are presented.
- The NIEO is a debate about the real and desirable basic structure of world economic relations.
- It is a debate about the form of knowledge appropriate to understand these issues.

A subtle distinction is sometimes made, especially by some US economists, between '*a* NIEO' and '*the* NIEO', the latter referring to the specific demands contained in the documents of the Sixth Special Session of the UN General Assembly and the former implying only marginal adjustments in the existing order. Attempts have also been made to view the issue in a much broader perspective. Jan Tinbergen, for instance, prefers the term 'New International Order' (NIO) to New International Economic Order (NIEO) because "the establishment of a new international economic order entails fundamental changes in political, social, cultural and other aspects of society".⁸

However, in discussions on the North-South new economic relationship, NIEO encompasses mostly a demand for the following:

- Improved access into the markets of the industrialised nations for manufactured exports from the South.
- Changes in the marketing structure and pricing mechanism of primary commodities.
- Reform in the international monetary system.
- Access by the South to the technology and capital markets of the North.
- An increase in foreign aid or other forms of resource transfers to the South.

NIEO encompasses trade, aid, technology transfer and international monetary system.

Why NIEO?

There is a strong feeling that the post-war international economic order or the existing order devised after World War II at Bretton Woods was designed mainly to solve the problems that the developed market economies were facing in the 1940s and to aid their speedy reconstruction and, renewed and continuous prosperity. The economic interests, needs, demands and special interests of the developing countries were largely ignored in the process of establishing the post-war economic order. In spite of subsequent changes, the existing order and its mechanisms did not improve the economic conditions, to the extent desired, of most of the developing countries, where a vast majority of world population lives. Acute poverty, chronic unemployment and underemployment, and perpetual dependence on rich countries continued to grow in the less developed South. The call for a new international economic order stems, thus, basically from the failure of, or dissatisfaction with, the existing economic order.

Many of the developing countries of today were not independent when the Bretton Woods and the United Nations System were established. The United Nations had only 51 members when it was established in 1945, but today it has more than thrice that number. Similarly, most of the present members of the IMF and IBRD joined these institutions years after their establishment.

There was no choice for the nations which joined the international community later but to accept an international order, an international law and international customs that were established without reference to them and sometimes contrary to their own interests.⁹

Against this background, the demand for the NIEO emerges from the realisation on the part of the developing countries, most of which became independent after the birth of the above-mentioned international organisations, that they should have an effective voice in the formation of the rules and institutions governing the international economic order in which they participate.

Demands of Developing Countries

The conviction prevailing among the developing countries that they do not get a fair deal from the existing international economic order has led them to collectively demand a fairer and even preferential deal in the field of trade, money and finance, technology and investment and participation in international decision making. Their main demands are the following.¹⁰

Trade

1. Remunerative prices for the exports from the developing countries. This also encompasses adoption of an integrated programme of commodities, including a common fund, for the regulation of prices and quantities.
2. Steps to improve LDC exports of manufactured goods and reduction of protectionism in the developed countries, especially non-tariff barriers (NTBs).
3. Promotion of trade among LDCs on a regional or sectoral basis.

Money and Finance

1. Larger share of Special Drawing Rights (SDRs) to LDCs and adoption of SDRs-aid link for this purpose.
2. Increasing official development assistance (ODA) with greater attention to the least developed countries.
3. Development of automatic sources of revenue, for example, taxes on brain drain and exploitation of non-renewable resources, sharing of revenues from ocean exploitation etc., and
4. More generous debt relief.

Technology and Investment

1. Transfer of suitable technology to LDCs at a reduced cost.
2. Control and regulation of the activities of MNCs, including the right of the LDCs to nationalise and expropriate foreign investment according to national, instead of international, law.

Participation in International Decision-making

1. Shifting of more economic issues to UN forums, where LDCs have a stronger voice.
2. Changing the weighted voting formulae in other forums.

3. Better coordination among different international economic organisations.

The above demands constitute a demand for structural changes in international economic relations.

According to UNCTAD, changes are needed in at least five major areas:

1. A new structure to govern the trade of LDCs in primary products.
2. A new reformed external framework to govern the industrialisation of LDCs, which must include the expansion of external markets for manufactured exports and a new framework for the acquisition, development and application of technology.
3. A new international monetary system with universal membership and serving the needs of LDCs in respect of reserve creation, adjustment mechanisms, balance of payments difficulties and participation in decision-making.
4. Cooperation among LDCs themselves, namely collective self-reliance.
5. Expansion of trade and other exchanges between LDCs and the socialist countries.

Evaluation of NIEO

The developed world has hardly shown any earnest appreciation of the NIEO. There has, in fact, been a tendency to brush it aside as irrational.

Though these demands of the LDCs are derided by the Western economists, who describe them as 'wish lists', 'shooting for the moon', 'a demand for everything by those who have nothing', 'a lecture on what others must do', 'trade union tactics', and 'demand for new forms of charity', it may be emphatically pointed out that the NIEO is not a list of demands from the South for the kind consideration of the North.¹¹ As the Report of the Club of Rome rightly points out, the Third World is not demanding massive redistribution of the past income and wealth of the rich nations. It is neither seeking charity from the prosperous nor equality of income. It is asking for equality of opportunity and insisting on the right to the right share in future growth. What the LDCs demand is nothing but "...the right to sit as equals around the bargaining table of the world".¹²

A quick look at the status in respect of the main elements of NIEO is provided below.

Trade The efforts of UNCTAD succeeded in creating a common fund for commodities. However, to what extent this will benefit the developing countries is to be seen. Although international commodity agreements were proposed for a number commodities, not much progress has been made in this direction.

Although developed countries introduced the Generalised System of Preferences (GSP) by which manufactured exports of the developing countries are granted preferential duty rates in the developed markets, as the developing countries compete among themselves rather than with developed countries, its benefits have been limited. Further, as the import duty rates in the developed countries on the major exports of the developing countries are very high, the developing world is still disadvantaged despite these little concessions. As pointed out in chapters 3 and 12, the developing countries face cruel tariff levels in the developed markets. Trade liberalisation under GATT/ WTO has largely benefited the North-North trade. Developed countries have in fact been increasing the agricultural protection and NTBs in some cases.

Although the developing countries have introduced the Generalised System of Trade Preferences (GSTP) and formed several regional trade agreements to encourage trade among themselves, the progress of South-South trade has not been accelerated much by it.

Although problems still exist, the developing countries have increased their share of global exports and there has been some shift in the pattern of the trade—about 40 per cent of their exports now go to other developing countries.¹³ The increase in their global share of the manufactured exports has been notable.

Money and Finance There has not been any achievement in respect of the demands pertaining to money and finance, except some initiatives for debt relief. In fact, the ODA as a percentage of the donor countries' GDP has declined.

Technology and Investment The demands in the sphere of technology and investment also remain unfulfilled. However, the Brandt Commission and the UN's Economic and Social Commission have drawn up Codes of Conduct for the MNCs.

Participation in International Decision-making In this area also there has not been any development worth mentioning, except some measures for cooperation among developing countries and for expansion of South-South trade.

NIEO still remains, by and large, a dream.

In short, even after more than three decades since this issue came to the fore prominently, the demand for a NIEO still remains largely unfulfilled.

SUMMARY

The economic disparity between the developed and developing economies has been widening in several areas. The widening or the persistence of the **international economic gap** has been caused by such factors as the differences in the growth rates; unequal access to the market for goods, services and finance; population explosion in developing countries; the extraordinarily unequal distribution of the gains of developments in several spheres like technology; and, the negligence by the developed countries of the humanitarian needs of the developing countries.

Further, within the group of the developing countries, there have been wide disparities in the per capita income levels, growth rates, share of trade, share of foreign investment and Official Development Assistance, etc.

The 1990s turned out to be a decade of increasing marginalisation, inequality, poverty and social exclusion for the LDCs.

The present international economic order, which is biased against the developing economies, is regarded as one of the important reasons for the alarming international economic gap. Global economic policy-making occurs in a world of grossly unequal economic and political power. The playing field is not level when the "teams" have vastly different resources, expertise and negotiating power. There has, therefore, been a growing demand for a new economic order that will help remedy this problem.

The term **New International Economic Order (NIEO)** refers to a set of demands to ensure that the developing countries are accorded a fair, equal and, in some cases, a considerate deal in the international economic system. The demand for a NIEO implies, obviously, that the existing order is unfair.

The NIEO encompasses mostly a demand for the following: Improved access to the markets of the industrialised nations for manufactured exports from the South; changes in the marketing structure and pricing mechanism of primary commodities; reform in the international monetary system; access by the South to the technology and capital markets of the North; an increase in foreign aid or other forms of resource transfers to the South, and, meaningful participation in international decision-making.

The developed world has hardly shown any earnest appreciation of the NIEO. There was a tendency to brush it aside as irrational. Hence, the demand for a NIEO still remains largely unfulfilled, although it is more than three decades since this issue came to the fore.

Review Questions

1. What is meant by international economic gap? Discuss its extent and dimensions.
2. Explain the reasons for the persistence of the international economic gap.
3. Explain how the present international economic order is biased against the developing countries.
4. Discuss the need for a new international economic order.
5. Explain the salient features of the demand for new international economic order.
6. Write notes on the following.
 - (a) NIEO
 - (b) International economic gap
 - (c) Participation gap

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Suggested Readings

CHAPTER 3

3

Global Trade

LEARNING OBJECTIVES

- ☐ To understand the salient features and trends in global trade in goods and services.
- ☐ To get a general picture of trade balance.
- ☐ To get a broad picture of certain developments, viz., countertrade and global sourcing.
- ☐ To examine the problems and prospects of developing countries vis-à-vis global trade.
- ☐ To evaluate the development of South—South trade.

Trade across different regions of the world, though sparse, existed since times immemorial. There are clear evidences of international trade between ancient civilizations at great distance from each other.

In modern times, trade has been one of the most important drivers of the global economic integration. Thanks to liberalisation, propelled by the WTO and other factors, international trade has become a vibrant economic force of globalisation.

Trade continues to be the most powerful force for global economic integration.

For a long time, global trade, both merchandise and services, has been growing much faster than global output. In 2006, the combined value of trade in goods and commercial services exceeded \$14 trillion. The ratio of merchandise and services, in global trade, has remained more or less stable, at about 80:20, since 1990.

Table 3.1 World Exports of Merchandise and Commercial Services, 2006

(Billion dollars and percentage)

	<i>Value</i>	<i>Annual Percentage Change</i>			
	<i>2006</i>	<i>2000-06</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>
Merchandise	11762	11	22	14	15
Commercial services	2710	10	10	11	11

Source: WTO

This chapter examines important trends in global merchandise trade; countertrade which covers a significant part of the merchandise trade, mostly; the services trade; and, global sourcing which accounts for a substantial chunk of the global trade, both merchandise and services.

MERCHANDISE TRADE

Growth of International Trade

For a long time global trade has been growing at almost double the rate of growth in global GDP, and the trend is likely to continue in the future. Most importantly, exports from developing countries have been growing at a faster rate than those from the developed countries. Trade has been growing faster than world output means that a growing proportion of the national output is traded internationally, and an increasing share of the domestic consumption is met by imports.

Table 3.2 Growth of World Merchandise Exports

<i>Year</i>	<i>Value of Merchandise Exports (US \$ billions)</i>
1950	55
1960	113
1970	280
1980	1846
1990	3311
2000	6350
2006	12083

Sources: IMF, *International Financial Statistics* (various issues) and World Bank, *World Development Report*, 2002 and WTO website.

In fact, substantial differences in the growth rates of global GDP and trade have been a long-term historical trend. A WTO Annual Report points out that trade growth has consistently outpaced overall economic growth for at least 250 years, except for a comparatively brief period from the year 1913 to 1950. Between the years 1820 and 1913, trade growth was about one-and-a-half times the GDP growth. Slow GDP growth between the years 1913 and 1950—the period with the lowest average economic growth rate since 1820—was accompanied by even slower trade growth, as war and protectionism undermined international trade. This period included the Great Depression. During this time, trade declined by an unprecedented 60 per cent in volume, as countries tried to ‘export’ their economic crises, including unemployment, through protectionist trade barriers.¹

The second half of the twentieth century has seen trade expand at a much faster rate than output, increasing the dependence of the national economies on international trade, in the overall economic activity. For more than two and a half decades, until the oil shock of the early 1970s, there was tremendous expansion in world trade, propelled by progressive trade liberalisation and high growth rates of output. However, there been a substantial growth in the non-tariff barriers to trade and a fall in the growth rates of the developed economies has caused a slow down in the pace of trade growth. However, the rate of growth has been significantly higher than that of world output.

Although the export growth rate slowed down in volume terms during the 1970s and 1980s, value of exports registered a record rise in the 1970s. Worldwide inflation, particularly the successive hikes in oil prices, contributed significantly to this unprecedented sharp increase. The spurt in the value of exports

during the 1970s underwent self-correction during the 1980s, resulting in muted growth in both the volume and value of trade. Despite considerable increase in trade volumes, international price situation during the 1990s remained subdued, reflecting, inter alia, enhanced competition, productivity improvements and recessionary conditions in many industrialised countries.²

Global trade has been growing at a much faster rate than global output for a long time.

Table 3.3 World Growth in Output, Trade and Prices (Period Average)

	1951- 60	1961- 70	1971- 80	1981- 90	1991- 2000	1951- 80	1981- 2002
1	2	3	4	5	6	7	8
Growth in Production (in real terms) [@]							
Total	5.2	6.0	3.8	2.5	2.6	5.0	2.3
Agriculture	3.0	2.5	2.2	2.5	2.2	2.6	2.2
Mining	4.6	5.4	2.5	0.2	1.5	4.3	0.8
Manufacturing	6.7	7.4	4.3	3.0	2.7	6.1	2.6
World GDP Growth (in real terms)	4.5	5.5	4.1	3.2	2.3	4.7	2.6
Exports Growth (in US \$)							
Total	8.1	9.3	20.9	5.7	6.4	12.8	5.5
Agriculture	4.1	4.9	17.2	3.7	3.1	8.7	3.3
Mining	9.3	9.3	31.1	-0.7	6.9	16.6	2.4
Manufacturing	11.2	11.6	19.4	8.6	7.1	14.1	7.1
Exports Growth (in volume)							
Total	7.8	8.6	5.4	4.0	6.4	7.3	4.8
Agriculture	5.0	3.9	3.6	1.6	4.1	4.2	2.8
Mining	8.3	7.2	1.9	1.1	4.1	5.8	2.4
Manufacturing	8.9	10.5	7.2	5.6	7.2	8.9	5.9
Unit Exports Prices in US (\$)							
Total	0.3	0.6	14.8	1.6	0.0	5.2	0.6
Agriculture	-0.9	0.9	13.4	2.1	-1.0	4.5	0.5
Mining	1.2	2.0	29.2	-1.6	2.6	10.8	0.1
Manufacturing	2.1	1.0	11.4	2.8	-0.1	4.8	1.2
Sectoral Share in Exports (in US \$ terms)*							
Agriculture	35.5	25.3	17.4	13.9	11.1	26.1	12.2
Mining	17.7	16.9	22.2	20.1	11.1	18.9	15.7
Manufacturing	44.7	54.4	57.2	63.1	74.1	52.1	69.2

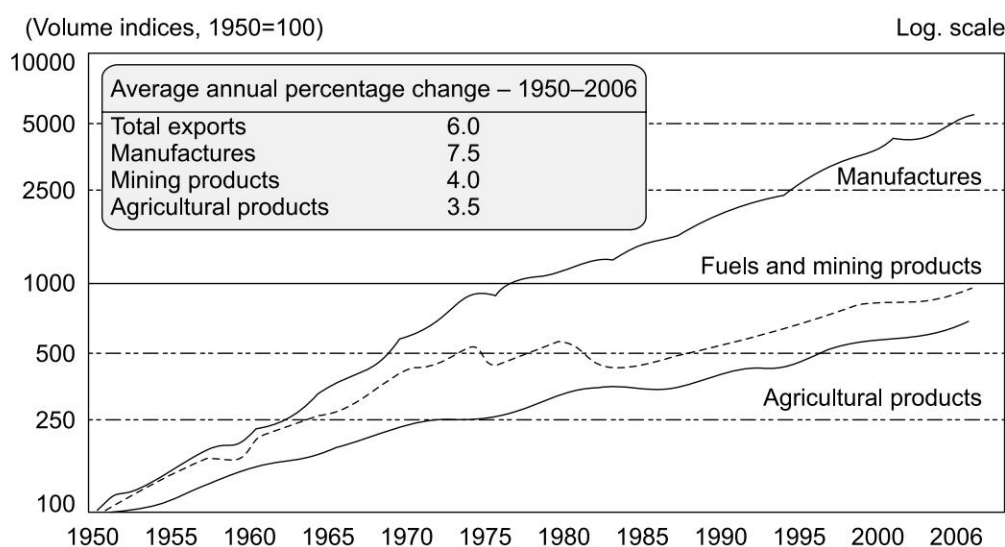
[@] World merchandise production differs from world GDP in that it excludes services and construction.

* The figures do not add up to 100 because of the presence of unspecified commodities.

Source: *International Trade Statistics*, WTO, 2003. (Cited by RBI, *Report on Currency and Finance*, 2002-03.

Except during the 1990s, when the volume and value of growth rates of merchandise exports were more or less the same, the rate of growth of value of exports since 1950 was higher than that of the volume. In the 1970s, the growth rate of export value was nearly four times that of the volume, mainly because of an average annual growth rate in the price of mining products (mostly oil), 29 per cent, while the volume growth rate of mining products was less than 2 per cent, compared to the average of more than 5 per cent for all the products. See Table 3.3.

Between 1950 and 2005, world trade has grown more than twenty-seven fold in volume terms. This expansion has been three times faster than growth in world GDP, which expanded eight-fold during the same period. The trade expansion was more pronounced for manufactures than for either agricultural products or fuel and mining products (see Fig 3.1). Trade in manufactures grew more than twice as fast as trade in agricultural products.



Source: WTO, *International Trade Statistics*, 2007.

Fig. 3.1

World Merchandise Exports by Product, 2006 (Billion dollars and percentage)

Salient Features of Global Trade Growth

The post-Second World War period shows two broad phases of global trade growth and integration: 1950-1980 and 1980 onwards.³

The **first phase** witnessed a revival of world trade, especially among the industrial countries. This was mainly facilitated by three factors:

1. Economic reconstruction following the two World Wars, and reduction in transportation costs.
2. Trade liberalisation, thanks mainly to GATT.
3. The move towards currency convertibility on current account transactions by leading industrial economies, which began in the late 1950s.

The **second phase** of trade integration started during the late 1970s when a number of East Asian economies embarked on the path of export-led growth. This was reinforced further during the 1980s and the 1990s, wherein a large number of developing countries gradually increased their degree of openness. During this period, outward oriented policies were undertaken on the grounds of efficient resource allocation, infusion of modern technologies, promotion of economies of scale, retention of consumer surplus, and reduction of rent-seeking and unproductive profit-seeking activities. For Latin America, the necessity to regain access to the international capital markets, to refinance outstanding debt, was an important consideration for opening-up during the 1970s. In contrast to earlier periods, in the 1990s, global economic integration has been much more widespread and is primarily driven by liberalisation of trade and capital controls. The technological revolution witnessed in the recent years and the emergence of new economy have further aided the integration process.⁴

Starting with some East Asian countries in the late 1970s, more and more developing countries have progressively liberalised trade.

India, however, remained, by and large, aloof till the early 1990s. In sharp contrast to the East Asian economies during most of this phase, India could not take full advantage of greater openness in trade regime. Despite some export promotion measures undertaken in the 1970s, Indian industries continued to remain protected. While the signs indicating a liberalised trade policy were clearly discernible in the latter half of 1980s, it was only in the 1990s that the country embarked on a truly liberalised trade regime.⁵

The increase in international trade, starting in the second half of the twentieth century, is unprecedented in historical terms. To put it in perspective, trade volume expansion between 1870 and the beginning of the First World War, sometimes described as the first wave of globalisation, was almost half of the expansion witnessed since 1950 (see Table 3.3). The difference in the rate of trade expansion between the first wave of globalisation and the post-war era persists even after taking into account the faster growth of GDP in the latter period. According to one estimate⁷, the trade to GDP ratio for the world rose from 4.6 per cent in 1870 to 7.9 per cent in 1913. This ratio has risen far more during the second wave of globalisation, reaching 19.4 per cent in 2005, thus confirming that trade growth in this era had outstripped the expansion of the previous period of globalisation.

The increasing **trade openness**, the thrust given to export development by the developing countries, and the impressive economic development of a number of these countries have contributed to the following structural changes in global trade:

Recent decades have witnessed structural changes in global trade.

1. Significant changes in the share of developing countries and Asia in world trade, mainly due to high export growth of China and East Asian countries since the 1980s;
2. Transformation of the exports basket of the developing countries from primary commodities to manufacturing exports;
3. Faster growth in export of technology intensive products by the developing countries compared to the industrial economies; and,
4. Faster growth in the South–South trade in the 1990s.

Over the past four decades, an important feature of international trade has been the growing participation of developing countries, as reflected by the faster growth of their exports as compared to the developed and Central and Eastern European countries.

Since the year 2000, import growth has been higher than export growth in North America, the Commonwealth of Independent States (CIS), the Middle East and Africa. Import growth was particularly strong in the CIS area during the period 2000–2006, where, on average, annual increase in imports was more than twice the exports (17 per cent and 8 per cent respectively). While for import and export growth rates South and Central America were almost balanced, Europe and Asia are the only regions where export growth has exceeded import growth since 2000. For Asia it has exceeded by almost one fifth.

Composition of Global Trade

There has been a considerable change in the composition of global trade. The share of manufactures in the total exports increased substantially, while that of the primary commodities declined correspondingly. The change has been more pronounced in as the developing countries the share of primary commodities, excluding fuels, dropped from 63 per cent in 1960 to 13 per cent in 2001 in their exports. The share of primary commodities, excluding fuels, in the global exports, was 12 per cent in 2006.⁸

Table 3.4 World Merchandise Exports by Major Product Group
2006

(Billion dollars and percentage)

	Agri- cultural Products	Fuels and mining products		Manufactures						
		Total	Fuels	Total	Iron and Steel	Chemicals	Office and Telecom Equipment	Auto- motive products	Textiles	Clothing
Value	945	2277	1771	8257	374	1248	1451	1016	216	311
Share in total exports	8	19.3	15.0	70.1	3.2	10.6	12.3	8.6	1.9	2.6
Annual percentage change 2000-2006	9	17	18	10	17	14	7	10	5	8

Source: WTO, *International Trade Statistics*, 2007.

Since the early 1950s, exports of manufactures have grown at nearly double the rate of growth in primary products.

From early 1950s to 2006, the volume of trade in manufactures has largely outperformed that in primary products, growing at an annual rate of 7.5 per cent, while agriculture and fuels and mining products grew at 3.5 percent and 4 percent respectively. The merchandise trade, as a whole, grew by 6 per cent during this period.

Agricultural exports accounted for almost 47 per cent of the total merchandise exports in 1950, but their share dropped to a record low of 8 per cent by 2006. In 1960, food items represented 17 per cent of world exports, while in 2001, they accounted for only 7 per cent. A similar drop occurred for agricultural raw materials. These patterns held true for both the developed and developing countries. Today, food represents about 80 per cent of agricultural exports.

The only exception is export of ores and metals, whose share in total exports remained fairly constant over the long period.

With 46 per cent global share in 2006, Europe is the largest exporter of agricultural products. Excluding the intra-trade, the European Union overtook the United States, as the leading exporter of agricultural products in 2005, Asia is the second major supplier with 19 per cent share in 2006.

Today, for South and Central America, the share of agricultural exports in their total trade is highest.

Manufactures increased their share from 38 per cent in 1950, to over three-fourths by the late 1990s. The share of manufactured goods in the developing countries' exports increased from 12 per cent in 1960 to 65 per cent in 2001, while in respect of the developed countries, it increased from 65 to 80 per cent during this period. The sharp increase in the export prices of crude petroleum, other minerals, and non-ferrous metals as compared to manufactures and agricultural products, for four years in a row, increased the share of fuels and mining to 19 per cent of the world merchandise trade in 2006, the highest share since 1986. The share of manufactures in global merchandise trade in 2006 was 70 per cent.

The dominant categories in the manufactured goods exports are office and telecom equipment and chemicals and automotive products, which together account for over 31 per cent of the total merchandise exports, and nearly 45 per cent of the manufactures exports, as per the data for 2006.

A number of factors—such as structural shifts in production caused by new technologies, demand pattern, new logistical factors, ways of organising and locating production, policies and new international trade rules and preference—are behind this change in the pattern of global trade. Primary products and resource based manufactures have been gradually losing importance, with the world trade witnessing a shift towards non-resource based products with increasing technological intensity.⁹

There are some noteworthy regional variations in the composition of exports:

- Asia has the highest share of manufactures in total exports, with more than 80 per cent of the region's exports stemming from this product group.
- The Middle East, Africa and the CIS are highly dependent on fuels and mining products, with more than two-thirds of their export revenues originating from this product group. This pattern of specialisation was accentuated with the rise in the international commodity prices.
- The least developed countries earn almost three-quarters of their export revenues from primary commodities, and manufactures (mainly clothing) account for only a quarter of their export earnings.
- South and Central America show the highest share of agricultural exports in their total trade.

Changes in the share of some countries in the global exports of manufactures is noteworthy. The most noteworthy is the emergence of China as the largest exporter of manufactures, with a share of nearly 11 per cent in 2006 from less than 1 per cent in 1980, surpassing the U.S. for the first time (having exceeded Japan in 2004). Between 2000 and 2006, China more than doubled its share, from 4.7 to 10.8 per cent. China gained mostly at the expense of USA and Japan, whose shares have fallen from 13 and 11 per cent respectively, in 1980, to 10 and 7 per cent in 2006. On the other hand, the share of USA in imports of manufactures increased from 11 per cent in 1980 to 16 per cent in 2006, that of Japan from 2.3 to 3.5 per cent and of China from about 1 to nearly 7 per cent for the same period.

China and USA together account for more than one-fifth of the global exports of manufactures.

In 2006, the EU accounted for 44 per cent of the manufactures exports and 40 per cent of the imports. (The respective extra-EU figures were 15 and 12). 15 countries account for more than 90 per cent of the total manufactures exports, and nearly 85 per cent of imports.

In 2006, India with a 1.0 per cent global share (compared to 0.5 per cent in 1980), was the 14th largest exporter of manufactures (compared to the 28th rank in the total merchandise exports). India, however, did not figure in the list of the 15 largest importers of manufactures.

Trends in Trade-GDP Ratio

The foreign trade-GDP ratio (i.e., the value of the exports and imports expressed as a percentage of the value of GDP) generally rises with economic development. This ratio had been generally high for the economically advanced countries as compared to the less developed countries. However, by the beginning of the 1990s, the developing countries overtook the developed countries in the trade-GDP ratio, and today, it is substantially higher for developing countries as compared to the developed ones. There are some extreme cases, like Singapore and Hong Kong, with exceptionally high foreign trade-GDP ratio, of well over 200 per cent. Being free ports, this is not, however, surprising. (Also see the sub-section *International Trade* under *Factors Affecting Global Economic Integration* in Chapter 1.)

The foreign trade-GDP ratio has been rising because of the faster growth of trade.

A WTO Annual Report points out that trade growth has consistently outpaced overall economic growth for at least 250 years, except for a comparatively brief period, from 1913 to 1950. Between 1720 and 1913, trade growth was about one-and-a-half times the GDP growth. Slow GDP growth between 1913 and 1950—the period with the lowest average economic growth rate since 1820—was accompanied by even slower trade growth, as war and protectionism undermined international trade. This period included the Great Depression. During this time, trade declined by an unprecedented 60 per cent in volume terms, as countries tried to ‘export’ their economic crises, including unemployment, through protectionist trade barriers.¹⁰

Table 3.5 World Exports and World GDP, 1870-2005

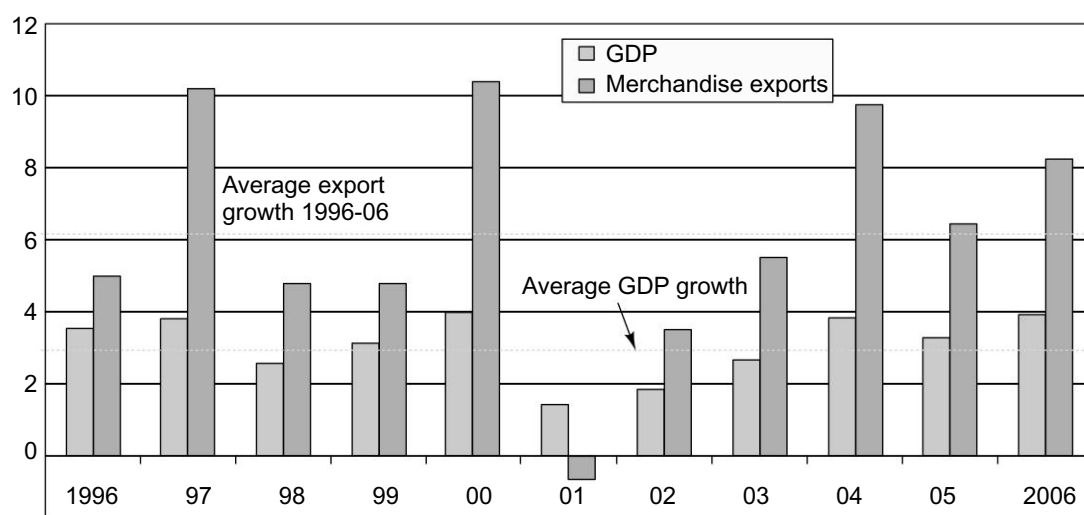
(In billions of constant 1990 dollars)

Item	1870	1913	Annual Growth: 1870-1913	1950	1998	2005	Annual Growth: 1950-2005
Exports	50.3	212.4	3.4%	296	5817	8043	6.2%
GDP	1,102	2,705	2.1%	5,336	33,726	41,456	3.8%
Trade/GDP	4.6%	7.9%		5.5%	17.2%	19.4%	

Source: Maddison, A. *The World Economy: A Millennial Perspective*, Tables B-18 and F-3 and WTO's calculations. The last two columns are not from Maddison. The figures in the last column are derived from the International Trade Statistics, 2005 and were used to calculate world exports and world GDP for 2005 (in 1990 prices). This table is reproduced here from WTO, *World Trade Report*, 2007.

The second half of the twentieth century has seen trade expand much faster than output, increasing the dependence of national economies on international trade in overall economic activity. In the last two decades of the twentieth century, world trade has grown twice as fast as world real GDP (6 per cent versus 3 per cent). In the case of manufactures, the difference between the growth rates of trade and

output has been much more staggering.¹¹ Between 1960 and 2000, the share of world merchandise exports in the world gross domestic product (export-GDP ratio) doubled from 10 per cent to 20 per cent. The trend has been continuing.



Source: WTO

Fig. 3.2

Growth in the Volume of World Merchandise Trade and GDP, 1996-2006 (Annual percentage change)

Because of the faster trade growth, by the beginning of the 1990s, the developing countries overtook the developed countries in the trade-GDP ratio, and today it is substantially higher for the developing countries than the developed ones. In 2005, the trade-GNI ratio was 43 per cent for high income economies, 66 per cent in respect of the middle income economies and 42 per cent for the low income economies. (The low and middle income countries fall within the category of developing countries).

Although the USA is a highly advanced economy, the foreign (merchandise) trade-GDP ratio is only about 20 per cent of the GDP. However, this largest economy in the world is also the largest trading nation in terms of the absolute volume of its international trade. The fact that the US is a large nation with abundant natural resources, and is richly endowed with capital, technology and enterprise, enables her to produce most of the goods she wants at home. These facts, as well as the high level of its GDP, explain why the total value of the foreign trade is equivalent to only a comparatively small percentage of the GDP.

India presented an interesting case. There was near stagnation in her foreign trade-GDP ratio for about four decades, since the commencement of development planning (1951). During this period, it hovered around 15 per cent. The inward looking economic policy, import compression and very slow progress on the export front were responsible for this. However, following economic liberalisation, ushered in 1991, there has been an increase in India's foreign trade-GDP ratio—it was about 33 per cent in 2006. The export-GDP ratio

India's trade-GDP ratio, which had been stagnant for a long time, has risen significantly since liberalisation.

increased from less than 6 per cent in 1990-91 to over 13 per cent in 2005-06. During the same period, the import-GDP ratio increased from less than 9 per cent in to nearly 20 per cent.

Trade Balance

There is no rule or empirical evidence that any particular category of countries will have trade deficit or surplus. Both the developed and developing categories have countries with trade surplus trade deficit. Further, the status of trade balance of some countries change from time to time. However, developing countries, as a group, have been showing favourable merchandise trade balance while the developed nations have been showing a collective negative balance. In the case of services trade, the positions are just the opposite.

The 1970s witnessed a remarkable turnaround in the merchandise trade balance of the developing countries. In 1980, their exports were 20 per cent more than imports, as compared to the merchandise trade deficit in the early 1970s. This improvement was largely attributable to the rise in oil prices, after the oil crises of 1974 and 1979. However, a number of non-oil exporters, too, have been enjoying trade surplus. The 1980s and the early 1990s witnessed a deterioration in the trade balance of the developing countries. In 1990, although the balance was still positive, exports were only 2 per cent more than imports. By the mid-1990s, the exports-to-imports ratio had returned to its 1970 level. The trade balance of the developed countries, on the other hand, remained negative during the period under consideration. In recent years, while the developing countries, as group, had a goods trade surplus, the high income countries showed net deficit. The group of middle income countries have registered trade surplus, while the low income economies have shown a deficit. (see Table 3.6). (The group of developing countries consists of both the middle income and the low income economies, and also some high income economies. While all developed countries are high income economies, some of the high income economies, like some oil exporters, are developing economies).

Developed countries, as a group, have goods trade deficit, and developing countries have goods trade surplus. Services trade balance presents the opposite picture.

Table 3.6 Foreign (Merchandise) Trade Scenario, 2005

Category	Exports (\$ billion)	Imports (\$ billion)	Trade balance (\$billion)	Exports as a percentage of imports
High income economies	7,351	7,790	-439	94
Middle & low income economies	3,042	2,862	180	106
Middle income economies	2,785	2,551	234	109
Low income economies	256	311	-55	82

Source: Computed from the *World Development Report*, 2007 data.

The services trade, however, has been showing the opposite trend—the developed countries, as a group, had a positive trade balance over the 1980s and the 1990s, while the services trade balance of the developing countries remained negative in these two decades. This trend continues in the present decade.

The USA, the largest importer and the second largest exporter the biggest exporter until recently, has been, consistently, the country with the largest merchandise trade deficit. In 2006, the US merchandise imports were about 86 per cent higher than the exports. The trade deficit of USA, in 2006 (\$ 881 billion), was larger than the value of GDP of all, except a few, developing countries and a number of developed economies. India's trade surplus with the US increased from \$1.6 billion in 1995-96 to \$ 6.5 billion in 2000-01.

Among the developing economies, China has been occupying an enviable position regarding trade balance. China, which had a trade deficit of over \$13 billion in 1985, had a surplus of nearly \$ 9 billion in 1990, \$ 25 billion in 2000 and \$ 177 billion in 2006. (The trade surplus of China has been much larger than the total merchandise exports of India—\$120 billion in 2006). Other developing countries with significant trade surplus include Malaysia, S. Korea and Taiwan. Many developing countries have remained in deficit. During the last five and a half decades or so, India's trade balance was always negative, except for two years (1972–73 and 1976–77). Among the transition economies, in recent years, while Russia has a large trade surplus, many others have an adverse balance.

Distribution of Global Trade

Much of the trade takes place between the developed countries, particularly the *triad* (USA, Western Europe and Japan). China has recently emerged as the largest exporter and importer. Bulk of the exports of the developing countries is also absorbed by the developed countries.

The global trade is dominated by a small number of countries.

Just three countries—Germany, USA and China—account for over a quarter of the global trade in goods. More than half of the world exports originate in just 10 countries. 15 countries contribute about two-thirds of the total exports. 21 countries contribute about three-fourths and 30 countries about 85 per cent of the global merchandise trade. The next 20 largest exporters contribute less than 10 per cent. Thus, while the top 50 exporters account for nearly 94 per cent of the global trade in goods, the remaining countries, more than three times this number, contribute only about 6 per cent of the total exports (see Table 3.7).

For many years, the top position, in terms of the value of merchandise exports, was occupied by the US, with Germany and Japan in second and third positions respectively. However, in 2003, Germany relegated USA to the second position in export of goods. The United States has been the largest importer, followed by Germany. China quickly emerged as one of the top importers, stepping up to the third rank in 2003, from 12th in 1997 and 6th in 2002, whereas China's rank in exports improved from 10th in 1997 and 5th in 2002, to 4th in 2003 and 3rd in 2004. In 2006, China's share of global export of goods was 8 per cent, and that of imports 6.4 per cent. China is very likely to emerge as the largest exporter within a few years.

Table 3.7 Leading Exporters and Importers in World Merchandise Trade, 2006

(\$ billion and percentage)

Rank	Exporters	Value	Share	Rank	Importers	Value	Share
1	Germany	1112.0	9.2	1	United States	1919.4	15.5
2	United States	1038.3	8.6	2	Germany	908.6	7.3
3	China	968.9	8.0	3	China	791.5	6.4
4	Japan	649.9	5.4	4f	United Kingdom	619.4	5.0
5	France	490.4	4.1	5	Japan	579.6	4.7
6	Netherlands	462.4	3.8	6	France	534.9	4.3
7	United Kingdom	448.3	3.7	7	Italy	437.4	3.5
8	Italy	410.6	3.4	8	Netherlands	416.4	3.4
9	Canada	389.5	3.2	9	Canada	357.7	2.9
10	Belgium	369.2	3.1	10	Belgium	353.7	2.9
11	Korea, Republic of	325.5	2.7	11	Hong Kong, China	335.8	2.7
12	Hong Kong, China	322.7	2.7		Retained imports ^a	35.9	0.3
	Domestic exports	22.8	0.2	12	Spain	316.4	2.5
	Re-exports	299.9	2.5				
13	Russian Federation	304.5	2.5	13	Korea, Republic of	309.4	2.5
14	Singapore	271.8	2.2	14	Mexico	268.2	2.2
	Domestic exports	143.1	1.2	15	Singapore	238.7	1.9
	Re-exports	128.6	1.1		Retained imports (a)	110.0	0.9
15	Mexico	250.4	2.1				
16	Taipei, Chinese	223.8	1.9	16	Taipei, Chinese	203.0	1.6
17	Saudi Arabia	209.5	1.7	17	India	174.8	1.4
18	Spain	205.5	1.7	18	Russian Federation (b)	163.9	1.3
19	Malaysia	160.7	1.3	19	Switzerland	141.4	1.1
20	Switzerland	147.5	1.2	20	Austria	140.3	1.1
21	Sweden	147.4	1.2	21	Australia	139.3	1.1
22	Austria	140.4	1.2	22	Turkey	138.3	1.1
23	United Arab Emirates	139.4	1.2	23	Malaysia	131.2	1.1
24	Brazil	137.5	1.1	24	Thailand	128.6	1.0
25	Thailand	130.8	1.1	25	Sweden	126.7	1.0
26	Australia	123.3	1.0	26	Poland	126.0	1.0
27	Norway	121.5	1.0	27	United Arab Emirates	97.8	0.8
28	India	120.3	1.0	28	Brazil	95.9	0.8
29	Ireland	111.1	0.9	29	Czech Republic	93.2	0.8
30	Poland	110.3	0.9	30	Denmark	86.3	0.7

Source: WTO

Although China is the only developing economy in the top 10 exporters, there are several other developing countries in the top 20 list. A small number of countries account for the bulk of the total exports of the developing countries.

India's share in the global merchandise exports declined from about 2 per cent in 1950 to about 0.4 per cent in 1980. From the mid 1980s, there has been a slight improvement, and it was about one per cent in 2006. In 2006, India's rank in global merchandise exports was 28th, and in imports, it was 17th, with a share of 1.4 per cent. In services trade, India's rank in exports was 10th, with a share of 2.7 per cent, and in imports, it was 13th, with a share of 2.4 per cent.

Table 3.8 shows the secular changes in the shares of different regions and countries in global trade.

The following important trends in the shares of different regions/countries, in respect of global merchandise trade, in the last six decades are noteworthy:

- There has been significant decline in the share of the following regions/countries in respect of merchandise exports: North America, United States, South and Central America, United Kingdom, Africa, Australia and New Zealand and Canada.
- The export shares of the following regions/countries improved substantially: Europe, Germany, Italy, China, Asia, Middle East and Mexico. There was a sharp increase in the share of Japan until the early 1990s, but it declined thereafter.
- The following regions/countries witnessed substantial increase in their shares in the merchandise imports: Asia, United States and China.
- The following regions/countries experienced significant decline in their shares of merchandise imports: United Kingdom, South and Central America, Africa and Australia and New Zealand.

Table 3.8 Changes in the Share (Percentage) of World Merchandise Exports and Imports by Region and Selected Economy

	<i>Exports</i>					<i>Imports</i>				
	<i>1948</i>	<i>1953</i>	<i>1973</i>	<i>1993</i>	<i>2006</i>	<i>1948</i>	<i>1953</i>	<i>1973</i>	<i>1993</i>	<i>2006</i>
North America	28.1	24.8	17.3	18	14.2	18.5	20.5	17.2	21.5	21.0
United States	21.7	18.8	12.3	12.6	8.8	13.0	13.9	12.3	16.0	15.8
Canada	5.5	5.2	4.6	4	3.3	4.4	5.5	4.2	3.7	3.0
Mexico	0.9	0.7	0.4	1.4	2.1	1.0	0.9	0.6	1.8	2.2
South and Central America	11.3	9.7	4.3	3.0	3.6	10.4	8.3	4.4	3.3	3.0
Brazil	2.0	1.8	1.1	1.0	1.2	1.8	1.6	1.2	0.7	0.8
Argentina	2.8	1.3	0.6	0.4	0.4	2.5	0.9	0.4	0.4	0.3
Europe	35.1	39.4	50.9	45.4	42.1	45.3	43.7	53.3	44.8	43.1
Germany ^a	1.4	5.3	11.6	10.3	9.4	22	4.5	9.2	9.1	7.5
France	3.4	4.8	6.3	6.0	4.2	5.5	4.9	6.3	5.8	4.4
United Kingdom	11.3	9.0	5.1	4.9	3.8	13.4	11.0	6.5	5.6	5.1
Italy	1.8	1.8	3.8	4.6	3.5	2.5	2.8	4.7	3.9	3.6

(Contd.)

Table 3.8 (Contd.)

Commonwealth of Independent States (CIS) ^b	1.5 3.6					1.2 2.3				
Africa	7.3	6.5	4.8	2.5	3.1	8.1	7.0	3.9	2.6	2.4
Middle East	2.0	2.7	4.1	3.5	5.5	1.8	2.1	2.7	3.4	3.1
Asia	14.0	13.4	14.9	26.1	27.8	13.9	15.1	14.9	23.3	25.0
China	0.9	1.2	1.0	2.5	8.2	0.6	1.6	0.9	2.8	6.5
Japan	0.4	1.5	6.4	9.9	5.5	1.1	2.8	6.5	6.4	4.8
India	2.2	1.3	0.5	0.6	1.0	2.3	1.4	0.5	.6	1.4
Australia and New Zealand	3.7	3.2	2.1	1.5	1.2	2.9	2.3	1.6	1.5	1.4
Six East Asian Traders	3.4	3.0	3.4	9.7	9.6	3.5	3.7	3.7	9.9	8.6
Memorandum item										
EU ^c	38.6 36.1 38.5					39.2 34.3 39.2				
Former USSR	2.2	3.5	3.7	1.9	3.3	3.5				
GATT/WTO members ^d	60.4	68.7	81.8	89.5	93.9	52.9	66.0	89.1	88.7	95.8

Legend

^afigures refer to the Fed. Rep. of Germany from 1948 through 1983.

^bfigures are significantly affected by i) changes in the country composition of the region and major adjustment in trade conversion factors between 1983 and 1993; and ii) including the mutual trade flows of the Baltic States and the CIS between 1993 and 2003.

^cfigures refer to the EEC(6) in 1963, EC(10) in 1983, EU(12) in 1993, and EU(25) in 2003 and 2006.

^dmembership as of the year stated.

Note: Between 1973 and 1983 and between 1993 and 2003 export shares were significantly influenced by price related developments.

Source: WTO, *International Trade Statistics*, 2007.

Distributional Consequences of Trade Liberalisation

A very important issue is the distributional consequences of trade liberalisation across countries. As the WTO observes, this is an important issue because some critics claim that the trading system and the globalisation process frustrate the integration of some developing countries into international economy, and contribute to an increasingly uneven income distribution in the world. There is, however, no evidence on systematic marginalisation of developing countries. World trade flows, for example, have not become more concentrated in the hands of a few countries. On the contrary, theory and empirical evidence suggest that small and less developed countries potentially stand to benefit most from trade liberalisation. It is rather the policy environment, including openness to trade, which determines the degree of trade integration, and whether countries move in the direction of income convergence, or marginalisation, and

impoverishment. External trade barriers, maintained by trading partners, affect the ability of some countries to benefit from trade, but it is not a widespread problem of income countries.¹³

It is suggested that there are at least four reasons why small countries potentially stand to benefit more from trade liberalisation than larger ones.

Theoretically, less developed countries should benefit from trade liberalisation.

First, liberalisation increases the size of markets in which firms operate. This will particularly benefit producers from small economies with limited domestic markets, as they may be able to exploit economies of scale and lower their production costs, following liberalisation in trading partner markets.

Second, liberalisation can break-up monopolies which are more likely to exist in small economies.

Third, trade enhances product diversity in small economies more than in large ones.

Finally, the impact of liberalisation on the transfer of productivity-enhancing technology is also likely to be greater in small countries. The smaller the country, the larger the fraction of know-how that has to be brought in from abroad. Part of this transfer typically occurs through trade.¹⁴

The claim that only a few countries have benefited from the rapid increase in trade, in recent decades, is based on the observation that the share of some regions in world trade has declined, and this is seen as part of the story of marginalisation. Sub-Saharan Africa, for example, which accounted for 3.1 per cent of world exports in the 1950s, saw its share fall to 1.2 per cent by 1990, and Latin America saw its world market share decline as well. Western Europe, on the other hand, increased its share of world trade from 40 to almost 45 per cent over the same period. In other words, critics claim that there is a built-in bias in the world trading system which has led to a concentration of trade flows in the world. Furthermore, critics argue that this bias has contributed to a growing income inequality in the world.¹⁵

Three questions, however, may be asked. First, can we observe an increase in the concentration of world trade flows? Second, has there been a growing income inequality in the world? Third, what is the link between these and the international and domestic policy environment?¹⁶

A study of the concentration of trade flows by Low, Olarreaga and Suarez, over a period of 20 years (1976–95), indicates that the increase in world trade has been relatively more evenly distributed across countries, and has improved the overall distribution of international trade in the world. The concentration indicator shows that world trade today is 50 per cent more evenly distributed than 20 years ago.¹⁷

This does not, however, mean that countries have not experienced marginalisation in terms of their participation in international trade. Trade integration, especially of some African countries, has been declining. The study, referred to above, only demonstrates that there is no systematic marginalisation of certain country groups, such as developing countries.

If we do not observe a systematic concentration of trade flows across the world, but there is a lack of trade integration of certain countries, then what is at the root of this marginalisation? Evidence on Sub-Saharan Africa by Ng and Yeats suggests that the decline in importance of this region in world trade is due to two main reasons. First, countries have lost competitiveness in their traditional export markets which, in turn, have been declining in relative importance in world trade. Second, these countries were unable to diversify their export base. As a result, many African countries, for example, are now highly dependent on relatively few export products, and this dependence has even increased over the past three decades. It is argued that the loss of competitiveness and absence of diversification is mainly due to trade restrictions and policy interventions in their own economies, which created a bias against

exports. Trade barriers in Africa have been higher than in other developing countries, resulting in higher domestic costs discouraging exports.¹⁸ (For an explanation of this point, see the section on *Trade Strategies* in Chapter 9).

Growing Intra-Regional Trade

Global trade flow is predominantly intra-regional.

An important trend has been the growth of the intra-regional trade. In fact, some people view world trade as consisting broadly of intra-regional and inter-regional trade. There is also talk of regionalisation versus globalisation of world trade.

Regional integration schemes tend to increase intra-regional trade. For example, trade between the 12 members of the European Community (EC) increased from about 40 per cent of their total trade in 1960 to 60 per cent in 1990. Intra-regional trade increased in the European Free Trade Association (EFTA) and the Association of South East Asian Nations (ASEAN).

In 1980s, the share of intra-regional trade in total world trade increased in Western Europe, North America and Asia. In 1990, intra-regional trade in goods accounted for 61 per cent of total trade in goods of the European Community. It was 41 per cent for Asia, 35 per cent for North America, and over 60 per cent for the Pacific Rim nations.

A 2007 WTO report observes that global trade is predominantly intra-regional in flow. Distance still appears to be a barrier to trade. Inter-regional merchandise trade flows between North America, Europe and Asia account for only 23 per cent of world trade, while intra-regional trade flows of the three regions represent 53 per cent of world merchandise trade, and almost two-thirds of the total merchandise trade of these regions. Europe's intra-trade shows the highest share (31 per cent), followed by Asia (14 per cent) and North America (8 per cent). Intra-regional trade for other regions (South and Central America, CIS, Middle East and Africa) account for only 2.5 per cent of their total exports. The most prominent growth in 2006 was recorded in Asia's exports to Europe, which increased by 21 per cent.¹⁹

Reciprocal Trade and Adversarial Trade

Intra-industry trade has been growing in importance, particularly among industrial economies.

Peter Ducker, world renowned management guru, argues that trade between industrial countries (except Japan) has become reciprocal as against the erstwhile competitive trade which was based on comparative advantage.²⁰

In reciprocal trade, a country imports the same sort of goods as it exports. For example, the US is the world's largest importer as well as exporter of chemicals. Similarly, the west European countries import large quantities of the same sorts of goods they export.

This, however, is not true of Japan which, according to Ducker, practices adversarial trade, i.e., Japan does not import the same sort of goods as it exports. For example, large exports of Japanese cars to US are not matched by such car imports from the US to Japan.

Ducker appears to have overlooked certain important factors in his analysis and categorisation of trade patterns.

A modern industry may consist of many segments. For example, the chemical industry consists of a large number of product groups and subgroups. A country may be more efficient in the production of some products, as compared to other countries, but may be inefficient in case of other products in the same industry. It may export the products it produces more efficiently, and import others from more

efficient producers. It is, therefore, quite possible that a country is a large exporter and importer of products of a particular industry. Trade is competitive in such a situation. (Also see the section *Intra-Industry Trade* in Chapter 6).

If Japanese automobiles increase their share in the US, it must be because the consumers regard them as superior to the American makes on some determinant factor—price, fuel efficiency, features, etc. The US companies could not make inroads into the Japanese market because the Japanese consumers do not find American cars superior to Japanese cars. No wonder, despite voluntary export restraints, the share of Japanese cars in new car sales in the US increased substantially while, in spite of the support provided by the Japanese auto companies to increase the sales of American cars in Japan, the American share of the Japanese market has been very low.

One of the most objective evaluations of Drucker's charge of adversarial trade on Japan came from *The Economist*, which observed that it is "odd to claim that because Japan does not import large quantities of the same things as it exports, such trade is 'adversarial', a term generally contrasted to the sort of trade that is mutually beneficial. This is to misunderstand what trade is all about."²¹

Growing Protectionism

After World War II, there had been progressive liberalisation of trade by the developed countries. Successive rounds of negotiations at the GATT have cut tariffs on trade in manufactured goods, from an average level of 40 per cent in 1947 to approximately 3 per cent, in the industrial countries today.

Despite loud talks of trade liberalisation, trade barriers, particularly NTBs, inhibit and distort trade.

Even though the process of elimination of the tariff barriers continued, from around the mid 1970s, the liberalisation trend in the developed countries has been replaced by growing protectionism. A number of problems—like the currency crisis, oil crisis, debt crisis, recession and high rate of unemployment—produced an atmosphere in the world, in which demands for protection increased dramatically. Added to these is the growing competition from Japan and the newly industrialising countries. In response to these, the developed countries have increased the non-tariff barriers (NTBs). In addition to the *hard-core* NTBs, such as quotas, voluntary export restraints, multifibre arrangements (MFA), etc., these include measures such as price restraints or health and safety regulations. The exports of developing countries have been hit much more than those of the developed countries by such protectionism, and the developing countries have been losing very heavily as a consequence, as pointed out in Chapter 2.

Trade and Investment

Foreign trade and foreign direct investment (FDI) appear to be mutually influential.

FDI in the natural resource sectors, including plantations, in developing countries increase trade. The MNCs' FDIs in other sectors, due to several reasons, also increase international trade in many cases.

While some FDIs increase international trade, some FDIs decrease trade.

While, on the one hand, investment increases trade, (as stated above), on the other hand, foreign production by FDI substitutes foreign trade in many cases. Due to factors like foreign exchange problems, desire to industrialise fast, etc., the policies of many developing countries preferred foreign investment (for import substitution) to imports.

Due to the growing protectionism and some other factors, large amounts of FDI have been taking place in the developed countries, leading to substitution of foreign production for foreign trade, as described in the chapter on *International Capital Flows*. The regional integration schemes also tend to increase such investments, to substitute production for trade. For example, many foreign companies have been setting up manufacturing and assembly facilities in the EU to overcome the 'Fortress Europe'.

It may also be pointed out that, to a considerable extent, such investments are made possible by past trade—funds generated by trade are ploughed back for investment in foreign countries. The massive foreign investments made by the Japanese companies, since the mid 1980s, deserve a special mention in this context.

While international investment replaces international trade in certain products, it may generate trade in some other products. Ducker, who observes that although, traditionally, investment has followed trade, trade is increasingly becoming dependent on investment, points out that US exports in the years of the overvalued dollar would have been even lower, had the European subsidiaries of American companies and American joint ventures in Japan not continued to buy machinery, chemicals and parts from the US. Similarly, the foreign subsidiaries of America's financial institutions accounted for about one half of the US service income during those dismal years.²² That about half of the World trade in manufactured goods is intra-company, is ample indication of the investment-trade linkage. There is growing evidence that "...it is simply not possible to maintain substantial market standing in an important area unless one has a physical presence as a producer"²³. For many years, international investment has been growing much faster than international trade. "Increasingly, world investment, rather than world trade, will be driving the international economy. Exchange rates, taxes and legal rules will become more important than wage rates and tariffs."²⁴

Resource seeking and efficiency seeking investments normally increase trade. Value of exports of foreign affiliates of international firms increased from \$ 1523 billion in 1990 to \$ 4707 billion in 2006. This amounted to one-third of the global trade in goods and non-factor service in 2006.

As a RBI Report observes, existing empirical evidence appears inconclusive on whether FDI serves as a complement or a substitute to trade, since the nature of investment strategy, the level of data aggregation, and host and home-country specifics complicate this relationship. However, the liberalisation of FDI, especially since the 1980s, in East Asian economies is widely acknowledged to have provided a boost to their exports, with inward FDI shifting the incentives from import substitution production to export orientation. The contribution of FDI to export expansion has been particularly large for the ASEAN members and China, as against the exporting economies of Hong Kong, Korea and Taiwan, as the former countries attracted mainly export oriented FDI. Foreign affiliates accounted for about half of the total exports of China in the earlier half of this decade, and was even higher in some high-tech industries.²⁵

COUNTERTRADE

Countertrade is a form of international trade in which certain export and import transactions are directly linked with each other, and in which import of goods are paid for by export of goods, instead of money payments.

In modern economies, most transactions involve monetary payments and receipts, either immediate or deferred. As against this, "... countertrade refers to a variety of unconventional international trade practices which link exchange of goods—directly or indirectly—in an attempt to dispense with currency transactions."²⁶

Countertrade is barter type bilateral trade in which exports and imports are mutually linked.

Forms of Countertrade

Countertrade takes several forms. The following are the most common among them:

- (i) **Barter:** Barter refers to direct exchange of goods of equal value, with no money and no third party involved. For example, a countertrade deal between the MMTC and a Yugoslavian company involved import of 50,000 tonnes of rails of value of about \$38 million by the MMTC, and the purchase, in return, by the Yugoslavian company of iron ore concentrates and pellets of the same value.
- (ii) **Buy Back:** Under the buy back agreement, the supplier of plant, equipment or technology agrees to purchase goods manufactured with that equipment or technology. Under the buy back scheme, the full payment may be made in kind, or a part may be made in kind, and the balance in cash. Thus, a Rs 20 crore buy back agreement with the erstwhile Soviet Union provided for the import of 200 sophisticated looms by the National Textiles Corporation. The buy back ratio was 75 per cent.
- (iii) **Compensation Deal:** Under this arrangement, the seller receives a part of the payment in cash, and the rest in products.
- (iv) **Counterpurchase:** Under the counterpurchase agreement, the seller receives the full payment in cash but agrees to spend an equivalent amount of money in that country, within a specified period. A classic example of this kind of an agreement was Pepsi Cola's trade with erstwhile USSR. Pepsi Cola got paid in Roubles for the sale of its concentrates in the USSR, but spent this amount for purchase of Russian products, like Vodka and wine.

The array of countertrade transactions reported in the trade press is intriguing. Some interesting examples are cited in the author's *International Business* (Prentice-Hall of India).

Growth of Countertrade

A significant volume of international trade is covered by countertrade. Countertrade, of course, is not a new phenomenon. The 1970s and 1980s witnessed a remarkable growth in this type of international trade, encouraged by many governments, and actively involved by many trading houses, both private and public, although organisations like GATT and IMF do not favour it.

According to some reports, there was an increase in the number of countries practicing countertrade. According to an estimate by the *Economist*, sometime ago, countertrade accounted for one-fourth of all world trade.²⁷ The political and economic changes in the former USSR and Eastern Europe do not appear to have adversely affected the growth of countertrade.

Countertrade has been growing with government patronage. According to one report, more than 81 countries across the world had actual pro-countertrade government policies.²⁸ Countertrade has been made mandatory by a number of countries. Even though a number of other countries have no mandatory provisions, all encourage their importers to settle transactions on countertrade basis. Indian public sector agencies like STC and MMTC are active in countertrade. The Government of India had set up a special cell in the Ministry of Commerce to monitor international developments in countertrade, and to develop an appropriate policy to enable Indian canalising agencies to make best use of the opportunities available, to boost India's exports through countertrade.

It may be noted that the South Commission has advocated countertrade as a useful mechanism for overcoming difficulties of payments, export credit and foreign exchange, which may otherwise be serious

obstacles in the expansion of trade between developing countries. As the Commission points out, so far, the bulk of countertrade between developing countries has been conducted through intermediaries in the industrial countries. It is the developed countries who have benefited most from this type of trade, and they obviously have no interest in helping the indirect trading partners in the LDCs to establish direct contacts and develop durable trading relationships. Therefore, the developing countries need to organise themselves for countertrade, as this can also pave the way for the growth of more conventional trading relations.²⁹

Reasons for the Growth of Countertrade

There are several reasons that have made countertrade popular. Obviously, the countries, or the companies concerned, have encouraged or involved in countertrade due to certain specific advantages, although some of the benefits may be purely temporary.

1. Countertrade was very common between the communist countries. It also became popular with respect to trade between the Communist Bloc and many developing countries, because many developing countries were eagerly looking towards this bloc for increasing their exports, among other things, and this naturally led to the acceptance of the trade practice preferred by these centrally planned economies.
2. Countertrade became popular in the East-West trade mainly due to the foreign exchange problems faced by the Eastern Bloc. Pepsi Cola is just one example of a multinational corporation which has made considerable international business with the USSR by countertrade.
3. When the foreign exchange problem became very severe for the developing countries, following the oil price hikes, they began to actively pursue countertrade in a frantic bid to increase their exports by any means.
4. Many companies in the advanced countries have resorted to countertrade for various reasons, like selling obsolete products, increasing the sale of capital goods, increasing aggregate business, etc. Countertrade has also been resorted to by several companies to mitigate the effects of recession. Such recessionary situations in the capital goods industries, in the advanced countries, gave the developing countries an opportunity to push their exports by tying imports of capital goods with exports, by countertrade.
5. The results of a survey of 35 British companies involved in international countertrade, by Shipley and Neale, indicate that the Eastern Bloc countries resorted to countertrade because of such factors as their acute currency and international debt problems. Nevertheless, a substantial proportion of firms conduct countertrade in the world's less developed regions, while there is some limited support for the claims that developed nations countertrade among themselves.³⁰
6. The results of the above survey also suggest that countertrade enables firms to penetrate difficult markets, to increase sales volume and to achieve fuller capacity utilisation. It has also been revealed that countertrade enables firms to dispose of declining products, which is particularly important, given the rapid pace of technological advance. Thirty seven per cent of the companies surveyed reported this benefit.
7. Some countries have also made countertrade a means to increase sales through disguised undercutting of the cartel prices (for example, the oil price fixed by the OPEC).

8. Having realised the potential of increasing business by engaging in countertrade, many international trading corporations became active in countertrade. Their trading with many countries enabled them to even take up such complex transactions as the case of Daimler-Benz cited earlier.

It may be noted here that, after the disintegration of the erstwhile Soviet Union, when the Government of India is finding it difficult to establish two-way trade flows, the Pepsi Foods Private Ltd (PFPL) has made an attractive offer to the government to enter into countertrade deals with individual enterprises in the Commonwealth of Independent States to import the much needed oil, non-ferrous metals, fertilisers and newsprint.

Drawbacks

Although countertrade has several justifications, particularly in the short run, it suffers from a number of disadvantages and problems also, particularly in the long run.

1. Countertrade encourages bilateralism at the expense of multilateralism.
2. It adversely affects export market development.
3. Although several developing countries regard countertrade as an easy route to export, they often stand to lose in terms of price. For instance, Poland bought Libyan oil at a discount and sold it at a higher price at the Rotterdam spot market.
4. It adversely affects competition.

Countertrade dampens multilateralism, distorts trade flows and injures long-term interests of the participants.

TRADE IN SERVICES

According to the IMF's *Balance of Payments Manual*, services are economic output of intangible commodities that may be produced, transferred and consumed at the same time. However, services cover a heterogeneous range of intangible products and activities that are difficult to capture within a single definition, and are sometimes hard to separate from goods. Services are outputs produced to order, and they typically include changes in the condition of the consumers realised through the activities of the producers, at the demand of customers. Ownership rights cannot be established over services. By the time the production of a service is completed, it must have been provided to a consumer. Examples of services include wholesale, hotel, catering, transport, insurance, education, property rental, telecommunications, marketing, health and cultural and recreational services.³¹

Growing Importance of Services

International trade in services, which make-up a major share of the invisibles account of the Balance of Payments, has been growing fast.

Economic development is generally characterised by an increase in the share of services in the GDP and total employment. This trend tends to increase the international trade in services. The services sector, which contributes more than 60 per cent of the world GDP, is growing fast. It is the largest sector in most economies, and it is the fastest growing sector in many of them. The developed economies

The services sector accounts for a major share of income and employment generation.

(and many developing economies too) are primarily service economies, in the sense that the service sector generates the bulk of employment and income. The contribution of services to GDP and employment is substantially high, particularly in the developed economies (see Table 3.9).

Although, the share of services in the GDP of developing economies is lower than in the developed ones, the service sector has been growing very fast in the developing world. The share of services in the GDP of India increased substantially in the last quarter century. According to the Annual Report, 2006-07 of the RBI, in 2006-07 contribution of the service sector to the real GDP of India was 62 per cent, and of the industry was about 20 per cent, while agriculture and allied activities accounted for nearly 19 per cent at 1999-2000 prices.

Table 3.9 Contribution of Services to Value Added as Percentage of GDP

Region / Country	1980	2005
World	56	68
High Income Economies	59	72
Low & Middle Income Economies	42	52
India	39	54

Source: World Bank, *World Development Report* (various issues).

Growth of Services Trade

Global trade in services expanded rapidly in the late twentieth century, growing, on an average, much faster than both the world GDP and world merchandise trade. The value of services exports more than doubled in the decade 1997 to 2006, from about \$ 1310 billion to \$ 2710 billion. The share of services, in the total global trade, increased from 17 per cent in 1980 to 20 per cent in 1990. The share of services in the total global trade have remained nearly constant (about one-fifth) since then. During 2000–2006, services trade growth rate lagged behind that of merchandise (10 per cent and 11 per cent respectively).

Services account for nearly one-fifth of the total world trade.

As a World Bank report observes, the tremendous growth of trade in services and, more recently, of electronic commerce, is part of the new trade pattern. Exports of commercial services have grown on every continent (particularly Asia) throughout the 1990s. This change has its own special significance, as services are frequently used in the production of goods, and even other services. Enhanced international competition in services means reduction in price and improvements in quality, that will enhance the competitiveness of downstream industries. Both industrial and developing economies have much to gain by opening their markets. Developing countries would derive large gains from an easing of barriers to agricultural products, and to labour-intensive construction and maritime services. Over the longer term, electronic business will loom large as an area where expanding opportunities for trade require an expanding framework of rules.³²

As a RBI Report points out, growing trade in services reflects, partly, the increasing importance of tertiary activities in the world. A far more important factor, underlying the increased importance of services in international trade, has been the revolution in information technology in the 1990s, which has reduced the time, as well as cost, of transport and communication. As a result, services, hitherto

considered as non-tradable, have entered the arena of tradability. The rapid rise in the share of the services sector in the structure of national economies, as well as in world trade, has been particularly beneficial for the developing economies, given the labour-intensive nature of most services. The 1990s have, therefore, broadened the scope for diversification in favour of trade in services. Another factor providing an impetus to internationalisation of services has been the changing character of capital flows, particularly the shift towards private capital flows in the form of foreign direct investment flows. Service activities, like banking and insurance, have attracted increasing FDI investment worldwide. Reflecting the IT revolution, the share of IT goods in world trade increased considerably in the 1990s. At the same time, the rapid growth of IT production and the use of IT-related services around the world, have raised concerns about cross-border propagation of business cycles.³³

As a WTO report points out, many services, which have long been considered genuine domestic activities, have increasingly become internationally mobile. This trend is likely to continue, owing to the introduction of new transmission technologies (e.g. electronic banking, tele-health or tele-education services), the opening-up, in many countries, of long-entrenched monopolies (e.g. voice telephony and postal services), and regulatory reforms in hitherto tightly regulated sectors, such as transport. Combined with changing consumer preferences, such technical and regulatory innovations have enhanced the 'tradability' of services and have, thus, created a need for multilateral disciplines.³⁴

An orderly development of international trade in services was expected to be fostered by the adoption of the General Agreement on Trade in Services (GATS). The barriers to international trade in services, however, remain high and opaque. These barriers emerge from the fact that a large part of the services trade involves movement of labour and capital across borders, both of which continue to confront restrictions on movement. (Also see the section GATS in the chapter on WTO).

According to IMF estimates, gains from liberalisation of services trade would be about US\$1,181 billion, almost double the gains that would emanate from liberalisation of merchandise goods (US\$677 billion), highlighting the welfare-enhancing potential of liberal trade in services.

FDI and Internationalisation of Services

The development of the services sector and international trade in services have been promoted by international investments. It is pointed out that the 'internationalisation of services is reflected in the growth of both trade and foreign direct investment flows. Both have been driven by innovations in information and communication technology, that allowed increasing specialisation.'³⁵

The rising share of services, at the expense of manufacturing and primary sectors, in global FDI, has been boosting globalisation of services production and trade.

There has been a significant rise in the share of services in the global FDI, at the expense of the manufacturing and primary sectors. According to the *World Investment Report (WIR)*, 2004, the services sector accounted for only one-quarter of the world FDI stock in the early 1970s. According to *WIR*, 2007, the share of services in world FDI stock increased from less than 50 per cent in 1990 to over 60 per cent in 2005. In the recent years, on an average, services accounted for about two-thirds of total FDI inflows. As the transnationalisation of the services sector lags behind that of manufacturing, a further shift of FDI towards services is generally expected.

The ascendancy of services in economies, as indicated above, lead to an increase in FDI in this sector. There is, however, one special reason for the spurt in FDI in services—most services are not tradable, and, therefore, they need to be produced when and where they are consumed. Hence, the principal way

to bring services to foreign markets is through FDI. A facilitating factor is that countries have liberalised their services FDI regimes, which has made larger inflows possible, especially in industries previously closed to foreign entry.

Major Service Traders

Services trade is dominated by industrial economies more than goods trade.

The world trade in commercial services is dominated by the developed economies and they, as a group, constantly have a surplus balance of trade in services. In 2006, the four top exporters—USA, UK, Germany and Japan contributed nearly one-third of the world total. Six countries

accounted for about 40 per cent and nine countries contributed nearly half of the total service exports.

The three largest service importers—USA, Germany and UK—accounted for more than a quarter of the global total, and 40 per cent of the imports were made by 6 nations, while nearly half of the total service imports were made by 8 countries (see Table 3.10).

China, Japan and Germany, which have large merchandise trade surplus, have huge services trade deficit. However, other major traders and regions present a different picture of trade balance in respect of merchandise and services trade. North America and EU have large services trade surplus as against merchandise trade deficit. Transition economies have deficit in services trade, as opposed to their position in merchandise.

It may be noted that USA which has a huge deficit in the merchandise trade, has a huge surplus in the services trade.

As in merchandise exports, the developing countries increased their share in global export of services over the years. However, their share of global trade in services is much lower than that of goods.

From 1980 to 1990, the share of developing countries in global export of services was stagnant at about 19 per cent; but by 2006, it increased to about 25 per cent and the transition economies accounted for 3 per cent of the total. Among the developing regions, the Asia is most active and successful in world trade in services. Its share of world services exports rose from less than 10 per cent in 1980 to nearly 22 per cent in 2006, progressively improving Asia's balance of trade in

this area.

Europe was the largest exporter of other commercial services, accounting for 54 per cent of world exports of this product group (37.4 per cent, if intra-European Union trade is excluded), followed by Asia (21.8 per cent) and North America (17.9 per cent). Although, in value terms, positive growth was recorded, the share of Europe and North America in world trade in other commercial services declined, mainly in favour of Asia, and, to a lesser extent, the CIS.

As in merchandise trade, the least developed countries did not take advantage of the expansion of international trade in services, and their position in total exports was weaker in 2006 (0.4 per cent) than it had been nearly a quarter of a century ago.

With 2.7 per cent share in 2006, India's rank in global export of services was 10th, compared to the 28th rank in merchandise exports with a one per cent share, and with 2.4 per cent share of global import of services, her rank was 13th, as against 17th in merchandise imports with a 1.4 per cent share. In recent years, India has significantly improved her share and rank in services trade.

Table 3.10 | **Leading Exporters and Importers in World Trade in Commercial Services, 2006**

(\$ billion and percentage)

<i>Rank</i>	<i>Exporters</i>	<i>Value</i>	<i>Share</i>	<i>Rank</i>	<i>Importers</i>	<i>Value</i>	<i>Share</i>
1	United States	388.8	14.1	1	United States	307.8	11.6
2	United Kingdom	227.5	8.3	2	Germany	219.1	8.3
3	Germany	168.8	6.1	3	United Kingdom	172.0	6.5
4	Japan	122.5	4.4	4	Japan	144.0	5.4
5	France	114.5	4.2	5	France	108.8	4.1
6	Spain	105.5	3.8	6	China	100.3	3.8
7	Italy	97.5	3.5	7	Italy	98.4	3.7
8	China	91.4	3.3	8	Ireland	78.1	3.0
9	Netherlands	82.5	3.0	9	Netherlands	78.1	2.9
10	India	73.8	2.7	10	Spain	77.9	2.9
11	Hong Kong, China	72.7	2.6	11	Canada	71.7	2.7
12	Ireland	68.0	2.5	12	Korea, Republic of	69.8	2.6
13	Austria	58.9	2.1	13	India	63.7	2.4
14	Canada	57.7	2.1	14	Singapore	60.8	2.3
15	Belgium	57.6	2.1	15	Belgium	54.0	2.0
16	Singapore	57.3	2.1	16	Austria	53.3	2.0
17	Denmark	51.7	1.9	17	Denmark	45.0	1.7
18	Luxembourg	51.1	1.9	18	Russian Federation	44.3	1.7
19	Switzerland	50.6	1.8	19	Sweden	39.3	1.5
20	Korea, Republic of	50.4	1.8	20	Hong Kong, China	36.6	1.4
21	Sweden	49.2	1.8	21	Taipei, Chinese	32.6	1.2
22	Greece	35.7	1.3	22	Thailand	31.8	1.2
23	Norway	32.7	1.2	23	Australia	31.6	1.2
24	Australia	32.4	1.2	24	Luxembourg	30.6	1.2
25	Russian Federation	30.1	1.1	25	Norway	30.6	1.2
26	Taipei, Chinese	28.8	1.0	26	Switzerland	28.8	1.1
27	Thailand	23.9	0.9	27	Brazil	26.9	1.0
28	Turkey	23.5	0.9	28	Indonesia	26.5	1.0
29	Malaysia	21.2	0.8	29	Malaysia	23.0	0.9
30	Poland	20.5	0.7	30	Mexico	22.7	0.9

Source: WTO, *International Trade Statistics*, 2007.

Major Services

Travel and transportation account for major share of the services trade. However, trade in 'other commercial services' (particularly financial services—including banking and insurance—construction services and computer and information services) has been growing faster than these two categories and,

as a result, their share in the total has increased from nearly 38 per cent in 1990 to 45 in 2000, and to about 50 per cent in 2006, while the share of travel and transportation has declined correspondingly. The share of travel in world commercial services exports has constantly been declining in recent years, from 31 per cent in 2000 to less than 27 per cent in 2006.

Table 3.11 World Exports of Commercial Services Trade by Major Category, 2006

(Billion dollars and percentage change)

Item	Value	Annual Percentage Change			
	2006	2000-06	2004	2005	2006
Commercial services	2710	10	20	11	11
Transport	626	10	25	12	9
Travel	737	7	18	8	7
Other commercial services	1347	12	19	12	13

Source: WTO, *International Trade Statistics*, 2007.

Europe was the largest exporter of other commercial services, with 54 per cent of world exports of this product group (37.4 per cent, if intra-European Union trade is excluded), followed by Asia (21.8 per cent) and North America (17.9 per cent). Although in value terms positive growth was recorded, the share of Europe and North America in world trade in other commercial services declined, mainly in favour of Asia and to a lesser extent the CIS.

The Goods-Services Trade Drift

It is as if a rule that goods trade balance and services trade balance move in the opposite direction.

Analysis of global trade statistics by regions, categories of economies and even by individual nations reveal a very interesting fact—it is as if a rule that those which have merchandise trade deficit will have services trade surplus and vice versa (with a few exceptions—for example, Italy was an exception in 2006). In many cases, the sizes of the surpluses

and corresponding deficits are related to some extent, i.e., those with large goods surplus tend to have large services deficit, and vice versa.

Many developed economies have merchandise trade deficit and services trade surplus.

Columns 4 and 8 of Table 3.12 clearly show that all those regions/categories of economies/countries which have a favourable merchandise trade balance, have an unfavourable services trade balance, and vice versa. Disaggregated data for 2006 for the top 30 exporting nations, which together account for over 85 per cent of the global exports, show more or less the same pattern, with the exception of some countries, like Netherlands, Belgium, Switzerland, Sweden and Italy.

The group of 50 least developed countries which, with not even one per cent share of the global trade, is more or less marginalised in the global trading system, has both goods and services trade deficit.

Barriers to trade in services are widespread and high, due, mainly, to the sensitive and strategic nature of many services.

Barriers to Trade in Services

International trade in services involves intricate issues like right to establish and factor mobility. These are the problems faced in liberalising trade in services as compared to trade in goods.

Table 3.12 Goods-Services Trade Imbalances

Country/Region 1	Merchandise (Billions of dollars)				Services (Billions of dollars)			
	2 Exports	3 Imports	4 Trade Balance	5 2 as % of 3	6 Exports	7 Imports	8 Trade Balance	9 6 as % of 7
North America	1675	2546	-871	66	460	401	59	115
South and Central America	426	351	75	121	77	80	-3	96
Europe	4957	5218	-261	95	1382	1223	159	113
European Union(25)	4527	4743	-216	95	1247	1132	115	110
Commonwealth of Independent States (CIS)	422	278	144	152	51	74	-23	69
Africa	361	290	71	124	64	80	-16	80
Middle East	644	373	271	173	63	96	-33	66
Asia	3276	3023	253	108	614	666	-52	92

International trade in many services involve international factor mobility. There are a number of international transactions involving temporary factor relocation services, such as those requiring temporary residence by foreign labour to execute services transactions.

Due to the special characteristics and the socio-economic and political implications of certain services, they are generally subject to various types of national restrictions. Tariff as well as non-tariff restrictions are widespread. Protective measures include subsidies, tariffs, taxes, quotas and technical standards, visa requirements, investment regulations, restrictions on repatriation, marketing regulation, restrictions on employment of foreigners, compulsion to use local facilities, etc. Thus, the policy instruments that affect international trade in services are similar to those used in the goods context. 'However, border measures in general, and ad valorem tariffs in particular, are often difficult to apply to trade in services for the simple reason that customs agents in many instances will not be able to observe the services as they 'pass the frontier.' Customs agents will only observe service suppliers or consumers, as they pass the frontier. The value (or volume) of the any service transactions, that occur, cannot be known until after they have been produced/consumed, and are, therefore, not known to customs and immigration authorities.³⁶

Quotas, Prohibitions and TRIMs Quantitative restrictions (QRs) are often used to restrict international trade in services, although the intangibility and non-storability of many services implies that quotas may be applied to providers to services, rather than services per se.³⁷

There are a number of areas where quantitative restrictions are applied, like restrictions on the number of immigrants (who are service providers), restrictions on the number of schedules that foreign airways can operate, etc.

International trade in services is prohibited in many instances. Common examples, where foreign access to services markets may be reserved exclusively for domestic suppliers, are the transportation of goods within a country (whether by air, road, or water) and basic telecommunication service providers (for example, voice telephony). Many countries also require that activities, such as legal, insurance, educational, surveying or investment advisory services, be provided by the residents or citizens of the country concerned.³⁸

In many cases, restrictions take the form of trade related investment measures (TRIMs), such as local content stipulations—like employment of nationals, use of domestic inputs, etc.

Price-based/Tariff Restrictions Price-based/tariff restrictions are also common in services trade. Tariffs are potentially important barriers to trade for services, that are either embodied in goods or are for goods that are necessary inputs for the production of services. Examples of the former include films, television programmes and computer software on disk or tape, while examples of the latter include computers, telecommunications equipment and specific advertising or promotional material.³⁹

Price controls frequently go hand in hand with capacity or quantitative restrictions, the intention usually being to ensure that prices are not set at either market clearing levels, or at the monopoly level, in cases where providers of specific services have substantial market power. Major examples of services sectors subject to price controls are air transportation, financial services and telecommunications, where government agencies frequently impose minimum or maximum prices, enforce a price setting rule or formula, or require uniform pricing.⁴⁰

Standards, Licensing and Procurement Market access may be denied, or made very difficult, by setting standards, technical and other (for example, by not recognising foreign degrees, diplomas or other qualifications). Licensing and registration requirements restrict market access in several cases.

For example, in respect of USA, it is pointed out that for financial services, the restrictions include the difficulty for foreign mutual funds to make public offerings in the US, because the Securities and Exchange Commission's conditions make it impracticable for a foreign fund to register under the US Investment Company Act of 1940.⁴¹

Government procurement and sourcing policies in many instances are designed to discriminate in favour of domestic service providers.

Discriminatory Access to Distribution Networks Restrictions may also be caused by discriminatory access to distribution networks. In order to offer/provide many types of services, suppliers need to be able to use existing distribution and communications infrastructures, especially telecommunication networks. For example, a dominant telecommunication carrier—whether public or private—may discriminate across users/demanders of its network services, by imposing restrictions on the ability of new service providers to attach specific types of equipment to the network, or by forcing newcomers to build additional infrastructure to reach interconnection points, that are rationed by the incumbent.⁴²

The Uruguay Round of trade negotiations has initiated measures for liberalisation of trade in services. See Chapter 6 for details.

Services Trade and Developing Countries As described above, the international trade in services is subject, in general, to a lot of restrictions. The developing countries, in particular, have problems in liberalising the services trade.

Services were outside the scope of the GATT. Therefore, the GATT which tried to liberalise the trade in goods could not do the same for services. However, as mentioned above, the Uruguay Round has made a beginning in liberalising trade in services. In the year 2000, Government of India decided to allow private investment, both domestic and foreign, in the insurance sector.

Although the services sector of developing countries suffer from a number of handicaps, many, including India, have been significantly benefiting from the global trade in services.

The conflicts of interests, or the differences of opinion, between the developed and developing countries came to the fore at the Uruguay Round, when the developed countries sought to extend the GATT negotiations to services, and to liberalise the international trade in services. The developing countries strongly opposed this move, particularly in the early stages of the Round. When India and Brazil were among the prominent opponents.

The developing countries fear that the liberalisation of trade in services will lead to domination of the services sector in the developing countries by multinationals from industrialised countries. As a matter of fact, the trade in services is already dominated by the developed countries. The developing countries are net importers of services, and their deficit has been growing. The apprehension is that liberalisation of trade in services will accentuate the problem.

Although, many services are labour intensive and therefore, the developing countries should be expected to have an advantage here, there have been several constraints in their benefiting from this advantage—technical, organisational, financial and legal. Moreover, immigration laws of developed countries restrict the manpower inflow from developing countries. This severely limits the scope of developing countries in benefiting from their comparative advantage. It may be noted that the industrial countries did not like to bring up this issue at the Uruguay Round.

‘In reality, the service sector offers industrial countries the opportunity to exercise their traditional strengths—their access to finance, their accumulated knowledge and skills, their access to telecommunications and information technologies, as well as a history of established relationships and contacts.’⁴³

Lack of finance is a very important handicap for the developing countries. Several services require huge amounts of finance. International airlines, for example, need large investments in the most modern fleets and reservation systems, if they are to compete internationally. Similarly, technology is also playing an increasingly important role in service industries and is demanding higher levels of skill. “Here, too, the developing countries are in danger of falling behind even further, not only because they lack the necessary human skills, but also because many technological improvements in services require substantial financial back-up, often missing in banking, construction, engineering design, communications and professional and business design.”⁴⁴

Even in areas where the developing countries have a lot of development potential-like tourism-shortage of capital and managerial expertise often pose serious problems.

Construction is an area where the developing countries have high hopes, with much of this market in the developing countries, this represents the largest source of international construction contracts. The construction market, however, shrunk in the 1980s. Although the developing countries account for a significant share of the construction contracts, the share of the developing countries’ supply of this service has fallen to a very insignificant level.

Some countries, like India, have made some progress in certain modern areas, like development of advanced software.

Some economists argue that liberalization, and the resultant competition, will improve the efficiency of the service sector in the developing countries, and this will help improve the overall efficiency of the economy and its export competitiveness.

It has been pointed out that several developing countries have acquired enough strength in different services to successfully compete with the developed countries. For example, countries like Korea, Brazil, India, Lebanon and Taiwan have done well in international construction and design contracts. Several developing countries have great potential in the field of professional services. Some already have considerable exports of tourism and shipping.

It has been argued that if developing countries protect the more expensive or the lower quality services produced by local firms, they run the risk of handicapping their exports of goods. Many services are upstream or downstream services to producers. Access, at reasonable cost, to quality services can make the difference between success or failure in exporting. In many developing countries, the need for such services calls for at least selective liberalisation. If this encourages the multinational corporations of the industrial countries to provide these services to developing countries, it would help developing countries' exports of manufactured goods in three ways. *First*, it would lower their costs and help them to develop markets. *Secondly*, it would encourage the multinational corporations to move away from goods in favour of producing more services. *Thirdly*, if industrial nations can sell more services, they may be more willing to lower protective barriers elsewhere.⁴⁵

It is cautioned, however, that unless the developing countries take measures to strengthen their services before liberalisation, it would adversely affect the domestic service industries.

India has been doing well in services exports; a tremendous potential remains to be tapped.

India has great potential in a variety of services. The large number of scientists, professionals and skilled and semi-skilled personnel working abroad is indicative of India's potential in several fields. With such a resource potential, we should be able to develop a number of service industries capable of obtaining customers abroad. For example, can we not provide health care instead of just exporting doctors and other medical personnel? Can we not provide education instead of just exporting teachers?

With proper planning and development, India can make great strides in services trade.

GLOBAL SOURCING

As pointed out in Chapter 1, global sourcing/production sharing has been growing profoundly. A World Bank publication, which describes this as a new pattern in international trade, observes that sourcing components from abroad is an increasingly common practice, and use of the Internet is sure to expand the process, encouraging entry by new producers throughout the developing world. While precise numbers are difficult to come by, in the early 1990s, one-third of all manufactures trade (approximately \$800 billion) involved parts and components. This type of trade has generated an ever-spreading web of global production networks that connect subsidiaries within transnational firms to unrelated designers,

Global sourcing provides enormous opportunities for developing countries.

producers, and distributors of components. These networks offer their constituent firms access to new markets and commercial relationships, and facilitate technology transfer. Advances in information technology help to link firms from developing countries to global production

networks. General Electric, for instance, posts information on its components, and firms from all over the globe bid to supply them.⁴⁶

Encouraged by the success of the Japanese industry, out-sourcing became so prominent in the United States that an increasing dependence on outside suppliers, during the 1980s, helped reverse a trend towards increased vertical integration, that had been in existence for almost a century. In other words, the 1980s witnessed a trend toward deintegration, or the emergence of hollow manufacturing companies. This trend is becoming more and more pronounced globally.

Much of the increased sourcing, over the past three decades or so, has been global in nature.

Some of the offshore sourcing was, in fact, accompanied by plant or product line closings in countries like the United States, as domestic manufacturers sought the advantage of cheaper labour abroad, either in their own plants or from others.⁴⁷

According to one survey, the reasons for offshore purchases, listed in the order of importance, are lower price, better quality, only source available, more advanced technology, more consistent attitude, more co-operative delivery, and, counter trade requirements.⁴⁸

It may be noted that besides the above, outsourcing has certain other advantages. It reduces the capital and manpower requirements. It may also impart more flexibility to adjust to certain conditions, like recession.

International sourcing accounts for an estimated one-third of the world trade. Many developing countries have taken advantage of this trend. Although India did not benefit significantly in the past, with changes in the business environment since the late 1990s, there has been a substantial turnaround, so that it has become very common, particularly in the US, to talk about migration of jobs to India by business process outsourcing (BPO). This has even resulted in several States in the US passing laws banning global outsourcing of government jobs. Some manufacturing industries of India have also been taking significant advantage of the global outsourcing. The Indian auto components industry, for instance has become, supplier to foreign heavy weights, like General Motors, Renault, Fiat, etc. The export performance of the Indian auto components is expected to improve very significantly, with further improvement in quality and productivity, which the industry is now striving to achieve.

It may be noted that Indian companies have also been sourcing globally.

An interesting fall-out of production sharing is that a ban on the import of a product could mean harm to some industrial units in that country, which are parties to the production sharing. Thus, “when shoe workers’ union in the United States, or shoe manufacturers in North Carolina, agitate for a ban on importation of ‘cheap foreign imports’, no cattle grower in the great plains realises that they are actually agitating to ban the export of American hides (out of which the shoes are manufactured) on which his livelihood depends.”⁴⁹ (Also, see section *Factors Promoting Global Economic Integration* in Chapter 1)

Offshoring of Services

The spurt in the offshoring of services has been tremendous. In the past decade or so, advances in information and communication technologies have made it possible for more and more of these services to be produced in one location, and be consumed elsewhere—they have become tradable. The implication of this ‘tradability revolution’ is that the production of entire service products (or parts, thereof) can be distributed internationally—in locations offshore from firms’ home

Technological advances have substantially increased the tradability and scope for offshoring of services.

countries—in line with the comparative advantages of individual locations, and the competitiveness enhancing strategies of firms.⁵⁰

There are two ways of offshoring: *captive offshoring*, i.e., internally, through the establishment of foreign affiliates, or by outsourcing a service to a third-party service provider (*offshore outsourcing*). Offshoring, to a large extent, is an offshoot of the tendency of firms to concentrate on ‘core competencies’ in a bid to enhance their international competitiveness. For many firms in all sectors, this means that the production of various services (accounting, billing, software development, architectural designs, testing, etc.) is outsourced, i.e., turned over to other (specialist) companies. Captive offshoring is preferred when strict control of an activity is crucial (as in R&D), information is sensitive, internal interaction is important, or when a firm seeks to capture savings and other advantages. Back-office and front-office work, that can be easily standardised and separated from other activities, is more likely to be outsourced (and eventually offshored).

As the WIR, 2004 observes, the revolution in the tradability of services is mainly responsible for the surge in the offshoring of services. Traditionally, most services have been ‘non-tradable’ as they require buyers and sellers to be in the same place at the same time. Services remained non-tradable due to various reasons. Some types of information (such as music before the discovery of recording devices) could not be stored, and had to be produced and consumed instantaneously. Some information could be stored (such as words or data in books or other written form), but could not be transmitted rapidly and economically (and in bulk) across countries for processing. Some information was processed in-house by enterprises because ‘it had always been so’; for example, it was customary to do accounting, archiving or designing internally. Some information exchange between service providers and consumers traditionally involved face-to-face contact, such as patients meeting their doctors, or clients meeting their lawyers or bankers for consultation.

New information and communication technologies (ICTs), however, are dramatically changing the tradability of the information-centred set of services, in several ways. For example, all kinds of information can be stored by digitization, and much cheaper and faster transportation allows instantaneous exchange of digitized information and voice communication between people anywhere around the globe (provided the necessary infrastructure exists). In addition, customs and traditions are being broken as people are being induced to use electronic media to acquire services they had previously only accessed by direct contact.

Differences between Globalisation in Services and Manufacturing

Offshoring represents the cutting edge of the global shift in production activity, giving rise to a new international division of labour in the production of services. While the fragmentation and globalisation processes in services and manufacturing are similar, there are important differences. First, although the services sector is much larger than the manufacturing sector, only about 10 per cent of its output enters international trade, compared with over 50 per cent for manufacturing. Second, the pace of globalisation of services affected by the tradability revolution is faster than in manufacturing. Third, whereas the relocation of goods production has involved, overwhelmingly, firms in manufacturing only, service functions are offshored by companies in all sectors. Fourth, the skill intensity is generally higher for offshored tradable services than for manufacturing located abroad, thus affecting white-collar jobs in particular. And fifth, services that are offshored may be more footloose than the relocated manufacturing activities, because of lower capital-intensity and sunk costs, especially services that do not require high skills.

Limitations of Offshoring of Services

There are, however, important limitations to offshoring of services. For many services, proximity to markets, interaction with customers and trust and confidence outweigh the possible benefits of international division of labour. Further, technological limitations cannot be discounted. It is not possible for all service functions to be digitized and/or separated from related activities. Some businesses will continue to need localised services or person-to-person contact for exchanging highly confidential information, or for adapting to rapidly changing customer needs. Regulations and legal requirements (such as regarding privacy) may also raise transactions costs and limit international trade in services.

The total market for all offshore service exports was estimated to be \$32 billion in 2001. The fastest growth is expected in the offshoring of IT-enabled services, which was forecast to expand from \$1 billion in 2002 to \$24 billion in 2007. Even among the 1,000 largest firms in the world, 70 per cent have still not offshored any services to low-cost locations, but many have plans to do so. This is an indication of the future potential for offshoring.

A relatively small number of countries account for the lion's share of offshoring. In 2001, for example, Ireland, India, Canada and Israel, in that order, accounted for over 70 per cent of the total market for offshored services, mostly in software development and other IT-enabled services. However, the share of developing countries and CEE in offshored projects is increasing.

GLOBAL TRADE AND DEVELOPING COUNTRIES

As mentioned earlier, the past four decades have witnessed growing participation of developing countries in global trade. Since the 1960s, their merchandise export has been growing faster than the world average. As a result, their share of world exports of goods increased from less than one-fourth to one-third, between 1960 and 2002, while their share in global GNP is about one-fifth. Between 1980 and 2000, the volume of developing country exports increased more than six-fold, compared to a three-fold increase for developed countries.

Developing countries' share of world merchandise exports reached an all time record of 36 per cent in 2006. The share of developing countries in world merchandise imports was 31 per cent, the largest share in more than a quarter of a century.

Many economists acclaim international trade as an engine of growth, and significant efforts have been made by the GATT/WTO to liberalise trade, because of the dictum 'freer the trade greater the welfare'. Indeed, international organisations, many economists and others exalt the virtues of trade for developing countries, and argue that freer trade should benefit them still further. The UNCTAD, often vociferous about the handicapping of the developing countries in the international economic order, argues that despite discriminations of the global economic order against them, there are chances of developing countries benefiting from trade. Developing countries have a comparative advantage in abundant, low-cost, unskilled labour. If they concentrate on goods whose production is simple and labour intensive, greater integration into global markets should increase their exports and output, raising the demand for unskilled labour, and raising the incomes of the poor, relative to those of the non-poor. Moreover, countries move up the trade ladder, exporting more sophisticated products, leaving space on the ladder below for countries later industrialising. All this helps reduce poverty. The countries on the

Developing countries, as a group, significantly increased their share in global trade due to the robust performance of a handful of them. However, the participation of the majority of developing countries in global trade is insignificant.

higher runs benefit most, but even those on the lower runs should see poverty fall. And free trade should also help poor consumers—without trade protection, local prices should fall to world prices. There should also be benefits for employment from a liberal financial regime. Removing restrictions on capital flows should attract more FDI, creating more jobs for the poor, by integrating them into international systems of production.⁵¹

True, a number of developing countries have enormously benefited from the expansion of global trade. As revealed by Table 3.4, there are several developing countries among the top exporters. Only a small part of the increase in the share of developing countries in world trade, over the 1990s, was the result of increase in oil prices; it was due rather to their ability to expand their role in world exports of manufactured goods, the most dynamic part of world trade.⁵²

Export of Manufactures

Significantly, developing countries have made strides in the export of manufactures. Manufacturing exports now account for the bulk of developing country exports, with their share being more than 80 per cent for South Asia, East Asia and the Pacific. It is pertinent to note that developing countries are growing faster than industrial countries in export of more technology intensive products.

The developing countries accounted for 27 per cent of world exports of manufacture in 2000, a remarkable increase from their 17 per cent share in 1990. The largest share of this increase is accounted for by China, Mexico and East Asian exporters of office and telecom equipment. Such equipment also accounts for a very large share in total developing countries' exports of manufactures. For the decade as a whole, a number of smaller exporters—particularly in Asia—also recorded export growth rates well above the global average. Unlike two decades ago, when developing countries were net importers of manufactures, they are now net exporters of the category 'other manufactured goods' while developed countries have become net importers of both electronics and 'other manufactured goods'.

The manufactured exports of developing countries are concentrated in computers and office equipment, telecommunications, audio and video equipment, semiconductors and clothing. All these products involve labour-intensive processes, which suggests that the increased importance of global production sharing has been a crucial factor in the growth of their exports.

As pointed out earlier, because of the faster trade growth of the developing countries, and the resultant higher trade-GDP ratio, today the developing countries are much more integrated with the global economy by trade than the developed ones.

It may be noted that the impressive figures of trade performance of developing countries, as a group, are the result of rapid strides made by a small group of countries. For example, five countries—China, S. Korea, Taiwan, Hong Kong and Singapore—have increased their share in global exports, from about 5 per cent in 1980 to about 17.5 per cent in 2006. In other words, while just five top developing country exporters (the oil exporters are not considered here) account for half of the aggregate exports of the developing countries, the remaining half is made up of nearly 160 developing economies. This implies that most developing countries have been unable to overcome the obstacles to expanding and diversifying their exports. With the exception of East Asian and Central American economies, developing countries did not see their exports increase significantly. This is particularly true for the African states, which have averaged a modest annual growth rate of 2 per cent since 1980. The shares, in total world exports, of South American, Central and Eastern European, and African economies were actually lower in 2002, than in 1960.

Global Trade and Least Developed Countries

The share of the least developed countries (LDCs), numbering 50, in the global trade, is very dismal. Their share actually fell from 0.7 per cent in 1980 to 0.4 in 1990, and began to increase slightly only in the late 1990s, reaching 0.6 per cent in 2000. Their exports rose sharply in 2006, due to much larger values of fuels exports and stronger exports of other primary products and manufactured goods, taking their share in global exports to the record level of 0.9 per cent.

The least developing countries, 50 in number, have been marginalised in global trade.

A major part of this is due to the contribution of a small number of oil exporters among them. For trade purposes, it is useful to distinguish at least the following three country groups of the LDCs.

1. **Oil-exporting LDCs**, such as Angola, Yemen, Sudan and Equatorial Guinea, which have benefited from high oil prices. These four countries alone accounted for well over half of LDC exports in 2006. These countries have increased their share from about 40 per cent in 2000 to 53 per cent in 2006. Angola alone accounted for one-third of the LDC exports in 2006.
2. **LDCs that export mostly manufactured goods**. This group, which accounted for more than one-fifth (22 per cent) of LDC exports in 2006, comprises Bangladesh, Myanmar, Cambodia, Madagascar, Lao People's Democratic Republic, Nepal, Lesotho and Haiti. As a group, these countries have recorded high export growth rates throughout the 1990s, nearly matching or exceeding that of China. During 2000–2006, however, the performance of some of them was erratic, although several of them registered an average annual growth rate between 17 and 21 per cent. In many instances, exports from affiliates of multinational companies contributed to the outstanding trade growth.
3. **The largest group** consists of those LDCs whose exports are limited to a few primary commodities. Their export performance is often determined by the cyclical demand in commodity markets, and the vagaries of weather. Exports of many of these LDCs are erratic. While a number of them experienced negative export growth during 2000 and 2006 (– 20 per annum in case of Eritrea), some of them, like Zambia, Mozambique, Sierra Leone, Mauritania and Bhutan, have registered very impressive growth rates. Some of these LDCs (Afghanistan, Burundi, Congo, Rwanda, Sierra Leone and Somalia) experienced a severe contraction in trade in the 1990s, to levels below the ones 20 years ago, due to armed conflicts and civil strife. Their exports, however, revived in the present decade.⁵³

Another important fact is that for most developing countries from Oceania and America—particularly Central America—and for the least developed countries, during the past four decades imports expanded faster than exports, resulting in increasing trade deficits for their economies.

To what extent the developing countries gain or lose by the trading system has been a popular topic of debate for a long time, and it would continue to be an unsettled issue. The developing countries, however, have been becoming more and more integrated with the global economy by trade, as is evident from the fast increase in their trade-GDP ratio.

Global Trade Challenges

The successive rounds of multilateral trade negotiations have led to substantial tariff reductions and other trade liberalisations. However, as Anne McGuirk points out, the global trading system faces major

challenges. *First*, even after Uruguay Round commitments are fully implemented, protection will remain high and concentrated in areas of particular interest to developing countries, such as agriculture and labour intensive manufactures. In agriculture, only limited progress has been made in reducing high tariffs and trade-distorting subsidies. In both agriculture and manufacturing, *tariff peaks* and *escalation* persist, and use of contingent protection, such as anti-dumping measures, is now widespread, impeding the diversification of developing country exports. Moreover, developing countries, themselves, maintain high protection in the same areas; their tariffs on industrial products are three to four times as high as those of industrial countries. *Second*, the progress of trade liberalization, by tariffs reductions and removal of quantitative import restrictions, has been hit with other obstacles to trade that touch on domestic policies, such as industrial subsidies and intellectual property rights, and, more recently, investment and competition policies. While some find this shift necessary for the trading system to remain relevant, others believe that pressures to bring domestic regulatory policies into the WTO could hurt the interests of developing countries, partly by diverting attention from more pressing needs. *Third*, many poorer developing countries feel that they are bearing the costs of implementing difficult and complex Uruguay Round agreements (for example, customs valuation, intellectual property rights) without seeing the benefits of improved market access, or obtaining adequate technical and financial assistance to ease their integration into the global economy. Given the constraints on their capacity to negotiate and undertake needed supply-side investments, they are reluctant to engage in further multilateral negotiations.⁵⁴

It was argued that implementation of the Uruguay Round Agreement, which caused an unprecedented controversy, and created a deep scare and widespread apprehensions in the developing countries, would substantially benefit the developing countries. Estimates by the World Bank and others suggest that the static welfare gains, by removing barriers to merchandise trade, would amount to between \$250 billion and \$620 billion a year—with developing countries capturing one-third to one-half of these gains, largely by opening their own markets. This is far more than the annual flow of aid to these countries. Removing barriers to trade in services would increase global welfare even more, given the dominant role of service sectors in most economies, and the large trade barriers typical of these sectors.⁵⁵

It is, however, very important to note that the overall gains obscure a more complex balance sheet of winners and losers. Projected losses are heavily outweighed by the gains, and the losses will be concentrated in a group of countries that can least afford them. It is estimated that the least developed countries stand to lose up to \$600 million a year, and Sub-Saharan Africa \$1.2 billion. This scenario has disturbing implications for poverty and human welfare. Foreign exchange losses will translate into pressure on incomes, a diminishing ability to sustain imports and increased dependence on aid, at a time when aid itself is under severe pressure.⁵⁶ Revenue from trade will be lost, undermining the capacity of governments to undertake development and welfare activities.

Further, even the expected gains to the developing countries are evading them, due to the failure of the developed nations in implementing, in letter and spirit, many of the provisions of the multilateral agreements that will benefit the developing countries. Worse, still, is the tendency of the developed countries to increase protectionism to the detriment of the developing countries.

The problems which the developing countries face are very frightening. The primary commodities, an important category of export for many of them, has been facing stagnant demand, and has been battered by volatile prices, and the two sectors in which developing countries have a strong comparative advantage—agriculture and labour-intensive manufactures, like textiles and clothing—are heavily protected, not only in the industrial countries but in developing countries as well. One of the important deterrents to the trade expansion of developing countries is the *tariff peaks* and *tariff escalation*, which

the *average* tariff levels mask. In the developed countries, tariff peaks are concentrated in labour-intensive manufactures and primary products. Tariff peaks are even more common in developing countries. Tariff escalation, which is seen in both industrial and developing countries, is designed to protect processing or manufacturing industry in the importing country, which sets low tariffs on imported materials used by its industry and higher tariffs on imported finished products that would compete with the domestic industry's own products. This creates hurdles for countries trying to move up the technology ladder, discouraging them from expanding their processing industries and diversifying exports, and, therefore, leaving them dependent on commodities, whose prices are often volatile.⁵⁷

It may be noted that, although most tariffs in industrial countries are low, those on specific categories of goods remain prohibitively high. Tariffs on many consumer, agricultural and labour-intensive products are 10-20 times higher than the overall average tariff. For example, US import tariffs on clothes and shoes average 11 per cent, and go as high as 48 per cent. Although, in 2001, clothes and shoes accounted for only 6.5 per cent of US imports, in value terms, they brought in nearly half of the \$20 billion US tariff revenue. Other industrial economies are no different. The European Union (EU), for example, applies tariffs of up to 236 per cent on meat, 180 per cent on cereals, and 17 per cent on sneakers. In contrast, its tariffs on raw materials and electronics rarely exceed 5 percent.⁵⁸

Developing countries that primarily export agricultural and labour-intensive goods, such as textiles and clothing, are hit hard by industrial countries' tariff policies. One can clearly see the disparate effects of these tariffs by looking at the *effective* tariff rates—the amount of import duties collected as a per cent of total imports—of different countries. For example, on imports of \$2.4 billion from Bangladesh (a major clothing exporter), the United States collected duties of \$331 million in 2001—slightly more than the \$330 million it collected on \$30 billion imports from France. Thus, poor countries like Bangladesh—that are beginning to move from subsistence agriculture and dependency on exports of primary commodities to light manufacturing—face the highest effective tariffs, on an average, four or five times more than those faced by the richest economies.⁵⁹

Most quantitative restrictions and other non-tariff barriers have been converted into tariffs since the Uruguay Round of trade talks, improving the transparency of trade regimes. Protectionism has actually increased in some cases, however, and trade barriers are still higher for the products typically exported by developing countries than for those from industrial countries. This is partly because developing countries made little effort to participate in multilateral trade talks before the Uruguay Round, and partly because of the political sensitivity of liberalising agriculture and labour-intensive manufactures. Developing countries, too, have high tariffs that limit trade among them.⁶⁰

As pointed out in the chapter on *protectionism*, developing countries are affected by *contingent protection* and *standards*.

The liberalisation of trade in services, which is generally subject to far greater restrictions, offers opportunities for developing countries that, according to some estimates, are even greater than in merchandise trade (for instance, in labour-intensive services that require temporary movement of workers). But, here too, restrictions continue to be prohibitive in many respects. Though it was thought that the Uruguay Round Agreement will liberalise agricultural trade, but many trade barriers still continue to keep poor countries' agricultural products out of rich country markets, and the developed countries are even increasing protection. Although producer support in the OECD (Organisation for Economic Cooperation and Development) countries began to decrease in the late 1980s, reaching its lowest level in 1997, it started going up again as world prices of major commodities fell. In May 2002, the United States introduced a farm bill significantly boosting agricultural subsidies. The subsidisation of agriculture

in the OECD countries depresses world prices of commodities and increases price volatility, which hurts poor countries and their poorest citizens. The costs of distortions in agricultural trade to the global economy are large, and it is estimated that even if only static effects are considered, the welfare costs of agricultural distortions may be over \$120 billion (based on 1997 data). One-fifth of the cost is borne by developing countries, and the export revenues lost are much larger. Both developing and developed countries suffer most from their own restrictive policies. In the OECD countries, producer support—domestic subsidies for farmers and border measures (import tariffs and export subsidies)—was estimated to be nearly one-third of total farm receipts. Prices received by OECD farmers were, on an average, 31 per cent above world prices. Border measures have greatest distortionary effects on trade.⁶¹

In short, the developing countries present a mixed picture of trade performance, and encounter a hostile trade environment. On one side is the spectacular performance of some countries, while on the other side is the dismal picture presented by many. One is, therefore, tempted to draw a hypothesis that trade performance linked to the domestic economic factors, including development and trade strategies, and the external environment.

Developing countries present a mixed picture of trade performance.

Salient Points

The salient points of trade of developing countries vis-à-vis global trade may be listed as follows.

1. The trade of developing countries, as a group, increased faster than their GDP and trade of developed countries.
2. There are a number of developing countries in the list of top 20 merchandise exporters. China, a developing country, has quickly emerged as a dominant player in global trade.
3. As a result of their faster trade growth, the share of developing countries in the global trade has increased significantly. Their share in the global trade is higher than their share in the global GDP.
4. The trade-GDP ratio of developing countries is higher than that of the developed countries, which implies that they are more integrated with the global economy by trade than the developed countries, or that they are more trade dependent than the developed countries.
5. The manufactured exports of developing countries have grown very fast, so that the share of manufactures in the total exports of developing countries, and the share of developing countries in the global trade of manufactures, have gone up significantly.
6. The developing countries' trade relations have changed markedly from the traditional north-south pattern, and 40 per cent of their exports now go to other developing countries.
7. The impressive picture of trade performance of developing countries, as a group, is the result of the rapid strides made by a small group of countries, like China, S. Korea, Taiwan, Hong Kong and Singapore. While just five top developing country exporters account for about half of the aggregate exports of the developing countries, the remaining half is made up by nearly 160 developing economies. This implies that most developing countries have been unable to overcome the obstacles to expanding and diversifying their exports. Several of the important developing country exporters, besides those mentioned above, are oil exporters.
8. The share of the 50 least developed countries (LDCs) in global trade is dismal—less than 1 per cent, and the major part comprises of the contribution of a small number of oil exporters among them.
9. A number of low income countries have been marginalised by the global trading system.

10. Although, the developing countries as a group stand to benefit from multilateral trade liberalisation, a number of them will be heavy losers.
11. Exports of developing countries face high tariff and non-tariff barriers in developed countries. Although, it was expected that the Uruguay Round Agreement would liberalise agricultural trade, not only many trade barriers continue to keep poor countries' agricultural products out of rich country markets, but the developed countries are even increasing protection.
12. High trade barriers in developing countries are affecting south-south trade.

The lion's share of the developing country exports is contributed by a small number of countries with impressive economic growth and oil exporters.

SOUTH-SOUTH TRADE

Developing countries which depend heavily (as almost all of them do) on the developed country markets for exports are likely to be affected by slow-down in their economic growth. In his 1979 Nobel lecture, Arthur Lewis analysed the consequences of a slow-down of trade, the 'engine of growth'. According to Lewis, this engine, in the past, was fueled by industrial growth in developed countries. The slow-down is attributed to secular decline in the rate of economic growth in developed countries, since the mid 1970s. The only way to keep the engine of LDCs growth going at a satisfactory rate is to turn to an alternative source of fuel. This, Lewis argues, lies in trade among developing countries, which, he asserts, can "...take up the slack left by MDCs (more developed countries), as MDCs slow down."⁶² Thus, in contrast to the import substitution solution given by the export pessimism of the 1950s, Lewis' remedy, coming two decades later, when most import substitution possibilities in many of the LDCs have almost been exhausted, retains the trade engine, but seeks an alternative source of fuel to drive it.

The suggestion for increasing trade among developing countries has been gaining importance. Economic cooperation among developing countries (ECDC), including expansion of trade, is one of the measures suggested, for the New International Economic Order (NIEO), by the United Nations. Leaders and economists of the South (i.e., developing countries) have been paying increasing attention to the South-South Cooperation (i.e. ECDC). Manmohan Singh observes, "The deterioration in the international environment for development, since the mid-seventies, implies that the transmission of growth stimulus from the developed to the developing countries can hardly be as strong or broad-based as was the case before 1973. The new international development context would thus require a major adjustment in the development strategies of the developing countries."⁶³ He cautions, "It must be frankly recognised that, in recent years, the developing countries' bargaining power vis-a-vis the developed countries has deteriorated rather than improved. As such, they are not in a strong position to force the pace of reform of the international economic system."⁶⁴ He, therefore, suggests, "Increased economic cooperation among developing countries can help to soften considerably, the rigour of harsh adjustment measures imposed by a hostile international economic environment. There are immense opportunities for expansion of trade, based on known complementarities in the structure of production and demand pattern, for cooperation in upgradation of technology and harmonisation of investment plans among developing countries."⁶⁵ Expansion of South-South trade and cooperation in trade are among the important measures suggested by the *South Commission* to improve the economic conditions of the South. (For details, see the chapter on *South-South Cooperation*.)

Substantial increase in trade among developing countries will enhance their status and bargaining power vis-à-vis the developed countries.

South–South trade has grown steadily and substantially (twice as fast as global trade). It now accounts for nearly 40 per cent of their total trade.

Over the past four and a half decades, trade among developing countries has increased substantially and steadily, and their trade relations have changed markedly from the traditional north (industrial economies)–south (developing countries) pattern. In 2001, 40 per cent of their exports went to other developing countries, compared to less than 25 per cent in 1960. There has indeed been a robust trend in intra-developing country trade since the 1990s. Between 1990 and 2001, South–South trade grew twice as fast as world trade (10 per cent versus 5 per cent), with the share of intra-developing country trade in world merchandise exports rising from 6.5 per cent to 10.6 per cent. Over this period, developing country economies grew much faster than those of the developed and transition countries. Growth was essentially driven by the rise in the share of exports from the South–East Asian developing countries.

A key contributor to this outcome was the strong trade performance of a number of middle income developing countries that trade with other developing countries. Much of this expansion in South–South trade took place in developing Asia (which accounts for more than two-thirds of intra-developing country trade). The combination of high growth in the global IT industry and its production sharing arrangements across much of Asia also played a significant part in the growth of South–South trade. Manufactures, in particular office and telecom equipment, also played a leading role in the growth of intra-developing country trade. This strong performance can be attributed, in part, to open trade and investment policies in the major developing economies of Asia. In recent years, some of the larger developing countries have become major markets for other developing countries.⁶⁶

It may, however, be noted that while growth in South–South trade has contributed to diversification and development, this has not come about, to any major degree, through preferential arrangements among developing countries, but rather through creating the underlying conditions to exploit comparative advantage (See the chapter on *Economic Integration* for details).

There are many impediments to the expansion of South–South trade. The progress of intra-developing country trade is held back by both the trade barriers, and numerous other non-trade barriers. Among the major obstacles faced by many developing countries are relatively high transport, insurance and communication costs, difficulties in trade financing and insufficient marketing and distribution skills. The lack of product diversification can also be an obstacle as dependence on a few (non-fuel) primary products, facing sluggish long-term demand growth, constitutes a structural handicap for the expansion of trade. This is true for trade in general, as well as for trade with other developing countries having similar resource endowments. This means that trade liberalisation needs to be complemented by measures that address these infrastructure and supply-side bottlenecks, and for which resources need to be mobilised.⁶⁷

SUMMARY

Global trade, one of the important means of global economic integration, has been growing faster than world output, and the trend is likely to continue in the future.

Global trade is dominated by the developed countries. In 2003, the top three exporters accounted for more than 25 per cent of global exports of goods, and nearly 30 per cent of services exports.

The United States, the largest merchandise exporter for a long time, was relegated to the second position by Germany in 2003. The US, however, is far ahead of all other countries in services exports, in which Germany's rank in 2003 was 3, the second position being occupied by UK.

The developed countries are also the major markets for the exports of the developing countries.

The largest importer of merchandise is the US, followed by Germany and China.

There has been a considerable change in the composition of the global trade. The share of manufactures in the total exports increased substantially, while that of the primary commodities declined correspondingly. Machinery and transport equipments account for major chunk of the global merchandise trade—well over one-third of the total exports, and about half of the manufactures.

A significant volume of international trade is covered by countertrade. Countertrade is a form of international trade in which certain export and import transactions are directly linked with each other, and in which import of goods are paid for by export of goods, instead of money payments.

International trade in services, which makes up a major share of the invisibles account of the Balance of Payments, has been growing fast. Services now account for about one-fifth of the total global trade. The growth rate of trade in services was faster than that of goods.

Travel and transportation account for major share of the services trade. However, trade in other commercial services (particularly financial services—including banking and insurance—construction services and computer and information services) has been growing faster than these two categories.

Due to the special characteristics and the socio-economic and political implications of certain services, they are generally subject to various types of national restrictions. Protective measures include visa requirements, investment regulations, restrictions on repatriation, marketing regulation, restrictions on the employment of foreigners, compulsion to use local facilities, etc. Heavily protected or restricted services in different countries include banking and insurance, transportation, television, radio, film and other forms of communication, and so on.

India's trade performance has improved recently. With 2.7 per cent share, India's rank in global export of services in 2006 was 10th, compared to the 28th rank in merchandise exports, with one per cent share, and with 2.4 per cent share of global import of services, her rank was 13th, as against 17th in goods with a share of 1.4 per cent. In recent years, India has substantially improved her share and rank in services trade.

International sourcing accounts for an estimated one-third of the world trade.

Exports of developing countries, as a group, have been growing faster than those of the developed countries. As a result, their share in the global exports increased very significantly; their share in world exports today is nearly 30 per cent, while their share in global GNP is about 20 per cent. Several developing countries are among the top exporters in the world. It may be noted that the impressive figures of trade performance of developing countries, as a group, is the result of the rapid strides made by a small group of countries. Just five top developing country exporters account for half of the aggregate exports of the developing countries, the remaining half is made up by nearly 160 developing economies. This implies that most developing countries have been unable to overcome the obstacles to expanding and diversifying their exports. In short, the developing countries present a mixed picture of trade performance and encounter a hostile trade environment. On one side is the picture of spectacular performance of some countries, and on the other is a dismal picture presented by many.

There South–South trade, i.e., trade among developing countries has also expanded fast. There are, however, many impediments to the expansion of the intra-developing country trade.

Review Questions

1. Discuss the salient features of global trade in merchandise.
2. Examine the important trends in global merchandise trade.
3. Discuss the important features and trends in global trade in services.
4. Explain the important issues in trade in services.

5. Explain countertrade. Give a brief account of the reasons for the growth of countertrade. Is countertrade desirable?
6. Write notes on the following:
 - (a) Production sharing
 - (b) Trade in services and developing countries
 - (c) Trade and marginalisation
 - (d) Intra-regional trade
 - (e) Global sourcing

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CHAPTER 4

4

Globalisation

LEARNING OBJECTIVES

- ☐ To understand the meaning and dimensions of globalisation.
- ☐ To examine the differences and similarities between the old and present globalisations.
- ☐ To examine the impact of globalisation and the policy measures required to minimise the harmful effects of globalisation on developing countries.
- ☐ To evaluate the problems and prospects of globalisation of Indian business.
- ☐ To get an idea of the globalisation strategies.

The IMF defines globalisation as “the growing economic interdependence of countries worldwide through increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology”.¹ The world economy has indeed been increasingly globalising by the growing integration of national economies through trade and investment flows, and the multinational firms’ strategy of global sourcing and networking of various phases and aspects of business.

Globalisation is the process of integration of economies across the world through cross-border flow of factors, products and information.

The sweeping political and consequent economic policy changes in the erstwhile communist and socialist countries, dramatic shifts in the economic policies in a large number of countries such as communist China to democratic India, privatisation in a number of market economies and the liberalisation of trade and investment fostered by the GATT/WTO have added momentum to the forces of globalisation.

The universal economic liberalisation which gathered momentum in the last two decades of the twentieth century, reinforced and enforced by the WTO, seems to have made globalisation irreversible and unstoppable. If it is an option, it is an inevitable option. If it is an evil, it is an inevitable evil. The challenge, therefore, to the individuals, businesses and countries is to endeavour to take advantage of the benefits of globalisation and mitigate the adverse effects.

In his *Management Challenges for the 21st Century*, renowned management professor Peter Ducker cautions: “All institutions have to make *global competitiveness* a strategic goal. No institution, whether a business, a university or a hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world”.²

Globalisation, of course, is not a new phenomenon. The period 1870 to 1914 experienced a growing trend towards globalisation. The new phase of globalisation which started around the mid-20th century

became widespread, more pronounced and overcharging since the late 1980s, by gathering momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalise international trade and investment, and the technological and communication revolutions.

We may consider globalisation at two levels, viz. at the macro level (i.e. globalisation of the world economy) and at the micro level (i.e. globalisation of the business and the firm).

Globalisation of the world economy is achieved, quite obviously, by globalising the national economies. Globalisation of the economies and globalisation of business are interdependent.

GLOBALISATION OF WORLD ECONOMY

A global or transnational economy is one which transcends the national borders unhindered by artificial restrictions like government restrictions on trade and factor movements. Globalisation is a process of development of the world into a single integrated economic unit.

The world economy has been emerging as a global or transnational economy.

The transnational economy is different from the international economy. The international economy is characterised by the existence of different national economies, the economic relations between them being regulated by the national governments. The transnational economy is a borderless world economy characterised by free flow of trade and factors of production across national borders.

Management guru Peter Ducker in his *New Realities* observes that in the early or mid-nineteen seventies—with OPEC and the floating of the US dollar—the world economy changed from being international to transnational. According to Ducker, the transnational economy is characterised by, inter alia, the following features:³

1. The transnational economy is shaped mainly by money flows rather than by trade in goods and services. These money flows have their own dynamics. The monetary and fiscal policies of sovereign governments increasingly react to events in the international money and capital markets rather than actively shape them.
2. In the transnational economy, management has emerged as the decisive factor of production and the traditional factors of production, land and labour, have increasingly become secondary. Money and capital markets too have become transnational and universally obtainable. Ducker, therefore, argues that it is management on which competitive position has to be based.
3. In the transnational economy the goal is market maximisation and not profit maximisation.
4. Trade, which increasingly follows investment, is becoming a function of investment.
5. The decision making power is shifting from the national state to the region (i.e. the regional blocs like the European Community, North American Free Trade Agreement etc.).
6. There is a genuine—and almost autonomous—world economy of money, credit and investment flows. It is organised by information which no longer knows national boundaries.
7. Finally, there is a growing pervasiveness of the transnational corporations which see the entire world as a single market for production and marketing of goods and services.

There are, thus, many factors which tend to promote the transnationalisation of the world economy. The multilateral trade negotiations under the auspices of GATT/WTO have been liberalising trade and investment.

As pointed out in Chapters 1 and 3, a growing proportion of the world output is traded internationally and the faster growth of trade, than the GDP, is bringing about world economic integration. As indicated in Chapter 1 and the chapter on *International Capital Movements*, this economic integration is reinforced by the massive cross-border capital flows. The progress of the regional blocs increasingly integrate the regional economies, as explained in the chapter on *Economic Integration*.

DRIVERS OF GLOBALISATION

The section *Factors Promoting Global Economic Integration* in Chapter 1 has given some indications of the factors driving globalisation.

Sullivan observes that globalisation represents the increasing integration of the world economy, based on five inter-related drivers of change:⁴

- International trade (lower trade barriers and more competition).
- Financial flows (foreign direct investment, technology transfers/licensing, portfolio investment, and debt).
- Communications (traditional media and the Internet).
- Technological advances in transportation, electronics, bioengineering and related fields.
- Population mobility, especially of labour.

Each of these drivers of change has accelerated in recent years and each reinforces the other.

COMPARISON BETWEEN THE OLD AND NEW GLOBALISATIONS

There are several similarities and differences between the two phases of globalisation (1870–1913 and 1950 onwards). Both the phases were characterised by rising trade-GDP ratio and rising international investments.

There are several similarities and differences between the old and present globalisations.

During the first phase of globalisation, the tariff barriers to trade were fairly very high; during the second phase although the tariff barriers have substantially come down, the NTBs have been high. Although WTO is trying to bring down NTBs, there is a tendency to increase NTBs.

Similarities between Old and New Globalisations

Nayyar⁵ draws the following four similarities of both the phases of globalisation:

1. The absence or the dismantling of barriers to international economic transactions.
2. The development of enabling technologies.
3. Emerging forms of industrial organisation.
4. Political hegemony or dominance.

Differences between Old and New Globalisations

Nayyar also highlights important differences between both the phases of globalisation in respect of trade flows, FDI flows, financial flows and labour flows.⁶ The salient points are the following:

Trade Flows During 1870 to 1913, an overwhelming proportion of international trade was constituted by inter-sectoral trade, where primary commodities were exchanged for manufactured goods. This trade was, to a significant extent, based on absolute advantage derived from natural resources or climatic conditions.

The significant pattern of trade has transformed from inter-sectoral through inter-industry to intra-industry and intra-firm.

During the period 1950–1970, inter-industry trade in manufactures, based on differences in factor endowments, labour productivity or technological leads and lags, constituted an increasing proportion of international trade.

Since 1970 intra-industry trade in manufactures, based on scale economies and product differentiation, has constituted an increasing proportion of international trade.

Further, now about one-third of the international trade is estimated to be intra-firm trade, i.e. trade between affiliates of the same company located in different countries. The composition of intra-firm trade has undergone a change, characterised by a steady decline in the importance of primary commodities and an increase in the importance of manufactured goods and intermediate goods.

FDI Flows There is also a marked difference between the two phases in respect of the spatial and sectoral distribution of FDI. During the second phase, its distribution between the developed and developing countries was more uneven than in the first phase. However, the 1990s witnessed an increase in the share of developing countries in FDI inflows, although still behind the industrialised countries. A small number of countries absorb the lion's share of the FDI flows to the developing world.

During the pre- World War I period, developing countries and primary sector received much larger share of FDI than today.

In 1913, the primary sector accounted for more than half (55 per cent) of the long-term foreign investment, followed by trade and distribution (30 per cent), and the share of the manufacturing sector was very low (10 per cent). In the early years of this decade, the service sector accounted for about two-thirds of the FDI inflows.

In the early twentieth century foreign investment was only long-term. Two-thirds of it was portfolios while one-third of it was direct. In the second phase, much of the long-term investment is direct, although portfolio investment has risen sharply in the 1990s.

Financial Flows Nayar observes that in the last quarter of the nineteenth century, capital flows were a means of transferring investible resources to underdeveloped countries or newly industrialising countries with the most attractive growth opportunities. In the second phase, these capital flows have been destined mostly for the industrialised countries, which have high deficits and high interest rates to finance public consumption and transfer payments rather than productive investment. During the first phase of globalisation from 1870 to 1913, the object of financial flows was to find avenues for long-term investment in search of profit.

Between the two phases, there are important differences in the destination, object, intermediaries and instruments in respect of the financial flows and transactions.

During the second phase of globalisation since the early 1970s, financial flows were constituted mostly by short-term capital gains. The intermediaries, too, were different. In the late nineteenth century, banks were the only intermediaries between lenders and borrowers in the form of bonds with very long maturities. In the latter phase, institutional investors such as pension funds and mutual funds were more important than banks: the latter continue to act as intermediaries but now borrow short to lend long, thus resulting in a maturity mismatch. Consequently, the financial instruments need to be far more sophisticated and diversified than earlier. In the late nineteenth century, there were mostly long-term bonds with

sovereign guarantees provided by the imperial powers of the governments in borrowing countries. In the present phase, there has been an enormous amount of financial innovation through the introduction of derivatives (futures, swaps and options). These derivatives (which are also not entirely new to the world and are reported to have existed in the seventeenth and eighteenth centuries: options in the Amsterdam stock exchange and futures in the Osaka rice market) are a means of managing the financial risks associated with international investment. This is essential now because, unlike the earlier phase of globalisation, there is a maturity mismatch and there is no effective security provided by national states. International financial markets have simply developed the instruments to meet the needs of the times. It is paradoxical that such derivatives, which have been introduced to counter risk, may in fact increase the risk associated with international financial flows by increasing the volatility of short-term capital movements.

Labour Flows The fundamental difference between the two phases of globalisation is in the sphere of labour flows. In the late nineteenth century, there were no restrictions on the mobility of people across national boundaries. Passports were seldom needed. Immigrants were granted citizenship with ease. Between 1870 and 1914, international labour migration was enormous.

During the first phase of globalisation there was free cross-border mobility of people.

The only significant evidence of labour mobility during the last quarter of the twentieth century is the temporary migration of workers to Europe, the Middle East and East Asia. The present phase of globalisation has found substitutes for labour mobility in the form of trade flows and investment flows. For one, industrialised countries now import manufactured goods that embody scarce labour.

The first phase of globalisation in the late nineteenth century was characterised by integration of markets through an exchange of goods which was facilitated by the movement of capital and labour across national boundaries. This was associated with a simple vertical division of labour between countries in the world economy. The second phase of globalisation is characterised by an integration of production with linkages that are wider and deeper, except for the near absence of labour movements. It is reflected not only in the movement of goods, services, capital, technology, information and ideas, but also in the organisation of economic activities across national boundaries. This is associated with a more complex—part horizontal and part vertical—division of labour between the industrialised countries and a few developing countries in the world economy. The process of globalisation in the first phase was dominated by imperial states not only in the realm of politics but also in the sphere of economics.

Features of New Globalisation

The *Human Development Report*, 1999, mentions the following as the new features of the current phase of globalisation.

New Markets

- Growing global markets in services—banking, insurance and transport.
- New financial markets—deregulated, globally linked, working around the clock, with action at a distance in real time, with new instruments such as derivatives.
- Deregulation of anti-trust laws and proliferation of mergers and acquisitions.
- Global consumer markets with global brands.

New Actors

- Multinational corporations integrating their production and marketing.
- The World Trade Organization—the first multilateral organisation with authority to enforce national governments' compliance with rules.

- An international criminal court system in the making.
- A booming international network of NGOs.
- Regional blocs proliferating and gaining importance—European Union, Association of South-East Asian Nations, Mercosur, North American Free Trade Association and Southern African Development Community among many others.
- More policy coordination groups—G-7, G40, G-22, G-77 and OECD.

New Rules and Norms

- Market economic policies spreading around the world, with greater privatisation and liberalisation than in earlier decades.
- Widespread adoption of democracy as the choice of political regime.
- Human rights conventions and instruments building up in both coverage and number of signatories—and growing awareness among people around the world.
- Consensus goals and action agenda for development.
- Conventions and agreements on the global environment—biodiversity, ozone layer, disposal of hazardous wastes, desertification and climate change.
- Multilateral agreements in trade, taking on such new agendas as environmental and social conditions.
- New multilateral agreements—for services, intellectual property, communications—more binding on national governments than any previous agreements.
- The Multilateral Agreement on Investment under debate.

New Tools of Communication

- Internet and electronic communications linking many people simultaneously.
- Cellular phones.
- Fax machines.
- Faster and cheaper transport by air, rail and road.
- Computer-aided design.

GLOBALISATION OF BUSINESS

Meaning and Dimensions

Globalisation in its true sense is a way of corporate life necessitated, facilitated and nourished by the transnationalisation of the world economy and developed by corporate strategies. Globalisation is an attitude of mind. It is a mindset which views the entire world as a single market so that the corporate strategy is based on the dynamics of the global business environment. International marketing or international investment does not amount to globalisation unless it is the result of such a global orientation.

Corporate strategies of MNCs are based on the global dynamics of business.

Globalisation encompasses the following:

- Doing, or planning to expand, business globally.
- Giving up the distinction between the domestic market and foreign market and developing a global outlook of the business.
- Locating the production and other physical facilities on a consideration of the global business dynamics, irrespective of national considerations.

- Basing product development and production planning on the global market considerations.
- Global sourcing of factors of production, i.e. raw materials, components, machinery/technology, finance etc. are obtained from the best source anywhere in the world.
- Global orientation of organisational structure and management culture.

Companies which have adopted a global outlook stop “thinking of themselves as national marketeers who venture abroad and start thinking of themselves as global marketeers. The top management and staff are involved in the planning of worldwide manufacturing facilities, marketing policies, financial flows and logistical systems. The global operating units report directly to the chief executive or executive committee, not to the head of an international division. Executives are trained in worldwide operations,

A truly global corporation views the entire world as a single market; it does not differentiate between domestic market and foreign markets.

not just domestic or international. Management is recruited from many countries, components and supplies are purchased where they can be obtained at the least cost, and investments are made where the anticipated returns are the greatest”.⁷

Stages of Globalisation

Normally, a firm passes through different stages of development before it becomes a truly global

A domestic firm normally passes through different stages of strategic orientation to become a truly transnational corporation.

corporation. Typically, a domestic firm starts its international business by exporting. Later it may establish joint ventures or subsidiaries abroad. From an international firm it may then develop into a multinational firm, and finally into a global or transnational one.

Ohmae identifies⁸ five different stages in the development of a firm into a global corporation. The first stage is the firm's length service activity of essentially domestic company which moves into new markets overseas by linking up with local dealers and distributors. In stage two, the company takes over these activities on its own. In the next stage, the domestic based company begins to carry out its own manufacturing, marketing and sales in the key foreign markets. In stage four, the company moves to a full insider position in these markets, supported by a complete business system including R&D and engineering. This stage calls on the managers to replicate in a new environment—the hardware, systems and operational approaches that have worked so well at home. It forces them to extend the reach of domestic headquarters, which now has to provide support functions, such as personnel and finance, to all overseas activities. During stage four, the headquarters' mentality continues to dominate. Different local operations are linked and their relation to each other is established by their relation to the centre.

In the fifth stage, the company moves towards a genuinely global mode of operation. In this context, Ohmae points out that a company's ability to serve local customers in markets around the globe, in ways that are truly responsive to their needs as well as to the global character of its industry, depends on its ability to strike a new organisational balance. What is called for is what Akio Morita of Sony has termed *global localisation*, a new orientation that simultaneously looks in both directions.

Getting to stage five, however, means venturing onto a new ground altogether. Ohmae argues that to make this organisational transition, a company must denationalise its operations and create a system of values shared by corporate managers around the globe to replace the glue a nation-based orientation once provided.

ESSENTIAL CONDITIONS FOR GLOBALISATION

There are some essential conditions which need to be satisfied on part of the domestic economy as well as the firm for successful globalisation of the business. They are the following:

Business Freedom There should not be unnecessary government restrictions which come in the way of globalisation, such as import restriction, restrictions on sourcing finance or other factors from abroad, foreign investments etc. That is why the economic liberalisation is regarded as a first step towards facilitating globalisation.

Facilities The extent to which an enterprise can develop globally from home country base depends on the facilities available, for example the infrastructural facilities.

Government Support Although unnecessary government interference is a hindrance to globalisation, government support can encourage globalisation. Government support may take the form of policy and procedural reforms, development of common facilities such as infrastructural facilities, R&D support, financial market reforms and so on.

Resources Resources is one of the important factors which often decides the ability of a firm to globalise. Resourceful companies may find it easier to thrust ahead in the global market. Resources include finance, technology, R&D capabilities, managerial expertise, company and brand image, human resource etc. It should, however, be noted that many small firms have been very successful in international business because of one or the other advantage they possess.

Competitiveness The competitive advantage of the company is a very important determinant of success in global business. A firm may derive competitive advantage from any one or more of the factors such as low costs and price, product quality, product differentiation, technological superiority, after sales service, marketing strength etc. Sometimes small firms may have an edge over others in certain aspects or times of business.

Orientation A global orientation on part of the business firms and suitable globalisation strategies are essential for globalisation.

IMPLICATIONS AND IMPACT OF GLOBALISATION

The almost universal acceptance of the market economy and the globalisation driven by private enterprise tend to aggravate most of the harmful effects traditionally attributed to neo-colonialism.

III Effects of Globalisation

- The global dominance of industries by MNCs is on the increase. Global gross product attributable to foreign affiliates of MNCs was about one-tenth of global GDP in 2000 compared to five per cent in the beginning of the 1980s.
- Many countries are indiscriminate in liberalising foreign investment. Pepsi, Coke and 'junk food' are allowed in even countries like China.
- A number of countries allow high foreign stake even in industries where that is not really required. This could affect domestic enterprise of developing countries.

Globalisation has several adverse effects on the developed as well as developing economies.

- There has been a large number of cases of takeover of national firms by foreign firms. In some of these cases, the domestic firms are driven to a situation of having to hand over the majority or complete equity to the foreign partners of joint ventures because of the inability of the domestic partners to bring in additional capital or some other incapability.
- Nexus between MNCs and governments is not uncommon. An alarming development under the Indian liberalisation was the unscrupulous way the Government was implementing the policy as well as the foreign companies were behaving. The Government policy would have given the public an impression that even in the priority industries foreign equity participation would be limited to 51 per cent. However, a number of foreign companies, after having jacked up their equity holding in the Indian subsidiaries for a song, through preferential issue, to 51 per cent, are setting up new fully owned subsidiaries to do business which their existing subsidiaries could do. Most of these are in non-priority areas. This was a covert deception by the Government-multinational collusion using the saving clauses and exceptions of the policy. This could cause large foreign exchange outflow by way of dividend repatriation. Foreign investment should be discouraged in non-priority areas.
- Replacement of traditional and indigenous products by modern products, resulting in the ruin of traditional crafts and industries and the livelihood of people in these sectors, has also been happening in several countries.
- Sometimes liberalisation is adopted to serve the vested interests of certain sections or without assessing the possible impacts, leading to miseries for, for example, farmers, small firms etc.
- Another problem is that in several cases domestic firms of developing countries are made to compete with foreign firms without a level playing ground. For example, Indian firms which have several odds against them would find it difficult to compete with firms from countries where the interest rates, input costs etc. are low and infrastructural facilities are well developed and efficient.
- One of the common criticisms is that the technology that the MNCs bring in may not be the one suited to the host country but that suits the objectives of the MNCs.
- Another usual criticism is that MNCs dump obsolete technology to the developing world. This criticism, however, is not as valid today as in the past, and in future it is likely to be even less valid. In the past, because of the entry restrictions and resultant absence or lack of competition, developing countries could be used as a dumping ground for obsolete products, including technology. The business environment today, however, is vastly different. Because of the competition between MNCs (and national firms) made possible by the dismantling of entry barriers (and freeing of technology imports by national firms and added thrust on R&D by them) technological edge is an important determinant of success. The evolution of the motor car market in India, for example, gives some indication of this.
- The developing countries, in general, have been disadvantaged by the international trading system, as pointed out in Chapters 2 and 3. The least developed countries have been the most deprived. It may, however, be noted that one of the reasons for the adverse terms of trade of developing countries is the demand-supply factor. Several developing countries have improved their export performance substantially and several of them figure in the list of the top 20 exporters.

Developing country firms find it very hard to fight the powerful foreign firms.

The developing countries vehemently argued for the liberalisation of trade in textiles. The criticism now, however, is that some of the developing countries will lose because of the removal of the

MFA and it will be the more competitive among the developing countries who benefit. If countries lose out in the international trade because of lack of competitiveness or because of demand supply factors, it would be unfair to criticise the trading system. At the same time, it is also true that the economically powerful nations and dominant firms try to exploit the weak bargaining position of the developing nations. Multilateral trade liberalisations were mostly in respect of goods traded between industrial economies, and those exported from developing to the developed countries did not benefit so much. While developing countries as a group now face tariffs 10 per cent higher than the global average, the least developed countries face tariffs 30 per cent higher because tariffs remain high on the goods with greatest potential for the poorest countries, such as textiles, leather and agricultural commodities.⁹

- While developing countries, which in the past were against globalisation, have opened their doors for globalisation, many people in developed countries like USA are angry against globalisation. American jobs and wage levels are severely affected by the influx of cheap imports and shifting of production to low cost overseas locations. According to a *BusinessWeek*/Harris poll in early 2000, more than two-thirds of Americans believe that globalisation drags down US wages. A strong majority of the Americans feel that trade policies have not adequately addressed the concerns of American workers, international labour standards, or the environment. The important adverse effects of globalisation according to the survey are:

Developed nations are experiencing deindustrialisation and fall in employment.

- (1) Millions of Americans have lost jobs due to imports or production shift abroad. Most find new jobs that pay less.
- (2) Millions of others fear losing their jobs, especially in companies operating under competitive pressure.
- (3) Workers face pay cut demands from employers, which often threaten to export jobs.
- (4) Service and white collar jobs are increasingly vulnerable to operations moving offshore.
- (5) US employees can lose their comparative advantage when companies build advanced factories in low-wage countries, making them as productive as those at home.

The above problems may be applicable to the developed countries in general.

Benefits of Globalisation

1. Foreign capital, if properly utilised, can make substantial contribution to the economic development of a nation. A classical example is the communist China.
2. Productivity grows more quickly when countries produce goods and services in which they have comparative advantage. Living standards can go up faster.
3. Increase in competition would make companies more cost and quality conscious, and innovative.
4. Global competition and imports keep a lid on prices, so inflation is less likely to derail economic growth.
5. Liberalisation and global competition enhance consumer choice and consumer surplus.
6. An open economy spurs innovation with fresh ideas from abroad.
7. Export jobs often pay more than other jobs.
8. Unfettered capital flows give the country access to foreign investment and keep interest rates low.

9. Globalisation opens up enormous domestic and global opportunities for firms in developing countries.
10. Despite discriminations of the global economic order against them, there are chances of developing countries benefiting from trade. See the first paragraph of the section *Developing Countries and Global Trade* in the previous chapter.

Globalisation Challenges

Survival of the fittest is the order of globalisation.

Globalisation throws up a number of challenges for the individuals, firms and countries. Globalisation will doom the future of those who fail to meet these challenges effectively.

1. In a competitive environment, a firm can survive only if it is efficient. Companies all around the world, including many large multinationals, have been cutting down the size of their human resources as one of the means of achieving cost efficiency. The problem of over-staff is very severe in the developing countries. Unless these firms get rid of the surplus labour, they can hardly be competitive and successful. That means, the liberalisation can succeed only if the economy grows fast to absorb the displaced labour and the new addition to the labour force.
2. Attracting foreign investment is a real challenge, as is evident from the fact that the FDI inflow to India is far below the target. It is criticised that developed countries receive most of the FDI. A very small number of developing countries, which are relatively developed or large or fast growing in the developing world, account for the lion's share of the FDI flows to this category. What the critics do not appreciate is that, as foreign investment flows are based on economic rational, it is unrealistic to expect the pattern of flow to be different.
3. Another criticism is that the liberalisation increases the economic inequality. Even in China, the liberalisation has created many islands of affluence. If inequality increases because of the worsening of the living conditions of the poor, it certainly is unjustifiable. But, if the increase in inequality is the result of improving the economic conditions of a section, while there is no economic deterioration of any section, or because of the disproportionate benefits, then the question is whether the economic progress of some sections should be curbed so that there will not be a widening of the inequality. It goes without saying that a government shall strive towards growth with justice.

Liberalisation may increase inequality. Further, several sectors and sections may not directly and immediately benefit from mere liberalisation. There may also be shocks and other adverse effects on the weaker sections. It is, therefore, necessary that there should be real socio-economic reforms rather than just liberalisation. Targeted poverty eradication programmes and social safety net are very important. The fast growth and overall development resulting from liberalisation could have a major impact on poverty. Naisbitt points out that there were an estimated 200 to 270 million Chinese living in absolute poverty in 1978 (the year in which the liberalisation began) and their number came down to 100 million by 1985.¹⁰

4. Although MNCs, by the virtue of their size and resources, have certain advantages, they may also have limitations or disadvantages in certain spheres or aspects of business. Small and medium firms often have some edge over the large ones in respect of standardised products or technologies such as greater flexibility and adaptability, lower overheads, intimacy with the customers etc. Lower costs is a great advantage which firms from developing countries enjoy. It may be noted that the major component of growth of several Indian pharmaceutical firms is the foreign market. They are relying mostly on bulk drugs and generics. What is often ignored while discussing the impact

of the product patent is that patented drugs account for only about 15 per cent of the Indian drug market. There are several more products which would go off patent in the coming years which can also be taken up by the Indian firms. The new patent regime should be expected to help the Indian industry by prompting it to give added thrust to R&D and thereby enabling Indian firms also to develop patented products. Positive signs are already there on the horizon.

There are also many evidences of the better technology brought in by the MNCs, inducing or provoking Indian firms to absorb similar technology and thus leading to their enhanced competitiveness and market expansion.

5. The domestic and cross-border M&As pose a serious challenge to governments in ensuring fair competition. An effective competition policy and law, and their proper implementation assume great importance here.
6. Liberalisation will be successful only if the policy is proper and clear and there is the required political mandate, will and boldness. Lack of clarity regarding privatisation; lack of boldness to implement labour law reforms, downsizing, bureaucratic hurdles and so on are retarding India's reform process. Lack of clarity in policies and delays can make the situation worse instead of realising the objectives of liberalisation.

POLICY OPTIONS

With a view to minimising the damages and maximising the opportunities of globalisation from the macro socio-economic point of view, the *Human Development Report 1997* of the UNDP has made the following policy suggestions.

A number of international and national policy measures are needed to safeguard the interests of developing nations.

1. Manage trade and capital flows more carefully.
2. Invest in poor people.
3. Foster small enterprises.
4. Properly manage new technology.
5. Reduce poverty and introduce safety nets.
6. Influence governance.

The report also points out that to seize the opportunities of globalisation, the poorest developing countries need the following.

1. *A more supportive macro-economic policy environment for poverty eradication.* The world clearly needs much more effective macro-economic policy management at the global level, with more stable sources of international liquidity, better surveillance, faster crisis response mechanisms and a larger multinational lender of last resort. Existing organisations serve these purposes inadequately.
2. *A fair institutional environment for global trade.* There is an urgent need to treat the products of developing countries at par with those of industrial countries, to accelerate the liberalisation of markets of interest to poor countries, such as textiles, and institute a comprehensive ban on dumping agricultural exports.
3. *A partnership with multinational corporations to promote growth for poverty reduction.* An incentive system that, while avoiding excessive regulation, encourages multinational corporations to contribute to poverty reduction and be publicly accountable and socially responsible shall be promoted. Both industrialised and developing countries have interests here. Those of the industrialised include preventing tax evasion.

4. *Action to stop the race to the bottom.* In a world of competition, countries underbid each other in labour costs, labour standards and environmental protection, to produce as cheaply as possible for the international market. Many countries unilaterally try to restrain these races to the bottom. And some may come under external pressure if they tolerate dangerous working conditions and child labour, with human rights issues a basis for unilateral trade sanctions. A more efficient and equitable approach would be to strengthen institutions such as the International Labour Organisation—to support respect for labour right—and to develop similar institutions for international environmental protection. International coordination is also needed to avoid races to attract international investors by offering overly generous tax incentives that erode the tax base.
5. *Selective support for global technology priorities.* The R&D priorities should be reoriented from the needs of the rich to the more urgent human needs of the poor.
6. *Action on global debt.* The highly indebted poor countries need debt relief now, not at some indeterminate point in the future. Providing effective relief to the 20 worst-affected countries would cost between \$5.5 billion and \$7.7 billion—less than the cost of one Stealth bomber and roughly equivalent to the cost of the Euro-Disney in France. These meager financial costs contrast with the appalling human costs of inaction.

GLOBALISATION OF INDIAN BUSINESS

India's economic integration with the rest of the world was very limited because of the restrictive economic policies followed until 1991. Indian firms confined themselves, by and large, to the home market. Foreign investment by Indian companies was very insignificant.

Globalisation is both a challenge and opportunity for Indian firms.

With the new economic policy ushered in 1991, there has been a change. Globalisation has in fact become a buzzword with Indian firms now and many are expanding their overseas business by different strategies.

This section takes a look at the hurdles and prospects in globalisation of Indian business and the different globalisation strategies.

Obstacles to Globalisation

The Indian business suffers from a number of disadvantages in respect of globalisation. The important problems are:

Government Policy and Procedures Government policy and procedures in India are among the most complex, confusing and cumbersome in the world. Even after the much publicised liberalisation, they do not present a very conducive situation. One prerequisite for success in globalisation is swift and efficient action. Government policy and the bureaucratic culture in India in this respect is not that encouraging.

High Cost High cost of many vital inputs and other factors, such as raw materials and intermediates, power, finance infrastructural facilities like port etc., tend to reduce the international competitiveness of the Indian business.

Poor Infrastructure Infrastructure in India is inadequate and inefficient and, therefore, very costly. This is a serious problem affecting the growth as well as competitiveness.

Obsolescence The technology employed, mode and style of operations etc. are, in general, obsolete and these seriously affect the competitiveness.

Resistance to Change There are several socio-political factors which resist change and this comes in the way of modernisation, rationalisation and efficiency improvement. Technological modernisation is resisted due to fear of unemployment. The extent of excess labour employed by the Indian industry is alarming. Because of this labour productivity is very low and this, in some cases, more than offsets the advantages of cheap labour.

Poor Quality Image Due to various reasons, the quality of many Indian products is poor. Even when the quality is good, the poor quality image that India has becomes a handicap.

Supply Problems Due to various reasons like low production capacity, shortages of raw materials and infrastructures like power and port facilities, Indian companies, in many instances, are not able to accept large orders or to keep up delivery schedules.

Small Size Because of the small size and the low level of resources, in many cases Indian firms are not able to compete with the giants of other countries. Even the largest of the Indian companies are small compared to the multinational giants.

Lack of Experience The general lack of experience in managing international business is another problem.

Limited R&D Marketing research and R&D in other areas are vital inputs for development of international business. However, these are poor in Indian business. Expenditure on R&D in India is less than one per cent of the GNP, while it is two to three per cent in most of the developed countries.

Growing Competition The competition is growing not only from the firms in the developed countries but also from the developing country firms. Indeed, the growing competition from the developing country firms is a serious challenge to India's international business.

Trade Barriers Although the tariff barriers to trade have been progressively reduced thanks to the GATT/WTO, the non-tariff barriers are still a problems, particularly in the developed countries. Further, trading blocs like the NAFTA, EC etc. could also adversely affect India's business.

Favourable Factors of Globalisation

Although India has several handicaps, there are also a number of factors favouring globalisation of Indian business.

Human Resources Apart from the low cost of labour, there are several other aspects of human resources in India's favour. India has one of the largest pool of scientific and technical manpower. The number of management graduates is also surging. It is widely recognised that given the right environment, Indian scientists, technologists and managers can do excellently. Similarly, although the labour productivity in India is generally low, given the right environment it will be good. While several countries are facing labour shortage and may face diminishing labour supply, India presents the opposite picture. Cheap labour has particular attraction for several industries.

Wide Base India has a very broad resource and industrial base which can support a variety of businesses.

Growing Entrepreneurship Many of the established industries are planning to go international in a big way. Added to this is the considerable growth of new and dynamic entrepreneurs who could make a significant contribution to the globalisation of Indian business.

Growing Domestic Market The growing domestic market enables Indian companies to consolidate their position and to gain more strength to make foray into the foreign market or to expand their foreign business.

Niche Markets There are many marketing opportunities abroad in the form of market niches. (Niche is a small segment of the market ignored or not properly catered to by the large players.) Such niches are particularly attractive for small companies. Several Indian companies have become successful by niche marketing.

Expanding Markets The growing population and disposable income, and the resultant expanding national markets provide enormous business opportunities.

Transnationalisation of World Economy Transnationalisation of the world economy, i.e. the integration of the national economies into a single world economy as evinced by the growing interdependence and globalisation of markets, is an external factor encouraging globalisation of Indian business.

NRIs The large number of non-resident Indians who are resourceful—in terms of capital, skill, experience, exposure, ideas etc.—is an asset which can contribute to the globalisation of Indian business. The contribution of the overseas Chinese to the recent impressive industrial development of China may be noted here.

Economic Liberalisation The economic liberalisation in India is an encouraging factor of globalisation. The delicensing of industries, removal of restrictions on growth, opening up of industries earlier reserved for the public sector, import liberalisations, liberalisation of policy towards foreign capital and technology etc. could encourage globalisation of Indian business. Further, liberalisation in other countries increases the foreign business opportunities for Indian business.

Competition The growing competition, both from within the country and abroad, provokes many Indian companies to look to foreign markets seriously to improve their competitive position and to increase the business. Sometimes companies enter foreign market as a *counter-competitive strategy*, i.e. to fight the foreign company in its own home market to weaken its competitive strength.

Globalisation Strategies

Indian industry can move towards globalisation by different market entry strategies such as developing exports, foreign investments including joint ventures and acquisitions, strategic alliance, licensing, franchising etc.

Market Entry Strategies

Exporting Exporting, of course, is one of the important ways of globalisation. With economic liberalisation an environment for globalisation of Indian exports has been emerging. In a truly globalised environment, the exports will also be very much global: The sourcing of finance, materials and managerial inputs will be global, based on purely business considerations.

In fact, in the early 1950s India's economic position was much better than those of most of the countries. Among the developing countries, India had a relatively broad based industrial structure and significant export market share for several commodities. However, advantage could not be taken of this position due to the absence of an effective export development strategy.

India has potential for significantly increasing the exports of many products if appropriate measures are taken. As a matter of fact, in case of number of products several other developing countries which started their exports later than India have gone much ahead of India while India's progress has been slow.

The point is that although there are a number of products with large export potential, India failed to exploit the potential satisfactorily. Because of the advance made by other developing countries in the export of such products, although the situation has now become more difficult for India, there still exists a lot of scope for substantially increasing the exports of many of these products.

With the right policy and procedural reforms and institutional support, technological upgradation, modernisation and enlargement of production facilities, thrust on quality and value added products, improvements in infrastructural facilities and the right marketing strategy, great strides could be made in the export of a number of products.

Broadly, the important strategies to increase the export earnings are: increase the average unit value realisation; increase the quantity of exports to the existing markets; export new products and develop new markets.

Foreign Investment It is very difficult to maintain substantial market standing in an important area unless one has a physical presence as a producer. Besides the advantage of getting a feel of the market, offshore investments are encouraged by such factors as cost advantage, trade barriers etc. The demand for 'local content' is also satisfied by production in the respective countries.

Foreign investment by Indian companies was very limited until recently. The attractiveness of the domestic market, lack of global orientation, government regulations etc. were responsible for this. Recently, however, there has been a substantial increase in foreign investments by the Indian companies, as pointed out in the chapter on *foreign investments*. Foreign investments may be for establishing wholly owned subsidiaries, joint ventures, assembly facilities or marketing infrastructure. Foreign investments are also caused by cross-border mergers and acquisitions (M&As). Recently there has been a substantial increase in foreign investment by Indian companies.

Mergers and Acquisitions Mergers and Acquisitions (M&As) are very important market entry as well as growth strategy. M&As have certain advantages. It may be used to acquire new technology. M&As would have the effect of eliminating/reducing competition. One great advantage of M&As in some cases is that it provides instant access to markets and distribution network. As one of the most difficult areas in international marketing is the distribution, this is sometimes the most important objective of M&As.

A number of Indian companies have resorted to acquisition of companies abroad to gain a foothold in the foreign market and to increase the overseas business. For example, several Tata group companies and companies like Ranbaxy, Dr. Reddys, Asian Paints and Essel Propack (earlier Essel Packaging) entered some of the foreign markets and substantially expanded their global business by acquisitions. M&As is a very important globalisation strategy of a number of Indian companies.

Joint Ventures Joint venture is a very common strategy of entering the foreign market. In the widest sense, any form of association which implies collaboration for more than a transitory period is a *joint venture* (pure trading operations are not included in this concept). Such a broad definition encompasses many diverse types of joint overseas operations, viz. sharing of ownership and management in an enterprise, licensing/franchising agreements, contract manufacturing and management contracts. However, what is often meant by the term joint venture is *joint ownership* venture, the essential feature of which is that the ownership and management is shared between a foreign firm and a local firm. In some cases there are more than two parties involved.

A joint ownership venture may be brought about by a foreign investor buying an interest in a local company, a local firm acquiring an interest in an existing foreign firm or by both the foreign and local entrepreneurs jointly forming a new enterprise.

It is also a common practice to split the local interest between a partner and various public participation (including public sector firms or industrial development organisations). Such a strategy may enable the international firm to retain much control despite a minority holding, as the power of the remaining shares is spread out. Further, equity holding by the public would help the enterprise get some public support. Partnership with government organisation could also help to obtain favourable treatment from the government.

In countries where fully foreign owned firms are not allowed or favoured, joint venture is the alternative if international marketeer is interested in establishing an enterprise in the foreign market. One important advantage of joint venturing is that it permits a firm with limited resources to enter more foreign markets than might be possible under a policy of forming wholly owned subsidiaries. In some cases, it is also possible to swap know-how (such as patent rights for equity) in forming joint venture as a means of securing ownership in foreign operations.

Partnership with local firms has certain specific advantages. The local partner would be in a better position to deal with the government and public. Further, there would not be much public hostility when there is a local partner; it would be much less when there is equity holding by the government sector and the public. A right local partner for a joint venture can have a major impact on a firm's competitiveness because such a partner can serve as a cultural bridge between the manufacturer and the market. A joint venture can succeed only if both the partners have something definite to offer to the advantage of the other, and reap definite advantages, and have mutual trust and respect.

Joint venture is a very important foreign market entry and growth strategy employed by Indian firms. It is an important route taken by pharmaceutical firms like Ranbaxy, Lupin, Reddy's etc.

The liberalisation of policy towards foreign investment by Indian firms along with the new economic environment seems to have given joint ventures a boost. Not only the number of joint ventures is increasing, but also the number of countries and industries in the map of Indian joint ventures is expanding. Further liberalisation, like enhancement of the investment limit of automatic clearance, is needed for a fast expansion of the Indian investment abroad.

Assembly Operations A manufacturer who wants many of the advantages that are associated with overseas manufacturing facilities and yet does not want to go that far may find it desirable to establish overseas assembly facilities in selected markets. In a sense, the establishment of an assembly operation represents a cross between exporting and overseas manufacturing.¹¹

Having assembly facilities in foreign markets is very ideal when there are economies of scale in the manufacture of parts and components, and when assembly operations are labour intensive and labour is cheap in the foreign country. It is also popular when exporting the product as completely built unit (CBU) makes transportation cost very high and there is import duty differential between CBU and CKD (completely knocked down) or SKD (semi-knocked down) imports.

Assembling the product meant for the foreign market in the foreign market itself has certain other advantages, besides the cost advantage. Assembly operations would satisfy the 'local content' demand, at least to some extent. Because of the employment generation, the foreign government's attitude will be more favourable than towards the import of the finished product. Another advantage is that the investment to be made in the foreign country is very small in comparison with that required for establishing complete manufacturing facilities. The political risks of foreign investment is, therefore, not much. Facilities for servicing of the product may also be established along with the assembly facility. Some Indian auto firms have such facilities abroad.

Licensing and Franchising Licensing and franchising, which involve minimal commitment of resources and effort on the part of the international marketer, are easy ways of entering the foreign markets. Under international *licensing*, a firm in one country (the licensor) permits a firm in another country (the licensee) to use its intellectual property (such as patents, trade marks, copyrights, technology, technical know-how, marketing skill or some other specific skill). The monetary benefit to the licensor is the royalty or fees which licensee pays. In many countries, such fees or royalties are regulated by the government; it does not exceed five per cent of the sales in many developing countries.

Franchising is "a form of licensing in which a parent company (the franchiser) grants another independent entity (the franchisee) the right to do business in a prescribed manner. This right can take the form of selling the franchiser's products, using its name, production and marketing techniques, or general business approach".¹² Usually franchising involves a combination of many elements mentioned above. The major forms of franchising are *manufacturer-retailer* systems (such as automobile dealership), *manufacturer-wholesaler* systems (such as soft drink companies), and *service firm—retailer* systems (such as lodging services and fast food outlets).

Many Indian firms can use licensing or franchising for the overseas market, particularly the developing countries. For example, Ranbaxy has licensing arrangement in countries like Indonesia and Jordan.

Strategic Alliance Strategic alliance has been becoming more popular in international business. Also known by such names as *entente* and *coalition*, this strategy seeks to enhance the long-term competitive advantage of the firm by forming alliance with its competitors, existing or potential, in critical areas, instead of competing with each other. Strategic alliance provides scope for the Indian business to enter/expand the international business. This is particularly important for technology acquisition and overseas marketing. Alliance is indeed an important international marketing strategy employed by several Indian firms.

Strategic alliance is also sometimes used as a market entry strategy. For example, a firm may enter a foreign market by forming an alliance with a firm in the foreign market for marketing or distributing the former's products. For example, Tata Tea had entered in to a strategic alliance with Tetley for marketing tea abroad. Later, Tetley was acquired by Tata Tea.

Management Contract Under the management contract, the firm undertakes the management of a firm in the foreign market. The firm providing the management know-how may not have any equity stake in the enterprise being managed. In short, in a management contract the supplier brings together a package of skills that will provide an integrated service to the client without incurring the risk and benefit of ownership.

Management contract could, some times, bring in additional benefits for the managing company. It may obtain the business of exporting or selling otherwise of the products of the managed company or supplying the inputs required by the managed company.

Some Indian companies—Tata Tea, Harrisons Malayalam and AVT—had contracts to manage a number of plantations in Sri Lanka. Tata Tea also has a joint venture in Sri Lanka namely Estate Management Services Pvt. Ltd.

Conclusion

Many Indian companies have admirably responded to the globalisation challenge.

The intent of globalisation is efficiency improvement and market optimisation, taking advantage of the opportunities of the global environment. Therefore, in many cases, Indian companies have to globalise to survive and grow in the emerging competitive environment.

The limitations of national markets, the diversity and unevenness of resource endowments of different nations, complexity of technological developments, differences in the levels of development and demand patterns, differences in production efficiencies and costs, technological revolution in communication and other fields etc., prompt globalisation.

The restrictive economic policies of the past severely affected the competitiveness and growth of the Indian industry in general. The new economic policy, albeit suffering from certain defects, is a welcome change.

If the Indian firms have the facility to obtain the latest technology in the world, to raise finance from the cheapest source and procure the materials from the best source in the world, they are on equal footing with foreign firms in many respects. If the Indian firms can muster some edge over the foreign firms in respect of labour cost, productivity, product quality/features etc. that could be a competitive advantage.

In many cases, size is an important factor which influences the competitive power. The economic liberalisation by pruning down the list of industries reserved for the public sector, delicensing and formulating a take-over code, has provided an environment which enables companies to grow fast, both internally and externally. The growth plans of many Indian companies indicate a great leap forward. The increase in the size could keep the companies on a strong footing to make further dent into both the domestic and foreign markets.

India, however, ranks miserably low in the list of large corporations of the world like the *Fortune 500* list. A small country like South Korea has many companies, with fairly good ranks in the *Fortune 500*. Many Indian companies, however, are becoming more global oriented. Several Indian companies are already leading/significant players in the global market.

The export-GDP ratio (i.e. the ratio of the value of exports to GDP) shows a corresponding reinforcing trend. A corollary indication of the strengthening competitiveness of the Indian companies is the rise in their export intensity (i.e. the ratio of exports to total sales).

The economic liberalisation has also helped to bring about a noticeable structural change towards a more stable and sustainable balance of payments. There was a marked improvement in the coverage ratio (i.e. the ratio of export bill to import bill) and in the flow of invisible receipts. See the chapter on *India's Trade and BOP* for more information.

The growth impulses provided by the liberalisation, increasing competition in the domestic market and growing business opportunities abroad are encouraging many Indian companies to enter foreign market/expand foreign business.

The Indian liberalisation, however, is not devoid of problems. There is a lot of confusion at the policy and implementation levels. Measures are also needed to mitigate the harmful effects of liberalisation.

The liberalisation in India and in other countries pose a real challenge to the Indian business to prove its mettle. Global economic integration and globalisation, the forces of which have been dubbed by some as neo-colonialistic, have become all pervasive. They have both beneficial and harmful effects. Nations with fairly large and growing economies with good infrastructure, pragmatic policies and political stability have immense potentials to benefit from these. The endeavour of a nation should be to take full advantage of the opportunities and to minimise the adversities. A number of local, national and international policy initiatives are needed for this.

Liberalisation has prompted Indian business to become more competitive.

SUMMARY

Globalisation is the process of integration of economies across the world through cross-border flow of factors, products and information. Globalisation may be considered at two levels, viz. at the macro level (i.e. globalisation of the world economy) and at the micro level (i.e. globalisation of the business and the firm) which are very much interdependent. Globalisation of the world economy is achieved, quite obviously, by globalising the national economies.

At the corporate level, globalisation in its true sense is a way of corporate life necessitated, facilitated and nourished by the transnationalisation of the world economy and developed by corporate strategies. Globalisation is an attitude of mind—it is a mindset which views the entire world as a single market so that the corporate strategy is based on the dynamics of the global business environment.

Normally, a firm passes through different stages of development before it becomes a truly global corporation. Typically, a domestic firm starts its international business by exporting. Later it may establish joint ventures or subsidiaries abroad. From an international firm it may then develop into a multinational firm and finally into a global/transnational one.

Although the globalisation trend has been pronounced for over the last two decades or so, it is not a new phenomenon. The period 1870 to 1913 experienced a growing trend towards globalisation. The new phase of globalisation which started around the mid-20th century became widespread, more pronounced and overcharging since the late 1980s by gathering more momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalise international trade and investment, and the technological and communication revolutions.

There are several similarities and differences between the two phases of globalisation. However, the current phase of globalisation is characterised by several new features: new markets, new technologies, new actors and new rules and norms.

There are some essential conditions to be satisfied on part of the domestic economy as well as the firm for successful globalisation of the business. They include the following: Business freedom, required facilities, government support, resources, competitiveness and proper strategic orientation.

There are a number of **foreign market entry strategies** for going global, such as exporting, licensing, franchising, contract manufacturing, management contracting, joint venturing, wholly owned subsidiaries etc. The choice of the most suitable alternative is based on the relevant factors related to the company and the environment of the domestic and foreign markets.

Globalisation has both beneficial and harmful effects. It differently affects different countries, sectors, industries, firms and sections of people.

It is interesting to note that while developing countries which, in the past, were against globalisation, have opened their doors for globalisation. Many people in developed countries like USA are angry against globalisation because of the de-industrialisation, job cuts etc. and the associated problems.

Although globalisation can benefit the developing countries in several ways, unregulated globalisation will cause serious problems for developing countries. The almost universal acceptance of the market economy and the globalisation driven by private enterprise tend to aggravate, in the absence of proper regulation, most of the harmful effects traditionally attributed to neo-colonialism. Several measures at the national and international levels are required to mitigate the harmful effects and to reap the benefits of globalisation.

India's economic integration with the rest of the world had been very limited because of the restrictive economic policies followed until 1991. Till then Indian firms confined themselves, by and large, to the home market. Foreign investment by Indian firms was very insignificant. With the new economic policy ushered in 1991, there has, however, been a change. Globalisation has in fact become a buzzword with Indian firms now and many are expanding their overseas business by different strategies.

The Indian business, however, suffers from a number of disadvantages in respect of globalisation of business. Not only that the government policy lacks a positive orientation in some respects, but also the government policy and procedures in India are among the most complex, confusing and cumbersome in the world. Another problem is that the high cost/inadequacy of many vital inputs and other factors such as raw materials and intermediates, power, finance, infrastructural facilities like port etc. tend to reduce the international competitiveness of the Indian business. There are also problems related to technology, small size and lack of experience of firms, poor quality, lack of R&D efforts etc.

Although India has several handicaps, there are also a number of favourable factors for globalisation of Indian business. These include the human resources, growing entrepreneurship, growing domestic market, the growing foreign market that is opening up more, niche markets, large number of non-resident Indians who are resourceful etc. If the Indian firms have the facility to obtain the latest technology in the world, to raise finance from the cheapest source and procure materials from the best source in the world, they are on equal footing with the foreign firms in many respects. And if the Indian firms can muster some edge over the foreign firms in respect of labour cost, productivity, product quality/features etc. that could be a competitive advantage.

Review Questions

1. Explain the meaning, dimensions and stages of globalisation.
2. Discuss the similarities and differences between the old and new globalisations.
3. Discuss the problems and prospects of globalisation of Indian business.
4. Examine the pros and cons of globalisation with special reference to India.
5. What policies do you suggest for minimising the damages and maximising the opportunities of globalisation from the macro socio-economic point of view?

6. What are the important globalisation strategies employed by Indian companies?
7. Write notes on the following:
 - (a) Dimensions of globalisation.
 - (b) Joint ventures.
 - (c) Challenges of globalisation
 - (d) Essential conditions for globalisation
 - (e) Obstacles to globalisation.

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PART TWO

Bases of Trade and Development

2

CHAPTERS

- ❖ Analytical Tools
- ❖ Theories of International Trade
- ❖ Gains from Trade and Terms of Trade
- ❖ Economic Growth and Trade

CHAPTER 5

5 Analytical Tools

LEARNING OBJECTIVES

- ☐ To understand certain tools used in economic analysis.
- ☐ To know the use of these tools is explaining economic theories and issues.

This chapter introduces some basic tools which we will use in some of the following chapters to analyse certain theories and issues in international economics.

PRODUCTION POSSIBILITY CURVE

The production possibility (possibilities) curve, (also known as *substitution curve*, *production indifference curve*, *transformation curve* and *production frontier*), shows all the alternative combinations of two commodities that a nation can produce by fully utilising all its factors of production. In other words, the production possibility curve shows the frontier beyond which production cannot be carried on with the available resources and technology.

Figure 5.1 depicts the production frontier of country A. With a given amount of productive resources, it can produce either 10 units of cloth (if it employs all resources in cloth production) or 20 units of wine (if all resources are used in wine production). Alternately, it can have a combination of cloth and wine if resources are allocated for both. For example, it may have eight units of cloth and four units of wine, or six units of cloth and eight units of wine. If it reduces the output of cloth by one unit, it can increase the output of wine by two units because with the resources required to produce one unit of cloth, two units of wine can be produced.

In short, any point on the production possibility curve (*PA*) shows the combination of cloth and wine output when the productive resources are fully employed and allocated between cloth and wine in a certain proportion.

Any point above the *PA* line is beyond reach with the particular quantum of resources. For example, point *N* indicates a combination of eight units of cloth and ten units of wine which is impossible to obtain with the available resources. For, when eight units of cloth are produced, the remaining resources are sufficient to produce only four units of wine. Any point below the production possibility curve represents a combination of cloth and wine when

A production possibility curve represents all the possible combinations of two commodities that can be produced by fully employing the resources of a nation.

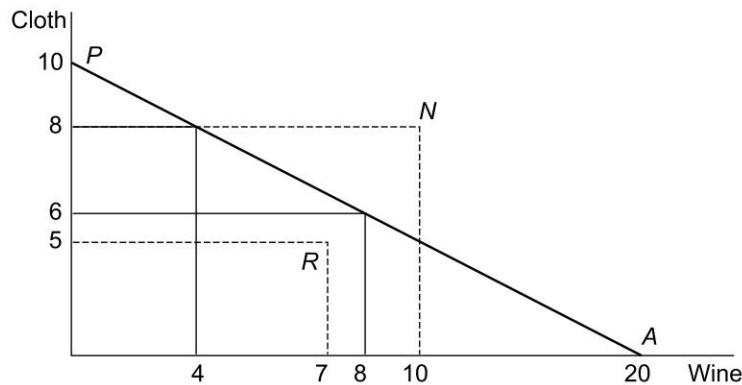


Fig. 5.1 Production Possibility Curve Under Constant Costs

the available resources are not fully employed. For example, point *R* represents a combination of five units of cloth and seven units of wine. When only five units of cloth are produced, the remaining resources, if they are fully employed, can give an output of ten units of wine.

It may be clear from what has been explained above that we are measuring the cost of producing cloth in terms of the amount of wine foregone in order to produce one more unit of cloth and vice versa (not in terms of labour or in terms of any real cost). In other words, we are measuring the *opportunity cost* of producing a unit of the commodity.

The slope of the production possibility curve represents the marginal rate of transformation (MRT) or the amount of the commodity that the nation must give up in order to get one more unit of the second commodity. If the nation faces constant costs or MRT, then its production possibility curve is a straight line (as depicted in Fig. 5.1) with (absolute) slope equal to the constant opportunity costs or MRT and to the *relative* commodity prices in the nation.

In many cases, production is subject to the law of increasing opportunity costs or MRT. Under such conditions, the production possibility curve is concave to the origin, as shown in Fig. 5.2. In Fig. 5.2:

$$AC = C C_1 = C_1 C_2 = C_2 C_3$$

$$OW > WW_1 > W_1 W_2 > W_2 W_3$$

Starting with *OA* output of cloth and zero of wine, if *AC* unit of cloth is given up, we can produce *OW* wine. But, if we give up further *CC*₁ output of cloth and reduce cloth production to *C*₁ level, the increase in wine output that can be achieved is *WW*₁, which is less than *OW*. The addition to the wine output that can be made by giving up yet another equivalent amount of cloth is *W*₁*W*₂ which is still lower than *WW*₁ and so on. Thus, the amount of extra wine we can produce by decreasing production of cloth with a given amount of resources steadily decreases as we move downward along the production possibility curve. This implies that opportunity cost of wine in terms of cloth is steadily increasing as we increase the production of wine and decrease the production of cloth.

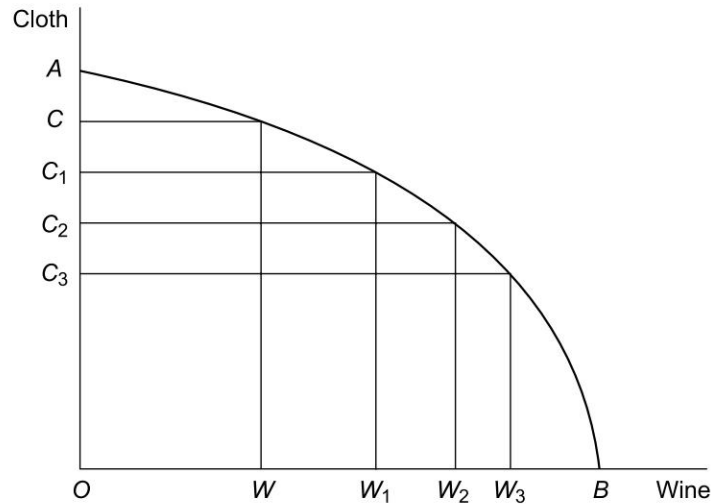


Fig. 5.2 Production Possibility Curve Under Increasing Costs

Conversely, for every additional unit of cloth, the amount of wine to be given up increases. For the subsequent increases in the cloth output, the amount of wine to be given up per unit of cloth increases from W_2W_3 to W_2W_1 and from W_1W to WO .

Under increasing costs, a nation will choose a combination of output at which the MRT will equal the equilibrium relative commodity price in the nation. The equilibrium relative commodity price in the nation is determined by the supply and demand conditions in the nation. This is shown in Fig. 5.3. If PP represents the price ratio in the country, production will be at point F , representing OC_1 cloth and OW_1

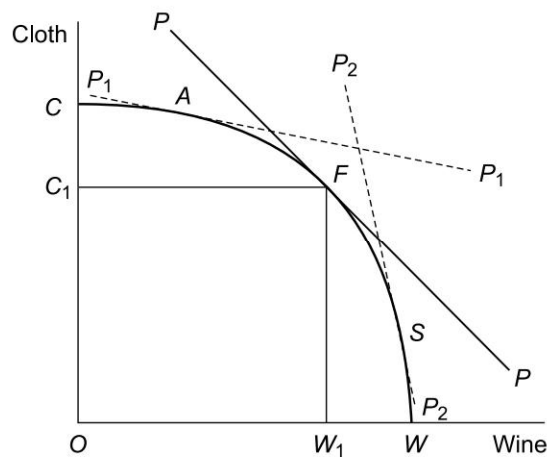


Fig. 5.3 Production Possibility Curve and Optimum Combination of Output

wine, because at F , PP , which represents the price ratio, is tangent to the production possibility curve. When the price ratio is PP , if the country were to produce at some other point, for example A , the opportunity cost of producing more wine would be lower than its price which implies that producers could increase their profits by producing more wine. The profit will be maximum at point F at which the relative prices and opportunity costs are equal.

If the price of cloth increases and P_1P_1 becomes the new price ratio, producers will reallocate resources to produce more cloth and move to A at which the price line is tangential to the production frontier. On the other hand, if the cloth price falls and price ratio changes to P_2P_2 , production of wine will be increased by reducing the output of cloth and a new equilibrium will be established at point S .

Changes in factor supplies will cause a shift in the production possibility curve of a nation, *ceteris paribus*. An increase in the factors of production will cause an outward shift and a decrease will cause an inward shift of the production frontier. In Fig. 5.4, AA represents the original production possibility curve (PPC). Supposing that all the factors of production increase in the same proportion, it will cause a shift of the PPC upward and the new PPC, A_1A_1 , will be parallel to the old PPC, AA .

Changes in factor supplies will shift the position of the production possibility curve reflecting the change in the maximum possible output.

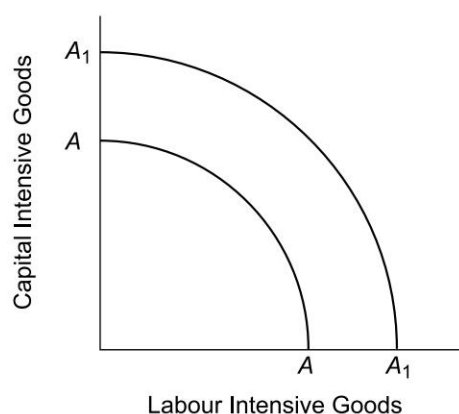


Fig. 5.4 Changes in Factor Supplies and Shift in Production Possibility Curve

If only one of the factors of production increases or if the increase in the factors of production is disproportionate, the shape of the new PPC will be different from that of the old one. Assume that in Fig. 5.5 the X-axis represents labour intensive goods and the Y-axis represents capital intensive goods. If only the supply of labour increases, the PPC will shift from AA to A_2A_2 as shown in Fig. 5.5, implying that the country is now capable of producing a much larger amount of labour intensive commodities.

On the other hand, if only the supply of capital increases, the PPC will shift from AA to A_3A_3 as shown in Fig. 5.6.

Technological progress increases the productivity of a nation's factors of production and has the same general effect on the production possibilities as an increase in the supply of its factors of production. In respect of technological advances, we may consider the following three different cases.

Neutral Innovation This refers to an innovation that increases the productivity of all factors by the same proportion. This will cause a uniform or symmetrical outward shift in the nation's PPC as shown in Fig. 5.4.



Fig. 5.5 Changes in Factor Supplies and Shift in Production Possibility Curve



Fig. 5.6 Changes in Factor Supplies and Shift in Production Possibility Curve

Labour Saving Innovation This refers to an innovation that increases labour productivity. *Ceteris paribus*, a labour saving innovation will cause the PPC to shift as shown in Fig. 5.5 (from AA to A_2A_2).

Capital Saving Innovation A capital saving innovation increases the productivity of capital and causes the PPC curve to shift as shown in Fig. 5.6 (from AA to A_3A_3).

In some cases, production may be subject to the law of increasing returns or decreasing costs. Under such a situation, the production possibility curve will be convex to the origin as shown in Fig. 5.7.

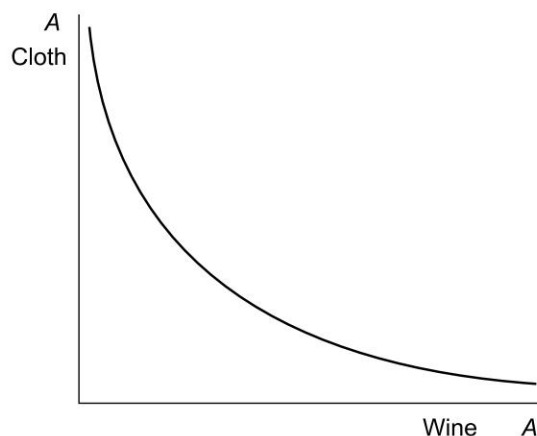


Fig. 5.7 | Production Possibility Curve Under Decreasing Costs

COMMUNITY INDIFFERENCE CURVE

The community indifference curve is a tool of analysis extensively used in International Economics. The use of community indifference curves in international economics was developed by economists like Leontief, Kaldor and Scitovsky.

An individual consumption indifference curve shows various combinations of commodities which yield the same level of satisfaction to an individual. A community indifference curve shows various combinations of two commodities which yield equal satisfaction to the community or nation. Kaldor defines the community consumption indifference curve as “the locus of points representing a constant real income for the community as a whole”.¹

Students of economics must be familiar with the characteristics of the indifference curve: Indifference curves are negatively sloped, convex to the origin, a higher indifference curve represents a higher level of satisfaction, and curves do not intersect each other.

In Fig. 5.8, point P on the community indifference curve Cl_1 , representing OB cloth and OA wine; point Q representing OB_1 cloth and OA_1 wine and point R representing OB_2 cloth and OA_2 wine yield the community the same level of satisfaction. The community will, therefore, be indifferent between P , Q and R (or any other point on Cl_1). Any point on Cl_2 is preferable to any point on Cl_1 , because Cl_2 represents a higher level of satisfaction than Cl_1 . The community will, however, be indifferent between any point on Cl_2 , because all points on it yield equal satisfaction. Similarly, any point on Cl_3 is definitely preferable to any point on Cl_2 but all points on Cl_3 are equally preferred.

Under autarchy (where there is no trade), a country will be in equilibrium when it has reached the highest indifference curve possible with its production possibility curve. In Fig. 5.9, E is the equilibrium point at which the nation produces and consumes OM cloth and ON wine. At E , the Marginal Rate of Substitution (MRS) i.e. the slope of the community indifference curve, the MRT, i.e. the slope of the production possibility curve, and the price ratio between cloth and wine, i.e. the slope of the price line, are the same. A point on Cl_3 , D , is certainly preferable to E as Cl_3 is a higher indifference curve, but D is beyond the production possibility of the country and hence unattainable under autarchy. Points T and

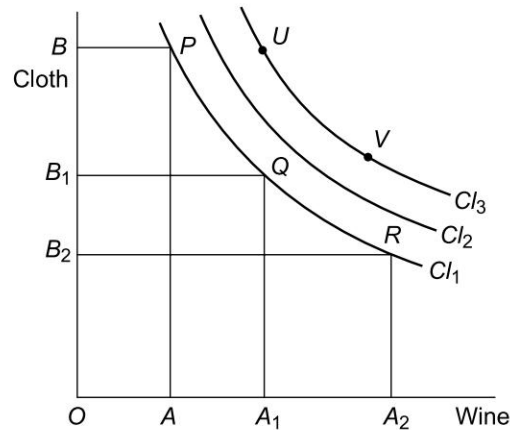


Fig. 5.8 Community Consumption Indifference Curve

R on Cl_1 are within the production possibilities of the country but they are not desirable as, being on a lower indifference curve, they represent a lower level of satisfaction.

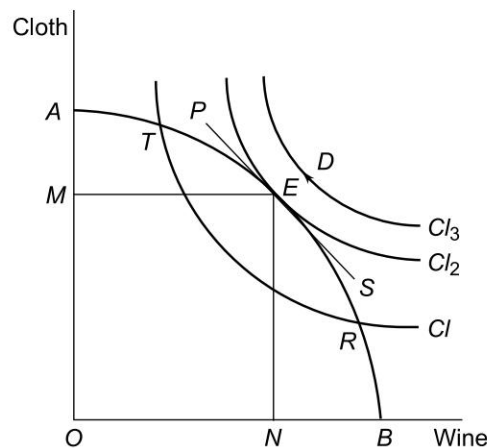


Fig. 5.9 Equilibrium Under Autarchy

The community indifference curve can also be used to show how international trade increases community welfare.

Figure 5.10 represents a situation under international trade where P_1A_1 represents the international price ratio. The country represented in Fig. 5.10 expands the output of wine to ON_1 for the production of which it is best suited, and contracts cloth production to OM_1 . The country will establish equilibrium at D by exporting N_2N_1 of wine (and consuming ON_2 of wine) and importing M_1M_2 of cloth and consuming OM_2 of cloth. D , being on a higher indifference curve, certainly yields more satisfaction for the country than E under autarchy.

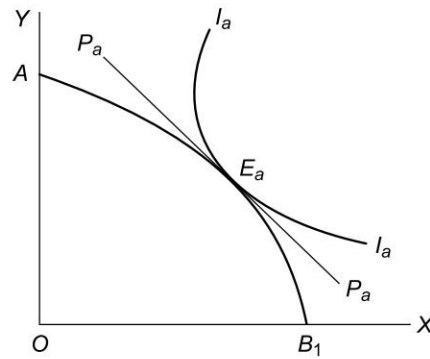


Fig. 5.11 Price Ratio Line in Country A (Negative Slope)

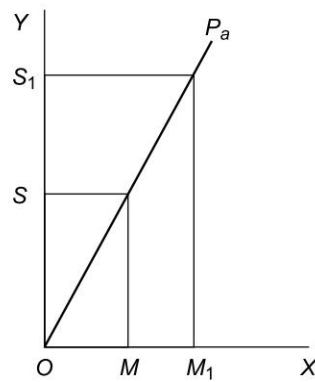


Fig. 5.12 Price Ratio Line in Country B (Positive Slope)

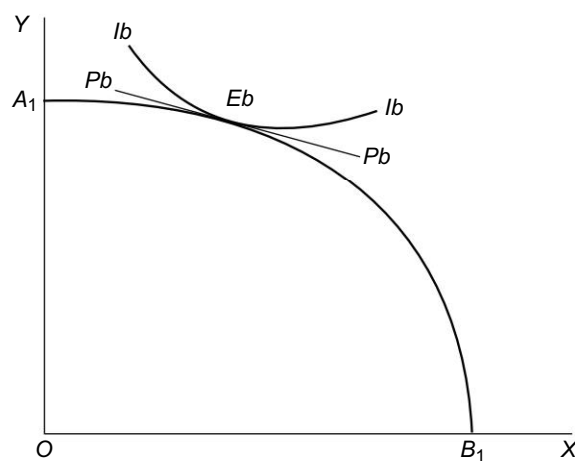


Fig. 5.13 Price Ratio Line in Country B (Negative Slope)

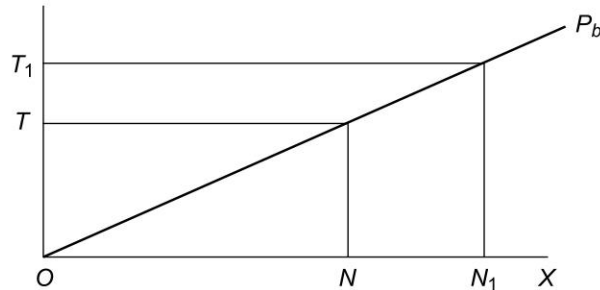


Fig. 5.14 Price Ratio Line in Country B (Positive Slope)

When both countries trade with each other, the international price ratio will settle somewhere in between the domestic price ratios. In Fig. 5.15, P_a represents the domestic price ratio in country A and P_b the domestic price ratio in country B. When there is trade between the two countries, the price ratio line cannot shift to the left of P_a or the right of P_b because domestic exchange ratios set the limits of international price variations. The international price ratio is most likely to settle in between the limits set by the domestic price ratios, i.e. P_a and P_b . P_1 , P_2 and P_3 represent some possible international price ratios when both the nations trade with each other.

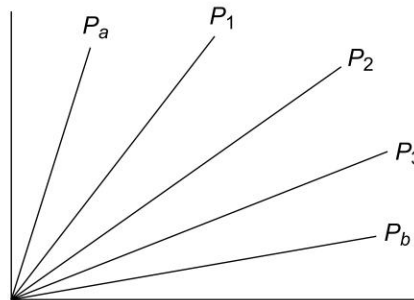


Fig. 5.15 Possible International Price Ratios

OFFER CURVES

The offer curves, introduced by Alfred Marshall, help us to understand how the equilibrium price ratio is established in international trade.

An offer curve may be defined as the locus of various combinations of two commodities which a nation finds acceptable in trade. In other words, the offer curve of a nation shows how much of its import commodity the nation requires in exchange for various quantities of its export commodity.

The offer curve of a nation is derived from the nation's production possibility curve, its indifference map and the various hypothetical relative commodity prices at which trade takes place.

It has already been discussed how the price ratio line is derived from the production possibility line and the indifference map. Hence, let's see how the offer curve is obtained, given various hypothetical price ratios.

In Fig. 5.16, the price ratio line $P(1:0.2)$ represents the pre-trade domestic exchange ratio between commodity X and Y in country A . At point R country A is willing to exchange eight units of X for two units of Y . At point S , she is willing to offer only 15 units of X for five units of Y . At point T it should get 10 units of Y to part with 20 units of X , and at point U the exchange ratio is 1:1, i.e. 25 units of X for 5 units of Y . This shows that as its import of Y rises, country A has to be offered larger amounts of Y to make it give up additional units of X . Thus, country A is prepared to sell larger quantities of X only at higher prices. In other words, it is ready to increase its imports only if the price of Y is reduced.

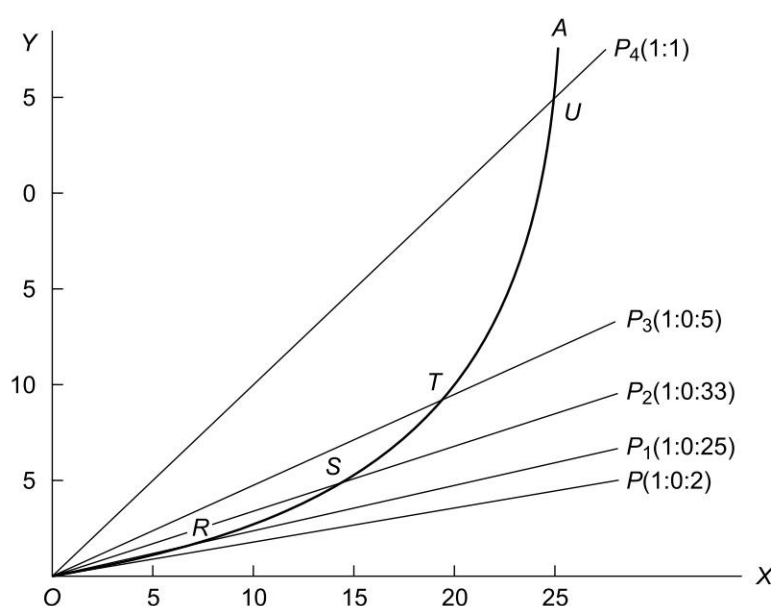


Fig. 5.16 Offer Curve of Country A

If we join points R , S , T and U of Fig. 5.16, we obtain the offer curve of country A . OA in Fig. 5.16 represents the offer curve of country A thus obtained.

We can obtain the offer curve of country B also in the same way. In Fig. 5.17, at point W country B is willing to offer 10 units of Y for three units of X , but at point V it should be offered 10 units of X to make it part with 20 units of Y . At point U the exchange ratio is 1:1 ($25Y = 25X$). We can obtain the offer curve of country B by joining the points W , V and U . OB in Fig. 5.17 represents the offer curve of country B .

In Fig. 5.18, $P_4(1X = 1Y)$ is the equilibrium exchange ratio or terms of trade because at this ratio country A is willing to offer 25 units of X for 25 units of Y and country B is willing to accept 25 units of X in exchange for 25 units of Y . Thus, point U emerges as the equilibrium point, as at this point the total supply of X equals the total demand for X and total supply of Y equals the total demand for Y . The corresponding exchange ratio, represented by P_4 , therefore, is the equilibrium terms of trade. Further elaboration of offer curves and the determination of equilibrium terms of trade is presented in Chapter 7.

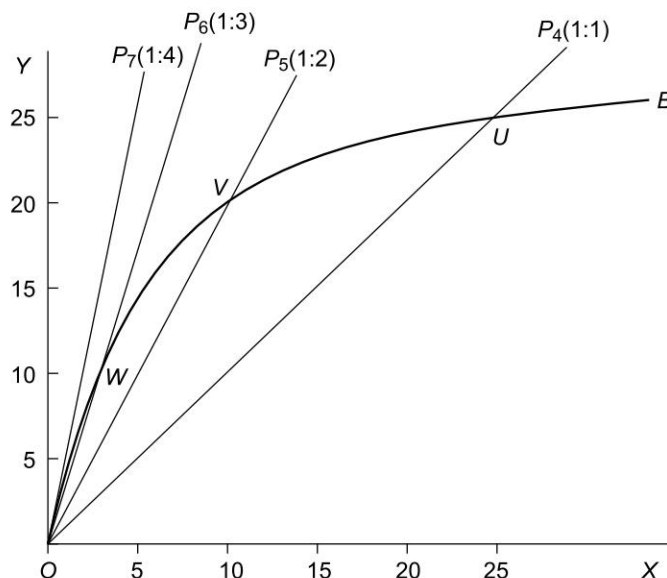


Fig. 5.17 Offer Curve of Country B

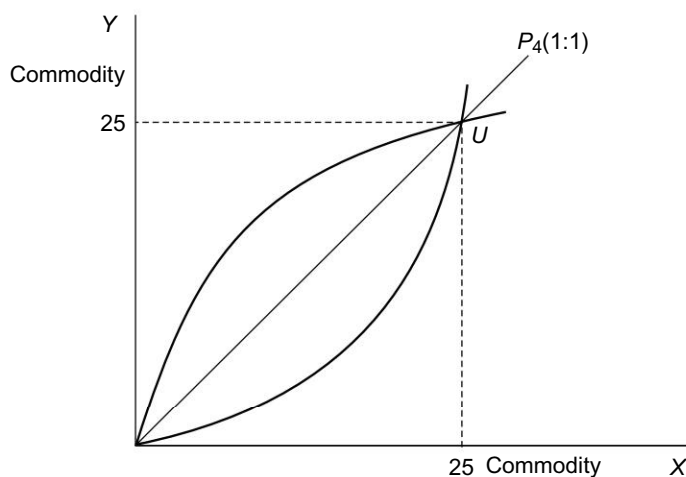


Fig. 5.18 Offer Curve and Equilibrium Exchange Ratio

ISOQUANTS, ISOCOSTS AND EQUILIBRIUM

An isoquant is a curve showing various combinations of two factors of production, for example labour and capital, which give a specific level of output. Isoquants have the same general characteristics of

indifference curves. They are negatively sloped, convex to the origin, a higher isoquant represents a higher level of output and lower isoquant represents a lower output, and they do not intersect each other. There is, however, one important difference between isoquants and indifference curves: Isoquants give a cardinal measure of output, while the indifference curves give only an ordinal measure of utility.

An isoquant represents various combinations of factors of production which give a specific level of output.

The negative slope of the isoquant means that when the quantity used of one factor is reduced, that of the other factor is increased to obtain the same level of output. The (absolute) slope of the isoquants is called the *marginal rate of technical substitution* of labour for capital in production (MRTS). The MRTS measures the amount of one factor (capital) that should be given up by increasing the other factor (labour) by one unit to remain on the same isoquant.

In Fig. 5.19 $2C$, represents a higher level of output of cloth than $1C$, and $2W$ represents a higher level of output of wine than $1W$.

As per Fig. 5.19, cloth is more capital (K) intensive than wine and wine is more labour (L) intensive than cloth (The capital labour ratio = K/L , for cloth is one whereas it is four for wine).

An *isocost* is a line that shows the various combinations of two factors of production, such as labour and capital, that can be procured with a given outlay (amount of money).

An isocost represents various combinations of factors of production that can be obtained with a given outlay.

In Fig. 5.19, Q represents an isocost which involves double the outlay than IQ . IQ indicates that with a given total outlay either three units of capital or six units of labour or any combination of capital and labour between these two extremes can be hired.

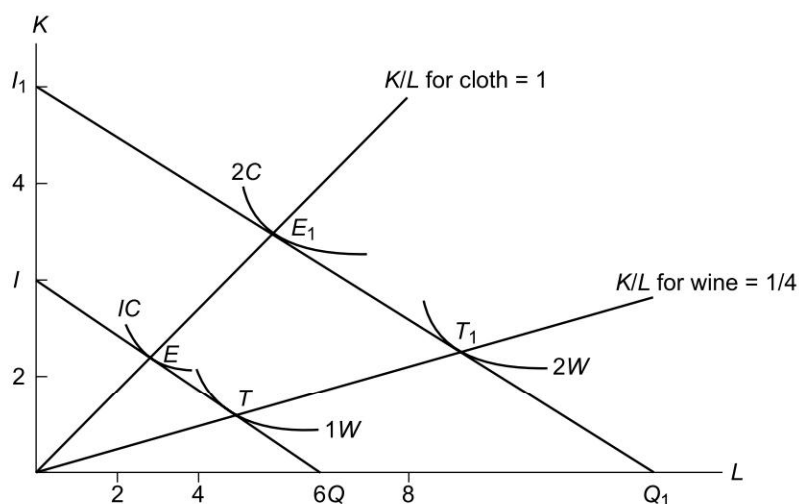


Fig. 5.19 Isoquants and Isocost Lines

A producer is in equilibrium when he reaches the highest isoquant (i.e. level of production) possible with a given isocost. In Fig. 5.19, the equilibrium point is E for cloth (where the isoquant $1C$ is tangent to the isocost) and T for wine, given the isocost IQ . When the isocost is Q , the respective equilibrium points are E_1 and T_1 .

The straight line from the origin connecting the equilibrium points is known as *expansion path*. In Fig. 5.19, the straight line from the origin joining the equilibrium points E and E_1 represents expansion path of cloth and that passing through T and T_1 shows the expansion path of wine.

A straight line expansion path, which implies that any increase in the inputs results in a proportionate increase in the output, is a *Cobb-Douglas production function* that is homogeneous of degree one and represents a constant return to scale. Since the ratio between the use of the two factors (K/L) remains the same with this production function (as long as the factor prices do not change), the productivity of these factors also remain the same regardless of the level of output.

With the Cobb-Douglas production all the isoquants representing various levels of output of a particular commodity have identical shape. As a result, the elasticity of substitution of one factor for the other (labour for capital) is equal to one.

SUMMARY

There are a number of tools used for illustrating certain concepts and theories.

The **production possibility curve**, (also known as substitution curve, production indifference curve, transformation curve and production frontier), shows all the alternative combinations of two commodities that a nation can produce by fully utilising all its factors of production.

A **community indifference curve** shows various combinations of two commodities which yield equal satisfaction to the community or nation.

The **price ratio curve (price line)** depicts the rate of exchange between two commodities.

An **offer curve** is the locus of various combinations of two commodities which a nation finds acceptable in trade. In other words, the offer curve of a nation shows how much of its import commodity the nation requires in exchange for various quantities of its export commodity.

An **isoquant** shows various combinations of two factors of production, for example labour and capital, which give a specific level of output. An **isocost** is a line that shows the various combinations of two factors of production that can be procured with a given outlay (amount of money).

Review Questions

Explain the following and their use in economic analysis.

- (a) Production possibility curve.
- (b) Community indifference curve.
- (c) Offer curve.
- (d) Isoquants and isocost curves.

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CHAPTER 6

6 Theories of International Trade

LEARNING OBJECTIVES

- ☐ To understand why international trade in goods takes place.
- ☐ To examine the theoretical explanations of the bases of international trade.

International trade has been in existence since ancient times. It has grown enormously in modern times. Today, on a global average, nearly 15 per cent of the national product ends up in foreign markets and an almost equivalent percentage of the domestic consumption is met by goods imported. In the case of developing countries this ratio is about 20 per cent. A very pertinent question in this context, therefore, is why do nations engage in trade between them? What are the reasons for international trade? This chapter reviews the theoretical attempts to explain the bases of international trade.

MERCANTILISM

Mercantilism refers to the views of a heterogeneous group of influential people as to how a nation could regulate its domestic and international affairs to promote its own interests. In fact, mercantilism, which

According to mercantilists, a nation's wealth and prosperity depended on its stock of precious metals which, in turn, was a function of trade surplus.

prevailed in Europe during 1500–1800, cannot be regarded as a formal school of economic thought; it is rather a collection of similar attitudes reflected in the writings of a diverse group of people (merchants, bankers, government officials and even philosophers).

The principal assertion of mercantilism was that a nation's wealth and prosperity reflected in its stock of precious metals, gold and silver. At that time, as gold and silver were the currency of trade between nations, a country could accumulate gold and silver by exporting more and importing less. The basic tenet of mercantilism is embodied in the British mercantilist writer Thomas Mun's postulate that "the ordinary means therefore to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: To sell more to strangers yearly than we consume of their's in value." Led by this belief, the mercantilists advocated achieving as high a trade surplus as possible. In fact, they saw no virtue in a large volume of trade per se; what mattered was a large trade surplus. The mercantilists, therefore, argued that government should do everything possible to maximise exports and minimise

imports. Imports were to be restricted by such measures as tariffs and quotas and exports were to be subsidised. Since all the nations could not simultaneously have an export surplus, and as the supply of gold and silver was fixed at any particular point of time, one nation could gain, obviously, at the expense of another. In other words, according to mercantilism economic activity was a *zero-sum game* (i.e. one's gain is the loss of another).

To increase trade surplus and prosperity, a nation shall strive to maximise exports and minimise imports.

Mercantilist "ideas not only were spawned by events of the time but also influenced history through their impact on government policies. Geographical explorations that provided new opportunities for trade and broadened the scope of international relations, the upsurge in population, the impact of Renaissance on culture, the rise of merchant class, the discovery of precious metals in the New World, changing religious views on profits and accumulation, and the rise of nation states contributed to the development of mercantilist thought. Indeed, mercantilism is often referred to as the political economy of state building".¹

Enhancement of state power was, indeed, inherent in the mercantilist philosophy. A strong army, strong navy and merchant marine, control over navigation, shipping and trade routes, colonisation of nations to ensure low-cost source of raw materials and agricultural products, and export market for manufactures were all part of the policy under mercantilism.

The importance given to precious metals under mercantilism resulted in what was referred to as bullionism, i.e. government control of the use and exchange of precious metals—their export by individuals was prohibited and the governments let specie leave the country only out of necessity.

Governments also attempted to control the trade. For example, certain companies were granted exclusive trading rights over certain routes or areas, which often tended to create monopoly and monopsony market conditions (for example, East India Company).

Flaws of Mercantilism

The mercantilist ideas came in for scathing criticism in the eighteenth century. David Hume made an eloquent exposition of one of the basic flaws of mercantilism. According to Hume's *price-specie-flow doctrine*, a favourable trade balance was possible only in the short run because over a period it would be eliminated. For example, suppose that country A has a favourable trade balance. This will result in an inflow of gold and silver resulting in an increase in the money supply in country A. This will cause an increase in price and wages in that country and will adversely affect exports and encourage imports, ultimately wiping out the trade surplus. On the other hand, consequent to the outflow of gold and silver from the country with trade deficit, prices and wages will fall in that country, thus increasing its international competitiveness which will eventually restore the equilibrium.

Another flaw of mercantilism is that it viewed trade as a zero-sum game. This view was challenged by Adam Smith and David Ricardo who demonstrated that trade was a *positive sum game* in which all trading nations can gain even if some benefit more than others.

It is because of the mercantilists' static view of the world economy that they regarded trade as a zero-sum game. Adam Smith refuted the mercantilist view that the world's economic pie is of constant size and convincingly argued that international trade expands the scope of division of labour (specialisation), which increases productivity and output. The

The basic flaw of mercantilism was that trade was regarded a zero-sum game; trade is actually a positive-sum game.

dynamic view of trade highlights the fact all the trading partners can simultaneously enjoy higher level of production and consumption with free trade.

Neo-Mercantilism

Despite the scathing criticism of mercantilism by economists, it is by no means dead. Jarl Hagelstam, a director at the Finnish Ministry of Finance, has observed that in most trade negotiations the approach of

Nations are mercantilistic in their attitude, in varying degrees, even today.

all negotiating countries, both industrialised and developing, has been to press more trade liberalisation in areas where their own comparative competitive advantages are the strongest. They

resist liberalisation in areas where they are less competitive and fear that imports would replace domestic production.²

Indeed, the trade strategy of many nations is designed to simultaneously boost exports and limit imports. This has been true of developed as well as developing countries. Many Americans allege that Japan is a neo-mercantilist nation. The US itself is not free from the neo-mercantilistic policies in respect of certain industries/sectors. The Multi-Fibre Arrangement (MFA), which sought to limit the import of textiles and clothing, is a manifestation of the neo-mercantilist attitude of developed nations.

ABSOLUTE COST THEORY

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

Table 6.1 Absolute Cost Advantage

	USA	UK
No. of units of wheat per unit of labour	10	4
No. of units of cloth per unit of labour	3	7

In the above hypothetical example, US has an absolute advantage in the production of wheat over UK, and UK has an absolute advantage in the production of cloth over US. Hence, according to Adam Smith's theory, US should specialise in the production of wheat and meet its requirement of cloth through import from UK. On the other hand, UK should specialise in the production of cloth and should obtain wheat from US. Such trade would be mutually beneficial.

Adam Smith pointed out that the scope for division of labour (i.e. specialisation) depended on the size of the market. Free international trade, therefore, increases division of labour and economic efficiency and consequently economic welfare.

In his treatise *Wealth of Nations*, Adam Smith observes: "By means of it (foreign trade) the narrowness

The basis of international trade is the absolute difference in the cost of production of different commodities between nations.

of home market does not hinder the division of labour on any particular branch of art or manufacture from being carried to the highest perfection. By carrying a more extensive market for whatever part of the produce, for their labour may exceed the

home consumption, it encourages them to improve its productive powers and to augment its annual produce to the utmost and thereby increase the real revenue and wealth of society.”

Adam Smith also considered foreign trade as a vent for surplus. In short, according to Smith’s theory, three kinds of gains accrue to a country from international trade:

- (a) Productivity gain.
- (b) Absolute cost gain.
- (c) Vent for surplus gain.

The famous classical economist David Ricardo has demonstrated that the basis of trade is the *comparative cost difference* i.e. trade can take place even in the absence of absolute cost difference, provided there is comparative cost difference.

COMPARATIVE COST THEORY

The comparative cost theory was first systematically formulated by the English economist David Ricardo in his *Principles of Political Economy and Taxation*, published in 1817.³ It was later refined by J.S. Mill, Marshall, Taussig and others.

In a nutshell, the *doctrine of comparative costs* maintains that if trade is left free, each country, in the long run, tends to specialise in the production and export of those commodities in whose production it enjoys a comparative advantage in terms of real costs, and to obtain by importation those commodities which could be produced at home at a comparative disadvantage in terms of real costs, and that such specialisation is to the mutual advantage of the countries participating in it.⁴

Assumptions The Ricardian theory is based on the following assumptions:

- (a) Labour is the only element of cost of production.
- (b) Goods are exchanged against one another according to the relative amounts of labour embodied in them.
- (c) Labour is perfectly mobile within the country, but perfectly immobile between countries.
- (d) Labour is homogeneous.
- (e) Production is subject to the law of constant returns.
- (f) International trade is free from all barriers.
- (g) There is no transport cost.
- (h) There is full employment.
- (i) There is perfect competition.
- (j) There are only two countries and two commodities.

Ricardo’s illustration of the comparative cost theory, using a two-country-two-commodity model, shows that trade between countries can be profitable even if one of the two countries can produce both the commodities more efficiently than the other country, provided that it can produce one of these commodities with comparatively greater efficiency than the other commodity. The law of comparative advantage indicates that a country should specialise in the production of those goods in which it is more efficient and leave the production of the other commodity to the other country. The two countries will then have more of both goods by engaging in trade.

Differences in the comparative cost of production of commodities between nations can result in trade; absolute cost advantage/disadvantage is not necessary for trade.

Ricardo, in his celebrated two-country-two-commodity model, has taken the hypothetical example of production costs of cloth and wine in England and Portugal to illustrate the comparative cost theory (see Table 6.2).

Table 6.2 Comparative Cost Advantage

Country	No. of units of labour per unit of cloth	No. of units of labour per unit of wine	Exchange ratio between wine and cloth
England	100	120	1 wine = 1.2 cloth
Portugal	90	80	1 wine = 0.88 cloth

From the above example, it is evident that Portugal has an absolute superiority in both branches of production. However, a comparison of the ratio of the cost of wine production (80/120) with ratio of the cost of cloth production (90/100) in both the countries reveals that Portugal has an absolute superiority in both the branches of production. It will, therefore, pay her to concentrate on the production of wine in which she has comparative advantage over England ($80/120 < 90/100$), while importing cloth from England, which has a comparative advantage in cloth production. England will gain by specialising in producing cloth and selling it in Portugal in exchange for wine.

In the absence of trade between England and Portugal, one unit of wine commands 1.2 and 0.88 unit of cloth in England and Portugal, respectively. In the event of trade taking place, under the assumption that within each country labour is perfectly mobile between various industries, Portugal will gain if it can get anything more than 0.88 units of cloth in exchange for one unit of wine, and England will gain if it has to part with less than 1.2 units of cloth against one unit of wine. Hence, any exchange ratio between 0.88 units and 1.2 units of cloth against one unit of wine represents a gain for both the countries. The actual rate of exchange will be determined by the *reciprocal demand*.

Thus, according to the comparative cost theory, free and unrestricted trade among countries encourages specialisation on a larger scale. It, thereby, tends to bring about:

- The most efficient allocation of world resources as well as maximisation of world production,
- A redistribution of relative product demands, resulting in greater equality of product prices among trading nations, and
- A redistribution of relative resource demands to correspond with relative product demands, resulting in relatively greater equality of resource prices among trading nations.

Evaluation of the Theory

The comparative cost doctrine is not complete in itself. It has been severely criticised, particularly for its wrong assumptions. The main criticisms of the theory are:

- As the theory is based on the labour (cost) theory of value, it has inherited all the defects of the labour theory of value. Labour is certainly not the only element of cost. Further, in the real world, the exchange ratio between commodities need not necessarily reflect the respective cost ratio. The demand and supply conditions play a very important role in the determination of the price at which commodities are exchanged.
- In a money economy it is not proper to express the cost of production in real terms (labour units). Differences in wages may alter the price ratios from the ratios of labour units expended, particularly between countries. Indeed, wage differences is the reason for an important part of the global trade.

- (c) The assumptions about the mobility and homogeneity of labour are also incorrect. There rarely is perfect mobility of labour from one branch of production to another. In fact, there are non-competing groups of labour. Inter-regional mobility of labour within a country is also not perfect. It is also wrong to assume that labour is completely immobile between countries. Further, it is unrealistic to assume that labour is homogeneous; there are in fact many different qualitative types of labour.
- (d) Ricardo tacitly assumed constant costs, but constant cost is a rare case. Costs may rise or fall as production increases.
- (e) The assumptions of full employment and perfect competition, which are characteristics of classical economic theories, are also wrong.
- (f) Similarly, it is highly unrealistic to assume that international trade is free and does not involve cost of transport.
- (g) By taking a two-country-two-commodity model, Ricardo has over simplified the situation.
- (h) As Graham has pointed out, even if we assume that all the assumptions are true, it will not lead to complete specialisation if one of the two countries is small and the other is big. The small country may be able to specialise fully, but the big country cannot since it cannot sell its entire surplus in the small country and cannot get from the small country the quantity of goods which it can produce though at a comparatively higher cost.
- (i) The theory of comparative cost fixes only the limit within which the exchange ratio must settle under international trade; it does not show how the exact point within these two limits is determined. In other words, the theory does not say how the terms of trade are determined.
- (j) As Ellsworth and Leith point out, an important "...feature of the classical trade theory is that Ricardo, Mill and their followers appear to have regarded it not primarily as an explanation of the actual pattern of trade, but as a convincing demonstration of the gains from trade",⁵ and they have used it "...as a powerful argument for a more rational trade policy in a tariff ridden world".⁶
- (k) Though the Ricardian theory maintains that comparative differences in labour costs form the basis of international trade, it does not explain what underlies such differences in relative costs of production.
- (l) According to Krugman and Obstfeld, clearly there are a number of ways in which the Ricardian model makes misleading predictions. First, the simple Ricardian model predicts an extreme degree of specialisation that we do not observe in the real world. Second, the Ricardian model assumes away effects of international trade on the distribution of income within countries, and thus predicts that countries as a whole will always gain from trade; in practice, international trade has strong effects on income distribution. Third, the Ricardian model allows no role for differences in resources among countries as a cause of trade, thus missing an important aspect of the trading system. Finally, the Ricardian model neglects the possible role of economies of scale as a cause of trade, which leaves it unable to explain the large trade flows between apparently similar countries.⁷

Krugman and Obstfeld, however, observe that in spite of these failings, the basic prediction of the Ricardian model—that countries should tend to export those goods in which their productivity is relatively high—has been strongly confirmed by a number of studies over the years. It is an extremely useful tool for thinking about the reasons why trade may happen and about the effects of international trade on national welfare.⁸

The Ricardian theory, though based on a number of wrong assumptions, is regarded as an important landmark in the development of the theory of international trade. Paul Samuelson

Despite the highly simplifying assumptions, the Ricardian theory provides a sound explanation of the underlying reason for international trade.

remarks: "If theories, like girls, could win beauty contests, comparative advantage would certainly rate high in that it is an elegantly logical structure."⁹ He adds: "The theory of comparative advantage has in it a most important glimpse of truth... A nation that neglects comparative advantage may have to pay a heavy price in terms of living standards and potential rates of growth."¹⁰

ELABORATIONS AND REFINEMENTS OF THE CLASSICAL THEORY

The Ricardian theory of comparative costs was based on a number of simplifying assumptions. This, however, does not mean that the theory is valid only under the assumptions upon which it was originally

Several elaborations and refinements of the Ricardian theory show that it is valid even if several of the assumptions are removed.

formulated; the relaxation of the simplifications does not invalidate the law of comparative advantage. This classical doctrine has been elaborated and modified by economists like J.S. Mill, Alfred Marshall and Taussig.

Introduction of Money

One of the major criticisms of the comparative cost theory is that it expresses production cost in real terms and not in money terms. But as Haberler states, in a modern economy, "...goods are not exchanged directly against other goods, but goods are bought with money. People do not think of the exchange relations between goods *in natura* but money prices. The flow of international trade is determined directly by absolute differences in money prices and not by comparative differences in labour cost".¹¹ To make the theory more realistic, labour cost should, therefore, be transformed into money price. The translation of comparative differences in cost into absolute differences in price in no way alters the real exchange relations between commodities which lie behind the money prices.

To illustrate the refinement of the comparative cost theory with introduction of money, let us take the hypothetical example of labour costs of wine and cloth in Portugal and England and assume that the wage per unit of labour is \$1 in England and \$1.3 in Portugal. Then, the price per unit of cloth will be \$100 in England and \$117 in Portugal and the price per unit of wine will be \$120 in England \$104 in Portugal (see Table 6.3). Therefore, England will import wine from Portugal instead of producing it at home at a higher cost. Similarly, Portugal will import cloth from England instead of producing it at a higher cost.

Table 6.3 Comparative Money Costs

Country	No. of Units of Labour Required for One Unit of		Wage Per Unit of Labour (\$)	Price Per Unit of	
	Cloth	Wine		Cloth (\$)	Wine (\$)
England	100	120	1.00	100.00	120.00
Portugal	90	80	1.30	117.00	104.00

The above illustration clearly shows that the discarding of labour cost and the introduction of money does not invalidate the comparative cost theory. It should, however, be noted that if wages rise or fall below certain limits, it will distort the trade pattern. For example, while the money wage remains stable in England, if it rises above \$1.5 in Portugal, the price of wine will exceed \$120 (the price in England) and, therefore, England will not import wine from Portugal. Similarly, a rise in wages beyond a certain

level in England will make the English cloth more expensive than the Portuguese. A fall in the wage in a country beyond a certain limit will cause a similar situation. For example, if the wage level remains stable in England and if it falls to less than \$1.11 in Portugal, English cloth will no longer be cheaper than that produced in Portugal.

Introduction of Transfer Costs

The Ricardian theory assumed that the transfer of goods between countries does not involve any cost. Quite obviously, certain transfer costs like the cost of transport are involved in international trade. It is not difficult to introduce the costs of transfer to the comparative cost theory. The introduction of transfer costs, however, decreases the extent of the international division of labour because if the cost of transfer of a commodity is more than the difference in the costs of production between two countries, it will not be traded between them. For instance, with reference to our previous example, if the cost of the transfer of wine from Portugal to England is more than \$16 per unit, England is not likely to import wine from Portugal because the landed cost of Portuguese wine in England will be more than \$120 (which is the price of the domestic wine.)

In the absence of transfer costs, the condition for the establishment of trade between country A and B is that $X_a/X_b < Y_a/Y_b$, where X_a and Y_a denote the number of units of the commodities X and Y which one unit of labour can produce in country A . X_b and Y_b denote the number of units of the commodities X and Y which one unit of labour can produce in country B . Introduction of transfer costs requires the fulfilment of two more conditions for the establishment of trade, viz. $X_a/X_b^1 < Y_a/Y_b$ and $X_a/X_b < Y_a^1/Y_b$ where X_b^1 denotes the number of units of commodity X which can be produced and transferred to A with one unit of labour in B , and Y_a^1 denotes the number of unit of commodity Y which can be produced and transported to B with one unit of labour in A .

More than Two Commodities

Though Ricardo considered only two commodities, the theory can be applied to cases in which not merely two commodities but any number of goods are produced in the two countries. If Countries I and II exchange a number of commodities between them, according to the doctrine of comparative cost differences, Country I must be enjoying a comparative advantage over Country II in all its export commodities relatively to all its import commodities. Similarly, Country II must be enjoying a comparative advantage over Country I in all its export commodities relatively to all its import commodities.

To get an idea of which commodities a country exports and imports, we may arrange various goods in order of the comparative advantage of Country I over Country II, so that if we call them a, b, c, d, e, \dots $a_1/a_2 < b_1/b_2 < c_1/c_2 < d_1/d_2 < e_1/e_2 \dots$ Country I will export commodities on the left side and import commodities on the right side. Country II, on the other hand, specialises in the production of commodities on the right side and imports those on the left side. It is not possible that Country I exports a, b, d and imports c . If it imports c , it must necessarily be importing d (assuming, of course, that d has a demand in Country I).

Relying only on the cost data, we cannot determine the exact position of this dividing line. We can say only that it must be drawn in such a manner that Country I enjoys a comparative advantage in every commodity it exports relatively to every commodity it imports. The dividing line will be at a position at which the balance of payments will be in equilibrium. The point at which the balance of payments will be in equilibrium will be determined by the reciprocal demand of the two countries for each other's products.

An examination of Table 6.4 will make the meaning of the algebraic expression clear.

Table 6.4 Production Costs of Goods in Two Countries

<i>Kinds of Goods</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>F</i>	<i>G</i>	<i>H</i>	<i>I</i>	<i>J</i>	<i>K</i>	<i>L</i>
Real cost per unit, In Country I*	30	30	30	30	30	30	30	30	30	30	30	30
expressed in (a_1, b_1, c_1, \dots)												
units of labour In Country II	55	50	46	40	32	30	27	25	20	15	12	10
(a_2, b_2, c_2, \dots)												

* In this example, the units of quantity of various commodities are chosen in such a way that the cost per unit of every commodity in Country I is the same. Hence, the number of units of labour per unit of every commodity is equal (30).

If we assume that money wages are the same in both the countries, we can easily say which goods will be exported and which will be imported. Country I will export goods *A* to *E* and Country II will export goods *L* to *G*. It depends upon the reciprocal demand whether or not this situation maintains equilibrium in balance of payments.

More than Two Countries

Though the Ricardian model consists of two countries only, the theory is equally applicable to a situation in which more than two countries participate. Each country will specialise in the commodity or commodities in the production of which it has comparative advantage over the others and import from other countries goods which can be produced domestically only at a comparative disadvantage.

A country may import a commodity from more than one country just as it may export a commodity to more than one country. Assume that the international price of commodity *X* is \$100 per unit. Now, all countries who can produce at a cost of less than \$100 per unit, can export *X*. However, the gains to the different exporting countries may vary. The country with the least production cost will gain the maximum (per unit of export) and vice versa. All countries with costs of production of over \$100 per unit of *X* will gain by importing it rather than producing domestically at a higher cost. The extent of gain from import also may vary between the various importing countries. The gain (per unit) will be the maximum for the importing country with the highest domestic cost of production of *X* and vice versa.

Variable Costs of Production

Ricardo assumed a constant cost of production. The removal of the assumption of constant costs and the introduction of variable costs do not, however, change the substance of the comparative cost theory. It should, however, be noted that although the consideration of conditions of increasing costs calls for no basic modifications of the theory, production under conditions of increasing costs does prevent international specialisation from developing, consequently reducing the potential gains from trade. Production under conditions of decreasing costs, on the other hand, tends to widen national costs differentials and also the limits of the terms of trade.

Non-Competing Groups

The Ricardian theory assumed that labour in each country is homogeneous and perfectly mobile within the country. But, as a matter of fact, labour force in any country consists of many different groups, i.e.

the technical, skilled, semi-skilled and unskilled, and mobility between these groups is far from perfect. These distinct categories of labour with rather well marked and enduring differences in wages are known as “non-competing” groups.

The mere existence of such groups would not affect the theory of international trade, provided that in each country the relative scale of wages was the same. But the relative scale of wages differs between countries due to factors like the relative abundance or scarcity of certain categories of labour, and this affects the pattern of trade. For instance, abnormally low wages for a particular category of labour in a country enables it to produce some commodity or commodities at a lower money cost than its competitors, even though it has no comparative advantage. Abnormally low wages for particular kind of labour, thus, act as a substitute for real comparative advantage. The existence of non-competing groups within a country affects international trade only when the situation thus engendered is peculiar to that country.

Capital Charges

Taussig has pointed out that interest charges influence international trade when different quantities of capital are used in the production of different commodities. Hence, like non-competing groups of labour interest charges may also affect the cost of production and pattern of trade. A low rate of interest tends to give a country a comparative advantage for those goods which are made with much capital; these tend to be exported from it. A high rate of interest correspondingly is a handicap on the export of these same goods and a stimulus to their import. However, high or low interest does not in itself act as an independent factor; it exercises an influence only so far as it enters to a greater degree in one commodity than in another.¹² The conclusion is of the same sort as that reached with regard to non-competing groups and differences of wages.

OPPORTUNITY COST THEORY

One of the main drawbacks of the Ricardian comparative cost theory was that it was based on the *labour theory of value* which stated that the value or price of a commodity was equal to the amount of labour time going into the production of the commodity. Gottfried Haberler gave new a life to the comparative cost theory by restating the theory in terms of opportunity costs in 1933.

The opportunity cost of a commodity is the amount of a second commodity that must be given up in order to release just enough factors of production or resources to be able to produce one additional unit of the first commodity. For example, supposing that the resources required to produce one unit of commodity *X* are equivalent to the resources required to produce two units of commodity *Y*. Then, the opportunity cost of one unit of *X* is two units of *Y*.

The opportunity cost of a product is the amount of another product that must be given up in order to release just enough resources to produce one additional unit of the first product.

According to the opportunity cost theory, a nation with a lower opportunity cost for a commodity has a comparative advantage in that commodity and a comparative disadvantage in the other commodity. If the opportunity cost of one unit of *X* is two units of *Y* in Country *A* and 1.5 unit of *Y* in Country *B*, then Country *A* must specialise in production of *Y* and import its requirements of *X* from *B*, and *B* should specialise in the production of *X* and import *Y* from *A* rather than producing it at home.

We can illustrate the opportunity cost theory with the help of the production possibility curve, price line and the community indifference curves.

In Fig. 6.1, *AA* represents the production possibility curve (PPC) of Portugal and *BB* in Fig. 6.2 represents the PPC of England. A comparison of the shape of the PPC of Portugal with that of the PPC

of England makes it clear that opportunity cost of wine, in terms of cloth, is lower in Portugal and higher in England. In other words, Portugal is better suited for wine production and England for cloth.

Let us first take the case of Portugal. Under autarchy (i.e. in the absence of international trade) the country is in equilibrium at E , producing and consuming OC of cloth and OW of wine. Under autarchy, equilibrium is established at the point of tangency between the given domestic price line ($P_a P_a$ in Fig. 6.1), the transformation curve (AA) and the highest community indifference curve (I). The domestic price ratio is determined by the demand conditions. Under increasing costs the slope of the transformation curve varies throughout, indicating variation in the relative costs of the two commodities. At point E in Fig. 6.1, the slope of the PPC (i.e. the rate of transformation of cloth into wine through production) is the same as the slope of the price line (i.e. the rate of transformation of cloth into wine through trade). Point E is on the highest indifference curve the country can reach with available resources. Hence, the economy will be in equilibrium at E .

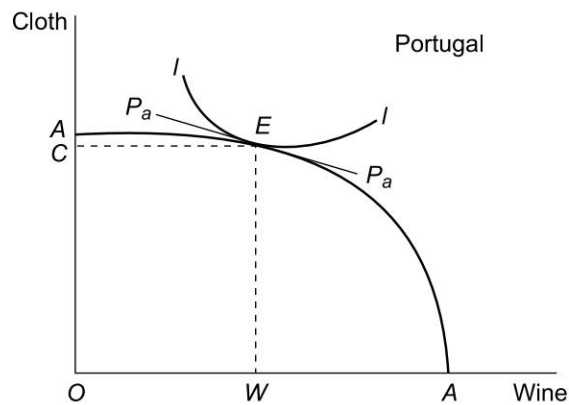


Fig. 6.1 Equilibrium under Autarchy (Portugal)

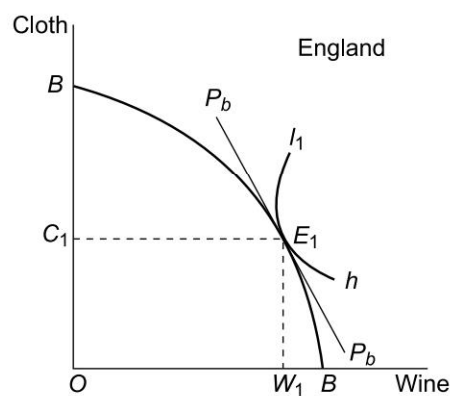


Fig. 6.2 Equilibrium under Autarchy (England)

Similarly, England will be in equilibrium at E_1 under autarchy.

If Portugal and England enter into trade with each other, the international price ratio is mostly likely to be somewhere in between the pre-trade price ratios in both the countries. In other words, the international price line would neither be as flat as the autarchy price line in Portugal ($P_a P_a$) nor be as steep as the autarchy price line in England ($P_b P_b$). The slope of the international price line would be somewhere in between these two extremes—the actual slope of the international price line will be determined by the reciprocal demand (for details see next chapter). $P_i P_i$ in Figs 6.3 and 6.4 represents a possible international exchange ratio.

If $P_i P_i$ represents the international price ratio, Portugal will expand the output of wine by MN by contracting the output of cloth by EM . If Portugal wishes to maintain wine consumption at the old level of OW , it can now export MN of wine and get in exchange ME_2 cloth. Note that under autarchy, MN of wine will exchange for only ME of cloth. Hence, the gain from trade to Portugal is equivalent to EE_2 of cloth. Portugal is now able to be at a higher equilibrium point E_2 on the community indifference curve $I_2 I_2$. In the absence of trade this point cannot be reached by Portugal as it is beyond its production frontier.

Under trade, $P_i P_i$ being the international price line, England would expand production of cloth by TS by contracting wine output by TE_1 . If it would like to maintain pre-trade level of consumption of cloth, it can export TS cloth and obtain TE_3 wine and attain equilibrium at point E_3 which cannot be reached under autarchy. The gain to England from trade will be equivalent to $E_1 E_3$ of wine.

The differences in the opportunity cost of production of commodities is the basis of specialisation and trade.

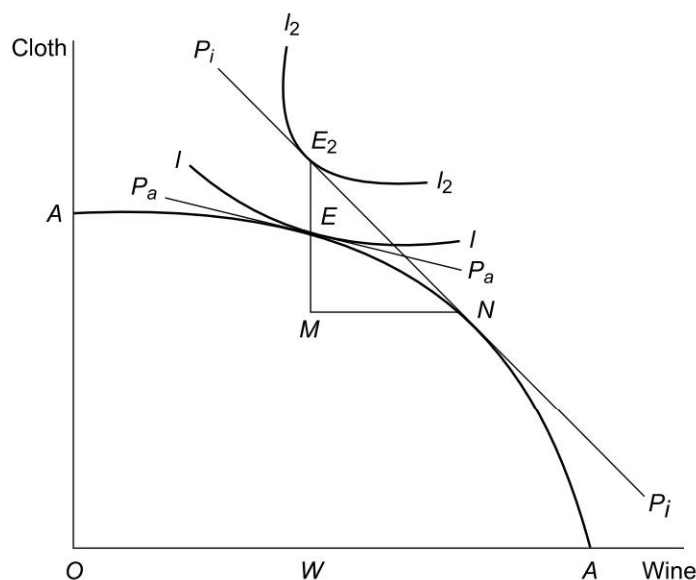


Fig. 6.3 Equilibrium under Trade (Portugal)

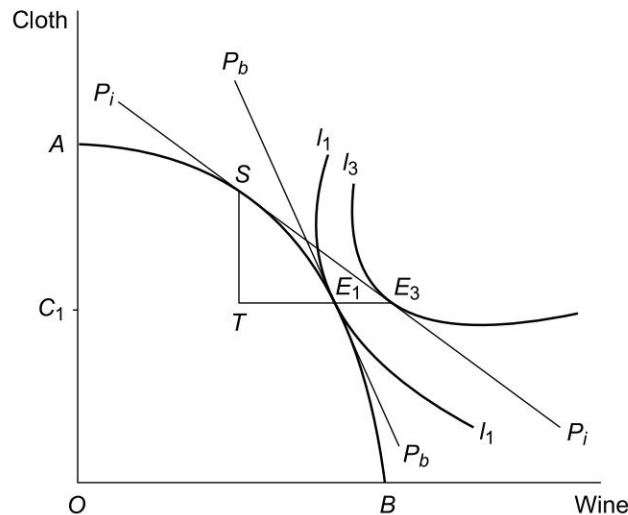


Fig. 6.4 Equilibrium under Trade (England)

In the above analysis, we have assumed that Portugal would wish to maintain the pre-trade level of consumption of wine and England the pre-trade level of consumption of cloth. But the real situation may be different. Consumption of these commodities by the respective countries under trade may be less or more than under autarchy so that community welfare could be maximised.

It should be noted that as production takes place under conditions of increasing costs, in the above illustration, neither country will be entirely specialised, but at the point at which trade settles there is no gain from additional trade and specialisation. The opportunity cost theory is applicable under conditions of constant and decreasing costs too.

To sum up, the opportunity cost theory demonstrates that trade is beneficial as long as opportunity costs differ.

Assumptions The opportunity cost theory too is based on most of the common assumptions of the classical theories. The important assumptions of this theory are:

- (a) Two-country-two-commodity model.
- (b) There are only two factors of production, viz. labour and capital. Factors of production are perfectly mobile within a country but immobile between countries.
- (c) Factors of production are fixed in supply.
- (d) There is perfect competition in both factor and product markets.
- (e) The price of each factor is equal to its marginal productivity in each employment.
- (f) The price of each commodity is equal to its marginal cost of production.
- (g) There is full employment in each country.
- (h) There is no technological change.
- (i) International trade is free.

Evaluation of Opportunity Cost Theory

Merits The opportunity cost approach is superior to the Ricardian theory in the following ways.

- (a) It recognises the existence of many different kinds of productive factors (although for simplicity sake the theory considered only two factors) whereas Ricardo considered only labour. The opportunity cost theory tells us that even if we discard the labour theory of value as being invalid and rely on the opportunity cost theory, the comparative cost theory is still valid.
- (b) The opportunity cost theory considers trade under constant, increasing and decreasing costs, whereas the comparative cost theory assumes constant cost of production.
- (c) It recognises the importance of substitution in production.
- (d) It provides a simple general equilibrium model of international trade.

Limitations The opportunity cost theory is subject to the following criticisms:

- (a) It is based on a number of unrealistic approaches.
- (b) Jacob Viner in his *Studies in the Theory of International Trade* argued that the opportunity cost approach is inferior to the classical real cost approach as a tool of welfare evaluation because it fails to measure real costs in terms of sacrifices, disutilities or irksomeness.
- (c) Viner also argued that the opportunity cost approach ignored the changes in factor supplies. However, V.C. Walsh points out that the changes in factor supplies can be measured in terms of opportunity cost by taking into account changes in commodity price ratio and marginal productivities of factors.¹³
- (d) Viner argues that opportunity cost approach failed to take into account the preference for leisure vis-à-vis income. This criticism has also been refuted by Walsh by arguing that when the trading nations exchange at an international price ratio, there will normally be an increase in real income and part of this will be taken in the form of more leisure, so that the output of both commodities may decrease.

The opportunity cost theory of Haberler is a refinement of the Ricardian theory. As far as the basis of international specialisation and trade is concerned, the logic behind the comparative cost approach and the opportunity cost approach are the same. Paul Samuelson, who has highly appreciated the comparative cost theory, makes the following observation about Haberler's theory: "The opportunity cost approach is more fertile because it can be readily extended into a general equilibrium system. It is, therefore, not surprising that the opportunity cost approach has gained more and more popularity and it is used by even who, in principle, attack it."¹⁴

FACTOR ENDOWMENT THEORY

The factor endowment theory was developed by Swedish economist Eli Heckscher and his student Bertil Ohlin. Paul Samuelson and Wolfgang Stolper have also made significant contributions to this theory.

This theory consists of two important theorems, namely, the Heckscher-Ohlin theorem and the factor price equalisation theorem. The Heckscher-Ohlin theorem examines the reasons for comparative cost differences in production and states that a country has comparative advantage in the production of that commodity which uses more intensively the country's more abundant factor. The factor price equalisation theorem examines the effect of international trade on factor prices and states that free international trade

equalises factor prices between countries, relatively and absolutely, and thus serves as a substitute for international factor mobility.

The Heckscher–Ohlin theory does not refute the Ricardian theory. It, in fact, supplements it by explaining the reasons for the differences in the comparative costs.

Heckscher–Ohlin Theorem

Heckscher and Ohlin have explained the basis of international trade in terms of factor endowments. The classical theory demonstrated that the basis of international trade was comparative cost difference. However, it made little attempt to explain the causes of such comparative cost difference. The alternative formulation of the comparative cost doctrine developed by Heckscher and Ohlin attempts to explain why comparative cost differences exist internationally. They attribute international (and inter-regional) differences in comparative costs to:

Factor endowments differ between countries.

- different prevailing endowments of the factors of production, and
- the fact that production of various commodities requires that the factors of production be used with different degrees of intensity.

In short, it is the difference in factor intensities in the production functions of goods along with actual differences in relative factor endowments of the countries which explains international differences in comparative cost of production.

Thus, the Heckscher–Ohlin theory states that a country will specialise in the production and export of goods whose production requires a relatively large amount of the factor with which the country is relatively well endowed.

In the Heckscher–Ohlin model, factors of production are regarded as scarce or abundant in relative terms and not in absolute terms. That is, one factor is regarded as scarce or abundant in relation to the quantum of other factors. Hence, it is quite possible that even if a country has more capital, in absolute

A factor is regarded abundant or scarce in relation to the quantum of other factors

terms, than other countries, it could be poor in capital. A country can be regarded as richly endowed with capital only if the ratio of capital to other factors is higher when compared to other countries.

(i) In Country *A*:

Supply of labour = 25 units
Supply of capital = 20 units
Capital-labour ratio = 0.8

(ii) In Country *B*:

Supply of labour = 12 units
Supply of capital = 15 units
Capital-labour ratio = 1.25

In the above example, even though Country *A* has more capital in absolute terms, Country *B* is more richly endowed with capital because the ratio of capital to labour in Country *A* (0.8) is less than in Country *B* (1.25).

Different goods have different factor intensities.

The following diagram (Fig. 6.5) illustrates the pattern of world trade according to the Heckscher–Ohlin approach.

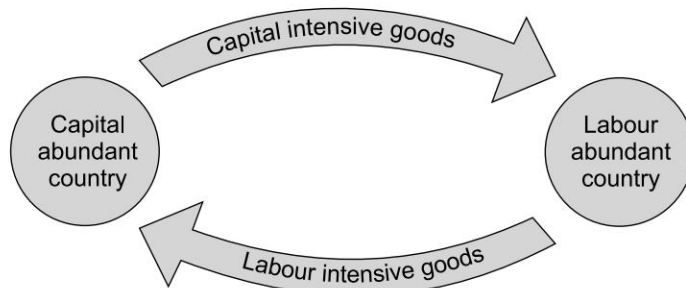


Fig. 6.5 Pattern of Trade under Heckscher-Ohlin Model

The two-country-two-commodity model of Heckscher and Ohlin is based on a number of explicit and implicit assumptions. The important assumptions of the model are:

- (a) Both product and factor markets in both countries are characterised by perfect competition.
- (b) Factors of production are perfectly mobile within each country but immobile between countries.
- (c) Factors of production are of identical quality in both countries.
- (d) Factor supplies in each country are fixed.
- (e) Factors of production are fully employed in both the countries.
- (f) Factor endowments of one country vary from that of the other.
- (g) There is free trade between the countries, i.e. there are no artificial barriers to trade.
- (h) International trade is costless, i.e. there is no transport cost.
- (i) Techniques of producing identical goods are the same in both countries. Due to this, the same input mix will give the same quantity and quality of output in both the countries.
- (j) Factor intensity varies between goods. For instance, some goods are capital intensive (i.e. they require relatively more capital for their production) and some others are labour intensive (i.e. they require relatively more labour for their production).
- (k) Production is subject to the *law of constant returns*, i.e. the input-output ratio will remain constant irrespective of the scale of operation.

A country will specialise in the production and export of those goods which are intensive in its abundant factors and will import those goods which are intensive in its scarce factors.

Factor Price Equalisation Theorem

The factor price equalisation theorem states that free international trade equalises factor prices¹⁵ between countries, relatively and absolutely, and this serves as a substitute for international factor mobility.

International trade increases the demand for abundant factors (leading to an increase in their prices) and decreases the demand for scarce factors (leading to a fall in their prices) because when nations trade, specialisation takes place on the basis of factor endowments. According to Ohlin, "The effect of inter-regional trade is to equalise commodity prices. Furthermore, there is also a tendency towards equalisation of the prices of factors of production, which means their better use and a reduction of the disadvantages arising from the unsuitable geographical distribution of the productive factors."¹⁶ Since from each region goods containing a large proportion of relatively abundant and cheap factors are exported,

Free international trade will lead to equalisation of factor prices internationally.

while goods containing a large proportion of scarce factors are imported, “...inter-regional trade serves as a substitute for such inter-regional factor movements”.¹⁷

Evaluation of Factor Endowment Theory

The Heckscher-Ohlin theory has been often criticised for its wrong assumptions.

Studies conducted by Leontief and some others tend to question even the validity of the theory. (For details see the section on “Empirical Testing of the H-O Model”).

Merits of Heckscher-Ohlin Theory The Heckscher-Ohlin theory has certain definite merits.

- (a) The Heckscher-Ohlin theory rightly points out that the immediate basis of international trade is the difference in the final price of a commodity between countries, although the actual basis or ultimate cause of trade is comparative cost difference in production. Thus, the Heckscher-Ohlin theory provides a more comprehensive and satisfactory explanation for the existence of international trade.
- (b) Although the Ricardian theory points out that comparative cost difference is the basis of international trade, it does not explain the reasons for the existence of comparative cost differences between countries. The Heckscher-Ohlin theory explains the reasons for the differences in the cost of production in terms of differences in factor endowments. This is another aspect that makes it superior to the Ricardian analysis.
- (c) Further, Heckscher and Ohlin make it very clear that “international trade is but a special case of inter-local or inter-regional trade” and hence, there is no need for a special theory of international trade. Ohlin states that regions and nations trade with each other for the same reasons that individuals specialise and trade. The comparative cost differences are the basis of all trade—inter-regional as well as international. Nations, according to Ohlin, are only regions distinguished from one another by such obvious marks as national frontiers, tariff barriers and differences in language, customs and monetary systems.
- (d) The Heckscher-Ohlin theory is formulated within the framework of the general equilibrium analysis as against the unrealistic labour theory of value on which the classical theory is based. Hence, the modern theory of trade is also called the General Equilibrium Theory of international trade as it points out that the general demand and supply analysis applicable to inter-regional trade can generally be used without substantial changes in dealing with problems of international trade.
- (e) The classical theory implicitly assumes that international trade will come to an end if the labour costs of production of commodities become equal every where, whereas the Heckscher-Ohlin theory indicates that trade will continue even if the labour costs of production of commodities become equal every where because of the differences in the factor endowments.
- (f) While the classical theory is based on comparative differences in the labour costs of production of commodities between countries, the Heckscher-Ohlin theory is more realistic as it considers the differences in the production function.
- (g) Another superiority of the Heckscher-Ohlin theory over the classical theory is that the Heckscher-Ohlin theory which concentrates on the basis of trade partakes of the positive economics, whereas the classical theory goes to explain the gains from trade. Actually, instead of regarding it as a weakness, the classical theory needs to be appreciated for its attempt to demonstrate the welfare implication of trade.

- (h) As Haberler points out in his *A Survey of International Trade Theory*, one of the merits of the Heckscher–Ohlin theory is that it is a location theory; it is indeed the spatial aspects of factor endowments that give rise to trade. The classical theory, on the other hand, treats trade as taking place between nations defined by political boundaries, ignoring the space factor. (The description of *Region State* given in Chapter 1 supplements this point).
- (i) The Heckscher–Ohlin theory highlights the role of relative prices of factors in determining the trade flow while the classical theory confines itself to the relative prices of goods.
- (j) Another merit of the Heckscher–Ohlin theory is that it indicates the impact of trade on product and factor prices.

H–O theory is useful in explaining international trade in raw materials, agricultural products and labour intensive manufactures.

Effects of International Trade

The Heckscher–Ohlin theory indicates that international trade will ultimately have the following results:

1. Equalisation of Commodity Prices International trade tends to equalise the prices of internationally traded goods in all the regions of the world, because trade causes the movement of commodities from areas where they are abundant to areas where they are scarce. This would tend to increase commodity prices where there was abundance and decrease prices where there was scarcity due to the redistribution of commodity supply between these two regions as a result of trade. International trade tends to expand up to the point where prices in all regions become equal. But perfect equality of prices can hardly be achieved due to the existence of transport costs and due to the absence of free trade and perfect competition.

2. Equalisation of Factor Prices International trade also tends to equalise factor prices all over the world. International trade increases the demand for abundant factors (leading to an increase in their prices) and decrease the demand for scarce factors (leading to a fall in their prices) because when nations trade, specialisation takes place on the basis of factor endowments. However, the presence of a number of imperfections make the achievement of perfect equality in factor prices impossible.

Empirical Testing of H-O Model

Some notable attempts have been made to empirically test the validity of the Heckscher–Ohlin (H–O) Model. A brief account of some of them are given below:

Leontief Paradox The credit for making the first comprehensive and detailed verification of the Heckscher–Ohlin theory goes to Wassily W. Leontief.

The United States of America was believed to be a country with abundant capital endowment and scarce labour endowment. Then, if the factor proportions theory were correct, the US should have been exporting capital intensive commodities and importing labour intensive commodities. However, the result of Leontief's test disproved this hypothesis. This paradoxical result of the test, that showed that the United States was actually exporting labour intensive goods and importing capital intensive goods, came to be popularly known as the *Leontief Paradox*.

Leontief paradox refers to the research finding that the US was exporting labour intensive goods and importing capital intensive goods

Leontief tested his hypothesis with the help of an input-output table for the US for 1947, taking into account only two factors, labour and capital. To test the hypothesis, he also assumed that the United States decreased its production of exports and its imports by an equal amount, \$1 million. When exports are decreased, both labour and capital are released and more capital

and labour are needed to increase the production of import-competing goods. Then, if the American exports were capital intensive and imports labour intensive, when export production is contracted by \$1 million, the labour released is not sufficient to increase the output of import-competing goods by \$1 million, and the capital released is more than what is required to increase the import-competing production by \$1 million. Leontief's test, however, showed that it was the other way round—the ratio of capital to labour was higher in the import substitution industries than in the export industries. He found that the capital-labour ratio (dollars per man-year) was only 13,911 in export industries as against 18,185 in import replacement industries. Leontief, therefore, concluded that America's participation in the international division of labour was based on its specialisation on labour intensive rather than capital intensive lines of production. In other words, the country resorted to foreign trade in order to economise its capital and dispose of its surplus labour, rather than vice versa.

Explanations of Leontief Paradox Several attempts have been made to reconcile Leontief paradox with H-O theory. Some of the explanations of Leontief paradox are given below.

Differences in Labour Productivity Leontief himself has given two explanations for the paradoxical results. In the US, though labour was numerically small in relation to the capital stock, the effective supply of labour was relatively greater on account of the superior quality of the US labour. He suggested that the productivity of the American worker was three times higher than that of a foreign worker. With this suggestion, Leontief tried to reconcile with the Heckscher-Ohlin theorem. As Sodersten observes, "If production functions are identical between countries, if factor reversals are ruled out, and if factors of production are homogeneous and identical between countries except for a multiplication constant (Leontief suggested a constant of three for labour in the United States), Leontief's explanation might be valid."¹⁸ The question, however, is how many of these 'ifs' are satisfied in a real situation. Some studies reveal that the differences in the labour productivity is very much lower than what Leontief postulated. Trefler, however, argues that the US was relatively abundant in land and relatively scarce in both labour and capital. By adjusting for productivity differences across countries, the US would have been classified as a labour-abundant country and expected to export labour-abundant goods.¹⁹

Role of Third Factor The second explanation given by Leontief for the paradoxical result is the exclusion from his study of certain factors which also determine a country's productive capacity. Only labour and capital were explicitly taken into account by him, but as he notes, a third factor or rather as a whole additional set of factors determining a country's productive capacity and, in particular, its comparative advantage vis-a-vis the rest of the world, are natural resources: agricultural lands, forests, rivers and mineral deposits.²⁰

Sodersten argues: "By taking into account this third factor an explanation to the Leontief paradox can be found. It might be the case, for instance, that imports require more capital to labour than exports. It is still, however, possible that imports are intensive in the third factor, for example land. If capital and the third factor (land) are substitutes but both are complementary with labour, it might be the case that import-competing goods are capital intensive in the United States but land intensive abroad. By bringing a third factor into account in this way, possible explanations might be found."²¹

Differences in Production Function Ellsworth²² has brought to light an important flaw in Leontief's analysis by pointing out that the capital intensity of United States' import replacement industries is irrelevant to the comparison, because production functions, i.e. ways of producing goods, are not identical between countries. As he rightly points out, what is really required is a comparison of the capital intensity of US exports with the capital intensity in the countries which produce US imports.

Since America is a capital rich country and employs capital intensive production methods, import replacements would naturally use relatively more capital to produce similar goods than the countries supplying them to the US. It is not surprising that to make in America goods which are normally imported from other countries would require a higher capital to labour ratio than is typically found in American export industries. Leontief considered import replacements in terms of American productive practice. What he ought to have done was to see whether goods imported into America are capital or labour intensive in the countries of origin, argues Ellsworth.

Ford argues that Leontief's conclusion is not applicable to the basic Ohlinian theorem and cannot, therefore, invalidate it because Leontief was concerned with export industries and competitive import replacements and not actual imports, whereas the Heckscher-Ohlin theorem applies to actual exports and imports. Not only this, but one could expect American import replacement production to be more capital intensive than export production, simply because American production methods are directed toward using a relatively large amount of capital. A fair proportion of America's raw material imports (since they may not exist in America in economic quantities) would require, if America were to produce them itself, relatively large amounts of capital. Then America exports capital intensive products and "...imports products, which, if it were to produce them, would require relatively more of its abundant factor", concludes Ford.²³

It has also been suggested by some economists that the paradoxical result of Leontief's test may be due to the factor intensity reversals.

Differences in Demand Pattern It is pointed out that demand patterns across trading partners differ to such an extent that trade does not follow the H-O pattern. Romney Robinson has suggested that demand conditions within a country might be so biased towards consumption of a product embodying a relatively abundant factor of production, that its relative abundance is neutralised by a high level of domestic demand. Likewise, a country well endowed with capital may import the capital intensive commodity if it has reached the level of real income at which its income elasticity of demand for such goods is high. Similarly, a labour endowed country may export a capital intensive product if its income level at the margin is such that it chooses to use the labour intensive product at home.²⁴ As regards the first point, Professor A.J. Brown has shown that American consumption patterns do not appear to be biased towards capital intensive goods; rather the reverse.²⁵

Trade Barriers It has also been suggested that distortion of the trade pattern caused by trade barriers could have influenced the results of Leontief's test. Factor endowment cannot, therefore, be expected to determine trade patterns when trade is far from free. It is well known that trade barriers in the US are very high on labour intensive goods.

Human Capital and Skill It is suggested that one of the most important reasons for the paradoxical finding of Leontief was the exclusion of human capital (such as investment in education, training, health etc. of workers) from the computation of capital. When human capital is taken into account, US exports may turn out to be capital intensive, not labour intensive. Kravis argued that the finding that wages in US exports were higher than wages in US import-competing industries was a reflection of the greater productivity and human capital embodied in US exports than in US import substitutes.²⁶

R&D and Technology Another important factor, which is somewhat related to human capital, is the influence of research and development (R&D) on US exports. The "knowledge" capital resulting from R&D leads to an increase in the value of output derived from a given stock of material and human resources. Thus, human and knowledge capital are important considerations in determining the pattern of US trade. These were not considered by Leontief in his study.²⁷

In short, countries tend to have a comparative advantage in export goods whose production intensively uses its abundant factor of production. What needs to be considered is what constitutes a factor of production? Physical capital can be used as a factor as it was described in the simple version of the theory. The same cannot be said for labour. The knowledge and skills the labour force (human capital) possesses needs to be treated as a separate factor of production. The same is true for technology. The basic logic embodied in the factor-proportions theory is correct. We just need to broaden the concept of factors of production to include factors other than capital and labour.²⁸

Factor-Intensity Reversal Another explanation of the Leontief paradox is factor intensity reversal. There is factor intensity reversal when a good is produced in one country by relatively capital intensive methods, but is produced in another country by relatively labour intensive methods. Hence, although US import goods might have been produced labour-intensively overseas, the production process of these goods in the United States was relatively capital intensive.

All these comments suggest that Leontief's test is not strong enough to disprove the Heckscher-Ohlin theory. It is perhaps paradoxical to describe the result of Leontief's study as the Leontief Paradox.

Other Tests Some other attempts have also been made to test the empirical validity of the Heckscher-Ohlin Model.

R. Bhargava's study indicated that Indian exports to the US were capital intensive while its imports from the United States were labour intensive. This rather surprising result appears to refute the Heckscher-Ohlin analysis. But, as Wells points out, here again it is possible that production methods differ widely between the US and India.²⁹

An examination of German trade for 1956 by Stopler and Roskamp revealed that exports are capital intensive while imports are labour intensive; this would be in line with the Heckscher-Ohlin approach since three quarters of the erstwhile East German trade was with the communist block, of which East Germany was one of the most highly industrialised members.³⁰

Analysis of Japan's trade with different categories of countries, made by Tatemoto and Ichimura suggests that the trade pattern endorses the Heckscher-Ohlin theory.³¹ On the other hand, Wahl found in the case of Canada that exports were capital intensive and imports labour intensive. Since the bulk of Canadian trade was with the US, this result seemed to refute the Heckscher-Ohlin approach.³² Several other tests also indicate that trade often does not run in the direction that the Heckscher-Ohlin theory predicts.

Several studies show mixed results. Salvatore cites, inter alia, the following studies: In a 1987 study, Bowen, Learner and Sveikauskas, using 1967 cross-sectional data on trade, factor input requirements, factor endowments for 27 countries, 12 factors (resources) and many commodities, found that the H-O trade model was supported only about half of the time. More recent evidence, however, does provide support for some restricted form of the H-O trade model. In a 1993 study, Brecher and Choudhri found production evidence in support of the H-O model for the United States and Canada; a 1994 study by Wood supports the H-O model for trade between developed and developing countries based on differences in their relative availability of skills and land, and so does a 1995 study by the World Bank). Additional evidence in support of the H-O model for trade in manufactured goods among the largest industrial countries is provided by a 1996 study by James and Elmslie. Broad but qualified support for the H-O model is also provided by Learner (1993, 1995), Wood (1997), and Davies and Wemstein (1998).³³

In view of these conflicting results, it is concluded that the H-O model is useful in explaining international trade in raw materials, agricultural products, and labour intensive manufactures, which is a large component of the trade between developing and developed countries. It is also useful in examining the effects of international trade, especially its effect on the distribution of income.³⁴

However, the available studies are not substantiative enough either to strongly support or to refute the Heckscher-Ohlin theory.

Factor Intensity Reversal

According to the Heckscher-Ohlin theory, the pattern of international trade is determined by factor endowments and factor intensities. But, changes in the relative factor endowments and factor intensities is possible over time. Such changes could change or even reverse the pattern of trade.

Factor intensity reversal refers to a situation where the factor intensities in the production of a product reverses between two cases. For example, a good which is capital intensive in production in the US could be labour intensive in India. Factor intensity reversal may also occur for a product in the same country over time. For example, several products which were labour intensive in the past have turned more capital intensive now. A growth in factor supplies may eventually make the scarce factor abundant and vice versa. This relative change in factor endowments may change the commodity composition of trade.

The commodity composition of trade may be reversed also by changes in production functions. For example, a technological change may make a labour intensive good a capital intensive one. Similarly, some technological change or government policy in favour of labour intensive production techniques could make the production of certain capital intensive goods more labour intensive.

The factor endowment theory assumes that production function is decidedly biased, i.e. a given commodity uses a particular factor of production intensively. However, production intensity need not be biased at all and the reversal in factor intensities is possible.

In Fig. 6.6, the prevailing factor prices are represented by isocosts LK and L^1K^1 . It is clear from the diagram that production of commodity X at point A is more labour intensive than production of commodity Y at B . If factor prices change the isocosts will shift to L^2K^2 and L^2K^2 , hence the production of commodity Y at point C becomes more labour intensive than of X at point D .

It is also clear from Fig. 6.6 that commodity X will be more labour intensive at factor price ratios that lead to production points to the left of point E , and that commodity Y will be the more labour intensive at price ratios leading factor combinations to the right of point E .

Factor reversals may occur when production functions are symmetrical, and hence factor endowments do not necessarily determine which commodities a nation will export or import. The factor reversal hypothesis, thus, tends to question the validity of the factor endowment theory in a static sense. As has been mentioned in the beginning, production functions could alter due to factors like technological change or change in government policies.

Past studies have shown that factor intensity reversals do take place, but are not common. However, the recent technological developments have changed the factor intensities of many products.

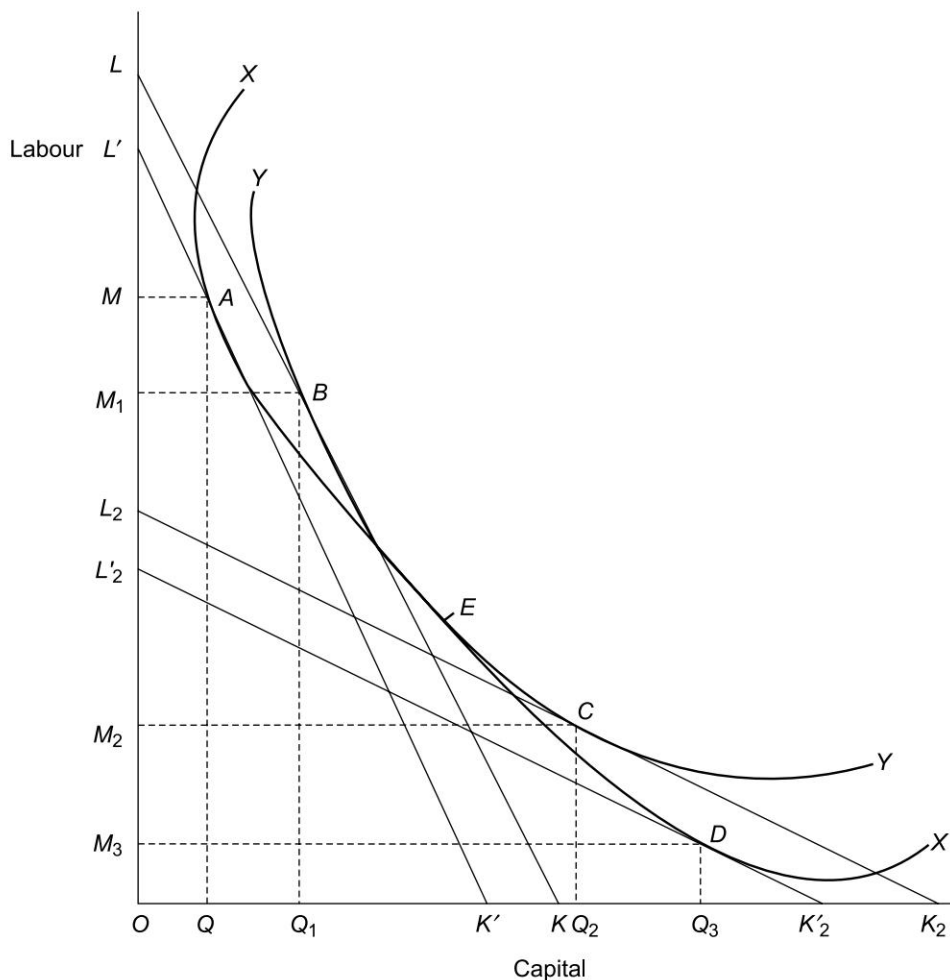


Fig. 6.6 Factor Intensity Reversal

COMPLEMENTARY TRADE THEORIES

There is a significant portion of the international trade that is not explained by the basic Heckscher-Ohlin model. Some theories have been propounded to explain different patterns of or reasons for trade which are not explained by the basic H-O model. These theories which are described as *complementary trade theories* or *extensions of the H-O trade model* are outlined below.

Stolper-Samuelson Theorem

Wolfgang Stolper and Paul Samuelson have propounded a theorem explaining the effect of change in relative product prices on factor allocation and income distribution.

Assumptions The Stolper-Samuelson theorem (SST) is based on a set of assumptions. These include:

- The $2 \times 2 \times 2$ trade model (two factors, two commodities and two countries).
- Each commodity is produced with two factors of production and the commodities differ in their factor intensities.
- The factors are qualitatively identical in both the countries.
- The technological production functions are the same in both the countries.
- There is free trade.

Effects of Tariffs and Trade on Income Distribution The initial article of Stolper-Samuelson, published in 1941, focused on the income distribution effects of tariffs. The theorem was subsequently extended to explain the income distribution effects of international trade in general. The Stolper-Samuelson theorem, thus, can be used to deal with two cases:

- The effects of tariff on factor allocation and income distribution.
- The effects of free trade on factor allocation and income distribution.

The Stolper-Samuelson theorem postulates that an increase in the relative price of a commodity raises the return or earnings of the factor used intensively in the production of that commodity. If the relative price of labour intensive commodity rises, there will be an increase in the wages. Similarly, an increase in the relative price of capital intensive product will raise the return to capital.

Suppose that a capital abundant country imposes a tariff on the import of the labour intensive commodity. This will raise the relative price of the labour intensive commodity, leading to an increase in the wages. This is because when the relative price of the labour intensive product rises, the relative profitability of the labour intensive product also rises leading to an increase in the production of the labour intensive commodity and a decline in the production of the capital intensive product whose relative profitability has declined. The use of more capital per unit of labour increases the productivity of labour, and, therefore, the wages rise.

As indicated above, although the Stolper-Samuelson theorem originally dealt with the factor reallocation and income distribution, resulting from a change in the relative product prices caused by imposition of import tariff, it was subsequently extended to explain the effect of trade on factor prices and income distribution. The Stolper-Samuelson theorem, accordingly, postulates that *under a set of assumptions free trade unambiguously raises the returns to the factor used intensively in the rising price industry and lowers the returns to the factor used intensively in the falling price industry. This implies that free trade would raise the returns to the abundant factor and reduce the returns to the scarce factor.* In the case of a labour-abundant capital-scarce country, free trade would raise the wages and reduce the returns to capital, and a capital-abundant labour-scarce country will experience rise in returns to capital and fall in wages. This is because free trade will increase the demand for the product intensive in the country's abundant factor (for example free trade will increase the demand for the labour intensive goods of the labour-abundant country because of export demand, leading to an increase in demand for labour to increase the supply of the labour intensive product), and will decrease the price of the product intensive in the scarce factor (because the product embodying the scarce factor will be imported). *The increase in the demand for the abundant factor will raise its returns and the fall in the demand*

International trade will increase the returns to the abundant factor and reduce the returns to the scarce factor.

for the scarce factor will reduce its reward. This implies that trade will raise the share of labour in the national income of the labour-abundant country and reduce the share of capital. It will have the opposite effect on income distribution in the capital-abundant country.

The Stolper-Samuelson theorem, thus, suggests that labour abundant developing countries will benefit by adopting a strategy of promotion of labour intensive exports.

Although the SST postulates that the change in the relative product prices leads to a redistribution of income, it is important to remember that whether one will be better off or not will depend not only on the changes in his income but also on the prices of the goods and services he consumes. Those workers who are employed in the rising price industry and consume the import-competing goods will be better off because of the fall in the price of these goods and the rise in the wages. However, as both the price of the exportable good and the wage rate have increased, the effect of trade on workers who consume the exportables is ambiguous. It will depend on whether the wage rate or the product price has risen higher. It becomes more difficult to find out the net effect of trade on the economic welfare of the labour when the labour consumes both the exportable good and the import-competing good.

Further, “we may not see clear-cut income distribution effects with trade because relative factor prices in the real world do not often appear to be as responsive to trade as the H-O model implies. In addition, personal or household income distribution reflects not only the distribution of income between factors of production but also the ownership of the factors of production. Since individuals and households often own several factors of production, the final impact of trade on personal income distribution is far from clear”.³⁵

Metzler Paradox

Lloyd A. Metzler, who examined the relation of the Heckscher-Ohlin theory to the tariff problem, has drawn a conclusion which seems to be different from the Heckscher-Ohlin theory and paradoxical to the Stolper-Samuelson findings.³⁶

In view of the tendency of international trade, according to the Heckscher-Ohlin theory, to equalise relative factor returns among different countries, it might seem that the owners of a factor of production which is relatively scarce in a given country would have a strong interest in restricting international trade. By doing so they could preserve the relative scarcity which might otherwise be threatened by competition from abroad. In a country with an abundant supply of land and a limited supply of labour, for example, the working class might well benefit by tariffs on manufactured goods.

Stolper and Samuelson, in their study which formed a sequel to the works of Heckscher and Ohlin, have shown that the real return and the relative return of a particular factor of production are likely to move in the same direction. In other words, if a tariff increases the share of the national income accruing to the working class, it will also improve the workers’ standard of living, and conversely. According to the Stolper-Samuelson argument, a country with a comparatively small labour supply could thus increase its real wage rate by means of protection, even though national income as a whole were thereby diminished. The workers would, therefore, get not merely a larger share of a smaller pie but a share which was larger, in absolute magnitude, than their previous smaller share of a larger pie. The detrimental effects of the tariff would be shifted entirely upon the country’s “abundant” factors of production.

Metzler points out that, like the earlier works on the subject, the study by Stolper and Samuelson made no allowance for changes in the terms of trade. Since Stolper and Samuelson assumed that a country’s external terms of trade were unaffected by a tariff, they were actually considering the least

favourable case possible with respect to the real income of the country imposing the duty. In the Stolper-Samuelson argument, the tariff interfered with the allocation of resources without bringing about any offsetting favourable movement in the terms of trade. Real income of the country as a whole was, therefore, unambiguously reduced by the import duty.

Metzler argues that although the Stolper-Samuelson argument (i.e. in the case of a country that has a scarcity of labour and therefore imports commodities requiring a large amount of labour, the real as well as the relative returns of labour are increased by a tariff even when the duty reduces real income of the country as a whole—it also implies that the rise in real wages would be even greater if real income as a whole were increased) seems plausible, it is actually misleading because the improvement in terms of trade affects not only real income as a whole but also the degree of scarcity of the so-called “scarce” factors. Paradoxical as it may seem, when changes in the terms of trade are taken into consideration tariffs or other impediments to imports do not always preserve or increase the scarcity of the scarce factors of production. Under some conditions of international demand the industries competing with imports and the scarce factors of production, which are usually required in large amounts in such industries, may benefit from free trade and suffer from protection.

Metzler paradox refers to the possibility that tariffs and export subsidies might have perverse effects on international prices.

Metzler points out that whether a tariff injures or benefits a country’s scarce factors of production depends largely upon how it affects the output of exports and of commodities competing with imports. If output expands in the industries competing with imports and contracts in the export industries, the increased demand for scarce factors of production in the expanding industries will normally exceed the supplies made available in the contracting export industries; and, as Stolper and Samuelson have shown, the real returns as well as the relative shares of the scarce factors in the national income will thus be increased. Nevertheless, when both primary and secondary price changes are taken into consideration, this is by no means a self-evident proposition. The tariff itself is the cause of a direct increase in the domestic prices of imports over and above world prices, and this constitutes an immediate benefit to the industries competing with imports. On the other hand, the tariff is also the cause of a series of events which tend to reduce the world prices of the country’s imports relative to the prices of its exports—i.e. to improve the terms of trade—and this secondary reduction of world prices of imports relative to exports may more than offset the initial primary increase.

Metzler argues that the conclusions of Heckscher-Ohlin as well as Stolper and Samuelson are valid only when the foreign demand for a country’s exports is elastic. When the foreign demand is sufficiently inelastic a tariff, far from protecting industries competing with imports at the expense of the export trades, may actually benefit the latter at the expense of the former. If this happens, resources tend to be shifted from the “protected” industries to the export industries, and the factors of production which are used in relatively large amounts in the export industries enjoy both a relative and an absolute increase in real income.

Metzler, however, points out that despite superficial differences, his conclusions are essentially consistent with those of Heckscher and Ohlin. The contradictory appearance of the conclusions is attributable entirely to a difference in the point of comparison. When Heckscher and Ohlin say that international trade increases the demand for a country’s scarce factors, they mean that the demand is increased compared with the demand in a state of complete isolation. In other words, they are comparing free trade or restricted trade with a state of affairs in which there is no trade at all; this is by no means the same as comparing trade under one tariff system with trade under smaller tariffs.

In short, Metzler paradox refers to the possibility that tariffs and export subsidies might have perverse effects on internal prices in a country. This paradox has roughly the same status as *immiserising* growth and a transfer that makes the recipient worse off; i.e. it is possible in theory but will happen only under extreme conditions and not likely in practice.³⁷

INTRA-INDUSTRY TRADE

One important pattern of international trade left unexplained by the H–O theory is the intra-industry trade or the trade in the differentiated products, i.e. products which are similar but not identical (for example, different models of motor cars). A large proportion of such trade takes place between the industrialised countries.

Historically, the pattern of international trade has undergone major changes. As pointed out in the chapter on *Globalization*, until about the mid-nineteenth century, an overwhelming proportion of international trade was constituted by inter-sectoral trade, where primary commodities were exchanged for manufactured goods. This trade was, to a significant extent, based on absolute advantage derived from natural resources or climatic conditions. During the period 1950–1970, inter-industry trade in manufactures, based on differences in factor endowments, labour productivity or technological leads and lags, constituted an increasing proportion of international trade. Since 1970 intra-industry trade in manufactures, based on scale economies and product differentiation, has constituted an increasing proportion of international trade. Intra-industry trade now accounts for a major share of the international trade.

As indicated above, intra-industry trade refers to the trade between countries in the products of the same industry. For example, a country simultaneously exports and imports steel, exports and imports motorcars etc. Intra-industry trade is highly prevalent in the case of trade between developed countries. Developing countries, however, have been increasingly participating in intra-industry trade. India, for example, has been exporting as well as importing motor cars, electronic products, electrical equipments, crude oil, petrochemicals, textiles and clothing, cardamom, sugar etc.

The North–North trade growth has been driven mostly by intra-industry trade. The intra-EU trade has grown much faster than the average growth in the global trade. The trade growth between the members of the European Union has mostly been due to intra-industry trade rather than inter-industry trade.

As Krugman and Obstfeld observe, “Intra-industry trade tends to be prevalent between countries that are similar in their capital-labour ratios, skill levels etc. Thus, intra-industry trade will be dominant between countries at a similar level of economic development. Gains from this trade will be large when economies of scale are strong and products are highly differentiated. This is more characteristic of sophisticated manufactured goods than of raw materials or more traditional sectors (such as textiles or footwear). Trade without serious income distribution effects, then, is most likely to happen in manufactures trade between advanced industrial countries.”³⁸

Estimates of the indices of intra-industry trade for US industry in the early 1990s has shown that it is more than 90 per cent for inorganic chemicals, power generating machinery, electrical machinery and organic chemicals, more than 80 per cent for medical and pharmaceutical and office machinery and more than 60 per cent for telecommunication equipment and road vehicles. On the whole, “about one-fourth of world trade consists of intra-industry trade, i.e. two-way exchange of goods within standard industrial classifications. Since the major trading nations have become similar in technology and resources, there is often no clear comparative advantage within an industry and much of international trade therefore

Intra-industry trade is dominant in North–North trade.

takes the form of two-way exchanges within industries—probably driven in large part by economies of scale—rather than inter-industry specialisation driven by comparative advantage.”³⁹

Krugman and Obstfeld observe that “intra-industry trade produces extra gains from international trade, over and above those from comparative advantage, because intra-industry trade allows countries to benefit from larger markets ... by engaging in intra-industry trade a country can simultaneously reduce the number of products it produces and increase the variety of goods available to consumers. By producing few varieties, a country can produce each at large scale, with higher productivity and lower costs. At the same time consumers benefit from the increased range of choice”.⁴⁰

Intra-Industry Trade Theories

The interest in the intra-industry trade was largely stimulated by the studies done in the 1960s on the impact of the EEC on the trade flow between the member countries. These studies have shown that the major chunk of the trade is intra-industry trade. This encouraged economists to develop theoretical explanations for the growing intra-industry trade. There are indeed a variety of models, which seek to explain the reasons for intra-industry trade.

Features of Intra-industry Trade Theories

Sodersten and Reed point out that these models, despite their variety, have the following common features.⁴¹

- While it is possible to deduce that intra-industry trade will emerge, it is often impossible to predict which country will export which good(s).
- Diversity of preferences among consumers, possibly coupled with income differences, plays an important role.
- Similarity of tastes between trading partners may play a major role. Economies of scale are a frequent element of intra-industry trade models, and may be an important source of gains from trade.
- In many of these models the move from autarchy to free trade will involve lower adjustment costs than would be the case with inter-industry trade.

Explanations of Intra-industry Trade

The explanations for the intra-industry trade vary from simple reasoning to intricate analysis.

One of the simple explanations of the intra-industry trade is the transportation cost. For example, in the case of geographically vast country like India, the cost of transporting goods from one end of the country to the other extreme end would be very high. Cross-border trade will be beneficial for two adjoining regions of neighbouring countries, other things remaining the same.

Another simple explanation is the seasonal variations between different countries in the production of a particular commodity. Another explanation is that producers cater to ‘majority’ tastes within each country leaving the ‘minority’ tastes to be satisfied by imports.

Such minor market segments, which are overlooked or ignored by the major market players but have potential for other players, are referred to as market *niches* in Marketing Management parlance. Such niches often provide an opportunity for entering the market by new or small players. For example, the large companies in the United States had ignored the market segments for small screen TVs, small cars, small horse-power tractors etc. This provided a good opportunity for the Japanese companies, for whom these products had a large domestic market, to enter the US market. It may be noted that *niche marketing* has been a very successful

High transportation costs, seasonal variations in production between countries, differences in demand pattern etc. may lead to intra-industry trade.

international marketing strategy employed by Japanese companies. Indian companies too have been employing this strategy.

Over a period of time, consumer tastes and preferences and demand patterns may change and a 'minor' market segment may become a large segment. Thus, the oil price hike substantially increased the demand for the fuel efficient compact cars in the US and the Japanese companies enormously benefited from it. Through shrewd marketing strategies a company could succeed, in many cases, in expanding a minor segment of the market into a large segment.

Further, it has also been observed, particularly with regard to the Japanese companies, that after consolidating their position in a market segment, with the strength and reputation they have built up, they gradually move to other segments and expand their total market share.

Another reason for the failure of the basic H-O model to explain the intra-industry trade is, as Kindleberger and Lindert observe, "...to recognise the inadequacy of lumping factors of production into just capital, land and couple of types of labour. In fact, there are many types and qualities of each. Further, there are factors specific to each sub-industry or even each firm. Heterogeneity is especially evident in the higher reaches of management and other rare skills".⁴² In short, the H-O theory can be extended to the inter-industry trade if we recognise the existence within each industry of a number segments with distinctive characteristics and enlarge the definition of factor endowments to include such factors as technology, skill and management also. "Disaggregating the factors of production into finer groupings could add to the explanatory power of the H-O emphasis on factor proportions. Sectors of the economy are bound to look more different in their endowments once finer distinctions are made. In the extreme, endowments of factors of production that are specific to each sector can be very unequal across countries and very intensively used in their own sectors, thereby suggesting explanations for trade patterns."⁴³

Search for the reasons for intra-industry trade led to the development of a number of models in the imperfect competitive environment, which are often referred to as new trade theories. These explanations of the intra-industry trade revolve around factors such as product differentiation, economics of scale, monopolistic competition or oligopolistic behaviour, strategies of multinational corporations etc.

Sodersten and Reed classify the intra-industry trade models into two broad industry structures, viz. intra-industry trade when there are many firms and intra-industry trade when there are only a small number of firms (oligopoly).

Intra-Industry Trade when there are Many Firms

There are mainly three categories of models, which explain the intra-industry trade when there are many firms, viz. Neo-Heckscher-Ohlin models, Neo-Chamberlinian models and Neo-Hotelling models.

Neo-Heckscher-Ohlin Models The neo-Heckscher-Ohlin models seek to explain the intra-industry trade in terms of factor endowments by linking product specifications to different combinations of the basic factors, such as capital and labour. One such model, purported by R.E. Falvey, is described here.

Let us assume a two-country model of an industry, for example industry *X*, producing differentiated goods in both the countries, the basis of differentiation being quality, often referred to as *vertical differentiation*.

It is assumed that higher quality product requires a higher quantity of capital in its production. Let's assume that the production of one unit of *X* requires one unit of labour irrespective of the quality. This means that an improved quality version of the product can be obtained at higher capital-labour ratio

(K/L). The quantity of capital to produce one unit of any variety of good X is P , and the higher is P , the higher is the quality of the good, so that we may use P to index that quality. Then, the cost of producing one unit of good X of quality P in Country A will be:

$$Ca(P) = wa + Pra$$

where wa and ra are the wage rate and the reward to the quality-specific capital respectively in Country A . Similarly, the cost of producing one unit of the same quality X in Country B will be:

$$Cb(P) = wb + Prb$$

If $wb < wa$ and $rb > ra$, Country A may be regarded as the capital rich country and B the labour abundant country.

There will be some quality of the good X , P^1 , where the unit cost is the same in both the countries (we may call this the marginal quality good). This quality is given by

$$wa + P^1ra = wb + P^1rb$$

Country B will have a lower unit cost of production in the case of the sub-marginal quality products and the capital rich A will have an advantage in the production of the super-marginal quality products.

Illustration Suppose that X_1 to X_5 represent different varieties (based on quality) of good X and that cost of one unit of labour is five in Country A and four in B and cost of one unit of capital is four in A and five in B .

In the example given in Table 6.5, X_2 is the marginal variety. Country B has advantage in the production of the sub-marginal variety (X_1) and A has advantage in the production of the super-marginal varieties (X_3 to X_5).

Table 6.5

Factor Combinations and Production Costs

Product Variety	Factor Combination Required	Cost in A	Cost in B
X_1	1L + 0.5 K	$5 + 2 = 7$	$4 + 2.5 = 6.5$
X_2	1L + 1K	$5 + 4 = 9$	$4 + 5 = 9$
X_3	1L + 2 K	$5 + 8 = 13$	$4 + 10 = 14$
X_4	1L + 3 K	$5 + 12 = 17$	$4 + 15 = 19$
X_5	1L + 4K	$5 + 16 = 21$	$4 + 20 = 24$

This kind of situation is true of several industries between developed and developing countries (clothing, leather goods, footwear, engineering goods etc.). Developing countries, either because of their obsession with labour intensive technology or because of the non-availability of the state of the art technology, remain in the low quality segment of the industry, whereas the advanced countries with sophisticated technology dominate the superior quality segment.

An alternative 'Heckscher–Ohlin' explanation of intra-industry trade that has been suggested extends the basic model to include the human capital embodied in skilled labour. If higher quality versions of a good embody a greater proportion of skilled labour (and so of human capital), then the standard Heckscher–Ohlin prediction would apply: Countries that are well endowed with human capital will export goods intensive in that factor.⁴⁴ India's software exports are a good example here.

Neo-Chamberlinian Models Like the neo-Heckscher–Ohlin models, the Chamberlinian and Neo-Chamberlinian models seek to explain intra-industry trade based on product differentiation. There

Differences in factor endowments vis-a-vis vertical product differentiation cause intra-industry trade.

is, however, one important difference related to product differentiation. While in the neo-Heckscher-Ohlin models the product differentiation is vertical (viz. different quality levels), in the Chamberlinian and neo-Chamberlinian models product differentiation is horizontal. For example, in the well-known Lancaster model, a good is viewed as a bundle of attributes. The differences in the product attributes or characteristics offered by firms make the products differentiated.

Perhaps, the most popular neo-Chamberlinian model is the one purported by Paul R. Krugman. The

Like the neo-H-O model, the Chamberlinian and neo-Chamberlinian models are based on product differentiation.

Krugman model marks a distinctive and realistic departure from the traditional models by recognising economies of scale and monopolistic competition.

Features and Implications of Krugman Model The salient features and implications of the Krugman model, which seeks to explain trade between similar countries and intra-industry trade, are the following.

- Factor endowments can determine the broad range of types of goods a country will export and import, but within that broad range product differentiation and economies of scale play a very important role in generating trade and the gains from trade.
- Trade can cause an increase in demand, production and real income, facilitated by economies of scale.
- Trade increases the choice available to consumers and thereby improves consumer welfare.
- Another potential result of the Krugman model is that “the increased well-being from trade is available to all consumers. Thus, even if a person in a ‘scarce factor of production’ in a Heckscher-Ohlin context would tend to lose from trade, the gains for that person in the Krugman model, both from a higher real wage due to the scale economies and from the increased variety of goods due to product differentiation, can more than offset the loss from being in a scarce factor. Hence, the ‘gainer-loser’ income distribution aspects of trade do not necessarily occur if trade consists of an exchange of differentiated manufactured goods produced under conditions of economies of scale”.⁴⁵

The only factor of production in the Krugman model is labour and the economies of scale is reflected in the decreasing ratio of labour to output as production expands. This is incorporated in the following equation:

$$L = a + bQ$$

where L is the quantity of labour needed to produce any specific level of output, a is a technologically determined constant, Q the output level and b specifies the relation at the margin between the output level and the amount of labour needed.

If $a = 10$, and $b = 2$, consider how the labour employed changes for different output levels.

Table 6.6 Output-Cost Relationship

Output Level	Labour Required ($L = a + bQ$)	Labour Required at Constant Returns
50	$10 + 2 (50) = 110$	110
100	$10 + 2 (100) = 210$	220
200	$10 + 2 (200) = 410$	440
500	$10 + 2 (500) = 1010$	1100

The above example reflects the operation of the economics of scale, unlike in the Ricardian model which assumes constant cost (where quantity of labour will increase as shown in the last column of the table).

The second important premise on which the Krugman model is based is the market structure of monopolistic competition.

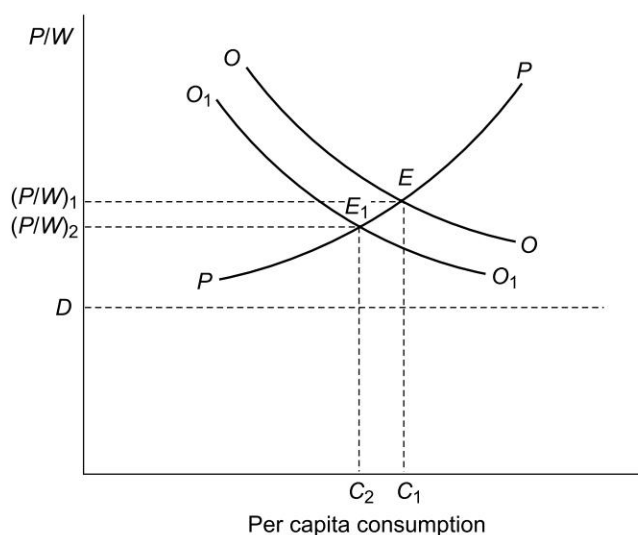


Fig. 6.7 Basic Krugman Diagram

The Krugman model is explained with the help of Fig. 6.7. The horizontal axis represents the per capita consumption of a typical product and the vertical axis indicates the ratio of the price of the product to the wage rate (P/W).

The PP curve reflects the relationship of the price of the product to the marginal cost. Krugman has assumed a constant marginal cost. The upward PP curve indicates that as per capita consumption increases, the price of the product will increase.

As the consumption increases, demand becomes less elastic and with constant marginal cost profit maximisation dictates a higher price. Thus, P/W rises as per capita consumption increases, and the PP curve is upward slope.

The economic profit for a firm in monopolistic competition is zero in the long run equilibrium. Zero profit means that price is equal to average cost. The OO curve reflects this fact.

In Fig. 6.7, equilibrium is established at E where the long-term equilibrium, profit represented by OO , is equal to the price P , at per capita consumption level C_1 .

When trade opens, the market for the firm's good enlarges. So does the market for the foreign firm's good because of the opening up of the domestic market. Although the total demand for the firm's product increases (because of the increase in the number of consumers) the per capita consumption may fall. The increase in the total demand and the consequent production brings down the cost and price because of economies of scale. A new equilibrium is established at E_1 , where the per capita consumption and price are lower than at E . A fall in the price (P/W) means a rise in its reciprocal (W/P). A rise in W/P indicates a rise in the real income because W/P represents the real wage of the workers.

Analyses similar to that of the Krugman model have been done by economists such as Dixit and Norman, Venables, and Lawrence and Spiller.

In the Venables model, which assumes a homogeneous good produced under constant cost conditions, multiple equilibria are possible. According to this model, it is possible for a country to specialise in the production of the differentiated product and the other in the homogeneous product.

While the Krugman model assumed a single factor of production, the one suggested by Lawrence and Spiller is a two-factor two-good model, envisaging a capital intensive horizontally differentiated product and a labour intensive homogeneous product. According to this model, the two countries have different initial factor endowments. Lawrence and Spiller suggest that the number of varieties produced will rise in the capital rich country and will fall in the other, and the scale of production of the differentiated good will increase in the capital rich country, while the labour rich country increases production of the homogeneous good. These results are obviously similar to those of the basic Heckscher-Ohlin model and the Falvey model.⁴⁶

Limitations of neo-Chamberlinian Models As Sodersten and Reed point out, the neo-Chamberlinian models described above are limited by their own assumptions. The form utility function assumed rules out the possibility that consumers have some preference over varieties, and implies that there can never be an excess of varieties. Product variety is also completely independent of demand in such models. The assumptions of the Krugman and Venables also imply that there are no adjustment costs: Firms face no costs in changing the variety they produce, and no variety will disappear with the opening of trade.⁴⁷

Neo-Hotelling Models The neo-Hotelling models of intra-industry trade are essentially based on horizontal product differentiation, consumer preferences for variety and the structural adjustment of the industry accordingly. K.J. Lancaster's paper "Intra-industry Trade Under Perfect Monopolistic Competition", published in 1980, marked the beginning of this stream of the models.

Lancaster has in fact suggested a variety of trade models. The simplest of these assumes that the differentiated variety of a product consists of different combinations of two specific characteristics and that the consumers' preferences defer in that each consumer considers a certain mix of the two core properties in the product as the ideal. Each consumer is assumed to be willing to pay the maximum for this ideal (i.e. his most preferred) variety.

In Fig. 6.8, X_1 to X_6 on the straight line ab represent a spectrum of differentiated varieties of the product X , each variety embodying a combination of the core characteristics A and B . As we move to the right along the line ab , the ratio of B to A in the variety increases and vice versa.

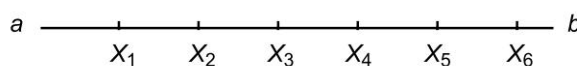


Fig. 6.8

Spectrum of Differentiated Varieties of Product X

If X_3 is the ideal variety for a consumer, he will be prepared to pay the maximum for that. The demand of the consumer for any variety depends on its price and income. For a given income his demand for any other variety will be lower than that for the ideal variety. The farther a variety is from the ideal variety, the lower will be its demand.

In Fig. 6.9, Dx_3 is the consumer's demand curve for the ideal variety X_3 ; Dx_2 and Dx_5 represent the demand curves for varieties x_2 and x_5 .

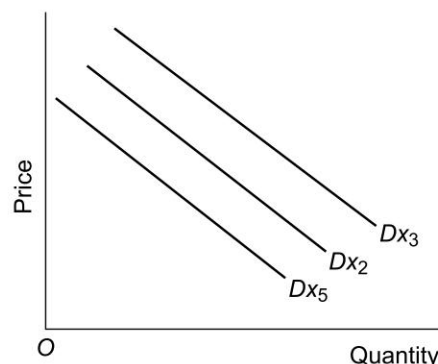


Fig. 6.9

Effect of Difference Between a Variety and Consumer's Ideal Variety on Demand

The Lancaster model assumes freedom of entry and exit for firms and the same cost of production for all the varieties of the goods. These assumptions have important implications for the industry structure and the product varieties available in the market. If there is a very wide gap between two adjacent varieties, that will attract new firm(s). If two varieties are very close in their core characteristics, neither firm will have enough sales to cover all the costs so that one of these firms will have to leave the market or change the variety.

Lancaster's model contemplates what he refers to as perfect monopolistic competition in which each firm will be earning normal profit (i.e. price will be equal to average cost). The freedom of entry and exit along with the equal density of preferences and the identity of same cost functions ensures that in the long run equilibrium the actual varieties produced will be spaced evenly along the spectrum and that each variety will be produced in the same quantity and will sell at the same price.⁴⁸

For discussing the intra-industry trade, the following assumptions are made: There are two countries which are identical in all respects. There are two sectors—the manufacturing sector producing differentiated good and the agricultural sector producing homogeneous good. The differentiated good has an income elasticity of demand greater than one. Production is subject to constant cost. There is one factor (labour) which is mobile, but each sector may have another factor of production which is specific.

As it is assumed that both the countries are identical in all respects, opening of free trade is equivalent to creating one country which is twice the size of either of the two countries, except that factors of production will not move between countries. There will not be any trade in agricultural goods (because it is homogeneous and the cost is the same in both the countries). The differentiated product will be traded and its production will have to be adjusted so that only one firm will produce each product. Each country will have the same number of consumers. As there is no trade in the agricultural good, trade in the manufactured good will have to balance, i.e. each country will export the same volume of each number of goods at the same price. In other words, each country will produce half of the total number of the varieties and half of the total volume of every variety is sold in the domestic market and the balance in the foreign market.

In Fig. 6.10, DD is the domestic demand curve for the firm under autarchy (i.e. when there is no trade) and CC is the average cost curve. Equilibrium is established at E , with OQ output and OP price. The increase in the demand following the opening up of the trade tends to shift the demand curve to the right, to D_1D_1 . D_1D_1 is flatter than DD because the firm can gain more customers by cutting price and a new equilibrium is temporarily obtained at E_1 with OQ_1 output and P_1 price (price falls as the cost falls with increase in output). However, the super normal profit will attract other firm to enter the market with new varieties so that the demand curve will shift backwards to DD and the new long run equilibrium will be at E where the price and the average cost are equal (normal profit) at OQ level of output. The D_1D_1 demand curve is flatter than DD because under trade the increase in the varieties and the consequent increased nearness of the adjacent varieties make it more elastic.

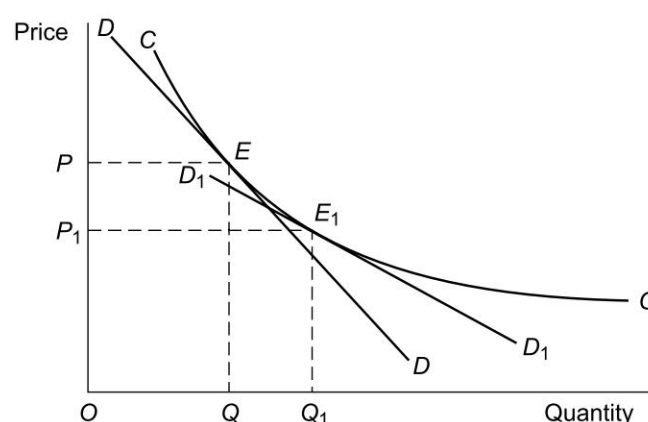


Fig. 6.10 Autarchic and Free Trade Equilibria

Trade will also result in a fall in the number of varieties and firms. When trade opens, initially there will be a doubling of the number of varieties sold in each market. However, as pointed out earlier, if two varieties are very near to each other in their core characteristics neither firm will have enough sales to cover all the costs (smaller volumes increase the average cost), and one of these firms will have to exit or modify the variety to fill a gap in the spectrum.

It is obvious that according to this model the intra-industry trade based on horizontal product differentiation can have several important consequences.

- It will increase the choice available to consumers and enable them to obtain their most preferred or ideal product or one which is nearer to that. In other words, trade will modify each country's consumption, benefiting the consumers.
- Trade will modify each country's production. Some varieties and firms will exit.
- The increase in the output of each firm reduces the cost and price (compare the autarky equilibrium with the new long-term equilibrium in Fig. 6.10). This stimulates consumption and improves consumer welfare.

Lancaster has also analysed a 'Heckscher-Ohlin' variant of his model in which there are assumed to be two mobile factors, with manufacturing capital intensive and agriculture and labour-intensive. The factor endowments in the countries are not so dissimilar that there would be complete specialization with free trade. Lancaster argues that the relatively labour rich country will export both the agricultural goods and some varieties of the manufactured product, and will import the other varieties. The labour

rich country will produce fewer varieties of the manufactured product than will the capital rich country, and will be a net importer of manufactures.⁴⁹

- It is also possible that some consumers who could get their ideal variety under autarchy are not able to get that if that variety has gone out of production because of the production restructuring under trade. However, as trade has brought down the price of all available varieties, it is difficult to say whether consumers are better off now.

Oligopolistic Models

In the previous section, we have dealt with some intra-industry trade models related to market structures characterised by the existence of many firms. Many industries across the world, however, are characterised by oligopolistic competition.

Brander–Krugman Model (Reciprocal Dumping Model) A popular model of intra-industry trade in the oligopolistic situation is the reciprocal dumping model of international trade suggested by James Brander and Paul Krugman.

As the term reciprocal dumping indicates, the Brander-Krugman model envisages a situation in which two firms of two countries resort to dumping in each other's domestic market.

Reciprocal dumping refers to a situation in which dumping leads to two-way trade in the same product.

Dumping is a practice in which a firm sells its products in foreign market at a price lower than its domestic price. "The situation in which dumping leads to two-way trade in the same product is known as **reciprocal dumping**."⁵⁰ The possibility of reciprocal dumping was first noted by Brander in the paper "Intra-industry Trade in Identical Commodities" published in the *Journal of International Economics* in 1981. It was then extended by Brander and Krugman in the paper "A Reciprocal Dumping Model of International Trade" published in the same journal in 1983.

Although many trade models rule out the possibility of two way trade in homogeneous products, the Brander–Krugman model suggests the possibility of such trade even if the two firms in different countries have the same marginal cost and there is no initial difference in the price of the good in the two markets.

The Brander–Krugman model starts with consideration of two monopolies, each producing the same good, one in the home country and the other in the foreign country. To simplify the analysis, it is assumed that these two firms have the same marginal cost. If there are some transport cost between the two markets and if the firms charge the same price, there will be no trade and each firm's monopoly will be uncontested.

Trade may, however, emerge if we introduce the possibility of dumping. In the domestic market, each firm will fix its quantity at that point where the marginal cost is equal to marginal revenue, as a typical monopolist does. The price (average revenue) will be higher than the marginal cost. If it tries to sell more than this quantity in the domestic market, the marginal revenue will fall below the marginal cost resulting in a loss on the additional sales. However, if the firm can sell some quantity in the foreign market at a price which is higher than its marginal cost and cost of transportation, it will add to its profit even if the price of the foreign sales is lower than the domestic price. The impact of the increased supply in the foreign market will fall on the price of the foreign firm and it will not affect the domestic price.

The possibility of selling in the foreign market by an Indian firm exists if:

$$MC_1 + CT < P_f$$

where MC_1 is the marginal cost of the Indian firm, CT the cost of transportation and P_f the price in the foreign market.

Similarly, the foreign firm can sell in India if:

$$MC_f + CT < P_i$$

where MC_f is the marginal cost of the foreign firm and P_i the price in the Indian market.

If these conditions prevail, each firm has an incentive to 'raid' the other market, selling some quantity at a price lower than the home market price but above the marginal and transportation cost. If both firms sell in each other's market, it is reciprocal dumping. In other words, international trade can take place in homogeneous product even when there is no initial difference in the price of the good in the two markets and even though there are some transportation costs. With the opening up of the trade the monopoly situation turns into a duopolistic market structure (which is a form of the oligopolistic structure).

The Brander–Krugman reciprocal dumping model, thus, explains the intra-industry trade in homogeneous products. Such trade will result in the price of the good settling somewhere between the pre-trade price and the marginal cost plus the transportation cost in the short-term. In the long-term, equilibrium price cannot be lower than the average cost.

Brander–Krugman model raises a pertinent question: Is such peculiar and seemingly pointless trade socially desirable? The answer is ambiguous. It is obviously wasteful to ship the same good, or close substitutes, back and forth when transportation is costly. However, notice that the emergence of reciprocal dumping in the model eliminates what were initially pure monopolies, leading to some competition. The increased competition represents a benefit that may offset the waste of resources in transportation. The net effect of such peculiar trade on a nation's economic welfare is therefore uncertain.⁵¹

ECONOMIES OF SCALE

The H–O model is based on the assumption of constant returns to scale. However, with increasing returns to scale (decreasing costs), i.e. when economies of scale exist in production, mutually beneficial trade can take place even when the two countries are identical in every respect.

In Fig. 6.11, PEC represents the production possibility curves of both the Countries A and B (both the nations are assumed to have identical endowments and technology). The production possibility curve is convex to the origin implying economies of scale (for explanation, see Chapter 5). In the absence of trade, both nations produce and consume at point E on indifference curve I .

Economies of scale may prompt international trade.

Since production is subject to increasing returns to scale, it is possible to reduce the cost of production if one country specialises in the production of wheat and the other rice. For example, Country A may specialise completely in the production of wheat (i.e. move from E to P in production) and Country B may move production from E to C , specialising completely in rice. By doing so both nations gain 10 units of wheat and 10 units of rice, as shown by the new equilibrium point N on the indifference curve II , although the production possibilities of both the nations remain the same.

DIFFERENT TASTES

Even if all countries are identical in their production abilities and have identical production possibility curves, there could be a basis for trade as long as tastes differ.

This is illustrated with the help of Fig. 6.12. The production possibility curve shown in the figure represents the production possibility curve for wheat and rice of Country A as well as of B because the production possibilities of both the countries are the same. In other words, both the countries can produce wheat or rice equally well. We assume that A is a wheat preferring country and B is a rice preferring

country. In the absence trade, the preference for wheat and the resultant increase in the demand for wheat will increase the price of wheat in Country *A*. Similarly, a higher price for rice will prevail in the rice preferring Country *B*.

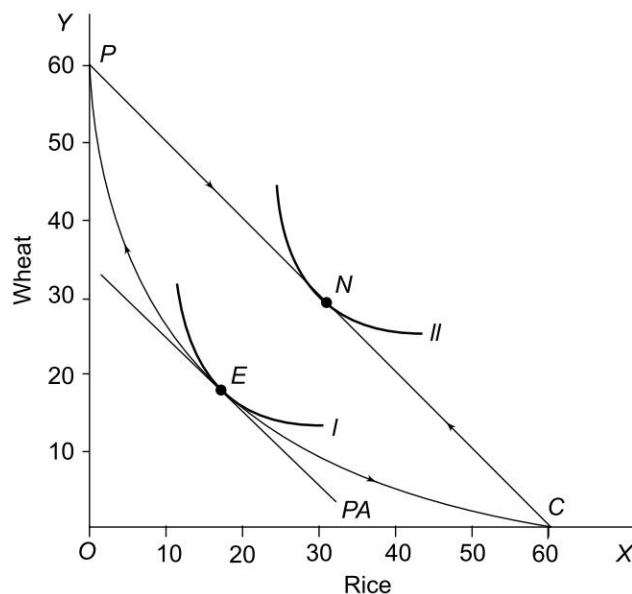


Fig. 6.11 Trade Based on Economies of Scale

The pre-trade positions are represented by points *F* and *G*, respectively, in Fig. 6.12. International trade alters the price structure and establishes a new equilibrium price ratio, *IP*. Producers in both the countries will shift their production so as to make their marginal costs equal to the same international price ratio. Since the production possibilities are the same for both the countries, they will both produce at the same point *E* where the price line is tangent to the production possibility curve. The wheat preferring country will satisfy its greater demand for wheat by importing wheat. Its new consumption point *C* at a higher indifference curve implies that trade enables it to attain a higher level of satisfaction with the same productive resources. Similarly, trade enables the rice preferring Country *B* to reach the point *D* on a higher indifference curve than the pre-trade situation.

Thus, even if production capabilities remain same for two or more countries when tastes differ, mutually beneficial international trade could take place.

TECHNOLOGICAL GAPS AND PRODUCT CYCLES

There are two models which explain international trade based on technological change:

- The Technological Gap Model.
- The Product Cycle Model.

In case of both the models, the key element that causes the trade is the time involved in acquiring the technology by different nations.

According to the **technological gap model** propounded by Posner, a great deal of trade among the industrialised countries is based on the introduction of new products and new production processes. In

other words, technological innovation forms the basis of trade. The innovating firm and nation get a monopoly through patents and copyrights or other factors which turns other nations into importers of these products as long as the monopoly remains. However, as foreign producers acquire this technology

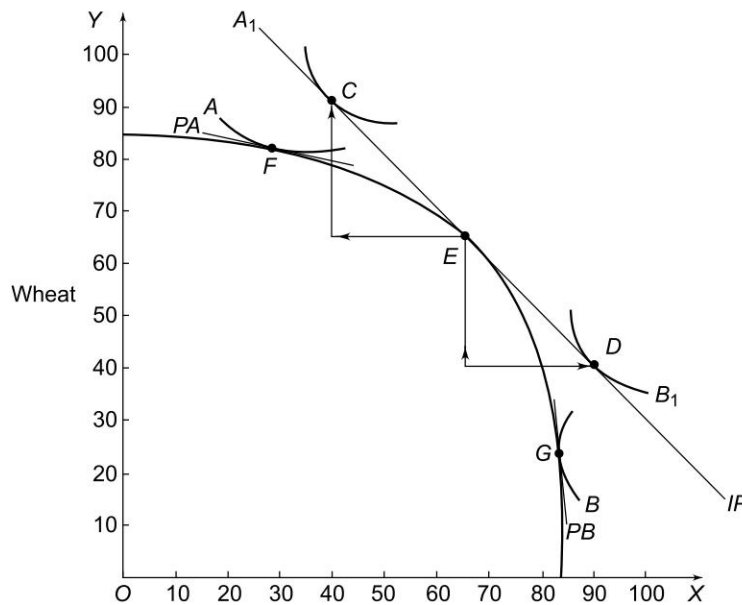


Fig. 6.12 Trade Based on Differences in Tastes

they may become more competitive than the innovator because of certain favourable factors (for example, low labour cost). When this happens, the innovating country may turn into an importer of the very product it had introduced. Firms in the advanced countries, however, strive to stay ahead through frequent innovations which make the earlier products obsolete.

The **product cycle model** developed by Vernon represents a generalisation and extension of the technological model. According to this model an innovative product is often first introduced in an advanced country like the USA (because of certain favourable factors such as a large market, ease of organising production etc.). The product is then exported to other developed countries. As the markets in these developed countries enlarge, production facilities are established there. These subsidiaries, in addition to catering to the domestic markets, export to the developing countries and to the United States. Later, production facilities are established in the developing countries. They would then start exports to the United States (TV receiving sets is one such example). The situation is portrayed in Fig. 6.13.

The international product life cycle theory may be diagrammatically illustrated differently as in Fig. 6.14. Until the point of time, t_1 , the US is the only producer and consumer of the product. At t_1 USA starts producing more than the domestic consumption requirement and other developed countries start importing it from the US. At point t_3 these developed nations become net exporters. As the production in

Over the product life cycle, the production bases shift between countries and, correspondingly, the trade pattern also changes.

other countries grows, exports of US fall and the US eventually becomes a net importer. The developing countries start consumption only at a later stage than the developed countries, and they are net importers until t_4 . As developing countries net exports grow, the developed countries find their exports falling.

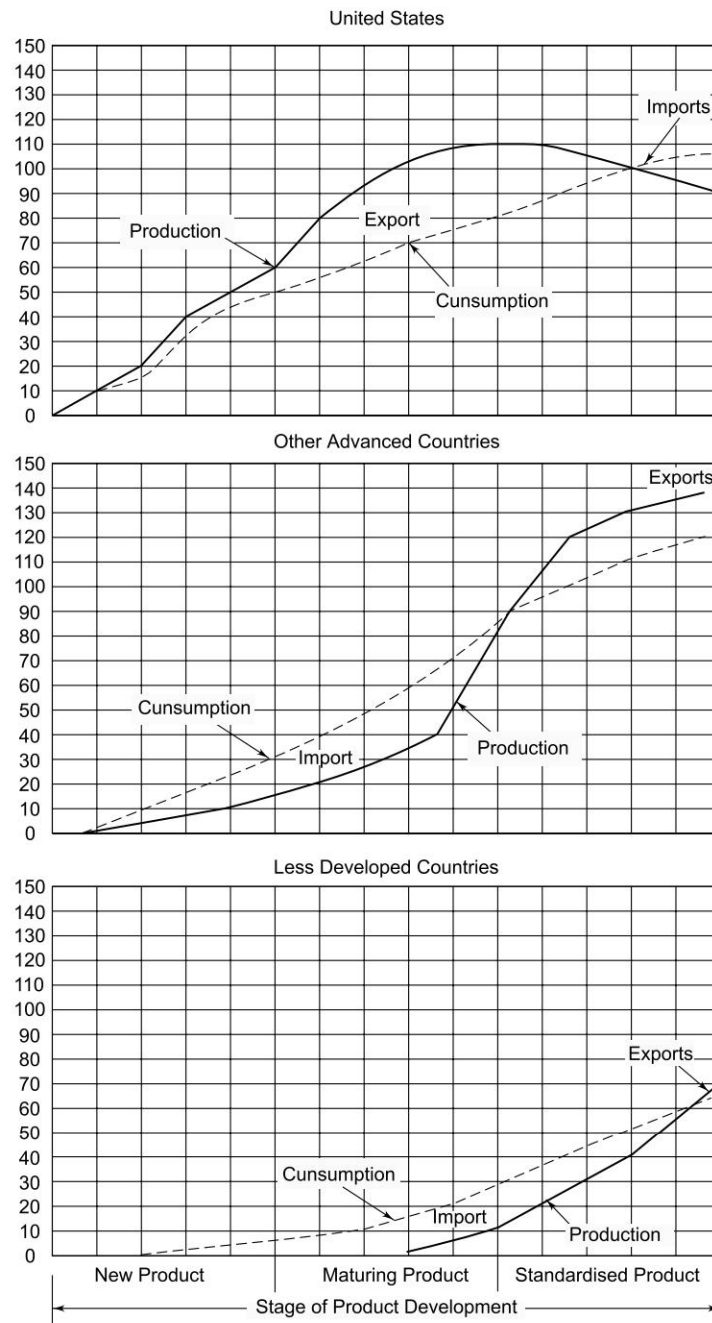


Fig. 6.13 International Trade and Production in the Product Life Cycle

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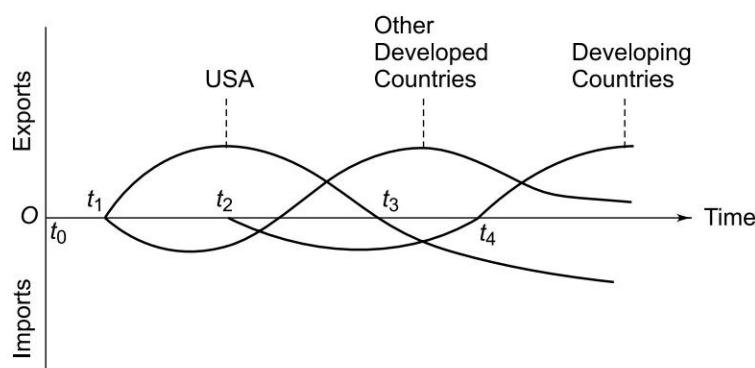


Fig. 6.14 International Trade Cycle Theory

AVAILABILITY AND NON-AVAILABILITY

The *availability approach* to the theory of international trade seeks to explain the pattern of trade in terms of domestic availability and non-availability of goods. Availability influences trade through both demand and supply forces.

The pattern of international trade may be explained in terms of domestic availability and non-availability of products.

In a nutshell, the availability approach states that a nation would tend to import those commodities which are not readily available domestically and export those whose domestic supply can be easily expanded beyond the quantity needed to satisfy

the domestic demand.

Kravis argues that Leontief's findings that the United States' exports have a higher labour content and a lower capital content than United States' imports can be explained better and more simply by the availability factor. Goods that happen to have high capital content are being bought abroad because they are not available at home. Some are unavailable in absolute sense (for example, diamonds), others in the sense that an increase in output can be achieved only at much higher costs (that is the domestic supply is inelastic). When availability at home is due to lack of natural resources (relative to demand), the comparative advantage argument is perfectly adequate.⁵²

According to Kravis, there are other facets of the availability explanation of commodity trade pattern that cannot be so readily subsumed under the rubric 'comparative advantage'. One of these is the effect of technological change. Historical data for the United States suggests that exports have tended to increase most in those industries which have new or improved products that are available only in the United States or in a few other places. Product differentiation and government restrictions are some of the other factors tending to increase the proportion of international trade that represents purchases by the importing country of goods that are not available at home.⁵³

According to Kravis, there are four bases of the availability factor, namely natural resources, technological progress, product differentiation, and government policy.

The first three of the four bases—natural resources, technological progress and product differentiation—probably tend, on the whole, to increase the volume of international trade. The absence of free competition, a necessary condition for the unfettered operation of the law of comparative advantage, tends to limit trade to goods that cannot be produced by the importing country, argues Kravis. The most important

restrictions on international competition are those imposed by the governments and by cartels. Those imports that are unavailable or available only at formidable costs are subject to the least government interference. Kravis thinks that the quantitative importance of the availability factor in international trade must be considerable. This appears to apply especially to half of world trade that consists of trade between the industrial areas, on the one hand, and primary producing areas, on the other.⁵⁴

The availability approach has, undoubtedly, considerable merit in its explanation of the pattern of trade.

FURTHER TOPICS IN TRADE THEORY AND POLICY

Trade in Intermediate Goods

Intermediate goods constitute a substantial share of the international trade. Trade in intermediate goods is fostered by the growing trends of global sourcing.

Most manufactured final goods embody several intermediate goods (or manufactured inputs). For example, hundreds of components/parts go into the production of an automobile.

These intermediate goods may be manufactured in-house or outsourced (i.e. obtained from independent intermediate goods producers. For a long time, there had been a trend towards vertical integration (i.e. manufacturing more of the intermediates in-house). However, in the last few decades the trend has been just the opposite, i.e. de-integration (also known as *hollowing of the corporation*) or outsourcing even what were earlier manufactured in-house. (See the section *Global Sourcing* in Chapter 1, for the reasons for outsourcing.)

Outsourcing has been increasingly assuming global dimensions because global sourcing enables firms to procure the intermediates from the best source anywhere in the world (in terms of price, quality, features etc.). Trade in intermediate goods has, therefore, been growing in importance and volume.

It would be useful to understand the meaning of certain terms which are relevant in this context.

Gross Production and Net Production Gross production or gross output is the total quantity of a good produced by a sector. A part of this output may, however, go to other sectors as intermediate good. Net production is that part of the output of the sector which goes for final consumption (i.e. gross production excluding that which goes to other sectors as intermediate good).

Value Added Value added is the difference between the price at which a final good is sold and the cost of the outsourced intermediates used in the production of the final good.

Inputs and Factors of Production The term inputs is sometimes used very broadly to include even the factors of production (such as labour, land and capital). However, sometimes a distinction is made between inputs and factors of production so that inputs mean those goods used in the production of other goods. Value addition takes place when a final good is made out of these inputs using the factors of production.

Condition for Production of Intermediate and Finished Products An intermediate good will be produced in a country only if its cost of production is less than or equal to the international price. For example, an intermediate good, I , will be produced in the country only if the following condition is satisfied.

$$I_c \leq I_p$$

I_c is the cost of production of the intermediate good in the country and I_p the international price of that good.

A finished good embodying intermediate good will be produced in a country only if the following condition is satisfied.

$$I_x + V_x < X_p$$

I_x is the cost of the intermediate good used in the finished good X , V_x the value added by the country in X and X_p the international price of X .

Free trade tends to increase trade in intermediate goods and finished goods. It tends to increase trade in intermediate goods in two ways. If the domestic cost of producing the intermediate good is more than its international price, imported intermediate good will be used in the finished good for the domestic market. Similarly, imported intermediate good will be used in the finished good for exports.

In the absence of free trade in intermediate good, a country will not be able to export the finished good if the cost of the intermediate good including the value added is higher than the international price of the finished good. However, when there is free trade in intermediate good, if the availability of the intermediate good at international price enables the country to produce the finished good at a cost (cost of intermediate plus value added) lower than the international price, the country can export that product.

Indeed, it is the international sourcing of intermediates that enables many firms to achieve international price competitiveness for their finished products. Non-price factors (such as quality, delivery etc.) also encourage international sourcing.

Intermediates are relatively labour intensive than the finished products. This provides a comparative advantage for the developing countries, where labour is comparatively cheap, in the production of intermediate goods. Many developed country firms, therefore, outsource manufactured inputs from the developing countries.

Non-traded Goods

In international economics, non-traded goods refer to goods which are not traded between countries, and traded goods are those which are internationally traded.

There are several reasons for goods not being traded internationally. These include:

- There is no demand outside the country for certain goods.
- The cost of transportation of the goods is prohibitive vis-à-vis its price.
- The cost of product modification or adaptation to satisfy the foreign market requirements is very high relative to the market size.
- The export of certain goods is not allowed either because of domestic supply situation or other reasons.
- The import of certain goods is not allowed because of protectionist reasons or other reasons such as hazardous nature of the product, economic reasons (import of luxury items), cultural reasons (import of animal tallow to India, for example).
- Absence of developed trade channels or lack of realisation of the trade potential.

Prices of non-traded goods are indigenously determined (i.e. by the interplay of domestic demand and supply) whereas prices of traded goods are determined by the forces of international demand and supply. Prices of traded goods, in respect of small countries in particular, are determined exogenously.

It should, however, be noted that the prices, demand and supply of non-traded goods may not be completely insulated by exogenous factors. For example, developments in the traded goods sector, which are caused by exogenous factors, can affect the non-traded goods sector through its impact on the factor prices and the demand for each sector's goods by the other.

Equilibrium between Traded and Non-traded Goods To examine how the equilibrium in the production and consumption of traded and non-traded goods is established, we may make some assumptions for simplicity. Accordingly, we consider a small country in which there are three sectors—export producing sector, import competing sector and non-traded goods sector. It is further assumed that there are four factors of production of which labour is a common and mobile factor and each of the other factors is special to one of the sectors. Again, the export and import prices are assumed to be fixed so that the import and export goods are merged into a single composite traded good, and factors of production transferred from the non-traded sector to the traded sector will be allocated between the production of export and import-competing goods in a way determined by their fixed relative prices. We, thus, have two sectors—the traded good and the non-traded good for analytical purpose.

In Fig. 6.15, the vertical axis represents traded goods and the horizontal axis represents non-traded goods. The country is at equilibrium at E where the relative price lines PP and the indifference curve representing consumers' preference is tangent to the production possibility curve AB . The equilibrium output is ON of non-traded goods and OT of traded goods. PP which represents the relative price of the traded and non-traded goods is known as the real exchange rate.

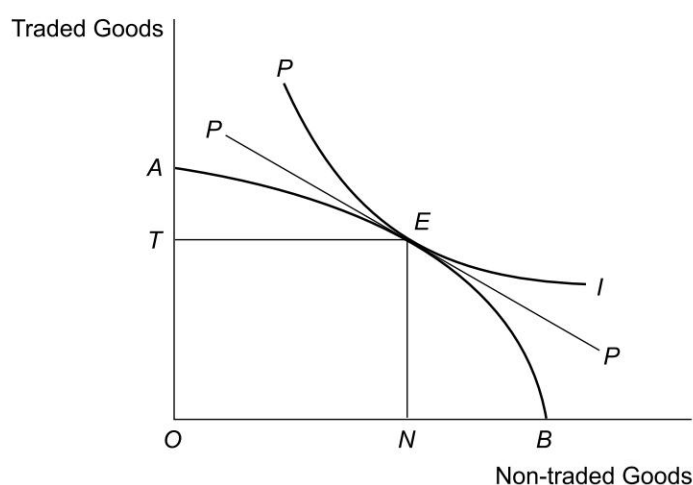


Fig. 6.15

Equilibrium in the Production and Consumption of Traded and Non-Traded Goods

Although the non-traded goods are not directly affected by exogenous factors, the influence of exogenous factors on the traded goods sector can impact the non-traded good sector. For example, we have assumed above that labour is a common factor of production and is mobile between sectors. If the demand for labour in the traded goods changes, it may affect the non-traded sector. The discussion of the Dutch disease that follows throws some light on this.

Dutch Disease

The term *Dutch disease* refers to the deindustrialisation of a sector caused by the boom in another traded good sector. This is called the Dutch disease because this problem was first explained with reference to the development of new natural gas fields in Netherlands and the resultant contraction of the traded manufactured goods sector. It was as if the more the natural gas sector of the Netherlands boomed, the more depressed its manufacturers of traded goods sector became. This phenomenon was also observed in other parts of the world like Britain, Norway, Australia, Mexico and others with newly developed natural resources.

To analyse how it happens, let us assume a small country and fixed supply of labour, the only mobile factor of production. If one of the traded goods sectors expands it will hire more labour causing a rise in the wage rate. This will increase the production costs in all the sectors, both traded and non-traded. The non-traded sector can absorb this cost increase as it can pass it on to the consumers by increasing the price (because there is no import of these goods to fight the high domestic price). The traded good sector, however, cannot increase the price because its price is internationally determined. The impossibility of raising the price as the cost increases would cause a contraction of the industry. The traded good sector will face further problem if the booming export earnings of the expanded traded good sector results in an appreciation of its currency (appreciation of the currency will make country's goods more costly in the foreign market and make the imports cheaper). Thus, the boom in one or some of the traded goods sectors may cause a deindustrialisation of other traded goods sectors. It may adversely affect the exports of other sectors and the import competing industries. Not only that, the non-traded sector may be able to withstand the cost increase by passing it on to the consumers, it may also benefit by the boom in the traded good sector if a part of the increase in the income of that sector is spent on the goods of the non-traded sector.

Although the Dutch disease really implies deindustrialisation, it is pointed out that there are two ways in which industry could actually expand. First, if the price of the natural resource does drop contrary to the terms of the example presented above, and the resource is a major industrial input (such as oil), then profits and production in the industrial sector could be raised instead of cut. Second, the new natural resources could be taxed and the tax proceeds given out, according to industrial production in such a way as to bring net stimulus to industry (e.g. as direct output subsidies or as generous tax breaks for such things as real industrial investment or export sales).⁵⁵ The compatibility of these suggestions with the WTO regulations needs to be ascertained.

Threat of Dutch Disease in India? The substantial increase in the emigrant remittances and the strong performance of the software exports, which have contributed to the growth of foreign exchange reserve, have created concerns about a possible “Dutch disease” effect which may erode the competitiveness of traditional exports of India. The appreciation of the rupee against dollar since the early 2003 has strengthened this feeling in some corners.

The general feeling, however, is that the Dutch disease problem is at best a very distant reality for India. Real appreciation of rupee has been sought to prevent both through reserves build-up and sterilization (the former preventing nominal appreciation and the latter preventing higher inflation). Excessive consumption/investment has been prevented by maintaining the current account deficit (CAD) within sustainable levels. Thus, both the channels through which the Dutch disease can spread, have been effectively regulated and their impact on the economy has been contained. With stronger recovery in demand, the surplus condition created by strong growth in remittances and software exports as well as capita flows would be absorbed automatically, reducing the scope for any Dutch disease effect and the need for any larger than desirable level of reserve build-up.⁵⁶

If the currency appreciation erodes the price competitiveness of a sector, one way out of the problem is to reduce costs by modernisation, productivity improvements etc. Foreign exchange resources may be utilised for helping the modernisation etc. Comfortable reserves position would also help further import liberalization in desired areas and this could also help prevent the occurrence of Dutch disease.

Transportation Cost and International Trade

Transportation cost is the reason for many goods and services not entering international trade. A number of goods which were not traded in the past are traded now because of the increase in the efficiency of transportation, fall in transportation costs and developments such as refrigerated transportation facilities.

Transportation cost prevents equalisation of prices internationally. Prices between countries tend to vary by the extent of the transportation cost.

In Fig. 6.16, the common vertical axis OP measures the price of commodity X in both Country A and country B . In Country A , the pre-trade equilibrium is E_a and the equilibrium price of X is P_a and in Country B they are E_b and P_b .

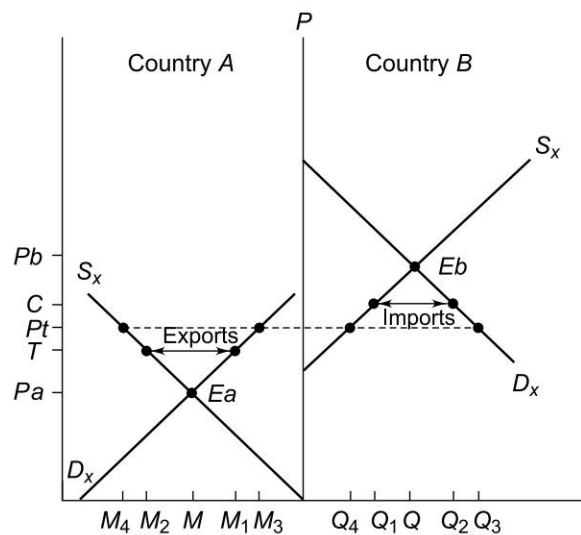


Fig. 6.16 Transportation Cost and International Trade

If the transportation cost between the countries is T_c per unit of X , the post trade price will be P_t , assuming that the cost of transportation will be equally shared between the importer and exporter. As the price in Country A increases to P_t from P_a , domestic demand will fall to M_2 from M and supply will increase from M to M_1 and $M_1 - M_2$ (i.e. the difference between domestic consumption and production) is exported. In country B , the fall in the price from P_b to P_t will have the effect of increasing demand by QQ_2 and reducing supply by QQ_1 , and importing X by Q_1Q_2 . In the absence of transportation cost, the export from country A would have been M_3M_4 and import Q_3Q_4 .

Transport cost may affect international trade by its influence on the location of the industry. In this context, three types of industries may be distinguished.

Material-oriented Industry Industries with high material index (material index is the ratio of the weight of the localised material, e.g. natural resource like iron ore—to the weight of the finished product) tend to be located near the source of the localised material. High material index industries are those which are characterised by substantial weight loss in processing, such as iron and steel, aluminium, basic chemicals etc. Because of this characteristic, the cost of transporting the finished product to the market is substantially lower than the cost of transporting the raw material to the market for the finished product.

Market-oriented Industry Market-oriented industries are those which tend to be located in or near to the market for the finished product. These are industries which add substantial weight/bulk to the product in processing, such as the soft drink industry.

Foot-loose Industries These are industries which neither gain nor lose significant weight in the production process and, therefore, is not significantly influenced by transportation cost in their location. They tend to have high value-to-weight ratio and to be highly mobile or foot-loose. Their location is influenced by factors such as labour cost and other factors of the business environment. Many foot-loose industrial units have been relocated from the developed to the developing countries because of the labour cost factor. It has been common with American firms to ship components to overseas locations to assemble them using cheap labour, and ship the finished product back to the US. For example, it was reported that about one million Mexican workers were employed to assemble US-made components, which were then shipped back to the United States to be packaged into the final product for sale on the US market. (Mexican wages were less than one-sixth the US wages for comparable labour.)

In some cases, high transportation cost may encourage international trade. For example, it may be cheaper to get a product from across the border than from a far off place in the same country.

SEQUENTIAL PATTERN OF INDUSTRIALISATION

As economies develop, certain shifts in their investment, production and trade patterns often occur. A sequential pattern of industrialisation was observed from the agricultural sector to the industrial sector, with small capital requirements to heavy and petrochemical industries, and to precision and electronics industries with latecomers repeating the changes in industrial composition. The process of export-led industrialisation in the Asian countries is perceived to have led to intra-regional spillover effects mainly emanating from technological transfers through direct investment from Japan, and production relocations and outsourcing from the industrial economies. Each shift in the industrial focus of the Japanese economy, from light to heavy to electronics and high-tech industries, created market opportunities for other economies in the region such as Korea and Taiwan. Even within the electronics industries, mid-range goods gradually began to be supplied by Korea, Taiwan, Singapore and Malaysia, and only the most sophisticated goods were produced in Japan. More recently, as Korea, Taiwan and Singapore started specialising in heavy and high-tech goods sectors, the light industries were picked up by Thailand, Philippines and Indonesia. This sequence of industrialisation, often called the “flying geese pattern”,

A sequential pattern of industrialisation is observed as nations move up the development ladder.

succeeded in the East Asian economies in passing on the comparative advantages in manufacturing from a leader to the followers, and then to the followers' followers.⁵⁷

COMPETITIVE ADVANTAGE OF NATIONS

Why does a country achieve international success in a particular industry? Management guru Michael Porter in his renowned *Competitive Advantage of Nations* points out that the answer lies in four broad attributes of a country that shape the environment in which local firms compete that promote or impede the creation of competitive advantage. These factors are factor conditions; demand conditions; related and supporting industries and firm strategy, structure and rivalry.

Countries are most likely to succeed in industries or industry segments where the national *diamond* (a term used by Porter to refer to these four determinants as a system, forming four corners of a diamond when represented schematically) is the most favourable. The diamond is a mutually reinforcing system. The effect of one determinant is contingent on the state of others. While competitive advantage based on one or two determinants is possible, *albeit* usually unsustainable, in natural resource dependent industries or industries involving little sophisticated technology or skills, advantages throughout the diamond are necessary for achieving and sustaining competitive success in the knowledge-intensive industries that form the backbone of advanced economies.

The factors which give global competitive advantage to a nation in an industry are factor conditions, demand conditions, inter-firm rivalry, related and supporting industries, government and chance.

Factor Conditions

Competitive advantage from factors depend on how efficiently and effectively they are employed.

Advanced factors (such as modern digital data communication infrastructure, highly educated personnel and research industries in sophisticated disciplines) and *specialised factors* (such as narrowly skilled personnel, infrastructure with specific properties, knowledge base in particular fields, and other factors with relevance to a limited range or even to a single industry) are more critical in determining competitive advantage than *basic factors* (such as natural resources, climate, location, unskilled and semi-skilled labour and debt capital) and *generalised factors* (such as the highway system, a supply of debt capital or a pool of well motivated educated employees).

Development of advanced and specialised factors demands concerted effort and large and often sustained investments in both human and physical capital. Countries succeed in industries where they are particularly good at factor creation.

It is also important to note that selective disadvantages in the more basic factors can prod a company to innovate and upgrade. For example, the very poor position in natural resources have only served to spur Japan's competitive innovation.

Demand Conditions

There are three attributes of home demand which influence the competitive advantage, viz, the composition (or nature of buyer needs) of home demand, the size and pattern of growth of home demand, and the mechanism by which a nation's domestic demands are transmitted to foreign markets.

Countries gain competitive advantage in industries where the home demand gives their companies a clearer or earlier picture of emerging buyer needs, and where demanding buyers pressure companies to innovate faster and achieve more sophisticated competitive advantages than their foreign rivals.

The size and pattern of growth of home demand can reinforce the national advantage in an industry: Large home market size can lead to competitive advantage in industries where there are economies of scale or learning, by encouraging a country's firms to invest aggressively in large-scale facilities, technology development and productivity improvements. Large home demand, however, will be an advantage only if it is for segments that are demanded in other countries.

A country may also gain advantage when its domestic demand internationalises and pulls its products and services abroad. This may happen when a country's buyers for a product or service are mobile (like those who extensively travel abroad) or are MNCs, or when domestic needs and desires get transmitted to or inculcated in foreign buyers (for example US medical equipment firms find a receptive audience abroad in the doctors trained in the US).

Related and Supporting Industries

The presence in the country of related and supporting industries that are internationally competitive creates advantages in downstream industries in several ways such as the supply of the most cost-effective inputs in an efficient and sometimes preferential way. More important, however, is the advantage they provide in innovation and upgrading based on close working relationships.

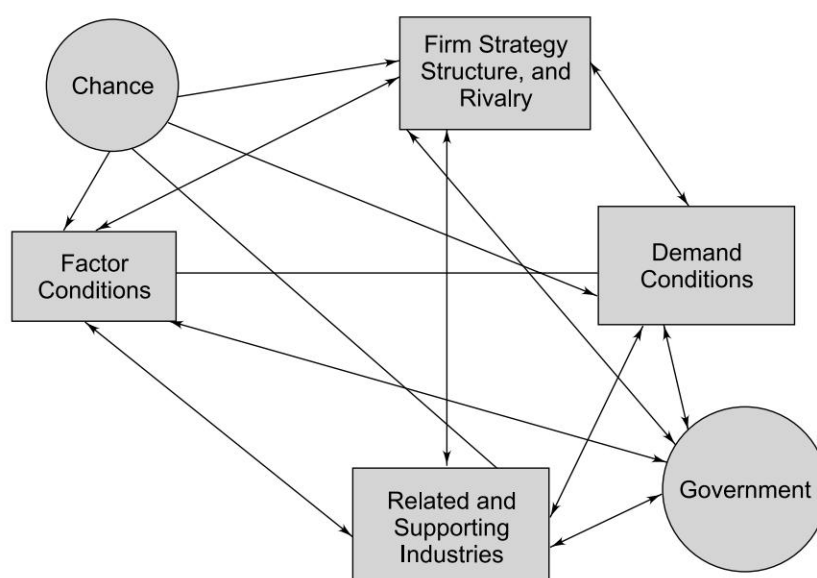


Fig. 6.17

Factors Determining Competitive Advantage of Nations

Firm Strategy, Structure and Rivalry

National circumstances and context create strong tendencies in how companies are created, organised and managed as well as what the nature of domestic rivalry will be.

Among all the points on the diamond, domestic rivalry (i.e. competition) is arguably the most important because of the powerfully stimulating effect it has on all others. Domestic rivalry not only creates pressures to innovate but to innovate in ways that upgrade the competitive advantages of a nation's firms.

Role of Government and Chance

In addition to the above four determinants which shape the competitive advantage of countries, two variables, viz. government and chance, also play important roles.

Government can influence each of the four determinants by industrial, fiscal and monetary policies, promotional and regulatory measures in respect of industry and trade etc.

Chance events can affect competitive position because of developments such as major technological breakthroughs or new inventions, political decisions by foreign governments, wars, significant shifts in world financial markets or exchange rates, discontinuities in input costs such as oil shocks, surges in world or regional demand etc.

The complete system determining the competitive advantage of nations, as presented by Porter, is portrayed in Fig. 6.17, the system consisting of the four determinants excluding government and chance represents the diamond.

SUMMARY

There have been a number of theoretical explanations of the bases and pattern of international trade. The oldest of the dominant trade philosophy is known as **Mercantilism**. The mercantilists argued that government should do everything possible to maximise exports and minimise imports. Very active state intervention was required to implement the mercantilist philosophy. According to mercantilism, economic activity was a *zero-sum game* (i.e. one's gain is the loss of another). This view was challenged by Adam Smith and David Ricardo who demonstrated that trade was a positive sum game in which all trading nations can gain even if some benefit more than others. Despite the scathing criticism of mercantilism by economists, it is by no means dead. In most trade negotiations, the negotiating countries, both developed and developing, often press for more trade liberalisation in areas where their own comparative competitive advantages are the strongest and to resist liberalisation in areas where they are less competitive and fear that imports would replace domestic production. We now, thus, confront neo-mercantilism.

Adam Smith believed that the basis of international trade was **absolute cost advantage**. According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at an absolute advantage (over the other country) and the other country could, in turn, produce another commodity at an absolute advantage over the first. Smith rightly pointed out that the scope for division of labour (i.e. specialisation) depended on the size of the market. Free international trade, therefore, increases division of labour and economic efficiency and consequently economic welfare.

Challenging the Smith theory, famous classical economist David Ricardo has demonstrated that the basis of trade is the *comparative cost difference* i.e. trade can take place even in the absence of absolute cost difference, provided there is comparative cost difference. According to the **comparative cost theory**, if trade is left free, each country, in the long run, tends to specialise in the production and export of those commodities in whose production it enjoys a comparative advantage in terms of real costs, and to obtain by importation those commodities which could be produced at home at a comparative disadvantage in terms of real costs, and that such specialisation is to the mutual advantage of the countries participating in it.

The classical theories were based on a number of wrong assumptions, viz. labour is the only element of cost of production and goods are exchanged against one another according to the relative amounts of labour embodied in them (*labour cost theory of value*); labour is perfectly mobile within the country but perfectly immobile between countries; labour is homogeneous; constant returns; international trade is free from all barriers; no transport cost; full employment; perfect competition etc. Further, the analysis was too much simplified by a two-countries-two commodities model. However, although the relaxation of these assumptions make the analysis complex and difficult, it does not negate the basic revelations made by these theories. In fact, many extensions of the classical theories have been done by removing the assumptions or adding new dimensions.

The Ricardian theory, though based on a number of wrong assumptions, has been regarded as an important landmark in the development of the theory of international trade. According to the Nobel laureate Paul Samuelson, "The theory of comparative advantage has in it a most important glimpse of truth... A nation that neglects comparative advantage may have to pay a heavy price in terms of living standards and potential rates of growth".

The **opportunity cost theory** put forward by Gottfried Haberler by displacing one of the main drawbacks of the Ricardian comparative cost theory, viz. labour cost theory of value, gave a new life to the comparative cost theory by restating it in terms of opportunity costs. The opportunity cost of anything is the value of the alternatives or other opportunities which have to be foregone in order to obtain that particular thing. According to the opportunity cost theory, the basis of international trade is the differences between nations in the opportunity costs of production of commodities. Accordingly, a nation with a lower opportunity cost for a commodity has a comparative advantage in that commodity and a comparative disadvantage in the other commodity. The superiority of Haberler's approach is that it recognises the existence of many different kinds of productive factors whereas Ricardo considered only labour. The opportunity cost theory is a refinement of the Ricardian theory. As far as the basis of international specialisation and trade are concerned, the logic behind the comparative cost approach and the opportunity cost approach are the same.

The **factor endowment theory**, developed by Eli Heckscher and Bertil Ohlin, establishes that trade, whether national or international, takes place because of the differences in the factor endowments of the various regions (for example one country may be rich in capital and another in labour) and the differences in the factor intensity of various products (like capital intensive products and labour intensive products) and trade will lead to commodity and eventually factor prices equalisation internationally. The factor endowment theory consists of two important theorems, namely, (i) **Heckscher–Ohlin theorem** which states that a country has comparative advantage in the production of that commodity which uses more intensively the country's more abundant factor, and (ii) **Factor price equalisation theorem** which says that free international trade equalises factor prices between countries, and, thus, serves as a substitute for international factor mobility. The H-O theory is also based on most of assumption of the classical theories mentioned above.

There is a significant portion of the international trade that is not explained by the basic Heckscher-Ohlin model. Some theories have been propounded to explain different patterns of or reasons for trade which are not explained by the basic H-O model. These theories are described as complementary trade theories or extensions of the H-O trade model.

The **Stolper–Samuelson theorem**, which explains the effect of change in relative product prices on factor allocation and income distribution, postulates that an increase in the relative price of a commodity raises the return or earnings of the factor used intensively in the production of that commodity. That is, if the relative price of labour intensive commodity rises, that will cause an increase in the wages. Similarly, an increase in the relative price of capital intensive product will raise the return on capital. Free trade will raise the returns to the factor used intensively in the rising price industry and lower the returns to the factor used intensively in the falling price industry. This implies that free trade would raise the returns to the abundant factor and reduce the returns to the scarce factor.

A large and growing proportion of the international trade, particularly the North-North (industrialised countries) trade, is **intra-industry trade** or the trade in the differentiated products, i.e. products which are similar but not identical (for example, different models of motor cars). There is indeed a variety of models which seek to explain the reasons for intra-industry trade. Sodersten and Reed point out that these models, despite their variety, have the following common features. First, while it is possible to deduce that intra-industry trade will emerge, it is often impossible to predict which country will export which good(s). Second, diversity of preferences among consumers, possibly coupled with income differences, plays an important role. Third, similarity of tastes between trading partners may play a major role. Fourth, economies of scale are a frequent element of intra-industry trade models, and may be an important source of gains from trade. Finally, in many of these models the move from autarky to free trade will involve lower adjustment costs than would be the case with inter-industry trade.

The explanations for the intra-industry trade vary from simple reasoning to intricate analysis. One of the simple explanations of the intra-industry trade is the high transportation cost between different places of the same country when the transportation cost across the border is low. Another simple explanation is the seasonal variations between different countries in the production of a particular commodity. Another reason for the intra-industry trade is that producers cater to 'majority' tastes within each country leaving the 'minority' tastes to be satisfied by imports.

The H-O model is based on the assumption of constant returns to scale. However, with increasing returns to scale (decreasing costs), i.e. when **economies of scale** exist in production, mutually beneficial trade can take place even when the two nations are identical in every respect.

Even if all countries are identical in their production abilities and have identical production possibility curves; there could be a basis for trade as long as there are **differences in tastes**.

The **technological gap** between countries and the shift in the comparative cost advantage in production over the **product cycle** also give rise to international trade.

According to the **availability approach** to the theory of international trade, a nation would tend to import those commodities which are not readily available domestically and export those whose domestic supply can be easily expanded beyond the quantity needed to satisfy the domestic demand.

Management guru Michael Porter points out that the **competitive advantage of a nation** in any industry is shaped by four broad attributes, viz. factor conditions; demand conditions; related and supporting industries; and firm strategy, structure and rivalry. In addition to these, government and chance also play important roles.

As economies develop, certain shifts in their investment, production and trade patterns often occur. A sequential pattern of shifts is observed.

Review Questions

1. Critically examine the Comparative Cost Theory.
2. "If theories, like girls, could win beauty contests, comparative cost theory would certainly rate high in that it is an elegantly logical structure." Discuss.
3. Give a brief account of the elaborations and refinements of the classical theory.
4. Explain the opportunity cost theory.
5. Discuss the factor endowment theory.
6. Evaluate the Heckscher-Ohlin model.
7. Explain the factors which determine the competitive advantage of nations.
8. With reference to the Porterian model of competitive advantage of nations, discuss why India could not gain much competitive advantage.
9. Give a brief account of the intra-industry trade theories.
10. Write notes on the following:
 - (a) Non-competing groups.
 - (b) Factor endowment.
 - (c) Factor intensity reversals.
 - (d) Heckscher-Ohlin theorem.
 - (e) Factor price equalisation theorem.
 - (f) Leontief paradox.
 - (g) Intra-industry trade.
 - (h) Technological-gap model.
 - (i) Product Cycle Theory.
 - (j) Availability and non-availability approach.
 - (k) Non-traded goods.
 - (l) Trade in intermediate goods.

- (m) Stolper- Samuelson theorem.
- (n) Metzler paradox.
- (o) Dutch disease.
- (p) Transportation costs and international trade.

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CHAPTER 7

7

Gains from Trade and Terms of Trade

LEARNING OBJECTIVES

- ☐ To understand the gains from international trade.
- ☐ To examine the factors which influence the distribution of the gains.
- ☐ To know the different concepts of terms of trade.
- ☐ To understand the problems/disadvantages of trade.

GAINS FROM TRADE

The tremendous expansion of international trade is in itself the best proof that countries gain from trade.

The comparative cost theory demonstrates the fact that international trade can increase real income and consumption. Consider the example we used to illustrate the comparative cost theory in the previous chapter and assume that when Portugal and England trade, the exchange ratio settles at one unit of wine equal to one unit of cloth. This implies that people in England will now have to part with only one unit of cloth to obtain one unit of wine (in the absence of trade, it is 1.2 unit of cloth for one unit of wine). Thus, the British can now save 0.2 unit of cloth on every unit of wine they purchase. This represents an increase in their real income. This increase in the real income enables them to increase their total consumption. Similarly, the Portuguese can get one unit of cloth for every unit of wine; in the absence of international trade it is only 0.88 unit of cloth. Thus, they gain 0.12 unit of cloth on every one unit of wine they exchange. This shows the international trade can actually increase economic welfare.

Free international trade enhances global economic welfare.

That international trade can increase both consumption levels and economic welfare can be demonstrated diagrammatically. In Fig. 7.1, AA represents the production possibilities of Country A , producing X and Y . In the absence of trade, equilibrium is established at point E , the domestic exchange ratio being represented by the price line PP . When there is trade, Country A contracts the output of Y and expands that of X because it is more economical for her to specialise in X . If the country chooses to have the old level of consumption of X , it can export the additional output of X equivalent to MN and import ME_1 of Y because P_1P_1 represents the international exchange ratio. Note that for MN of X only ME of Y can be obtained domestically. Hence, the gain from the trade is equivalent to EE_1 of Y . The new equilibrium point E_1 is on a higher indifference curve, C_1I_1 , when compared to E on CI . This proves that international trade has made the community better off. It is quite clear that in the absence of trade the country would

not have been able to reach the consumption point E_1 because it is beyond the production possibilities of the country.

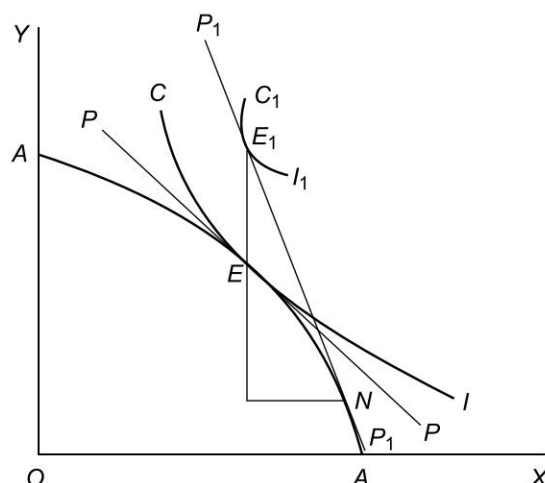


Fig. 7.1 Gains From Trade

International trade, thus, leads to the division of labour or specialisation on a larger scale. As Adam Smith has rightly pointed out, division of labour is limited by the extent of the market. International trade enlarges the market and, therefore, the scope of division of labour. International trade, thus, increases the gain from the division of labour.

When there is free trade, goods and services produced all over the world are available to people everywhere. In other words, international trade makes available to the people of a country a galaxy of goods and services at the most competitive prices. A country may not have the factor endowments or technological capability to produce certain goods. If there is no trade with other countries it will have to do without such goods, but through international trade it is able to procure them.

Free international trade makes available goods and services produced all over the world at the most competitive prices.

The gains from international trade may be summed up as follows:

- It encourages the development of the most efficient sources of supply.
- International trade enables specialisation on a large scale because of the expanded market, which enables the realisation of economies of scale. When the size of the market is limited, certain investments are uneconomical.
- International specialisation and the economies in production make goods available comparatively cheaper.
- International trade increases real incomes and consumption. This could lead to expansion of employment and output, and foster economic growth.
- Trade on a global scale makes available even goods that cannot be domestically produced.
- Trade enables a country to conserve certain scarce resources, as commodities which embody these scarce resources may be imported from countries where they are abundant.

Distribution of Gains

The gains from trade may not be evenly distributed between the participants. Some countries may gain more whereas others may gain relatively less.

The most important determinant of the distribution of gain is the *terms of trade*, i.e. the rate at which a country's exports are exchanged for imports.

Gains from trade may not be equitably distributed between nations.

The greater the difference between the domestic cost ratios (i.e. difference between cost ratio in Country *A* and cost ratio in Country *B*), the greater will be the gains from the trade. However, the distribution of the gains between the two countries will depend upon the international exchange ratio or the terms of trade. The closer the terms of trade to the domestic exchange ratio of a country, the lesser will be the gain for that country and the greater will be the gain for the other country and vice versa.

Taking the example used to illustrate the comparative cost theory, if the terms of trade is nearer to one unit of wine equal to 1.2 unit of cloth (exchange ratio in England), Portugal will be gaining more; but if the terms of trade is nearer to 1 unit of wine = 0.88 unit of cloth (exchange ratio in Portugal), England will be gaining more.

Thus, terms of trade is the major determinant of the gains from trade for a country. Hence, to understand more about the factors that determine the distribution of gains from trade, one should examine the factors that influence the terms of trade. These are dealt with in the section *Influences on Terms of Trade* later in this chapter.

Special Gains to Small Countries

Theoretically, small countries may gain more than large countries from international trade. This is because a small country can specialise in the production of a single commodity without significantly affecting its price in the international market, but if a large country specialises in the production of a single commodity, the significant increase in its supply would cause a fall in its price, adversely affecting its terms of trade.

As a small country's supply is not likely to significantly affect international supply and price situations, it may be able to trade with a large country at the price ratio prevailing in the large country or very close to it. As we have seen above, the closer the terms of trade to the pre-trade exchange ratio in the foreign

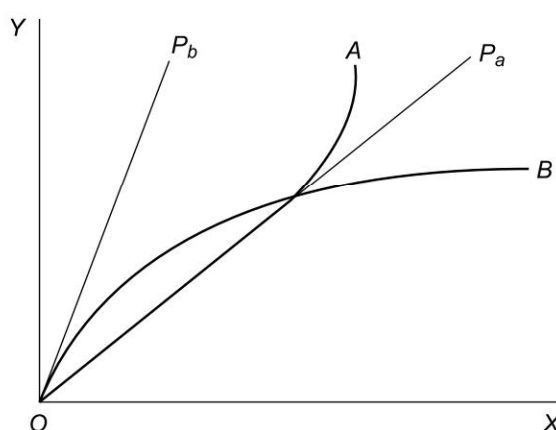


Fig. 7.2

Gains to Small Countries

country, the lesser will be the gain from trade for the foreign country and the greater will be the gain for the other country. Hence, under such a situation, most of the gains from the trade will accrue to the small country. Figure 7.2 illustrates such a hypothetical case. P_b represents the pre-trade exchange ratio in Country B , which is a very small country, and P_a the pre-trade exchange ratio in Country A , a very large country. OB is the offer curve of Country B and OA the offer curve of Country A . Country B is so small that its offer curve crosses the straight line segment of the offer curve of Country A . Thus, international trade takes place at the domestic exchange ratio in Country A , enabling Country B to capture all the gains.

Disadvantages/Problems of Trade

International trade has certain disadvantages/problems as well:

International trade produces several problems too.

- One important problem is that the gains from trade are not equally distributed. There is a general feeling that a major part of the gains from trade are cornered by the more developed countries.
- International trade sometimes leads to fast exhaustion of non-replenishable resources. This is especially so in the case of less developed countries whose exports are mostly natural resources or commodities embodying natural resources.
- International trade sometimes ruins domestic industries and competition.
- International trade sometimes disturbs domestic economic institutions and structures, as well as social and political set ups.

TERMS OF TRADE

As stated above, terms of trade is the most important determinant of the distribution of gains from trade. Terms of trade is an important measure to evaluate gains to individual countries from international trade. Hence, this section discusses this concept in detail.

Mill's Doctrine

The Ricardian theory pointed out that the basis of international trade was comparative cost differences in production. Ricardo, however, made no attempt to explain how values were determined in international trade. If we take the example given to illustrate the comparative cost theory, when England and Portugal trade with each other, the exchange ratio must lie somewhere in between the two extremes of 1 unit of wine = 1.2 unit of cloth (domestic exchange ratio in England) and 1 unit of wine = 0.88 unit of cloth (domestic exchange ratio in Portugal). Ricardo did not attempt to explain where exactly the international exchange ratio would lie and how it would be determined. It was left to John Stuart Mill to explain the determination of the terms of trade in international trade.

Terms of international trade is the ratio of exchange between a nation's export and import goods.

In international economics, terms of trade refer to the ratio index of export prices to import prices. In other words, it is the ratio at which a country's exports are exchanged for imports.

According to Mill's doctrine, the international terms of trade between two commodities will depend upon the strength of the world supply and demand for each of the two commodities. In other words, the terms of trade is determined by reciprocal demand. If people have an intense desire for wine (relative to the available supply) the exchange ratio

will settle, in our example, near 1 unit of wine = 1.2 unit of cloth (i.e. it will be more favourable to Portugal). On the other hand, if cloth is much in demand in both the countries, the final exchange ratio will settle near 1 unit of wine = 0.88 unit of cloth (i.e. it will be more favourable to England).

In short, Mill points out that the actual ratio at which goods are traded will depend upon the strength, and elasticity of each country's demand for the other country's product, or upon reciprocal demand. The domestic cost ratios determine the range and the relative strength of reciprocal demand sets the actual terms of trade within this range.

Mill has also pointed out that when the value of each country's exports just equals the value of its imports, the terms of trade will be in equilibrium. This condition has been referred to by Mill as the *equation of international demand*.

The terms trade will depend on the strength and elasticity of each country's demand for the other country's products, i.e. reciprocal demand

Ellsworth and Leith sum up the reciprocal demand theory as follows: (1) the possible range of barter terms is given by the respective domestic terms of trade as set by comparative efficiency in each country; (2) within this range, the actual terms depend on each country's demand for the other country's produce; and (3) finally, only those barter terms will be stable at which the exports offered by each country just suffice to pay for the imports it desires.¹

Evaluation Mill's theory is subject to a number of criticisms. Graham even argues that this theory in its essence is fallacious and should be discarded.

Unrealistic Assumptions Mill's theory is based on a number of assumptions characteristic of most classical economic analyses, such as the existence of full employment, perfect competition, free trade, free mobility of factors of production, specialisation on the basis of comparative advantage and the two-country-two-commodity model. Although these assumptions are wrong, they do not completely invalidate Mill's doctrine.

Overemphasis on Demand According to Graham, one of the important defects of the reciprocal demand theory is that it concentrates too much on the demand and neglects the role of supply in determining international values. Actually supply conditions can vary significantly to affect the international exchange ratios.

Neglect of Domestic Demand The domestic demand (not only foreign demand) can also affect the terms trade. This factor, however, does not appear to have been given due importance by Mill.

Neglect of Variations in Income Mill's theory does not recognise the possibility of variations in income of the countries and its impact on the terms of trade.

Neglect of other Relevant Factors Graham argues that Mill has neglected several factors, besides supply, such as price and wage rigidities, transitional inflationary and overvaluation gaps and balance payments problems which could impact the exchange ratios.

Unequal Size of Nations The reciprocal demand theory best applies when both nations are of equal economic size, so that the demand of each nation has a noticeable effect on market price. But if one nation is small and the other very large, the relative demand strength of the smaller nation is likely to be dwarfed by that of the larger nation, and the international price ratio will be very close to the domestic price ratio of the larger nation. If both the nations are of approximately the same size and with similar taste patterns, the gains from trade will be shared about equally between them. However, if one nation is

significantly larger than the other, the larger nation attains fewer gains from trade while the smaller nation attains most of the gains from trade.

Despite the criticisms, Jacob Viner points out that the “reciprocal demand analysis is an attempt, imperfect but superior to available substitutes, to describe the aggregate or average results of such changes in desires or cost when they affect appreciably a wide range of commodities”.²

The “terms of trade can be directly influenced by the reciprocal demands and by nothing else. The reciprocal demands in turn are ultimately determined by the cost conditions together with the basic utility functions”.³

Viner also points out that “in the exposition of Mill and his followers, the defect is not that they exaggerated the importance of reciprocal demand in the determination of terms of trade, which is logically impossible, but that whatever they may have known, they did not sufficiently emphasise the influence of cost conditions on reciprocal demand”.⁴

Offer Curves and Equilibrium Terms of Trade

We may take the help of the offer curves to illustrate the determination of the equilibrium terms of trade. In Fig. 7.3, OA represents the offer curve of Country A which specialises in the production of commodity X , and OB represents the offer curve of Country B which specialises in the production of commodity Y . OT represents the equilibrium terms of trade and E the equilibrium point. When the terms of trade is OT , Country A would be willing to offer OX of X for OY of Y and Country B would be willing to offer OY of Y for OX of X . Hence, E emerges as the point of equilibrium, OT being the equilibrium terms of trade.

What would happen if the terms of trade change? Suppose that the terms of trade have changed from OT to OT_1 . This shift of the terms of trade curve towards the right implies that commodity X has become cheaper in terms of Y . At the new terms of trade, i.e. OT_1 , Country B would demand OX_2 of X , but Country A would be willing to supply only OX_1 of X . Thus, at OT_1 terms of trade, there is an excess demand for X equivalent to X_1X_2 . This excess demand would tend to drive the price of X upwards. As the price of X increases, its supply would also tend to increase. These changes would have the effect of re-establishing the equilibrium terms of trade.

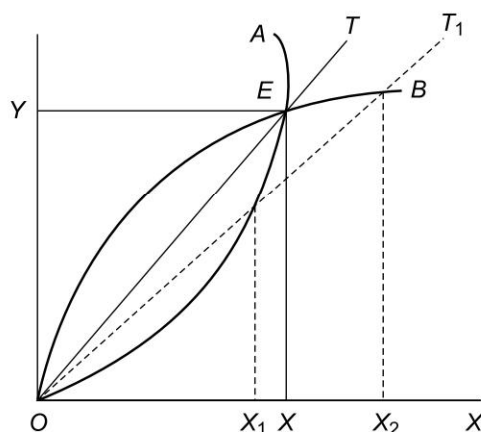


Fig. 7.3

Offer Curves and Terms of Trade

Effect of Changes in Demand on Terms of Trade

A change in the demand for a commodity would cause a change in the equilibrium terms of trade. In Fig. 7.4, assume that OT is the original terms of trade and E the corresponding equilibrium point, established by OA , the offer curve of Country A producing X and OB , the offer curve of Country B producing Y . Now, suppose that the demand for X increases in Country A , causing an increase in its price. This increase in price will shift the offer curve of Country A towards the left implying that now Country A will have to be offered more Y to make it part with any given amount of X .

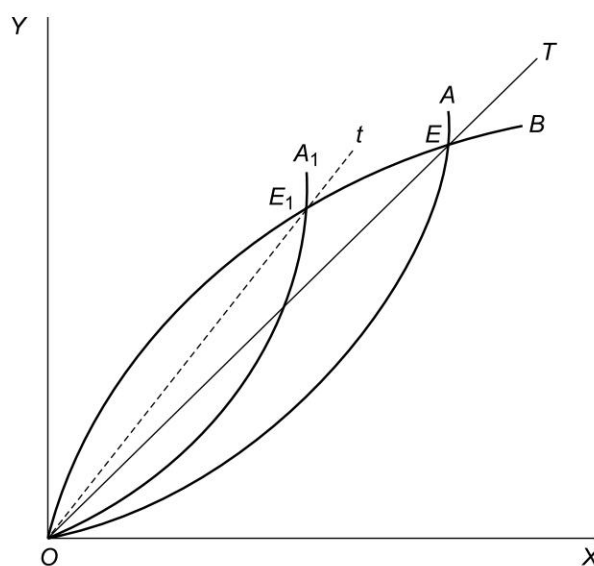


Fig. 7.4 Effect of Changes in Demand on Terms of Trade

Suppose that as a result of the change in demand for X and the concomitant increase in price, the offer curve of Country A shifts from OA to OA_1 (Fig. 7.4). Then E_1 will emerge as the new equilibrium point and Ot the corresponding equilibrium terms of trade.

It is quite clear from the Fig. 7.4 that the shift in Country A 's offer curve to the left has caused a decline in the volume of international trade. This is natural because as the domestic demand for X increased in Country A , the amount of X now available and offered for exports has also reduced. As exports pay for imports, lower exports of X would also mean lower imports of Y .

Relative changes in demand and supply affect terms of trade.

Effect of Change in Supply on Terms of Trade

Suppose that due to an advance in technology, the output of X increases in Country A . *Ceteris paribus*, this increase in the supply of X will cause a fall in its price and a shift in the offer curve of Country A towards the right as shown in Fig. 7.5.

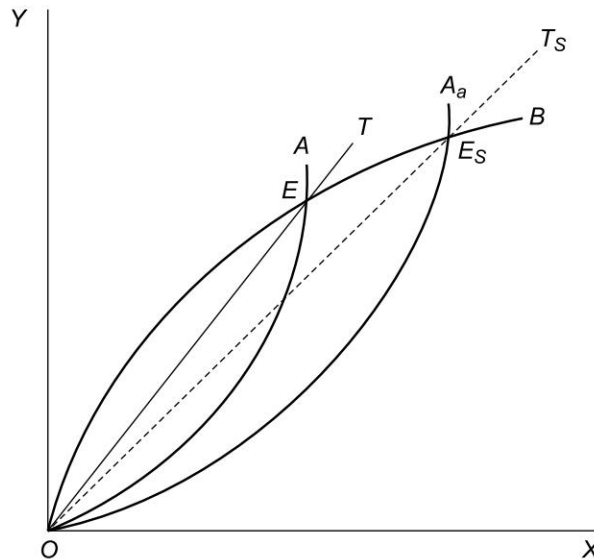


Fig. 7.5

Effect of Change in Supply on Terms of Trade

This shift of the offer curve from OA to OA_a implies that now Country A is willing to offer a larger quantity of X than before, for any given amount of Y . E_s is the new equilibrium point and OT_s the corresponding equilibrium terms of trade.

This change in the terms of trade need not result in a loss to Country A because if the increase in the supply of X is caused by a technology advance, it could reduce the cost of production of X . It could be even possible that at the new exchange ratio, though unfavourable compared to the original one, Country A is gaining more now for the sacrifice involved in producing any given amount of X .

Figure 7.5 shows that the increase in the supply of X and the fall in its price leads to an expansion of international trade. This is natural because at the lower price of X , Country B would demand more X and Country B would demand and import more X by exporting more Y .

Different Concepts of Terms of Trade

In the foregoing section we have defined terms of trade as the ratio index of export prices to import prices. Of course, in the early days the concept meant what we have stated above. But, later, terms of trade measures have been extended to cover the trends in the rate of consumption of productive resources by goods exported and net utility from trade.

Gerald M. Meier⁵ has classified the different concepts of terms of trade into the following three categories:

- **Those that relate to the ratio of exchange between commodities:**
 - (a) Net barter terms of trade.
 - (b) Gross barter terms of trade.
 - (c) Income terms of trade.

- Those that relate to the interchange between productive resources:
 - (a) Single factorial terms of trade.
 - (b) Double factorial terms of trade.
- Those that interpret the gains from trade in terms of utility analysis:
 - (a) Real cost terms of trade.
 - (b) Utility terms of trade.

Net Barter Terms of Trade Net barter terms of trade, also called the commodity terms of trade, measure the relative changes in the import and export prices and is expressed as

$$N = P_x / P_m$$

where P_x and P_m are price index numbers of exports and imports, respectively.

For example, with 1968–69 as the base, the unit value index of India's exports increased to 120 by 1972–73, but the respective index of imports declined to 97. Hence, India's net barter terms of trade in 1972–73 was 124. This implies that because of the higher rate of increase in the export price, 24 per cent more imports could be received, on the basis of price relations only, in exchange for a given volume of exports. However, by 1979–80 the unit value index of exports increased to 236 and of imports to 360. Therefore, in 1979–80, $N = 66$. This deterioration in India's net barter terms of trade was caused mainly due to the hike in the price of oil, one of her most important import items.

A rise in N indicates that a larger volume of imports could be received, on the basis of price relations only, in exchange for a given volume of exports. According to Taussig, however, the net barter terms are relevant only when nothing enters into the trade between countries except sales and purchases of merchandise.⁶

Thus, the concept of net barter terms of trade has certain drawbacks. It measures only the gain or loss arising out of relative changes in the export and import prices. It completely ignores the impact of factors such as (i) changes in the level or volume of exports and imports, (ii) changes in the quality of exports and imports, (iii) changes in the composition of trade, (iv) changes in the productivity of export industries and (v) unilateral payments.

Gross Barter Terms of Trade Taussig introduced the concept of gross barter terms of trade to correct the commodity or net barter terms of trade for unilateral transactions, or exports or imports which are surrendered without compensation or received without counter payment, such as tributes and immigrant's remittances.

The gross barter terms of trade is the ratio of the physical quantity of imports to physical quantity of exports. It may be expressed as

$$G = Q_m / Q_x$$

where Q_m and Q_x are the volume index numbers of imports and exports, respectively.

A rise in G is regarded as a favourable change in the sense that more imports are received for a given volume of exports than in the base year.

The appropriateness of incorporating unilateral payments into the terms of trade has, however, been questioned. Haberler has suggested that allowance should be made separately for unilateral transactions, instead of incorporating them in the terms of trade index.

Though Taussig introduced the concept of gross barter terms of trade as an improvement over the net barter terms of trade, it also has certain defects. For instance, like the net barter terms of trade, it also does not reflect the impact of changes in productivity nor changes in the quality and composition of foreign trade.

Income Terms of Trade G.S. Dorrance modified the net barter terms of trade and presented the income terms of trade. The income terms of trade, which indicates a nation's capacity to import is represented as

$$I = P_x \cdot Q_x / P_m$$

It may also be expressed as

$$I = N \cdot Q_x \text{ (because } N = P_x / P_m \text{)}$$

The income terms of trade indicates a nation's capacity to import because when the index of total export earnings ($P_x \times Q_x$) is divided by the import price index, we get the quantum index of imports that can be made with the export earnings.

Therefore, a rise in I indicates that the nation's capacity to import, based on exports, has increased, i.e. it can obtain a larger volume of imports from the sale of its exports.

It should, however, be clear that I indicates only the export-based capacity to import and not the total capacity of the nation to import. For, the total capacity to import depends on factors like capital inflow, receipts from invisibles and unilateral payments.

Even when export prices decline and import prices remain constant the income terms of trade will improve if the physical volume of exports increase more than in proportion to the fall in export price. This very well demonstrates that a change in the income terms of trade need not necessarily reflect the real gain or loss. This is a serious drawback of this concept.

Single and Double Factoral Terms of Trade Jacob Viner has introduced the concepts of single factoral and double factoral terms of trade to modify the net barter terms of trade and reflect changes in productivity.

The *single factoral terms of trade* is the net barter terms of trade adjusted for changes in the efficiency or productivity of a country's factors in its export industries. It may be expressed as

$$S = N \times Z_x$$

where Z_x is the export productivity index.

A rise in S implies that a greater quantity of imports can be obtained per unit of factor-input used in the production of exportables. Hence, a rise in N is regarded as a favourable movement.

The *double factoral terms of trade* is the net barter terms of trade corrected for changes in the productivity in producing imports as well as exports. It may be expressed as

$$D = N \times Z_x / Z_m$$

where Z_m is an import productivity index.

A rise in D is a favourable movement because it implies that one unit of home factors embodied in exports can now be exchanged for more units of the foreign factors embodied in imports.

D will diverge from S when there is a change in the factor cost of producing imports, but Gerald Meier states⁷ that this has no welfare significance for the importing country, even though it indicates a change in productivity in the other country from which commodities are imported. What matters to the

importing country is whether it receives more goods per unit of its 'exported factor input' (an improvement in S). It does not matter whether these imports contain more or less foreign inputs than before.

The factoral terms trade, both single and double, are of little practical importance because it is very difficult to measure statistically the changes in the productive efficiency of the factors of production. Another drawback is that they do not reflect the real gain arising out of international trade.

Real Cost Terms of Trade The concept of real cost terms of trade, introduced by Jacob Viner, attempts to measure the gain from international trade in utility terms.

The total amount of gain from trade may be defined in utility terms as the excess of total utility accruing from imports over the total sacrifices of utility involved in the surrender of exports. (Exports result in loss of utility to the exporting country because the resource used for export production could have been utilised for products meant for domestic consumption. Imports, on the other hand, represent gain of utility.)

To find out the real cost terms of trade, we correct the single factoral terms of trade index by multiplying S by the reciprocal of an index of the amount of disutility per unit of productive resources used in producing exports. The real cost terms of trade may be represented as

$$R = N \times F_x \times R_x$$

where F_x is the index of productivity efficiency in export industries and R_x is the index of the amount of disutility incurred per unit of productive factors in the export sector.

A rise in R indicates that the amount of imports obtained per unit of real cost is greater. R may rise as result of a change in the methods of producing exports or a change in factor proportions used in exports.

Utility Terms of Trade The concept of utility terms of trade, which was also introduced by Jacob Viner, marks an improvement of the real cost terms of trade.

Viner points out that the amount of gain from trade does not depend only on the amount of foreign goods obtained per unit of real cost involved in the production of the export commodities. It also depends on the relative desirability of import commodities as compared to the commodities which could have been produced for home consumption with the productive resources now devoted to production for export. To take account of changes in the relative desirability of import commodities and of native commodities, whose internal consumption is precluded by the allocation of productive resources to production for export when such changes in relative desirability are due to changes in tastes, it would be necessary to incorporate in the 'real cost trade index'. Real cost trade index is an index of relative average utility per unit of imported commodities and of native commodities whose internal consumption is precluded by allocation of resources to production for export.

The utility terms of trade may be represented as

$$U = N \times F_x \times R_x \times U_m$$

where U_m is the index of relative utility of imports compared to the commodities that could have been produced for internal consumption with those productive factors which are at present devoted to the production of export goods.

Influences on Terms of Trade

The terms of trade of a country depend on a number of factors. The important factors that influence the terms of trade are:

Elasticity of Demand and Supply The elasticity of demand for exports and imports, and of supply of exports and imports of a country significantly influence its terms of trade. When the demand for the country's exports is less price elastic, as compared to her imports, the terms of trade tend to be favourable because under such a situation exports can command a relatively higher price than imports. On the other hand, if the demand for imports is less elastic than that for exports, the terms of trade tend to be unfavourable.

If the supply of a country's exports is more elastic than the imports, the terms of trade is likely to be favourable because by contracting and expanding the supply of exports in accordance with the market conditions it may be possible to have some control over export prices.

Competitive Condition Competitive conditions in the international market are another important influence on the terms of trade. If the country enjoys monopoly or oligopoly power in case of the goods it exports and there are a large number of alternative sources of supply of imports, the country would have a favourable terms of trade. The absence of close substitutes enables a country to sell her products at high prices. It is the near monopoly power enjoyed by the oil cartel that enabled the OPEC (Organisation of Petroleum Exporting Countries) to improve their terms of trade by hiking the oil prices.

Tastes and Preferences Changes in tastes and preferences may also cause changes in the terms of trade. A change in the former in favour of a country's export goods could help improve its terms of trade and vice versa.

Rate of Exchange Changes in the rate of exchange of the currency also affect terms of trade. For instance, if a country's currency appreciates, the terms of trade of that country will, *ceteris paribus*, improve because the currency appreciation causes an increase in the prices of exports and a decrease in import prices.

Tariffs and Quotas The terms of trade of a country may be affected also by tariffs and quotas. The latter, if not retaliated by other countries, may have the effect of improving the terms of trade under certain conditions.

Economic Development There are two important effects of economic development to be considered, namely, the demand effect and the supply effect. The *demand effect* refers to the increase in demand for imports as a result of the increase in income associated with economic development. The *supply effect* refers to the increase in supply of import competing goods or import substitutes. The net effect on the terms of trade will obviously depend upon the extent of these effects.

Problems of Measurement of Terms of Trade

The use of price indices to measure terms of trade has the following limitations:

Changes in Quality Over the years, the quality of internationally traded goods may undergo a change, but the price indices may not reflect this change.

Changes in Composition Changes in the composition of the traded goods over a period of time may also not be reflected in the price indices.

Price Differences The price indices of import and export goods are usually based on the price declarations made to the customs authorities, which may differ from the actual market selling price of the imports and exports.

Problem of Weightage Another problem associated with the price index pertains to that of assigning appropriate weights to various commodities that enter the international trade of the country.

SUMMARY

International trade is beneficial in several ways. It encourages the development of the most efficient sources of supply; leads to specialisation on a large scale because of the expanded market; helps reduce prices; increases real incomes and consumption; makes available even goods that cannot be domestically produced; and may enable countries to conserve certain scarce resources as products which embody these scarce resources imported from countries where they are abundant.

Theoretically, small countries may gain more than large countries from international trade because a small country can specialise in the international market, but if a large country specialises in the production of a single commodity, the significant increase in its supply would cause a fall in its price, thus adversely affecting its terms of trade.

Trade has serious undesirable and adverse effects too. International trade sometimes leads to fast exhaustion of non-replenishable resources, particularly of less developed countries whose exports are mostly natural resources or commodities embodying natural resources. International trade ruining domestic industries and competition is not uncommon. Sometimes international trade disturbs domestic economic institutions and structures, as well as social and political set ups.

One important problem is that the gains from trade are not equally distributed. Some countries may gain more whereas others' gain may be relatively less. There is a general feeling that a major part of the gains from trade are cornered by the more developed countries.

The most important determinant of the distribution of gain is the **terms of trade**, i.e. the rate at which a country's exports are exchanged for imports. According to Mill's doctrine, the international terms of trade between two commodities will depend upon the strength of the world supply and demand for each of the two commodities. In other words, the terms of trade is determined by **reciprocal demand**.

Gerald M. Meier has classified the different concepts of terms of trade into three categories:

- Those that relate to the ratio of exchange between commodities (net barter terms of trade, gross barter terms of trade and income terms of trade).
- Those that relate to the interchange between productive resources (single factorial terms of trade and double factorial terms of trade).
- Those that interpret the gains from trade in terms of utility analysis (real cost terms of trade, and utility terms of trade).

The important factors which affect terms of trade are: The elasticity of demand for exports and imports and the elasticity of supply of exports and imports of a country; competitive conditions in the international market; changes in tastes and preferences of consumers; changes in the rate of exchange of the currencies; and trade barriers like tariffs and quotas. Economic development has two important effects on terms of trade to be considered, namely, the *demand effect* (the increase in demand for imports as a result of the increase in income associated with economic development) and the *supply effect* (the increase in supply of import competing goods or import substitutes).

Certain problems are often encountered in the measurement of the terms of trade. The use of price indices to measure terms of trade poses some problems. The quality of internationally traded goods may undergo changes over time, but the price indices may not reflect this change. Similarly, changes in the composition of the traded

goods over a period of time may also not be reflected in the price indices. Another limitation is that the price declarations made to the customs authorities, on the basis of which the price indices are calculated, may differ from the actual market selling price of the imports and exports. Another problem associated with the price index pertains to that of assigning appropriate weights to various commodities that enter the international trade of the country.

Review Questions

1. Explain the gains from trade.
2. Explain Mill's doctrine.
3. Describe the different concepts of terms of trade. What are the important factors which influence the terms of trade?
4. Write notes on the following:
 - (i) Special gains to small countries.
 - (ii) Effect of change in demand and supply on terms of trade.
 - (iii) Problems of measurement of terms of trade.

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CHAPTER 8

8 Economic Growth and Trade

LEARNING OBJECTIVES

- ☐ To examine the impact of economic conditions abroad on foreign trade of home country.
- ☐ To figure out the effect of technological change on economic growth and trade.
- ☐ To analyse the impact of trade on developing countries.
- ☐ To understand the impact of economic growth on foreign trade.
- ☐ To discern the impact of trade on economic growth.

While it is generally agreed that economic growth can impact trade, the nature of its effect on trade is a matter of differences of opinion. Similarly, the impact of trade on economic growth is a subject of debate.

There are two important issues often debated, viz. (i) the impact of the economic conditions in other countries on the home economy, and (ii) the implications of growth of the domestic economy that is part of a closely integrated world economy.

EFFECT OF ECONOMIC CONDITIONS ABROAD ON GROWTH

There are contradictory opinions regarding the impact of growth of foreign economies on the domestic economy.

Growth of foreign economies can be expected to be good for the domestic economy because the demand growth abroad can also mean an increase in the demand for exports of the home country. For example, as pointed out in the chapter on *Trade BOP of India*, good economic growth in the major foreign markets increases demand for India's exportables. The opposing view is that economic growth abroad means increasing competition for the country's exports.

A recession abroad can adversely affect the domestic economy as it can cause a fall in the demand for the nation's exports and increased competition for the exports (competition in the foreign markets may increase because the producers of the countries suffering from the recession, faced with the poor demand conditions in their home markets, would try to sell more abroad and exporters to the recession-ridden economy would also be compelled to seek markets elsewhere).

Economic conditions abroad can affect the trade prospects of a nation.

Recession abroad can also have favourable effects on the domestic economy; imports might become cheaper leading to an improvement in the terms of trade.

The effects of domestic growth on the domestic economy vis-à-vis trade are also shadowed by ambiguities.

Growth of the domestic economy is expected to have a favourable impact on exports as it increases the exportable surplus. This aspect is particularly important when one considers the fact that exportable surplus is a major constraint in respect of several of India's exports. However, it may also be noted that domestic growth would increase the demand which would mean an increase in demand for imports as well as domestic output.

GROWTH AND THE PRODUCTION FRONTIER

Economic growth results from an upward shift of the country's production frontier. Such a shift may be caused either by an increase in the resources or by technical factors which increase the factor productivity.

Depending on the pattern of the shift of production frontier (i.e. the shape of the new production frontier) the growth is classified as balanced growth and biased growth. If both the factors, capital and labour, grow at the same rate, the production frontier will shift out evenly so that the slope of the old and new frontiers will be the same at any point where they are cut by a straight line from the origin. This is known as balanced growth. Balanced growth can also be caused by neutral technological development described in a following subsection. The case of balanced growth is depicted in Fig. 5.4 (Chapter 5).

Growth is biased when the production frontier shifts more in one direction than in the other. The biased growth results from increase in the quantity of one factor alone (or increase in the quantum of one factor proportionately more than that of the other). Biased growth can also result from biased technological changes, described in a following subsection. Figures 5.5 and 5.6 represent the case of biased growth. The biased expansion of production possibilities will be in the direction of either the good to which the factor is specific or the good whose production is intensive in the factor whose supply has increased.

If the bias in the growth is in favour of the goods that the country exports, it is export-biased growth and if the growth is biased towards the goods it imports, it is import-biased growth.

EFFECT OF GROWTH ON TRADE

Economic growth of a nation may affect its terms of trade and trade volume.

Two important trade effects of the growth may be considered: The effect of growth on the terms of trade and the effect of growth on the volume of trade.

Effect of Growth on Terms of Trade

The terms of trade may be affected by the shift in the relative supply resulting from growth.

The effect of growth on the terms of trade may be illustrated with the relative supply (RS) curve and relative demand (RD) curve.

Suppose that the home country experiences growth strongly biased in favour of X , the commodity it exports, so that for the world as a whole the relative supply curve of X (supply of X relative to the supply of the other commodity, Y) shifts to the right, from RS to RS_1 , as shown in Fig. 8.1. (It may be noted that the point here is a change in the relative supply of the product in the world trading economy as a whole, whether the biased growth occurs in the home country or in the rest of the world.) As a result of the shift in the relative supply curve from RS to RS_1 , the relative price of the exportable, X , (price of

$X/\text{price of } Y$) falls from P to P_1 which means a deterioration in the terms of trade of the home country and an improvement in the terms of trade of the X importing countries.

An import (Y) biased growth will have the effect of shifting the relative supply curve of the exportable (X) to the left as shown in Fig. 8.2. (from RS to RS_1). This means an improvement in the terms of trade of the home country (the relative price having risen from P to P_1) and a worsening of the terms of trade of the foreign countries exporting that good.

Thus, export-biased growth tends to worsen a country's terms of trade to the benefit of the rest of the world and import-biased growth tends to improve the terms of trade of the country at the expense of the rest of the world.

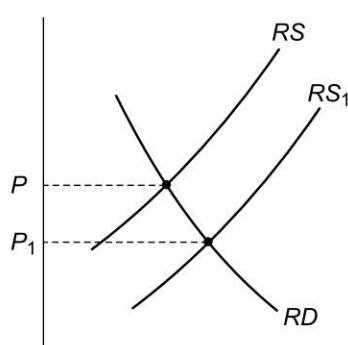


Fig. 8.1 Export Biased Growth

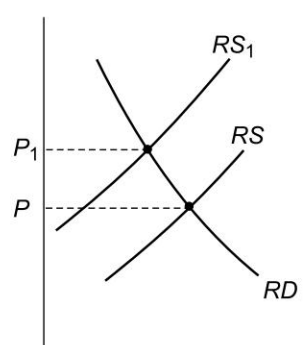


Fig. 8.2 Import Biased Growth

The cases of *secular deterioration* of the terms trade of developing countries and *immiserising* growth deserve mention here.

According to the secular deterioration hypothesis, export-biased growth in the developing countries (the assumption is that their exportables are primary commodities) results in an increase in their relative supply, thus resulting in the deterioration of their terms of trade. (A hypothesis behind the secular deterioration theory is that the primary products exports of the developing countries face an unfavourable demand condition in the international market as their demand is assumed to be inelastic. Further, several products face the threat of substitution by synthetic products. For details see Chapter 9.)

A relative increase in the export volume can cause a deterioration of the terms of trade.

According to the immiserising growth hypothesis, growth in poor economics could actually be self-defeating because the export-biased growth would worsen their terms of trade so much that they would be worse off than if they had not grown at all.

It should be clearly born in mind, to avoid confusion, that in this discussion of effect of growth on the terms of trade, what we have considered are the relative supply of/demand for the good in the world as a whole, and not for any particular country. An individual country may increase its exports considerably and still experience an improvement in the terms of trade if the relative world demand is very strong. On the other hand, it is possible that the terms of trade of a country deteriorate even as its production and export of the commodity falls if the relative world supply of that good increases.

The effect of the growth bias on the terms of trade has a very important policy implication: To maintain a favourable terms of trade, it is essential to manage the relative supply. That is how the cartel, OPEC, regulated the oil supply and hiked the price in the 1970s. The Commodity Agreements, described in Chapter 13, also endeavours to manage the relative supply and thereby the price.

The Effect of Growth on Trade Volume

Economic growth may be pro-trade, anti-trade or neutral. The effect of growth on the volume trade depends on the rate at which the output of the nation's tradable commodities grows, and on the consumption pattern of the nation as its national income expands through growth and trade.

Economic growth may affect trade volume by affecting the export and import volumes.

Trade volume can be affected by changes in production or consumption. Growth in production is regarded *pro-trade* if it leads to a more than proportionate increase in trade. This can happen when the output of a nation's exportable commodity grows proportionately

more than the output of its importable commodity at constant prices.

Consumption is regarded *pro-trade* when the nation's consumption of its importable commodity increases proportionately more than the consumption of its exportable commodity at constant relative commodity prices.

Growth in production or consumption is *neutral* if it leads to a proportionate increase in the volume of trade and *anti-trade* if it tends to increase trade less than proportionately.

The net effect of growth on the trade will depend on the combined effects of production and consumption. If both the production effect and consumption effect are *pro-trade*, the volume of trade will expand proportionately faster than the output growth. If both the production and consumption are *anti-trade*, the volume of trade will grow proportionately less than the output. If they are very strongly *anti-trade*, the absolute volume of trade will even decline.

If either production or consumption is *pro-trade* and the other is *anti-trade*, the effect on the trade will depend on the net effect of these two opposing forces. The net effect depends, obviously, on the relative strengths of these opposing effects. If both production and consumption effects are *neutral*, which is quite unlikely, trade will expand in the same proportion as output.

Growth is regarded *ultra trade-biased* when at unchanged trading price, the country produces not only more of the exportable commodity but also reduces the output of the importable commodity. An *ultra export-biased* growth has the effect of worsening the terms of trade. An *ultra import-biased* growth, on the other hand, improves the terms of trade.

Changes in export and import volumes are affected by changes in the domestic production and consumption patterns.

The effect of economic growth on foreign trade will depend on how the producers will allocate the resources for production and how the consumers will spend the additional real income. In other words, whether the economic growth makes the country more or less dependent on trade will be determined by the behaviour of the producers and consumers.

We may illustrate the production effects of growth with the help of Figs 8.3A and 8.3B. In the pre-growth situation, the country is producing at E (OQ wine and QE cloth). However, it consumes only OQ_1 wine and exports QQ_1 wine in exchange for SD cloth (import) so that it consumes at D (OQ_1 wine and QD cloth).

As growth occurs, the production frontier shifts upwards. This implies that the producers can now choose to produce on any point on the new production frontier (indicated by the dotted curve, $P_1 P_1$, in Fig. 8.3B) that will maximise their profits.

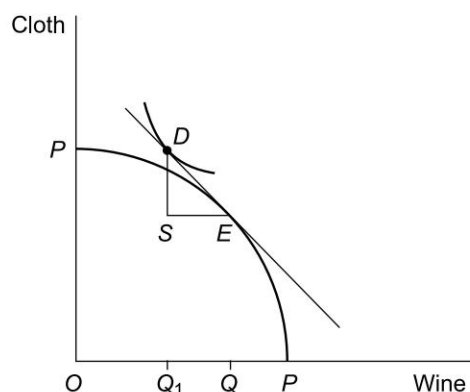


Fig. 8.3A Production Effects of Growth

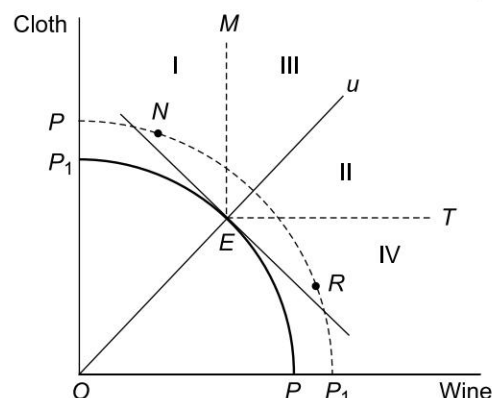


Fig. 8.3B Production Effects of Growth

For the wine-cloth combination of the production, there are three possibilities:

- Increase the production of both the commodities in the same proportion as previously.
- Produce more of both the commodities in a dissimilar proportion than previously (i.e. increase the production of one more than proportionately than of the other).
- Increase the production of one commodity and reduce the production of the other.

In Fig. 8.3B, PP represents the production frontier of Fig. 8.3A, and E represents the production combination of Fig. 8.3A.

If the new production is on a point beyond E on the straight line (OU) passing through the origin and point E , it reflects the first possibility mentioned above (i.e. production of both wine and cloth have increased in the same proportion as at point E). This is a case of neutral production effect as production of the exportable (wine) and import competing good (cloth) have grown at the same rate.

Production points lying to the left of the vertical line EM (Sector I) represent the third possibility mentioned above, viz. increase in the production of one commodity (cloth) and decrease in the output of the other (wine). For example, at point N , wine output is lower than what it was at E and the cloth output is higher than at E . Sector I represents ultra-antitrade-biased production. It tends to reduce exports as the production of the exportable (wine) falls and tries to reduce imports as the production of the import-competing commodity (cloth) increases.

Sector I also represents the third possibility mentioned above, viz. increase in the production of one commodity and decrease in the production of the other.

Production points below the horizontal line ET (Sector IV) represent the other extreme—ultra-pro-trade-biased production—characterised by an increase in the production of the exportable and a fall in the output of the importable. For example, point R represents a higher production of the exportable (wine) and lower production of the importable (cloth). In other words, it tends to increase both exports and imports.

Sector IV also represents the third possibility of increase in the production of one commodity and decrease in the production of the other.

Sector II represents the second possibility mentioned above, viz. the output of one commodity increases at a greater rate than that of the other. Production points in this sector indicate greater production of both wine and cloth, but the increase in the production of wine is relatively greater than that of cloth.

Sector *II* represents pro-trade-biased growth since the proportionately greater growth of exportable tends to increase exports and relatively lower increase in the production of the importable tends to increase the import.

Sector *III* (points between the vertical line *EM* and the line *OU*) also represents the second possibility mentioned above. Production of both wine and cloth increases. But in contrast to the situation in Sector *II*, Sector *III* is characterised by increase in the output of cloth more than proportionately that of wine. This represents anti-trade-biased growth since the greater growth of the importable (cloth) tends to reduce imports and the lower growth of the exportable (wine) tends to reduce exports.

The actual post-growth point of production will be that point where the new production possibility curve (P_1P_1) will be tangent to the international price line. (In the above analysis it is assumed that the prices remain constant. If the country considered is a small one, growth may not lead to changes in the international prices as the volume increase will not be substantial enough to affect the international price.)

The consumption effect of growth on trade may be illustrated with the help of Fig. 8.4 in which *D* represents the original equilibrium point.

Points lying beyond *D* on the straight line *OJ*, passing through the origin and equilibrium point *D*, reflect a proportionate increase in the consumption of both the commodities. In other words, growth does not change the relative consumption pattern. This means that the consumption effect of growth is neutral.

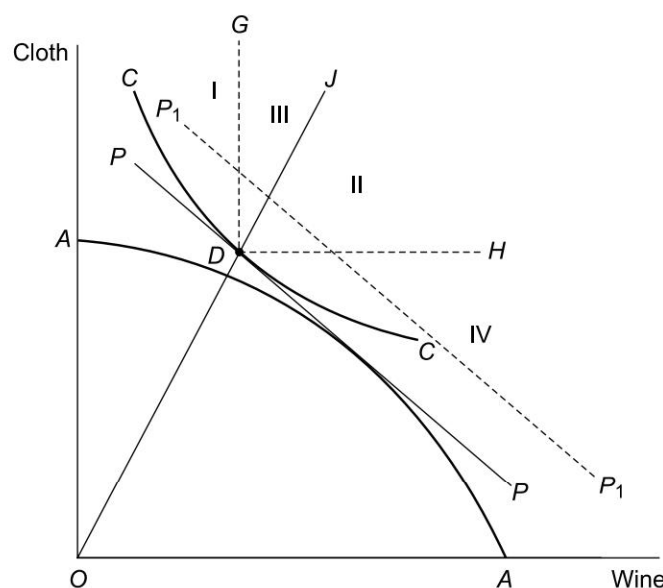


Fig. 8.4 Consumption Effects of Growth

Consumption points lying to the left of the vertical line *DG* (Sector *I*) represent an increase in the consumption of the importable (cloth), necessitating more imports, and decrease in the consumption of the exportable (wine), increasing the exportable surplus. This is ultra-pro-trade-biased consumption.

Sector *IV* represents the other extreme, characterised by increase in the consumption of the exportable (thereby reducing the exportable surplus) and decrease in the consumption of the importable (thereby reducing the import requirement). The consumption effect of growth, therefore, is ultra-anti-trade-biased.

Consumption points in Sector *II* reflect increase in consumption of both wine and cloth, but the increase in the consumption of the exportable (wine) is larger in proportion than the consumption growth of the importable (cloth). This is anti-trade consumption effect because the relatively higher growth of consumption of the exportable tends to reduce exports and the lower consumption growth of the importable tends to reduce imports.

Sector *III* is also characterised by growth resulting in increase in the consumption of both the goods; but the consumption of the importable (cloth) increases relatively more than that of the exportable (wine). The consumption effect in this case is *pro-trade-biased*—the greater growth in the consumption of the importable tends to increase imports and the lower consumption growth of the exportable tends (by increasing the exportable surplus) to increase the exports.

The net impact of economic growth on trade depends on the effect on both production and consumption. The expansionary impact of growth on trade is larger when both the production and consumption are in the ‘pro’ or ‘ultra-pro’ sectors.

The net result of the production and consumption effects of growth on the trade depends on the income elasticity of demand for imports measured as the percentage change in the demand for importables divided by the percentage change in the national output.

Growth is neutral if this elasticity is equal to one (i.e. trade is growing at the same rate as national income).

It is pro-trade-biased if the income elasticity of demand for importables is greater than one (i.e. trade is growing faster than income). And, it is anti-trade-biased if the elasticity is less than one (i.e. trade is growing slower than national income). Growth is ultra-anti-trade-biased if the elasticity is negative. It is ultra-pro-trade-biased if the elasticity exceeds the original ratio of national income to imports (an alternative way of expressing a negative output-elasticity of demand for exportables).

An important issue pertaining to growth vis-à-vis trade is whether growth makes the country relatively less self-sufficient (i.e. more dependent on trade), no more or less dependent on trade, or relatively more self-sufficient (i.e. less dependent on trade). These are determined by the elasticities of consumption and supply. The three types of growth conceptualised above may be described as follows:

Pro-trade Growth which increases the demand for the country’s imports and supply of exports more than proportionately to output.

Neutral or Unbiased Growth which increases the country’s demand for imports and supply of exports in proportion to the output.

Anti-trade Growth which increases the country’s demand for imports and supply of exports less than proportionately to output.

Besides these three basic types, two extreme cases are distinguished.

Ultra-pro-trade-biased Growth which increases the production of the exportable and a decreases the output of the importable.

Ultra-anti-trade-biased Growth which tends to reduce exports by reducing the output of the exportable, and tends to reduce imports by increasing the production of the import-competing commodity.

Economic Growth—The Small Country Case

Theoretical analyses propose that economic growth in small country would not affect its terms of trade whereas growth in a large country may cause a deterioration of its terms of trade.

As pointed out in the chapter *Gains from Trade and Terms of Trade* under the section *Special Gains to Small Countries*, theoretical analyses propose that small countries may gain more than large countries from international trade.

As it is assumed that the increase in the exports of the small country following growth will not be large enough to influence the international price, it would be able to trade without affecting the terms of trade. (See the section *Special Gains to Small Countries* in the chapter *Gains from Trade and Terms of Trade*).

This section examines the effect of economic growth in a small country on its production.

As pointed out earlier, growth represents an outward shift in the production frontier, caused either by an increase in factor supplies or technological progress.

In Fig. 8.5, F_1F_1 indicates a labour-biased growth. The pre-growth equilibrium is at E where the price line is tangent to the production possibility curve. The new equilibrium is established at E_1 where the unaltered price line is tangent to the new production frontier. (It is assumed that the relative product prices remain constant, as the increase in production by the small country will not be substantial enough to influence the international price.) The new equilibrium represents a substantial increase (OQ to OQ_1) in the output of the commodity intensive in the factor, the supply of which has increased (labour) and an absolute fall (from OR to OR_1) in the output of the product intensive in the other factor.

This phenomenon is often referred to as the Rybczynski theorem after the British economist T.M. Rybczynski.

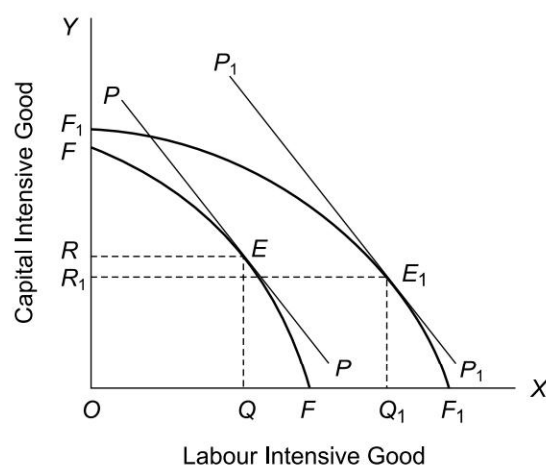


Fig. 8.5 Labour-biased Growth

Rybczynski Theorem

The Rybczynski theorem examines the effects of a biased growth on the output of two goods.

According to the Rybczynski's theorem, the increase in the quantity of a factor (given the other) will cause an increase in the output of the commodity which is intensive in that factor by a greater proportion and a decrease in the output of the other commodity, at unchanged commodity and factor prices. For example, if the supply of labour increases (that of capital remaining unchanged) it will lead to an increase in the output of the labour intensive commodity more than proportion and a decrease in the output of the capital intensive commodity.

An increase in the supply of one factor causes a more than proportionate increase in the output of the product intensive in that factor and fall in the output of the other product.

When the quantity of a factor increases, the more than proportionate increase in the output of the commodity intensive in that factor is known as the *magnification effect*.

The fact that after growth the output of the commodity intensive in the factor that has expanded increases more than in proportion, and the output of the other commodity falls, implies that some factors have been released from the production of the latter for increasing the supply of the former.

In Fig. 8.6 (which is similar to Fig. 8.5), PF represents the production frontier before growth. As a result of the increase in labour supply, the production frontier has shifted to P_1F_1 . Before growth, the optimum output combination was OS of Y and OQ of X .

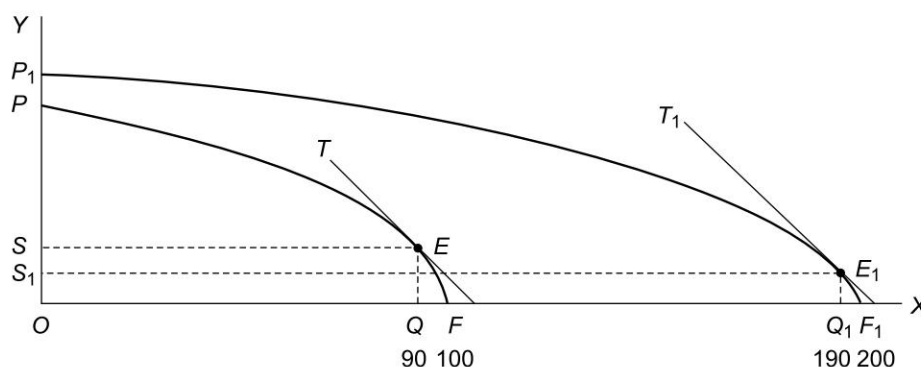


Fig. 8.6 Rybczynski Theorem

After the expansion of the labour supply, equilibrium was established at E_1 where the price ratio is tangent to the production frontier (the ratio is assumed to remain same as before the growth). As Fig. 8.6 indicates, the output of X , the labour intensive good, increased more than in proportion to the increase in the labour endowment, and the output of Y (the capital intensive product) decreased (from S to S_1).

Proof of Rybczynski Theorem The commodity prices will remain constant only if the factor prices remain constant. The factor prices can remain constant only if the factor proportions and the factor productivities in the production of both the products remain constant. The only way to fully employ all of the increase in labour and still leave the capital-labour ratio unchanged in the production of both the commodities is for the output of Y (the capital intensive commodity) to fall in order to release enough capital (and of course, little labour) to absorb all of the increase in labour in the production of the labour intensive commodity, X . Thus, the output of X rises while that of Y falls at constant commodity prices.

Economic Growth—The Large Country Case

Whether growth will improve or worsen the welfare of the nation depends on two factors—the terms of trade effect and the wealth effect of growth.

A large country, by changes in its production and consumption, may be in a position to influence prices. That is, growth can affect the terms of trade. The *terms of trade effect* depends on what happens to the country's volume of trade following growth. The terms of trade tend to deteriorate when the country's volume of trade expands at constant prices and they tend to improve if growth reduces the volume of trade. (The effect of changes in demand and supply on the terms of trade is explained with the help of diagrams under the sections *Effect of Changes in Demand on Terms of Trade* and *Effects of Supply on Terms of Trade* in the chapter *Gains from Trade and Terms of Trade*).

Economic growth may result in wealth effect. The *wealth effect* refers to the increase in the output per worker or per capita income as a result of growth. Although a positive wealth effect tends to improve the country's welfare, the net effect of growth on the welfare depends on the net effect of both the welfare and terms of trade effects.

If the growth results in a positive wealth effect and the trade effect of the growth improves the terms of trade, the country's welfare will definitely improve. In contrast, the country's welfare will definitely decline if the wealth effect is negative (or even neutral) and the terms of trade turn adverse. If the wealth effect and the terms of trade effect move in opposite directions, the country's welfare may deteriorate, improve or remain unchanged depending on the relative strengths of these two opposing forces.

The description of the welfare effects of growth given above is applicable to small countries as well.

TECHNICAL PROGRESS

Technical progress has made tremendous contribution to economic growth, international trade and factor movements.

Factor saving technological progress has the same effect of an increase in the factors of production.

Technical progress can affect economic growth, international trade and factor movements.

For example, a technological development that reduces the labour requirement per unit of output of a product by 50 per cent has the same effect of doubling of the labour supply in respect of that product. Similarly, capital saving technology has the same effect of an increase in capital supply.

The labour saving technological developments in the agricultural sector generated surplus labour in that sector, which helped meet the increasing labour requirements of the industrial sector during the industrial revolution.

Technical progress has been increasing production scales and reducing costs. The tremendous technological advances in transport and communication, which stupendously improved their efficiency and reduced the costs, have boosted the cross-border transactions.

Technological changes have also brought about significant changes in the comparative advantages of nations in the production of different products. In other words, as a result of technological developments some nations lost the comparative advantage in certain products while some others gained comparative advantage. For example, when a labour intensive product becomes capital intensive, a labour abundant country, which does not quickly adopt the new technology, may lose its comparative advantage in that product.

Types of Technical Progress

The classification of technical progress proposed by John Hicks, a Nobel Laureate, is generally followed in the economic analysis of the effects of technical progress. Accordingly, technical progress may be neutral or biased.

According to the Hicksian definition, technical progress is neutral if, at unchanged capital/labour ratio, it causes an equiproportional increase in the marginal productivities of both the factors.

Biased Technical Progress Technical progress has a factor saving bias if it increases the marginal productivity of the other factor more than in proportion to the increase in the marginal productivity of the saved factor. For example, a labour saving technical progress will increase the marginal productivity of capital more than that of labour.

A factor saving bias also implies a factor using bias. Technical progress has a factor using bias if it increases the marginal productivity of a factor (the used factor—in the case of the labour saving technology the used factor is capital) more than in proportion to the marginal productivity of the other factor. In other words, labour saving is synonymous with capital using, and capital saving with labour using.

The types of technical progress may be defined as follows also. A *neutral technical progress* is one, which, at unchanged factor price ratio, leaves the optimum factor ratio unaltered, and a *biased technical progress* is one which alters the optimum ratio between the factors. In other words, a labour saving technical progress reduces the optimum labour/capital ratio (i.e. relatively less labour is used), and a capital saving innovation reduces the capital labour ratio, at unchanged factor-price ratio.

A diagrammatical illustration of the different types of technical progress is given under section production possibility curve in the chapter *Analytical Tools* (Figs 5.4 to 5.7).

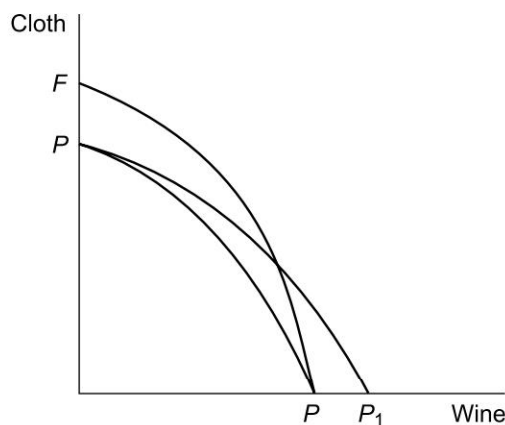


Fig. 8.7 Product Specific Technological Change

Technological change can also be product specific, i.e. the technological progress increases the productivity in respect of a specific product only. Figure 8.7 depicts this case. PP is the original production frontier. The shift of the frontier represented by PF is cloth specific technical change (i.e. the technical progress increases factor productivity only in the cloth industry), and PP_1 represents wine specific innovation.

In the traditional economic literature, technology was treated as an exogenous factor (i.e. an independent external factor). The recent period, however, has witnessed a significant change. Since the late 1980s, a series of long-run growth models which regard technological change as an endogenous factor (i.e. within the system) have been purported. According to these endogenous models, the rate of technological change is determined by internal factors such as growth in physical capital, increase in human capital etc. These models highlight the importance of investment in research and development (R&D). These models also examine the implications of endogenous technological change on international issues like dynamic comparative advantage, trade and growth, product cycles and international transmission of policies. The importance of the endogenous factors is also implied in the Porterian model of *Competitive Advantage of Nations* described in Chapter 6.

A graphical interpretation of the Hicksian classification of the technical progress as neutral, labour saving is given below.

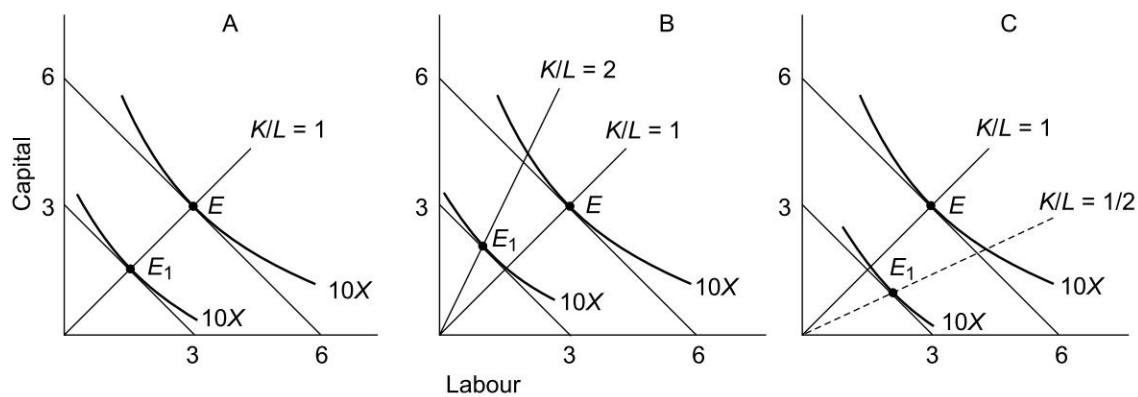


Fig. 8.8 Neutral, Labour Saving and Capital Saving Technical Changes

In Figs 8.8 A to C, the original equilibrium is at E where the isoquant is tangent to the isocost line.

Figure 8.8A represents the case of neutral technical progress. Ten units of commodity X were produced using three units of capital and three units of labour (i.e. the capital labour ratio (K/L) in the production of X is one). Assume that the neutral technical progress has doubled the productivity of both capital and labour. The same output level ($10X$) can now be obtained by half of the previous level of input. At the new equilibrium E_1 , $10X$ is produced by 1.5 units of capital and 1.5 units of labour.

Figure 8.8B represents the case of labour saving (capital using) technical change, which has raised the capital labour ratio to 2 ($K/L = 2$). The new equilibrium point E_1 represents $10X$ with an input combination of two units of capital and one unit of labour at constant relative factor prices.

In Fig. 8.8C, the capital saving (labour using) technical development has lowered the capital-labour ratio to 0.5 ($K/L = 1/2$) and $10X$ is produced at the new equilibrium, E_1 , with one unit of capital and two units of labour at constant relative factor prices.

The reason for the substitution of the factors when technical changes occur is the change in the marginal productivity-cost ratio of the factors. For example, at point E_1 in Fig. 8.8B (which represents labour-saving technical development) the ratio of the marginal productivity of capital to its cost-interest (MPK/r) exceeds the ratio of the marginal productivity of labour to wage (MPL/w) and, therefore, capital is substituted for labour in the production of the commodity X .

In Fig. 8.8C, which represents capital saving technical change at E_1 the MPL/w exceeds MPK/r , labour is substituted for capital.

TRADE—AN ENGINE OF GROWTH?

The role of trade in economic development, particularly in respect of developing countries, has been widely debated. While many economists view trade as a powerful engine of growth, there are many, including some very renowned economists, who highlight the deleterious effects of trade on developing countries. While economists like Haberler and Cairncross strongly argue that foreign trade can contribute substantially to the development of the developing countries, Gunnar Myrdal, Prebisch, Singer and several others maintain that the accrual of the gains from trade is biased in favour of the advanced industrial countries, that foreign trade has inhibited industrial development in the poor nations, and that—contrary to what would be expected from classical trade doctrine—free trade has in reality accentuated international inequality. This chapter gives a brief account of the views of both these groups of economists.

Trade can be a powerful engine that propels economic growth.

Trade, undoubtedly, has several benefits. It promotes growth and enhances economic welfare by stimulating more efficient utilisation of factor endowments of different regions and by enabling people to obtain goods from efficient sources of supply. Trade also makes available to people goods which cannot be produced in their country due to various reasons. The role of trade in enhancing consumer choice (even delight) is tremendous. The foreign trade multiplier, described above, shows how an injection of income arising out of trade can lead to economic expansion.

Some of the benefits of trade were highlighted by the father of Economics himself—Adam Smith pointed out the role of trade in increasing the division of labour (i.e. specialisation) and the economic benefits flowing from it, viz. increase in productivity and national wealth. Similarly, J.S. Mill also underlined the dynamic effects of trade on the productive power of the world. As is clear from his exposition of the comparative cost theory, the classical economist Ricardo also indicated certain benefits arising from trade between nations. Haberler argues: “International division of labour and international trade, which enable every country to specialise and to export those things that it can produce cheaper in exchange for what others can provide at a lower cost, have been and still are one of the basic factors promoting economic well-being and increasing national income of every participating country.”¹

D.H. Robertson made the profound observation that trade is ‘an engine of growth’. Though he made this observation in the context of the nineteenth century developments, a number of economists maintain that it is equally true of today. For instance, Haberler has argued that international trade has made a tremendous contribution to the development of less developed countries in the 19th and 20th century and can be expected to make an equally big contribution in the future, if it is allowed to proceed freely. He has, however, made it clear that it does not necessarily follow that a 100 per cent free trade policy is always most conducive to most rapid development and that marginal interference with the free flow of trade may speed up development. Haberler further notes that drastic deviations from free trade can be justified, on development grounds.² According to Cairncross, “As often as not, it is trade that gives birth to the urge to develop, the knowledge and experience that make development possible, and the means to accomplish it.”³

Haberler lists the following benefits of trade to stress the importance of trade to development of the less developed countries.⁴

- Trade provides material means (capital goods, machinery and raw and semi-finished material) indispensable for economic development.
- Even more important, trade is the means and vehicle for the dissemination of technological knowledge, the transmission of ideas, for the importation of know-how, skills, managerial talents and entrepreneurship.
- Trade is also the vehicle for the international movement of capital, especially from the developed to the underdeveloped countries.
- Free international trade is the best anti-monopoly policy and the best guarantee for the maintenance of a healthy degree of free competition.

It may be noted that India's trade liberalisation has brought in significant benefits for the consumers and the nation as a whole. Now, a wide choice of goods of foreign and domestic producers are available; prices have been becoming more competitive; quality and feature improvements, innovation, and pre and after sales services have been gaining importance.

There is, however, a strong view that the gains of trade are cornered, by and large, by the developed countries and that the developing countries which are mostly primary exporters are at a disadvantage. The *Prebisch-Singer thesis* and the *Immiserising Growth thesis* explain this viewpoint.

Vent for Surplus Theory

Trade, by providing a vent for surplus, may enable firms as well as nations to achieve optimum/full utilisation of productive capacity.

When a firm is not able to reach optimum capacity utilisation because of domestic market constraints, international trade can help increase capacity utilisation and the profitability of the domestic business. This is illustrated with the help of Fig. 8.9.

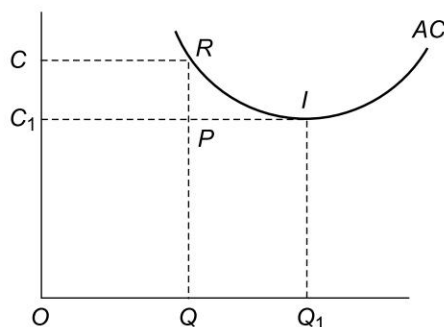


Fig. 8.9

Impact of Exports on Average Unit Cost

In the figure, AC is the average cost curve. The average cost of production per unit will be the lowest if the plant is operated at optimum capacity, i.e. if the quantity of production is Q_1 . However, because of the domestic demand constraint the output level is only Q and the corresponding average cost is C . If the company can export QQ_1 quantity, it can operate at optimum capacity and reduce the average cost by CC_1 . Under such a situation exporting even on no-loss-no-profit basis is advisable because by optimum utilisation of the capacity the profitability of the domestic business is increased. In the above example,

the profitability per unit will be increased by CC_1 and the total profit from domestic business will increase by $CC_1 PR$. Thus, in this case, trade increases the profit from domestic business without any increase in price or domestic sales.

The doctrine of vent for surplus embodied in Adam Smith's theory of international trade highlights the role of trade in respect of a country where the resources are underutilised. Adam Smith, observes in the *Wealth of Nations*: "Between whatever places foreign trade is carried on, they all of them derive two distinct benefits from it. It carries out that surplus part of the produce of their land and labour for which there is no demand among them, and brings them back in return for it something else for which there is a demand. It gives a value to their superfluities by exchanging them for something else, which may satisfy a part of their wants and increase their enjoyments. By means of it, the narrowness of the home market does not hinder the division of labour in any particular branch of art or manufacture from being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive powers, and to augment its annual produce to the utmost and thereby to increase the real revenue and wealth of society."⁵

Opportunity for exporting domestic surplus facilitates better utilisation of resources.

According to Hla Myint, who has highlighted the relevance of the Vent for Surplus theory to the underdeveloped countries, there are two leading ideas in the above observation of Smith:

- International trade overcomes the narrowness of the home market and provides an outlet for the surplus product above domestic requirements. This develops into what may be called the "vent for surplus" theory of international trade.
- By widening the extent of the market, international trade also improves the division of labour and raises the general level of productivity within the country. This develops into what may be called the "productivity" theory.⁶

The vent for surplus theory suggests that trade would help a country to achieve better utilisation of its resources and move to a higher level of consumption and welfare.

In short, trade helps firms and nations to overcome the problem of small size of the domestic market and achieve economies of scale or better utilisation of national resources. This highlights the importance of export-led growth for countries which suffer from domestic demand constraints.

TRADE LIBERALISATION AND POVERTY

There are strongly opposing views regarding the impact of trade liberalisation on poverty in developing countries. Many economists, particularly from developed countries, and international organisations strongly argue that trade liberalisation can foster economic growth, help mitigate poverty and improve the overall welfare. On the other hand, it is vehemently argued that trade liberalisation will further impoverish the poor countries.

Trade liberalisation can have beneficial and harmful effects on poverty.

The Positive Side

Theoretically, trade liberalisation can lead to reduction of poverty. Several country studies substantiate this theoretical postulate. The possible impacts of trade liberalisation on poverty are the following.

- The expansion of the export sector following trade liberalisation will increase the demand for labour. (Exports of developing economies are assumed to be mostly labour intensive.) This will

reduce unemployment in countries where there is unemployment. Where the labour is fully employed, the increase in demand for labour will push up wages, benefiting labour. Labour will also benefit if there is migration of labour from low paid occupations to relatively high-wage export industries.

- Expansion of the export sector will increase the demand for other factors/resources, benefiting their owners.
- Further, the acceleration of economic growth caused by export growth will benefit the economy in general. Experiences of South-East economies show the benefits of export led growth.
- The boom of India's IT exports has been generating large number of high paid jobs for the educated youth and it has trickled down effects.
- It is also argued that trade liberalisation can reduce the cost of living by providing access to cheaper imports of food and essential consumer goods, and by keeping domestic prices in general under check because of the global competition.
- Further, the expansion of higher levels of national economic activity can increase government revenue enhancing the capability of the government to increase the outlay on welfare activities for the poor.
- Another argument is that, indirectly, trade can contribute to long-term poverty reduction by enhancing production and resource allocation efficiencies and concentrating economic activity in areas where the greatest economic gains are possible.⁷

The Negative Side

The trade liberalisation in actual practice is not fair but biased to serve the vested interests of the developed countries. For example, exports of developing countries face high trade barriers in developed countries. These countries are losing market share even in traditional commodities, mainly owing to situations with their physical and social infrastructures, lack of technical and institutional capacity (transfer of technology and know-how), and subsidies observed in some key sectors. Attempts by developing countries as a group to shift away from **commodity dependence** have generally been frustrated by restrictive trade rules' bias against agricultural commodities (for example, via **tariff escalation**).

- The developing countries, particularly the least developed countries and many other poor ones, are characterised by large subsistence sector which can hardly withstand the global competition
- Multinational firms with smart marketing strategies change the consumption habits and attitudes of people which could play havoc with traditional economic activities and in due course with the well being of the consumers.
- With the secular deterioration in the terms of trade, more openness can lead to immiserising growth for developing countries.

The Evidence

Evidences of impact of trade liberalisation on poverty are mixed.

The evidences brought out by studies of the impacts of trade liberalisation on poverty present a mixed picture, with positive impacts on some countries and negative on some others while there is no clear indications in certain cases.

Results of some country-based studies in East, South East and South Asia demonstrate that trade-led growth has helped reduce poverty, directly or indirectly. However, this has been made possible through strategic trade liberalisation by the countries concerned. In this region, with an average annual economic growth rate of over six per cent, GDP per capita has tripled, pulling some 400 million people out of extreme poverty since 1981. In contrast, studies on the experience of other regions have not been so encouraging, particularly in some African and Latin American countries. For example, since 1981, in the Latin America and Caribbean region, economic growth has been meagre, only marginally reducing poverty, while in Sub-Saharan Africa the number of people living on less than \$1 a day nearly doubled to over 310 million. This is despite the fact that in these two regions countries have undertaken extensive trade liberalisation, autonomously, under the structural adjustment programmes of international financial institutions, or as part of their contribution to regional and multilateral trade negotiations.⁸

The Indian Case

According to a study sponsored by UNCTAD and Government and conducted by Veena Jha et. al., the results of which are published as a book, *Trade Liberalisation and Poverty in India*,⁹ trade liberalisation is contributing to poverty reduction in India. The study which covered agriculture, textiles and services, indicates that the services sector has a particularly large potential for poverty alleviation, as its employment generating capacity is much greater. After the removal of textile quotas under the Multi-fibre Arrangement (MFA) with effect from January 1, 2005, India's textile exports are expected to rise 143 per cent, lifting 310,000 out of poverty. But these gains will only materialise if India's major trading partners do not take trade defence measures, such as anti-dumping and subsidies.

Trade liberalisation has limited impact on the agricultural sector which employs 60 per cent of the Indian population, and, therefore, critical to poverty and hunger alleviation. But, if developed countries were to reduce their hefty agricultural subsidies, India's agricultural exports could rise by up to 13 per cent and lift 400,000 people out of poverty each year.

The book concludes that while trade liberalisation and its concomitant growth can help significantly, it will not take India out of poverty; direct government expenditure on health care, education and nutrition are far more critical for poverty alleviation.

The book also establishes quite succinctly that trade liberalisation will not help achieve reduction in poverty unless accompanied by necessary domestic reforms. For globalisation to be pro-poor, it needs to be combined with policies which create a more equal distribution of, or access to, productive assets and resources which build the capacity of vulnerable groups to face successfully increased competition. National trade strategy must create and sustain a dynamic process of capital accumulation, structural change and technical progress to develop productive capacities of national economies. Particularly in the case of services sector, it is seen that states in India which had placed emphasis in the development of human capabilities, especially education, access to land and empowerment of women have benefited significantly.

This study has its own limitations. While it has estimated some of the possible positive impacts, it does not appear to have considered the damages that can be caused to these sectors by trade liberalisation. The beneficial and harmful effects of globalisation on other sectors is beyond the scope of this work. The findings of this study shall, therefore, needs to be approached cautiously for interpretation and generalisation.

EXPORT-LED GROWTH AND CAPITAL-FLOW INDUCED GROWTH

It may be noted that while a large number of developing countries do not derive from trade benefits significant enough to propel economic growth, there are also several countries like the newly industrialising countries (NICs) such as S. Korea, Taiwan, Singapore and Hong Kong which have experienced very

Export-led growth enabled several developing countries to overcome the limitations of small domestic market.

high rates of growth through what is generally regarded as an export-led growth. After completing the first phase of import substitution, these countries shifted the emphasis to export promotion. (For more information, see the chapter on *Trade Strategies*.) The foreign markets have enabled these countries to establish manufacturing capacities of

economically viable sizes, and much beyond. Thus, foreign trade enabled them to overcome the limitations of the domestic market in reaping the advantages of economies of scale. Encouraged by the experience of these countries, several other Asian economies, including China, have begun to give more importance to export promotion. As a matter of fact, the trade strategy of many countries has been becoming progressively outward oriented.

Indeed, perceptions on the role of foreign trade in growth have changed dramatically in the last five decades. During the 1950s and the 1960s import substitution-based industrialisation represented the dominant growth strategy pursued by several developing countries. In the 1970s, the growth experiences of individual countries led to scepticism regarding the virtues of import substitution. The resultant shift in policy stance in favour of outward-oriented trade strategies that started towards late 1970s gathered momentum in the subsequent years as a large number of cross-country studies validated the positive relationship between export growth and output growth. Some evidence demonstrating the superior growth performance of countries with export-oriented trade strategies is also available.

The outward orientation has become more pronounced in the 1990s and afterwards.¹⁰

The theoretical arguments supporting an export-led growth strategy state that trade restrictions can reduce economic growth by distorting the pattern of resource allocation and by limiting the scope for innovation, technical progress and export efficiency. Trade liberalisation, in turn, could contribute to economic growth by facilitating technology transmission, international integration of production and the associated possibility for reaping scale economies, reduction in price distortions and increase in efficiency. In imperfectly competitive markets, increased competition through trade could bring about welfare gains by reducing the deadweight losses stemming from monopolies and oligopolies. Trade liberalisation could be highly conducive to growth as import substitution inflicts static costs on the economy by way of resource misallocation as also dynamic costs by raising the incremental capital-output ratios and by depriving access to new technology.¹¹

There can also be capital induced growth, i.e. by infusion of foreign capital that will spur investment and growth.

The standard analysis of growth in an open economy encounters an apparent contradiction between “export-led growth” on the one hand, and “capital-flow-induced growth” on the other, even though in reality both strategies could be operationalised simultaneously to strengthen the growth process. The apparent contradiction arises from the macro-economic identity $[Y = C + I + G + (X - M)]$ which suggests that while a surplus in the external goods and services account—reflecting the result of an export-led growth strategy—could increase GDP, that would tantamount to no role for net external financing, as the country must necessarily save more than it can invest, leading to net capital outflows.

The underlying assumption behind this assessment is that an export-led growth strategy can stimulate growth only by generating a surplus in the external goods and services account. The actual external resource transfer process and the stages over which the importance of each form of transfer changes can explain how a developing country could simultaneously benefit from both export-led and capital-flow-induced growth strategies.¹²

A developing economy may accelerate its growth by simultaneous sustainable level of current account deficit (CAD) and capital account surplus by large foreign investment inflow (refer the chapter on *Balance of Payments* for explanation of current and capital accounts).

A CAD deficit means current domestic consumption more than the current domestic production. A CAD at high levels of exports should be a stimulant to domestic economic growth, given the required favourable environment. A relatively high marginal productivity of investment in developing countries, due to factors such as low production costs and expanding markets, would encourage foreign investment.

Simultaneous sustainable CAD and capital account surplus can accelerate economic growth of developing countries.

A deficit in the goods and services account and the associated net capital inflows can enable the economy to bridge its consumption gap, and also help in achieving output convergence with the advanced economies. An export-led growth strategy could enhance the ability of a developing country to achieve this goal faster by allowing higher levels of sustainable imports. Sustainable capital inflows to finance the gap so created would be growth enhancing. In small open economies, a surplus generated in the trade (for goods and services) account could raise GDP. Residents would increase their external financial assets, acquired in exchange of real resources through the trade surplus. Financial assets, in turn, represent command over future goods and services. An open capital account in such economies helps in allowing freedom of portfolio adjustment and consumption smoothing to each resident. Small open economies, however, depend largely on external demand conditions for sustaining the export-led growth. A slow-down in external demand conditions can give rise to a large scale deceleration in domestic GDP growth in such economies. For example, Singapore's external current account exhibited large surplus in recent years (in excess of 20 per cent of GDP) indicating the role of net exports in growth. However, given its high degree of openness and sensitivity of GDP growth to global demand conditions, the global economic conditions can significantly impact its growth.¹³

FDI can make an important contribution to sustaining an export-led growth strategy. The comparative advantage positions of industries of a country normally change as an economy develops (for example the emergence of industries like software, auto components, pharmaceuticals as important export performers of India) and, therefore, it becomes important to attain dynamic shifts in comparative advantage. FDI can play a major role in imparting the desired dynamism on account of its associated technological and innovative capabilities and global marketing network. But when market seeking (see chapter on *International Capital Flows* for explanation), the expected contribution to dynamic comparative advantage of the host country may not materialise. That FDI has been largely market seeking is indicated by the fact that annual sales of foreign affiliates outpaced total volume of global annual merchandise exports in the 1990s, showing the growing importance of market access through FDI in relation to exports.

In a number of studies, cross-country comparisons suggest a high degree of co-movement between export-growth and output-growth even though in empirical findings there is as yet no consensus. A positive export-GDP relation in several semi-industrialised countries is attributable to the contribution of export earnings in releasing the import constraint to growth.¹⁴

EXPORT PESSIMISM AND IMPORT SUBSTITUTION STRATEGY

As mentioned earlier, in the 1950s, economists like Prebisch, Myrdal and Nurkse purported the export pessimism, i.e. pessimism about demand for LDC exports in the markets of the developed countries. Arguing that the demand for ‘*periphery* countries’ exports in the 20th century were far weaker than they

Developing countries heavily dependent on primary commodity exports may not benefit significantly from trade.

were in the 19th century, trade as an engine of growth, a function which Nurkse, like several others, felt it served in the 19th century. Nurkse listed several factors for the deterioration of the demand for LDC exports. They are summarised by Cairncross as follows:¹⁵

- The change in industrial structure in favour of heavy industries with a low content of imported raw materials.
- The rising share of services in total output of advanced countries.
- The low income elasticity of consumer demand for many agricultural products.
- Agricultural protectionism.
- Economies in the use of raw materials, e.g. through reprocessing of scrap, and the introduction of synthetic materials.

Nurkse, however, failed to take into account the price factor adversely affecting the developing country exports. The terms of trade issue was introduced primarily by Prebisch and Myrdal who, as Kravis points out, “went beyond Nurkse’s pessimism about the adequacy of markets and claimed that free trade would be an impediment to economic advance in the poor countries.”¹⁶

The solution prescribed in the 1950s by Nurkse and several others with export pessimism was an inward looking (i.e. import substitution) strategy, in effect, to scrap the trade engine altogether (for details regarding the inward oriented strategy, see the chapter on *Trade Strategies*). Nurkse, for instance, maintained that “when developing countries face difficulties in exporting both traditional and new exports, import substitution strategy may be adopted by them as an escape route from economic stagnation.”¹⁷

The ISI strategy was received with warmth, perhaps, also due to reasons other than those mentioned above. For instance, Meier argues: “The promotion of a sheltered home market had a common appeal to the bureaucratic-authoritarian state, urban manufacturers, and multinationals that supplied technology and capital. Protection also met the State’s objective of pursuing revenue and expenditure—maximising activities through maximum revenue tariffs and export taxes.”¹⁸

Whatever be the real combination of motives, a number of countries pursued the import substitution strategy in different forms, for different periods and with different intensities and extent.

Import substitution strategy has contributed to the industrial development of a number of countries. In several cases import substitution set the stage for successful export promotion. However, in India and several Latin American countries, where the import substitution strategy has been extended too far, neglecting export development, it has severely hampered economic progress (see the chapter on *Trade Policy of India*). On the other hand, countries which, after a certain period of import substitution strategy, shifted emphasis to export promotion, (South Korea, for example) have achieved impressive economic growth.

Several studies indicate that the major drawbacks of the excessively inward looking trade regime of India was that it led to an inefficient and high cost industrial structure, which also adversely affected the prospects for export growth.¹⁹ Also see the section *Import Substitution* in the chapter on *Trade Regulation and Promotion* in part 6.

HARMFUL EFFECTS OF TRADE

International trading system is biased against developing countries.

While trade can be beneficial to nations and the world as a whole, it can also have harmful effects on some countries and the world as a whole.

The international trading system is biased against the developing countries, particularly the poor among them, because of factors like their weak bargaining power vis-à-vis the advanced countries, the participation gap (described in Chapter 2), dependence on the developed countries for various needs etc.

The important harmful effects of trade are the following.

- Trade may lead to indiscriminate exploitation of natural resource, particularly of developing nations. Trade has been resulting in the drain of resources from the developing to developed countries.
- Trade also causes environmental problems because of the indiscriminate exploitation of resources and location/relocation of polluting and hazardous industries in the developing world for the benefit of the developed world.
- The deterioration of the terms of trade of the developing countries causes large income transfers from the developing to the developed countries (see the following subsections—*Prebisch-Singer thesis* and *Immiserising Growth*).
- International trade may also give rise to demonstration effect in the developing countries. *Demonstration effect*, a term associated with Nurkse, refers to the tendency of poor people to imitate the life styles of the rich. In international economics, it refers to the tendency of the people of developing countries to follow the consumption habits of the people of the advanced countries by importing. This could have harmful social and economic effects. It could also have some favourable effect if it can encourage the development of the domestic industries of the developing countries.
- Another important harmful effect of trade is what is described as the *backwash effect*. Some of the domestic industries of the developing countries, particularly small scale units, which are unable to compete with the well developed industries of the advanced countries, could be destroyed or damaged by unregulated imports. India has had a paradoxical policy of reserving many items for the small scale sector but allowing the import of these items. The recent trade liberalisation is adversely affecting the agricultural, often subsistence, sector of many developing countries even as the agricultural sector is heavily protected in the developed world.

Globalisation and free trade are now adversely affecting the developed countries too because of the edge the developing countries have over the developed ones in the production of many products. (See the sub-section *III Effect of Globalisation* in Chapter 3.)

- Trade also results in the introduction of the *pope* and *cola* cultures to the developing countries which have important social implications.

PREBISCH-SINGER THESIS (SECULAR DETERIORATION THESIS)

Economists like Gunnar Myrdal, Raul Prebisch and Hans Singer have argued that the primary exporting countries, particularly those of the Third World, have been experiencing a secular (i.e. long-term) deterioration in the terms of trade. The implications of this argument, which is often referred to as the Prebisch-Singer thesis, is that less developed countries had to export increasing amounts of their primary products in exchange for imports of manufactured goods from the

There has been a secular deterioration in the collective terms of trade of developing countries.

industrially advanced countries. The secular deterioration in the terms of trade was considered as one of the important reasons for these countries' economic backwardness.

This deterioration in the terms of trade causes large transfer of income from developing to developed countries, as indicated towards the end of this section.

In support of the secular deterioration thesis it has been claimed, for instance, that between the latter part of the 19th century and 1939, there was a fall in the prices of primary goods relative to the prices of manufactured goods. On average, a given bundle of primary goods reduced, in exchange, to 60 per cent of the quantity of manufactures that could be secured earlier. From this, it has been deduced that there must have been a comparable worsening of the terms of trade of the underdeveloped countries. Some studies have indicated that the terms of trade of the developing countries have deteriorated in the recent decades also.

Causes for Deterioration The Prebisch-Singer thesis points out three causes for the deterioration of the terms of trade of the primary exporters.

(a) Differences in the Elasticity of Demand The demand for primary products is relatively income inelastic, i.e. as income increases, the demand for primary products increases less than in proportion. The demand for manufactured goods, on the other hand, is relatively income elastic i.e. as income increases, the demand for manufactured goods increases more than in proportion. Other things remaining equal, such a demand bias causes terms of trade of primary product exporters to deteriorate over time.

(b) Technological Change Raw material saving innovations have tended to reduce the demand for primary products (for example, the development of low-cost synthetic rubber can substitute natural rubber in some areas). Fall in the demand for primary products due to such innovations naturally cause a fall in their prices.

(c) Monopoly Power The higher degree of monopoly power that exists in industry than in agriculture makes it possible to charge a higher price for the manufactured products as compared to the agricultural products.

Criticism of Prebisch-Singer Thesis

The Prebisch-Singer thesis is subject to a number of criticisms. Bhagwati points out, for instance, the following drawbacks of the thesis.²⁰

- (a) It is not possible to infer the behaviour of the terms of trade of underdeveloped countries directly from that of primary products vis-à-vis manufactured goods. The underdeveloped countries export different types of primary products and sometimes even manufactured goods. They also import different types of manufactured goods and even primary products. Any aggregated analysis of primary products versus manufactured goods, therefore, will not give a firm clue regarding the behaviour of the terms of trade of underdeveloped countries.
- (b) The index as computed tends to understate the gains of primary exporters in trade. Manufactured products have improved tremendously in quality over the period, but the index hardly allows for it.
- (c) The index refers to the British data for the period. This again overstates the loss of the primary producers, as transport costs were falling over the period.

Post-War Developments

Even though the Prebisch-Singer hypothesis, proposed in 1950, was originally based on the pre-Second World War data, Singer points out that post war history has done nothing to discredit the original simple Prebisch-Singer thesis. Primary commodities certainly have declined in price relative to manufactured goods.²¹ He further argues that the big exception, i.e. oil, in fact proves the hypothesis since the oil price hike was achieved by superseding market mechanism through a producers' cartel (OPEC). Apart from industrialisation and more processing, the formation of producers cartels (or in a milder form, international commodity agreements for setting minimum prices) were natural recommendations flowing from the Prebisch-Singer hypothesis.²²

The Prebisch-Singer thesis was originally limited to the rather direct and empirical statistical problem of the barter terms of trade. It postulated, as has already been stated earlier, a declining trend for exporters of primary commodities and improving trend for exporters of manufactured goods.

Subsequently, the hypothesis was broadened in such a way as to apply to the exports of developing countries (regardless of commodity composition) as against their imports from the more developed countries. This expansion of the hypothesis led to the theories of dependence (associated with such names as Osvaldo Sunkel) and, above all, to the theories of unequal exchange (associated with A. Emmanuel).²³

Singer points out that the recent pressure of debt problems on developing countries has given yet another twist to the hypothesis. It strengthens it in two ways:²⁴

- (a) A high proportion of export proceeds are not available for imports; this is of course, equivalent to a corresponding deterioration in terms of trade; and
- (b) The pressure to increase exports in order to repay debts, reinforced by IMF-induced adjustment policies, forces developing debtor countries to compete with each other for export earnings, again leading towards a deterioration of terms of trade.

As referred to above, during the post war period also the terms of trade of the primary commodities and of the developing countries deteriorated, in general. Between 1955 and 1975, the terms of trade of the developed countries remained roughly constant while that of the third world fell by over 20 per cent. In contrast, oil exporting nations realised an extraordinary improvement in their terms of trade from an average of 97 in 1955 to 303 in 1976.²⁵ One estimate has placed the extra costs of deteriorating terms of trade for the LDCs at over \$2.5 billion per year during the 1970s.

The 1980s was also a decade of deterioration for the primary commodities (and also the developing countries), and real commodity prices in the 1990s were 45 per cent lower than those in the 1980s, and 10 per cent lower than the lowest level during the Great Depression, in 1932. The terms of trade for the least developed countries have declined a cumulative 50 per cent over the quarter century since 1970.²⁶

The transfer of resources from the developing to the developed countries that this deterioration involved is massive.

WTO's *World Trade Report 2003* observes that over the long term, real commodity prices have suffered a decline marked by significant volatility, and that evidence suggests that commodity price shocks retard growth rates and threaten persistent or rising poverty in already poor countries. The original finding of Prebisch about the terms of trade has been confirmed by contemporary research with price data up to the end of the 20th century, which indicates that the secular decline has been continuing. The conclusion is

robust regardless of the commodity price data used or the deflators chosen. The high level of agricultural support in developed countries (which has a price depressing effect) and manipulative power of the intermediaries at various stages of the marketing chain have also been contributing to this trend, besides those explained by Prebisch–Singer.²⁷

The unit value index of exports for developing countries as a whole fell sharply in the 1980s. This trend continued, although less markedly, during the 1990s. For instance, in 2002 the price index of agricultural commodities deflated by the price index of manufactured exports of industrial economies in US dollars (74) was one half of the same index in 1980 (145). For tropical beverages and food, the decline was even steeper. The long-term real decline in commodity prices has led to severe deterioration in terms of trade for many commodity dependent developing countries. This has influenced balance of payments sustainability, impeded development and affected social welfare, while increasing impoverishment and environmental degradation.²⁸

Today the Prebisch–Singer thesis about the deterioration of terms of trade and the long-term decline of commodity prices is more valid than ever.²⁹ In short, either the Prebisch–Singer or Lewis explanation still implies that if a country specialises in commodity production, it will face the long-term challenge of managing adverse terms of trade movements. In the face of continued growth in agricultural productivity, greater diversification in the economic structure of commodity-dependent countries will be the only effective way to manage the problem.³⁰

In view of the increase in the share of the manufactures in the exports of developing countries, attention needs to be paid to the relative movement in the prices of manufactures exported by developing countries vis-à-vis developed countries. Such price movements primarily reflect the differences in terms of technological capacity, labour market institutions and prevalence of surplus labour among the country groups. As a result, while some developing countries like China and India experienced a relatively stable terms of trade, others such as Korea, Brazil and Thailand witnessed a secular decline since the 1970s.³¹ (Also see the section *Global Trade and Developing Countries* in Chapter 3.)

Recent Trends

Prices of primary products, including agricultural, improved since 2002 and the rising trend is expected to continue in the near future. On the other hand, the terms of trade of manufactures have deteriorated.

Prices of primary commodities have shown an upward trend recently. There has been boom in commodity prices since 2002. Prices of minerals, ores, metals, food commodities, agricultural raw materials and tropical beverages group experienced sharp price increases in varying degrees.

As a result, the UNCTAD price index for non-fuel commodities reached its highest level since 1960 in current dollars. Price indices of minerals, ores and metals, agricultural raw materials and crude petroleum also hit an all-time record in nominal terms. The food index reached its highest level since its last peak in 1996, while the price indices for tropical beverages and vegetable oilseeds and oils remained below their previous peaks attained in 1997 and 1998 respectively. The prices of agricultural raw materials equaled those reached in 1995. However, even though the price indices of all commodity groups in nominal terms have been above their declining long-term trend in real terms, most real prices of commodities are still far below their levels of 1970s and early 1980s. Only the real prices for the minerals, ores and metals group have substantially exceeded those levels.

The Impact of the price rise on the terms of trade of different categories of exporters vary. Net barter terms of trade of developing country exporters of fuels minerals and mining products rose steeply, and of exporters of manufactures and primary commodities improved very little, while that of exporters of manufactures significantly and of agricultural commodities slightly declined.

These trends are reflected in the different developing regions: East, South and South-East Asia (where manufactures constitute the largest share of exports) saw a further deterioration in their terms of trade; West Asia and Africa experienced sharp increase (mainly in the oil exporting countries of those regions); and Latin America and the Caribbean recorded moderate, but still significant gains. These aggregate outcomes conceal wide differences within each group. In developing America, most South American countries posted gains in their terms of trade, while several Central American and Caribbean countries suffered losses. In Africa, the terms of trade improved particularly in the oil-rich sub-regions (North Africa, West Africa and Middle Africa) there were wide differences between the oil and gas exporters of the Gulf States and those exporting mainly manufactures, such as Jordan and Turkey.³²

According to WTO's World Trade and Development Report 2007, the outlook is that commodity prices will remain high for some years, on account of solid demand for commodities in the rapidly growing developing countries, even though global economic growth is expected to slow somewhat. But the rates of growth of commodity prices may decelerate as new supplies enter the markets. However, there is no clear understanding as to when this might happen, particularly for metals and minerals. Supply response will be much faster for some agricultural commodities, which will also be subject to volatility due to weather conditions. China will continue to play a key role in commodity markets, both the demand side and the supply side. According to some reports, the Chinese Government might be even considering investing part of its foreign exchange reserves in increasing its strategic commodity reserves.³³ Thus, there seems to be a structural change in commodity markets, which indicates the prices are likely to slump because of supply-side factors. Consequently, commodity prices are likely to remain above the long-run declining trend in real terms, but it will be too optimistic to conclude that there might soon be a reversal of this trend.

IMMISERISING GROWTH

The theory of immiserising growth, put forward by Jagdish N. Bhagwati,³⁴ purports that under certain circumstances economic expansion and trade may harm the developing country. Immiserising growth refers to a case where growth (due to technical progress and/or factor accumulation) leads to a sufficiently acute deterioration in the terms of trade, which imposes a loss of real income outweighing the primary gain in real income due to the growth itself.

In other words, the concept of immiserising growth is that a substantial increase in the export of a commodity can depress its price in the world market to such an extent of making growth damaging for the country. That is, the negative terms of trade effect outweighs the positive effect of increased output.

The following three crucial conditions are necessary for immiserising growth to occur.³⁵

- (a) The country's growth must be biased towards the export sector.
- (b) The foreign demand for the country's exports must be price inelastic, so that an expansion in export supply leads to a large drop in price.

A substantial increase in export supply of a commodity can result in a negative terms of trade effect outweighing the positive effects of growth.

- (c) The country must already be heavily engaged in trade for the welfare meaning of the drop in the terms of trade to be great enough to offset the gains from being able to supply more.

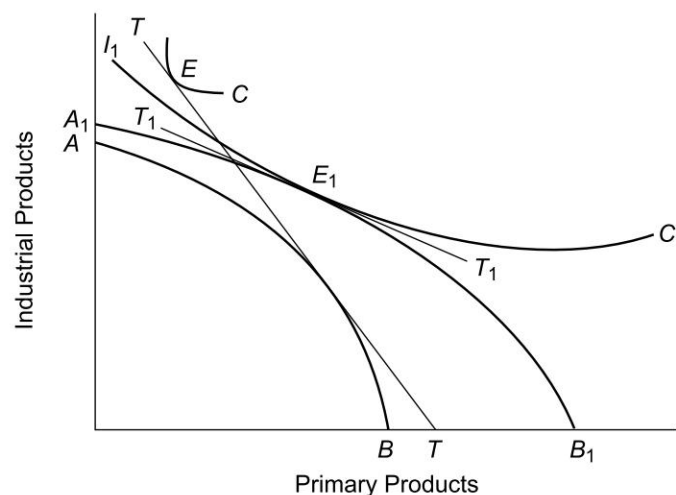


Fig. 8.10 Immiserising Growth

Figure 8.10 illustrates a case of immiserising growth. In the figure, we represent an underdeveloped country exporting primary products and importing industrial goods. Originally, with the AB —production possibility curve, and TT —terms of trade, the country is on the consumption point E on the indifference curve IC . Now suppose that the production possibility curve shifts from AB to A_1B_1 , reflecting an increase in the production potential biased strongly towards primary products and the terms of trade become T_1T_1 , which is flatter than TT , implying a deterioration for the country. (This is because the increase in the supply of the primary product results in a fall in its price, demand for the primary product being relatively inelastic.) Now, the country is on the consumption point E_1 on the indifference I_1C_1 , which represents a lower level of welfare than IC . This implies that the production gain is more than offset by the declining terms of trade, resulting in a decreased welfare position.

Supplementing Bhagwati's proposition, Harry Johnson has shown that the phenomenon of immiserising growth, involving reduction in social welfare below the initial pre-growth level, can arise also in the case of a small country without any monopoly power in trade if technical progress occurs in a tariff-protected import competing industry or if the factor in the use of which this industry is intensive is augmented.³⁶

The case presented by Bhagwati and Johnson belong to a general class of immiserising growth phenomena which can arise in the presence of distortions. In the case presented by Bhagwati, where gains from growth were outweighed by losses from worsened terms of trade, the distortion is foreign; the average terms of trade differ from the marginal. In the tariff situation for a small country analysed by Johnson, the distortion is policy imposed. In either case, the essential point is that the gain which would accrue from growth is outweighed by the incremental loss of real income which the distortion imposes in the post-growth situation. Thus, the phenomenon of immiserising growth can occur, in principle, whenever distortions occur in an economic system.³⁷

SUMMARY

Economic growth can impact trade, but views about its effect on trade differ.

Growth of foreign economies will benefit the domestic economy if the demand growth abroad results in an increase in the demand for exports of the home country. On the other hand, a recession abroad can adversely affect the domestic economy as it can cause a fall in the demand for the nation's exports and increased competition for the exports. However, recession abroad can also have favourable effects on the domestic economy if imports become cheaper leading to an improvement in the terms of trade.

Growth of the domestic economy is expected to have a favourable impact on exports as it increases the exportable surplus. However, it may also be noted that domestic growth would increase the demand which would mean an increase in demand for imports as well as domestic output.

Economic growth results from an upward shift of the country's production frontier. Depending on the pattern of the shift of the production frontier, the growth is classified as balanced growth and biased growth. If the bias in the growth is in favour of the goods the country exports, it is export-biased growth and if the growth is biased towards the goods it imports, it is import-biased growth.

Two important trade effects of the growth to be considered are the effect of growth on the terms of trade and the effect of growth on the volume of trade.

The terms of trade may be effected by the shift in the relative supply resulting from growth. The export-biased growth tends to worsen a country's terms of trade to the benefit of the rest of the world, and import-biased growth tends to improve the terms of trade of the country at the expense of the rest of the world.

The effect of growth on the volume trade depends on the rate at which the output of the country's tradable commodities grows and on the consumption pattern of the country as its national income expands through growth and trade. Growth in production is regarded **pro-trade** if it leads to a more than proportionate increase in trade. Consumption is regarded *pro-trade* when the nation's consumption of its importable commodity increases proportionately more than the consumption of its exportable commodity at constant relative commodity prices. Growth in production or consumption is *neutral* if it leads to a proportionate increase in the volume of trade and *anti-trade* if it tends to increase trade less than proportionately. Growth is regarded *ultra trade-biased* when, at unchanged trading price, the country produces not only more of the exportable commodity but also reduces the output of the importable commodity. An ultra export-biased growth has the effect of worsening the terms of trade. An ultra import-biased growth, on the other hand, improves the terms of trade.

The net result of the production and consumption effects of growth on the trade depends on the income elasticity of demand for imports measured as the percentage change in the demand for importables divided by the percentage change in the national output. Growth is neutral if this elasticity is equal to one (i.e. trade is growing at the same rate as national income). Growth is pro-trade-biased if the income elasticity of demand for importables is greater than one (i.e. trade is growing faster than income). Growth is anti-trade-biased if the elasticity is less than one (i.e. trade is growing slower than national income). Growth is ultra-anti-trade-biased if the elasticity is negative. It is ultra-pro-trade-bias if the elasticity exceeds the original ratio of national income to imports (an alternative way of expressing a negative output-elasticity of demand for exportables).

In sum, the different types of growth vis-à-vis trade are the following.

Pro-trade Growth, which increases the demand for the country's imports and supply of exports more than proportionately to output.

Neutral or Unbiased Growth, which increases the country's demand for imports and supply of exports in proportion to the output.

Anti-trade Growth, which increases the country's demand for imports and supply of exports less than proportionately to output.

Ultra-protrade-biased Growth, which increases the production of the exportable and a decreases the output of the importable.

Ultra-antitrade-biased Growth, which tends to reduce exports by reducing the output of the exportable and tends to reduce imports by increasing the production of the import-competing commodity.

Theoretical analyses propose that economic growth in small country would not affect its terms of trade, whereas growth in a large country may cause a deterioration of its terms of trade.

Theoretically, small countries may gain more than large countries from international trade because the increase in the exports of the small country following growth will not be large enough to influence the international price, it would be able to trade without affecting the terms of trade.

According to the **Rybczynski's theorem**, which examines the effects of a biased growth on the output of the two goods, the increase in the quantity of a factor (given the other) will cause an increase in the output of the commodity which is intensive in that by a greater proportion and a decrease in the output of the other commodity, at unchanged commodity and factor prices. For example, if the supply of labour increases (that of capital remaining unchanged) it will lead to an increase in the output of the labour intensive commodity more than in proportion and a decrease in the output of the capital-intensive commodity.

Whether growth will improve or worsen the welfare of the nation depend on two factors—the terms of trade effect and the wealth effect of growth.

The terms of trade effect depends on what happens to the country's volume of trade following growth. The terms of trade tend to deteriorate when the country's volume of trade expands at constant prices and the terms of trade tend to improve if growth reduces the volume of trade.

The wealth effect refers to the increase in the output per worker or per capita income as a result of growth. Although a positive wealth effect tends to improve the nation's welfare, the net effect of growth on the welfare depends on the net effect of both the welfare and terms of trade effects.

If the growth results in a positive wealth effect and the trade effect of the growth improves the terms of trade, the nation's welfare will definitely improve. In contrast, the nation's welfare will definitely decline if the wealth effect is negative (or even neutral) and the terms of trade turns adverse. If the wealth effect and the terms of trade effect move in opposite directions, the nation's welfare may deteriorate, improve, or remain unchanged depending on the relative strengths of these two opposing forces.

Technical progress has made tremendous contribution to economic growth and international trade and factor movements.

Technical progress is neutral if, at unchanged capital/labour ratio, it causes an equiproportional increase in the marginal productivities of both the factors. Technical progress has a factor saving bias if it increases the marginal productivity of the other factor more than proportionately to the increase in the marginal productivity of the saved factor. For example, a labour saving technical progress will increase the marginal productivity of capital more than that of labour.

There are very different views about the role of trade in economic development, particularly in respect of developing countries. While many economists view trade as a powerful engine of growth, many others highlight the deleterious effects of trade on developing countries.

Trade can promote growth and enhance economic welfare by stimulating more efficient utilisation of factor endowments of different regions and by enabling people to obtain goods from efficient sources of supply. Trade, by providing a vent for surplus, may enable firms as well as countries to achieve optimum/full utilisation of productive capacity. Trade also makes available to people goods which cannot be produced in their country due to various reasons. The role of trade in enhancing consumer choice (even delight) is tremendous. Further, international trade can increase competition and become a counter-monopoly force.

Trade helps firms and nations to overcome the problem of small size of the domestic market and achieve economies of scale or better utilisation of national resources. While a large number of developing countries do not derive, from trade, benefits significant enough to propel economic growth, on the other hand, there are also several countries which have experienced very high rates of growth through what is generally regarded as an export-led growth.

There can also be capital induced growth, i.e. by infusion of foreign capital that will spur investment and growth. The comparative advantage positions of industries of a country normally change as an economy develops and, therefore, it becomes important to attain dynamic shifts in comparative advantage. FDI can play a major role in imparting the desired dynamism on account of its associated technological and innovative capabilities and global marketing network.

There is, however, a strong view that the gains of trade are cornered, by and large, by the developed countries and that the developing countries who are mostly primary exporters are at a disadvantage. The **Prebisch-Singer thesis** and the immiserising growth thesis explain this viewpoint. The Prebisch-Singer thesis suggests that, in the long-term, prices for primary commodity exports fall in relation to prices of manufactured imports. According to the hypothesis, this drop results from a number of factors, including divergence between the income elasticity of demand for primary products and the income elasticity of demand for manufactured products. Thus, the net barter terms of trade for commodity-producing developing countries are declining.

The implications of the Prebisch-Singer thesis, which says that there is a secular deterioration in the collective terms of trade of developing countries, is that less developed countries have to export increasing amounts of their primary products, in exchange for imports of manufactured goods from the industrially advanced countries. This deterioration in the terms of trade causes large transfer of income from developing to developed countries, as indicated towards the end of this section.

It is also argued that foreign trade may have backwash effect—destruction of or damage to domestic industries by unregulated imports.

According to the theory of **Immiserising Growth**, a substantial increase in the export of a commodity can depress its price in the world market to such an extent of making growth damaging for the country. That is, the negative terms of trade effect outweighs the positive effect of increased output.

Review Questions

1. Discuss the effect of economic growth on trade.
2. Explain the production and consumption effects of growth on trade.
3. Examine the effects of economic growth on the trade of small and large countries.
4. Discuss the effects of technical changes on growth and trade.
5. Discuss the inter-relationship between foreign trade and economic development.
6. Discuss the impact of trade on developing countries
7. Write notes on the following:
 - (a) Rybczynski theorem.
 - (b) Types of technical change.
 - (c) Trade—an engine of growth.
 - (d) Import substitution.
 - (e) Prebisch-Singer thesis.
 - (f) Immiserising growth.

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PART THREE

Trade Policies and Issues

3

CHAPTERS

- ❖ Trade Strategy
- ❖ Trade Barriers
- ❖ Cartels, Commodity Agreements and State Trading
- ❖ Social Issues in International Trade

CHAPTER 9

9 Trade Strategy

LEARNING OBJECTIVES

- ☐ To understand the inward and outward oriented trade strategies.
- ☐ To evaluate the pros and cons of free trade and protection.
- ☐ To review the arguments for protection.
- ☐ To get a picture of the evolution of India's trade strategy.

Trade strategy refers to the system of government interference in foreign trade. The nature of government interference or trade policy has very broad implications—it has impact not only on the volume and composition of imports and exports, but also on the pattern of investment and direction of development, competitive conditions, cost conditions, entrepreneurial and business attitudes, consumption patterns etc.

While the need for government interference in the trade, as in other sectors, of the developing countries is well recognised, there is no agreement on the type of trade strategy or the nature of the government interference in trade that is suitable for the developing countries.

The choice of the trade strategy is one of the most important economic policy decisions a developing country has to make because of its wide implications indicated above. The trade policy is only one of the elements of the macroeconomic policy mix where all the elements of the mix should be mutually supportive for the development strategy to be successful.

OUTWARD ORIENTED AND INWARD ORIENTED STRATEGIES

With reference to the government policy towards trade, trade strategies may be broadly divided into two groups, viz. outward oriented and inward oriented strategies.

An outward oriented or *outward looking strategy* is one in which trade and industrial policies do not discriminate between production for the domestic market and exports, nor between purchase of domestic goods and foreign goods.

As Krueger observes, an outward oriented strategy is “not a government decree that exports are desirable ... Rather, it is an entire set of policies oriented toward encouraging the production of good and services efficiently”.¹

An outward oriented strategy is neutral between production for domestic market and exports and between consumption of domestic goods and foreign goods.

An outward oriented strategy is, thus, a neutral strategy and it does not mean an export oriented or export promotion strategy as is sometimes mistaken, although such a strategy could pave way for an export-led growth as experienced by some of the South-East Asian countries. An outward oriented policy neither discriminates in favour of exports nor is it against import substitution. It is an open policy. Neutrality is its essence.

An inward oriented or *inward looking strategy* is characterised by a bias of trade and industrial policies in favour of domestic production and against foreign trade. As import substitution is the key element of the inward oriented strategy, it is often described as the 'import substitution strategy'.

An inward oriented strategy discriminates against foreign goods by protecting domestic industries from foreign competition.

Protection of domestic industries from foreign competition is an essential feature of the inward oriented strategy. Protection may be accorded by tariffs, quantitative methods etc. However, quantitative methods and such administrative restrictions as licensing are very dominant under the inward looking strategy.

An inward oriented strategy does not intend a bias against exports, but it discourages exports in the following ways:

- The cost of some exportables increases because of the high cost of imported items (due to reasons like import duty) used in exportables.
- Cost of exportables increases also because of the general rise in prices in the economy due to protection.
- The 'lucrative'ness' of the protected domestic market discourages exports.
- The sellers' market that emerges from protection often results in the neglect of cost and quality. This also adversely affects exports.
- The emphasis on import substitution may lead to the relative neglect of industries with export potential. For example, Manmohan Singh points out that, in the mid-1950s, while export industries like jute and cotton textiles were denied foreign exchange for their much needed modernisation, a much too liberal approach was followed in India in allocating foreign exchange to many non-essential industries in the name of import substitution.²

In short, the import substitution strategy, by breeding a high-cost, uncompetitive economy and by protecting its market, in effect has a bias against exports. The inward oriented strategy, thus, is biased against foreign trade.

Countries which adopt inward oriented strategy are often eager to encourage exports. In fact, one of the major reasons for adopting an import restriction policy is the foreign exchange problem. Export promotion, naturally, is another way to overcome this problem. The inherent contradiction, however, is that the inward looking strategy is 'export discouraging', as pointed out earlier. Countries following an inward oriented strategy often try to overcome these disadvantages by offering export subsidies and other incentives. However, several factors like the complexity of such a regime, the administrative cost of the regime, the burden on the exchequer of the subsidies etc., and the existence of certain disadvantages of the inward oriented strategy which are not offset by the export incentives, limit the success of the export promotion programme.

Extent of Strategy Orientations

On the basis of empirical information, the World Bank has classified the countries into strongly outward oriented, moderately outward oriented, strongly inward oriented and moderately inward oriented economies. The criteria for inclusion in any of the four categories are given below.³

Strongly Outward Oriented Trade controls are either non-existent or very low in the sense that any disincentives to export resulting from import barriers are more or less counterbalanced by export incentives. There is little or no use of direct controls and licensing arrangements, and the exchange rate is maintained so that the effective exchange rates for importables and exportables are roughly equal.

Moderately Outward Oriented The overall incentive structure is biased towards production for domestic rather than export markets. But the average rate of effective protection for the home markets is relatively low and the range of effective protection rates relatively narrow. The use of direct controls and licensing arrangements is limited, and although some direct incentives to export may be provided, these do not offset protection against imports. The effective exchange rate is higher for imports than for exports, but only slightly.

Moderately Inward Oriented The overall incentive structure distinctly favours production for the domestic market. The average rate of effective protection for home markets is relatively high and the range of effective protection rates relatively wide. The use of direct import controls and licensing is extensive, and although some direct incentives to export may be provided there is a distinct bias against exports, and the exchange rate is clearly overvalued.

Strongly Inward Oriented The overall incentive structure strongly favours production for domestic market. The average rate of effective protection for home markets is high and the range of effective protection rates relatively wide. Direct controls and licensing disincentives to the traditional export sector are pervasive, positive incentives to non-traditional exportables are few or non-existent, and the exchange rate is significantly overvalued.

Indicators of Trade Strategy

In principle, the distinction between an inward oriented and an outward oriented strategy is a matter of effective protection provided to production for domestic markets. In practice, however, it is rather more difficult to measure, because a trade strategy comprises many policies at work simultaneously, and also because the data are limited. However, the following indicators help classify the orientation of a country's trade strategy.⁴

The nature of the trade strategy may be indicated by the extent of protection of domestic industries and export incentives and the exchange rate policy.

Effective Rate of Protection The higher the effective protection for domestic markets, the greater the bias towards import substitution.

Use of Direct Controls The greater the reliance on direct controls (such as quotas and import licensing schemes) on imports, the more inward oriented the economy.

Use of Export Incentives As pointed out earlier, because of the inherent bias of the inward oriented policy against exports, countries which have adopted such a strategy generally employ export incentives to promote exports.

Degree of Exchange Rate Overvaluation Inward orientation generally leads to an overvaluation of the exchange rate.

Policy Instruments

The inward oriented strategy is implemented by means of several policy instruments such as commercial policy, industrial policy, foreign exchange policy, fiscal policy and monetary policy. They are employed to curtail imports and promote import substitution.

Under inward orientation, domestic industry is protected by commercial, industrial, foreign exchange, monetary and fiscal policies.

The commercial policy makes imports restrictive. The fiscal policy may supplement the commercial policy in this respect (by means of customs duties, for example). A restrictive monetary policy may also be used to curtail imports. Foreign exchange controls are often used for import controls.

Industrial policy seeks to support the inward oriented strategy by fostering import substitution. The fiscal, monetary and foreign exchange policies may be used to give a positive support to import substitution industrialisation.

Countries vigorously pursuing an inward oriented strategy usually make a heavy reliance on direct controls like import licensing and quantitative restrictions than on tariffs. Stipulations such as local content requirement, phased manufacturing programme, preferential treatment to local suppliers etc. are also common in countries following the inward looking strategy.

The outward orientation, in contrast with the inward orientation, is an open strategy. It links the domestic economy to the world economy. The discriminatory use of tariffs, quotas, investment licensing, tax and credit subsidies etc. would be incompatible with the purest sort of outward oriented strategy. In practice, however, outward orientation does not necessarily mean less government intervention. Some countries have pursued outward orientation by offsetting some of the anti-export bias of import barriers; they have promoted exports while dismantling import barriers only slowly.⁵

Evaluation of Inward Orientation

An inward oriented strategy was followed by many countries because it was perceived, obviously, to have certain considerable merits.

- An important objective was the conservation and socially justifiable use of the scarce foreign exchange resources.
- Import regulation was usually necessary to support the resource allocation strategy of a developing country, particularly in the early stages of development.

An inward oriented economy suffers from all the problems associated with lack of competition.

- Protection of infant industries is a very important justification for the inward orientation.
- Efficient import substitution could help foster industrialisation and economic development.

However, the achievement of the avowed objectives of inward orientation is fraught with several problems. Besides, there are problems of formulation of the appropriate inward oriented strategy and its proper implementation.

Inward orientation, because of its inherent bias against exports, has several adverse effects on exports, as pointed out in an earlier section of this chapter.

The import substitution strategy generally breeds high cost, inefficiency and neglect of quality and customer service. Although countries try to offset the adverse effects of the inward orientation by export incentives, many a time, they do not achieve the desired level of results.

Studies by the World Bank have shown that export performance and economic performance in general was poor in the case of countries following inward orientation compared with those with an outward oriented strategy.

Krueger argues that under import substitution “...there appears to be an almost irresistible pressure on policy makers to regulate domestic markets using price controls, physical allocations, investment licensing and other inventions in all aspects of economic life... The fact that there are large differences in the degree of protection accorded to the different industries (and firms), that many controls entail deadweight losses in resource allocation, and that the system becomes increasingly cumbersome over time, all combine to reduce the rate of growth of output and productivity”.⁶

The general feeling is that it is because of the inward looking development strategies, which emphasised import substitution rather than promotion of trade, that a large number of developing countries could not adequately reap the benefits of the buoyant world trade witnessed in the aftermath of the World War II. The negative effect of the inward looking policies on efficiency, productivity and competition encouraged a number of developing countries, especially from East Asia, to opt for more outward looking policies. Over time, these countries transformed themselves from being producers of labour intensive undifferentiated products to exporters of skill and technology intensive products. The economic success of many of these countries encouraged other developing countries to increase their trade openness. As a result, since the 1980s, a large number of developing countries have unilaterally increased their openness towards international trade. This trend got further thrust by the trade liberalisation at the multilateral level under the aegis of GATT/WTO.⁷

Evaluation of Outward Orientation

Outward oriented strategy has several advantages:

- Outward orientation encourages competition and innovation, and thereby promotes economic efficiency.
- It permits countries to take better advantage of the technological opportunities available to them. By orienting production towards exports, producers in developing countries are able to construct manufacturing facilities of efficient size and to produce in economically viable batches, thereby taking advantage of economies of scale and overcoming the indivisibilities in the production process.⁸ The adoption of such a strategy enabled the *Asian Tigers*, viz. South Korea, Taiwan, Singapore and Hong Kong, to overcome the limitations of a small-sized domestic market in reaping the advantages of economies of scale.
- An outward oriented strategy prevents a country “from making some of the costly mistakes often associated with inner oriented, restrictive, trade and industrialisation strategies”.⁹
- It is argued that an outward oriented strategy forces policies upon governments that generally lead to a better economic performance by the private sector.¹⁰
- It has been observed that industry provides more jobs in the outward oriented economies than it does in the inward oriented ones and consequently, employment has grown faster in the outward oriented economies.¹¹

Outward orientation helps an economy to become globally competitive.

To cite a case for a little elaboration, in North Korea the export oriented industrial strategy placed emphasis on the development of internationally competitive industries. Accordingly, labour intensive, light manufactured goods such as textile garments, footwear, wigs, electronics and plywood were prominent export products. The strategy took full advantage of a large, low-cost labour force, which was

particularly used in such new fields as electronics and machinery, developed with the help of new technology from industrially advanced countries. This development of new industries using new technology to produce new export products was the key element responsible for sustained export growth. This outward looking industrialisation required domestic production to be improved and expanded to enable the country to benefit from economies of scale and strengthen its competitive position on the international market. The enlarged scale of operations, in turn, facilitated the adoption of scientific management and rationalisation of business operations. The supply of resourceful entrepreneurs was nurtured through the above process.¹²

- Although the links between trade strategy and macroeconomic performance are not entirely clear (i.e. whether outward orientation leads to better economic performance or whether superior economic performance paves the way for outward orientation), the World Bank study suggests that the economic performance of the outward oriented economies has been broadly superior to that of the inward oriented economies in all respects, namely the average annual growth rate of real GDP and per capita income, the gross domestic savings ratio, the average incremental capital-output ratio, the average annual growth rate of real manufactured exports, and the group median of average annual rates of inflation.

On the basis of the results of the study, the World Bank suggests that a good case can be made for suggesting that outward orientation leads to a more equitable distribution of income. *First*, the expansion of labour-intensive exports means higher employment. *Secondly*, reinforcing this, outward orientation removes the bias in favour of capital-intensive industries which is often implicit under inward oriented policies. *Thirdly*, the direct controls of an inward oriented strategy generate rents that channel income to those with access to import licenses or subsidised credits.¹³

It is pointed out¹⁴ that open trade and liberal capital account policies allow a country to exploit comparative advantage in production, promote lowest cost product import with embedded advanced technology, and to deploy larger variety of intermediate and capital goods to enhance the productivity of its own resources. Since 1985, the developing countries that achieved the fastest economic growth were the countries that had the highest ratio of exports and imports to GDP as well. Moreover, the countries that substantially liberalised their trade over this period also experienced a noticeable increase in their absolute income levels. However, empirical evidence shows that trade liberalisation alone is not sufficient for ensuring faster growth. Infrastructural developments, required structural changes in the economy, political stability and complementary trade policies, such as a stable and non-discriminatory exchange rate system and prudent monetary and fiscal policies etc., are also important influencing factors. High exports growth in the Asian countries has been possible on the back of a strong domestic industrial sector which created a base for sustainable growth. The value added in the industrial sector during the high growth phase exceeded 10 per cent per annum) in these economies.

Although many merits are attributed to the outward oriented strategy, it has certain drawbacks also.

Protection of certain domestic industries is necessary in some situations.

Measures to conserve the foreign exchange resources including import restrictions are necessary, particularly in the early stages of development, to protect the interests of the developing country. An outward oriented strategy is unlikely to be appropriate under such a situation.

A country which has not developed the industries in which it has comparative advantage will need to give protection to the infant industries for a reasonable period of time to ensure the development of economy. Outward orientation is a strategy that can be employed only after the economy has attained certain level of development and acquired certain basic strengths. Further, the opening up of the economy should be gradual.

It may be noted that even in case of the Republic of Korea, which is often quoted as one of the shining examples of success of export orientation, the emphasis was first placed on import substitution in such key areas as cement, oil refining and fertilisers, and on development of infrastructure, including roads, railways and electricity. The phase of creating simple import substitution industries for non-durable consumer goods was completed by early 1960s.

In Korea's First Five Year Economic Development Plan (1962–66), the government paid attention to the development of agriculture and extended its import substitution policy to machinery and durable consumer goods. At the same time, it started to promote exports of labour intensive manufactured goods. Newly created industries were encouraged to take potential foreign demand into account when considering the adoption of the new policy. In short, it was only after a fairly strong economic foundation was laid by the development of infrastructure and industries with scope for viable import substitution and utilisation of the abundant cheap labour that the country adopted an outward oriented strategy. Equally important is the fact that the opening up of the economy to the outside world was gradual.

It may also be noted that the continued success of Korea owes a lot to the diversification of the industrial structure responding to the internal and external pressures. Internally because further development of the country's light industries is limited owing to increasing labour costs, and both externally and internally owing to increasing competition for light industry exports coming from other developing countries. Since 1962, the key industries that are considered to have been the engines of export success include metal, machinery, electronic, shipbuilding, textile and petrochemical industries. Other important industries with a high growth rate have been footwear, automobiles, fine chemicals, plastics, fertilisers, ceramics, plywood and food processing.

The Transition Process and Problems

The transition from inward orientation to outward orientation involves several measures. The transition process is often long drawn. It may be noted that even in respect of Republic of Korea, which is often cited as an example of a country which achieved enormous success through outward orientation, import liberalisation has been rather slow.

Trade policy liberalisation is the most important measure in the change towards outward orientation. Moving from quantitative restrictions to tariffs is generally considered the first step towards a more open system because tariffs are generally less protective than quantitative restrictions. It may be noted that trade policy reform is one of the important measures taken by the East European countries also which have been moving towards a more open system.

As a *World Development Report* points out, the movement towards greater neutrality has two dimensions—The lowering of the average level of protection and the reduction in the average dispersion, or variance of protection. If the dispersion of tariffs is not reduced as the tariff average is reduced, the tariff structure may not become more neutral. Indeed, a reform that reduces tariffs on intermediate and capital goods, but leaves intact those on final outputs, could increase effective protection—the level of protection afforded to domestic value added—even though it reduces the average level of tariffs.¹⁵

Trade policy liberalisation is the most important means of transition from inward to outward orientation.

Countries which do not liberalise the imports sufficiently often try to offset the adverse affects of import restrictions on exports by schemes such as making available inputs at international prices to the export sector, export subsidies, incentives etc. However, as pointed out in an earlier section, several problems are associated with such schemes, such as burden on the exchequer, administrative problems, the risk of WTO disputes and retaliation by countervailing duties in the importing countries.

The move towards outward orientation is not confined to trade policy reforms. For its success, the whole set of macroeconomic policies will have to be made suitable. It may be noted that the recent changes in India in favour of outward orientation are characterised by several macroeconomic reforms.

Countries resorting to outward oriented reforms may confront several problems during the transitional period. Employment may shrink in industries hit by import liberation. However, more employment may be generated in the sectors activated by the policy changes. Hence, the unemployment problem caused by the liberalisation may be sectoral and short-term. In the long run, however, there may be net increase in employment. However, the short-term problem could cause social and political unrest. Businessmen adversely affected by the liberalisation may try to make use of such an unrest for pressurising for policy changes favourable to them.

It may be noted that some countries which attempted liberalisation in the past like Bolivia, Cameroon, Colombia, Costa Rica, Guatemala, Indonesia, Madagascar and Nigeria, reversed the policy orientation. It may take time to realise the positive effects of liberalisation. Further, success also depends on the suitable changes in a number of spheres, as mentioned earlier.

Another problem is that in the case of several countries, the reforms were attempted at a time when serious economic crisis emerged, and because of this the transitional problems were also serious.

Prerequisites for an Open/Outward Oriented Economy

According to Krueger, there are eight prerequisites for a successful outward oriented strategy. While many other factors will assist the strategy, and particulars vary from country to country and time to time, the prerequisites are:¹⁶

- The government's policy cannot be half oriented towards import substitution and half towards export promotion. Either the economy is outward oriented and the rewards and incentives are for performance in the international market, or the economy is inward oriented, and firms are sheltered and find the domestic market rewarding. The bias on average must not be towards the internal market.
- There must be a clear cut commitment on the part of the government that it is undertaking an export oriented strategy, will continue to do so, and will make exporting profitable.
- At least in the longer run, the first two prerequisites imply that a realistic exchange rate is essential for the pursuit of an outward oriented trade strategy. This requirement implies both that the level of

Success of an outward oriented strategy depends on a number of conditions.

the exchange rate must be appropriate and that the exchange rate will be adjusted in accordance with differentials in the inflation rates between the exporting country and its major trading partners.

- An outward oriented strategy is possible only if the quantitative restrictions on trade are removed. In general, an outward oriented strategy is not consistent with a detailed government quantitative intervention in any aspect of trade.
- Exporters must have ready access to the international market for whatever purchases they may require, including raw materials, spare parts, technical services, marketing skills, freight, insurance and transport. It should be noted, in particular, that a duty drawback system is probably too cumbersome administratively and otherwise to provide the required access.
- It is probably not feasible to generate a successful outward oriented trade strategy unless the communications and transport infrastructure make possible both rapid communications with the rest of the world and relatively quick receipt and delivery of goods.

- It is unlikely that an outward oriented trade strategy can generate rapid growth unless the labour market functions in response to market forces.
- It is possible for a government to identify *ex ante* the industries that are likely to become successful exporters. Policies assisting those attempting to export have a high probability of success; policies determining what commodities shall be exported are probably destined to fail.

Krueger points out that “when these prerequisites are met, the evidence is that rapid growth, usually with a pronounced increase in economic efficiency, can be achieved. The evidence also suggests that politically it is extremely difficult to set the prerequisites in place and to whether the initial economic readjustments that are required as resources are reallocated from import-competing to exportable sectors at the margin. If the readjustment period can be successfully passed through, with the decision makers convinced that the outward oriented commitment will continue, it would appear that outward oriented growth becomes relatively easier to sustain”.¹⁷

Lessons of Trade Liberalisation

The World Bank study makes the following observations based on the experiences of countries which undertook trade liberalisation.¹⁸

Trade policy reform is complicated. It is closely linked to liberalisation in capital, labour, domestic product markets and to macroeconomic policy. It is partly a political process in which credibility and expectations play an important role. Feasible policy choices may differ from country to country, and reform may be vulnerable to changes in international environment. Due to this complexity, there is no single optimal path to reform. But there are, nonetheless, lessons to be drawn from previous attempts.

Corresponding liberalisations in several other spheres are necessary for the success of trade liberalisation.

- Trade liberalisation must involve large shifts of resources, but it has not always raised unemployment by as much as is commonly supposed.
- Strong and decisive reforms have carried greater credibility and have been better sustained than more timid reforms.
- Replacing quantitative restrictions with tariffs is a useful first stage of trade liberalisation.
- Providing a realistic real exchange rate is vital to the successful introduction of trade reforms. Keeping it stable is essential if the reform is to be sustained. All this requires a macroeconomic policy that manages inflation and the nominal exchange rate so as to keep domestic costs in line with world prices.
- The scope for successful trade liberalisation depends on complementary reforms in the domestic economy—especially in financial and labour markets.

Trade liberalisation—like any major economic reform—is not easy. Above all, it requires a strong political commitment. It is to be hoped that this commitment will come more easily as the evidence mounts that trade policy reform will quickly bring benefits at a lower cost than policy makers have sometimes feared.

ARGUMENTS FOR FREE TRADE

Free trade refers to the trade that is free from all artificial barriers to trade like tariffs, quantitative restrictions, exchange controls etc. *Protection*, on the other hand, refers to the government policy of according protection to the domestic industries from foreign competition. There are a number of arguments for and against both free trade and protection.

The important arguments in favour of free trade are as follows:

- Free trade leads to the most economic utilisation of the productive resources of the world. Under free trade each country will specialise in the production of those goods for which it is best suited, and will import from other countries those goods which can be produced domestically only at a comparative disadvantage.
- Under free trade, division of labour occurs on an international scale leading to greater specialisation, efficiency and economy in production.
- As there will be intense competition under free trade, the inefficient producers are compelled either to improve their efficiency or to quit.
- Free trade helps to break domestic monopolies and free the consumers from exploitation.
- Free trade benefits the consumers in different ways. It enables them to obtain goods from the cheapest source. Free trade also makes available large varieties of goods.
- Further, under free trade there is not much scope for corruption which is rampant under protection.

Free trade promotes competition and efficient use of resources.

ARGUMENTS FOR PROTECTION

Theoretically speaking, free trade has certain virtues, as we have seen above. But, in reality, governments resort to some manner of protective measures to safeguard the national interests. It is interesting to note that the US, which appeared to be the champion of the cause for free trade, has been becoming protectionist as its industries are threatened by increasing global competition.

There are a number of arguments put forward in favour of protection. Some of these arguments are very valid while some others are not. We provide below the gist of the popular arguments for protection.

Infant Industry

The infant industry argument, advanced by Alexander Hamilton, Frederick List and others, asserts that a new industry having a potential comparative advantage may not get started in a country unless it is given temporary protection against foreign competition. An established industry is normally stronger than an infant one because of the advantageous position of the established industry like its longstanding experience, internal and external economies, resource position, market power etc. Hence, if the infant is to compete with such a powerful foreign competitor, it will be a competition between unequals and this would result in the ruin of the infant industry. Therefore, if a new industry having a potential comparative advantage is not protected against the competition of an unequally powerful foreign industry, it will be denying the country the chance to develop the industry for which it has sufficient potential. The intention is not to give protection for ever but only for a period to enable the new industry to overcome its teething troubles. The policy of protection has been well expressed in the following words: “*Nurse the baby, Protect the child and Free the adult*”.

The infant industry argument, however, has not been received favourably by some economists. They argue that an infant will always be an infant if it is given protection. Further, it is very difficult for a government to identify an industry that deserves infant industry protection. “The infant industry argument boils down to a case for the removal of obstacles to the growth of the infants. It does not demonstrate that a tariff is the most efficient means of attaining the objective.”¹⁹

Diversification

It is necessary to have a diversified industrial structure for an economy to be strong and reasonably self-sufficient. An economy that depends on a very limited number of industries is subject to many risks. A depression or recession in these industries will seriously affect the economy. A country relying too much on foreign countries runs a number of risks. Changes in political relations and international economic conditions may put the country into difficulties. Hence, a diversified industrial structure is necessary to maintain stability and acquire strength. It is, therefore, advised to develop a range of industries by according protection to those which require it.

Improving the Terms of Trade

It is argued that the terms of trade can be improved by imposing import duty or quota. By imposing tariff the country expects to obtain larger quantity of imports for a given amount of exports, or conversely, to part with a lesser quantity of exports for a given amount of imports. However, the terms of trade could be expected to improve only if the foreign supply is inelastic. If the foreign supply is elastic, a tariff or a quota is unlikely to improve the terms of trade. Further, there is also the possibility that the foreign countries will retaliate by imposing counter tariffs and quotas. The validity of this argument is, therefore, questionable.

There are sound reasons for protecting certain domestic industries.

Improving Balance of Payments

This is a very common ground for protection. By restricting imports, a country may try to improve its balance of payments position. The developing countries, especially, may have the problem of foreign exchange shortage. Hence, it is necessary to control imports so that the limited foreign exchange will be available for importing the necessary items. In developing countries, generally, there is a preference for foreign goods. Under such circumstances it is necessary to control unnecessary imports lest the balance of payments position become critical.

Anti-Dumping

Protection is also resorted to as an anti-dumping measure. Dumping, certainly, can do harm to the domestic industry; the relief the consumers get will only be temporary. It is possible that after ruining the domestic industry by dumping, the foreign firms will obtain monopoly powers and exploit the home market. Sometimes, dumping represents a transmission of the recession abroad to the home country. These factors point out the need to protect domestic industries against dumping.

Bargaining

It is argued that a country which already has a tariff can use it as a means of bargaining to obtain from other countries lower duties on its exports. It has been pointed out, however, that the bargaining lever, instead of being used to gain tariff concessions from foreign powers, may be employed by others to extract additional protection from the home government.

Employment

Protection has been advocated also as a measure to stimulate domestic economy and expand employment opportunities. Restriction of imports will stimulate import competing industries and its spread effects will help the growth of other industries. These, naturally, create more employment opportunities.

This method of employment generation, however, has some problems. First, when we reduce imports from foreign countries employment and income will shrink abroad, this is likely to lead to a fall in the demand for our exports. Secondly, the foreign countries will be tempted to retaliate to protect their employment.

National Defence

Even if purely economic factors do not justify such a course of action, certain industries will have to be developed domestically due to strategic reasons. Depending on foreign countries for our defence requirements is rather foolish because factors like change in political relations can do serious damage to a country's defence interest. Hence, it is advisable to develop defence and other industries of strategic importance by providing protection if they cannot survive without protection.

Key Industry

It is also argued that a country should develop its own key industries because the development of other industries and the economy depends a lot on the output of the key industries. Hence, if we do not have our own source of supply of key inputs, we will be placing ourselves at the mercy of the foreign suppliers. The key industries should, therefore, be given protection if that is necessary for their growth and survival.

Strategic Trade Policy

Strategic trade policy which advocates protection and government cooperation to certain high-tech industries in the developed countries is somewhat similar to the infant industry argument applied to the developing countries. The argument is that government support should be accorded to gain comparative advantage in the high technology industries which are crucial to the future of the nation, such as semiconductors, computers, telecommunications etc. It is also argued that state support to certain industries becomes essential to prevent market monopolisation. For example, outside the former Soviet Union, only three firms build large passenger jets. If European governments do not subsidise the Airbus Industries, only the two American companies, Boeing Company and Mc-Donnell-Douglas Corporation, will remain.

The oft cited examples of industries developed with the support of the strategic trade policy include the steel industry in Japan in the 1950s, semiconductors in the 1970s and 1980s, and the development of the supersonic aircraft, Concorde, in Europe in the 1970s and the development of the Airbus aircraft in the 1980s.

As Salvatore observes, while strategic trade policy can theoretically improve the market outcome in oligopolistic markets subject to extensive economies and increase the nation's growth and welfare, even the originators and popularisers of this theory recognise the serious difficulties in carrying it out. The following difficulties are pointed out,²⁰ in particular. *First*, it is extremely difficult to choose the winners (i.e. choose the industries that will provide large external economies in the future) and devise appropriate policies to successfully nurture them. *Secondly*, since most leading nations undertake strategic trade policies at the same time, their efforts are largely neutralised so that the potential benefits to each may be small. *Thirdly*, when a country does achieve substantial success with strategic trade policy, this comes at the expense of other countries (i.e. it is a 'beggar-thy-neighbour' policy) and so, other countries are likely to retaliate.

The arguments mentioned above have been generally regarded as 'serious'. There are, however, a number of other arguments also which have been branded as 'nonsense', 'fallacious', 'special interest' etc. Common among them are the following:

Keeping Money at Home

This argument is well expressed in the form of a remark falsely attributed to Abraham Lincoln: “I do not know much about the tariff, but I know this much: When we buy manufactured goods abroad we get the goods and the foreigner gets money. When we buy the manufactured goods at home we get both the goods and the money.” As Beveridge rightly reacted, this “argument has no merits; the only sensible words in it are the first eight words”.

The fact that imports are ultimately paid for by exports clearly shows that the ‘keeping money at home’ argument for protection has no sense in it.

Some of the arguments for protection are flimsy.

The Pauper Labour

The essence of this argument is that if in the home country the wage level is substantially high compared to foreign countries, the foreign producers will dominate the home market because the cheap labour will allow them to sell goods cheaper than the domestic goods, and this will affect the interests of the domestic labour. This argument does not recognise the fact that high wages are usually associated with high productivity. Further, labour cost differences may not be a determining factor.

Size of the Home Market

It is argued that protection will enlarge the market for agricultural products because agriculture derives large benefits not only directly from the protective duties levied on competitive farm products of foreign origin, but also indirectly from the increase in the purchasing power of the workers employed in industries similarly protected. It may be pointed out against this that protection of agriculture will harm the non-agriculturists due to the high prices of agricultural products and the protection of industries will harm agriculturists and other consumers due to high prices encouraged by protection.

Equalisation of Costs of Production

Some protectionists have advocated import duties to equalise the costs of production between foreign and domestic producers, and to neutralise any advantage the foreigner may have over the domestic producers in terms of lower taxes, cheaper labour or other costs. “This argument allegedly implies a spirit of ‘fair competition’, not the exclusion of imports. When, however, by reason of actual cost structure or artificial measures, costs of production become identical, the very basis of international trade disappears. The logical consequence of this pseudo-scientific method is the elimination of trade between nations. Thus, the equalisation of costs of production argument for protection is utterly fallacious and is one of the most deceitful ever advanced in support of protection.”²¹

DEMERITS OF PROTECTION

The following defects are generally attributed to protection:

- Protection is against the interest of consumers as it increases price and reduces variety and choice.
- Protection makes producers and sellers less quality conscious.
- It encourages domestic monopolies.
- Even inefficient firms may feel secure under protection and it discourages innovation.
- Protection leaves the arena open to corruption.
- It reduces the volume of foreign trade.
- Protection leads to uneconomic utilisation of world’s resources.

Protection breeds inefficiency and corruption.

FALL AND RISE OF PROTECTIONISM

The period of over two-and-a-half decades until the early 1970s, witnessed rapid expansion of the world output and trade. World trade, in fact, grew much faster than the output. After the Second World War, there was a progressive trade liberalisation until the early seventies. Thanks to the efforts of GATT, the tariff reductions in the industrial countries continued even after this. The average levels of tariff on manufactures in industrial countries is now about three per cent compared to 40 per cent in 1947.

Although the period until the early 1970s was characterised by trade liberalisation in general, there were several exceptions. In the developed countries, heavy protection was given to the agricultural sector through import restrictions and domestic subsidies. Further, in manufactured goods, textiles and clothing were subject to heavy protection. There was also protection associated with regional trade agreements like the EEC. Imports to developing countries were, in general, highly restrictive due to reasons such as balance of payments problems and the need to protect infant industries. In the industrial countries, anti-dumping and countervailing duties began to assume more importance since the mid-sixties. The overall trend in the industrial countries, however, was one of liberalisation. This trend was reversed in the seventies.

Since about the mid-seventies, protectionism has grown alarmingly in the developed countries. This has taken mainly the form of non-tariff barriers (NTBs).

The main reason for the growing protectionism in industrialised countries is the increasing competition they face from Japan and developing countries like, for example, the South-East Asian countries. Due to the fact that the competition has been very severe in the case of labour intensive products, the import

Although tariff barriers have declined substantially there was a tendency to increase NTBs.

competing industries in the advanced countries have been facing the threat of large retrenchments. Several other industries, like the automobile industry in the US, have also been facing similar problems.

The demand for protection has, therefore, grown in the industrial countries to protect employment. Protective measures have also been employed to pressurise Japan and the developing countries to open up their markets for goods, services and investments of the industrial countries.

As mentioned earlier, the NTBs affect the exports of developing countries much more than those of the developed ones. In other words, the main target of the developed country import restrictions in the last two decades has been the developing countries. By 1987, NTBs affected a very significant part of OECD imports from developing countries. While developing countries as a group faced tariffs 10 per cent higher than the global average, the least developed countries faced tariffs 30 per cent higher—because tariffs remain higher on the goods with greatest potential for the poorest countries, such as textiles, leather and agricultural commodities.²²

Labour intensive products like textiles, clothing and footwear were among the most highly protected imports. The restriction on the textiles and clothing, which account for nearly one-fourth of the developing country exports, was exercised mainly by the Multi-Fibre Arrangement (MFA) which denied the developing countries a huge amount in terms of export earnings.

Tariff escalation (i.e. increase in tariffs with the level of processing) is yet another important factor which discourages developing countries' manufactured goods. For example, while the tariff on raw sugar is less than two per cent, it is around 20 per cent for processed sugar products. The tariff escalation discourages the developing countries' graduation as exporters of manufactured goods from commodity exporters. Tariff escalation affects a wide variety of products such as jute, spices, vegetables, vegetable oils, tropical fruits beverages etc.

As the industrial countries face more competition, they increase protectionism. This encourages one to think that they wanted free trade only as long as they enjoyed a dominant position; when their dominance

is challenged they increase the trade barriers. Ironically, industrial countries are increasing trade restrictions while the developing countries are liberalising trade. Although the Uruguay Round Agreement provided for the liberalisation of agricultural trade, not only that the developed countries are not sincere in opening up the highly protected agricultural sector but also countries like the US tend to increase the protection. In the Uruguay Round, the developed countries, particularly the US, were very eager to liberalise the services sector. Now, they seek to protect those services where they are losing their competitiveness, like the software and IT-enabled services to the detriment of developing countries like India. (Also see the section *Global Trade and Developing Countries* in Chapter 3 for some indication of the developed country protectionism against developing countries.)

PROTECTION'S PRICE

Trade restrictions prove costly not only for the affected exporting country, but also for the importing country restricting the trade. The consumers often pay a heavy price for protection.²²

The striking fact about protection to preserve jobs is that each job often ends up costing consumers more than the worker's salary. For example, each job preserved in the car industry in Britain is estimated to have cost consumers between \$19,000 and \$48,000 a year. In the United States the cost was between \$40,000 and \$108,500 a year. Looked at another way, in the United Kingdom the cost to consumers of preserving one worker in car production was equivalent to four workers earning the average industrial wage in other industries. In the US car industry, the equivalent cost would be the wages of six ordinary industrial workers. VERs in the US steel industry cost consumers \$114,000 per protected job each year. For every dollar paid to steel workers who would have lost their jobs, consumers lost \$35 and the US economy as a whole lost \$25.

According to some earlier estimates, for every \$20,000 a year job in the Swedish Shipyard, tax payers in that country pay an estimated \$50,000 annually in subsidy. Protection costs Canadian consumers \$500 million a year to provide an additional \$135 million of wages for the clothing industry. Estimates of the costs of protection for the clothing and textiles in the United States had shown that protection cost the nation \$1 for every seven cents gained by workers whose jobs were preserved. The corresponding figures for Canada were one and a half cents for one Canadian dollar.

In many cases, protection harms domestic consumers in particular and the economy in general.

According to one calculation, consumers and government in rich countries pay \$350 billion per year supporting agriculture. Agricultural protection causes an increase in the annual food cost by \$1,500 for a family of four in the European Union. Protection of the sugar industry makes the US consumers pay an additional \$43 billion annually. Because of the protection of the textile industry, the UK consumers are estimated to pay annually an additional 500 million pounds. Corresponding figures for the Canadians is C\$780 million and for Australians A\$300 million. In 1995, aluminium users in the EU paid an extra \$472 million due to tariff barriers. At the 1998 tariff levels, the Australian consumers pay on an average A\$2,900 more for every car. When the US limited Japanese car imports in the early 1980s, car prices rose by over 40 per cent between 1981 and 1984. The objective was to protect jobs in the US, but the higher prices was an important reason why one million fewer new cars were sold, leading to more job losses.

It is, of course, questionable whether protection can do any more than temporarily preserve some jobs in the protected industry at the expense of jobs in other industries in the economy. The extra cash spent on protecting job implies less cash to spend on other goods and services, and therefore, fewer jobs in production of these other goods and services. Even in the protected sector the effects of protection on saving jobs are usually small.

TRADE STRATEGY OF INDIA

In the four decades since the commencement of planned development in 1951, India followed a strong inward oriented policy. With the adoption of the import substitution industrialisation (ISI) strategy in the Second Five Year Plan, the inward orientation became very powerful.

Outright ban on the import of many products, quantitative restrictions, tariff wall, which was one of the highest in the world, and administrative restrictions like import licensing, foreign exchange regulations etc. were important instruments used to pursue this strategy. In addition, regulations like local content requirement, phased manufacturing programme, export obligation and restrictions on domestic sales etc. were also stipulated.

Until the early 1990s, the trade strategy of India was strongly inward oriented.

Inward orientation was, of course, necessary in the early stages of development. The import substitution has significantly contributed to industrial development until the late 1960s.

There is, however, a general feeling that the Indian policy had an overemphasis on import substitution and that the import substitution strategy followed in India was a rather indiscriminate one (i.e. the strategy was not a selective one as practiced in countries like Korea where industries for import substitution were selected on consideration of their potential comparative advantage and resources were concentrated on their development). It is also felt that in India protection was not limited to a reasonable period.

Due to factors like export pessimism of the Indian planners, export development was neglected in the first and second plans. Although several measures were taken since the third plan for export promotion, they were not adequate enough to provide the needed incentives for exports. Krueger observes that although import substitution countries like India had special policies to promote exports and provide export subsidies for individual manufactured commodities if they were exported, those policies really served only to offset the very strong incentive to produce for the domestic market. With that they could lead to the same chaotic set of high rates of implicit subsidy and protection for the exporters as existed for import substitution firms. Careful analysis suggests that these export incentives were really for import substitution industries to export some part of their output.²⁴

Some studies have shown that exporting was unprofitable in absolute terms without export incentives, and even with the incentives they were relatively unprofitable for many Indian firms doing exporting.

The overemphasis on import substitution had a very adverse effect on exports. As pointed out earlier, while foreign exchange was easily available even for indiscriminate import substitution because of the respectability attached to import substitution, genuine needs of the export sector were overlooked.

Import substitution and the associated protection of domestic industries had other adverse effects too. The sheltered domestic market acted as a deterrent to efficiency improvement and thus the “prospects of newly established industries becoming at some stage earners of foreign exchange are further diminished”.²⁵ The Committee on Import-Export Policies (Mudaliar Committee), Committee on Import-Export Policies and Procedures (Alexander Committee), Committee on Export Strategy for the Eighties (Tandon Committee) and the Committee on Trade Policies (Abid Hussain Committee) among others, have commented on the adverse effects of import substitution and the indiscriminate protection on the productive efficiency and exports.

The high input costs due to protection, production units of uneconomic size and certain other factors have increased the cost of exportables. World Bank’s various studies had identified such cases as a price

Undue protection resulted in high costs, inefficiencies, poor quality, lack of innovativeness, shortages and neglect of consumers.

premium of 300 per cent on synthetic fabrics for garment manufactures and prices of basic chemicals and raw materials for the chemical industry averaging 90 per cent above world prices.²⁶ Import restrictions have starved the export sector of quality raw materials

and components at competitive prices and, thus, the unpragmatic trade policy had discouraged export development. The sheltered domestic market did not compel producers to achieve cost reduction, improve quality and to innovate.

The inward-oriented strategy has had very adverse effects on India's export performance and economic development. It may be noted that, as pointed out in the chapter on India's foreign trade, the export performance of India has been very poor even in comparison with that of several developing countries.

Some critics of the Indian economic policy, particularly those with a leftist political orientation, argue that since the early 1980s, especially since Rajiv Gandhi became the Prime Minister, India was following an export oriented strategy. Even in the 1980s the Indian policy was, undoubtedly, strongly inward oriented. It is true that several incentives were offered for export promotion. But, to argue that the incentives or other export measures taken in India amounted to export orientation is quite wrong. Exports is just one of the several priority sectors, such as small industry, agriculture, backward area development, which is given incentives. Further, the so-called export incentives were mostly aimed at compensating the Indian exporters for the disadvantages which they suffered in comparison with their counterparts in other countries and, as the Abid Hussain Committee pointed out, the element of incentive, if any, was very negligible.

It is true that there was some liberalisation of the imports in the 1980s. This enabled to strengthen the export sector to a certain extent by technological upgradation and easy access to some of the inputs. One of the factors which contributed to the acceleration of export growth of the late eighties is believed to be this. The liberalisation has also made the domestic economy more competitive to the benefit of the consumers. The fact, however, is that even after these liberalisations of the 1980s, the Indian economy was strongly inward oriented.

The trade policy regime of India since independence has three distinct phases.

It has been rightly observed that the "Indian export policy has evolved over the period from indifference, pessimistic neglect, and, for several major items, even a constellation of measures adding up to positive discouragement to growing encouragement via escalating subsidisation (culminating in the 1966 devaluation) and promotional measures undertaken by the government. These two periods broadly correspond to the first two Five Year Plans (1951/56 and 1956/61) and the period thereafter".²⁷ Since 1991, India's trade policy has been going increasingly liberal in line with the ongoing macroeconomic reforms and the WTO agreements and principles.

Period of Export Pessimism

As a matter of fact, the first two Five Year Plans were formulated under the assumption that it would not be possible to achieve significant increase in exports during the early stages of development of the economy. The Second Plan document observed: "On the whole, the fact remains that the increase in exports that we visualise over the plan period is not very striking. India's export earnings are derived from a few commodities. Three of them, namely tea, jute and cotton textiles, account for nearly one half of the total. These major exports are meeting increasing competition from abroad. This limits the scope for any substantial increase in exports in the short run. While every effort has to be made to promote exports of new items and to develop and diversity the markets for the country's major exports, it has to be recognised that it is only after industrialisation has proceeded some way that increased production at home will be reflected in larger export earnings."²⁸ The Third Plan document has indeed admitted that "one of the main drawbacks in the past has been that the programme for exports has not been regarded as an integral part of the country's development effort under the Five Year Plans".²⁹

In the early period, the planners were pessimistic about India's export prospects.

The Import-Export Policy Committee (Mudaliar Committee) pointed out, in 1962, that “if we were to discard historical times, for the moment, it could be said that the country had no great export tradition. Nor has one been developed so far—much less have we developed the necessary export apparatus... so far the country has touched only a fringe of the export problem. An important lacuna in the export effort is that whereas targets of a high order have been, theoretically, drawn up, adequate steps have not yet been taken to dovetail the import-export targets with the plans and projects of development in the private and in the public sector and to lay the foundation of a big trade”.³⁰ The committee further added: “There is no clear picture as to what items, specially non-traditional items, would be available at a given time for export; how they would be available and in what quantities; and by what measures and means, and where, would these quantities be outletted.”³¹

The above anecdotes from the official documents clearly evince the official pessimism and the resultant failure to take adequate development measures on the export front. “This bearishness with regard to exports is attributable to two specific perceptions. Exports of primary products or of traditional manufactures based on them were seen as facing poor demand prospects in the world market. At the same time, it was felt that other newer manufactures had little likelihood of securing a sizable export market until industrialisation itself was well under way. The natural consequence of such export pessimism was a conviction that, in the long run, industrialisation could lead to a viable balance of payments only if it was based on a programme which minimised imports. Much of policy was dominated by a feeling of export pessimism. Thus, import substitution, particularly in basic intermediate and machine building, became a major element of trade policy in the late fifties, while exports suffered relative neglect”.³²

In short, as Manmohan Singh observes, “On the one hand there was a widespread feeling that not much could be done to increase export earnings in view of the stagnant demand for India’s major exports. On the other hand, responsible economists were assuring the country that import substitution, wherever it meant, would by itself be able to solve India’s balance of payments difficulties, so that India would, in fact, not need a greatly intensified export in the long run. The result was a neglect of exports and, ...even the available opportunities were missed out”.³³

It is quite clear that it was the export pessimism which resulted in the neglect of export promotion and certain government measures which biased against exports which were responsible for the stagnation of India’s export earnings in the 1950s. As several authors³⁴ have pointed out, the domestic policies of the Indian government via export controls and quotas, export duties, inflationary pressures and policies aimed at promoting domestic consumption were inhibiting the expansion of export earnings.

In short, the export pessimism and the resultant indifference to export development in the earlier plans resulted in the neglect of several sectors with tremendous export potential, like textiles, fisheries etc. Further, even after recognising the export potential of many products, the failure to effectively harness the potential has been more conspicuous than achievements in several cases.

The increasing trade deficit during the second plan pointed to the need to promote exports and since the middle of the second plan period a series of measures had been initiated with the object of stepping up exports. These included organisational changes, increased facilities and incentives and diversification of trade. However, as the third plan document observes, these measures were not adequate in relation to the underlying factors inhibiting exports and one of the main drawbacks was that the export promotion programme was not regarded as an integral part of the country’s development effort under the Five Year Plans.³⁵

Era of Export Promotion and Import Restriction

The period of about three decades, 1961–91, extending from the beginning of the Third Five Year Plan to the eve of the Eighth Plan is characterised by import restriction and the adoption of a number of

measures for export promotion. The early part of this period also witnessed vigorous import substitution efforts. Although there was some liberalisation of the imports since the mid-1980s, imports were highly restricted. Further, many of the import liberalisation measures were for export promotion.

Export promotion became an important component of India's trade policy since the early 1960s.

During the Third Plan, the institutional framework for promoting exports was broadened and strengthened and certain fiscal incentives like drawback of import duty and refund of excise duty and income tax concession were introduced. A major factor was the operation of special export promotion scheme providing import entitlement against exports in respect of a number of manufactured and processed products. A limited scheme of direct subsidies for about 22 products was also operated to promote exports of non-traditional products. Another important aspect of the trade policy during the Third Plan was the importance given to diversification, both country-wise, and product-wise, of the foreign trade.

It is pointed out that despite their proliferation, the incentive schemes implemented during the Third Plan period “failed not only to generate self sustaining exports but also generated widespread manipulations in the form of over invoicing of exports, export of shoddy goods, besides the obvious distortions in the pattern of resource allocation in the country”.³⁶

A major development soon after the Third Plan was the devaluation of the Indian rupee (on June 6, 1966) by 36.5 per cent which was resorted to “partly to obviate the need for administering a system of export incentive schemes, which became increasingly complex, and partly due to the failure of the schemes to generate self sustaining exports”.³⁷

Poor trade performance and foreign exchange crisis compelled India to devalue the rupee in 1966.

With the devaluation, export promotion schemes like import entitlement and cash subsidy were withdrawn (but were reintroduced later, in modified form), and the import and industrial policies were liberalised with a view to removing bottlenecks in production.

Subsequent to the devaluation, further modifications, adjustments and extensions in export promotion schemes were made. These took the form mainly of adjustments in export duties and in cash assistance, modifications of import facilities for exporting units and industries, and strengthening of credit arrangements for exports.

Realising the country's potential for achieving a rising level of exports and recognising the need for the adoption of appropriate policies and measures designed to promote investment in promising sectors to generate exportable surplus, and the need for providing adequate facilities and incentives to promote the growth of the export trade, an *Export Policy Resolution* was announced by the Government of India in 1970.

The Export Policy Resolution, 1970, reflected the importance of harnessing the nation's export potentials.

The Export Policy Resolution, presented with the hope that “the export effort will be viewed as one of the highest national commitments”, reflected the government's resolve (i) to strengthen the domestic production base so as to generate more exportable surplus in a variety of sectors; (ii) to strengthen and develop the export marketing infrastructures; (iii) to develop overseas markets; and (iv) to provide incentives to give a boost to the export sector.

It has been argued that “the policy decisions taken subsequently by the Government, their rapid implementation and the results achieved have amply proved that the policy has been adumbrated after a very careful study. This is evident from the rate of growth in exports in the subsequent years. Between 1950–51 and 1970–71, the average annual increase in exports was only three per cent whereas it was as high as 25.4 per cent between 1971–72 and 1976–77. Even though a part of this may be attributed to inflation it is no mean achievement”.³⁸

With the burgeoning trade deficit since the emergence of the oil price hike in the early 1970s, export promotion assumed added importance and export promotion measures have been sought to be enlarged.

These measures aim, in general, to expand and strengthen the export production base, diversify export markets and products, develop export markets, improve export marketing and export competitiveness, and to give incentives for exports.

A number of measures were taken in the eighties to promote exports. These included liberalisations of industrial and import policies to encourage production of export goods, development of export processing zones, promotion of hundred per cent export oriented units (EOUs), rationalisation and simplification of schemes of export assistance and incentives etc.

During the Seventh Plan (1985–90) efforts were made to identify sectors, industries and products which have a good export potential and to provide a suitable policy framework. Fourteen broad sectors were identified by the Government in consultation with the export promotion councils and commodity boards, for making special thrusts in the overseas markets without minimising the importance of increased exports from other sectors as well. The 14 thrust sectors included tea (especially in packaged and value added form), cereals (in particular wheat), processed foods (including fruits and juices, meat and meat products and fresh fruits and vegetables), marine products (especially in the value added form), iron ore, leather manufactures, handicrafts and jewellery, capital goods and consumer durables, electronic goods and consumer software, basic chemicals, fabrics, piece goods and made-ups, readymade garments, woolen fabrics and knit wear, and projects and services.

As a results of these measures and some other favourable factors, the export growth accelerated in the late 1980s.

Towards an Open System

Trade policy reform has been an integral part of the economic policy reform ushered in India since July 1991.

The trade policy cannot be viewed in isolation; it should be seen in the context of the overall economic policy. One of the important features of the new economic policy is a move towards a more open economy by liberalising the foreign investment policy and imports.

Since the early 1990s, the trade policy of India has been progressively liberalised in tandem with the general economic reforms.

On the trade front, imports have been substantially liberalised by lowering duties and removing quantitative restrictions. However, import duty levels in India are still higher than in many developing countries like China.

Salient features of the economic policy liberalisation in India, including trade reforms, are given under the section *India and the Global Economy* in Chapter 1.

The package of economic policy reforms introduced since July 1991 ushered in a new direction to the India's trade and development strategy orientation. These reforms aim at, *inter alia*, making the Indian economy progressively more outward oriented.

Although economic liberalisation has opened new opportunities for Indian entrepreneurs, import liberation causes severe problems for several firms established in the past. For example, firms with high fixed costs and those with plants of uneconomic size or obsolete technology due to the policies of the past now find it very difficult to face international competition. This is one of the ways in which the cost of the inward orientation becomes evident. Persistence of inward orientation increases such costs in aggregate.

The import competing industries will have a tough time. They will have to increase their operational efficiency, quality and customer service to effectively fight the competition. There may also be policy induced distortions. For example, while an industry faces international competition for its output, it could be in trouble if it is not able to get the inputs at internationally competitive price and quality. The policy reforms should be adequately comprehensive to avoid such distortions.

SUMMARY

Trade strategy, i.e. the system of government interference in foreign trade, can impact not only the volume and composition of imports and exports, but also the pattern of investment and direction of development, competitive conditions, cost conditions, entrepreneurial and business attitudes, consumption patterns etc.

There are broadly two types of trade strategies, viz. **outward oriented and inward oriented strategies**. An outward oriented or outward looking strategy is one in which trade and industrial policies do not discriminate between production for the domestic market and exports, nor between purchase of domestic goods and foreign goods. An inward oriented or inward looking strategy is characterised by a bias of trade and industrial policies in favour of domestic production and against foreign trade. As import substitution is the key element of the inward oriented strategy, it is often described as the 'import substitution strategy'. Protection of domestic industries from foreign competition is an essential feature of the inward oriented strategy. Although an inward oriented strategy does not intend a bias against exports, in effect it is biased against foreign trade.

The inward oriented strategy is implemented by means of several policy instruments such as commercial policy, industrial policy, foreign exchange policy, fiscal policy and monetary policy to curtail imports and promote import substitution.

An outward oriented strategy encourages competition and innovation and thereby promotes economic efficiency. The policy, however, has certain drawbacks also. Measures to conserve the foreign exchange resources including import restrictions are necessary, particularly in the early stages of development, to protect the interests of the developing country. An outward oriented strategy is unlikely to be appropriate under such a situation.

There are a number of arguments for and against both **free trade and protection**.

The important arguments in favour of free trade include the most economic utilisation of the productive resources of the world; benefits of division of labour on an international scale; efficiency improvements necessitated by the intense competition under free trade; and availability of goods from the cheapest source.

There are a number of arguments put forward in favour of protection, some of which are very valid while some others are not. The serious arguments are protection of infant industries; industrial diversification; improving the terms of trade; improving balance of payments; preventing dumping; means of bargaining; employment protection; national defence; strategic trade policy and development of key industries.

Other arguments include keeping money at home; protection of pauper labour; enlarging the size of the home market; and, equalisation of costs of production between foreign and domestic producers.

Protection has a number of defects; these are implicit in the arguments for protection.

After the Second World War, there was a progressive trade liberalisation until the early 1970s. However, since about the mid-1970s, protectionism has grown alarmingly in the developed countries, mainly by NTBs.

The **trade policy of India** in the four decades, since the commencement of planned development in 1951, was strongly inward oriented. Outright ban on the import of many products, quantitative restrictions, tariff wall which was one of the highest in the world, administrative restrictions like import licensing, foreign exchange regulations etc. were important instruments used to pursue this strategy. In addition, regulations like local content requirement, phased manufacturing programme, export obligation and restrictions on domestic sales etc. were also stipulated.

Things, however, began to change since the early 1990s. Trade policy reform has been an integral part of the economic policy reform. One of the important features of the new economic policy is a move towards a more open economy by liberalising the foreign investment policy and imports. Imports have been substantially liberalised by lowering duties and removing quantitative restrictions.

Review Questions

1. Evaluate the inward oriented trade strategy.
2. Critically examine the outward oriented trade strategy.
3. Give a brief and critical account of the trade strategy of India since 1951.
4. Give a brief and critical account of the arguments for protection.
5. Present your views on protection vs liberal trade in respect of a developing country like India.
6. What are the advantages and disadvantages of free trade for a developing economy?
7. What, in your opinion, is the right trade strategy for India in the emerging international economic environment?
8. Review the trade liberalisation in India and its impact and implications.
9. Write notes on the following:
 - (a) Indicators of trade strategy.
 - (b) Policy instruments for inward oriented strategy.
 - (c) Problems of transition from inward orientation to outward orientation.
 - (d) Prerequisites for outward oriented economy.
 - (e) Infant industry argument.
 - (f) Strategic trade policy.
 - (g) “When we buy manufactured goods abroad we get the goods and the foreigner gets money. When we buy the manufactured goods at home we get both the goods and the money”. Discuss.
 - (h) Trends in trade liberalisation.

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CHAPTER 10

10 Trade Barriers

LEARNING OBJECTIVES

- ☐ To understand the types and nature of trade barriers.
- ☐ To analyse the effects of trade barriers.
- ☐ To review the trends in trade barriers.

Though there are a number of advocates of free trade, international trade is generally characterised by the existence of various trade barriers. *Trade barriers* refer to the government policies and measures which obstruct the free flow of goods and services across national borders. The main objectives of imposing trade barriers are:

- To protect domestic industries or certain other sectors of the economy from foreign competition;
- To guard against dumping;
- To promote indigenous research and development;
- To conserve the foreign exchange resources of the country;
- To make the Balance of Payments position more favourable; and
- To curb conspicuous consumption and mobilise revenue for the government.

International trade is restricted by tariffs and non-tariff measures.

Trade barriers may be broadly divided into two groups, namely tariff barriers and non-tariff barriers (NBTs).

TARIFF BARRIERS

Tariffs in international trade refer to the duties or taxes imposed on internationally traded products when they cross the national borders.

Tariff is a very important instrument of trade protection. However, mostly because of the efforts of the GATT/WTO aimed at trade liberalisation, in the industrial countries, there has been a substantial reduction in the tariffs on manufactured goods over the last five decades. Although the tariff rates are still fairly high in the developing countries, many of them have also been progressively reducing the tariff levels.

Tariffs are generally regarded as less restrictive than other methods of protection like quantitative restrictions. Therefore, organisations like the WTO generally prefer tariff to non-tariff barriers.

Classification of Tariffs

There are different ways of classifying tariffs.

- On the basis of the origin and destination of the goods crossing the national boundary, tariffs may be classified into the following three categories:

There is a variety of duties affecting trade flows.

Export Duties An export duty is a tax imposed on a commodity originating from the duty-levying country destined for some other country.

Import Duties An import duty is a tax imposed on a commodity originating abroad and destined for the duty-levying country.

Transit Duties A transit duty is a tax imposed on a commodity crossing the national frontier originating from and destined for other countries.

- There is a three-fold classification on the basis for quantification of the tariff:

Specific Duties A specific duty is a flat sum per physical unit of the commodity imported or exported. Thus, a specific import duty is a fixed amount of duty levied upon each unit of the commodity imported.

Ad-Valorem Duties Ad-Valorem duties are levied as a fixed percentage of the value of the commodity imported/exported. Thus, while the specific duty is based on the quantum of the commodity imported/exported, the ad-valorem duty is based on the value of the commodity imported/exported.

Compound Duties When a commodity is subject to both specific and ad-valorem duties, the tariff is generally referred to as compound duty.

- With respect to its application between different countries, the tariff system may be classified into the following three types:

Single-Column Tariff The single-column, also known as uni-linear tariff system, provides a uniform rate of duty for all like commodities without making any discrimination between countries.

Double-Column Tariff Under the double-column tariff system there are two rates of duty on some or all commodities. Thus, the double-column tariff discriminates between countries.

The double-column tariff system may be broadly divided into (a) *general and conventional tariff* and (b) *maximum and minimum tariff*. The general and conventional tariff system consists of two schedules of tariffs—the general and the conventional. The general schedule is fixed by the legislature at the start, while the conventional schedule results from the conclusion of commercial treaties with other countries. The maximum and minimum system consists of two autonomously determined schedules of tariff—the maximum and the minimum. The minimum schedule applies to those countries who have obtained the concession as a result of the treaty or through MFN (most favoured nation) pledge and the maximum schedule applies to all other countries.

Triple-Column Tariff The triple-column tariff system consists of three autonomously determined tariff schedules—the general, the intermediate and the preferential. The general and intermediate rates are similar to the maximum and minimum rates mentioned above under the double-column tariff system. The preferential rate was generally applied in the case of trade between the mother country and its colonies.

- With reference to the purpose they serve, tariffs may be classified into the following categories:

Revenue Tariff Sometimes the main intention of the government in imposing tariff may be to obtain revenue. When raising revenue is the primary motive, the rates of duty are generally low lest imports be highly discouraged, thus defeating the objective of mobilising revenue for the government. Revenue tariffs tend to fall on articles of mass consumption.

Protective Tariff Protective tariff is intended primarily to accord protection to domestic industries from foreign competition. Naturally, the rates of duty tend to be very high in this case because, generally, only high rates of duty curtail imports to a significant extent.

Countervailing and Anti-Dumping Duties Countervailing duties may be imposed on certain imports when they have been subsidised by foreign governments. Anti-dumping duties are applied to imports which are being dumped on the domestic market at a price either below their cost of production or substantially lower than their domestic prices. Countervailing and anti-dumping duties are, generally, penalty duties as an addition to the regular rates.

Impact of Tariff

Tariff affects an economy in different ways. An import duty generally has the following effects:

An import duty has multiple effects on the economy.

Protective Effect An import duty is likely to increase the price of the imported goods. This increase in the price of imports is likely to reduce imports and increase the demand for domestic goods. Import duties may also enable the domestic industries to absorb higher production costs. Thus, as a result of the protection accorded by the tariff, the domestic industries are able to expand their output.

Consumption Effect The increase in prices resulting from the import duty usually reduces the consumption capacity of the people.

Redistribution Effect If the import duty causes an increase in the price of domestically produced goods, it amounts to redistribution of income between the consumers and producers in favour of the producers. Further, a part of the consumer income is transferred to the exchequer by means of the tariff.

Revenue Effect As mentioned above, a tariff means increased revenue for the government (unless, of course, the rate of tariff is so prohibitive that it completely stops the import of the commodity subject to the tariff).

Income and Employment Effect The tariff may cause a switch over from spending on foreign goods to spending on domestic goods. This higher spending within the country may cause an expansion of domestic income and employment.

Competitive Effect The competitive effect of the tariff is, in fact, an anti-competitive effect in the sense that protection of domestic industries from foreign competition may enable the domestic industries to obtain monopoly power with all its associated evils.

Terms of Trade Effect In a bid to maintain the previous level of imports to tariff imposing country, if the exporter reduces the prices, the tariff imposing country is able to get their imports at a cheaper price. This will, *ceteris paribus*, improve the terms of trade of the country imposing the tariff.

Balance of Payments Effect Tariffs, by reducing the volume of imports, may help the country to improve its Balance of Payments position.

Diagrammatic Illustration of Effects of Tariff Figure 10.1 illustrates the consumption, protective revenue and redistributive effects of tariff. DD_1 is the domestic demand curve and SS_1 the domestic supply curve. In the absence of foreign trade the equilibrium price is P_2 , domestic demand and supply being Q_4 . For simplicity, it is assumed that the foreign supply is perfectly elastic at price P . Therefore, under free trade the supply position is represented by PF .

Under free trade, at price P the total domestic demand is Q ; Q_2 of which is met by domestic supply and $Q_2 Q$ is imported. Now, assume that the government imposes a tariff of PP_1 per unit of import so that the price rises from P to P_1 . Consequent upon the increase in price, the total domestic demand falls to Q_1 . The increase in price enables the domestic supply to increase from Q_2 to Q_3 . The remaining part of the domestic demand ($Q_3 Q_1$) is met by import.

Under free trade, the total consumers' surplus is DPF but with the tariff it is reduced to $DP_1 F_1$, thus the total loss of consumers' surplus being $P_1 PFF_1$. This loss to consumers is absorbed in a number of ways.

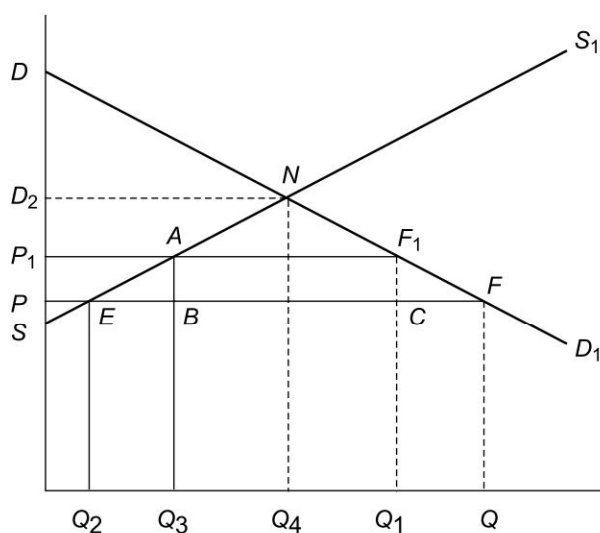


Fig. 10.1 Effects of Tariff

When the tariff per unit is PP_1 , the total imports is $Q_3 Q_1$. Therefore, government gets tariff revenue equivalent to $ABCF_1$ ($PP_1 \times Q_3 Q_1$). This is the *revenue effect* of the tariff.

At the higher tariff imposed price the producers get an additional return of PP_1 on every unit. As the supply curve also represents the cost curve, the total gain to the producers due to the imposition of the tariff is $PP_1 AE$. This additional economic rent to the producers represents a transfer of income from the consumers to the producers. This is the *redistributive effect* of the tariff.

Protection enables the domestic producers to increase supply from Q_2 to Q_3 . ABE represents the sum of the additional cost per unit of output. This is the *protective effect* of the tariff.

Due to the increase in price as a result of the protection, consumption has fallen from Q to Q_1 , causing a loss of consumer surplus by CFF_1 . This is the *consumption effect* of the tariff.

It must be noted that part of the loss of the consumer surplus represented by the revenue effect and the redistribution effect are gained by the government and the producers. Hence, they do not represent a loss to the economy; they represent transfer of income from one sector to other sectors within the economy. Hence, the total net loss imposed by the tariff upon the economy is a sum of the protective effect and the consumption effect ($ABE + CFF_1$).

The effect of tariff on terms of trade can be illustrated with the help of offer curves. In Fig. 10.2, OH is the offer curve of the home country exporting X goods and importing Y goods, and OF is the offer curve of the foreign country exporting Y goods and importing X goods. The free trade equilibrium terms of trade is represented by the slope of OT .

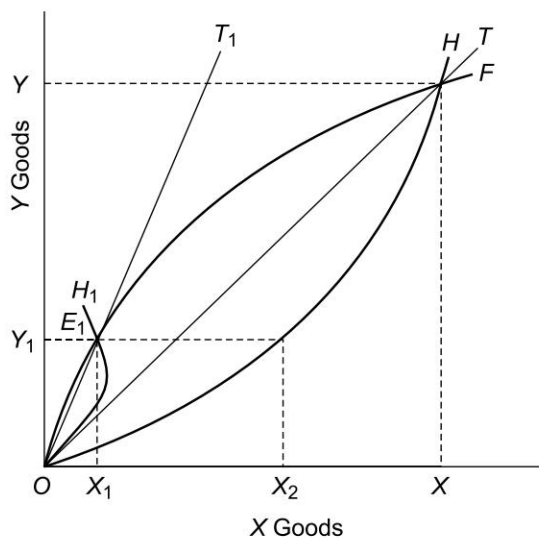


Fig. 10.2 Effect of Tariff on Terms of Trade

Now, suppose that the home country imposes a tariff on its imports so that its offer curve shifts from OH to OH_1 . This means that now the home country is getting a larger quantity of imports for a given quantity of its exports, or conversely it offers a lesser quantity of exports for a given quantity of imports. New equilibrium is established by the intersection of OH_1 and OF at E_1 , and OT_1 emerges as the new

equilibrium terms of trade. OT_1 is more favourable than OT for the home country while it is more unfavourable for the foreign country. It must, however, be noted that such an improvement in the terms of trade of the home country is possible with the tariff only if the foreign country does not retaliate by imposing tariff on its imports from the home country.

Nominal and Effective Tariffs

Nominal tariff refers to the actual duty on an imported item. For example, if a commodity is subject to an import duty of 25 per cent ad-valorem, the nominal tariff is 25 per cent.

The extent of protection an industry gets depends not only on the import duty on the output product but also on the proportion of imported inputs used and the duty on them.

Corden defines¹ the effective protective rate as the percentage increase in value added per unit in an economic activity, which is made possible by the tariff structure relative to the situation in absence of tariffs but the same exchange rates. It depends not only on the tariff on the commodity produced but also on the input coefficients

and the tariffs on the inputs.

Effective protective rate of industry 'j' (E_j) may be defined as the difference between the industry's value added under protection (V_j^1) and under free market conditions (V_j), expressed as a percentage of free market value added.

$$E_j = \frac{V_j^1 - V_j}{V_j}$$

Obviously, the protective effect of a tariff on domestic manufacturing is larger when the import duty on the raw materials used in its manufacture is lower.

Illustration Suppose that product X uses imported materials worth Rs. 6,000 and its domestic value added is Rs. 4,000. Thus, the total cost of product X is Rs. 10,000. Suppose, further, that under free trade the imported price of X is only Rs. 9,000. The domestic industry, therefore, cannot survive without protection. The government imposes an import duty of 40 per cent (nominal tariff) on product X . This would increase the price of imported X to Rs. 12,600. The domestic industry could now increase the domestic value addition up to Rs. 6,600 (Rs. 12,600 – 6,000). The effective rate of protection is thus:

$$\frac{6,600 - 4,000}{4,000} = 0.65 \text{ (i.e. 65 per cent)}$$

This means that the 40 per cent nominal import duty enables the domestic producer to increase his value addition up to 65 per cent.

Suppose now that the government imposes an import duty of 20 per cent on the imported materials. This increases the cost of the imported materials to Rs. 7,200 from Rs. 6,000. The maximum domestic value addition that can take place now is Rs. 5,400 (Rs. 12,600 – 7,200). Therefore, the effective rate of protection is:

$$\frac{5,400 - 4,000}{4,000} = 0.35 \text{ (i.e. 35 per cent)}$$

It is clear that if the domestic producer of X reduces the proportion of the imported materials (assuming that the indigenous materials are available at prices lower than the imported prices), he can enjoy a higher rate of protection. In some cases, import duty on inputs encourages indigenisation/import substitution.

Optimum Tarif

As a country raises its tariff (import duty) unilaterally, the terms of trade may improve and the volume of trade may decline. The improvement in the terms of trade initially tends to more than offset the accompanying reduction in the volume of trade. Hence, a higher trade indifference curve is reached and community welfare is enhanced. Beyond some point, however, it is likely that the detrimental effect of successive reductions in trade volume will begin to outweigh the positive effect of further improvements in the terms of trade so that community welfare begins to fall. Somewhere in between there must be a tariff which optimises a country's welfare level under these conditions.

Thus, the *optimum tariff* is the rate of tariff beyond which any further gain from an improvement in terms of trade would be more than offset by the accompanying decline in trade volume. By raising the rate of tariff beyond the optimum rate, it may be still possible to improve the country's terms of trade, but the gain from this improvement in the terms of trade is more than offset by decline in the volume of trade.

Figure 10.3 illustrates optimum tariff. OH is the offer curve of the home country and OF is the offer curve of the foreign country. Under free trade both the offer curves intersect at E and OT is the equilibrium terms of trade. IC is the trade indifference curve of the home country. Any tariff which distorts the home country's offer curve in such a way that it crosses the foreign country's offer curve between points E and S will lead to a higher trade indifference level. If the new tariff distorted trade point is at S , the trade indifference level will be unchanged because S is on the same old indifference curve IC .

Beyond a certain level of tariff, the gain from further improvement in terms of trade by increasing tariff will be offset by decline in volume of trade.

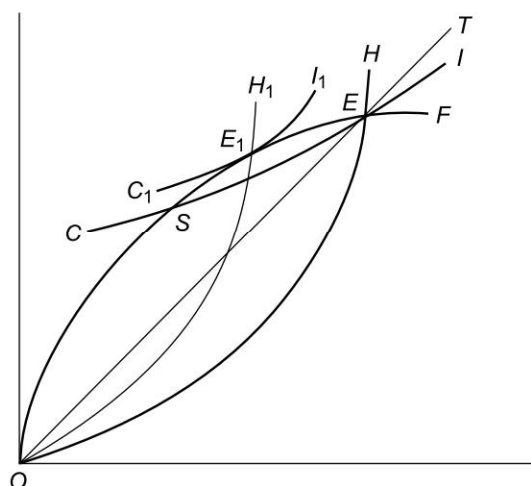


Fig. 10.3 Optimum Tariff

The highest possible trade indifference curve that the home country can reach is one that is tangent to the foreign offer curve. In Fig. 10.3 it is the trade indifference curve I_1C_1 which is tangent to OF at point E_1 . Hence, if the home country can impose a tariff of such magnitude that the tariff distorted offer curve (OH_1) intersects the foreign offer curve at point E_1 , it will be the optimum tariff, because given the foreign country's offer curve OF there is no tariff the home country can impose that will yield a higher level of community welfare.

The magnitude of the optimum tariff depends upon the elasticity of the foreign offer curve. The less elastic the foreign offer curve is, the higher will be the optimum tariff. If the foreign offer curve is perfectly elastic, no tariff will yield improved terms of trade for the home country.

In the above analysis we have assumed that the foreign country does not retaliate against the imposition of tariff by the home country. However, the foreign country will be tempted to retaliate and the retaliation and counter retaliations might set off a tariff war affecting the interests of both the countries.

Unfair Tariff Structures

Although most tariffs in industrial countries are low, those on several categories of goods remain prohibitively high. Tariffs on many consumer, agricultural and labour-intensive products are 10–20 times higher than the overall average tariff. For example, US import tariffs on clothes and shoes average 11 per cent and go as high as 48 per cent. Although, in 2001, clothes and shoes accounted for only 6.5 per cent of US imports, in value terms they brought in nearly half of the \$20 billion of US tariff revenue.

The prevailing tariff structures in industrial countries are highly harmful to developing countries.

Other industrial economies are no different. The European Union (EU), for example, applies tariffs of up to 236 per cent on meat, 180 per cent on cereals, and 17 per cent on sneakers. In contrast, its tariffs on raw materials and electronics rarely exceed five per cent.

Developing countries that export primarily agricultural and labour-intensive goods, such as textiles and clothing, are hard hit by industrial countries' tariff policies. One can clearly see the disparate effects of these tariffs by looking at the effective tariff rates—the amount of import duties collected as a per cent of total imports—of different countries. For example, on imports of \$2.4 billion from Bangladesh (a major clothing exporter), the United States collected duties of \$331 million in 2001—slightly more than the \$330 million it collected on \$30 billion of imports from France. Thus, poor countries like Bangladesh—that are beginning to move from subsistence agriculture and dependency on exports of primary commodities into light manufacturing—face the highest effective tariffs, on average, four or five times those faced by the richest economies.

To make matters worse, tariffs applied to similar categories of consumer goods are often higher on the cheaper goods than on the luxury versions. The US tariff on imported silk shirts is only 1.9 per cent, while it is 20 per cent on cotton shirts, and 32.5 per cent on synthetic-fiber shirts. Thus, the tariff structure on these products is a regressive tax on the poor, who can least afford to pay.

Tariff structures of this sort are not limited to textiles. Another type of discriminatory tariff is tariff escalation—when tariffs increase with the degree of processing involved in the product. Cocoa beans are taxed at a lower rate than cocoa butter, which is taxed at a lower rate than chocolate.

Tariff escalation is also seen in many major developing countries.

(This part is excerpted from “The Truth About Industrial Country Tariffs”, *Finance & Development*, September 2002.)

NON-TARIFF BARRIERS

Extent and Effects of NTBs

Non-tariff barriers (NTBs), some of which are described as *new protectionism* measures (as against tariffs which are regarded as traditional barriers), have grown considerably, particularly since the beginning of 1980s. The export growth of many developing countries has been seriously affected by NTBs. According to a World Bank study, NTBs in major industrial countries affect more than one-third of imports from developing countries as compared to more than one-fourth from all countries.²

Over the years, the NTBs have been becoming more extensive and intensive. Today, they are not confined to the labour intensive products where the developing countries have an advantage, but also cover sophisticated products. Japan and the newly industrialising countries (NICs) like S. Korea are also among the most affected countries by NTBs. The NTBs have come to affect the intra-OECD (i.e. trade between developed economies) also. The NTBs tend to offset favourable effects of the GATT negotiations, particularly of the Tokyo Round, on trade liberalisations like the reductions in the average levels of tariffs.

As a matter of fact, several advanced countries like the US, which were the high priests of free trade, increasingly resort to several NTBs, particularly against the developing countries and also certain economically powerful countries such as Japan.

The NTBs fall in two categories. The first category includes those tariffs which are generally used by developing countries to prevent foreign exchange outflows, or those which result from their chosen strategy of economic development. These are mostly traditional NTBs such as import licensing, import quotas, foreign exchange regulations and canalisation of imports.

NTBs proliferated particularly since the early 1980s.

The second category of NTBs are those which are mostly used by developed economies to protect domestic industries which have lost international competitiveness and/or which are politically sensitive for governments of these countries. One of the most important new protectionism measures under this category is the Voluntary Export Restraint (VER).

Demerits of NTBs

The NTBs are less transparent, difficult to identify, and their impact on exporting countries is almost impossible to quantify. They contravene widely accepted principles of non-discrimination and transparency in measures to restrict trade. Above all, the costs to the country imposing the NTB, and to the world as a whole, are higher than under and equivalent tariff. Moreover, NTBs are unfair, because they do not treat exporters equally. Often it is the exporters with the least bargaining power whose exports are most reduced.³

Although the NTBs are adopted to protect certain interests of the importing countries, the fact remains that both the exporting and importing countries are adversely affected by the protection. "Clearly the main costs of protection fall on the importing country. Non-Tariff Barriers cause higher prices for consumers, lost tariff revenue for governments, inefficient resource allocation, and diminished competition".⁴

Non-Tariff Barriers seriously affect many exporting countries. As pointed out earlier, developing country exports to developed countries face considerable NTBs. In several cases, the impact is very severe. For example, the VER covering the tapioca exports of Thailand to the European Community

(EC), established in 1982, caused its tapioca exports to decline by 40 per cent and its export earnings fell by about \$300 million (representing over 10 per cent of Thailand's total export earnings from the EC).⁵ However, such draconian VERs, which not only reduce the growth rate but also the level of exports, have not been widely applied to non-apparel exports of developing Asian countries other than South Korea.⁶

An Asian Development Bank study⁷ has brought out that with the reduction of the average tariff levels in the industrial countries, non-tariff barriers to imports of manufactures have increased in relative importance in these countries, including in categories of labour intensive and other products for which less developed countries have a strong comparative advantage. This study has also observed that through the exercise of various forms of administrative protection, non-tariff barriers have increased in importance in absolute terms and have been applied with increasing discrimination, causing bilateral trade arrangements in many cases to reign over more globally efficient multilateral trade arrangements and threatening the gains, especially to less developed countries of negotiated tariff reductions.

NTBs are less transparent and their impact is more vigorous and rigorous.

Apparel exports of the developing countries were the most affected because of such barriers. This was mostly via the Multi-Fibre Arrangement (MFA) which "constitutes a restrictive system, imposing economic costs on the economies of the developing as well as industrial countries. Several country studies cite instances of lost apparel exports, declining production and employment due to reporting, certification and other problems involved in administering bilateral MFA agreements, whereby the system of administrative controls creates such uncertainties, especially for new exporters of financially weak firms, that export production must be curtailed or abandoned by many firms".⁸

Another important cost of the MFA is rent seeking i.e. established exporters tend to enjoy greater than perfectly competitive returns from their exports sales since quota rights enable them to sell in protected markets.

Non-tariff barriers also cause diversion of production and exports. For example, some Indian textile and apparel firms decided to set up manufacturing facilities in Nepal to circumvent MFA quota controls of their exports from India, and to avoid the local costs of purchasing added quota rights. Similarly, exporters have attempted to diversify their exports to non-quota countries.

NTBs and India's Exports

The problem of NTBs on Indian exports has been growing. The ADB study of the effects of NTBs on India's exports to developed countries has come to the following conclusion.⁹

Conventional NTBs generally do not exist in developing country markets at least for Indian exports. Their impact on exports of marine products and leather and leather goods to developed economies is somewhat marginal. Their potential adverse effect on India's emerging exports of temperate zone agro-products can be critical. Exports of metal goods and readymade garments from India have suffered on account of the NTBs in developed economies. Extension and intensification of NTBs is bound to severely restrict India's export expansion in these two relatively important export sectors of the economy. Apart from the actual imposition of these NTBs, the 'noise' created is often adequate to drive out exporters and induce a fall in exports. NTBs and their administration bring about undesirable change in the structure of domestic industry and in the distribution of rewards between rent, profit and wage incomes. The uncertainty they create has an adverse effect on capacity creation and investment in the industry. As a factor responsible for an investment shortage, NTBs prevent the industry from making full use of

technological potential and economies of scale. These facts were unambiguously brought out in the survey of garment firms in India.

The study also pointed out that in case of NTBs, Indian exporters have not taken full advantage of the scope which exists. Thus, improvements in domestic capability will surely yield export expansion, at least in the short run.

The problem of NTBs for Indian exports has increased recently. The threat under the Super 301 and Special 301 is an indication of this. The indications are that India may have to face more problems in future. NTBs are often employed when a country's exports to a country increase considerably, causing problems to the industries in importing countries, or when the exporting country does not toe the economic or political lines of the powerful importing country.

According to estimates of Government of India (2002), about 44 per cent of the total exports to the US faced some or other form of NTBs.

A large part of Indian exports to industrial countries encounter NTBs. Developing country exports are hit hard by industrial country NTBs.

Forms of NTBs

There are different forms of NTBs. The NTBs which have significant restrictive effects are described as *hardcore* NTBs. These include import prohibitions, quantitative restrictions, Voluntary Export Restraints (VERs), variable levies, Multi-Fibre Arrangement (MFA) restrictions, and non-automatic licensing. Examples of NTBs excluded from this group include technical barriers (including health and safety restrictions and standards), minimum pricing regulations, and the use of price investigations (for example, for countervailing and anti-dumping purposes) and price surveillance.¹⁰

A brief account of the important NTBs is given below.

Voluntary Export Restraints Voluntary Export Restraints (VERs) are bilateral arrangements instituted to restrain the rapid growth of exports of specific manufactured goods. The United States and the European Community have, thus, regulated the imports of several products. Other bilateral arrangements have involved restraining the growth of specific exports from Japan and the newly industrialising countries.

Several NTBs are covert means of protection.

The VERs are usually highly discriminatory. The Uruguay Round Agreement has sought to abolish VERs.

Administered Protection Administered Protection encompasses a wide range of bureaucratic government actions, which have grown in absolute as well as relative importance over the last decade or more. Most recent VERs are in fact regarded as the outgrowth of administered protection actions.

Important administrative protection measures include the following:

Safeguards Safeguard actions, which under the WTO Articles enable countries to undertake temporary restrictions against 'influxes' threatening the viability of domestic industries, have become a common form of administered protection. Although such measures are resorted to provide some breathing space and flexibility for structural adjustment, they often lead to some or the other forms of permanent barriers.

Health and Product Standards Several health and product standards imposed by the developed countries hinder the exports of developing countries because of the added costs or technical requirements. The need for maintaining health and product standards is unquestionable. The objection should be to their use with the deliberate intention of trade restriction or discrimination.

The Agreement on Technical Barriers to Trade (also known as the Standards Code) evolved by the Tokyo Round of the GATT lays down that when governments or other bodies adopt technical regulation or standards for reasons of safety, health, consumer or environmental protection, or for other purposes, these should not create unnecessary obstacles to trade. However, exporters from developing countries complain that the code is not respected by developed countries in several cases.

Customs Procedures Certain customs procedures of many countries become trade barriers. For example, studies point out that frequent changes of Japan's customs regulations are a significant barrier to exporters, especially those not affiliated with Japanese overseas joint ventures.

The Tokyo Round formulated a Customs Valuation Code intended to provide a uniform and neutral system for the valuation of goods for customs purposes. The code will conform to the commercial realities and prevent the use of arbitrary or fictitious values.

Consular Formalities A number of countries insist on certain consular formalities, like certification of export documents by the respective consulate of the importing country, in the exporting country. This becomes a trade barrier when the fees charged for this is very high or the procedure is cumbersome.

Licensing Many countries regulate foreign trade, particularly imports, by licensing. In most cases the purpose of import licensing is to restrict imports.

Government Procurement These often tend to hinder free trade. The Tokyo Round has, therefore, formulated an agreement on government procurement with a view to secure greater international competition in government procurements.

State Trading State trading also hinders free trade many a times because of the countertrade practices, canalisation etc. State trading was an important feature of the foreign trade of the centrally planned economies and also many other developing countries. With economic liberalisation in most of these countries the role of state trading has declined.

Monetary Controls In addition to foreign exchange regulations, other monetary controls are sometimes employed to regulate trade, particularly imports. For instance, to tide over the foreign exchange crisis in 1990–91 and 1991–92, the Reserve Bank of India took several measures which included a 25 per cent interest rate surcharge on bank credit for imports subject to a commercial rate of interest of a minimum 17 per cent, the requirement of substantially high cash margin requirement on most imports other than capital goods, and restrictions on the opening of letters of credit for imports.

Environmental Protection Laws The growing concern for environmental protection has led to the extension of environmental protection regulation to the imports. For example, the US Congress has framed a legislation to prohibit the import of shrimp harvested with commercial fishing technology which might adversely affect the endangered or threatened sea turtles unless the President certified that the supplying country has a turtle conservation programme comparable to that of the US.

Foreign Exchange Regulations Foreign exchange regulations are an important way of regulating imports in a number of countries. This is done by the State monopolising the foreign exchange resources and not releasing foreign exchange for import of items which the government do not approve of for various reasons. Restrictions on currency convertibility can also adversely affect imports.

QUANTITATIVE RESTRICTIONS (QUOTAS)

Quantitative restrictions or quotas are important means of restricting imports and exports. A quota represents a ceiling on the volume of imports/exports.

This section discusses only quantitative restrictions on imports, i.e. import quotas.

Quantitative restriction is an important traditional NTB.

Types of Import Quotas

There are five important types of import quotas, including import licensing.

Tariff Quota A tariff quota combines the features of tariff as well as of quota. Under a tariff quota, imports of a commodity up to specified volume are allowed duty free or at a special low rate, but any imports in excess of this limit are subject to duty/a higher rate of duty.

Unilateral Quota In the case of unilateral quota, a country unilaterally fixes a ceiling on the quantity of import of the commodity concerned.

Bilateral Quota A bilateral quota results from negotiation between the importing country and a particular supplier country, or between the importing country and export groups within the supplier country.

Mixing Quota Under the mixing quota, producers are obliged to utilise domestic raw materials up to a certain proportion in the production of a finished product.

Import Licensing Quota regulations are generally administered by means of import licensing. Under the import licensing system, prospective importers are obliged to obtain an import licence which is necessary to obtain the foreign exchange to pay for the imports. In a large number of countries, import licensing has become a very powerful device for controlling the quantity of imports of particular commodities or aggregate imports.

Impact of Quota

Like fiscal controls, quantitative restrictions on imports also have a number of effects on the economy. The following are, in general, the important economic effects of quotas.

Balance of Payments Effect As quotas enable the country to limit the aggregate imports within specified limits, they help to improve the balance of payments position of the country.

Quota has multiple effects on the economy.

Price Effect As quotas limit the total supply, it may cause an increase in the domestic prices.

Consumption Effect If quotas lead to an increase in prices, it may compel people to reduce their consumption of the commodity subject to quotas or some other commodities.

Protective Effect By guarding domestic industries against foreign competition to some extent, quotas encourage the expansion of domestic industries.

Redistributive Effect Quotas will also have redistributive effect if the fall in supply due to the import restrictions enables the domestic producers to raise prices. The rise in prices will result in the redistribution of income between the producers and consumers in favour of the producers.

Revenue Effect Quotas may also have a revenue effect. As quotas are administered by means of a licence, government may obtain some revenue by charging a licence fee.

Diagrammatic Illustration of Effect of Quota The effects of quota can be diagrammatically represented on the same lines we represented the effects of tariff. In Fig. 10.4, DD_1 is the domestic demand curve and SS_1 the domestic supply curve. The foreign supply is assumed to be perfectly elastic at price P . At price P the total domestic demand is Q_1 ; Q of which is met by domestic supply and QQ_1 imported.

Now, suppose that the government fixes the import quota as $Q_3 - Q_2$. The fall in domestic availability of the commodity due to the restriction of imports pushes up the domestic price to P_1 . The increase in price enables domestic producers to increase supply to Q_3 .

As under protective tariff, $P_1 PEA$ represents the redistributive effect, ABE represents the protective effect and CFE represents the consumption effect.

Under the protective tariff, $ABCF_1$ represents the revenue effect. What about under the quota? If the foreign supply curve is perfectly elastic, as we have assumed here, and if the government does not interfere in import procedure other than to impose the quota, these revenues may go to importers. If, on the other hand, the government decides to sell permission (in the form of import licenses) to import under the quota to the highest bidder, then government will collect revenues identical to those accruing to it under a tariff of equivalent import restrictive effect. If the government does not sell import licences, there is also a possibility that the whole or part of the revenue (represented by $ABCF_1$) may be collected by the foreign exporters if they are able to raise the delivery prices.

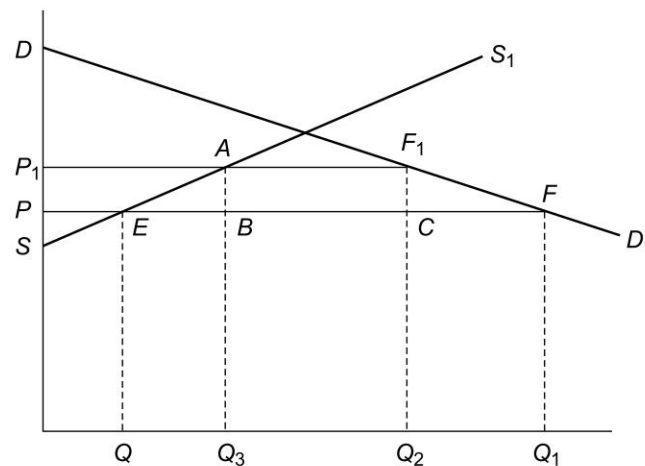


Fig. 10.4 Effects of Quota

The effect of quota on terms of trade can be illustrated with the help of offer curves. In Fig. 12.5, OH and OF are the free trade offer curves of the home country and foreign country, respectively, and the equilibrium terms of trade is represented by the slope of OT . Now, suppose that the home country imposes a quota on imports of Y goods from the foreign country in the amount OY . The home country's offer of X goods becomes zero once that quantity of imports has been reached. Hence, the home country's quota distorted offer curve becomes ORY and OT_1 emerges as the new terms of trade representing a substantial improvement over the free trade terms of trade for the home country.

The effect of quota on the terms of trade will depend upon the elasticity of the foreign offer curves.

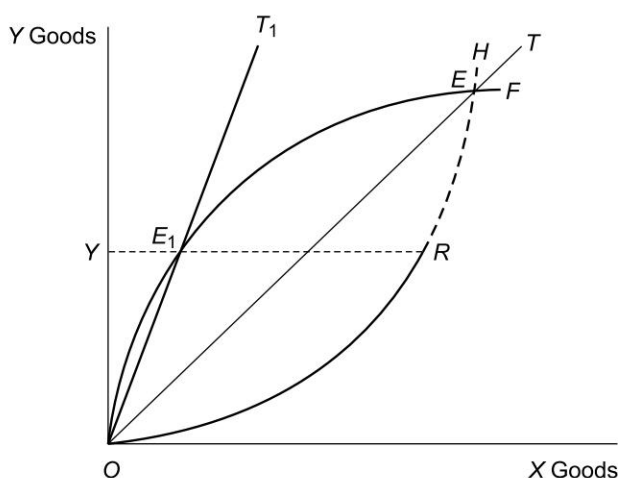


Fig. 10.5 Effects of Quota on Terms of Trade

TARIFFS VERSUS QUOTAS

Both tariffs and quotas have certain merits and demerits.

Let us first examine the *superiority of quotas* over tariffs.

- As a protective measure, quota is more effective than the tariff. Tariff seeks to discourage imports by raising the price of imported articles. However, it fails to restrict imports when the demand for imports is price inelastic. Especially in the case of the developing countries, the demand for many imports is price inelastic. Quota, on the other hand, is very effective in restricting the imports within the required limits.
- When compared to tariffs, quotas are more precise and their effects more certain. The reactions or responses to tariffs are not clear and accurately predictable but the effect of quota on imports is certain.
- It has been argued that “quotas tend to be more flexible, more easily imposed, and more easily removed instruments of commercial policy than tariffs. Tariffs are often regarded as relatively permanent measures and rapidly build powerful vested interests which make them all the more difficult to remove”.¹¹

Quota is a more effective protective measure than tariff.

- It has also been pointed out that quotas may also be employed as a measure to prevent the international transmission of severe recessions. Recession usually causes a decline in prices and this may encourage exports. A country may make use of quotas to guard against such recession induced exports into the country.

Quotas, however, have certain defects and *tariffs are superior* to quotas in some respects.

Economists generally prefer tariff to quota.

- The effects of quotas are more rigorous and arbitrary, and they tend to distort international trade much more than tariffs. That is why economists and WTO condemn quotas and prefer tariffs to quotas for controlling imports.
- Quotas tend to restrict competition more than tariffs by helping importers and exporters to acquire monopoly power. If the import quotas are allocated only to a few importers, it may enable them to amass fortunes by exploiting the market. Similarly, quotas tend to promote concentration among foreign exporters.

Professor Kindleberger observes: “A significant difference between a tariff and a quota is that conversion of a tariff into quota which admits the same volume of imports may convert a potential into an actual monopoly and reduce welfare”.¹²

SUMMARY

Trade barriers refer to the government policies and measures which obstruct the free flow of goods and services across national borders. They fall into two groups, namely, tariff barriers and non-tariff barriers (NTBs). Figure 10.6 gives a summary view of trade barriers.

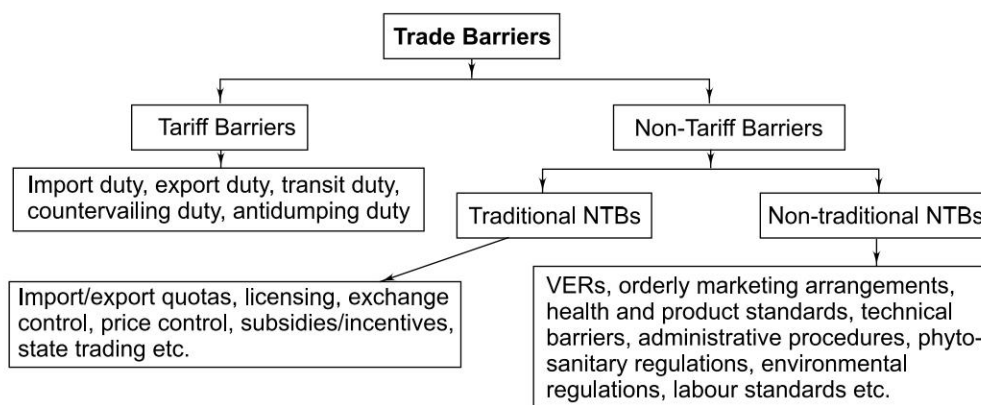


Fig. 10.6 Types of Trade Barriers

Tariff (duties or taxes imposed on internationally traded products) is a very important instrument of trade protection. However, mostly because of the efforts of the GATT/WTO aimed at trade liberalisation, there has been a substantial reduction in the tariffs on manufactured goods over the last five decades. In the developing countries, although the tariff rates are still fairly high, many of them have been progressively reducing the tariff levels. Although most tariffs in industrial countries are low, those on several categories of goods, particularly those exported from developing to developed countries, remain prohibitively high.

Tariffs are generally regarded as less restrictive than other methods of protection like quantitative restrictions. Therefore, organisations like the WTO generally prefer tariff to non-tariff barriers.

Tariff affects an economy in different ways. An import duty generally has a *protective effect* because of the increase in the price of the imported goods; *consumption effect* because of the fall in consumption due to the increase in prices; *redistribution effect*, i.e. redistribution of income between the consumers and producers in favour of the producers because of the an increase in the price of domestically produced goods facilitated by the import duty; *revenue effect*, i.e. tax revenue for the government; *income and employment effect* arising from the protection of domestic industries; *anti-competitive effect* of the protection of domestic industries; *terms of trade effect* arising from the improvement of the terms of trade of the country imposing the tariff; and *balance of payments effect* brought in by reducing the volume of imports.

Nominal tariff refers to the actual duty on an imported item. The **optimum tariff** is the rate of tariff beyond which any further gain from an improvement in terms of trade would be more than offset by the accompanying decline in trade volume.

Non-tariff barriers (NTBs) have grown considerably, particularly since the beginning of 1980s, seriously affecting the exports of, especially, developing countries. The NTBs fall in two categories. The first category includes those which are generally used by developing countries to prevent foreign exchange outflows, or those which result from their chosen strategy of economic development. These are mostly *traditional NTBs* such as import licensing, import quotas, foreign exchange regulations and canalisation of imports. The second category of NTBs are those which are mostly used by developed economies to protect domestic industries which have lost international competitiveness and/or which are politically sensitive for governments of these countries.

There are different forms of NTBs. The NTBs which have significant restrictive effects are described as *hardcore* NTBs. These include import prohibitions, quantitative restrictions, Voluntary Export Restraints (VERs), variable levies, Multi-Fibre Arrangement (MFA) restrictions, and non-automatic licensing. Examples of NTBs excluded from this group include technical barriers (including health and safety restrictions and standards), minimum pricing regulations, and the use of price investigations (for example, for countervailing and anti-dumping purposes) and price surveillance. Recently, social issues related NTBs have come to the fore.

The NTBs are less transparent, difficult to identify, and their impact on exporting countries is almost impossible to quantify. They are unfair because they do not treat exporters equally; often it is the exporters with the least bargaining power whose exports are most reduced.

Indian exporters have been facing a growing problem of NTBs .

Quantitative restrictions or quotas are important forms of NTB. As a protective measure, quota is more effective than the tariff. The effects of quotas are more rigorous and arbitrary and they tend to distort international trade much more than tariffs. Quotas tend to restrict competition much more than tariffs by helping importers and exporters to acquire monopoly power. That is why WTO condemns quotas and prefers tariffs to quotas for controlling imports.

Like tariffs, quantitative restrictions on imports also have *protective effect*; *redistribution effect*; *revenue effect*; *balance of payments effect* and *consumption effect*.

Quantitative restrictions have been, by and large, abandoned by countries.

Review Questions

1. Explain with the help of diagrams the impact of tariffs.
2. What are non-tariff barriers? Examine the impact of NTBs on exports of developing countries.
3. Why are NTBs regarded as more harmful than tariff barriers to trade? Give a brief account of the important NTBs.

4. Discuss the trends in NTBs since the early 1970s and their impact.
5. Explain the impact of quota.
6. Write short notes on the following:
 - (a) Types of tariffs.
 - (b) Nominal and effective tariff.
 - (c) Optimum tariff.
 - (d) New protectionism.
 - (e) Impact of NTB on India's exports.
 - (f) Superiority of quotas over tariffs.
 - (g) Defects of quotas.

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CHAPTER II

11 Cartels, Commodity Agreements and State Trading

LEARNING OBJECTIVES

- ☐ To get an idea of international cartels.
- ☐ To understand international commodity agreements.
- ☐ To review the role of and trends in state trading.
- ☐ To get a brief picture of canalisation in India.

Governments some times influence demand and supply, influencing the price of commodities in the international market and international trade flows by interventionist measures such as formation of cartels, commodity agreements and state trading.

INTERNATIONAL CARTELS

A cartel is a monopolistic type of organisation, of German origin, established originally for the purpose of restricting the output of member firms in order to keep up the price of their output.

Cartel may involve the establishment of a central selling organisation. The member firms, however, retain their independence, except in so far as they agree to restrict their output.

Although the main aim of a cartel, normally, is to control prices, this is often accompanied by output and investment quotas for making the price control effective.

Cartel is an association of producers/sellers which seeks to wield monopoly power by controlling production/supply and price.

Cartels are common in the market structure known as oligopoly which is characterised by a relatively small number of firms. As Wilson observes: "It is characteristic of this type of market that firms tacitly collude to keep out potential competitors and to reduce the degree of competition between themselves. Although these firms do not formally agree on these policies, they carry them out implicitly because it is in their mutual interest to do so."¹

Cartels are illegal in many countries as they seek to exploit the consumers by attaining monopolistic powers and restrict output and investment to maintain prices at high levels. However, sometimes cartels have been legalised. For instance, in Germany in the inter-war period cartels were legalised when they were seen as a means of achieving gradual rationalisation of an industry suffering from excess capacity, or of achieving sufficient

Cartels are common in oligopolistic markets.

strength to compete more effectively in international trade. The British Agricultural Boards are cartels compulsorily established by the State when a majority of the producers of a commodity desire one, but their policy has not generally been to restrict output, though there has always been restriction on the entry of new producers. However, cartels are normally illegal in the UK.

In India, cartels which cause restrictive trade practices are controlled by the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969. The MRTP Act defines a restrictive trade practice as a trade practice, which has, or may have, the effect of preventing, distorting or restricting competition in any manner and in particular (i) which tends to obstruct the flow of production, or (ii) which tends to bring about manipulation of prices or conditions of delivery, or to affect the flow of supplies in the market relating to goods or services in such a manner as to impose on the consumers unjustified costs or restrictions. The MRTP Act has prohibited several cartel agreements which came under the definition of restrictive trade practice.

International cartels are agreements between producers located in different countries or between governments of different countries to restrict competition.

While domestic cartels are often prohibited or controlled by the respective governments, international cartels are often sponsored or sanctioned by the governments of the countries concerned. Examples include the Organisation of Petroleum Exporting Countries (OPEC) and International Air Transport Association (IATA), a cartel of major airlines established to set up air fares and restrict competition.

Cartels should be distinguished from International Commodity Agreements. The cartel is basically a unilateral decision by producers to cooperate while a commodity agreement, in principle, includes consumers in the negotiations, although in practice consumers (as opposed to consuming governments) have little direct say in their operation.

It may also be noted that although the major objective of a cartel is to raise price and restrict competition, it may have other goals as well. For example, to develop the industry in a broader sense; or, as in the case of the OPEC, to act as a distributor of international aid.

It was with the quadrupling of the price of oil in the early 1970s and the arrival of OPEC as an effective cartel in the oil market that cartels began to receive considerable attention. "Developed countries were anxious to establish whether OPEC would be able to survive, and less developed countries were interested in the possibilities for replicating its example in other commodities exported mainly by poor countries."² After remaining as a powerful force for many years, the OPEC began to weaken due to several reasons, including conflict of interest, and finally, its disintegration also seemed to have begun. In 1992, Ecuador pulled out of the 13-member OPEC. In early 2005, its membership stood at 11.

The most powerful international cartel established so far is OPEC.

COMMODITY AGREEMENTS

International commodity agreements are intergovernmental endeavours to stabilise prices of primary commodities.

International Commodity Agreements are inter-governmental arrangements concerned with the production and trade of certain primary products.

Many developing countries which embark upon ambitious development programmes need large foreign exchange resources to finance some of their developmental requirements like import of capital goods. But they face problems like fluctuations in export prices of primary goods, i.e. agricultural products and minerals, which form a major part of their total exports. Apart from making export earnings unstable, it also causes deterioration in terms of their trade. Hence, there has been a growing demand for adopting stabilisation measures to

protect the interests of developing countries. International commodity agreements, it is believed, can help stabilise prices of the respective commodities.

Commodity agreements have been tried in different cases for quite some time now. "The worsening condition of primary product exporters in terms of trade in the second half of the fifties, their lagging export earnings, inadequate reserves, mounting external indebtedness, and the consequential frustration of plans for rapid economic development caused these countries to look around for ways of escaping from their predicament. Out of this search came the idea that commodity agreements could be used as a way of raising (or halting a fall in) the world prices of commodities and in this way of transferring income from consuming to producing countries."³

In its *Final Act* the UNCTAD I set out a comprehensive statement on the functions of international commodity agreements as follows. The commodity agreements should have "...a basic objective of stimulating a dynamic and steady growth and ensuring reasonable predictability in the real export earnings of the developing countries so as to provide them with expanding resources for their economic and social development, while taking into account the interests of consumers in importing countries, through remunerative, equitable and stable prices for primary commodities, having due regard to their import purchasing power, assured satisfactory access and increased imports and consumption as well as coordination of production and marketing policies."⁴

Objectives

Stabilisation of prices is only one of the objectives of Commodity Agreements. As Towle points out,⁵ the chief purposes for which governments, and in some instances non-governmental organisations, have entered into commodity agreements are as following:

The Promotion of Health and Morals The outstanding example of international agreements for the purpose of promoting health and morals is the international regulation of the trade in opium and narcotics.

The Conservation of Resources The conservation of natural resources is a direct or indirect objective of nearly all international raw material scheme. This is one of the objective of the OPEC.

Security Objectives Inter-governmental commodity agreements may also be useful as a offsetting preventive war measure by a scramble for scarce strategic materials for national stockpiling or other security purposes.

Price Stabilisation As has already been described above, price stabilisation is a very important purpose for which commodity agreements have been entered into.

The Management of Surplus Commodity agreements are sometimes entered into to manage the surplus. During times of bumper crops, there may arise a problem of surplus. Such surplus should be properly managed to avoid serious adverse effects on prices and also with a view to hold stock for the lean periods.

Commodity agreements may take any of the four forms namely quota, buffer stock, bilateral contract, and multilateral contract.

Quota Agreements

International Quota Agreements seek to prevent fluctuations in commodity prices by regulating their supply.

Quota agreement seeks to stabilise commodity price by controlling the supply.

Under the quota agreement, export quotas are determined and allocated to participating countries according to some mutually agreeable formula wherein they undertake to restrict the export or production by a certain percentage of the basic quota as decided by the central committee or council.

For instance, the *Coffee Agreement*, among the major producers of Latin America and Africa limited the amount that could be exported by each country.

Quota agreements have already been tried in case of coffee and sugar, and commodities like tea and bananas have been suggested as prospective 'candidates' for new agreements.

It has been pointed out that quotas "are bad theoretically because they imply misallocation of resources. They protect inefficient producers, freeze markets, and probably keep supply below the optimum. Quotas have the advantage, however, of being manageable. They avoid accumulation of stocks, require no financing and do not call for continuous operating decision."⁶

Buffer Stock Agreements

International Buffer Stock Agreements seek to stabilise the commodity prices by maintaining the demand-supply balance.

Buffer stock agreement endeavours to stabilise commodity price by maintaining the demand-supply balance.

Buffer stock agreement stabilises price, increasing the market supply by selling the commodity when the price tends to rise and by absorbing the excess supply to prevent a fall in the price. The buffer stock plan, thus, requires an international agency to set a range of prices and to buy the commodity at the minimum and sell at the maximum.

The buffer pool method has already been tried in case of tin, cocoa, and sugar, and commodities like rubber, tea, and copper have been suggested as prospective candidates for new agreements.

The buffer stock arrangement, however, has certain limitations. It can be effected only in case of those products which can be stored at relatively low cost without the danger of deterioration. Further, large financial resources and stock of the commodity are required to launch the programme successfully. It has also been pointed out that "In the absence of production and export quotas to protect the buffer pool, there is always the prospect that some countries might use it to create 'easy' foreign exchange for themselves. Export subsidies and special exchange rates might provide the means to that end. Finally, the present division of the world into different currency areas would hamper the functioning of buffer pools."⁷

Bilateral and Multilateral Contracts

Bilateral contracts to purchase and sell certain quantities of a commodity at the agreed upon prices may be entered into by the major importers and exporters of the commodity. In such an agreement an upper

Under bilateral/multilateral contract, government intervenes in the market when the commodity price fluctuates beyond the specified limit.

price and a lower price are specified. If the market price throughout the period of the agreement remains within these specified limits, the agreement becomes inoperative. But, if the market price rises above the upper limit specified, the exporting country is obliged

to sell the importing country a certain specified quantity of the commodity at the upper price fixed by the agreement. On the other hand, if the market price falls below the lower limit specified, the importer is obliged to purchase the contracted quantity at the specified lower price.

Such international sale and purchase contracts may also be entered into by two or more exporters and importers. The bilateral or multilateral agreements are usually concluded between the major supplier(s) and the major importer(s) of the commodities.

The best known example of this type of commodity agreement is the *International Wheat Agreement* which fixed the maximum price at which the exporting countries guaranteed to supply stipulated amount of wheat to the importing countries, and minimum price at which the importing countries agreed to purchase fixed amounts of wheat from the exporters.

As Wallich points out,⁸ this type of an agreement has the advantage of preserving the free market as an allocator of resources and an indicator of trends, provided not all supplies are covered by it.

The technical problems of the contract are quite manageable, although difficulties grow as the agreement is drawn tighter to make it more effective. The contract has the grave disadvantage, however, of creating a two-price system. It requires domestic controls of some sort and buffer stock to implement it, and it is quite apt to put the participating governments into the commodities business. In an extreme case, it may become nothing but a payment by the government of one country to that of another without ever touching the producer or consumer.

Futures Markets and Hedging

Futures markets offer a way to hedge commodity price risk and have been used for a long time in developed countries by trading companies and financial institutions, although these financial instruments are not typically purchased by farmers. Nevertheless, the benefits of such markets can filter down to farmers through intermediaries who package these instruments into simpler forms of price insurance. But financial institutions in developing countries may have little access to hedging instruments in international markets. This is because of the high costs and inherently more risky nature of such transactions. Poor countries may lack the physical facilities (for storage, transportation, processing), legal and institutional infrastructure which are necessary preconditions for the efficient functioning of such markets. The important challenge is to create the necessary conditions for these markets to function successfully in poor countries given the benefits from market-based hedging of commodity price risk.⁹

Futures markets help hedge commodity price risks.

Conclusion

The experience of the post-war market stabilisation schemes indicate that a combination of different control techniques is likely to be more effective than reliance on a single technique alone.

The WTO points out that the past decades have not been kind to international commodity agreements either. Some have collapsed, others faced adverse market conditions which made attempts at stabilisation impractical. Others were not able to raise the funds to intervene effectively, while still others have suffered from disagreement over the division of the benefits among countries. Difficulties have also arisen in circumstances where the implicit objective of price stabilisation schemes has been to change secular trends in prices rather than smooth out fluctuations in prices.¹⁰

STATE TRADING

In the Report of the Committee on State Trading, Government of India, state trading has been defined as import and export transactions of a state owned or state controlled agency involving purchase of goods for commercial resale or for use in production of goods for commercial resale. In a broader sense, state trading also includes purchases from abroad for governmental use and disposal of surplus stocks originally purchased by government.

Retrospect

It is a fact that international economic relations have not been left entirely to private enterprise at any time in history by any country of consequence. Long after internal trade has been liberated, foreign trade has often remained in the hands of government-designated monopolies or under close government supervision. Nineteenth-century Britain was an exception. Tariffs, subsidies, and quotas are now used by all governments in free enterprise countries to control and direct imports and exports.¹¹

In fact, trade canalising organisations are mentioned even in *Old Testament* and State corn trading monopoly existed in ancient Rome.¹² “In the twentieth century, government enterprises importing agricultural products flourished in industrial countries in response to the economic crises of the 1930s and the immediate post-war period. Once canalising organisations were established in some countries, they tended to proliferate in others in a mutually reinforcing manner. Attempts were made during the late 1930s to check the expansion of trade canalisation, but they proved to be ineffective. Countries that did not welcome this method were obliged to adopt them in self-defence, leading to further spread of canalisation.”¹³

In centrally planned economies, state trading was, naturally, the rule. In many non-communist developing countries like India, state trading was assigned an important role for the development of foreign trade and to protect certain other national interests. Indeed, in the past the communist countries have tried to use the foreign trade policy to encourage state trading by developing countries. In fact, one of the objectives of establishing the State Trading Corporation of India (STC) was to expand foreign trade with the centrally planned economies.

In the Communist and Socialist countries governments actively involved in foreign trade.

It may be noted that the recent economic reforms in the centrally planned economies and other developing countries have significantly reduced the role of state trading.

Reasons for State Trading

There are different reasons for state trading. Important reasons are given below:

1. State may directly buy the goods required by the various government departments and agencies for reasons of economy, reliability, etc.
2. State may engage in foreign trade to sell the surplus stock of goods procured by it as part of price support policy.
3. In the centrally planned economies, state trading was essentially an inevitable part of the economic system.
4. In mixed economies, state trading in certain areas may be a part of the economic system.
5. In some cases, state trading is a part of the entrepreneurial role played by the government in a mixed economy.

6. State trading in some commodities may be due to strategic reasons.
7. State trading may also be resorted to, to reap advantages of bulk buying and selling.
8. Another objective of state trading is to avoid unhealthy competition between domestic exporters.
9. Efficient regulation of foreign trade is an important objective of state trading.
10. Export market development is also an objective of state trading in several cases.
11. In case of some countries, like India, one of the objectives of state trading was expansion of foreign trade with the socialist countries.

Disadvantages of State Trading

State trading has several disadvantages.

1. State trading is often afflicted by the corruption and inefficiency usually associated with the public sector.
2. It is alleged that state trading promotes bilateral trade as against multilateral trade and obstructs free trade.
3. State trading eliminates or reduces competition and entrepreneurship.

State Trading in India

In India, the government's role in foreign trade is not confined to import and export controls, export promotion and import substitution measures. It directly participates in the import and export business through its agencies like the State Trading Corporation of India (STC), the Minerals and Metals Trading Corporation of India (MMTC), and the Mica Trading Corporation of India (MITCO) which have been set up by the Government of India to engage in import and export business in specified areas. In course of time, they came to account for more than one-fifth of India's foreign trade. The State Trading Corporation of India Ltd, was established in 1956, primarily to deal with bilateral trading partners in East European countries.

State trading played an important role in India's foreign trade until early 1990s.

The objectives of the STC, as envisaged by the Government, were:

1. To help reduce the difficulties experienced in expanding trade with centrally planned countries.
2. To help maintain quantitative regulations of imports and some equilibrium in the prices of commodities and indigenous products.
3. To provide developmental finance for organised production and boost exports of small-scale sector.
4. To check unhealthy competition and price undercutting in international markets.
5. To organise integrated development of production, transport and port facilities with respect to bulk commodities.
6. To promote the production of non-traditional items and open up new fields for the export of traditional items.
7. To undertake internal trade as and when the situation warrants it.
8. To ensure adequate and regular supplies at reasonable and stable prices of essential commodities to meet local demand.
9. To effect exports and imports at more favourable prices through increased bargaining power.

10. To stimulate the production of essential agricultural and industrial commodities by means of price and other incentives.
11. To facilitate the import of goods under foreign aid programmes.
12. To facilitate the implementation of trade agreements and barter deals.
13. To act as a vehicle for the implementation of government policies.

Later, the STC was asked to pay due attention to the development of non-canalised exports and also for the development of new products and market for exports.

The Minerals and Metals Trading Corporation of India Ltd. (MMTC), established in 1963 as a subsidiary of the STC, was later made independent of the STC and sometime later it was made a general trading house (instead of being confined only to mineral and metals trading).

Canalised trade was the mainstay of the public sector trading houses. With the new trade policy, the scope of canalisation has been substantially reduced. In this context the government has clarified that the objectives of public sector trading organisations would be reoriented towards their emerging as international trading houses capable of operating in a competitive global environment, of serving as effective instruments of public policy and of providing adequate support to the small scale and cottage industries.

CANALISATION

State trading is often associated with canalisation. Canalisation means establishment of state monopoly in foreign trade. In other words, an item that is canalised can be imported or exported, as the case may be, only by the designated state trading agencies. “The emphasis is on the control of foreign trade flows rather than on the ownership of the organisation or the agency conducting it.”¹⁴

State trading agencies may also trade in products which are not canalised, in addition to the canalised items. Thus, while canalisation essentially means state trading, there may also be state trading without canalisation.

Canalisation was widespread in the world. It was not confined to the centrally planned economies and other developing countries. It was also common with the developed countries. “In the period immediately after World War II, canalising enterprises sprang up in almost all OECD countries for trade in agricultural commodities, minerals and some industrial goods. Many of these enterprises subsequently grew in size, increased in relative importance and diversified their activities. Other than in commodities noted above, canalisation has existed at one point or other in products like petroleum, coal and iron.”¹⁵ After the oil crisis of 1973, several advanced countries canalised oil imports to ensure stable supply of oil. Almost all the industrialised countries have used this policy instrument in one form or other although the extent of canalisation is generally much lower than that in the developing economies.

Most of the objectives of the state trading mentioned earlier are also the objectives of canalisation. Canalisation also has, obviously, the disadvantages of state trading mentioned earlier.

It is pointed out “for a majority of developing countries, the basic rationale behind establishing canalising agencies, was more socio-economic and geo-political, than economic. Several adopted an ideological approach towards establishing them. In their post-independence zeal, many developing countries decided that the critical means of production should be in hands of the public. Espousing import canalisation was a part of this thought process. There were various objectives for setting up canalising agencies, which at times, were overlapping, irreconcilable and even confusing ...one can find

Canalisation means state monopoly in the international trade of the product.

canalising agencies which were based totally on economic considerations, and varying combinations of the two objectives.”¹⁶

Estimates for the mid-1980s indicated that approximately 15 per cent of the world imports were canalised.¹⁷

Canalisation in India

Canalisation had grown considerably in India. The Committee on Import-Export Policies and Procedures (Alexander Committee—1978) pointed out that there were at that time 24 canalising agencies which together handled as many as 200 products. Beginning in the early 1970s, there was a steady increase in the incidence of canalisation and during the period from mid 1970s to the early 1980s, canalised imports constituted as much as three-fifths to two-thirds of the total imports.

As the Alexander Committee¹⁸ points out, the need for bulk purchasing, deriving optimum price for imports and exports, safeguarding the interest of the small producers, mopping up premium elements involved in trading operation in the situation of excess demand condition, provision of infrastructural facilities for generating imports and export trade at lower costs, etc. are some of the arguments for the introduction of canalisation. At one time in the history of canalisation, the objective of nationalisation of import and export trade had also figured as a factor towards the progressive expansion of scope of nationalisation.

The trade and industry, and a number of studies, including the reports of the Alexander Committee and the Abid Hussain Committee, have expressed clear dissatisfaction with the canalisation system.

Considering the pros and cons of the various issues and also taking into account the views expressed by the trade and industry circles on canalisation, the Alexander Committee took the view that canalisation as an instrument of trade policy has not been effective in the case of many of the canalised items in the past. The Committee also felt that, in the past, decisions for canalising an item had not always been taken on considerations of the product characteristics, the nature of the market and market structure, and price support measures. The Committee noted with surprise that the small-scale sector which was supposed to benefit by the canalisation system was the most vociferous in highlighting the disadvantages of the system. The main contention of the small scale sector was that the canalising agencies had not always provided the advantage of bulk purchasing and low prices, and had collected the commission charges without providing any services expected of them, often there were considerable delays in making the inputs available at the right time, they also insisted on purchase of raw materials at a high price even though the current market price was lower. The general contention had been that the canalisation system had upset the approach of optimum inventory management by the industry instead of helping it in reducing its costs in this regard.

Canalisation failed to achieve its objectives in India.

The Abid Hussain Committee also noted with concern the dissatisfaction, expressed by trade and industry, about canalisation with respect to availability, delivery schedules and prices, which tended to escalate costs and compound inventory management problems. The Committee recognised these problems but felt that they arose on account of the choice of items sought to be canalised, the agencies chosen for the task, or just poor implementation. The Committee, therefore, suggested the following guidelines for a systematic review and rationalisation of canalisation policies regarding imports.

The Rationale Canalisation of imports should constitute the exception rather than the rule, the objective of which should be to:

1. Obtain better terms of trade, through bulk purchases, than would otherwise have been possible.
2. Realise economies of scale in trade operation.
3. Plan for the volume of imports to manage the supply of essential inputs and commodities.

Choice of Items Canalisation of imports should be selective and based on the following criteria:

1. Items where the size of imports exceeds a certain minimum threshold in terms of absolute value.
2. Items which are either homogeneous or standardised.
3. Items which are subject to administered prices.
4. Items which are strategic or sensitive in nature.

Choice of Agencies Agencies for canalised imports should be selected on the basis of the following two criteria:

1. A manufacturing firm should not be the agency for importing the item it produces.
2. There should not be a multiplicity of canalising agencies; in other words, it would not be advisable to adopt the principle of nominating a separate canalising agency for each item.

There are two reasons underlying the latter criterion. First, it takes both time and resources to develop infrastructure and expertise for operating in world markets and wherever possible canalising agencies should benefit from economies of scale which stem from operations across a range of items. Secondly, this method would enable agencies responsible for a large value of canalised imports to develop into trading houses with a potential for export promotion.

A critical study of import canalisation by Dilip Das has come to the conclusion that the manner in which import canalisation has worked in India also reveals that business acumen tends to be replaced by a risk averse and procedure-oriented approach. Since the canalising agencies are also *de facto* monopolies in the domestic market, they manifest many of the frailties associated with monopolistic behaviour.¹⁹

The growing trend of canalisation was reversed by mid 1980s.

The views expressed by the Alexander Committee, Abid Hussian Committee and other expert studies encouraged the government to decanalise a number of items. A trend towards decanalisation was set in with the Exim policy for 1985–88 which decanalised 53 items of import which did not meet the criteria for canalisation. The subsequent Export-Import Policies significantly pruned the list of canalised items.

SUMMARY

Governments some time influence supply and demand, influencing the price of commodities in the international market by interventionist measures such as formation of cartels, commodity agreements and state trading.

International supply and/or prices in certain sectors are sought to be regulated by **International Cartels**. Examples include the Organisation of Petroleum Exporting Countries (OPEC) and International Air Transport Association (IATA).

An important international cooperation endeavour for the protection of the mutual benefits of the producers and consumers of primary commodities is **International Commodity Agreements** which are inter-governmental

arrangements concerned with the production of, and trade in, certain primary products with a view to stabilising their prices. Commodity Agreements may take any of the four forms, namely, quota, buffer stock, bilateral contract, or multilateral contract.

While a cartel is basically a unilateral decision by producers to co-operate, a commodity agreement, in principle, includes consumers in the negotiations, although in practice consumers (as opposed to consuming governments) have little direct say in their operation.

State trading was very popular, particularly among the centrally planned economies and developing economies until the 1980s. It still continues although not as pervasive as in the past. State trading refers to import and export transactions undertaken by the state owned or state controlled agencies. State trading may also be resorted to due to strategic reasons; to reap advantages of bulk buying and selling; and, to avoid unhealthy competition between domestic exporters. In case of some countries, like India, one of the objectives of state trading was expansion of foreign trade with the socialist countries.

State trading is often associated with **canalisation**; an item that is canalised can be imported or exported, as the case may be, only by the designated state trading agencies. Here, the emphasis is on the control of foreign trade flows rather than on the ownership of the organisation or the agency conducting it. Canalisation had grown considerably in India but since the mid 1980s a decanalisation trend set in because of the several drawbacks of the system of canalisation.

State trading and canalisation have several disadvantages. They are often afflicted by the corruption and inefficiency usually associated with the public sector. They may promote bilateral trade as against multilateral trade and obstructs free trade. Further, State trading eliminates or reduces competition and entrepreneurship.

Review Questions

1. Give an account of international commodity agreements.
2. Explain the objectives, characteristics and defects of state trading.
3. Review India's state trading.
4. Write notes on the following:
 - (a) International cartels
 - (b) OPEC
 - (c) Bilateral and multilateral contracts
 - (d) Bufferstock agreements
 - (e) Canalisation of foreign trade
 - (f) State Trading Corporation of India.

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CHAPTER 12

12 Social Issues in International Trade

LEARNING OBJECTIVES

- ☐ To examine the issue of ethics international business.
- ☐ To understand the concept of social responsibility of nations and business.
- ☐ To get an idea of the environmental issues in international business.
- ☐ To understand the labour issues associated with international business.

With growing globalisation the concern about certain social issues has been increasing. The important social issues related to international trade are business ethics, social responsibility of business, environmental factors and labour standards.

BUSINESS ETHICS

Business ethics is often a very intricate, controversial and perplexing issue because of, among other things, the varying ethical norms and social values.

In the sphere of international trade, we may consider the issue of ethics at two levels—the ethics of the trading nations and of the trading firms.

Business Ethics and Trading Nations

There is a feeling that the developed nations, particularly, resort to a number of unethical practices in international trade. For example, certain sections of the Omnibus Trade and Competitiveness Act, 1988, of the USA, viz., Super 301 and Special 301, have become very controversial because of the way they have been used (or threatened to be used) against other countries for economic reprisals. The avowed objective of these sections of the Act is to expand global trade by opening markets. It is part of the strategy of reciprocal market access. In other words, they aim at improving the United States' competitiveness by trade reprisals. The Section 301 of the Act deals with the steps the US government must take if it perceives a threat to the trading interests of the US by the unjustifiable or unreasonable or discriminatory trade partners.

Many a time industrial nations are not ethical/fair enough to developing nations.

The major allegation is that the Section 301 has been used to humble successful trade rivals and those countries which do not toe the US political and economic lines. For instance, it was alleged that the major provocation for including India and Brazil in the watch list, in the long past, under this Section was the strong stand which they took in the Uruguay Round to uphold the cause of the developing countries, opposing the stand of the US and other developed countries. It had been reported that the Assistant USTR (United States Trade Representative) stated that “part of our intent in using the instrument (Super 301) is to prod India to be less obstructionist in Geneva as a spokesperson for developing countries.”¹

It is interesting to note that in the US and West European countries there has been a growing demand for more protective measures in the light of the challenge of their trade supremacy.

The US axe is often directed against countries with substantial trade surplus with the US like Japan, and countries for which the US is the major export market (including developing countries like India).

Jagdish Bhagwati observes that since the late 1970s, in the US and the EC, protectionism has increasingly taken covert shape. Weapons like Section 301 could allegedly be used for covert protectionism like harassment of successful foreign rivals. First the rivals might be accused of indulging in unfair trade and then they could be taken through time consuming and expensive procedures.²

It is ironic that while the developed countries want the developing countries to open their economies more and more, they have been very keen to increase the protection of the vulnerable sectors of their own economies, like agriculture and labour intensive manufacturing. As pointed out in Chapter 3, the trade regime of the developed countries is highly biased against the developing countries.

The developed countries using their might in the international organisations like WTO, IMF, World Bank etc. to bend the policies and decisions to serve their vested interests to the detriment of the developing countries should also be regarded as unethical.

Business Ethics and Trading Firms

There are also large number of instances of firms engaged in international business resorting to unethical practices.

The term business ethics refers to the system of moral principles and rules of conduct applied to business. That there should be business ethics means the business should be conducted according to certain self-recognised moral standards. There is, however, no unanimity of opinion regarding what constitutes business ethics. An international marketer often finds that the norms of ethics vary from

Business ethics is dependent on the societal ethics at large.

country to country. What is ethically wrong or condemned in one nation may not be so in another. In this connection, Peter Drucker, renowned Management guru, very appropriately remarks: There is neither a separate ethics of business, nor is one needed.”³ “For, men and women do not acquire exemption from ordinary rules of personal behaviour because of their work or job. Nor, however, do they cease to be human beings when appointed vice president, city manager, or college dean. And there have always been a number of people who cheat, steal, lie, bribe or take bribes. The problem is one of moral values and moral education of the individual, of the family, of the school.”⁴

Bribery, pay-offs or kickbacks are common in business in many countries. However, the extent and intensity of it vary from country to country. In some countries it is a common practice with government officials and other employees. The law in respect of such practices also varies among countries.

According to the regulation in some countries, while bribing is illegal within the country, bribing by the nation's firms in foreign markets to get or conduct business is not illegal because of the feeling that that is inevitable in some markets. The position appears to be that "morality only exists within a culture. And it is not for us to say what is moral in someone else's culture".

Several West European countries either condone bribery or look the other way—such expenses are tax deductible up to a certain amount in some countries. However, the US Foreign Corrupt Practices Act of 1977 prohibits a firm from making or authorising payments, offers, promises, or gifts for the purpose of corruptly influencing actions by governments or their officials in order to obtain or retain orders for a company. American businessmen complain that they are severely handicapped because of this legislation when they have to compete with those who are not so regulated. In countries like France and Germany, the money paid for bribes to secure business overseas is a legitimate tax write-off.

Whatever may be the legal position regarding bribing, it is basically a question of the moral values and self regulation. Some people, who hold that bribing politicians and top officials to get business is unethical, feel that paying the lower levels is not unfair if the papers don't move normally otherwise.

Another issue is whether it is ethical to sell products which are banned in some countries because of their harmful effects in other countries (often in developing countries). One issue is that if the government of a country permits the marketing of such a product, should a company give up the sale of the product on its own? If the harmful effects of a product outweigh the benefits, a company with sound ethics will not do business in that product even if there is no legal objection.

SOCIAL RESPONSIBILITY

Besides being ethical in business, nations, particularly developed ones as well as firms, particularly the large companies, have some social responsibilities.

Developed nations have a moral responsibility to help the development of developing countries in general and the poorest in particular. These include meeting the ODA target and encouragement of exports of developing countries by preferential treatment. In fact, this moral responsibility should tend to be binding when the injustice the developing world has been subjected to is considered, as pointed out in Chapter 2.

Besides being fair in the economic transactions, developed nations have a moral responsibility to assist the development of developing countries.

Social responsibility of business or corporate social responsibility (CSR) refers to what the business does, over and above the statutory requirement, for the benefit of the society. The word *responsibility* connotes that the business has some moral obligations to the society. The term *corporate citizenship* is also commonly used to refer to the moral obligations of business to the society. This implies that, just as individuals, corporates are also integral part of the society and that their behaviour shall be guided by certain social norms.

As the High-Powered Expert Committee on Companies and MRTP Acts (Sachar Committee), set up by Government of India, observed: "in the environment of modern economic development, the corporate sector no longer functions in isolation. If the plea of the companies that they are performing a social purpose in the development of the country is to be accepted, it can only be judged by the test of social responsiveness shown to the needs of the community by the companies. The company must behave and function as a responsible member of society, like any other individual. It cannot shun moral values, nor can it ignore actual compulsions. The real need is for some focus of accountability on the part of the management which is not limited to shareholders alone. In modern times, the objective of business has

CSR implies that companies shall contribute to social welfare, over and above the statutory requirements.

to be the proper utilisation of resources for the benefit of others. Profit is still a necessary part of the total picture; but it is not the primary purpose. This implies that the claims of various interests will have to be balanced, not on the narrow ground of what is best for the shareholders alone but from the point of view of what is best for the community at large. The company must accept its obligation to be socially responsible and to work for the larger benefit of the community.”⁵

There has been a growing acceptance of the plea that business should be socially responsible in the sense that the business enterprise, which makes use of the resources of society and depends on society for its functioning, should discharge its duties and responsibilities in enhancing the welfare of the society of which it is an integral part.

Singhania, a prominent Indian industrialist, has classified the nature of the social responsibility of business into two categories.⁶

- The manner in which a business carries out its own business activity. This involves the acceptance of the fact that business is not merely a profit-making occupation but a social function which involves certain duties, and requires that appropriate ethics are followed. For example, a business must obey all the laws, even when they are disagreeable; it should produce the maximum goods of good quality, ensure smooth supplies at competitive prices, pay taxes, shun malpractices, pay a fair wage to employees and a reasonable dividend to shareholders.
- The welfare activity that it takes upon itself is an additional function. In addition to its commercial activity businesses also must participate in activities for the welfare of the society.

George Goyder, in his famous book, *The Future of Private Enterprise: A Study in Responsibility*, mentions the following as the principal objectives of a responsible company:⁷

1. The extension, development and improvement of the company's business and the building up of its financial independence.
2. The payment of fair and regular dividends to the shareholders.
3. The payment of fair wages under the best possible conditions to the workers.
4. The reduction in the prices to be charged to consumers.

In other words, the primary objectives of a socially responsible business should be to strengthen itself with due regard to the interests of the shareholders, employees and consumers.

A responsible company has certain secondary objectives as well. The important among them are:

1. To enhance labour welfare.
2. To enhance customer service and goodwill.
3. To assist in developing and promoting the amenities in the locality.
4. To assist in developing the industry of which the firm is a member.
5. To contribute to national goals.

There is a growing recognition that the business should pay due attention to the long-term welfare of society. The enormous resources at the disposal of large business corporations enable them to carry out extensive research and development. They should also devote their R&D efforts to the social needs of the developing countries, rather than being completely guided by profit maximisation. Because of their resources position, they are expected to make a significant contribution to social welfare. An amount equivalent to the annual spend on entertainment by some MNCs can go a long way to improve the social welfare in some small poor economies.

The multinationals must show as much social responsibility in the foreign countries as they do in the home country: one criticism against the MNCs is that they adopt double/multiple standards—with different norms/stands for developing countries compared to the home country or developed countries.

A detailed account of *social responsibility* is available in the author's *Business Environment: Text and Cases* (Himalaya Publishing House).

ENVIRONMENTAL ISSUES

Environmental issues have been engaging increasing discussion in the international business horizon.

Economic Growth, Globalisation and Environmental Problems

There is a close association with the pattern of economic growth and environmental problems. Globalisation, by accelerating certain types economic activities, causing unscrupulous exploitation of natural resources and using ecologically unfriendly technologies and operations, makes the problem more serious.

Economic growth and globalisation cause environmental problems.

Rostow's theory of economic growth tells us that after a certain stage growth becomes 'self-sustaining'. But the trends of ecological damages associated with economic growth seem to tell us that if the present style of growth is pursued for long, economic growth will become 'self-defeating', and not self-sustaining. For, the seeds of destruction are present in the process of growth itself. Destruction of ecological balance seems to have become a concomitant of rapid growth. The environmental problems become more acute with increasing levels of industrialisation, urbanisation and intensification of agricultural activities with the modern pollution-prone technology.

Population explosion and modern technology are upsetting the ecological balance. The process of economic growth has been functioning as a double-edged weapon. With one edge it has been cutting open the way to human prosperity but at the same time with the other edge it has been choking off future prospects. The modern industrial technology, which enhances human welfare by making available a large variety of goods and services on a massive scale also takes a heavy toll on human welfare by the environmental destruction caused by it. The agro-chemicals, which helped revolutionise agriculture, besides poisoning the food crops and causing soil and water pollutions, reduce the original productive capacity of land.

The fouling of water by industries and other sources cause destruction of fish wealth, thus fouling the daily bread of tens of thousands of poor fishermen. The crop damages caused by air, water and air pollution are severe.

Environmental pollution has been regarded as the root cause of most of the diseases. If a realistic estimate of the cost of human health and life on account of pollution is made, including the loss of life, medical and public health expenditures, loss of production and productivity due to ill health and other associated problems created by pollution, we will get an astounding figure. As the United States President's Council on Environmental Quality rightly points out, "the present levels of pollution and environmental degradation result in costs to society in the form of increased health services, lost productivity and direct damage to crops, materials and other property." The loss of scenic values and recreational areas, destruction of valuable ecological systems and the loss of pleasant surroundings do not enter traditional economic calculus directly but they are no less economic costs.

One of the relationships between economic affluence and the destruction of environment is very well implied in the statement that the affluent society has been becoming an "effluent" society. Alvin Toffler in his famous *Future Shock*, characterises the modern industrial society as "the throw away society."

Napkins, towels, non-returnable containers, cans, toys plastic packs, pastry tins etc. create mounting solid disposal problems. In many developing countries there is no effective arrangement for their disposal and this causes a very serious damage to the ecology and poses an alarming threat for the future generations.

Globalisation increases these problems because of the indiscriminate increase in the consumption of such throw away categories of products in societies which are not environment conscious.

The problem of environmental degradation is thus assuming more and more serious proportions. It is high time comprehensive long term measures were taken to combat the problem. The Stockholm Conference on Human Environment, held decades ago, suggested a number of measures towards this end. The following are the main principles of the Stockholm declaration.

- (a) The natural resources of the earth including the air, water, land, flora and fauna and representative samples of natural ecosystem must be safeguarded for the benefit of present and future generations through careful planning or management as appropriate.
- (b) The capacity of the earth to produce vital renewable resources must be maintained and wherever possible restored or improved.

Comprehensive measures are needed to prevent growth becoming self-defeating.

- (c) The non-renewable resources of the earth must be employed in such a way as to guard against the danger of their future exhaustion and to insure that benefits from such employment are shared by all mankind,
- (d) States must take all possible steps to prevent pollution of the seas by substances that are liable to create hazards to human health, to harm living resources and marine life, to damage amenities or interfere with other legitimate uses of the sea.
- (e) For the developing countries, stability of prices and adequate earnings for primary commodities and raw material are essential to the environment management since economic factors as well as ecological processes must be taken into account.
- (f) Resources should be made available to preserve and improve the environment, taking into account the circumstances and particular requirements of developing countries and any costs, which may emanate from their incorporating environmental safeguards into their developmental planning. There is also need for making available to them, upon their request, additional international technical and financial assistance for this purpose.
- (g) Rational planning constitutes an essential tool for reconciling any conflict between the needs of development and the need to protect and improve the environment.
- (h) States have, in accordance with the charter of the United Nations and Principles of International Law, the sovereign right to exploit their own resources pursuant to their own environmental policies, and the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other states or of areas beyond the limits of national jurisdiction.
- (i) States must cooperate to develop further the international law regarding liability and compensation for the victim of pollution and other environmental damage caused by activities within the jurisdiction of such states to areas beyond their jurisdiction.
- (j) International matters concerning the protection and improvement of the environment should be handled in a cooperative spirit by all countries, big or small, on an equal footing. Cooperation through multilateral or bilateral arrangements or other appropriate mean is essential to prevent, eliminate or reduce and effectively control adverse environmental effects resulting from activities conducted in all spheres, in such a way that due account is taken of the sovereignty and interests of all states.

- (k) States must ensure that international organisations play a coordinated, efficient and dynamic role for the protection and improvement of environment.
- (l) Man and his environment must be spared the effects of nuclear weapons and all other means of mass destruction. States must strive to reach prompt agreement, in the relevant international organs, on the elimination and complete destruction of such weapons.

The Disadvantaged Developing Countries

As in the case of some other social issues in the fore, the environmental issues raised are mostly those which disadvantage the developing countries, ignoring or relegating to the background several serious issues which hold the developed nations or firms from such nations guilty.

Some countries prohibit the import of goods, which cause ecological damage. For example, the US has banned the import of shrimp harvested without turtle excluder devise because of its concern for the endangered sea turtles. Countries like India are affected by it.

Globalisation increases ecological problems in developing nations.

Developing countries are affected by the relocation of polluting industries from the developed to the developing ones. Similarly, several products which are banned in the developed nations are marketed in the underdeveloped world.

The dumping of nuclear and hazardous wastes in developing countries and the shifting of polluting industries to the developing countries impose heavy social costs on them. The exploitation of the natural resources of the developing countries to satisfy the global demand also often cause ecological problems.

When the multinationals employ in the developing nations polluting technologies which are not allowed in the developed countries or do not care for the ecology as much as they do in the developed nations, it is essentially a question of ethics.

Another serious problem is that developed nations some times raise environmental issues as a trade barrier or a coercive measure rather than for genuine reasons.

Trade and Environment

The Negative Side The debate has intensified in recent years on the links between trade and the environment, and the role the WTO should play in promoting environment-friendly trade.⁸ A central concern of those who have raised the profile of this issue in the WTO is that there are circumstances where trade and the pursuit of trade liberalization may have harmful environmental effects. Three main arguments are forwarded as to how this might occur. *First*, trade can have adverse consequences on the environment when property rights in environmental resources are ill-defined or prices do not reflect scarcity. This situation results in production or consumption “externalities” and can lead to the abuse of scarce environmental resources and degradation, which is exacerbated through trade. Some of the pollution can be purely local, such as a very noisy factory. Other pollution can have global repercussions, for example, the excessive emission of greenhouse gases, the destruction of rainforests, and so on. Critics argue that trade liberalization which encourages trade in products creating global pollution is undesirable.

The *second* argument linking trade and the environment is related to the first one. If some countries have low environmental standards, industries are likely to shift production of industries that are environment-intensive or highly-polluting products to such so-called pollution havens. Trade liberalisation can make the shift of “smoke-stack” industries across borders to pollution havens even more attractive. If these industries then create pollution with global adverse effects, trade liberalisation, indirectly, promotes environmental degradation. Worse, trade induced competitive pressure may force countries to lower their

Trade can have both positive and negative effects on environment.

environmental standards. The argument, in other words, is that trade liberalisation leads to a “race to the bottom” in environmental standards.

The *third* concern by environmentalists about the role of trade relates more to social preferences. Some practices may simply be unacceptable for certain people or societies, so they oppose trade in products which encourage such practices. These can include killing dolphins in the process of catching tuna, using leg-hold traps for catching animals for their furs, or the use of polluting production methods which have only local effects.

The Positive Side On the other hand, it has also been pointed out that trade liberalisation may improve the quality of the environment rather than promote degradation. *First*, trade stimulates economic growth, and growing prosperity is one of the key factors in societies’ demand for a cleaner environment. Growth also provides the resources to deal with environmental problems at hand, resources which poor countries often do not have. *Second*, trade and growth can encourage the development and dissemination of environment-friendly production techniques as the demand for cleaner products grows and trade increases the size of markets. International companies may also contribute to a cleaner environment by using the most modern and environmentally clean technology in all their operations. This is less costly than using differentiated technology based on the location of production and helps companies to maintain a good reputation. *Finally*, the costs of meeting environmental regulations often accounts for only a small fraction of total production costs, so that this factor is unlikely to be at the basis of relocation decisions—other factors such as labour costs and the adequacy of infrastructure are much more important.

Review of literature on the impact of trade on environment suggests that trade may not specifically add in a significant way to environmental problems, beyond those that arise through economic activity generally. But whether this is the case or not, restrictive trade policy will rarely offer an adequate solution to problems of environmental degradation. The solution lies instead in the use of appropriate environmental policies, whether they entail assigning property rights, taxing or subsidizing, or applying regulatory remedies.

LABOUR ISSUES

One of the important social issues in the developed countries in respect of business with the developing countries pertains to ill-treatment of labour and children.

Child labour used in the manufacture of exports from the developing countries is widely criticised by people in the developed countries. There is protest against this in the developing countries too. For example, it is alleged that child labour is used by the carpet industry in India and some other countries and social activists in the developed nations demand ban on the import of goods employing child labour. Consumers are called upon to boycott such goods.

A similar issue is the *sweat labour*. The argument here is that goods are manufactured by labour working in inhuman/unhealthy working conditions not getting fair wages should be banned or boycotted. Certain important developing country exports, like garments, are alleged to be suffering from such problem.

Some multinationals are criticised for outsourcing products from developing countries benefiting from the sweat labour.

According to an ILO Report, it is a regrettable feature of many export processing zones that both male and female workers are trapped in low wage and low skill jobs. Labour relations and human resource development remain two of the most problematic aspects of zone functioning. The frequent

Labour issues associated with international business is a reflection of international concern for the welfare of labour and children.

absence of minimal standards and poor labour-management relations have predictable outcomes, such as high labour turnover, absenteeism, stress and fatigue, low rates of productivity, excessive wastage of materials and labour unrest which are still too common.

Another important issue is trade union rights. Absence of trade union rights in some countries provides them a cost advantage. Should the products of such countries be permitted in other countries? It may be noted that many multinationals are taking advantage of the absence of trade union rights in some countries.

While some labour issues raised are valid, there are also vested interests behind some.

While some of the criticisms are valid, it is also a fact that the developed country firms, which are adversely affected by the cheap imports blow up the issues to serve their vested interests.

According to the WTO,⁹ the debate on the interaction between trade and labour standards is in many ways similar to the debate on trade and environmental standards. A concern expressed in some industrial countries is that excessively low standards in certain countries will impose downward pressure on standards, or give the low-standard countries an unwarranted competitive advantage. Developing countries, on the other hand, fear that this argument may be used as a surrogate form of protection. As with environmental standards, the WTO was not designed to set labour standards. This was made clear in the Singapore Ministerial Declaration of December 1996, which also acknowledged the competence of the International Labour Organization (ILO) in the matter of labour standards. Specifically, the Singapore Ministerial Declaration concluded that (i) Members are committed to the observance of internationally recognised core labour standards, (ii) these standards should be addressed in the ILO, whose work the Members support, (iii) standards are promoted by growth and development, fostered through trade liberalisation; and (iv) Members reject the use of labour standards for protectionist purposes, and agree that the comparative advantage of countries must in no way be put into question. Members of the ILO recently agreed on a “Declaration of Fundamental Principles and Rights at Work”, in which ILO Members agreed to increase the scrutiny of adherence to core labour rights and reiterated the commitment in the Singapore Declaration not to use labour standards for protectionist purposes.

The WTO points out that the debate on labour standards distinguishes between so-called basic labour rights and less commonly accepted standards. Basic labour rights are part of the ILO Conventions on human rights and labour standards and include the prohibition of forced labour, the freedom of association, the right to organise and bargain collectively, the elimination of child labour exploitation and the non-discrimination in employment. Other less common accepted standards include minimum wages, limits on the hours worked and occupational safety and health standards. The following discussion focuses only on the basic standards.

Universal acceptance of certain labour standards is necessary to protect interests of labour.

The Negative Side The arguments of those favouring inclusion of basic labour standards in the WTO framework are very similar to those in the trade and environment debate. Trade could have adverse consequences on labour rights if individual countries disregard labour standards. Trade, it is argued, increases the demand for products produced with labour that does not enjoy adequate labour standards, and thereby encourages such practices. If poor working conditions are the main reasons for a country's competitiveness, then international competition will induce companies to relocate to countries with weak, non-existent or unenforced labour standards. Countries with higher labour standards may be forced to relax their own standards in a “race to the bottom”. Value judgements also play a role, when people argue that they are not willing to accept exchange of products which have been produced under morally unacceptable conditions. If trade has such adverse consequences on labour standards, critics argue, labour standards should become an integral part of the WTO framework.

Trade can have both positive and negative effects on labour welfare.

The Positive Side On the other hand, a number of arguments suggest that trade can contribute to more stringent labour standards and their enforcement. Trade promotes economic growth, which in turn increases people's demand for better working conditions. Growth and prosperity also provide the means to finance improvements in labour standards, and to send children to school instead of factories. International companies are reluctant to provide inhuman, working conditions or to use child labour for the fear of their reputation and boycotts. Finally, the production of exportable products today increasingly requires people with some skills, and safe and clean working conditions.

The WTO also points out that empirical studies do not provide support for the claim that trade undermines labour standards; most evidence suggests a positive link between trade and labour standards, mainly through trade's positive effect on income.

Globally, several social movements protest against poor labour conditions. For example, the *clean clothes* campaign, a movement that began in Europe, has challenged bad working conditions in the textiles sector. Cases against major garment companies like Adidas, Nike, Levi Strauss, have been presented before various tribunals in different European countries. The consumer movement has not spared companies which do not ensure labour standards.

Not only the big buyers such as Wal-Mart, but also even smaller companies that approach Indian textile manufacturers and garment makers insist on a 'social audit'. This audit extends beyond checking that minimum wages are paid and that standard hours are maintained to determining the number of paid holidays available, the medical facilities, creche with basic education facilities for the workers' children, safety conditions at work, and so on.

Consumer organisations also actively network with each other. It is felt that the day is not far off when, such movements will usher in ideal working conditions—something that mere legislation or strong armed tactics of labour unions failed to achieve.

SUMMARY

There are certain important social issues related to international trade, such as business ethics, social responsibility, environmental factors and labour standards.

The issue of **ethics** may be considered at two levels—the ethics of the trading nations and of the trading firms. There is a feeling that the developed nations, particularly, resort to a number of unethical practices in international trade. They resort to several covert protectionist measures. Further, developed countries use their might in the international organizations like WTO, IMF, World Bank etc. to bend the policies and decisions to serve their vested interests to the detriment of the developing countries.

There are also large number of instances of firms engaged in international business resorting to unethical practices. The term business ethics refers to the system of moral principles and rules of conduct applied to business. That there should be business ethics means the business should be conducted according to certain self-recognised moral standards. There is, however, no unanimity of opinion regarding what constitutes business ethics. An international marketer often finds that the norms of ethics vary from country to country. What is ethically wrong or condemned in one nation may not be so in another.

Besides being ethical in business, companies, particularly the large ones, have some **social responsibilities**. The enormous resources at the disposal of large business corporations enable them to carry out extensive research and development. They should also devote their R&D efforts to the social needs of the developing countries, rather than being completely guided by profit maximization. Because of their resources position,

they are expected to make a significant contribution to social welfare. The multinationals must show as much social responsibility in the foreign countries as they do in the home country: one criticism against the MNCs is that they adopt double/multiple standards—with different norms/stands for developing countries compared to the home country or developed countries.

Environmental issues have been engaging increasing discussion in the international business horizon. As in the case of some other social issues in the fore, the environmental issues raised are mostly those which disadvantage the developing countries, ignoring or relegating to the background several serious issues which hold the developed nations or firms from such nations guilty.

One of the important social issues in the developed countries in respect of business with the developing countries pertains to ill treatment of **labour** and children. Child labour used in the manufacture of exports from the developing countries is widely criticised by people in the developed countries. A similar issue is the *sweat labour*. The argument here is that goods are manufactured by labour working in inhuman/unhealthy working conditions not getting fair wages should be banned or boycotted. Another important issue is trade union rights. Absence of trade union rights in some countries provides them a cost advantage. While some of the criticisms are valid, it is also a fact that the developed country firms which are adversely affected by the cheap imports blow up the issues to serve their vested interests.

Review Questions

1. Give brief account of the important social issues related to international trade.
2. Discuss the impact of economic growth and international trade on the environment?
3. Write notes on the following.
 - (a) Possible favourable and unfavourable effects of international trade on the environment
 - (b) Ethics in international business
 - (c) Social responsibilities of developed nations and MNCs

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**Suggested
Readings**

PART FOUR

Economic Integration and Cooperation

4

CHAPTERS

- ❖ Economic Integration
- ❖ South-South Cooperation

CHAPTER 13

13

Economic Integration

LEARNING OBJECTIVES

- ☐ To understand the scope and objectives of economic integration.
- ☐ To get an idea of the integration theory and the effects of RIA.
- ☐ To get a broad picture of RIAs across the world.
- ☐ To examine the factors contributing to the success/failure of RIAs.
- ☐ To make a general review of the performance of RIAs.

BACKGROUND

The global trading system has been witnessing a proliferation of regional economic integration schemes or trade blocs (also known as regional integration agreement/arrangement—RIA—or regional trade agreement—RTA), designed to achieve various economic, social and political purposes. The increase in the number of RTAs has been very rapid, particularly, since the early 1990s.

There has been a significant increase, in the number of regional economic integration schemes. A total of 265 RTAs had been notified to the GATT/WTO until May 2003, although only less than 180 RTAs were in force then. As of 15 September, 2005, 211 were in force. A large additional number of RTAs are expected to become operational and a substantial number of RTA proposal are under negotiation. A number of countries that have traditionally remained outside regional agreements, like Japan, have joined or have been negotiating to join RTAs. With the single exception of Mongolia, all members of WTO are party to a regional trade agreement. In fact, many countries belong to more than one RIA. Mexico, an interesting example, in early 2003 was a participant in 13 FTAs, ten of which contained provisions on trade in services, and was engaged in negotiations with a number of other countries. Mexico currently derives over 80 per cent of its total imports from preferential partners, giving it one of the world's highest ratios.¹

There has been a proliferation of agreements among groups of nations to increase intra-group trade and, in some cases, other economic activities.

About 90 per cent of the RTAs are in the form of free trade arrangements (FTAs) and only 10 per cent are customs unions.

RIAs have been concluded among high-income countries, and low-income countries, and, starting with the North American Free Trade Area (NAFTA), between developed and developing countries. The number of RTAs signed between developed and developing countries has increased over the years. The European Union has played a major role in this

RIAs cover more than half of the global trade.

respect through a series of agreements with a number of countries including Turkey, Mexico, South Africa and Chile. Euro-Mediterranean Association Agreements have also been concluded or are being negotiated between the EU and the countries of North Africa and the Middle East.

More than half of world trade now occurs within actual or prospective trading blocs. More than one-third of world trade already takes place within the existing RIAs.²

The *World Trade Report 2003*, makes the following observations regarding the growth of RTAs.

While the recent rapid growth of RTAs began in the 1990s, the seeds of this development were arguably sown in the 1980s. Part of the impulse towards regionalism was driven then by the seemingly bleak prospects for progress on the multilateral agenda in the wake of the inconclusive 1982 GATT Ministerial Meeting. Moreover, Western Europe was continuing its moves towards deeper and broader regional integration. Highly significant also was the decision of the United States to explore the preferential approach to trade. Prior to this, the United States had relied almost entirely on the GATT and the most-favoured-nation (MFN) principle to define its trade relations with other nations. The United States signed its first free trade agreement (FTA) with Israel in the mid-1980s, followed by a FTA with Canada in 1988 and the North American Free Trade Agreement (NAFTA) in 1994. The current negotiations on free trade for the Americas (FTAA) span two continents and involve over 30 countries. More recently Asian countries, including Japan, have also departed from exclusive reliance on MFN-based trade.

A major explanation for the expansion in the number of RTAs in the 1990s was the collapse of the

There has been an overlapping of RTAs with many countries being members of several RTAs.

COMECON (the preferential arrangement involving the old Soviet Union and Eastern European countries) and the alignment of the Central and Eastern European countries to the European Union. Of the 123 new RTAs in force since 1990, covering trade in goods, about a third

were signed among transition economies. These new agreements were a response to the splintering of COMECON and represented efforts to make up for the forgone preferences. Hence, some of these new RTAs do not necessarily represent increased regionalisation of the international trade regime. Another third were agreements concluded as part of the effort of the transition economies to integrate with the European Union.

MEANING AND SCOPE

The term *economic integration* has been interpreted in different ways. “Some authors include social integration in this concept, others subsume different forms of international cooperation under this heading, and the argument has also been advanced that the mere existence of trade relations between independent national economies is a sign of economic integration.”³

However, the term is commonly used to refer to the type of arrangement that removes artificial trade barriers, like tariffs, between the integrating economies. “The structure of regional agreements varies hugely, but all have one thing in common—the objective of reducing barriers to trade between member countries. At their simplest, they merely remove tariffs on intrabloc trade in goods, but many go beyond that to cover non-tariff barriers and to extend liberalisation to trade and investment. At their deepest they have the objective of economic union, and they involve the construction of shared executive, judicial, and legislative institutions.”⁴

Balassa defines economic integration as “a process and as a state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies.”⁵

In interpreting his definition, Balassa draws a distinction between integration and cooperation. The difference is qualitative as well as quantitative. Whereas cooperation includes actions aimed at lessening discrimination, the process of economic integration comprises measures that entail the suppression of some forms of discrimination. For example, international agreements on trade policies belong to the area of international cooperation, while the removal of trade barriers is an act of economic integration. The main characteristic of economic integration is, thus, the abolition of discrimination within an area.

RATIONALE AND OBJECTIVES

Although multilateralism is generally accepted, in principle, as *the best* option, Governments opt for RIAs for a variety of reasons.

Rationale When possibilities for trade liberalisation or other forms of co-operation in certain areas at the multilateral level may be absent or attenuated, RIAs are justified on the basis of the *theory of the second-best*. If some countries are unwilling to liberalise while others wish to do so, for example, liberalisation via a regional agreement might be more beneficial to the world than the *status quo*. Governments may wish to go further, faster and at lower cost than is feasible in a multilateral setting.⁶

Dissatisfaction with global liberalisation prompt regionalism.

Second, governments may wish to go deeper in integrating their economies than seems possible in a multilateral framework. They may prefer to remove all trade barriers rather than just reducing some. Or they may want to negotiate agreements on a range of other issues not touched upon or fully dealt with in the WTO, such as investment, competition, trade in services, or environment and labour standards. There may be gains from deeper integration unattainable in the WTO, including harmonization of economic policies or regulations, that is feasible among similar or like-minded countries.⁷

Further, sometimes countries, especially smaller ones, may see participation in regional arrangements as a defensive necessity from an economic perspective. Governments may simply fear exclusion from markets, and regard participation as an insurance policy against being placed at a competitive disadvantage through discriminatory policies. The phrase “domino regionalism” has been coined in the literature to capture this kind of motivation, explaining to a degree the explosion of membership in regional arrangements.⁸

Objectives Economic integration schemes have several objectives. The motivation to form trading blocs may vary from region to region and from country to country. Nevertheless, as Shiells suggests,⁹ the following motivations seem to play a key role in the formation of trading blocs.

RIAs may have economic and non-economic objectives.

1. To obtain economic benefits from achieving a more efficient production structure by exploiting economies of scale through spreading fixed costs over larger regional markets, increased economic growth from foreign direct investment, learning from experience etc.
2. To pursue non-economic objectives such as strengthening political ties and managing migration flows.
3. To ensure increased security of market access for smaller countries by forming regional trading blocs with larger countries.
4. To improve members' collective bargaining strength in multilateral trade negotiations or to protest against the slow pace of trade negotiations.

5. To promote regional infant industries which cannot be viable without a protected regional market.
6. Finally, to prevent further damage to their trading strength due to further trade diversion from third countries.

Regional agreements frequently have political objectives and non-economic dimensions, including national security, enhancement of bargaining power, and bolstering the credibility of reforms (economic and political). The attainment of such political objectives depends primarily on agreement design, as this determines the size and distribution of net economic impacts.¹⁰ It is observed that vested interests within national bureaucracies could also drive RTA formation. Once the bureaucratic machinery has been set up to negotiate regionally, there is a natural temptation for those involved to seek to perpetuate their functions by creating conditions for the negotiation of successive agreements. There is perhaps also a sense in which governments have come to see the negotiation of trade agreements as a natural accompaniment of economic diplomacy.¹¹

FORMS OF INTEGRATION

There are different degrees or levels of economic integration. Bela Balassa in *The Theory of Economic Integration* (1961) perceived the following five possible levels or degrees of economic integration. At each succeeding stage, members surrender a greater measure of their national sovereignty.

Different forms of integration represent different levels of integration.

Free Trade Area The first (and least restrictive) form of economic integration is the free trade area/association which is a grouping of countries to facilitate free trade between them. The free trade area abolishes all restrictions on trade among the members. However, each member is left free to determine its own commercial policy with non-members.

Customs Union A customs union is a more advanced level of economic integration than the free trade area. It not only eliminates all restrictions on trade among members but also adopts a uniform commercial policy against the non-members.

Common Market The common market is a step ahead of the customs union. A common market allows free movement of labour and capital within the common market, besides having the two characteristics of the customs union, namely, free trade among members and uniform tariff policy towards outsiders.

Economic Union A still more advanced level of integration is the economic union. Apart from satisfying the conditions of the common market mentioned above, the economic union achieves some degree of harmonisation of national economic policies, through a common central bank, unified monetary and fiscal policies etc. Example: the European Union (EU).

Economic Integration The ultimate form is full economic integration characterised by the abolition of all barriers to intrabloc movement of goods and factors, unification of social as well as economic policies and all the members bound by decisions of a supranational authority consisting of executive, judicial and legislative branches.

FREE TRADE AREA	Free trade among members				
CUSTOMS UNION	Free trade among members	Common external commercial policy			
COMMON MARKET	Free trade among members	Common external commercial policy	Free factor mobility within the market		
ECONOMIC UNION	Free trade among members	Common external commercial policy	Free factor mobility within the market	Harmonised economic policies	
ECONOMIC INTEGRATION	Free trade among members	Common external commercial policy	Free factor mobility within the market	Harmonised economic policies	Supernational organisational structure

Fig. 13.1 Characteristics of Integration Schemes

INTEGRATION THEORY

The theory of economic integration evolved as a subset of international trade theory, though it has implications for location theory too. As viewed by the theorists, economic integration is a form of selective discrimination because it combines elements of free trade with greater protection: free trade among members and restrictions on trade with non-members. Among other things, integration theory is concerned with the various types or degrees of economic integration (described in the section *Forms of Integration*), the characteristics of member countries that are conducive to successful integration, and the effects that economic integration can be expected to have on international trade and location and on growth and development.¹²

The various dimensions of economic integration may be explained with the help of the **Theory of Customs Union**.

According to the definition given in the General Agreement on Tariffs and Trade (GATT), “a customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that (i) duties and other restrictive regulations of commerce are eliminated with respect to substantially all the trade between the constituent territories of the union, and (ii) substantially the same

duties and other regulations of commerce applied by each of the members of the union to the trade territories not included in the union.”

Theoretical analysis of the customs union is about six decades old now. Although some aspects had been covered in the writings of persons like Augustin Cournot and Knut Wicksell there had been no consistent theoretical analysis of all the issues involved until 1950, when the writings of Maurice Bye, Herbert Giersch and Jacob Viner appeared simultaneously.

Theory of customs union illustrates effects of economic integration.

Before the publication of Jacob Viner's classic book *The Customs Union Issue* (1950), it was generally believed that the formation of a customs union would foster economic welfare. Viner, however, showed that this view is not necessarily accurate and that the formation of a customs union combines elements of free trade with elements of greater protection and may either improve or worsen resource allocation and welfare, depending upon the respective strengths of *trade creation* and *trade diversion*. Following Jacob Viner, James Meade, Richard Lipsey and Kevin Lancaster generalised the principle of *second best* which states that in a world where there is more than one distortion of free market equilibria, the elimination of one of the distortions does not necessarily improve welfare.

A customs union has both *static* and *dynamic* effects.

Static Effects

Static effects “involve a reallocation of resources among existing industries, using existing supplies of

Static effects are primary effects and dynamic effects are consequential effects of customs union.

the factors and existing technology. Some industries expand, others contract, and consumers enjoy lower prices on certain products; otherwise everything goes on as before.”¹³

Dynamic effects refer to certain developments like increased competition, stimulus to technological changes, stimulus to investment and increased economies of scale that make the union economy dynamic.

There are, broadly, two types of static effects namely *Production Effects* and *Consumption Effects*. Viner demonstrated the production effects but overlooked the consumption effects. The latter were emphasised by Meade, Lipsey and Gehrels.

Production Effects Production effects refer to the changes in the sources of supply or production bases of a commodity resulting from the formation of the customs union. In other words, “production effects result from shifting purchases of a given commodity from more expensive domestic to cheaper member-country sources of supply (positive effect) and from shifting sources of supply from lower-cost foreign to higher-cost member-country producers (negative effect).”¹⁴

Trade Creation and Trade Diversion Jacob Viner distinguished between two types of production effects, namely, the trade creation effect and the trade diversion effect.

Trade creation effect refers to the beneficial effect of the customs union of shifting supply from a high-cost domestic source to a lower-cost source of a partner (i.e., another member of the union). We may illustrate this with the help of the following hypothetical example. The cost of production and price of commodity *X* in the Country *A* is Rs 25 per unit and in Country *B* is Rs 20. (For simplicity stake we assume that the price is equal to the cost of production and there is no transport cost). Countries *A* and *B* form a customs union. Before the formation of the customs union, Country *A* protected domestic producers by imposing a tariff of Rs 6 per unit of *X* from *B*. With the abolition of tariff between the members of the customs union, Country *A* will cease to produce *X* and, instead, will import from *B* because the imported *X* will be available in *A* for Rs 20 per unit against Rs 25 for the domestically produced *X*. Thus, *the formation of the customs union results in the creation of some new trade and this is referred to as the trade creation effect of the customs union.*

Trade diversion refers to the diversion of trade in a commodity from one country to another as a result of the formation of a customs union. We may illustrate this with the help of the following hypothetical example. Country *A* imposes a hundred per cent ad-valorem duty on imports of commodity *Y* to it. Country *B*'s supply price of *Y* is Rs 60 per unit and country *C*'s supply price of *Y* is Rs 50 per unit. Country *A* is importing *Y* from *C* because the landed cost of *Y* from *C* is only Rs 100 per unit (Rs 50 (price) + Rs 50 (duty)) whereas the landed cost of *Y* from *B* is Rs 120 per unit. Countries *A* and *B* now form a customs union and remove all tariffs on trade between them but the ad-valorem duty of 100 per cent is still retained on imports of *Y* from *C*. Hence Countries *A* will now stop imports from *C* and instead start imports from *B* (because the landed cost of *Y* from *C* is Rs 100 per unit including the duty whereas it is only Rs 60 if imported from *B*). Thus, the formation of the customs union causes diversion of trade from one country to another.

Customs union may cause shift in production locations and pattern of trade between nations.

Differences between Trade Creation and Trade Diversion The distinctions between trade creation and diversion are obvious. Trade creation refers to the newly created trade between the member countries of the customs union, whereas trade diversion refers to some old trade being diverted from a foreign country to a member country, consequent upon the formation of the customs union. Secondly, trade creation is beneficial to welfare whereas trade diversion is detrimental to it. Trade creation improves international allocation of resources by shifting the source of supply from a high-cost producer to a low-cost producer. Trade diversion, on the other hand, worsens international allocation of resources by shifting the source of supply from a low-cost producer to a high-cost producer.

Positive and Negative Production Effects Balassa remarks that the expressions trade creation and trade diversion cover only one aspect of production effects. Positive and negative production effects should be distinguished between. According to Balassa, "positive production effect is cost saving in nature resulting from a shift of purchases from higher cost to lower cost sources of supply. Negative production effects, on the other hand refer to the extra cost of producing a commodity in the partner country rather than in the foreign country as the trade diversion shifts the source of supply from lower cost (foreign) to higher cost (partner) producers. The world gains or loses according to whether the positive production effects are larger or smaller than the negative production effects."¹⁵

Determinants of Production Effect No *a priori* judgement can be made about the possible production effects of a hypothetical customs union. The following factors can, however, be regarded as the main determinants of the success of a customs union.

1. **Competitiveness and Complementarity** Before the publication of Viner's *The Customs Union Issue*, the literature on the customs union almost took for granted the fact that rivalry is a disadvantage and complementarity an advantage in the formation of customs unions. Viner, however, proved this wrong and demonstrated that if the economies forming the union are *rival* or *competitive* in nature, possibilities of trade creation are great but if they are *complementary*, little trade will be created and much will be diverted. Competitiveness denotes a large degree of overlapping in the range of the commodities produced, while complementarity means substantial differences in the scope of production.
2. **Size of the Union** Economists like Viner, Meade and Tinbergen argue that larger the area of a customs union, greater will be the positive production effects. Other things being equal, a larger economic area increases the potential scope for the internal division of labour. While a smaller customs union may lead to useful shifts in some lines of production, the chances for the reallocation

The effects of customs union depend on the economic characteristics of the members and the trading environments before and after formation of union.

of production increase with the extension of the area. At the same time, successive increases in the size of the union reduces the possibility of trade diversion. However, it is also possible that the enlargement of an economic area may increase trade diversion in

certain fields. Tinbergen and others point out that in the absence of a change in economic policies, this trade diversion will be more than offset by enhanced trade creation.

3. *Height of Tariff* The height of tariff levels of the members before and after the union and the height of the tariff levels of the export markets outside the union have an important bearing on the effects of the union. The following three conditions enhance the positive effects of the union: (a) If tariff levels were very high before the formation of the union, the formation of the union would lead to substantial trade creation. The removal of the tariff would tend to cause the substitution of many low-cost sources of supply within the union for high-cost domestic supplies. Obviously, under such a situation, the consumer gains would also be very great. (b) The low tariffs within the union as against the outside world would minimise trade diversion, by reducing the likelihood of excluding from the union market the low-cost outside producers, and (c) Low tariff levels in export markets outside the union would favour the export sector of the union, facilitating faster development of the union economy.
4. *Cost Differences* We have seen that the union of the competitive economies favours trade creation. This gain would be augmented if the production costs are significantly different for the members because this would lead to substantial reallocation of resources in order to increase the supply from the low-cost sources within the union. The reduction in prices that might follow from the lowering of the production costs will increase the real income of the consumers. On the other hand, if there are no significant cost differences between the union members, such gains will be limited.
5. *Transport Costs* High transport costs between countries limit the scope of trade creation of the union. Though transport costs can be reduced through technological improvements, they cannot be altogether avoided. Hence, if the union members are geographically far, the high costs of transport between them would still protect the high-cost producers.

Consumption Effects Jacob Viner has dealt only with the production effects (trade creation and trade diversion) of the customs union. A customs union, however, has consumption effects also. These consumption effects have been emphasised by Meade (in *The Theory of Customs Union*, 1955), Lipsey (in *The Theory of Customs Union: Trade Diversion and Welfare*, 1957) and Gehrels (in *Customs Union from a Single-Country Viewpoint*, 1956).

In the preceding section of this chapter, we have mentioned that a customs union may have both positive and negative production effects. Similarly, a customs union may have both positive and negative consumption effects.

Positive Consumption Effect Consumers in the customs union benefit from the positive production effects of the union, i.e. the increased efficiency in resource allocation. Before the formation of the customs union, they would be obliged to buy the expensive output of high-cost domestic producers but after the formation of the union, they would have access to lowest costs and prices in the region. In other words, because of the access to the low-cost source of supply facilitated by the customs union, the real income of the consumer increases (because a given amount of money income can buy more goods as prices decline). This is the *Positive Consumption Effect* of a customs union.

Negative Consumption Effect There is a parallel to the negative production effect also—the negative consumption effect. The customs union requires a uniform tariff on import of a commodity from non-members. Before the formation of the union, if a member country was importing a commodity duty free from a non-member, it will now have to impose a duty on it resulting in the diversion of the consumer purchases from low-cost outside producers to high-cost producers inside the customs union. This fall in the consumer welfare resulting from the decline in the real income due to rise in price is referred to as the *Negative Consumption Effect* of a customs union.

As has already been mentioned, Viner who coined the terms trade creation and trade diversion, ignored the consumption effects. However, today, a number of writers use trade creation in a broader sense to include both the positive production effects and the positive consumption effects. Similarly, trade diversion is also used in a broader sense to include both the negative production effects and negative consumption effects.

Jacob Viner also concluded, in some sense, that trade creation was a ‘good thing’ and trade diversion was a ‘bad thing’. However, Lipsey and others have shown that in some cases a trade-diverting customs union can raise welfare.¹⁶

Since the effects of a customs union on world efficiency depend upon the ensuing changes in the pattern of production and consumption, world real income can increase even in the absence of any improvement in productive efficiency, provided that efficiency in exchange improves.¹⁷

Changes in trade pattern caused by customs union can have both positive and negative welfare effects.

Even when a customs union results in negative production effects, it is possible that, “this loss in welfare will be more than outweighed by the gain in consumer satisfaction derived from the abolition of discrimination between domestic commodities and the products of the partner countries. The application of the theory of the second best shows that under such circumstances, a less efficient production solution would provide a more efficient welfare solution.”¹⁸

Diagrammatic Illustration of Production and Consumption Effects The static effects of the customs union is illustrated diagrammatically in Fig. 13.2.

In Fig. 13.2, DD_1 is the domestic demand curve for commodity ‘X’ and SS_1 is its domestic supply curve of Country A. PP_1 is the supply curve of Country B, assumed to be perfectly elastic for simplicity. Country A has imposed a tariff of PT per unit on imports of X from B so that B’s X is available in A at OT price. A’s total consumption of X is OQ_3 out of which OQ_2 is supplied by domestic producers and the remaining quantity, $Q_2 Q_3$ is imported from B.

Now, after the formation of the customs union between A and B, X imported from B is available to the consumers in A at OP price as against OT before (because there is no tariff on the trade between the members of the customs union). The fall in the price to OP increases the domestic demand for X to OQ_4 , out of which domestic supply is only OQ_1 (as against OQ_2 previously when the price was OT) and the remaining quantity, $Q_1 Q_4$, is imported from B.

The total gain to the consumer of A because of the formation of the customs union with B is represented by the area $PEFT$. But not all this is net gain to Country A because $PAGT$ represents the surplus enjoyed by the producers of A and $BCFG$ represents the tariff collected by the government before the formation of the union (both of which are now lost to the consumers of A). The net gain to the country, therefore, is represented by the area of two triangles, ABG and CEF .

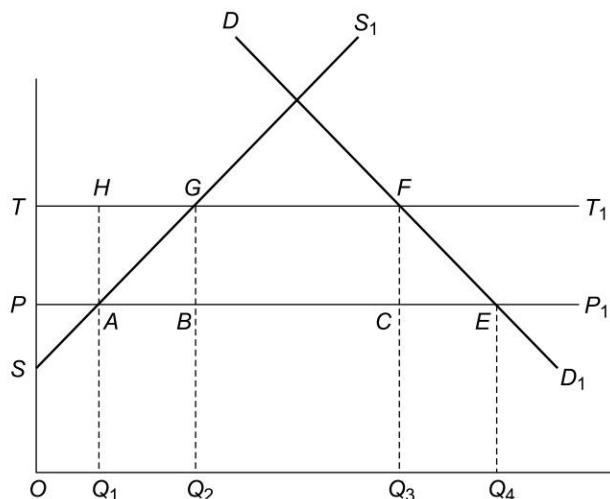


Fig. 13.2 Static effects of Customs Union

The triangle ABG represents Country A 's saving of real cost on domestic production replaced by imports and illustrates Viner's production effect of a customs union leading to trade creation. $Q_1 Q_2$ of X was formerly produced domestically at a total cost given by the area $Q_1 Q_2 GA$. This same amount ($Q_1 Q_2$) is now imported from a lower cost country (B) at a total cost given by the area $Q_1 Q_2 BA$. The area of the triangle ABG , therefore, represents a net gain.

The consumption effect is represented by the area of the triangle CEF . It is a net gain in consumer's surplus. It is the formation of the customs union and the consequent fall in the price of X that enabled the consumers to increase the consumption by $Q_3 Q_4$ and obtain the corresponding consumers' surplus equivalent to CEF . Meade classifies this gain as something different from the production gain and points out that this gain is due to *trade expansion* because it represents a *net* increase in A 's consumption that is satisfied from imports and is not just a mere replacement in domestic consumption of goods formerly produced in A , as is the production gain.

The total gain from trade creation (positive production plus positive consumption effect) is represented by the sum of the area of the two triangles ABG and CEF . This total gain from trade creation depends on (i) A 's initial tariff (in terms of Fig. 15.3, the distance of PT) (ii) A 's supply elasticity at pre-union consumption point G and (iii) A 's demand elasticity at pre-union consumption F . In general, the higher the initial level of A 's tariff and the more elastic A 's domestic demand and supply curves, larger the gain from trade creation.

Figure 13.3 illustrates trade diversion. In Fig. 13.3, SS_1 is the domestic supply curve and DD_1 is the domestic demand curve for commodity Y in Country A . CC_1 is Country C 's supply curve and BB_1 is Country B 's supply curve of Y , both assumed to be perfectly elastic.

Country A has imposed a tariff of CT per unit of Y imported. Hence Y imported from C costs OT in Country A and C 's supply curve of Y in A shift to TT_1 . The price of Y imported from B is $OZ(OB + CT \text{ tariff})$. Hence, Y is imported from the low cost sources in C and there is no import from B .

The total demand for Y in A is OQ_3 , out of which domestic supply is OQ_2 and the remaining part, $Q_2 Q_3$, is met by imports from C . On the import of $Q_2 Q_3$ of Y , the government gets a tariff of $URGF$.

Competition (Market Structure) The customs union removes, at least to some extent, the protection to domestic industries. This helps to break the monopoly or oligopolistic structure. Increased competition leads to the existence of inefficient units. Thus, the opening up of the economy to increased competition ensures higher efficiency, as well as the stimulation of research and development.

This view, however, has been opposed by some writers, who argue that economic integration may lead to the formation of cartels.

Economies of Scale The small size of the market is regarded as one of the chief constraints in achieving the economies of scale. Hence, it is believed that economic integration will permit the exploitation of economies internal to the firm that had previously not been forthcoming because of the limited size of the market. It follows that such gains could not be obtained if the integrated national economies had been large enough to exploit all sources of internal economies prior to integration. Balassa argues, however, that, in present day integration projects, economies of scale can be appropriated, at least in some branches of production, in a wider market.²⁰

Some writers, however, argue that increasing the scale of production does not necessarily produce any economies. Existing domestic and export markets may mean that the optimal plant size has already been achieved. Further increases in scale would therefore only result in internal and external diseconomies.

External Economies The concept of external economies comprises all forms of intra-industry and inter-industry relationships that contribute to cost reductions. Balassa makes a distinction between external economies operating outside the market mechanism (spreading of technological and organisational know-how and development of a managerial class and a skilled labour force in a large market) and those operating via the market (cost reductions through inter-industry repercussions and inter-dependence via income changes). As the market size increases, the external economies might also increase thus making the economy more dynamic.²¹

Technological Change The enlargement of the market and the resultant competition stimulates research and development. Balassa demonstrates²² the relationship between market size and research activity by (a) postulating large scale economies in research and (b) arguing that an enlargement of the market brings about a more than proportional increase in research expenditures. He contends that, "integration will be conducive to autonomous technological improvement, since large scale economies in research can be reaped on both the national and the firm level, and it is also likely that more will be spent on research and development after the freeing of trade barriers. The latter conclusion is reinforced by the prospects of accelerated growth in an integrated area."²³

Investment The customs union tends to stimulate investment. An increase in competition and technological changes lead to additional investments made to cope with the new situation and to take advantage of the newly created opportunities. The existence of high cost producers and technological changes may however cause some disinvestments also, though the new investments are likely to be more than the disinvestments.

The increased opportunities created by the union may accelerate foreign investments in the member countries. Apart from the foreign firms already operating in the union expanding their activities, new foreign firms are likely to invest in the union to take advantage of the increasing opportunities. Some economists attribute the massive American investments in Europe after 1955 to the formation of the European Economic Community. The EC 1992 also stimulated a lot of foreign investment in the EU.

Risk and Uncertainty As Balassa points out,²⁴ economic integration will reduce risk and uncertainty in the economic intercourse between the union members. In the present-day world, various factors contribute to the riskiness of foreign transactions. Uncertainties are associated with the complexity of trade regulations and with the possibility of unilateral changes in tariffs and other forms of trade restrictions, foreign exchange regulations, and economic policies in general. Integration tends to foster development by reducing such uncertainties.

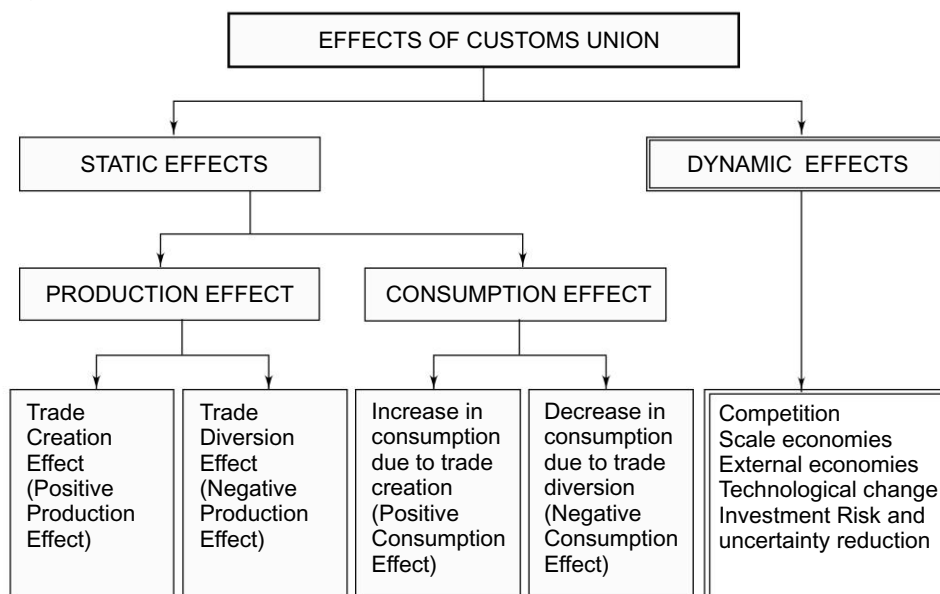


Fig. 13.4 Effects of Customs Union

DETERMINANTS OF SUCCESS

Some of the factors necessary for the success of RIAs have already been indicated in the subsection *Determinants of Production Effects* of customs union. The important determinants of RIAs are described below.

The success of RIA depends on the characteristics of member economies and the RIA.

Nature of Economies If the member economies are parallel or similar (i.e. they produce same type goods) the chances of success are greater than if they are dissimilar. If the economies are similar, the competition will compel companies to be efficient and innovative. Firms which are inefficient would go out of business.

Proximity of Members If the member countries are located geographically at long distances between them, the high transport cost will mitigate some of the favourable effects of the integration. Union of contiguous countries within a compact area have better chances of success.

Size of the RIA If the integration results in a large unified market, then it would be very conducive because it would help companies to achieve economies of scale and benefits of division of labour. As Adam Smith argued, the extent of the market is the limit to the division of labour. RIAs like the EU and NAFTA have the advantage of large size.

Size of Members If the member countries are individually small they are likely to gain considerably by the enlargement of the market.

Extent of Trade Barriers If the trade between the members was characterised by high trade barriers before the formation of the RIA, they are likely to benefit very significantly by free trade.

Intra-regional Trade The extent of benefit the members derive from free trade depends on the volume of trade among themselves. (Refer to the *complementarity index* described under the section *An Evaluation of RIAs* elsewhere in this chapter). It may be noted that one of the important limitations of the SAARC is the very low intra-regional trade. EU and NAFTA on the other hand have large intra-regional trade.

Share in Global Trade An RIA will be more beneficial if its members are major global traders.

BENEFITS AND DISADVANTAGES OF RIAs

Benefits

RIAs help achieve greater economic integration at a regional level, without adversely affecting global liberalisation initiatives. The benefits of RIAs are embodied in the description of the positive production and consumption effects and the dynamic effects of the customs union in an earlier section.

Results of RIA is often a mixed bag.

However, “making regional integration an effective element of national development strategies is a great challenge. Regional agreements can reduce the frictional costs of trade by harmonizing regulations and standards. By making national policies a part of international agreements, regional agreements can increase the credibility of reform initiatives and strengthen security arrangements between partners. They can be vehicles for governments to test the waters of freer trade. By reducing trade barriers on a subset of partners, however, countries generally increase the real cost of their imports, reduce the flow of technology from non-member countries, and increase dependence on particular export markets. Great care is required to ensure that such costs are compensated by other gains. If not, membership may hinder, rather than promote, development.”²⁵

Disadvantages/Problems

A major problem of RIAs is that they promote regionalism at the expense of multilateralism. The negative production and consumption effects, described earlier, are the results of this problem. It is very important that as regionalism grows the greater benefits of the *first-best* policy and the ultimate goal, multilateral free trade, are not neglected. Regional arrangements should be conceived and implemented in a manner that harnesses them securely to the long-run goal of multilateral liberalisation, so that the arrangements develop as building blocks and not stumbling blocks, to such liberalisation.

Although regional arrangements can be destructive of more desirable multilateral outcomes, they can also supplement and build upon multilateralism in positive ways. The economic impact of regional arrangements depends on their particular architecture, including how far they go in reducing trade barriers and how many sectors they cover. Regional trade agreements would be more strongly positive if they also improved trading conditions for outsiders through multilateral liberalisation. In a dynamic sense, they might do that if third parties are able to benefit from heightened economic activity and trade growth resulting from preferential liberalisation.²⁶

According to an WTO Report,²⁷ the following four key arguments are put forward as to why regional arrangements might frustrate the attainment of multilateral goals. *First*, a multiplicity of regional agreements safeguarding varying levels of protection against external third parties will almost certainly engender a degree of trade diversion, and the application of numerous rules of origin and differing standards will make international trade more complex and costly. In contrast, non-preferential trade liberalisation will allow the underlying pattern of comparative advantage in the world to emerge, leading eventually to patterns of specialisation among countries and regions that make the most efficient use of available resources.

Second, the growing number of overlapping bilateral and plurilateral agreements risks the transparency of trading rules, thus posing a threat to one of the fundamental principles of the WTO. The parallel existence in a single country of differing trade rules applying to different trading partners can represent a barrier to trade not only because of the costs involved in meeting a wide range of conditions of trade rules, but also because it is likely to introduce uncertainty and opacity into the trading system as a whole. In other words, ubiquitous and highly varied regional arrangements may not only reduce profitable trading opportunities, but also undermine the integrity and clarity of the multilateral trading system.

Third, regionalism may adversely affect the internal dynamics of trade liberalisation in a political economy sense, especially where RTAs exclude “difficult sectors” from coverage. If groups favouring liberalization can be at least partially satisfied through regional arrangements that exclude more protectionist sectors, then the balance of forces for and against liberalisation in a multilateral setting is tilted in favour of those seeking to arrest liberalisation. For example, many, if not most, regional agreements have excluded agriculture.

Finally, increasing regionalism will tend to distract attention and energy from multilateral negotiations.

INTEGRATION SCHEMES

Economic integration experiments have a long history dating back to the third decade of the nineteenth century. One of the earliest attempts of economic integration was the free trade attempted by Norway and Sweden in the nineteenth century. Although this effort failed, a number of customs unions formed at that time did survive. One of these was the German *Zollverein*, which joined together most of the independent small kingdoms and grand duchies (1834–1871) that eventually became modern Germany. Also still in existence are a number of customs unions, each of which joined a very small country with a larger one, an arrangement known as a *customs accession*. Examples are the union linking Switzerland and Liechtenstein (started in 1923), France and Monaco (founded in 1865), San Marino and Italy (launched in 1862), and Belgium and Luxembourg (started in 1921).²⁸

Economic integration gained great popularity in the second half of the twentieth century. It is pointed out that there has been a veritable explosion of regional integration agreements since around the mid-1980s. A World Bank *Policy Research Report* on Trade Blocks observes that during the last decade of the last century, the move to regionalism has become a headlong rush. At the beginning of 1999, there were 194 regional agreements notified to the GATzT/WTO, of which, 87 were notified since 1990.

RIA gained more popularity in recent times.

Reasons for Regional Integration According to the above Report, the recent period has witnessed qualitative, as well as quantitative, changes in regional integration schemes due to the following three major developments.²⁹

The *first* is the recognition that effective integration requires more than reducing tariffs and quotas. Many other barriers have the effect of segmenting markets and impeding the free flow of goods, services, investments, and ideas, and wide ranging policy measures—going well beyond traditional trade policies—

are needed to remove these barriers. This so-called deep integration was first actively pursued in the *Single Market Program of the European Union* (EU), and elements of this program are now finding their way into the debate in other regional agreements.

The *second* is the move from ‘closed regionalism’ to a more open model. Many of the trading blocs that were formed between developing countries in the 1960s and 1970s were based on a model of import substituting development, and regional agreements—with high external trade barriers—were used as a way of implementing this mode. The new wave of regional agreements—including resurrection of some old agreements—have generally been more outward-looking, and more committed to boosting, rather than controlling, international commerce.

The *third* development is the advent of trade blocs, in which both high-income industrial countries and developing countries are equal partners in agreements designed to bolster the economies of all the member countries.²⁹ Perhaps the most important example of this is the North American Free Trade Area (NAFTA), formed in 1994 when the Canada-US Free Trade Agreement was extended to Mexico. EU has linked with the transition economies of Eastern Europe through the Europe Agreements, and has

RIA between developed and developing nations is getting increasing appreciation.

developed the EU-Turkey customs union and a Mediterranean policy potentially incorporating agreements with nearly every Mediterranean country. There has been discussion of replacing the EUs trade preferences of the Lome agreements with reciprocal trade agreements with these developing countries.

As the Report observes, these developments have occurred against the backdrop of globalisation. New technologies and more liberal trading regimes have led to increased trade volumes, larger investment flows, and increasingly footloose production.³⁰

As implied in the description above, although the first wave of regional integration efforts was characterised by inward-oriented integration amongst similar countries that focused predominantly on tariff and non-tariff measures, recently, however, the trend is moving towards outward-oriented mixed agreements where developed countries are signing RIAs with developing countries. Perhaps the most

There is a trend toward making RIA more comprehensive in economic objectives and scope.

significant development in RIAs is their trend towards deep integration issues that go beyond border measures. Increasingly, they now include measures on investment, competition policy and services. This expansion into non-border measures has also included, in some cases, areas of domestic law such as standards.³¹

It is likely that some of the existing regional groupings will become more integrated and new regional integration schemes will come into being.

EUROPEAN UNION (EU)

The European Economic Community (EEC), also known as the European Common Market (ECM) or the European Community (EC) and now as European Union (EU), is by far the most successful of the regional economic integration schemes.

The EEC, which originally comprised six nations—namely, Belgium, France, Federal Republic of Germany, Italy, Luxembourg and the Netherlands—was brought into being on January 1, 1958 by the virtue of the Treaty of Rome, 1957.

The Treaty of Rome required every member country to:

1. Eliminate tariffs, quotas and other barriers on intra-community trade.
2. Devise a common internal tariff on their imports from the rest of the world.
3. Allow the free movement of factors of production within the community.

4. Harmonise their taxation and monetary policies and social security policies.
5. Adopt a common policy on agriculture, transport, and competition in industry.

The EEC was expanded in 1973 with the inclusion of the United Kingdom, Denmark and Ireland. Greece joined the Community in 1981. Spain and Portugal became members on January 1, 1986. With Austria, Finland and Sweden joining the EC later, the membership rose to 15.

By July 1, 1968, a Customs Union had been established among the original six members of the EEC as they abolished tariffs on trade among themselves and imposed a common tariff schedule on imports from other countries. The Community members had also taken some noteworthy steps towards approximating their economic policies, including the adoption of Common Agricultural Policy (CAP) in 1962 and establishment of the European Monetary System in 1979. A detailed programme for attaining a single integrated market was set forth by the EC Commission (the EC's executive body) in June 1985 in a White Paper entitled 'Completing the Internal Market'. The EC Council (the EC's supreme decision making body) promptly committed the EC to carry out the White Paper's programme by the end of 1992. This programme envisaged the unification of the economies of the member nations into a single market by removing all border barriers to trade and mobility and by unifying the economic policies and regulations. This came to be described as Europe 1992/EC 1992.

The EU which has progressed through the different forms of integration is the most advanced and successful RIA.

The White Paper listed 300 specific areas (subsequently reduced to 279) for action by 1992. These actions were intended to eliminate the physical, technical, and fiscal obstacles to an integrated market to achieve a genuine European Community without internal economic frontiers with freedom of movement for goods services, persons and capital.

The barriers targeted for removal pertained to the following eight categories:

1. Border control
2. Limitations on the movement of people and their right to establishment
3. Differing internal taxation regimes
4. Lack of a common legal framework for business
5. Controls on movement of capital
6. Heavy—and differing—regulation of services
7. Divergent product regulations and standards
8. Protectionist public procurement policies

With a population much larger than that of the US and a GDP close to that of the US and much higher than that of Japan, the EC is the largest market in the world. The EC accounts for roughly a quarter of the world trade.

In 1960, more than 60 per cent of the foreign trade of the 12 nations that were members of the EC took place outside the region, whereas today, 60 per cent of the foreign trade of those 12 nations stays within the community. The completion of the EC-92 process is expected to increase this ratio further. If the European Free Trade Area nations are included in the community, the ratio of intra-Western Europe trade could be in the neighbourhood of 70 per cent.

The European integration significantly increased intra-regional trade.

The unification of the EU is expected to produce great benefits for the member nations. It would lead to a restructuring of the economy of the EU and would result in efficiency improvement in production, trade creation and increase in income, employment and consumption. It was also expected to achieve significant reduction in prices.

Some observers regarded the EC-1992 as the *European Fortress/Fortress 92* implying that henceforth exports from non-member countries to the EC would have to encounter a mounting barrier. EC officials, however, maintained that the Fortress Europe story was senseless and groundless and that they would not be tempted by protectionism. They argued that the single European market would boost world trade and growth.

It is, however, true that the real purpose of the single market is to boost the competitiveness of European industry against its rivals, particularly the USA, Japan and South-East Asian nations. This being the fact, the benefits of liberalisation would not be extended to non-EC countries in a unilateral and automatic way. Non-members who want to sell their goods and services in Europe would have to provide EU with reciprocal access to their national markets.

Enlargement of EU from 15 to 25

With effect from May 1, 2004, the total membership of the EU increased to 25 with the accession of ten countries, viz., Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovak Republic, Hungary, Slovenia, Cyprus and Malta. As shown in Table 13.1, the ten acceding countries will account for 15 per cent of the EU population and 19 per cent of the EU area. While significant, historically this is not the biggest enlargement of the EU. The expansion from six to nine EU members in 1973 was larger in terms of the population criterion. All previous accessions added more in terms of land area than the current accession. But by far the smallest contribution will be in the economic size of the market. The ten countries will only add 5 per cent to the EU's GDP, which reflects both the small size of most of the acceding countries as well as low income per capita.³³

The EU is set to continue its expansion further. Bulgaria and Romania joined in 2007, taking the number of members of EU to 27. There are already indications of a number of other countries too becoming members of the Union in future.

Table 13.1 Shares (Percentage) of the acceding countries in population, surface, GDP and exports of the enlarged EU (1973–2004)

<i>The enlargement of the EU</i>	<i>Date</i>	<i>Population</i>	<i>Surface</i>	<i>GDP</i>	<i>Exports</i>
From 6 to 9	1973	25	22	20	21
From 9 to 12	1981–86	18	31	9	3
From 12 to 15	1995	6	27	7	9
From 15 to 25	2004	15	19	5	6

The enlargement is not expected to increase sharply the shares of trade between the EU (15) countries and the ten acceding countries because most of the trade re-orientation had already taken place under the umbrella of the Europe Agreements—extended free trade agreements—which preceded the enlargement. Under those agreements, the acceding countries have enjoyed virtually duty free access to the European market for industrial products since 1994 (fully free access since 1998).

The share of the EU in total imports of the ten prospective members remained constant at 58 per cent between 1995 and 2001. The share of acceding country exports going to the EU increased from 60 per

cent to 68 per cent during the same period. The share of the new entrants in total EU trade remained very small and stable over this period, at between 4 per cent and 5 per cent. Based on 2001 world trade values, enlargement will increase the share of intra-EU trade in the EU's total trade from nearly 62 per cent to 67 per cent, while the share of the EU in world merchandise exports (including intra-EU flows) will reach 41 per cent. The degree of integration of the acceding countries is also apparent from the sharp increase in FDI flows from the EU. The latter increased from 1.5 per cent of GDP of the acceding countries in 1996 to 3.2 per cent of GDP in 2000. The EU accounted for 80 per cent of acceding countries' FDI inflows in 2000.

Since the acceding countries will be adopting the common external tariff of the EC, other trade partners will be concerned with how their current market access to the ten countries will be affected. In adopting the *acquis communautaire*, Central and Eastern European countries are likely to increase average protection in agriculture and decrease it in industry and services. In contrast, the Balkan countries will decrease their average protection in all three sectors. Given that all ten countries are also WTO members, accession could result in improvements over existing WTO commitments in some areas but a deterioration in others. WTO members who may be adversely affected will have the right to negotiate for compensation.

Indo-EU Trade

The EU, taken as a single units, is India's largest partner. India's exports to EU grew from Rs 282 crore in 1970–71 to Rs 1447 crore in 1980–81 and Rs 8951 crore in 1990–91. The corresponding figures of India's imports from the EC were Rs 320 crore, Rs 2639 crore and Rs 12680 crore. In 2006–07, India's exports and imports with the EU were Rs. 130872 crore and Rs. 203885 crore respectively. In 2000–01 India had a trade surplus with the EU, although the position often is one of deficit.

The EU is India's major trading partner, accounting for nearly one-fifth of her trade.

EU's share in India's trade has shown significant fluctuations over the last several decades. During 2000–01 to 2003–04, EU (15)'s share in India's exports ranged between 23 and 21 per cent and of imports 23 and 17 per cent.

Within the EU, largest trade partners of India have been United Kingdom, Germany, Belgium and France.

India's main exports to EU include textiles, jute, leather and leather goods, polished diamonds, engineering goods, chemicals, marine products, etc. Imports include edible oils, dairy products, capital goods, optical instruments, aluminium and copper products, synthetic rubber, photo and cinematographic goods, etc. India also receives technology, investment and developmental aid from EU countries.

India's export performance has been regarded as poor. Several factors such as lack of price competitiveness, poor quality, poor quality image, bad reputation with respect to delivery schedules, poor export marketing skills, protectionist policy pursued by the EU countries etc. have contributed to this. These problems earmark the areas of corrective measures required in order to improve Indian exports to the EU. The EU is a highly competitive market courted by about 100 trading nations and unless Indian competitiveness measures up to the international level, things will become more difficult.

The EU has great potential as a market and India should pay sufficient attention in order to take advantage of this 'enlarging opportunity'. Many countries, including Japan and the South-East Asian countries, have been taking measures to overcome the Fortress by setting up manufacturing/assembling units in the Union. India's achievement in this direction has, however, not been impressive.

One great advantage for the Indian exporters, as well as for exporters from any other country from the unified Europe is that henceforth they will need to deal with only one set of rules and regulations instead of the rules and regulations of each of the member country to which they want to export. Similarly, one currency (Euro) applies to most of the members of EU.

Enlarged EU and India

The enlargement of EU by the accession of 10 new members is both a challenge and opportunity for India.

India's exports to these 10 nations were insignificant and imports were lower than exports.

India's trade with the 10 accession countries of EU has been negligible.

India's main exports to the accession countries (ACs) include gems and jewellery, drugs and pharmaceuticals, leather and leather products, textiles, plastics and linoleum products and agricultural commodities.

Benefits

1. One great advantage is the replacement of the different policy and regulatory environments of the newly joined members by the that of the uniform policy and regulatory environment of the Union and the reduction in transaction costs.
2. It is also likely that there would be expansion of the market benefiting from the enlargement of the Union.
3. Further, the availability of new ports in the enlarged EU could reduce transportation costs.
4. The harmonization of the tariff structures of the new members with that of the EU will increase the import duty of some countries above the pre-accession levels and reduce those of others. On the whole, the average weighted tariff of these countries will significantly come down to the benefit of the exporters to these markets.
5. It is expected that the removal of quota restrictions for textiles and clothing from January 2005 may also work to India's advantage, since it will reduce the protection presently available to ACs exports in the EU market.
6. The enlarged EU may also spur joint ventures with Indian companies looking forward to setting up manufacturing bases in the low cost ACs.

Challenges

1. Many Indian products will have to face a stiffer competition in the EU from the new members.
2. The low labour cost in these nations could encourage EU firms to establish manufacturing bases there or source from there which can affect Indian exports to EU and give rise to new competition from these firms in other markets.
3. It is feared that the relative competitive advantage of many of India's exports to the EU (15) may be affected by the enlargement of EU, as countries like Poland and Czech Republic compete with India in selling textiles and apparel, footwear and leather, chemical compounds, iron and steel, automotive parts etc. in the EU (15) market. According to one estimate, India and Poland compete in EU market for 46 of the top 100 exports from India to the

As some of the new members are India's competitors, the enlargement of EU raises new challenges for India.

EU. Exports of textiles may be adversely affected with low cost production in Central and Eastern European countries (CEECs) eating into India's EU (15) markets.

4. As the ACs are labour abundant and low income countries, India may also face stiffer competition on account of temporary movement of its natural persons to EU and business process outsourcing by EU to India.
5. The ACs may even affect the FDI inflow to India. Three of them—Poland, Hungary and Czech Republic—compete with India in top ten most attractive destinations for FDI. The enlargement of the EU establishes that it is a growing market which needs to be explored further.

Government may have to ease up its policy framework and the Indian businesses may have to reposition themselves to take full advantage of the opportunities posed by the expansion of the world's largest economic block.

NAFTA

The United States signed its first free trade agreement (FTA) with Israel in the mid-1980s, followed by a FTA with Canada in 1988 and the *North American Free Trade Agreement (NAFTA)* in 1994 which was later widened with the inclusion of Mexico (1994), making North America a giant free trade area.

NAFTA is a large trading bloc with a combined population and total GNP greater than the 15-member EU (but lower than the expanded EU). However, NAFTA could further expand substantially by adding more countries in the future. NAFTA is, in fact, perceived to expand by pulling together North, Central and South America.

The current negotiations on free trade for the Americas span two continents and involve over 30 countries.

Features of NAFTA

The NAFTA seeks to eliminate all tariffs on products moving among the three countries and end other barriers to services and investment capital within North America. NAFTA covers the following areas:³⁴

1. Market access—tariff and non-tariff barriers, rules of origin, governmental procurement.
2. Trade rules—safeguards, subsidies, countervailing and antidumping duties, health and safety standards.
3. Services—provides for the same safeguards for trade in services (consulting, engineering software, etc.) that exist for trade in goods.
4. Investment—establishes investment rules governing minority interests, portfolio investment, real property and majority-owned or controlled investments from the NAFTA countries; in addition, NAFTA coverage extends to investments made by any company incorporated in a NAFTA country, regardless of country of origin.
5. Intellectual property—all three countries pledge to provide adequate and efficient protection and enforcement of intellectual property rights, while ensuring that enforcement measures do not themselves become barriers to legitimate trade.
6. Dispute settlement—provides a dispute settlement process that will be followed instead of countries taking unilateral action against an offending party.

A very significant feature of the NAFTA is that, while most free trade agreements have provisions only for the trade liberalisation, it includes labour standards and environmental standards. The inclusion of the labour standards resulted from the pressure of the labour lobby which feared that the US and Canada would lose jobs to Mexico as a result of Mexico's cheaper wages, poor working conditions, and lax environmental enforcement. Similarly, the inclusion of the environmental standards resulted from the pressure of the environmental lobby which pushed for an upgrade of environmental standards in Mexico and the strengthening of compliance.

Impact of NAFTA

NAFTA has achieved substantial trade liberalisation. The trade between the US and Canada and the US and Mexico is substantial and has been rising fast. The two-way trading relationship between the United States and Canada is the largest in the world. Mexico replaced Japan as the second-largest market for US exports, while remaining as the third most important supplier to the US market after Canada and Japan. However, although the Canada-Mexico trade has been increasing fast after the Agreement, they are still marginal trading partners with each other.

NAFTA has achieved substantial increase in intra-regional trade.

Doubts are, however, raised about the impact of the NAFTA on employment in the US. The American companies would immensely benefit by shifting production to Mexico where labour is substantially cheap as compared to the US. It was pointed out that what NAFTA would help achieve is a free movement of American capital to Mexico—a superior alternative from the US viewpoint, when compared to the free movement of Mexican labour to the US. Environmentalists have also expressed concern about the US moving high pollution industries to Mexico which has less stringent environment protection laws.

There have been divergent views on the potential benefits and harmful effects of NAFTA and its members. Many feared that there would be an exodus of jobs to the substantially low-wage Mexico from the US and Canada, while the other school maintained that there would be substantial job creation in the US and Canada because of the huge increase in demand for US and Canadian goods and services in Mexico following the trade liberalisation. Many Mexicans feared that fierce competition from the US firms would seriously damage the Mexican industry and economy, while many others maintained that liberalisation and competition will increase the competitiveness of the Mexican industry.

The real impact of NAFTA on US employment is not clear. Although there are job losses to the US due to NAFTA, some estimates indicate significant net job creation in the US. This is corroborated by the relatively low unemployment rates prevailing in the US after the formation of the free trade area.

Foreign investment in Mexico has risen substantially since the Agreement. Companies from outside NAFTA have been making large investment in Mexico to gain a free entry to the huge NAFTA market. NAFTA has been resulting in a lot of trade diversion.

The NAFTA comprising Mexico also could cause difficulties for exports of the developing countries to the US and Canada as Mexico, a developing country, by virtue of being a member of the NAFTA would get a considerable edge over other nations in selling in the US and Canada.

ECONOMIC INTEGRATION OF DEVELOPING COUNTRIES

Rationale

Economic integration of developing countries has been advocated by many experts as a means to accelerate economic development and strengthen their trading and bargaining power vis-a-vis the developed economies. The South Commission has also emphasised this. The United Nations Conference on Trade and Development (UNCTAD) feels that “Regional economic groupings, integration or other forms of economic cooperation should be promoted among developing countries as a means of expanding their intra-regional and extra-regional trade and encouraging their economic growth.”³⁵ The countries participating in the Second Session of the UNCTAD reaffirmed “... that trade expansion, economic cooperation and integration among developing countries is an important element of an international development strategy and would make an essential contribution towards their economic development”.³⁶

RIAs among developing countries account for 30–40 per cent of the total.

Regional agreements among developing countries accounted for about 30–40 per cent of all RTAs in force in the beginning of millennium, including those not notified to the WTO. In Africa alone, there are about eighteen trading agreements.

Berry et. al observe that, LDCs enter into integration schemes for somewhat different purposes from those of advanced nations. Integration offers LDCs a means for simultaneously solving two trade problems: (1) It provides an opportunity for free trade with other countries that are at similar levels of development and are thus able to compete on equal terms, and (2) it presents a way to trade with advanced countries without being harmed by their superior economic power. Yet the promotion of trade is not necessarily the main reason why LDCs form integrated groups, as it is for advanced countries. A more urgent goal is to generate economic growth and development. The gains from integration are fundamentally similar for developing countries and advanced ones, but with some important differences. The less-developed nations have possibilities for proportionately greater benefits because they have so much further to go. In addition to the opportunities that integration offers for acquiring individual industrial specialities and trading the products of these with other members, union can improve the allocation of resources.³⁷

The domestic market of many less developed countries is limited by the low per capita income and the small size of the population. This naturally comes in the way of achieving economies of scale and industrial development. It is hoped that the increase in the size of the market due to integration will, therefore, remove this obstacle. It “...may be fair to say that if the less developed countries are determined to industrialise irrespective of the social cost, industrialisation through regional integration should be preferred where feasible. The reason is simple: Regional integration can support larger and more efficient production units.”³⁸ It is observed that there “... is much less interest in trade creation through destroying inefficient producing units existing in the member countries than in trade diversion—shifting purchases from the rest of the world to member countries, and more constructively the achievement of economies of scale.”³⁹ After all, the labor that goes into the trade diverting activities is seldom withdrawn from other useful activities. More often than not, such labour is drawn from the ranks of the unemployed or underemployed, and its opportunity cost is very low, near zero.

Unfavourable Factors

Economic integration of developing countries is beset with problems.

It has even been argued that integration can do pretty little to improve the economic performance of these nations. The following paragraphs give a very brief account of some very important factors that come in the way of economic integration of developing countries.

There are certain conditions to be satisfied for the success of an economic integration. The economic structure and conditions of the developing countries, by and large, do not satisfy some of these conditions.

1. A customs union would lead to net economic welfare if the economies of the partner countries are actually very competitive, or similar but potentially very competitive, or dissimilar because under such situation the trade creation will outweigh trade diversion. But "... if we apply the criterion of trade creation and trade diversion to the developing countries, it would not be possible to justify integration among them. The developing countries are in fact are producing similar products and also they are competitive. But the similar goods—mostly the primary products—that they produce are not for selling among themselves, but they are for the market in the developed countries. Unless they industrialise and diversify their production, they cannot develop complementarity. Since the conditions of complementarity and competitiveness cannot be fulfilled by the developing countries, integration among them will not lead to greater trade creation."⁴⁰
2. A customs union would increase economic welfare if the trade among the member countries could be substantial, i.e. the partners should constitute the major market for the principal exports of each of the members. Further, the success of an integration scheme also depends on the proportion of the world's production, consumption and trade which is covered by the members of the union. The developing countries do not, however, satisfy these two conditions, namely, scope for substantial intra-regional trade and substantial share of world's production, consumption and trade.

Apart from these unfavourable economic factors, there are certain practical problems with respect to economic integration of the developing countries.

First, there are political difficulties. Governments of this region would not favour sacrifice of their freedom, sovereignty and autonomy by integration. Further, political differences and narrow nationalistic views are "formidable obstacles to the integration of developing countries. This is more true of the developing countries of Asia and Africa which have national rivalries and boundary disputes."⁴¹

Secondly, the relatively poor and weak countries may have the apprehension that the relatively advanced and strong countries of the group would eventually dominate the entire customs union. The "...lagging country becomes frightened, that by giving its partners free access to its market, it will never be able to start any industry. Thus Bolivia refuses to join Latin American Free Trade Association (LAFTA) on the ground that it would impede its development rather than assist it. It regards LAFTA as a device to speed up the development of Mexico, Argentina, and Brazil—now leading in the area—at the expense of the slower countries."⁴²

Thirdly, in spite of their geographic proximity the less developed countries are not economically unified; they lack adequate transportation and other communication and infrastructural and institutional facilities for successful unification. "Forming a single land mass, as they do, the EEC members for the most part have an economic advantage over the outside world in the markets of the community."⁴³ In

contrast, "...in the developing countries, many of them with only exterior lines of communication (as noted for Argentina and Chile), there is no natural unity, and the artificial unity of political resolve is difficult to sustain. The fact that benefits for one member are costs for the others is divisive."⁴⁴

Fourthly, the unequal distribution of the gains from integration due to the unequal economic status of the developing countries themselves makes them less enthusiastic about integration. "As evidenced from the experience of the EU countries, the gains will not get distributed equally even in the case of member countries whose economic status is not very much different initially. If integrated production units are established guided by considerations of economies of scale, it is possible that industries might get concentrated in a few partner countries."⁴⁵

Fifthly the loss of revenue from customs duties, which is an important source of revenue for the governments of the less developed countries, tends to reduce the attractiveness of economic integration to these governments.

Thus, a number of obstacles come in the way of economic integration of the less developed countries. However, measures like those mentioned below⁴⁶ have been expected to promote regional economic cooperation and trade liberalisation among developing countries:

1. Development of regional trade infrastructure i.e. provision for economic intra-regional transport facilities, etc.
2. Establishment of regional institutions to facilitate intra-regional trade i.e. expansion of clearing or payment union, Regional Reserve Bank, regional import-export credit facilities, regional trade information centre, etc.
3. Effective implementation, improvement and widening the scope of regional 'commodity communities' i.e. coconut, tin, etc.
4. Plan harmonisation and regional investment projects i.e. exchange of experiences in national planning and economic aspirations, development of regional investment plans, standardisation of policies regarding investments from outside the region, etc.
5. A planned effort in the direction of reduction of tariffs and trade barriers between the member countries and possible agreements on common policies vis-a-vis non-regional countries i.e. a product by product or systematic reduction of intra-regional tariffs, etc.

Integration Schemes of Developing Countries

A number of integration schemes have been initiated by less developed countries "...and have experienced varying fortunes, raising questions of both of the efficiency of existing schemes and soundness of the theoretical and policy arguments upon which they are based."⁴⁷ Thus, the integration so far achieved has meant continuing interference with unfettered multilateral trade. While these arrangements may be argued to be a movement *towards* freer international trade it is fair to note that they have frequently been seen (at least in Latin America) as a *medium-term* alternative to non-discriminatory dismantling of tariffs."⁴⁸

For many developing countries in Latin America and Sub-Saharan Africa, regional trade agreements have been a key element in their policy agendas over the past three decades.

Regional integration has long been a priority in Sub-Saharan Africa, where, in the past thirty years, all the countries have joined regional integration schemes. However, none of these schemes has been

Developing countries have been enthusiastic to form RIAs among themselves to accelerate economic development and reduce dependence on industrial nations.

successful, for a variety of reasons, including the fact that the Sub-Saharan countries did not trade with each other a lot and are not what one would call natural trading partners.

Similarly, Latin American countries have been involved in regional integration schemes since the late 1950s.

Regional trade agreements among developing countries include the Latin American Free Trade Association (LAFTA), the Central American Common Market (CACM), the Andean Pact, and the Caribbean Common Market (CARICOM) in Latin America; the Economic Community of West African States (ECOWAS), the Preferential Trade Area (PTA), the Economic Community of Central African States (CEEAC), and the Southern African Development Coordination Conference (SADCC) in Sub-Saharan Africa; and the Gulf Cooperation Council (GCC) in the Middle East.

There has been a move to establish a Latin American Common Market consisting of Brazil, Argentina, Chile, Uruguay and Paraguay. The Southern Cone Common Market (Mercado Comun del Sur—MERCOSUR) consisting of Argentina, Brazil, Paraguay and Uruguay was formed in 1991. The Mercosur, the world's third-largest customs union, announced in May 2000, the decision to transform the bloc into a common market. In the beginning it would not have a common currency but it may be adopted later. The member nations decided to coordinate debt and deficit goals because "it is for the good of the region," and they felt that "it is perfectly possible for different countries with different monetary policies to work together toward economic stability." The Mercosur bloc links 210 million people who produced more than \$1 trillion in goods and services in 1999.

The Mercosur convergence plan has been dubbed a "little Maastricht" because it resembles the European Union treaty which helped the formation of the European Union and the Euro.

In the post-World War II period, the erstwhile Soviet Union and East European countries sought to foster economic development via the integration scheme of Council for Mutual Economic Assistance (CMEA or COMECON). With the dissolution of the CMEA in 1991 following the political changes, the regional trade of the Eastern bloc also collapsed.

The *Association of South East Asian Nations* (ASEAN) was formed by the Bangkok Declaration, 1967, by five countries, viz, Indonesia, Malaysia, The Philippines, Singapore and Thailand, with a view to accelerate economic progress. Brunei joined the Association in 1984. The economic growth rate of the ASEAN which is richly endowed with natural resources has been very high. This region accounts for the lion's share of the world's natural rubber, palm oil and tin. It is also an important producer of sugar, coffee, timber, petroleum, nickel, bauxite, tungsten and coal.

The ASEAN Free Trade Area (AFTA) was created in 1992 by the six nations mentioned above. However, as ASEAN expanded its membership to include countries in Indo-China; the new countries also joined AFTA. Between 1995 and 1999, Vietnam, Lao PDR, Myanmar and Cambodia acceded to AFTA taking the membership to ten.

AFTA reduced intra-regional tariffs or Common Effective Preferential Tariffs (CEPT) rates to a range of 0-5 per cent by 2002. The Agreement now also calls for elimination of all customs duties by 2010.

The ASEAN integration has also progressed from "shallow to deep" integration, i.e. going beyond the simple removal of trade barriers. The new agenda, sometimes called AFTA-Plus programme, includes preferential liberalisation of services and investment, harmonization of tariff nomenclature, intellectual property cooperation, the harmonization of product standards and mutual recognition of conformity

assessment tests. Despite the realization of AFTA (at least for its first six members), the share of intra-regional trade has not increased significantly since the 1970s.

In fact, the concentration ratio has been decreasing over time. It does not appear that the preferences under AFTA have significantly boosted intra-regional trade. There are a number of reasons for this. *First*, within ASEAN about 66 per cent of the tariff lines have the same MFN and CEPT rates. As far as the remaining one third of tariff lines is concerned, since many ASEAN countries have also autonomously reduced their tariffs in the 1990s, the difference between MFN and CEPT rates is small. Given the rule of origin of 40 per cent ASEAN content, traders may not have found the difference worth the cost of retooling their production to meet the content requirement. Hence, less than 5 per cent of intra-regional trade is covered by CEPT preferences. *Second*, many products with strong potential for intra-regional trade (agricultural products such as rice and sugar and industrial products like automobiles) are also politically sensitive and have had their liberalisation delayed by a number of members to a later date.

China and Asean have signed a major deal, in November 2002, to usher in the world's largest free trade zone encompassing more than 1.7 billion people struggling to attain prosperity after having remained in decades of poverty. The agreement came after talks with the leaders of Asean as well as with China, South Korea and Japan.

The agreement leads to creation of Asean-China free trade zone within ten years and would pave the way for elimination of tariff and non-tariff barriers to trade. A strong Asean Free Trade Area (Afta) and the new Asean-China deal would give companies an expanded consumer base with a combined gross domestic product of more than \$1.5 trillion. It is believed that it would also reduce the "south-east dependency" on traditional markets by opening new horizons. Within Asean, the annual turnover is one trillion US dollars.

RIAs are set to play an increasingly important role in Asia.

Under Afta, which came into force in 2002, six of Asean's established members have cut tariffs on most goods traded within the region to between 0 and 5 per cent. The newer members Cambodia, Laos, Myanmar and Vietnam have until 2005 to comply with.

Free trade area between Southeast Asia's 10 nations and Japan could be a reality within 10 years i.e. before 2010. A comprehensive economic partnership between Asean and Japan would provide greater market opportunities to their economies, through the creation of larger and new markets and enabling the industries to enjoy bigger economies of scale.

On November 7, 2003, the 10 Asean nations signed a landmark accord to form an economic community by 2020. This unified market would have about 500 million people and an estimated annual sales totalling US \$720 billion.

There is a strong view that India should also integrate with Asean. The first Asean-India summit held in November 2002 has been expected to set the stage for India to move purposefully ahead to achieve this. In October 2003, participating in the Bali summit of the Asean, where India enjoyed a partner status along with China, Japan and Korea, Prime Minister Vajpayee asked the grouping to establish a Free trade area with India in the next ten years. Some trade liberalisation measures have already been initiated by India.

Table 13.2 Major Economic Integration Agreements

<i>Category of Countries</i>	<i>Regional Integration Agreements</i>
Industrial and Developing Economies	<p>European Union (EU): formerly European Economic Community (EEC) and European Community, 1957: Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, the Netherlands; 1973: Denmark, Ireland, United Kingdom; 1981: Greece; 1986: Portugal, Spain; 1995: Austria, Finland, Sweden.</p> <p>European Economic Area: 1994: EU, Iceland, Liechtenstein, Norway.</p> <p>Euro-Mediterranean Economic Area (Euro-Maghreb): Bilateral agreements, 1995: EU and Tunisia; 1996: EU and Morocco.</p> <p>EU bilateral agreements with Eastern Europe: 1994: EC and Hungary, Poland; 1995: European Community and Bulgaria, Romania, Estonia, Latvia, Lithuania, Czech Republic, Slovak Republic, Slovenia.</p> <p>Canada-US Free Trade Area: 1988: Canada, United States.</p> <p>North American Free Trade Area (NAFTA): 1994: Canada, Mexico, United States.</p> <p>Asia Pacific Economic Cooperation (APEC): 1989: Australia, Brunei Darussalam, Canada, Indonesia, Japan, Malaysia, New Zealand, Philippines, the Republic of Korea, Singapore, Thailand, United States; 1991: China, Hong Kong (China), Taiwan (China); 1993: Mexico, Papua New Guinea; 1994: Chile; 1998: Peru, Russia, Vietnam.</p>
Latin American and Caribbean	<p>Andean Pact: 1969: revived in 1991, Bolivia, Colombia, Ecuador, Peru, Venezuela.</p> <p>Central American Common Market (CACM): 1960: revived in 1993, El Salvador, Guatemala, Honduras, Nicaragua; 1962: Costa Rica.</p> <p>Southern Cone Common Market (Mercado Comun del Sur—MERCOSUR): 1991: Argentina, Brazil, Paraguay, Uruguay.</p> <p>Group of Three: 1995: Colombia, Mexico, Venezuela.</p> <p>Latin American Integration Association (LAIA): formerly Latin American Free Trade Area, 1960: revived 1980, Mexico, Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, Venezuela.</p> <p>Caribbean Community and Common Market (CARICOM): 1973: Antigua and Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago; 1974: Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and the Grenadines; 1983: The Bahamas (part of the Caribbean Community but not of the Common Market).</p>
Sub-Saharan Africa	<p>Cross-Border Initiative: 1992: Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.</p> <p>East African Cooperation: 1967: formerly East African Community, broke up in 1977 and recently revived, Kenya, Tanzania, Uganda.</p>

Middle East
and Asia

Economic and Monetary Community of Central Africa: 1994: formerly Union Douaniere et Economique de l'Afrique Centrale, 1966: Cameroon, Central African Republic, Chad, Congo, Gabon; 1989: Equatorial Guinea.

Economic Community of West African States (ECOWAS): 1975: Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo.

Common Market for Eastern and Southern Africa: 1993: Angola, Burundi, Comoros, Djibouti, Egypt, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Rwanda, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.

Indian Ocean Commission: 1984: Comoros, Madagascar, Mauritius, Seychelles.

Southern African Development Community (SADC): 1980: formerly known as the Southern African Development Coordination Conference, Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, Zimbabwe; 1990: Namibia; 1994: South Africa; 1995: Mauritius; 1998: Democratic Republic of the Congo, Seychelles.

Economic Community of West Africa: 1973: revived in 1994 as West African Economic and Monetary Unit, Benin, Burkina Faso, Cote d'Ivoire, Mali, Mauritania, Niger, Senegal.

West African Economic and Monetary Union: 1994: Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal, Togo, 1997: Guinea-Bissau.

Southern African Customs Union (SACU): 1910: Botswana, Lesotho, Namibia, South Africa, Swaziland.

Economic Community of the Countries of the Great Lakes: 1976: Burundi, Rwanda, Democratic Republic of the Congo.

Association of Southeast Asian Nations (ASEAN): 1967: ASEAN Free Trade Area was created in 1992, Indonesia, Malaysia, Philippines, Singapore, Thailand; 1984: Brunei Darussalam; 1995: Vietnam; 1997: Myanmar, Laos Peoples Democratic Republic; 1999: Cambodia.

Gulf Cooperation Council (GCC): 1981: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

South African Association for Regional Cooperation: 1985: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.

Source: Presented by World Bank Policy Research Report *Trade Blocs*, based on WTO data, Oxford University Press, New York, 2000.

TOWARDS A COMPLEX NETWORK OF RTAs

The international trading system is increasingly characterised by a complex network of preferential trade regimes, sitting side-by-side with the WTO multilateral trading system.⁴⁹

One important development has been the rise in cross-regional agreements and the proliferation of inter-linked (overlapping) agreements. All major countries are involved in cross-regional FTAs. The EU

The proliferation of RIAs with overlappings is leading to a complex network of integration schemes.

for example, has concluded FTAs with Mexico, Chile, a number of South Africa and a number of other African and Middle Eastern countries and has been of negotiating with many other countries.

The EFTA has signed a FTA with Mexico and various African countries, and has been negotiating FTAs with Canada, Chile and South Africa. The United States which signed a FTA with Jordan has been negotiating with Australia, Chile, Egypt and Singapore. The *Trade Development Report*, 2003, points out that one-third of the FTAs under negotiation then were among countries that belong to different geographical areas. Within the ASEAN region, Singapore has concluded bilateral FTAs with New Zealand and EFTA. It has concluded negotiations with Australia and the United States and has been negotiating with a number of other countries.⁵⁰

The proliferation of RTAs and the increasing number of bilateral free-trade agreements has meant overlapping membership for many countries. A large number of countries are now a party to two or more RTAs. For example, the EU has over 30 preferential trade agreements. Mexico is a member of NAFTA and also has a FTA with the European Union and a number of other countries. Singapore is a member of AFTA and has bilateral FTAs with Australia, EFTA, Japan, New Zealand and the US. All these countries are involved in negotiating future agreements.⁵¹

Finally, recent RTAs take many different forms. Many go beyond the simple removal of tariff barriers and quotas. They include the removal or reduction of non-tariff barriers, through harmonization or mutual recognition of product standards and conformity assessment procedures. Increasingly, many RTAs contain provisions on trade in services. Some also reach into policy areas that are either not covered or are covered differently by WTO rules, such as capital mobility, competition, environmental standards, investment and labour standards. For example, the agreement between Japan and Singapore covers a broad range of economic aspects such as capital flows, harmonized regulations, co-operation on paperless trade, financial services, media/broadcasting services, movement of professionals and development of human resources. The agreement between the United States and Jordan includes commitments on labour and environmental standards.⁵²

With this patchwork of agreements and diverse treatment of issues, governments are increasingly likely to have to manage different provisions within the same policy areas. This carries the risk that some provisions are mutually inconsistent and may hamper trade. Complexity in the trade regime increases the transaction costs of conducting trade and the possibility of mutually inconsistent provisions creates uncertainty as regards the applicable rules.⁵³

EVALUATION OF RIAs

The RIAs present a diverse picture of the extent of success.

Developed vs Developing Countries

RIAs among industrial countries tend to be more successful than those among developing countries.

Experience shows that regional agreements among the developed countries would be more successful than those among the developing countries.

According to an IMF study,⁵⁴ regional arrangements in industrial countries initially contributed to an increase in intra-regional trade, although recent evidence is less conclusive. In the EC and EFTA, for example, intra-regional trade increased markedly in the first ten to fifteen years but leveled off or decreased in later years. The study cites several reasons why the industrialised country arrangements tend to increase intra-regional trade and face less implementation problems than their developing country counterparts.

First, trade liberalisation is principally carried out in differentiated manufactured goods. This can be achieved without major shifts in factor proportions and entails relatively lower transitional adjustment costs, particularly in terms of labour dislocations.

Second, industrial countries are in a better position to absorb structural adjustment costs within the context of steady growth.

Third, the industrial countries have postponed structural adjustment in sensitive sectors.

The *World Trade Development Report, 2003*, however, indicates that although the most powerful argument for RTAs is trade creation, the results of several studies do not show that trade is increasingly becoming concentrated within RTAs. It is true that the share of intra-regional exports as a percentage of regional bloc exports has been increasing since 1970 in most of the major regional trade blocs. Over 60 per cent of EU exports are to other EU partners and over half of NAFTA exports are to other NAFTA partners. However, intra-regional export shares within the EU have remained nearly constant and those for NAFTA have shown an upward trend since 1970, well before NAFTA entered into force in 1994⁵⁴. Similar patterns can be identified for other major RTAs. MERCOSUR is an exception, where data shows a sharp increase in intra-regional export shares after the agreement entered into force.⁵⁵

The following paragraphs also indicate several differences between the RIAs of developed and developing countries.

Trends in Income Disparity

According to a Ben-David study,⁵⁶ the overall dispersion of income levels in the EU has clearly shown an almost continuous convergence. Income differences narrowed by about two-thirds over the period studied (1947 to 1981), due mainly to more rapid growth of the lower-income countries. The most interesting features of the more recent experience are the strong performance of Ireland, Portugal, and Spain, who have made substantial progress in closing the gap with richer members of the EU.... This convergence did not take place in Greece, although it joined the EU earlier than Portugal and Spain, because Greece did not implement the necessary reforms after joining the EU. This suggests that even though integrating with a large and advanced region is potentially beneficial, economic reforms in the poorer country are needed in order to capture these benefits.

While European experience suggests convergence, the experience of most developing country RIAs does not. Indeed, there are several examples of integration being blamed for divergence of economic performance due to factors like the concentration of manufacturing in certain places of the Region.⁵⁷

Trade Complementarity Index

Many RIAs have failed, in part because of low complementarity in member countries' trade (i.e. countries' production structures are largely similar and their exports match the imports of their trading partners only poorly). In such a setting countries have little to gain from regional arrangements and should focus mainly on unilateral or multilateral trade liberalisation.

An important determinant of success of RIA is the complementarity in trade between the members.

A trade complementarity index can be used to provide some indication of the likelihood of successful integration in possible new regional trade arrangements. The index is *zero* when no good exported by one country is imported by the other, and *one* when the shares of one country's imports correspond exactly to those of the other's exports. Michaely suggests that the higher the index the more likely is a proposed regional trade arrangement to succeed in stimulating trade between its members.⁵⁸

There is a wide range between the index values for previous successful and unsuccessful arrangements at the time they were formed. Index values for the EEC Six averaged 0.53, while an even higher degree of complementarity existed between the trade of the United States and Canada. In contrast, the index for the unsuccessful LAFTA was less than 40 per cent of the EEC/US-Canada average. The Andean Pact index (0.07) shows that the export structures of Bolivia, Colombia, Ecuador, Peru, and Venezuela were almost completely dissimilar from those of their imports at the time this arrangement was initiated. Among recent arrangements, complementarity among NAFTA members is as high as among the early EEC members. In Mercosur (Argentina, Brazil, Paraguay, Uruguay) the average complementarity index of 0.29 is about half that of the most successful precedents, though the index is closer to 0.35 between the two central partners, Argentina and Brazil. This suggests that while the arrangement has a reasonable chance of promoting trade among members, countries must avoid an inward-looking "regional bloc" approach that de-emphasizes continued multilateral or unilateral trade liberalisation, as has sometimes happened in regional arrangements with high trade complementarity. Much the same could be said for two prospective regional trade arrangements, the expansion of NAFTA to the rest of Latin America and APEC in the Asia-Pacific; their complementarity indices are around 50 to 60 per cent of the EEC/US-Canada average.⁵⁹

Sub-Saharan African countries have low trade complementarity. The index for twenty countries averages only 0.09. This strongly suggests that the structure of African countries' exports and imports differs so widely that regional trade integration efforts hold little promise for accelerating industrialisation and growth (regional cooperation can, of course, be beneficial in Other areas, such as joint border projects and consolidation of peace). Liberalisation of trade barriers in the region either unilaterally or within a multilateral framework appears to be a far more promising option.⁶⁰

Problems of RIAs of Developing Countries

The RTAs among developing countries do not appear to have contributed significantly to expansion of South-South trade. Interestingly, according to a WTO analysis, there is an inverse correlation between intra-regional trade shares and the number of RTAs. Developing Asia, with only one major RTA, has the

Developing country
RIAs failed to boost
South-South trade.

largest share of intra-regional trade, whereas Africa, with the largest number of RTAs, has the smallest share of intra-regional trade. More than half of Latin America's exports to developing countries are shipped within the region, while for both Africa and the Middle East, developing markets outside those regions are far more significant.⁶¹

It has been observed that they have been more successful in other areas of cooperation, including agricultural research and development, and coordination of investment incentives.⁶²

Reasons for the Non-performance of RTAs There have been many reasons for the poor results. A World Bank Report reveals the following reasons:⁶³

1. In a number of cases (CARICOM and the Central American Common Market in Central America; UDEAC in Africa) intra-regional conflicts have made it difficult to liberate trade.
2. In many blocs, such as the Andean Pact, participants sought to rationalise production by allocating specific markets to designated producers instead of allowing the competitive process to determine the allocation of production. These designated producers were not necessarily the most efficient; nor were tariffs low enough in relation to the rest of the world to provide external competition. Consequently, the expected benefits from rationalisation of production or increased competition have been limited.
3. Trading opportunities and pro-competitive effects have been limited by the small size of regional markets in comparison with the rest of the world.
4. Regional trading blocs have frequently produced similar products, limiting the opportunity to exploit differences in skill or endowments.
5. Political interest in these arrangements has not always been translated into effective implementation of economic goals. The overall impact of these arrangements, has, therefore been limited.
6. Few developing country regional groups removed barriers across the board.
7. Strong vested interests in import competing industries and weakened external environment also thwarted efforts to liberalise intra-regional trade.
8. Inappropriate macroeconomic policies and political and institutional factors have also impeded implementation.

A number of economic, commercial and political factors are responsible for poor performance of South-South RIAs.

The South Commission observes that a basic handicap for regional organisations has been inadequate support from their member countries. It is clearly essential that this attitude should be reversed if the schemes are to gain the necessary strength.⁶⁴ The problems indicate the courses of action needed for making the integration schemes successful. The fact that the developed countries are 'extensifying' and intensifying integration schemes reveals certain important facts. Integration schemes have considerable benefits, if properly carried out. Secondly, this trend in the North will create more problems for exports from the South to North. Therefore, it is essential that the South also actively pursues such schemes, to mitigate the adverse effects of the integration of the North as well as to make better utilisation of the resources and development potentials of the South through cooperative endeavours. The South Asian Association for Regional Cooperation (SAARC) is described in the chapter, *South-South Cooperation*.

Benefits of North-South RIAs

According to a World Bank *Policy Research Report*, one reasonably firm conclusion is that for most developing countries, and especially for the poorer ones, a North-South RIA with a large industrial country is likely to be superior to a South-South RIA. The reasons are that:⁶⁵

1. South-South RIAs are more likely to generate divergence, with the less developed member losing relative to the more developed one.
2. South-South RIAs are more likely to generate trade diversion.
3. North-South RIAs are more likely to generate useful transfers of technology.

North-South RIAs have several beneficial dimensions.

4. North-South RIAs are more likely to provide lock-in mechanisms in the area of politics (such as democracy) and economics (in terms of policy credibility).
5. Given the industrial partner's superior institutions, a North-South RIA may provide more benefits from "deep integration" than a South-South RIA.
6. Given a larger endowment difference between member countries in a North-South RIA than in a South-South one, a developing country may be able to better exploit its comparative advantage in a North-South RIA.
7. The developing country partner is unlikely to capture most of the above-mentioned benefits of North-South integration unless it undertakes economic reforms.

Other conclusions include the following.

8. For any RIA, lowering external trade barriers (up to the optimum level) is beneficial: it will increase the RIAs gains or reduce its losses.
9. Though there are substantial benefits from a Customs Union, compared with an FTA in terms of simplicity or intra-bloc trade regulations there are also costs in terms of loss of sovereignty, difficulty in setting the common external tariff and sharing the tariff revenues. Thus, most recent RIAs have been FTAs, and mostly North-South ones where these costs of forming a CU are likely to be high.
10. For middle-income countries—such as the members of MERCOSUR or ASEAN—there may be sufficient gains from scale and competition effects to justify a RIA between them, but fully capturing these effects will require "deep integration" measures, and expansion and contraction of sectors and firms decided by the market.
11. However, if a middle-income country is located close to a large industrial RIA—such as Mexico, and Eastern European and Mediterranean countries—then it is likely to best capture the benefits of enhanced scale and competition by joining that RIA.

Regionalism Vs Multilateralism

The growth of regionalism poses a threat to multilateralism. A WTO Report observes: "Regionalism can serve as a catalyst for further liberalization at the multilateral level. But the increasing number of regional agreements may also represent a threat to multilateral liberalization. A multiplicity of regional agreements will almost certainly engender a degree of trade diversion, and the application of numerous rules of origin and differing standards will make international trade more complex and costly. The growing

Proliferation of RIAs hamper multilateralism and make the trading environment more complex.

number of overlapping bilateral and plurilateral agreements risks the transparency of trading rules, thus posing a threat to some of the fundamental principles of the WTO. Regional trading arrangements may create vested interests determined to avoid any dilution of preferential margins implied by multilateral trade liberalization. Finally, increasing regionalism will tend to distract attention and energy from multilateral negotiations."⁶⁶ The Report points out that two ground rules of policy behaviour could help to consolidate and build upon the benefits of regionalism and promote a more effective multilateral trading system. The first rule would be to refrain from engaging in regional commitments (on issues covered within the mandate of the WTO) which governments would be unwilling, sooner or later, to extend to a multilateral setting. The second would be to consolidate the first rule by agreeing to a consultative system that would map and monitor the timing and conditions

attached to the non-discriminatory, multilateral application of commitments made in regional arrangements. Such arrangements might provide a more effective link between regionalism and multilateralism than exists today.⁶⁷

ROLE OF WTO

The WTO has an important role to play to improve the environment to enable the developing countries to benefit more from RIAs. The World Bank *Policy Research Report* points out that this requires:⁶⁸

WTO has an important role in making the environment of regionalism fair to developing nations.

1. Changes in WTO rules to benefit developing countries
2. Improvement and enforcement of the rules.

With reference to the first it is recommended that:

1. Industrial countries should fully open their markets to developing country exports, particularly those from least-developing countries.
2. The WTO should modify its rules concerning trade blocs to create a presumptive right of association.
3. In return, developing countries should accept the disciplines of Articles XXIV and V for their RIAs.

The Recommendations in Respect of the Second are that:

4. WTO enforces the disciplines of Articles XXIV and vigorously in the CRTA, especially those on coverage and depth of liberalisation.
5. WTO defines the rules more rigorously: On “substantially all trade,” we advocate 94 per cent of trade after 10 years and 98 per cent after 15; on “other restrictive regulations of commerce,” we advocate inclusion of the abolition of internal barriers, such as safeguard actions and anti-dumping duties.

WTO Provisions on Regional Integration Arrangements (Extracts)

Article XXIV of GATT

4. The contracting parties...also recognize that the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to trade.
5. (a) With respect to a customs union... the duties and other regulations of commerce imposed at the institution...shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union...
- (b) With respect to a free trade area. ...the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area... shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area...
- (c) Any interim agreement... shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.

7. (a) Any contracting party deciding to enter into a customs union or a free-trade area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information...
8. (a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that: (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Article XI, XII, XIII, XIV, XV and XX) are eliminated with respect to..
.substantially all the trade in products originating in such territories...
8. (b) A free trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive

SUMMARY

There has been a significant increase, particularly since the early 1990s, in the number of regional economic integration schemes or **trade blocs** (also known as **regional integration agreement/arrangement- RIA** - or **regional trade agreement –RTA**). The term *economic integration* is commonly used to refer to the type of arrangement that removes artificial trade barriers, like tariffs and quantitative restrictions, between the integrating economies. More than one-third of world trade already takes place within the existing RIAs.

RTAs are designed to achieve various economic, social and political purposes. The expected benefits of RIAs include efficiency improvements due to economies of scale arising out of the enlarged market, enhanced bargaining strength of members in multilateral trade negotiations, promotion of regional infant industries which cannot be viable without a protected regional market, prevention of further damage to their trading strength due to further trade diversion from third countries etc.

There are different degrees or levels of economic integration, viz., **free trade area, customs union, common market, economic union** and **full economic integration**. The important features of them are summarised in Fig. 13.1.

The benefits and possible adverse effects of economic integration can be best explained by the theory of Customs Union. They are highlighted in Fig. 13.2.

A very notable development has been the rise in cross-regional agreements and the proliferation of inter-linked (overlapping) agreements. All major countries are involved in cross-regional FTAs. The proliferation of RTAs and the increasing number of bilateral free-trade agreements has meant overlapping membership for many countries.

The important determinants of success RIAs are the nature of economies, proximity of members, size of the RIA, size of members, extent of trade barriers before the formation of the RIA, extent of intraregional trade etc. By far the most successful of the RIAs is the **European Union (EU)**.

The **RTAs among developed countries** have been more successful than those between developing countries. Problems of **South-South RIAs** include intera-regional conflicts; vested interests in import competing industries; inappropriate macroeconomic policies; political and institutional factors; lack of complementarity; the tendency to rationalise production by allocating specific markets to designated producers instead of allowing the competitive process to determine the allocation of production etc.

North-South RIA with a large industrial country is likely to be superior to a South-South RIA for various reasons. Given a larger endowment difference between member countries in a North-South RIA than in a South-South one, a developing country may be able to better exploit its comparative advantage in a North-South RIA and gain benefits of transfer of technology.

A major problem of RIAs is that they promote regionalism at the expense of multilateralism. Although regional arrangements can be destructive of more desirable multilateral outcomes they can also supplement and build upon multilateralism in positive ways.

Review Questions

1. Give a brief account of the theory of customs union.
2. Explain the static effects of customs union.
3. Evaluate performance of RIAs.
4. Discuss the reasons for the poor performance of RIAs of developing countries.
5. Describe the stages in the evolution of the European Union and the important features of the European Union.
6. Discuss the problems and prospects of economic integration of developing countries.
7. Examine the economic integration schemes of developing countries.
8. Explain the dynamic effects of customs union. To what extent these are realised by the European Union?
9. Write notes on the following.
 - (i) Forms of economic integration
 - (ii) Production effect of customs union
 - (iii) Consumption effects of customs union
 - (iv) European Union
 - (v) EC-1992
 - (vi) Indo-EU Trade
 - (vii) NAFTA
 - (viii) The enlarged EU (15 to 25)

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Suggested Readings

CHAPTER 14

14 South-South Cooperation

LEARNING OBJECTIVES

- ☐ To understand the objectives and scope of SSC.
- ☐ To review the progress and problems of SSC.
- ☐ To get a broad picture of SSC and integration schemes involving India.

PROBLEMS FACING THE SOUTH

The developmental problems confronting the South (i.e. the developing countries), inhabited by about four-fifths of humanity are complex indeed. The South, characterised as it is by mass poverty and the resultant vicious circle, dearth of capital, technology and other resources, presents many developmental puzzles. Due to helplessness the south has been much too dependent on the North (i.e. developed economies) for its development and other requirements. There has been a strong feeling that this has led to a situation wherein the North is able to exert various kinds of pressures on the South and the multinational corporations based in the North are able to exploit the weak bargaining power of the South. How can the developing countries come out of such a situation and accelerate the pace of development of their economies, making better utilisation of their resource potential?

As the South Commission¹ observes, the crucial challenge that the developing countries face collectively is how to strengthen and diversify South-South Cooperation.

The need for South-South Cooperation (SSC), i.e. economic cooperation among developing countries (ECDC), has been recognised for quite a long time now and “a great deal of intellectual, political and organisational energy has been invested in South-South cooperation, much has been learned but so far not much has been achieved.”²

SSC aims at harnessing and augmenting the resources of developing countries to accelerate their development and reduce dependence on the North.

The development challenges which the South faces make SSC a much needed strategy. The need for SSC is reinforced by the growing integration of the developed countries, besides demonstrating the fruitfulness of such cooperation. Further, as the South Commission points out, “it has become apparent that the dynamics of economic growth in the North is no longer a reliable or sufficient motor for generating sustained growth in the South. The growth of world trade slowed down in the early 1980s and it is unlikely to return to the high rates of the 1960s. The share of the South in world exports also declined in the 1980s after reaching a peak in the 1978–80 period. Neither can the South rely on the North to provide it with technology on terms and conditions that suit the South, or to help it to generate its own

technology. In the area of finance, while every effort should be made to promote the Southward flow of surplus savings from developed countries, there is no assurance that this will take place in adequate volume. On the contrary, all the signs point to continuing stagnancy in capital flows from North to South in the years to come.”³

SCOPE OF ECDC

Scope of SSC is very broad.

The scope for economic cooperation among developing countries is immense. The South Commission observes:

“The variety of levels of development and the diversity of resource endowments among developing countries, which call for different routes towards liberation from underdevelopment, also provide expanded scope for South-South cooperation. By joint endeavours to use to the maximum their different resources of expertise, capital, or markets, all would be able to address their separate and differing needs more effectively, thereby widening their development options. South-South cooperation can provide important new opportunities for development based on geographical proximity, on similarities in demand and tastes, on relevance of respective development experience, know-how, and skills, and on availability of complementary natural and financial resources and management and technical skills. Additional possibilities for trading are also offered by the greater diversity in levels of development. By exploiting these openings for cooperation, the South as a group can also become stronger in its negotiations with the North.

Geographical proximity is one basis for cooperation, leading to bilateral, sub-regional, or regional action. Another situation in which countries may find it advantageous to work together is that where they can advance their common interest in a certain commodity or in developing a joint industry. In addition, political or cultural affinity can provide a rationale for cooperation. And in chosen fields cooperation can embrace the whole of the South. It is important that cooperation should not only take place between government agencies. Trading, industrial, and financial enterprises, trade unions, research organisations, non-governmental organisations, and the media of the South should all be encouraged and helped to contribute to the advancement of the collective cause of the South and its solidarity in action.”⁴

RATIONALE

SSC endeavours to enhance efficiency, accelerate development and improve the status of South vis-a-vis North.

The objectives of SSC are broadly three: To accelerate the pace of development; to increase economic efficiency; and, to strengthen the status of the South vis-à-vis the North

Acceleration of Pace of Development

One of the important objectives of South-South cooperation is to accelerate the pace of development of the countries of the South. Following are some of the important ways by which this can be achieved.

1. The relatively developed countries of the South can help other, particularly the least developed ones, through financial assistance. The capital surplus oil exporters and capital rich South-East Asian countries can play a very important role in this respect.
2. Transfer of technology between the countries of the South can help reduce the technological gap to a certain extent. Countries like India and the newly industrialising countries of Asia, like South Korea, Taiwan, Singapore and Hong Kong, can provide considerable technological assistance to

the developing countries. Further, there is considerable scope for technology transfer between the countries mentioned above. The South Commission points out that the technologies offered by Third World firms are often more labour-intensive, more suitable for utilising local resources, and less costly than similar technologies obtained from developed countries. Moreover, they are more suited to local levels of expertise and skill, and to local infrastructure and environmental conditions. The terms on which these firms transfer technology to others in developing countries appear to be generally more favourable than those stipulated by technology suppliers in the North. In addition, many Third World firms do not insist on having as high a share in the equity capital in joint ventures as transnationals from developed countries usually do. There is also much lesser fear of their exercising political and economic influence in host developing countries.⁵

3. An increase in trade between the developing countries may help alleviate several problems of the South like low price of the exportables, high price of the importables, inadequate demand for exportables, and balance of payments and foreign exchange problems.
4. South-South cooperation can also help ensure food security, as pointed out in a following sub-section.

Economic Efficiency Improvement

SSC in certain areas can help increase the economic efficiency of development activities through aggregation of resources and by increasing the efficiency of resource utilisation. There are a number of areas with considerable potential for such cooperation. There is a lot of scope for development in many areas by pooling together the resources and other collective efforts.

1. As pointed out earlier, technology transfers between the developing countries would enable developing countries to obtain technology in many field on much better terms than from the North. Such technology may also be more suited to the conditions of the LDCs than the technology of the North.
2. As the South Commission points out,⁶ joint production enterprises of the South can considerably broaden the range of the Third World's development options. They can facilitate the flow of capital, technology, and management and marketing skills to those developing countries that need them. Joint enterprises in strategic industrial sectors such as capital goods, fertilisers, agricultural machinery, pharmaceuticals, energy and petrochemicals, as well as those manufacturing products for meeting basic human needs, can lead to better use of the productive potential of the countries concerned and increase their trade.
3. Research is another area where joint efforts could have substantial benefits.
4. There is lot of scope for development by joint projects in flood control, irrigation, power generation, transport, communication, etc.
5. Considerable economic benefits could accrue from sub-regional and regional integration schemes.

Strengthening the Status of the South

The developments described above will help reduce the dependence of the South on the North and this would naturally enable the South to withstand the various sorts of pressures from the North. The solidarity of the South will increase the bargaining power of the South vis-à-vis the North. This should lead to a better North-South relationship.

SSC—EFFORTS, PROGRESS AND PROBLEMS

As the South Commission points out,⁷ South-South Cooperation (SSC) has been a goal of developing countries' foreign policy for close to four decades. It has evolved in response to changes within the South, as well as in the world economy and the South's relations with the North. Although a great deal of intellectual, political and organisational energy has been invested in South-South cooperation and much has been learned, so far not much has been achieved.

The idea of ECDC became very popular after the UN Sixth Special Session, in 1974, adopted the Programme of Action for establishing a *New International Economic Order* highlighting the importance of ECDC. The idea of ECDC, however, had been seriously considered even prior to this.

Although the idea of collective self reliance had its origin in the liberalisation and anti-colonial movements after the Second World War, the Afro-Asian Conference at Bandung in 1955, was the first

Although the idea of SSC is very old, the progress has been hindered by several adversities

indication of the entry of a self-aware South into the world arena. The founding of the Non-Aligned Movement (NAM) in 1961, and of the Group of 77 in 1964, marked the beginning of collective action by the South to advance its common interests. The subject of SSC has been seriously considered subsequently in many fora, national, sub-regional, regional and global. In the meanwhile, South-South economic links also came to be established—at bilateral, sub-regional levels—as developing countries turned to each other for mutual support in a bid to end their exclusive orientation towards North. A number of regional free trade associations have been established in Latin America and Sub-Saharan Africa. Schemes of regional cooperation have been formulated in other parts of the world like the ASEAN and SAARC.

There was considerable optimism about SSC in the 1970s. This period was marked by the thrust of OPEC on the world scene (for the first time, through united action, a group of developing countries wrested control of the production and pricing of a vital commodity from the North), and by increased activism of the NAM and the Group of 77 which led to the adoption by the UN General Assembly of the resolutions on the New International Economic Order and of the Charter of Economic Rights and Duties of States. There were also attempts to energise the various schemes established for economic integration and cooperation and to set up new ones.

The 1970s were a period of self-confidence and hope for the South. The decade saw improving commodity prices, lower real interest rates, OPEC surpluses, and buoyant growth in many developing countries. Starting from low levels, South-South trade grew dynamically, nearly doubling its share in total world trade (excluding fuels) between 1970 and 1981. Since the 1990s, there has been significant increase in SS trade. Financial flows among developing countries, including investment, increased. Several new regional financial institutions were established. The economic prosperity and capital surplus of OPEC members very significantly benefited a number of developing countries. The aid flow to the developing countries from these countries far exceeded, as a proportion of their GDP, the levels reached by any developed country, before then or ever since. In addition, some developing countries also received substantial investment from the OPEC members. Further, the OPEC countries offered employment opportunities for large numbers of workers from other developing countries, and markets for commodity and technology exports from the South. Nevertheless, the bulk of their imports continued to be from the North and most of the investments of their surplus funds were in the North.

The widening opportunities of the 1970s gave rise to a spate of initiatives to enlarge SSC, as is evidenced by, among other things, the establishment of several sub-regional organisations for economic cooperation in Latin America, Africa, and Asia.

The many plans and programmes for stepping up SSC could not, however, be effectively implemented. There were several unfavourable factors, including inadequate and ineffective institutions; lack of resources; and insufficient political commitment on the part of governments, who were preoccupied with other developmental matters. These weaknesses were to show themselves—and to grow—as the development crisis of the 1980s unfolded.

The foreign exchange and other crises forced the governments of most developing countries to concentrate on domestic economic management, short-term objectives, and their relations with the developed countries. Consequently, the SSC fell in their list of priorities.

As part of their adjustment programmes, the developing countries, except a few in Asia, sharply cut their total imports in the first half of the 1980s. This curtailment had a negative impact on the South-South trade. In addition, worsening balance of payments difficulties affected the earlier schemes for liberalising South-South trade and made the arrangements for financing, payments and clearing much less effective.

During the same period, disagreements and rivalries, conflicts and even wars among developing countries further sapped the South's ability to recover its strength, and limited the activities of important organisations of the South, including OAU and NAM. As a result, the South became weakened on the global scene. The developing countries were unable to resist the moves by the developed countries to change the global development agenda, to downgrade discussions and negotiations in those UN bodies where the G-77 and members of the NAM had previously deployed their collective strength most effectively, and to move many of the key development issues into the ambit of the Bretton Woods institutions and GATT, where the North was, and is, in full control.

On the whole, therefore, while moves to promote SSC have involved much effort and produced many initiatives and schemes, the practical results have been very limited.

Functional Areas of Cooperation

There is now a strengthened rationale for SSC because of several developments which call for collective action by the South to protect their interests vis-à-vis the North, to reduce their dependence on the North and to make use of the scope for accelerating the pace of development through collaboration in many areas.

There are a number of potential areas for SSC.

The building blocks for SSC are many and varied. According to the South Commission, the following functional areas deserve priority and sustained attention:

Finance Finance has proved to be the critical missing link in the entire range of South-South activities.

Schemes of cooperation whether in trade, production and investment, education, or science and technology, need adequate financial resources to be viable. Financial cooperation should cover such areas as multilateral clearing and payments arrangements; export credit financing facilities; regional and sub-regional development banks, multilateral institutions for financing and development assistance, particularly by the better of LDCs to the least developed countries; and, in the long run, a South Bank to meet the South's requirements of development assistance and trade finance. It has also been proposed to establish a debtors' forum to enable the debtor countries to consult each other and to coordinate their debt-management policies and procedures and to protect their common interest. Further, in view of the fact that several developing countries are not technically well equipped to negotiate effectively and on an equal footing on the complex issues with the IMF and the World Bank, it has been suggested that a standing group be set up consisting of experienced advisers whose services could be provided to any developing country seeking advice in its negotiations with these institutions.

Trade For increasing the South-South trade substantially, it is necessary to revitalise and enlarge the regional and sub-regional cooperation, while focussing attention on strengthening of inter-regional trade within the South. Measures to be taken for this purpose include strengthening of the Global System of Trade Preferences (GSTP); increasing cooperation among the state trading agencies; promotion of countertrade; improving the trade information system; and cooperation in commodity trade through such measures as setting up of producers' associations with a view to managing supplies and/or intervening in the market.

Industry and Business There is a lot of scope for SSC in the field of industry and business. Several developing countries have achieved very significant success in many sectors of the industry and business and their expertise could be of considerable assistance to others. There is also considerable scope for furthering the development of these better off developing countries through collaboration among themselves. The appearance of multinational firms based in the South with a lot of technological potentialities adds a new dimension to SSC.

The benefits of the developing countries' technologies over that of the North has already been mentioned earlier. Besides these, joint ventures between firms in the South would reduce the South's dependence on the North and strengthen its bargaining power in dealing with the North and its transnational corporations.

There are a number of very important industries with considerable scope for such joint ventures. The pharmaceutical industry, for example, offers ready scope for joint ventures to produce generic drugs for basic health needs. Besides other benefits, this would help lower the costs of pharmaceuticals and reduce the dependence on the North in meeting an important basic need in the South.

Services Cooperation in services is indispensable to the South's efforts to protect its collective interests vis-a-vis the powerful industries of the North. Policies for increasing cooperation in services sector should have the following objectives: The creation of an adequate infrastructure, particularly in telecommunications and informatics, and its integration into the global network. The development of producer services and the tightening of their links with sectors of material production and with other sectors. The improvement of the trade balance in services to be achieved by expanding exports of services and rationalising imports.

Science and Technology South-South collaboration is important for scientific and technological education, for higher training, for scientific research, for building-up of technological capabilities and for withstanding the various pressures from the North.

The Third World Academy of Sciences, founded in 1983 as an international forum for bringing together distinguished men and women of science from the South, aims at promoting basic and applied sciences in the Third World, facilitating contacts among scientists from developing countries, strengthening their research and furthering relations between their scientific institutions. The establishment of the Centre for Science and Technology of the Non-Aligned and Other Developing Countries in India was another welcome event. The Centre can play an important role in identifying those core activities in scientific and technological research which may be jointly sponsored and in coordinating work in these areas.

Efforts should also be made to make use of the expertise of the large number of scientists and technically qualified people from South who are working in the North.

Environment and Development Environmental issues are a global set of issues to which the South must respond collectively, in negotiating and interacting with the North. They also need to act collectively in the regional context in managing shared resources and in dealing with common problems.

The management of shared water resources is an instance where bilateral, sub-regional, and regional environmental cooperation in the South is required. Similarly, the management of their energy systems and needs is a critical determinant of the developing countries' ability to evolve a sustainable process of development. There is also a need for cooperation in the use of remote sensing techniques to assess natural resources and in the use of resulting data.

Food Security Food security is vital for the development of the South—from the economic, social and political points of view. The South should, therefore, become increasingly self-reliant in satisfying its food requirements. This may be achieved by collaboration in intensifying food production and agreements between food exporting and food deficit countries.

The Arab Authority for Agricultural Investment and Development provides an example of collective effort in this direction.

Risk-pooling arrangements, such as the regional pooling of food stocks, can reinforce national efforts to achieve food security. Already, the members of ASEAN and SAARC have agreed to a limited pooling of food stocks to meet emergency needs in their region.

There is a need for greater cooperation in agricultural research at the regional and sub-regional levels. Biotechnology is an area which demands considerable attention. Cooperation, particularly within regions and sub-regions in the South, holds much promise on account of their common genetic bases and ecosystem. Further, it is only through collaboration among themselves that developing countries will be able to resist the pressure from the North and the MNCs that rely mostly on the gene pool from the South in their global drive to exploit biotechnology to their commercial advantage.

Transport and Other Infrastructural Links One of the South's colonial legacies is a pattern of transport and communication that is heavily oriented towards links with the North. This has been an important obstacle for furthering ties between the countries of the South, including those with common borders. Improved transport, communication, and infrastructural facilities among the countries and regions of the South are very vital for reducing the South's dependence on the North and creating new opportunities for development, industrialisation and integration.

Information and Communications Efforts should be made to disseminate regular information and news on the situation in the South and to publicise through media various forms of South-South cooperation to the public. At the same time, the existing cooperation among the media of the developing countries should be greatly intensified and diversified, and the necessary infrastructural links improved. Action on these lines could greatly contribute to the forging of horizontal links within the South, to reducing dependence on the North-based global information services, and diversifying sources of information in developing countries.

People to People Contacts Inter-governmental and inter-institutional cooperation and links in the South need to be supplemented by broadbased interactions between civil societies and peoples of developing countries. Programmes of social interactions may include organisations representing self employed, neighborhood groups and non-governmental voluntary organisations, for these have valuable experience and expertise to share on how to get organised and how to deal with daily problems of economic, physical and environmental survival in developing countries.

GSTP

Expansion of trade among developing countries is viewed as an important aspect of ECDC. It is felt that trade preferences can help achieve expansion of South-South trade.

Although the UNCTAD gave its sanction to scheme of trade preferences as far back as 1968, it was not until 1979 that the Group of 77 drew an action plan for collective self-reliance. It took three more years for the Group to formally adopt a programme of Global System of Trade Preferences (GSTP).

The Group of 77 Ministerial Conference, held at New Delhi, in July 1985 resolved to complete the first round of negotiations of GSTP by May 1, 1987. The agreement reached at the Conference included

The objective of GSTP is to increase South-South trade by preferential trade.

an across-the-board tariff preference margin of 10 per cent, the removal or reduction of non-tariff barriers, selection of specific sectors and products where trade preferences could be extended as well as trade creating, production sharing and marketing arrangements. The GSTP became effective

in April 1989. In order to ensure that all participants benefit equitably, it takes into account the differences in the levels of industrial and economic development and trade, and contains special provisions to favour the least developed countries. The scheme is seen as complementing existing regional and sub-regional preferential trading arrangements.

The inordinate delay in formulating and implementing a meaningful scheme of GSTP is an indicator of lack of unity of purpose and will among the developing countries. Curiously, the Generalised System of Preferences (GSP), designed by major industrialised countries to give tariff concessions in favour of developing countries to facilitate easier access for the latter's exports to the former, particularly of manufactured and semimanufactured goods, came into being much faster than the GSTP. Indeed, the "... problem of trade preferences among developing countries is a complex one. These countries form an extremely heterogeneous lot with great diversities at levels of development and industrialisation, foreign trade regimes, and, not the least of all, approaches to development."⁸ Further, however effective the GSTP may be, it "can only be one of the many instruments for promoting South-South financial and monetary cooperation, new payment arrangements and joint ventures in production and marketing. On most of these issues the developing countries have made little progress in the past decade. Unless they display a unity of purpose and sense of urgency backed by strong political will, South-South trade will continue to remain on a weak wicket."⁹

The South Commission, which pointed out that as of then, GSTP was largely of symbolic value, observed that the challenge was to evolve a coherent strategy so as to ensure that GSTP will cover a substantial proportion of the intra-South trade in future. The Commission points out that in order to make GSTP more effective in expanding trade, the South needs to give careful consideration to the following closely related policy matters:¹⁰

1. Respect for the principle of mutual advantage implies the establishment of institutional arrangements to ensure equitable sharing of costs and benefits among countries with different levels of industrial and economic development and external trade.
2. Once products with the greatest potential for trade expansion are identified and made eligible for trade preference, arrangements must be made to ensure that they are not subjected to non-tariff measures of trade control.
3. The scheme should be flexible so as not to impair the effectiveness of regional and sub-regional preferential schemes. This risk could be mitigated to some degree if existing scheme were deepened simultaneously. The GSTP would then help to reinforce existing schemes of bilateral, sub-regional, and regional trade, and also facilitate an expansion of inter-regional, multilateral, and bilateral trade.

4. Any strategy for the expansion of intra-South trade would have to take into account the long-term nature of such an exercise. The expansion of the GSTP should be negotiated step-by-step and it should be subject to periodic reviews. The aim should be both to widen the range of concessions and to increase the number of participating countries.
5. A strong technical service, with adequate financial resources, needs to be established to support the process of implementation and to promote the scheme's expansion. This service should be able to work out the costs and benefits to members of deepening the system of preferences, and to persuade non-members of the benefits to be derived from participation. It should be given the function of drawing up a time table and programme of action for the future.

INDIA'S ROLE IN SSC

India has a very important role to play in the South-South cooperation. Dr. Manmohan Singh was the Secretary to the South Commission.

Although India is suffering from several problems of severe magnitude such as poverty, unemployment, etc. it is much better placed when compared to many other developing countries and has the potential to help others, particularly the least developed ones, in many fields, and with such potential India has the moral responsibility to do so. Being one of the first countries to become independent and having made commendable progress in many fields, India should, in fact, play a leading role in the South-South cooperation.

India has indeed been playing a leading role in organising the solidarity of the developing countries and to uphold their self respect since her Independence.

India's first Prime Minister, Jawaharlal Nehru, who was a driving force of the Non-Aligned Movement, played a great role for the cause of the developing countries. Some of those who succeeded him, particularly Indira Gandhi and Rajiv Gandhi, also left their own imprints on the collective efforts of the South.

The resourcefulness and development dynamism enable India to play an important role in SSC.

Despite the several economic problems confronting India, it can provide considerable assistance for the economic development of many LDCs. India's GDP is the third largest among the developing countries (it is also larger than the GDP of many developed countries). India has one of the largest pool of technical and scientific manpower in the world and is one of the important industrial powers of the world.

Although many deficiencies and problems still exist, India has a very broad based and diversified industrial sector and has built considerable expertise in fields of agriculture, industry, infrastructure development, management, etc.

With such a diversified and developed resource base, India could be of considerable assistance to many developing countries. India has, of course, extended various kinds of assistance—financial, technical, scientific to many countries. Such cooperation may be enlarged.

There is also significant scope for joint ventures with countries with similar levels of development as well as with those which are more advanced than India in several fields, like the newly industrialising countries of Asia.

Another fruitful area of cooperation is joint projects in the fields of flood control, irrigation, power generation, transport, tourism, etc., with neighbouring countries.

Earnest efforts should be made to make use of the scope for collaboration in the fields of telecommunications, education, training and research.

South-South trade is another very important area of cooperation. Steps should be taken to increase the intra-South trade and to regulate the intra-South competition with respect to their common export products.

India has been playing a very active role in several forums of the South and in arguing for the common interests of the developing countries in relevant international forums.

India has actively participated in the South Commission. The largest contribution for financing the work of the south Commission came from India and Kuwait (\$5,00,000 each).

India has a very important role to play in the SAARC, being the most resourceful member of the Association. Political hostilities of some of the neighbours, however, pose problems.

One of the important contributions which India can make to the South-South cooperation is the initiative and leadership which the nation can provide to mobilise the SSC.

INDIA AND REGIONAL COOPERATION

Regional cooperation schemes began to be considered seriously by India rather recently. At present,

India played a leading role to form the SAARC.

India is a member of SAARC Preferential Trading Agreement (SAPTA), Indian Ocean Rim Association for Regional Co-operation and the BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Co-operation). Moreover, it is a signatory to several bilateral trading agreements, the recent ones being those with

Thailand and Singapore. As mentioned in the previous chapter, a Framework Agreement for comprehensive economic cooperation was also signed between India and ASEAN during October 2003.

There is a view that, of late, India has become overenthusiastic about PTAs and FTAs and agreements are entered in to in haste without properly evaluating the pros and cons. It is feared that the absence of level playing field between India and countries like Thailand and Singapore can cause unjustifiable problems for several Indian industries. Further the excess capacities in some industries in such countries can also cause problems for Indian industries. The large investments already made by foreign companies in some industries such as automobile, in countries like Thailand may result in the development of Thailand as a production base at the expense of India. Moreover, it is alleged that India's free trade and preferential trade partner countries are used by others as a route to enter the Indian market in the absence of an effective monitoring system. Discussions with all concerned and proper home work are prerequisites for decision making on RIAs. It would be appropriate to cite here an observation by the WTO: "Vested interests within national bureaucracies could also drive RTA formation. Once the bureaucratic machinery has been set up to negotiate regionally, there is a natural temptation for those involved to seek to perpetuate their functions by creating conditions for the negotiation of successive agreements. There is perhaps also a sense in which governments have come to see the negotiation of trade agreements as a natural accompaniment of economic diplomacy. With regional agreements becoming so ubiquitous, the default question asked seems increasingly to be why a regional agreement does not exist with a trading partner, rather than why such an agreement should exist. To the extent that this tendency informs policy, the proliferation of unhelpful, complicated agreements of questionable economic value is a risk that should not be ignored."¹¹

Some RIAs involving India are detailed below.

SAARC

The long felt desire for cooperation among the countries of South Asia began to receive considerable support since the early 1980s and the South Asian Association for Regional Cooperation (SAARC) comprising seven countries, namely, India, Pakistan, Bangladesh, Nepal, Sri Lanka, Bhutan and the Maldives, was formally launched in December 1985. Late Rajiv Gandhi, the then Prime Minister of India, described the opening day of the SAARC Summit as an important day in the history of resurgent Asia when seven neighbours had come together in an act of faith. He called upon the developing countries to make a conscious effort to remain outside the vortex of tensions and conflicts which posed a serious threat to their progress and prosperity. The participants of the Summit affirmed that the birth of SAARC was a logical response to the problem facing the region. The Secretariat of SAARC is at Kathmandu, Nepal.

Objectives and Principles

The fundamental goal of SAARC is to accelerate economic and social development through optimum utilisation of the collective human and material resources.

According to Article I of the Charter of the SAARC, the Objectives of the Association are:

1. To promote the welfare of the people of South Asia and to improve their quality of life.
2. To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potentials.
3. To promote and strengthen collective self-reliance among the countries of South Asia.
4. To contribute to mutual trust, understanding and appreciation of each other's problems.
5. To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.
6. To strengthen cooperation with other developing countries.
7. To strengthen cooperation among themselves in international forums on matters of common interest.
8. To cooperate with international and regional organisations with similar aims and purposes.

Article II of the Charter Lays Down the Following Principles:

1. Cooperation within the framework of the Association shall be based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other States and mutual benefit.
2. Such cooperation shall not be substitute for bilateral and multilateral cooperation but shall complement them.
3. Such cooperation shall not be inconsistent with bilateral and multilateral obligations.

Profile of the SAARC Countries

With over 1353 million inhabitants (in 2001), the SAARC accounts for over one-fifth (22 per cent in 2001) of the world population. The density of population in the SAARC countries, which have only about 3.3 per cent of the world's land area, is very high—nearly double the average density in the low income economies taken as a whole. The density of population in some of the countries, Bangladesh and Maldives, are among the highest in the world. The population in the SAARC region has been growing very fast as is evident from Table 14.1.

SAARC countries are characterised by low per capita income, high population growth and density and heavy dependence on primary sector.

Table 14.1 SAARC Members—Some Basic Indicators

Country	Population			Area Thousand sq km	Gross National Income	
	Millions 2005	Average annual % growth 2000–2005	Density people per sq km		Billions of dollars 2005	Per capita dollars 2005
India	1095	1.5	368	3287	793	720
Pakistan	156	2.4	202	796	107	697
Bangladesh	142	1.9	1090	148	66	470
Nepal	27	2.1	190	147	7	270
Sri Lanka	20	0.5	303	66	23	1160
Bhutan	0.9	2.6	20	47	0.8	870
Maldives	0.3	2.5	1097	0.3	0.8	2390

Source: World Development Report 2007 and Manorama Yearbook 2003.

A major share of the world's poor live in these countries. All these are low income economies.

India has about three-fourths of the total population of SAARC countries. On the other extreme is the tiny country of Maldives with a land area of 298 sq km, inhabited by about 3 lakh people. Bhutan also is a comparatively small country, with a total population of about 8 lakh.

While Sri Lanka is an island and Maldives an archipelago, Nepal and Bhutan are land-locked countries for whom the easiest entry to the sea routes is via the ports of India and Bangladesh.

Among the SAARC members, Maldives has the highest and Nepal the lowest per capita income.

In spite of the growing importance of service and industrial sectors in these countries, a majority of population is still dependent on agriculture.

Some of the member countries, like Pakistan, Bangladesh and India, have been receiving large amounts of remittances from the nationals working abroad, particularly in the Middle East.

The share of this region in the world trade is only about one per cent. All the major countries of the region have trade deficit.

Intra-regional trade is an important means of promoting regional economic cooperation. In South Asia, however, such trade has been at a very low level. Statistics for recent years show that India accounts for a very large share of the total intra-regional exports. However, the share of India's intra-regional exports as a percentage of its total exports is very low. It may be noted that the total exports of India is more than twice the aggregate exports of all other members of the Association. The share of intra-regional trade in the total world trade of Nepal is exceptionally high because of its large volume of trade with India. India's exports to the SAARC countries increased marginally from 3 per cent in 1990–91 to 4.6 of the total in 2000–01, as against the increase from less than 12 to 19 per cent to other Asian developing countries with whom India does not have any trading agreement. During the same period, India's imports from SARRC crept up from 0.5 to 1.1 per cent whereas from other Asian developing countries it increased from 13.5 to nearly 17 per cent.

Intra-regional trade of SAARC is insignificant.

Table 14.2 Structure of Production

(Value added as percentage of GDP)

Country	Agriculture		Industry		Services	
	1965	2005	1965	2005	1965	2005
India	44	19	22	28	34	54
Pakistan	40	22	20	25	40	53
Bangladesh	53	21	21	22	36	58
Nepal	65	40	11	21	23	38
Sri Lanka	28	17	21	26	51	57

Source: World Development Report 1993 and 2007.

Table 14.3 Trade, Aid and Finance

Country	Merchandise trade \$ billions (2005)		Manufactured exports as % of total manufactured exports (2004)	High technology exports as % of total manufactured exports (2004)	FDI \$ millions (2004)	ODA \$ per capita (2004)	External debt \$ billions (2004)
	Exports	Imports					
India	89.8	131.6	73	5	5335	1	122.7
Pakistan	15.9	25.3	85	1	1118	9	35.7
Bangladesh	9.2	13.9	90	0	449	10	20.3
Nepal	0.8	1.9	74	0	0.0	16	3.4
Sri Lanka	6.3	8.9	74	2	233	27	10.9

Source: World Development Report 2007.

As Table 14.3 shows, manufactured exports account for a very large share of the exports of SAARC. However, the share of high technology exports in their total manufactured exports is either nil or very negligible. Although manufactured products predominate the export sector, primary products also contribute significantly to their exports. Among the SAARC countries, India's exports are relatively diversified.

Potential Areas of Cooperation

There are many potential areas of cooperation. Having started with some non-economic areas such as sports, arts and culture, the process of cooperation in the SAARC has moved to economic areas. Broad areas identified are:

1. Agriculture
2. Rural development
3. Meteorology

4. Telecommunications
5. Scientific and technological cooperation
6. Health and population activities
7. Transport
8. Postal service
9. Sports, arts and culture
10. Control of drug trafficking
11. Women in development

A regional plan called SAARC-2000 Integrated Plan to provide basic needs such as shelter, education, and literacy to over one billion people of the region by the turn of the 20th century was also suggested.

Identifying the broad areas of cooperation is just a preliminary step. To make the idea of cooperation practical and useful, projects which are viable, feasible and beneficial should be taken up. Implementation also involves identification of suitable firms, private or public, and organisations and also individuals in several cases. Panchamukhi observes: "It is now being recognised that economies of scope prevail as a more significant aspect than the economies of scale. The real question is one of indentifying such activities and facilitating the prospective entrepreneurs to undertake them. Another cost-effective approach of using the region is through fostering sustained networking among the institutions which are already existing in the countries of the region. A network of the chambers of commerce of the region could be a good starting point for bringing the trade and industry circle face to face for working out the cooperation process. The most fruitful networking would be in terms of linking the R and D centres in select fields."¹²

Problems

There are a number of problems which confront the SAARC.

1. Border disputes, ethnic issues and religious, political outlook and affiliations, etc. cause mutual distrust among some of the members of the Association and these prevent emotional closeness and, as a consequence, adversely affect the pursuit of cooperation.
2. One important problem that limits the scope of economic cooperation is that the economies of the member countries are similar rather than dissimilar. In other words, complementarity, an important contributor to the success of economic integration, is limited.
3. As the member countries have been emphasising very much on the promotion of exports to the hard currency areas, intra-regional trade has been relatively neglected.
4. Some of the member countries are important exporters of same type of products and are, therefore, competitors in the international market. For example, this is true of India and Bangladesh with respect to jute, and India and Sri Lanka with respect to tea. Similarly, textiles and clothing are very important export items of some of the members.
5. Due to the differences in the levels of development and economic strength, there is a feeling that the relatively advanced member countries would be the major beneficiaries of the cooperation and the least developed among them may not benefit much. As a matter of fact, the least developed members could enormously benefit from others, particularly from India, if proper schemes of cooperation are pursued.

SAARC is beset with problems.

6. Due to foreign exchange problems, these countries, generally, tend to restrict imports and this comes in the way of intra-regional trade too. Further, revenue considerations may discourage governments the abolition/reduction of tariffs even on intra-regional trade.
7. Underdevelopment of transport, communications, payment and clearing arrangements, institutional inadequacies etc. also hinder expansion of economic relations.

Analytical and Policy Issues

The SAARC, with countries representing very diverse political, ethnic and cultural backgrounds; different levels of economic development; and numerous economic challenges, raises a number of issues. Panchamukhi expresses this very succinctly: “Economic integration in this part of the world raises a number of analytical and policy issues. Can countries in similar stages of development identify and foster enough complementarities for promoting cooperation? Can countries with different sizes and different level of economic power cooperate with each other with equal status for each member? Is it feasible for the countries which have large pockets of poverty, inadequate capital and scarce foreign exchange resources, large population pressure, etc. to cooperate with each other for mutual advantages? How could the countries which are competing with each other convert their competitive environment into one of complementarities? How should one effect harmonisation in production programmes so that more complementarities in trade could be generated in the future periods? How should the countries share the benefits of cooperation so that sacrifices are compensated by benefits in totality? How should one identify viable regional projects so that, the primary resources of the countries of the region could be more effectively exploited? What kind of coordination among the financial institutions, service sectors, information systems, chambers of commerce, non-governmental organisations, etc. is essential for fostering cooperation? How to ensure sustainability of development with the preservation of environmental and ecological balance in the region along with process of industrialisation and rapid development? What kind of preferential trading regime, the countries could evolve for promoting intra-regional trade flows? Is it possible to keep the formation of a free trade area and customs union, or a fully integrated common market, as a viable goal in the region?”

Economic integration of SAARC region raises a number of analytical and policy issues.

These are some of the analytical questions, which deserve attention by the professional economists, technology experts, trade and industry circles and the policy-makers of countries in the region. Unfortunately, analytical and empirical work on the various issues of economic cooperation has been very inadequate, if not totally absent. Obsession with the impediments created by the political factors has over-shadowed any attempt for objective analysis of the potentials and the advantages of fostering economic cooperation in the region. While political factors, impeding the process of cooperation are important, it is feasible to argue that the political impediments could be forced to the background when once the advantages of cooperation are recognised at the levels of the policy-makers and the trade and industry circles. It is here that the role of the professional economists becomes relevant. Researchers and teachers in our universities and research institutions should take more interest in the various issues that need to be analysed for promoting cooperation in the region.”¹⁴

See the chapter on *Economic Integration* for a brief account of the integration schemes (and their problems) in developing countries.

Role of India

India has a dominant position in the SAARC—demographically, geographically and economically—as is clear from Tables 14.1 and 14.3.

Statistics for the past show that India accounts for over 40 per cent of the exports and over 20 per cent of the imports of the intra-regional trade. However, because of the very large volume of India's world trade in comparison with the total intra-regional trade, the share of India's intra-regional trade in its total world trade has been very low—about 2 per cent of the exports and less than one per cent of the imports.

Due to the commendable technological and other economic capabilities India has achieved and because of its gigantic size, India has a special role to play in the SAARC. India has a broad, diversified and relatively well developed industrial sector and has built up considerable scientific knowledge and expertise in several other areas like space science, agriculture, medical science, infrastructural development, electronics, telecommunication, etc. This strength of India could be of considerable help to the fellow members of the SAARC. This could be made use of for extending aid to other countries as well as for establishing joint ventures and supply of technology on commercial basis.

Although India too suffers from a number of economic problems, it is in a position to help other countries, particularly the least developed and tiny ones, of the Association. It may be noted that the total

Being the economic power-house in SAARC, India has a great role in SAARC.

population of Maldives (only three lakh) and of Bhutan (8 lakh) is not even half of the population of Bangalore where the second SAARC Summit was held in 1986! This shows that even an amount which is a very negligible share of the Budget of the Government of India would be a considerable one for Maldives or Bhutan. India has been providing considerable assistance to some of the member countries. It could perhaps step up its aid to the needy members, owning special moral responsibility because of its special position, even while it has its own problems. There is a lot of scope for joint ventures in the fields of industry and business. Considerable scope exists for cooperative ventures in agricultural development, energy development, transport and tourism, communications, etc.

There is also need for cooperation in education, training and research. While India could offer lot of assistance to others in these areas, India could also benefit by joint projects in research and development and by mutual exchange of scientists and other experts.

Indigenous medicine and system of treatment is an area with considerable scope for cooperation in research and development, and also practical application. The stage of development India has reached in the pharmaceutical industry could also be made beneficial to other countries.

There is also scope for cooperation in the field of foreign trade. For example, unhealthy competition in trade can be avoided and collective measures to strengthen the market power could also be adopted. The expertise of trading houses, including that of the state trading organisation like STC and MMTC, could be of help to other countries. These public sector organisation have done offshore trading (i.e. sourcing supplies from foreign countries for third countries) for some of the members of SAARC. Indian firms may also establish joint ventures, or other forms of enterprises in other countries in the export oriented sectors (for example, in the fisheries sector of Maldives).

Several hurdles, however, exist. An important one is the hurdle to the members becoming emotionally more closer, which is a must for the success of the Association. The dominant position of India, by the virtue of its resource endowments and impressive developments in many fields, should, however, be considered as an asset, but this is not always well taken by some of the members. Border disputes, ethnic issues, etc. often create problems. India has both the advantages and disadvantages of all other members being its neighbours.

It is also very much necessary that India, being in a dominant position to play a leading role, should consistently show the required political, emotional and diplomatic maturity and cooperative drive. As, Panchmukhi rightly observes, “regional cooperation is a multifaceted process. The national perspective, the regional perspective and the international perspectives signify its multiple facets. Success in regional cooperation is largely influenced by the nature of harmony that is inducted in these multiple facets. This harmony is fostered partly by conscious policy initiatives at the government level and partly by the removal of constraints that impede the process of cooperation.”¹³

SAPTA

The Sixth SAARC Summit held in Colombo in 1991 strongly mooted the idea of a SAARC Preferential Trading Arrangement (SAPTA) and the Foreign Ministers of all the member states (India, Pakistan, Bangladesh, Nepal, Sri Lanka, Bhutan and Maldives) signed the Agreement on 2nd April 1993 during the Seventh SAARC Summit in Dhaka. SAPTA became effective from 7th December 1995.

1. Overall reciprocity and mutuality of advantages.
2. Step-by-step negotiations and extension of preferential trade arrangement in stages.
3. Inclusion of all types of products-raw, semi-processed and processed.
4. Special and favourable treatment to Least Development Countries (LDCs).

The special treatment of LDCs includes allowance of favourable percentage points, application of relaxed rules of origin, favourable terms for technical assistance, duty-free access, deeper tariff preferences, removal of non-tariff and para-tariff barriers, negotiation of long-term contracts to support sustainable exports and provision of special facilities with regard to shipping and documentation, preparation and establishment of industrial and agricultural projects, training facilities and support to export marketing, etc. possibly linked to cooperative financing and buyback arrangements.¹⁵

SAPTA is a landmark development in the progress of SAARC.

The share of intra regional trade in the total trade of SAARC countries is very insignificant. This has not increased even after the formation of the SAARC. There was, in fact, some fall in the intra-regional trade after the coming into effect of the Association. The share of individual countries' trade within the region varies. While the share of the region in the total exports of Maldives, Nepal and Bangladesh is fairly high, that of India and Pakistan is very low.

The share of the region in the members' imports also shows a skewed pattern. While only about 0.5 per cent of India's imports originate from SAARC countries, it is fairly high in respect of Nepal (18.3 per cent in 1994). While India and Pakistan have been enjoying trade surplus in the intra-regional trade, all others have been confronting deficit. High levels of tariff and non-tariff barriers have been affecting the trading between SAARC countries.

All the SAARC countries have implemented substantial reduction in tariffs and also modified their tariff structures as part of the on-going economic policy reforms. These changes have been carried out with a view to improving the efficiency of domestic industries. This process in itself should help the expansion of intra-regional trade. But the presence of non-tariff barriers in different forms are acting as constraints to realise the potential for trade expansion.

The SAARC Preferential Trading Arrangement (SAPTA) is expected to play an important role in boosting the intra-regional trade. According to the country perspective exports on SAPTA, this preferential arrangement would benefit SAARC countries due to the following reasons.

1. The countries can substantially reduce the transport and transit cost because of geographical continuity among the members.
2. Capital goods produced within the region may be more compatible to the factor endowment of member states than those imported from developed countries.
3. The increasing competition among the member states would result in technical efficiency in existing industry as marginal firms might be forced to reduce their cost. Resources will be reallocated away from less efficient firms and monopolies protected by the tariff wall will no longer be in a sheltered position.
4. As economic ties get stronger and countries become committed to common economic goals, political problems will gradually recede. When economic benefits gain significance, amicable environment may evolve for dissolving political problems.
5. Regional cooperation may also pave the way for regional banks or corporation which might be influential in promoting regional investment in larger projects.

It is intended to develop SAPTA into a South Asian Free Trade Area. (SAFTA). The SAARC Council of Ministers which met in December 1995 reached an agreement to realise the objectives of SAFTA, preferably by the year 2000 but not later than 2005.

Today, SAARC countries' share in total world trade is not even one per cent, and their trade among themselves lingers below three per cent of their total foreign trade. This compares poorly with more than 60 per cent for intra-European Union trade of their global trade and nearly 40 per cent for North America, and East Asia.

Although some liberalisation measures have been taken following the establishment of SAPTA, some of them are regarded as flawed or inadequate. It is even suspected that the concession exercise is just so much playing to the gallery. Consider, for example, the fact that the majority of the products offered concessions by members are not being imported by them at all. It is, therefore, not surprising that preferential imports cover only a very small percentage of the total intra-regional trade.

It is also argued that the approach of SAFTA to introduce trade concessions, initially, on a product-by-product basis is a drag on trade liberalisation. There are, however, provisions in the Agreement for across-the-board tariff reduction as well as for adopting a sectoral approach to reduction in tariffs. The product-by-product approach may be justified on the ground that the developing countries need to exercise more caution in the matter of trade liberalisation. Further, members will not benefit from tariff concession on many products as they already have equal, or better, levels of tariff preferences and market access under other arrangements.

It is also pointed out that many items with large intra-trade potential are not extended the trade preferences.

There is a view that what is needed is a customs union and not a free trade area because a free trade area has an important problem that goods from a non-member country may enter a member country and from there freely flow throughout the free trade area causing damage to the domestic industry/agriculture of some of the members. The 'rule of origin' designed to check this does not work in practice, effectively.

INDO-LANKA FREE TRADE AGREEMENT

According to the Bilateral Free Trade Area Agreement signed by India and Sri Lanka on 28 December 1998, a large number of items will be eligible for duty free trade. India has offered to permit as much as

1000 items on zero duty from Sri Lanka and Sri Lanka will allow duty free imports of 900 items from India.

The main objectives of this free trade agreement, according to Its preamble, are the following:

1. To promote •through the expansion of trade •the harmonious development of the economic relations between India and Sri Lanka.
2. To provide fair conditions of competition for trade between India and Sri Lanka.
3. In the implementation of this agreement both the countries would pay due regard to the principle of reciprocity.
4. To contribute, in this way, by the removal of barriers to trade to the harmonious development and expansion of world trade.

The agreement also provides for safeguard measures under which if any product, which is the subject of preferential treatment, is imported into the territory of a contracting party in such a manner or in such quantities as to cause or threaten to cause serious injury in the importing country to the agreement, the importing country with prior consultations except in critical circumstances suspend provisionally without discrimination the preferential treatment accorded under the agreement.

The contracting parties are also free to apply their domestic legislation to restrict imports in cases where prices are influenced by unfair trade practices like subsidies or dumping. This agreement would have long-term consequences as other members might try to “multilateralise” it within the SAARC region by demanding similar preferential treatment within the trading arrangement bloc.

India-Lanka free trade agreement presents some risks too.

It is feared that the India-Sri Lanka Free Trade Agreement would very adversely affect the farmers of India as several cash crops would enter India duty free from Sri Lanka depressing their domestic prices.

As India is a very large market, the Free Trade Agreement is likely to benefit Sri Lanka a lot and the benefits to India may not be much as Sri Lanka is a small market.

INDO—SINGAPORE CECA

On June 29, 2005, India and Singapore signed a Comprehensive Economic Cooperation Agreement (CECA), paving way for an integrated package governing trade in goods and services, an agreement on investments, mutual recognition in services, cooperation pact in customs, science and technology, education, e-commerce, the media and intellectual property. The CECA took effect from August 1, 2005.

According to the Agreement, India would gradually cut tariffs on imports from Singapore to zero over a five year period. Singapore has zero customs tariff on all products except six and she has agreed to bind all their tariff lines at zero customs duty for India.

To prevent third-country imports piggybacking on preferential route, strict rules of origin (ROO) have been prescribed, along with value addition of 40 per cent and certain sufficient manufacturing operations to be performed for grant of originating status.

CECA goes beyond free trade as it has other elements such as special visa arrangements, agreement on investment and cooperation pact in several areas. A significant benefit to India is that Singapore has agreed to allow movement of natural persons (mode 4 service) with 120 professions having been recognized in this respect.

The CECA is expected to boost FDI and FII flows from Singapore to India.

The CECA is widely acclaimed as a win-win situation for both the nations. It, however, has two problems. There is a great risk of third country products, like cheap Chinese products, entering India duty-free through the primarily trading nation Singapore. Secondly, Indian firms have the disadvantage the uneven playing field.

Recent Developments

In India's PTAs/FTAs/RTAs, the neighbouring countries of India (like Bangladesh, Sri Lanka, Bhutan and Nepal), figure again and again. In case of most of the RTAs/FTAs which have been implemented, value of exports is generally higher than imports. Import and export growth rates increased immediately after the RTAs/FTAs were implemented, due to unshackling of restrictions, though import growth was generally higher. Studies also show that import growth of preferential items were higher than their export growth. However, there are other benefits like greater opportunities for investment and services exports. This also indicates that India has to move more towards CECAs, which are FTA plus arrangements.

India has come to pursue RTAs more seriously.

Although, in the past, India had adopted a very cautious and guarded approach to regionalism, recognising the fact that RTAs would continue to feature prominently in world trade, India began concluding, in principle, agreements, and even moving in some cases, towards Comprehensive Economic Cooperation Agreements (CECAs). The major recent FTAs/RTAs/CECAs efforts include India-EU Trade and Investment Agreement Negotiations; India-Japan Economic Partnership Agreement (EPA/CEPA) EPA/CEPA Negotiations; India-Korea Comprehensive Economic and Cooperation Partnership Agreement (CECPA); Framework Agreement on the Bay of Bengal initiative for Multi-sectoral Technical & Economic Cooperation (BIMSTEC FTA); Asia Pacific Trade Agreement (APTA); India-Chile Framework Agreement on Economic Cooperation; PTA/CECPA between India & Mauritius; Framework Agreement with South Africa Customs Union (SACU); India-Israel Preferential Trade Agreement; and, Framework Agreement on CECA between ASEAN.

Further, besides the Joint Task Force between India and China, Joint Study Groups (JSGs) have also been set up for examining feasibility of CECA between India-Brazil-South Africa; India-Russia; and India-Malaysia.

SUMMARY

As the South (i.e. the developing countries) has been at a disadvantageous position in the international economic system, there has been a growing realisation that the developing countries (i.e. the South) should foster strong cooperation among themselves to reduce their dependence on the North (i.e. developed countries) and to improve their standing vis-à-vis the north. It is propagated that **South-South Cooperation** (economic cooperation among developing countries) can help accelerate the pace of development of the countries, increase the economic efficiency of development activities through aggregation of resources and by increasing the efficiency of resource utilization, and can strengthen the status and bargaining power of the South vis-à-vis the North.

The important functional areas of SSC are finance; trade; industry and business; services; science and technology; environment and development; food security; infrastructure; information and communications.

India is a member of several RIAs such as SAARC Preferential Trading Agreement (SAPTA), Indian Ocean Rim Association for Regional Co-operation and the BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand

Economic Cooperation). Moreover, it is a signatory to several bilateral trading agreements, the recent ones being those with Thailand and Singapore. A Framework Agreement for comprehensive economic cooperation was also signed between India and ASEAN in 2003.

The **South Asian Association for Regional Cooperation (SAARC)** involving seven countries, namely, India, Bangladesh, Pakistan, Nepal, Bhutan, Sri Lanka and Maldives, was formally launched in December 1985. The fundamental goal of SAARC is to accelerate economic and social development through optimum utilisation of their human and material resources. A landmark in the progress of SAARC was the formation of the SAARC Preferential Trading Arrangement (**SAPTA**) which became effective from 7 December 1995.

In December 1998, India and Sri Lanka signed a bilateral **Free Trade Area Agreement** according to which a large number of items will be eligible for duty free trade between the countries in order to expand the bilateral trade for the mutual benefit.

Review Questions

1. Discuss the rationale and scope of economic cooperation among developing countries.
2. Discuss the need for South-South cooperation and India's role in SSC.
3. Discuss the problems and progress of economic cooperation among the South Asian economies.
4. Write notes on the following.
 - (a) SAARC
 - (b) SAPTA
 - (c) GSTP

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Suggested Readings

PART FIVE

International Monetary Economics

5

CHAPTERS

- ❖ Balance of Payments
- ❖ Policies for Internal and External Balance
- ❖ International Monetary System
- ❖ Foreign Exchange
- ❖ International Liquidity and Reserves
- ❖ International Banking and Eurocurrency Market

CHAPTER 15

15

Balance of Payments

LEARNING OBJECTIVES

- ☐ To get an analytical view of balance of payments.
- ☐ To understand factors causing BOP
- ☐ disequilibrium and measures to correct the disequilibrium.
- ☐ To understand the concepts of foreign trade
- ☐ multiplier and foreign income repercussions and their implications.

The **balance of international payments**, usually referred to as the balance of payments (BOP), is, in the words of the Reserve bank of India, *a statistical statement that systematically summarises, for a specific time period, the economic transactions of an economy with the rest of the world.*

The IMF publication *Balance of Payments Manual* describes the concept as follows:

“The Balance of Payments is a statistical statement for a given period showing:

1. Transactions in goods and services and income between an economy and the rest of the world.
2. Changes of ownership and other changes in that country’s monetary gold, Special Drawing Rights (SDRs) and claims on and liabilities to the rest of the world.
3. Unrequited transfers and counterpart entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which are not mutually offsetting.”

BALANCE OF TRADE AND BALANCE OF PAYMENTS

Balance of trade includes only those transactions arising out of the exports and imports of only the *visible items* (goods); it does not cover the exchange of *invisible items* such as the services rendered by shipping, insurance and banking; payment of interest, and dividend or expenditure by tourists. Balance of payments takes into account the exchange of both *visible* and *invisible items* (the current account items) and the capital account items (such as foreign investments, external assistance, external lending and borrowing, debt service, NRI deposits etc.). Besides the current account and capital account, balance of payment also includes unilateral payments account and official reserves account.

Balance of payments presents a much broader picture of a nation's external transactions than balance of trade.

The balance of trade includes only the visible items (merchandise trade) of the current account; it does not include any other item of the balance of payments. Hence, the balance of payments, which records all the economic transactions of a nation with the rest of the world, represents a better picture of a country's external balance.

COMPONENTS OF BALANCE OF PAYMENTS

The transactions that fall under Balance of Payments are recorded in standard *double-entry book-keeping*, under which each international transaction undertaken by the country will result in a *credit* entry and *debit* entry of equal size. As international transactions are recorded in double entry book-keeping, the balance of payments must always balance i.e. the total amount of debits must equal the total amount of credits. Sometimes, the balancing item *errors and omissions* must be added to 'balance' the balance of payments.

The format of the balance of payments given below shows the important types of transactions that enter the balance of payments. The various *debit* and *credit* entries are generally grouped under the following heads:

1. Current Account
2. Capital Account
3. Unilateral Payments Account
4. Official Reserves Assets Account

Current Account

The current account is a summary record of a nation's goods and invisibles (services) transactions with the rest of the world.

The current account includes all transactions which give rise to or use up national income.

The Current Account consists of two major items, namely, (a) *merchandise* exports and imports; and (b) *invisible* exports and imports.

Merchandise Exports and Imports Merchandise exports i.e. sale of goods abroad, are *credit* entries because all transactions giving rise to monetary claims on foreigners represent *credits*. On the other hand, merchandise imports, i.e. purchase of goods from abroad, are *debit* entries because all transactions giving rise to foreign money claims on the home country represent *debts*.

Merchandise imports and exports form the most important international transaction of most of the countries.

Invisible Exports and Imports Invisible exports, i.e. sale of services, are credit entries and invisible imports, i.e. purchase of services, are debit entries.

Important invisible exports include sale abroad of services like transport and insurance, foreign tourist expenditure in the home country and income received on loans and investments abroad (interests or dividends).

Purchase of foreign services like transport and insurance, tourist expenditure abroad and income paid on loans and investments (by foreigners) in the home country form the important invisible entries on the *debit* side.

Capital Account

The capital account consists of short-term and long-term capital transactions.

Capital account shows the capital inflows and outflows.

Capital outflow represents *debit* and capital inflow represents *credit*. For instance, if an American firm invests \$100 million in India, this transaction will be represented as a *debit* in the US Balance of Payments and a *credit* in the Balance of Payments of India.

Payment of interest on loans and dividend payments are recorded in the current account, since they are really payments for the services of capital. As has already been mentioned above, interest paid on

loans given by foreigners or dividend on foreign investments in the home country are debits for the home country, while, on the other hand, interest received on loans given abroad and dividends on investments abroad are credits.

Unilateral Transfers Account

Unilateral transfers is another term for *gifts*, and includes private remittances, government grants, reparations and disaster relief.

Unilateral payments received from abroad are *credits* and those made abroad are *debits*.

Official Reserves Account

Official reserves represent the holdings by the government or official agencies of the means of payment that are generally accepted for the settlement of international claims.

Table 15.1 Balance of Payments of India: Summary

(In US \$ million)

	1990– 91	2000– 01	2001– 02	2002– 03	2003– 04	2004– 05	2005– 06R	2006– 07 PR
1. Exports	18477	45452	44703	53774	66285	85206	105152	128083
2. Imports	27915	57912	56277	64464	80003	118908	157056	191254
3. Trade balance	– 9438	– 12460	– 11574	– 10690	– 13718	– 33702	– 51904	– 63171
4. Invisibles (net)	– 242	9794	14974	17035	27801	31232	42002	53405
Non-factor services	980	1692	3324	3643	10144	15426	23170	31180
Income	– 3752	– 5004	– 4206	– 3446	– 4505	– 4979	– 5855	– 6573
Pvt. Transfers	2069	12854	15398	16387	21608	20525	24493	27941
5. Goods & services balance	– 8458	– 10768	– 8250	– 7047	– 3574	– 18276	– 28734	– 31361
6. Current account balance	– 9680	– 2666	3400	6345	14083	– 2470	– 9902	– 9766
7. External assistance (net)	2204	410	1117	– 3128	– 2858	1923	1702	1767
8. Commercial Borrowing (net) ^a	2254	4303	– 1585	– 1692	– 2925	5194	2508	16155
9. NR deposits (net)	1537	2316	2754	2978	3642	– 964	2789	4321
10. Foreign Investment (net) of which	103	5862	6686	4161	13744	13000	15528	15541
(i) FDI (net)	97	3272	4734	3217	2388	3713	3034	8479
(ii) Portfolio	6	2590	1952	944	11356	9287	12494	7062
11. Other flows (net) ^b	1090	– 4356	– 615	8321	5735	9476	– 180	8967
12. Capital account total (net)	7188	8535	8357	10640	17338	28629	24954	46372
14. Reserve use (– increase)	1278	– 5842	– 11757	– 16985	– 31421	– 26159	– 15052	– 36606

PR: Partially Revised, P: Preliminary, R: Revised.

a: Figures include receipts on account of India Millennium Deposits in 2000-01 and related repayments, if any, in the subsequent years.

b: Include, among others, delayed export receipts and errors & omissions.

Source: Reserve Bank of India (Cited by Government of India, *Economic Survey 2007-08*)

MEANING OF CURRENT ACCOUNT BALANCE

The current account reflects the value of the flows of goods, services, income, and gifts between the home country and foreign countries. Current account balance refers to the net of these flows. When there is net inflow (a surplus i.e. inflows are more than outflows) the current account is said to be positive and when there is net outflow (a deficit i.e. inflows are less than outflows) the current account is said to be negative.

A current account surplus means an excess of exports over imports of goods, services, investment income, and unilateral transfers. This means that the nation earns that much in extra assets or reduced

Current account balance is synonymous with net foreign investment.

liabilities in its dealings with other countries. A deficit, on the other hand, means that the country must pay other nations that much by giving up assets or increasing its liabilities. It is, therefore, said that the current account balance represents the bottom line on a nation's income statement. If it is positive,

the nation is spending less than its total income and accumulating asset claims on the rest of the world. If it is negative, domestic expenditure exceeds income and the nation borrows from the rest of the world.

The current account balance is synonymous with net foreign investment in national income accounting. Thus, current account balance is also linked to its national saving and domestic investment. A country can do two things with its national saving (S): Invest in home country (I_d) or invest abroad (I_f). Hence,

$$S = I_d + I_f$$

Therefore, a country's net foreign investment (current account balance— CA) equals the difference between national saving and domestic investment, i.e.

$$CA = I_f = S - I_d$$

The current account balance also is linked to domestic production, income, and expenditure. A country's current account balance is the difference between its domestic production of goods and services and its total expenditures on goods and services. National output (Y) may be represented as:

$$Y = C + I_d + G + X - M$$

where C = domestic consumption; I_d = domestic investment; G = government expenditure; X = exports; M = imports. C , I_d and G all include purchases of both domestically produced and imported goods and services. Imports must be subtracted separately because imports are not demand for the home country's products.

A country's total expenditures on goods and services, i.e. $C + I_d + G$, is sometimes referred to as absorption (A). That is:

$$A = C + I_d + G$$

Therefore,

$$Y = A + (X - M)$$

In sum, current account balance (CA):

- = Net foreign investment (I_f)
- = The difference between national saving and domestic investment ($S - I_d$)
- = The difference between domestic product and national expenditure ($Y - A$)

A current account surplus means that:

- The country has positive net foreign investment (that is, the country is acting as a net lender to or investor in the rest of the world).

- The country is saving more than it is investing domestically.
- The country is producing more (and has more income from this production) than it is spending on goods and services.

The opposite is true for a country with a current account deficit: the country is a net foreign borrower, domestic saving is less than domestic investment, and the nation is spending more than production (or income).

Current account surplus implies that the nation is a net lender to or investor in the rest of the world and current account deficit means that the nation is a net borrower or domestic saving is less than investment.

BALANCE OF PAYMENTS DISEQUILIBRIUM

The balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is exactly equivalent to the supply of it. The balance of payments is regarded as being in disequilibrium when it shows either a *surplus* or a *deficit*. There will be a deficit in the balance of payments when the demand for foreign exchange exceeds its supply, and there will be a surplus when the supply of foreign exchange exceeds the demand.

There are a number of factors that may cause disequilibrium in the balance of payments. These various causes may be broadly categorised into (1) economic factors, (2) political factors, and (3) sociological factors.

A BOP disequilibrium may be caused by economic, political or social factors.

Economic Factors

There are a number of economic factors which may cause disequilibrium in the balance of payments. Various economic factors cause development disequilibrium, cyclical disequilibrium, secular disequilibrium and structural disequilibrium.

Development Disequilibrium Large scale developmental expenditures usually increase the purchasing power, aggregate demand and prices, resulting in substantially large imports. Development disequilibrium is common in the case of developing countries, because the above factors and large scale imports of capital goods needed for carrying out the various developmental programmes give rise to a deficit in their balance of payments.

Cyclical Disequilibrium Cyclical fluctuations of general business activity is one of the prominent reasons for balance of payments disequilibrium. As Lawrence W. Towle points out, depression always brings about a drastic shrinkage in world trade, while prosperity stimulates it. A country enjoying a boom all by itself will ordinarily experience a more rapid growth in its imports than in its exports, while the opposite will be true of other countries. But production in the other countries will be activated as a result of the increased exports to the former.

Secular Disequilibrium Sometimes, the balance of payments disequilibrium persists for long periods due to certain secular trends in the economy. For instance, in a developed country, the disposable income is generally very high and so is the aggregate demand. At the same time, the production costs are also very high due to the higher wages. This naturally results in higher prices. These two factors—high aggregate demand and higher domestic prices—may result in the imports being much higher than the exports.

Structural Disequilibrium Structural changes in the economy may also cause a balance of payments disequilibrium. Such structural changes include development of alternative sources of supply, development of better substitutes, exhaustion of productive resources or changes in transport routes and costs.

Political Factors

Certain political factors could also produce a balance of payments disequilibrium. For instance, a country plagued with political instability may experience large capital outflows and inadequacy of domestic investment and production. These factors may, sometimes, cause a disequilibrium in the balance of payments. Further, factors like war or changes in the world trade routes, could also produce similar difficulties.

Social Factors

Certain social factors also influence balance of payments. For instance, changes in the tastes, preferences and fashions, may affect imports and exports and thereby affect the balance of payments.

CORRECTION OF DISEQUILIBRIUM

A country may not be bothered about a surplus in the balance of payments but every country strives to remove or at least reduce the balance of payments deficit.

There are a number of measures available for correcting the balance of payments disequilibrium. They fall into two broad groups, namely, automatic measures and deliberate measures.

Automatic Correction

This worked well under the *gold standard*. The balance of payment disequilibrium may, however, be automatically corrected under the *paper currency standard* also. The theory of automatic correction is that if the market forces of demand and supply are allowed to have free play, in course of time, equilibrium will be automatically restored. For example, assume that there is a deficit in the balance of payments. When there is a deficit, the demand for foreign exchange exceeds its supply and this results in an increase in the exchange rate and a fall in the external value of the domestic currency. This makes the exports of the country cheaper and imports dearer than before. Consequently, the increase in exports and fall in

Under fixed exchange rate system, BOP disequilibriums may be corrected by adjustments in price, interest rate, income and capital flows.

imports restore the balance of payments equilibrium.

Under the fixed exchange rate system, the automatic adjustments of the balance of payment happens via changes in the adjustment variables—price, interest, income and capital flows.

Price Adjustments Under the gold standard, there had to be a gold outflow from a deficit country to a surplus country, causing, as a result, a fall in the money supply in the deficit country and increase in the money supply in the surplus country. This will result in rise in the prices in the surplus country which will encourage imports and discourage exports, and fall in prices in the deficit country which will encourage exports and discourage imports, leading to restoration of BOP equilibrium in due course.

Under the paper currency standard, the fall or rise of the foreign exchange reserves as a result of deficit or surplus in the BOP will cause similar changes.

Interest Rate Adjustments A monetary effect of BOP surplus or deficit, besides the price effect, is its impact on the short term interest rates. The contraction or expansion of money supply resulting from the BOP deficit or surplus leads to a rise or fall in the interest rates. This will encourage investors in the deficit country where the interest rate has risen to withdraw their funds from abroad and invest in the home country. Because of the fall in interest rate in the foreign country with BOP surplus, foreigners will be encouraged to send money to the deficit country where the interest rate has risen. These changes will also contribute to the restoration of BOP equilibrium.

Under the gold standard, changes in the money supply was brought about by the outflow and inflow of gold. Under the paper currency standard, the changes in the foreign exchange reserves due to BOP disequilibrium can have similar effect.

Income Adjustments Although the classical economists neglected the effect of income adjustments, Keynes demonstrated that under the fixed exchange rate system, changes in income will help restore BOP equilibrium automatically. A nation with persistent payments surplus will experience rising income causing increasing exports. The opposite will happen in the deficit nation. The income adjustment process is explained in the section *Foreign Trade Multiplier* later in this chapter.

Capital Flows As mentioned above, changes in the interest rates consequent to the BOP disequilibrium will encourage capital flows between the deficit and surplus nations, helping restoration of the BOP equilibrium.

Deliberate Measures

However, because of the various problems associated with the policy of automatic correction, deliberate measures are widely employed today.

As the name indicates, deliberate measures refer to correction of disequilibrium by means of measures taken deliberately with this end in view.

The various deliberate measures may be broadly grouped into (a) monetary measures (b) trade measures and (3) miscellaneous.

Monetary, trade and other measures are often employed to correct BOP disequilibrium.

Monetary Measures The important monetary measures are outlined below.

1. *Monetary Contraction/Expansion* The level of aggregate domestic demand, domestic price level and the demand for imports and exports may be influenced by contraction or expansion of money supply so that a balance of payments disequilibrium may be corrected. For example, assume a situation of balance of payments deficit for the correction of which a contraction of money supply is required. Contraction of money supply is likely to reduce the purchasing power and, thereby, the aggregate demand. It is also likely to reduce domestic prices. The fall in the domestic aggregate demand and domestic prices reduces the demand for imports. The fall in domestic prices is likely to increase exports. Thus, the fall in imports and rise in exports would help correct the disequilibrium.
2. *Devaluation* Devaluation means reduction of the official rate at which the domestic currency is exchanged for another currency. A country with fundamental disequilibrium in the balance of payments may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium. Devaluation makes export of goods cheaper and imports dearer. Devaluation is also known as *expenditure switching* measure as it encourages switching of expenditure between foreign and domestic goods. For details, refer the section on *Devaluation* in the next chapter.
3. *Exchange Control* Exchange control is a popular method employed to influence the balance of payments positions of a country. Under exchange control, the government or central bank assumes complete control over the foreign exchange reserves and earnings of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government/central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports. For details, refer to the chapter on Foreign Exchange.

Trade Measures Trade measures include export promotion measures and measures to reduce imports.

1. *Export Promotion* Exports may be encouraged by reducing or abolishing export duties, providing export subsidy, encouraging export production and exports by giving monetary, fiscal, physical and institutional incentives and facilities.
2. *Import Control* Imports may be controlled by imposing or enhancing import duties, restricting imports through import quotas, licensing and even prohibiting altogether the import of certain inessential items.

Miscellaneous Measures Apart from the measures mentioned above, there are a number of other measures that can help make the balance of payments position more favourable, like encouraging foreign investment in the home country, development of tourism to attract foreign tourists and providing incentives to enhance inward remittances.

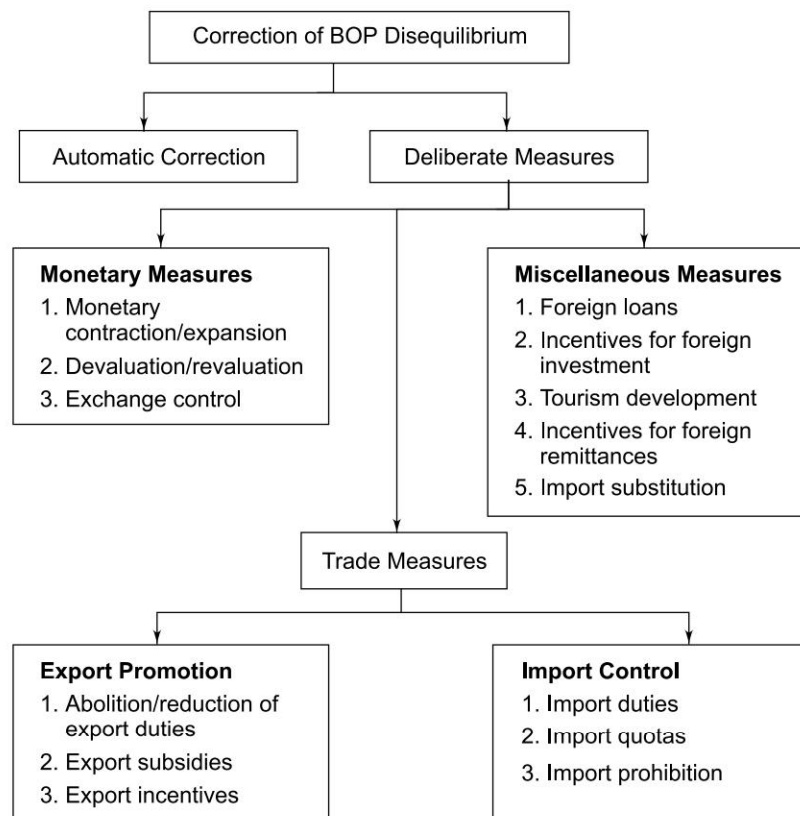


Fig. 15.1 Methods of Correction of BOP disequilibrium

FINANCING OF BOP DEFICIT

When a nation has a Balance of Payments deficit, i.e. when the total external payments obligations exceed the total receipts, an external payments problem arises. The nation has, therefore, to find out means for meeting the payments obligation. The common methods of financing the BOP deficit are the following.

Using Forex Reserves

If the nation has comfortable foreign exchange reserves, the deficit can be financed by drawing down the reserves. For example, at the beginning of 2003 India had a forex reserve of more than \$70 billion. If by any chance India ran into a BOP deficit, the reserves could be used to finance the deficit. The problem, however, is that only when the BOP has a continuous surplus that there, normally, will be a comfortable forex reserves. If a country experiences persistent deficits, the reserves would dry up and it will have to resort to some other method(s) to finance the deficit.

During the First Five Year Plan, the BOP deficit did not pose much problem for India as it had a stock of forex reserves which could be relied upon to finance the deficit. But the situation soon changed and by the Third Plan it became so serious that the nation had to resort to the drastic step of a steep devaluation of the currency in bid to encourage exports and discourage imports. In most of the years until the mid 1990s, India had a BOP problem and in July 1991, the forex reserves the nation had was just sufficient to meet 15 days of import requirements, against the generally accepted bare minimum requirement of three months import requirement. India, therefore, had to borrow from the IMF and it even had to pledge some of its monetary gold reserves with the Bank of England in order to borrow.

A nation which does not have forex reserves to finance BOP deficit may depend on external assistance.

External Assistance

If a nation does not have enough forex reserves to draw upon to finance the BOP deficit, it may have to take recourse to external assistance.

A very important source of assistance for countries with BOP problem is the IMF. As mentioned in the Chapter 27, one of the purposes of the IMF is to provide financial assistance to help countries to tide over BOP problems. India has made use of IMF assistance on several occasions.

A nation may also resort other external sources, including commercial borrowing to finance the deficit. In the 1950s and through the 1970s, almost the entire deficit of India was financed by concessional assistance and this kept the debt service burden low. In the 1980s, however, commercial borrowings and NRI deposits became the dominant external sources and this had substantially increased India's debt burden. The economic liberalisation and the consequent increase in the FDI and the FII flows have contributed to favourable BOP for India and the external debt service burden has also substantially come down.

FOREIGN TRADE MULTIPLIER

The classical balance-of-payments adjustment theory, which relied primarily on the price-adjustment mechanism, neglected the effect of *income adjustments*. The classical economists viewed income effect on BOP only as an accompaniment of price changes. The fact that the gold movements of the nineteenth century exerted only minor impacts on price and interest-rate levels, prompted economists to look for alternate explanations for balance-of-payments adjustment under a fixed exchange system. The Keynesian theory of income determination, published in the 1930s, espoused that under a system of fixed exchange rates, the influence of income changes in surplus and deficit nations will help restore payments equilibrium *automatically*, often via the working of the multiplier.

The principle of multiplier says that if the marginal propensity to consume is greater than zero, an increment in investment will increase the income greater than the incremental investment, through successive rounds of spending.

When a *closed economy* is in equilibrium:

$$Y = C + I = C + S$$

where Y stands for national income, C for consumption, S for savings and I for investment.

It is quite clear from the above equation that at equilibrium, investment must equal savings. That is:

$$I = S$$

Equality between savings and investments is a must for equilibrium because savings represent leakage from the income stream whereas investment is an injection of income. When $I = S$, whatever is leaked out of the income flow is made good by injecting an equivalent amount by way of investment.

In an *open economy*, there are two other important variables to be considered, namely, exports and imports. We may denote exports by X and imports by M .

Imports, like savings, represent leakage. When we import, money flows out of the country and hence is considered as leakage. Exports, on the other hand, means expenditure in our economy by foreigners. Exports, therefore, represent an injection to the economy.

In an open economy, the necessary condition for equilibrium, therefore, can be represented as:

$$S + M = I + X$$

Equilibrium level of income in an open economy can be represented as:

$$Y = C + I + X = C + S + M$$

As has already been mentioned, exports, like investment, are an injection of income; they represent spending on domestic goods and services and so are a source of income for domestic factors of production. Hence, like investment, exports might also have a multiplier effect. If there is no leakage from this additional income from exports, it will go multiplying itself indefinitely.

Like investment, injection of income by exports can have multiplier effect on income.

However, there are two possible leakages. A part of the newly injected income is likely to be saved. When income rises imports may also rise. Savings and imports, thus, represent the two possible leakages from the

income brought in by the increase in exports. Hence, the foreign trade multiplier, (also called the export multiplier) can be represented as:

$$K_f = 1/(s + m)$$

where K_f stands for export multiplier, s for marginal propensity to save and m for marginal propensity to import. (It may be recalled here that in a closed economy, the investment multiplier $K = 1/s$.) However, in an open economy, as there is an additional leakage (i.e., imports), the foreign trade multiplier is $K_f = 1/(s + m)$.

It is quite clear from the above equation that the smaller the leakages, (i.e., the smaller the marginal propensities to save and import) the greater the multiplier effect of an increase in exports. For example, if $s = 0.2$ and $m = 0.2$; then

$$K_f = 1/(0.2 + 0.2) = 1/0.4 = 2.5$$

If $s = 0.3$ and $m = 0.2$, then

$$K_f = 1/0.5 = 2$$

The foreign trade multiplier can be illustrated diagrammatically. In Fig. 15.2, the horizontal line marked X represents exports. The savings and imports function is represented by the line with a positive slope, marked $S + M$.

To start with, the economy is in equilibrium at Y level of income, where savings plus imports are equal to exports. Now, let us assume that there is an autonomous increase in exports so that the exports schedule is shifted from X to X_1 . This autonomous increase in exports may be caused by a change in the

tastes abroad in favour of our export goods. This increase in exports causes an injection of income to the economy. This will cause the income of the exporting country to rise by more than the amount of the new export injection because people spend some or most of all additional income on domestic goods and services; only part of the additional income will leak out by way of savings and imports. Suppose that the autonomous increase in exports amount to Rs 500 crore, and the income saved out of it and used for additional imports add up to Rs 250 crore. Then the total expansion of income will be Rs 1000 crore (because $s + m = 0.5$).

In terms of Fig. 15.2, new equilibrium is established at Y_1 level of income where savings and imports are equal to the new level of exports. Figure 15.2 clearly depicts the multiplier effect of the autonomous increase in exports because ΔY is greater than ΔX . How large is the expansionary effect on national income from a given increase in exports depends on the slope of the savings-imports schedule. This slope, obviously, depends on the marginal propensities to save and import. The smaller the sum of these propensities, the smaller will be the slope of the schedule and the larger the expansionary effect of an increase in exports on national income.

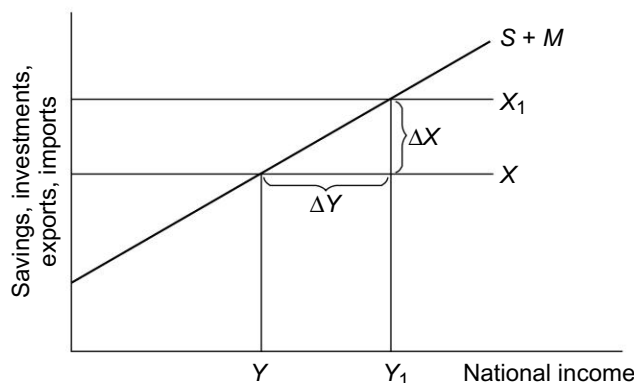


Fig. 15.2 Foreign Trade Multiplier

The effect of an autonomous rise in imports on national income will have an opposite effect to that of an autonomous increase in exports. Assume that due to an increase in the preference for foreign goods over domestic goods, imports rise. This implies a fall in demand for domestic goods. The fall in the demand for domestic goods will lead to a cut in production and fall in employment. As a result, income and aggregate demand for domestic goods will fall leading to a further fall in income and aggregate demand. This fall in income through the multiplier effect will continue until finally a new equilibrium is reached at a lower national income.

Foreign trade multiplier is effected by marginal propensities to save and import

Figure 15.3 illustrates the contractionary effect of an autonomous increase in imports on national income. The export schedule is represented by the line marked X and the import schedule by M . The economy is initially at equilibrium at Y . An autonomous increase in imports shift the import schedule from M to M_1 and the new equilibrium is established at a lower level of income, Y_1 . That the increase in imports has a multiplier effect on the contraction of income is evident from the fact that ΔY is much greater than ΔM .

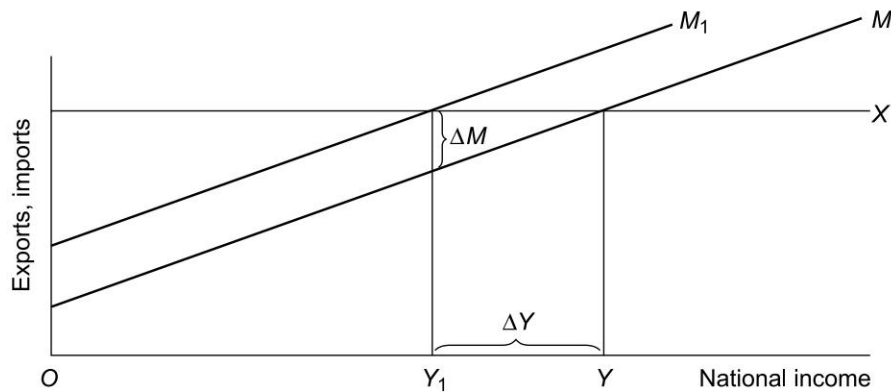


Fig. 15.3 Contractionary Effect of Increase in Imports on National Income

We shall now proceed to take a total view of an open economy.

In an open economy, the total investment of income injection consists of domestic investment and foreign investments or export. The total leakage consists of savings and imports. Hence, the necessary condition for equilibrium, as has been mentioned earlier, is:

$$I + X = S + M$$

In Fig. 15.4, I represents the schedule of domestic investment, where X -exports and $M + S$ imports plus savings. $I + X$ represents the total investment schedule, i.e. domestic investments plus exports. Initially, the economy is in equilibrium at Y level of income. At this income level, there is also equilibrium in the balance of current account because, as evident from the diagram, savings equal domestic investment ($S = I$) and exports equal imports ($X = M$).

The shift of the export-domestic investment schedule from $I + X$ to $I + X_1$ represents an autonomous increase in exports. The resultant expansionary multiplier effect establishes new equilibrium at Y_1 where, once again, the exports plus domestic investment equal savings plus imports. At the new equilibrium, there is, however, no equilibrium in the balance of the current account because the total savings are now larger than domestic investment. The difference between saving and domestic investment at Y_1 is given by the distance $A - B$. This implies that exports are larger than imports by the same amount and that the country exports capital.

A fall in exports will have a contractive effect on national income. Suppose that the domestic investment plus exports has fallen to $I + X_2$. This causes the income to contract to Y_2 where new equilibrium is established. At this level of income, domestic investment is larger than savings by the distance $C - D$, indicating that the imports are larger than exports by the same amount and that the country has a deficit in its balance of current account.

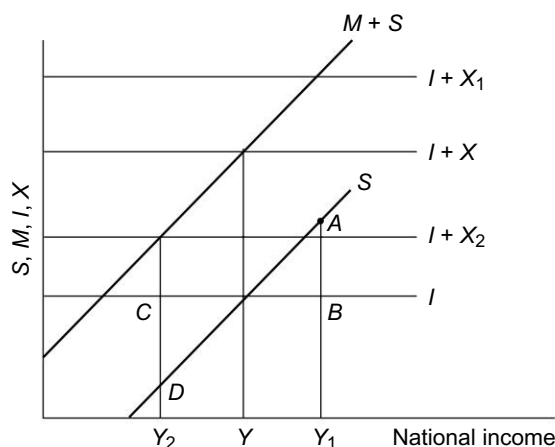


Fig. 15.4

Expansionary Effect of Increase in Investment and Export on National Income

Foreign Income Repercussions

In the discussion of the foreign trade multiplier, we have regarded imports as leakages with the implicit assumption that whatever is spent on imports is permanently lost as a component of aggregate demand for domestic product. This assumption can at best be true of small countries with negligible volume of foreign trade. When a nation's import is large and if it has exportables in demand abroad, the import could result in foreign income repercussions leading to an increase in the home country's exports.

A part of the export income received by the foreign country may be spent on imports from the home country.

For example, country *A* has large imports from *B* (the foreign market), the resultant expansion of income in *B* normally would result in an increase in the aggregate demand, a part of which is likely to be for goods and services of *A*. In other words, the imports of *A* results in a demand for *A*'s exports, depending on *B*'s marginal propensity to import from *A*.

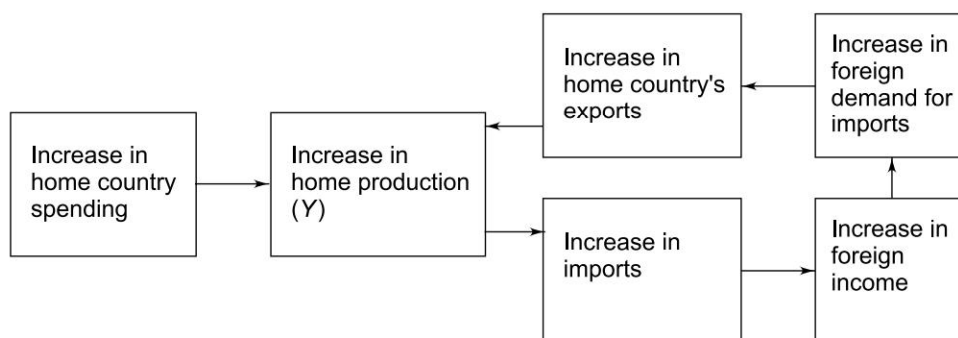


Fig. 15.5

Foreign Income Repercussions Effect

The extent of foreign repercussion effect depends in part on the economic size of a country in as far as foreign trade is concerned. A small nation increasing its imports from a large nation will have little impact on the large nation's income level where as foreign repercussion effect is likely to be significant for major trading nations.

In short, the foreign repercussion effect (also known as *backwash effect* and *feedback effect*) highlights the economic interdependence effect of trade between nations.

Implications of Foreign Trade Multiplier/Foreign Repercussions Effect

The concepts of foreign trade multiplier and foreign income repercussions effect highlight certain aspects of international economic interdependence.

1. It indicates that the effects of an economic boom or slump in one country or region will be transmitted to and fro the major trading partners. It, thus, exposes the stupidity of the beggar thy neighbour approach.
2. It also has a policy implication for the international economic order. It suggests, implicitly, that economic development of the developing countries will benefit the developed nations too. Recent trends in the North-South trade go to substantiate this. There is, thus, an economic logic too for the argument that the developed countries should actively support the economic development of developing countries.
3. The backwash effect underscores the importance of South-South trade in mutually supporting their economic development.
4. High trade restrictions may not produce the expected benefits because of the loss of the repercussions benefit of the forgone trade expansion.
5. An important policy implication of the foreign income repercussions effect is that investment that accelerates economic development is more beneficial than expenditure on mere export promotion. Those export development measures which have direct and substantial link with national economic development shall be preferred.
6. The concept of foreign trade multiplier highlights the importance of export-led growth.
7. The concepts of foreign trade multiplier and foreign income repercussions effect implicitly support outward oriented development strategy explained in Chapter 9.

Export multiplier/foreign repercussions effect has policy implications.

Deficiencies /Limitations of Foreign Trade Multiplier

1. The concept of foreign trade multiplier wrongly assumes that changes in foreign trade and investment are autonomous, i.e. independent of income.
2. An increase in exports or imports need not necessarily always mean an injection or leakage of income. For example, import of capital goods or production inputs will facilitate increase in output, even if initially that would amount to a leakage.
3. Another criticism of the concept of foreign trade multiplier is that it is based on the wrong assumption of full employment.

4. It also assumes away the impact of fiscal and monetary policies on foreign trade.
5. Further, it is assumed that international trade is free of barriers.
6. Other criticisms of the foreign trade multiplier are that it is a static concept and that it is based on the two country model. However, economists have shown that the foreign trade multiplier can be used to analysis the propagation of income in a dynamic context and that it can be extended to multi-country trade.

SUMMARY

Balance of payments is a statistical statement that systematically summarises the economic transactions of an economy with the rest of the world, for a specific time period.

Balance of payments account is vertically divided, mainly, in to current account, capital account, unilateral payments account and official reserves account.

Current account records exports and imports of visible items (goods) and invisible items (such as the services rendered by shipping, insurance and banking; payment of interest, and dividend or expenditure by tourists.) Balance of trade, which is a part of the current account is a summary record of the inflows and outflows of money on account of exports and imports of goods. Unilateral transfers is another term for *gifts*, and includes private remittances, government grants, reparations and disaster relief. Official reserves represent the holdings by the government or official agencies of the means of payment that are acceptable for the settlement of international liabilities.

The current account reflects the value of the flows of goods, services, income, and gifts between the home country and foreign countries. Current account balance refers to the net of these flows. A current account surplus means an excess of exports over imports of goods, services, investment income, and unilateral transfers. This means that the nation earns that much in extra assets or reduced liabilities in its dealings with other countries. A deficit, on the other hand, means that the country must pay other nations that much by giving up assets or increasing its liabilities.

The balance of payments of a country is said to be in **equilibrium** when the demand for foreign exchange is exactly equivalent to the supply of it. Disequilibrium in the balance of payments may be caused by economic, political and sociological factors. Disequilibrium caused by economic factors may be development disequilibrium, cyclical disequilibrium, secular disequilibrium, or structural disequilibrium.

The measures for correcting balance of payments disequilibrium fall into two broad groups, namely, automatic measures and deliberate measures.

Under the fixed exchange rate system, the automatic adjustments of the balance of payment happens via changes in the adjustment variables—price, interest, income and capital flows.

The various deliberate measures are broadly grouped into monetary measures, trade measures and miscellaneous measures.

The two common methods of financing balance of payments deficit are use of foreign exchange reserves and external assistance.

The concept of **foreign trade multiplier**, which is based on the Keynesian theory of income determination, treats exports as injection and imports as leakage of income and purports that exports will have a multiplier effect, given the propensity to save and import. In the analysis of the foreign trade multiplier, imports are regarded leakages with the implicit assumption that whatever is spent on imports is permanently lost as a component of aggregate demand for domestic product. This assumption can at best be true of small countries with negligible volume of foreign trade. But when a nation's import is large and if it has exportables in demand

abroad, the import could result in **foreign income repercussions** leading to an increase in the home country's exports. This is because the increase in income abroad will lead to some imports *from* the country which has made the original import (referred above as *home* country). The foreign repercussions effect is also known as *backwash effect* and *feedback effect*.

The concepts of foreign trade multiplier and foreign income repercussions effect highlight certain aspects of international economic interdependence. They indicate that the effects of an economic boom or slump in one country or region will be transmitted to and from the major trading partners. They also implicitly support the outward oriented development strategy.

Review Questions

1. Describe the structure and components of Balance of Payments.
2. What is meant by Balance of Payments disequilibrium? Give a brief account of the important causes of the Balance of Payments disequilibrium and measures to correct the disequilibrium.
3. Explain foreign trade multiplier.
4. Write notes on the following:
 - (i) Balance of trade and balance of payments
 - (ii) Current account of the balance of payments
 - (iii) Capital account of the balance of payments
 - (iv) Meaning of current account of the balance
 - (v) Invisibles account
 - (vi) Development disequilibrium
 - (vii) Effect of increase in exports on income
 - (viii) Effect of increase in imports on income
 - (ix) Foreign income repercussions effect
 - (x) Implications of foreign trade multiplier and foreign income repercussions effect.

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Annexure 15.1

SERVICES ITEMS OF INDIA'S BOP

A short description of some of the important items of India's balance of payments is given below.

Services

Travel represents all expenditure by foreign tourists in India, on the receipts side, and all expenditure by Indian tourists abroad, on payments side. Travel receipts constituted the second largest share in services receipts.

Transportation records receipts and payments on account of the carriage of goods and natural persons, as well as other distributive services (like port charges, bunker fuel, stevedoring, cabotage, warehousing, etc.), performed on merchandise trade.

Insurance receipts consist of insurance on exports, premium on life and non-life policies and reinsurance premium from foreign insurance companies. Insurance on exports is directly linked to total exports from India.

Government not Included Elsewhere (GNIE) receipts represent inward remittance towards maintenance of foreign embassies, diplomatic missions and international/regional institutions in India, while GNIE payments record the remittances on account of maintenance of Indian embassies and diplomatic missions abroad and remittances by foreign embassies on their account.

Miscellaneous services comprise of a host of business services and encompass communication services, construction services, financial services, software services, news agency services, royalties, copyright and license fees, management services and others. Under miscellaneous receipts, software services have the largest share.

Transfers Represent one-sided transactions, i.e., transactions which do not have any quid pro quo, such as grants, gifts, remittances for family maintenance, repatriation of savings and migrant transfer (financial and real resources transferred as a result of the migration from one economy to another). Official transfer receipts record grants and donations from non-residents to the Government and other assistance received by the Government from bilateral and multilateral institutions. Similarly, payments by India to other countries are recorded under official transfer payments.

Private transfers from expatriate Indians is traditionally a major source of invisible receipts. Among the various components of private transfer receipts, inward remittances constitute the largest part of transfer receipts.

Investment Income

Investment income transactions represent the servicing of capital transactions (both debt and non-debt). Investment income transactions are in the form of interest, dividend, profit and others, for servicing of capital transactions. Interest payments represent servicing of debt liabilities, while the dividend and profit payments reflect the servicing of non-debt (foreign direct investment and portfolio investment) liabilities. Investment income payments move in tandem with India's external liabilities.

CHAPTER 16

16 Policies for Internal and External Balance

LEARNING OBJECTIVES

- ☐ To understand the policy measures which can help achieve internal and external balances.
- ☐ To understand the effects of monetary and fiscal policies on internal and external balances under fixed and flexible exchange rate systems.
- ☐ To analyse how devaluation affects trade balance.

A nation desires to maintain internal and external balances.

Internal balance connotes (1) full employment (of labour and other resources), i.e. utilising more or less the feasible productive capacity of the nation, and (2) reasonable price stability.

Two important economic challenges for a nation is to achieve full employment with domestic price stability and to maintain BOP equilibrium.

External balance denotes a reasonable balance of payments with the rest of the world. This implies, very broadly, balance in the country's overall balance of payments. This means that the sum of current and capital accounts on the credit and debit sides should equal. When this is achieved, the country is neither losing official reserves nor is building it up.

POLICIES TO MAINTAIN INTERNAL/EXTERNAL BALANCE

The instruments that can be used to achieve internal and external balances are expenditure changing policies, expenditure switching policies, and direct controls.

Expenditure Changing Policies include monetary and fiscal policies. These policies seek to achieve external/internal balance by altering the aggregate level of demand for goods and services, both domestic and imported, by increasing or reducing the expenditure in the economy. For, example, a situation of excessive demand/inflation may be dealt with in expenditure reducing policy. Expenditure reducing fiscal policy encompasses measures such as reduction in government expenditure and increase in taxes. Contractionary monetary policy may take the form of an increase in interest rates (via, for example, bank rate policy) and reduction in money supply (via, quantitative credit controls). An expenditure increasing policy is employed to deal with recession.

Expenditure Switching Policy aims at causing switching of expenditure between domestic and foreign goods. For example, devaluation will make the domestic goods comparatively cheaper and foreign goods dearer, and this will encourage switching of expenditure away from foreign goods towards domestic goods. This will help remove the balance of payments deficit.

Direct Controls refer to government restrictions such as quotas, tariffs, production and distribution controls, price controls etc.

FISCAL AND MONETARY POLICIES FOR INTERNAL BALANCE

Under the fixed exchange rate system, a nation faces two challenges—maintaining internal balance and external balance. A major problem in this context is that in some cases the monetary and fiscal policies aimed at achieving internal balance may widen external imbalance and vice versa.

The effect of monetary and fiscal policies on the internal balance could be the opposite of their effect on external balance.

The effects of fiscal and monetary policies on the balance of payments are quite similar except for their effects on interest rates. An expansionary fiscal policy pushes up interest rate because increase in expenditure and income increases the demand for money and, given the supply of money, this will lead to increase in interest rate. An expansionary monetary policy, on the other hand, brings down interest rate (because of increase in money supply).

Fiscal Policy under Fixed and Floating Exchange Rates

Figure 16.1 summarises the short term effects of fiscal policy on a nation's internal sector.

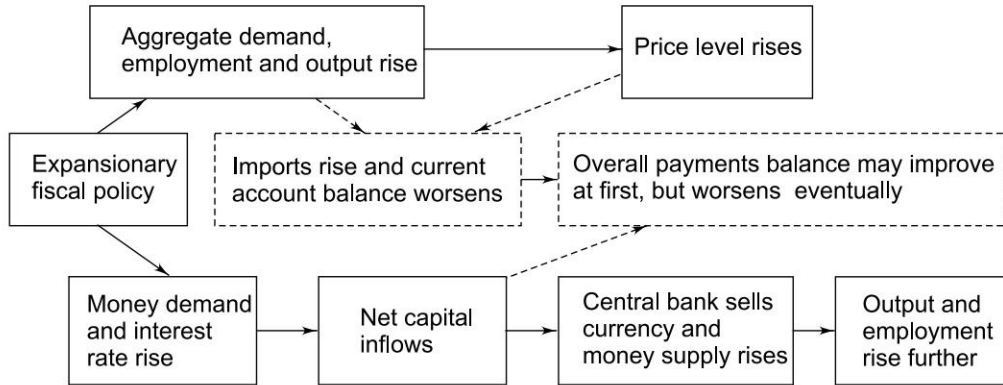
Part (a) in the Fig. 16.1 shows that under the fixed exchange rate system, fiscal policy can help achieve internal balance (i.e. an expansionary fiscal policy can help correct the problem of recession and a contractionary fiscal policy can be used to correct an inflationary situation). The policy, however, will impact the external balance too, which is represented by the dotted boxes in Fig. 16.1. Note that under fixed exchange rate system, the inflow of foreign capital is absorbed by the central bank selling national currency and the exchange rate is kept stable.

It may also be noted that although the fiscal policy is useful to achieve internal balance, it tends to worsen the external balance.

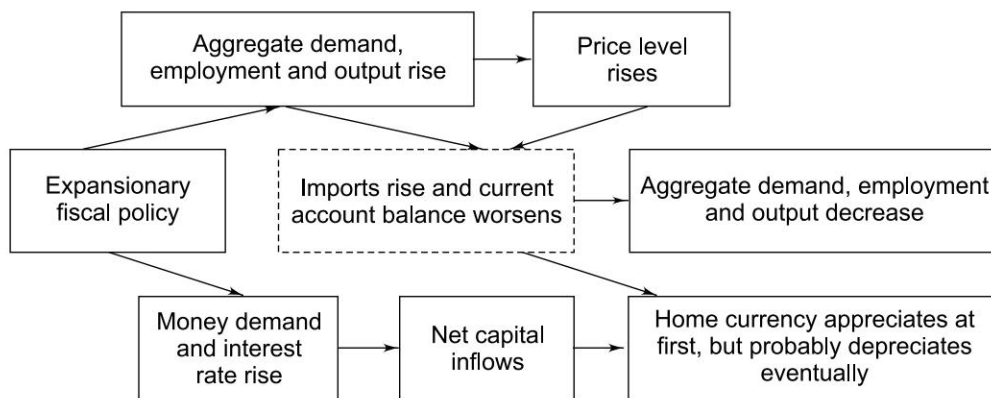
Part (a) in Fig. 16.1 depicts the effects of an expansionary fiscal policy. For contractionary fiscal policy, reverse the direction of all changes shown in Fig. 16.1.

Part (b) in Fig. 16.1 shows that under the flexible exchange rate system, fiscal policy is not useful to restore internal balance.

As pointed out above, fiscal expansion leads to higher output and income and higher interest rates. Higher income induces rising imports, leading the trade account into deficit. Higher interest rates lead to net investment inflows and a surplus in the capital account and if the capital inflow is robust, it is likely that the surplus, in the capital account, will exceed the deficit in the trade account, so that the overall payments balance becomes positive. This leads to an appreciation in the home currency's exchange value, making the domestic goods costly in terms of foreign currency and imports cheaper in domestic currency. (Under a floating exchange-rate system, however, the central bank does not intervene to maintain exchange rate.) The resultant fall in exports and rise in imports lead to decrease in aggregate demand, output, and employment, offsetting the initial gains of fiscal expansion. Fiscal policy under floating exchange rate system, thus, is ineffective to correct internal imbalance.



(a) Fiscal Policy Under Fixed Exchange Rate System*



(b) Fiscal Policy Under Flexible Exchange Rate System*

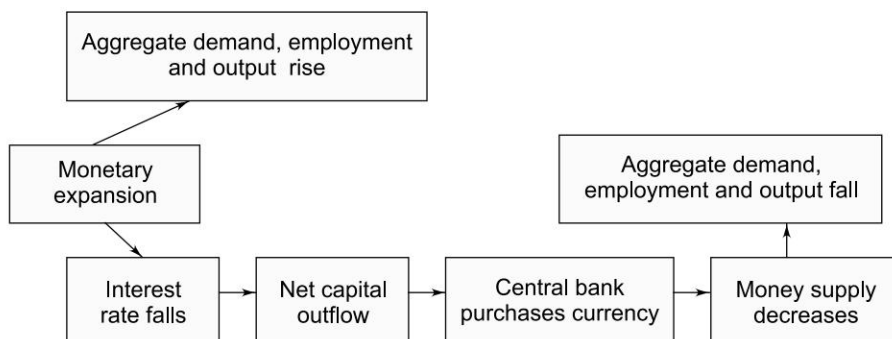
* For the case of contractionary fiscal policy, reverse all changes.

Fig. 16.1

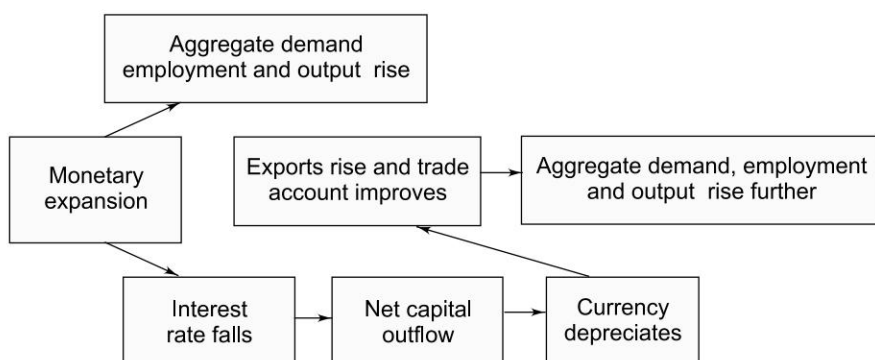
Short run Effects of Fiscal Policy on the Internal Sector

Monetary Policy under Fixed and Floating Exchange Rates

Figure 16.2 summarises the short term effects of monetary policy on a nation's internal sector. It is clear from the description given that under the flexible exchange rate system, monetary policy could be successful in restoring internal balance. But monetary policy is not effective in achieving internal balance under the fixed exchange rate system. This is because the initial increase in aggregate demand, employment and output resulting from the expansionary monetary policy is offset by the eventual fall in the aggregate demand, employment and output following the fall in the money supply because of the purchase of currency due to capital outflow.



(a) Monetary Policy Under Fixed Exchange Rate System*



(b) Monetary Policy under Flexible Exchange Rate System*

* For the case of contractionary monetary policy, reverse all changes.

Fig. 16.2

Short Run Effects of Monetary Policy on the Internal Sector

EFFECTS OF FISCAL AND MONETARY POLICIES ON EXTERNAL BALANCE

The short term effects of monetary policy under fixed exchange rate system is summarized in Fig. 16.3. (Only the fixed exchange rate system is considered here because under the floating exchange rate system balance of payments equilibrium is achieved by the automatic adjustment of the exchange rates.)

An expansionary monetary policy worsens the balance of payments while a contractionary policy improves it through its effects, as depicted in Fig. 16.3, in the short run. There are, however, chances of the effect becoming different in the long run. For example, an increase in the interest rate may encourage capital inflow and help improve the external balance; but the interest/dividend etc. payments on the foreign investment in the country will cause an outflow of money in due course (unless they are reinvested in the country) adversely affecting the balance of payments.

The short term effects of fiscal policy on the external balance is not as clear as those of the monetary policy. While a fall in the interest rate is associated with expansionary monetary policy, interest rate rises are associated with an expansionary fiscal policy.

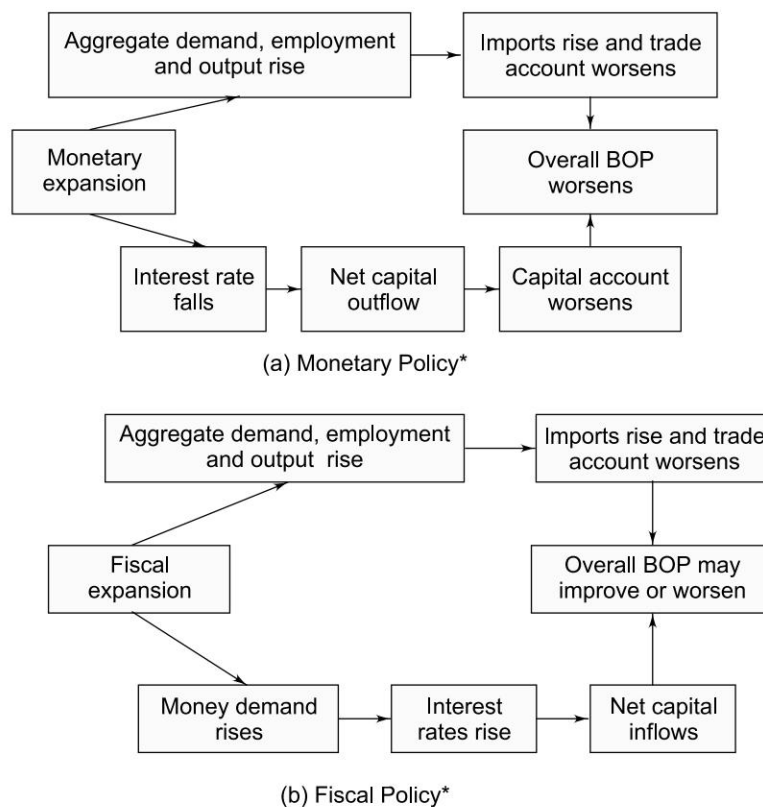


Fig. 16.3

Short Run Effects of Monetary and Fiscal Policies on the External Sector Under Fixed Exchange Rates

A rise in interest rate is associated with a contractionary monetary policy; a contractionary fiscal policy has the opposite effect on the interest rate, as pointed out earlier in this chapter. The interest rate effect and income effect of the monetary policy on balance of payments is in the same direction; but they are in the opposite directions in the case of fiscal policy and that is why the effect of fiscal policy on the external balance is difficult to assess. For example, in a recession, an expansionary fiscal policy leads to a rise in demand, employment and income, helping the attainment of internal stability. But the rise in demand and income is likely to cause increased imports, worsening the trade balance. The rise in interest rate, associated with the expansionary fiscal policy, may cause net capital inflows favourably affecting the balance of payments. The net effect of the fiscal policy on the external balance will depend on the difference between its income effect and interest effect.

Policy Dilemma and Assignment Rule

While certain combinations of internal and external imbalances are amenable to expansionary or contractionary monetary and fiscal policies, in the other combinations of imbalances and similar combinations of the policies (like expansionary monetary and fiscal policies) will help correct one of the imbalances and worsen the other imbalance.

Figure 16.4 shows four combinations of imbalances. In zone A—combination of high unemployment (internal imbalance) and balance of payments surplus (external imbalance) expansionary monetary and fiscal policies can help correct these imbalances. The expansionary policies will help increase the aggregate demand, employment and income. It will at the same time increase imports and help restore external balance. While the expansionary monetary policy tends to reduce the interest rate the expansionary fiscal policy tends to raise it so that there may not be any significant interest rate effect on the external balance. In zone D contractionary monetary and fiscal policies, with effects which are reverse to those mentioned above, will serve the purpose.

However, zones B and C present policy dilemma. For example, in zone B a contractionary monetary policy can help correct the external imbalance (fall in aggregate demand will reduce imports, rise in interest rate will encourage capital inflow) but will worsen internal imbalance (fall in aggregate demand will increase unemployment). A contractionary fiscal policy will also have similar effects on internal sector.

In zone C, an expansionary monetary policy will correct the external imbalance but will worsen the internal imbalance. An expansionary fiscal policy will help achieve external balance but will aggravate the internal problem. A contractionary monetary policy is helpful to correct the internal imbalance but will increase the balance of payments disequilibrium. A contractionary fiscal policy is useful to deal with the internal problem but will worsen the external imbalance.

State of balance of payments	State of domestic economy	
	<i>High unemployment</i>	<i>Rapid inflation</i>
<i>Surplus</i>	A Expansionary monetary and fiscal policies	C ??
<i>Deficit</i>	B ??	D Contractionary monetary and fiscal policies

Fig. 16.4 Monetary-Fiscal Policy Mixes for Internal and External Balances

The above policy conflicts indicate that we need to explore the ideal monetary-fiscal policy mix to deal with the combinations of the imbalances depicted above (zones B and C). **Robert Mundell** and **J. Marcus Fleming** point out that the different relative impacts of monetary and fiscal policies on internal and external balances imply that we should have two policy weapons to deal with the imbalances. In other words, monetary and fiscal policies can be mixed so as to achieve any combination of aggregate demand and overall balance of payments. Robert Mundell's **assignment rule** provides a useful guideline for assigning policy tasks to monetary and fiscal policies. The assignment rule is this: Assign to fiscal policy the task of stabilising the domestic economy only and assign to the monetary policy the task of stabilising the balance of payments only.

Employ fiscal policy for internal balance only and employ monetary policy for external balance only.

State of balance of payments	State of domestic economy	
	<i>High unemployment</i>	<i>Rapid inflation</i>
<i>Surplus</i>	A Expansionary monetary and fiscal policies	C Contractionary fiscal policy and expansionary monetary policy
<i>Deficit</i>	B Expansionary fiscal policy and contractionary monetary policy	D Contractionary monetary and fiscal policies

Fig. 16.5 Monetary-Fiscal Policy Mixes for Internal and External Balances

Going by the assignment rule, we can have a policy mix of expansionary fiscal policy and contractionary monetary policy for zone B and a contractionary fiscal policy and expansionary monetary policy mix for zone C (Figs 16.4 and 16.5).

DEVALUATION

As mentioned above, one of the ways to achieve external balance is expenditure switching policy. Devaluation seeks to bring about the desired switching of expenditure away from foreign goods to domestic goods.

Devaluation means a deliberate reduction of the value of the national currency in terms of other currencies. A country with a fundamental disequilibrium in the balance of payments may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium.

To illustrate, let us take the example of the devaluation of the Indian *Rupee* in 1966. Just before the devaluation of the Rupee with effect from June 6, 1966, the exchange rate was \$1 = Rs 4.76. The devaluation of the Rupee by 36.5 per cent changed the exchange rate to \$1 = Rs 7.50. Before the devaluation, the price of an imported commodity which cost \$1 abroad was Rs 4.76 (assuming cost free trade). But after devaluation, the same commodity which cost \$1 abroad, would cost Rs 7.50 when imported. Thus, devaluation makes foreign goods costlier in terms of the domestic currency and this discourages imports. On the other hand, devaluation makes exports (from the country that has devalued the currency) cheaper in the foreign markets. For example, before devaluation, a commodity which cost Rs 4.76 in India could be sold abroad at \$1 (assuming cost free trade), but after devaluation, the landed cost abroad of the same commodity was only \$0.64. This comparative cheapness of the Indian goods in the foreign markets was expected to stimulate demand for Indian exports.

Limitations of Devaluation

The success of devaluation depends on the fulfillment of certain conditions.

1. Devaluation is not likely to produce favourable effects if other countries retaliate by devaluing their currencies. Thus, the cooperation of other countries is necessary to make devaluation a success.
2. Devaluation will not succeed in increasing exports and decreasing imports if the domestic prices rise by a rate equal to or higher than the rate of devaluation. Sometimes, devaluation may lead to some rise in

Devaluation will be successful in achieving external balance only under certain conditions.

domestic prices. For instance, if imported goods are used even after devaluation, the cost of production of goods embodying imported inputs will go up.

3. The success of devaluation depends also on the price elasticities of demand for exports and imports. The *Marshall-Lerner* condition says that devaluation will improve the balance of payments only if the sum of elasticities of demand for the country's exports and demand for imports is greater than one.
4. Even though devaluation increases the demand for a country's exports considerably, there could be another constraint, namely inadequacy of exportable surplus.
5. A corollary of the above point is that the success of devaluation depends also on the extent of *absorption*.

Two important determinants of the success of devaluation, namely, the elasticities and absorption are dealt with in detail below.

Elasticities Approach

The elasticities approach presents the traditional approach to the effects of devaluation on the balance of trade (or payments). According to the elasticities approach, the success of devaluation as a measure to improve the balance of trade depends upon the elasticities of demand for the devaluing country's exports and its imports.

Effect of Devaluation on Exports Whether the devaluation will increase, reduce or leave unaffected the export earnings will depend upon the extent of the elasticity of demand for the country's exports.

For the purpose of analysis, we will consider the following three situations, (based on the *Marshallian total outlay* method).

The effect of devaluation on exports will depend on the price elasticity of demand for the country's exports.

Elasticity Greater than Unity Devaluation will result in an increase in the total export earnings if the price elasticity of demand for its exports is greater than unity, i.e. $ex > 1$ (where ex is the price elasticity of demand for the exports of the devaluing country). If elasticity is greater than unity, a fall in price by P per cent will result in an increase in the quantity demanded by *more than* P per cent so much so that there will be an increase in the total export earnings.

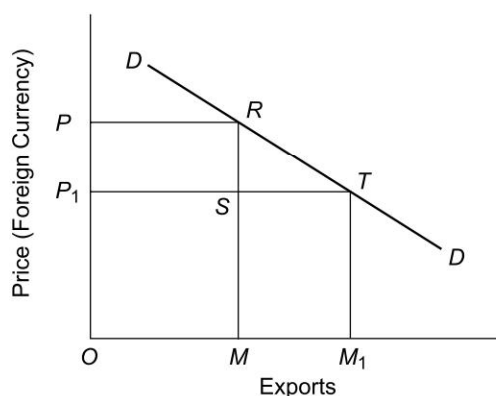


Fig. 16.6

Effect of Devaluation on Exports—Elasticity Greater than Unity

In Fig. 16.6, the price of exports, expressed in terms of foreign currency, before devaluation is OP and OP_1 after devaluation. Total exports is OM before devaluation and OM_1 after the devaluation. Due to the fall in price consequent to devaluation, on every unit exported there is a loss of foreign exchange equivalent to PP_1 ; the total loss of foreign exchanges on OM quantity is PP_1SR . However, the fall in price of exports brought about by the devaluation increases exports from OM to OM_1 . The total foreign exchange earnings on the additional exports of MM_1 is MM_1TS . The gain (MM_1TS) is greater than the loss (PP_1SR). Hence, the net effect of devaluation in this case is an increase in the total export earnings. That is to say, *devaluation will increase the total export earnings if the price elasticity of foreign demand for the country's exports is greater than unity and the supply of exports is sufficiently elastic to meet the increased demand for the exports.*

Elasticity Less than Unity Devaluation will result in a decrease in the total export earnings if the price elasticity of demand for the exports is less than unity i.e. $ex < 1$.

If elasticity is less than unity, a fall in the price by P per cent will increase the quantity demanded by less than P per cent so much so that there will be fall in the total export earnings.

In Fig. 16.7, the price of exports, in terms of foreign currency, is OP before devaluation and OP_1 after devaluation; total exports is OM before devaluation and OM_1 after devaluation. The gain from the additional exports of MM_1 is MM_1TS . The total loss of unit value of exports due to devaluation is PP_1SR . As MM_1TS is less than PP_1SR , the net effect of devaluation in this case is a fall in the total export earnings. Thus, *devaluation will decrease the total exports earnings if the price elasticity of foreign demand for the country's exports is less than unity.*

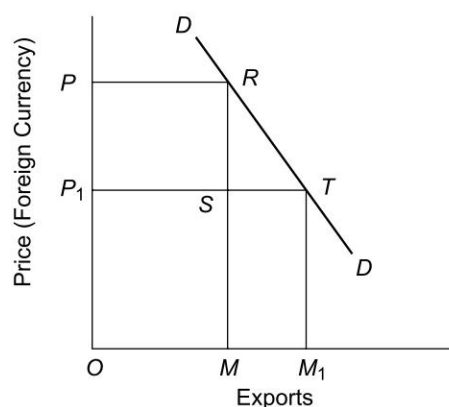


Fig. 16.7

Effect of Devaluation on Exports—Elasticity Less than Unity

Elasticity Equal to Unity If the price elasticity of demand for exports is equal to unity ($ex = 1$), devaluation will not affect the total export earnings.

If elasticity is equal to unity, a fall in the price by P per cent will cause the demand to increase proportionately so that there will not be any change in the total export earnings (i.e. if, price is halved, the exports double—a unique property of the rectangular hyperbola DD , any point on which will represent rectangles having same area).

In Fig. 16.8, total loss of export earnings due to the fall in the unit price of exports is PP_1SR and the total earnings from the additional exports of MM_1 is MM_1TS . $PP_1 = MM_1TS$. In other words, devaluation does not have any effect on the total export earnings. Thus, *if the price elasticity of foreign demand for the country's exports is equal to unity, and the supply of exports is sufficiently elastic to meet the increased demand, devaluation will not cause a change in the total exports earnings.*

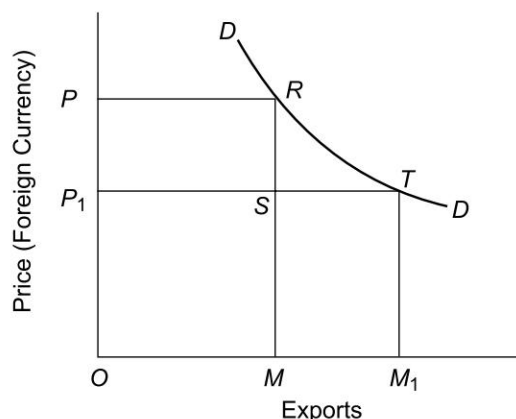


Fig. 16.8 Effect of Devaluation on Exports—Elasticity Equal to Unity

Effect of Devaluation on Imports As pointed out in the beginning of this chapter, devaluation increases the price of imports (in terms of the currency that is devalued). It must be remembered that the price of imports rises in terms of the home currency and not in terms of the foreign currency. Devaluation does not directly affect the supply price of imports expressed in foreign currency.

The effect of devaluation on the country's imports will depend on the price elasticity of demand for imports.

As devaluation increases the price of imports in terms of the home currency, there will be a fall in the volume of imports if the price elasticity of demand for imports is greater than zero ($em > 0$). When the volume of imports falls, there will, obviously, be a proportionate saving of the foreign exchange spent on imports. The extent of fall in the volume of imports and the corresponding savings of the foreign exchange will depend upon the price elasticity of demand for imports.

In Figs 16.9 and 16.10, OP is the price of imports, in terms of the home currency, before devaluation and OP_1 is the price after devaluation. Imports before devaluation is OQ quantity.

Figure 16.9 represents a situation wherein the price elasticity of imports is zero. Hence, devaluation fails to bring about any fall in the volume of imports. Therefore, the total import bill (in terms of foreign currency) of the country will also not be affected by the devaluation.

In Fig. 16.10, the elasticity of demand for imports is greater than zero but less than one. In other words, the demand curve DM_1 is relatively inelastic. Due to the increase in the price caused by devaluation, the volume of imports falls from OQ to OQ_1 . Though the supply price of imports expressed in foreign currency is not changed by devaluation, the total import bill (expressed in foreign currency) will fall because of the fall in the volume of imports by OQ_1 .

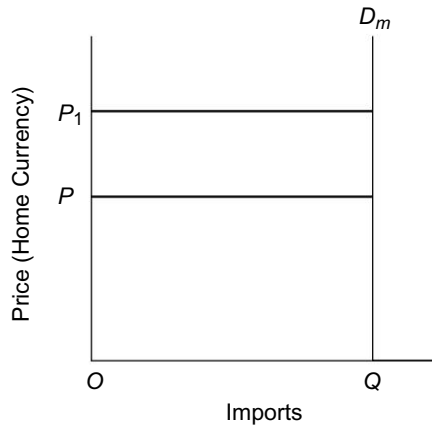


Fig. 16.9

Effect of Devaluation on Imports—Zero Elasticity



Fig. 16.10

Effect of Devaluation on Imports—Elasticity Greater than Zero

In Fig. 16.11, the demand curve DM_2 is relatively elastic (i.e. $em > 1$). Due to the increase in price of imports caused by the devaluation, the volume of imports falls from OQ to OQ_2 . This decline in imports by OQ_2 is substantial when compared to the situation in Fig. 16.10. The import bill expressed in foreign currency will also fall proportionately. Thus, the extent of foreign exchange savings on imports due to devaluation will depend upon the price elasticity of demand for imports.

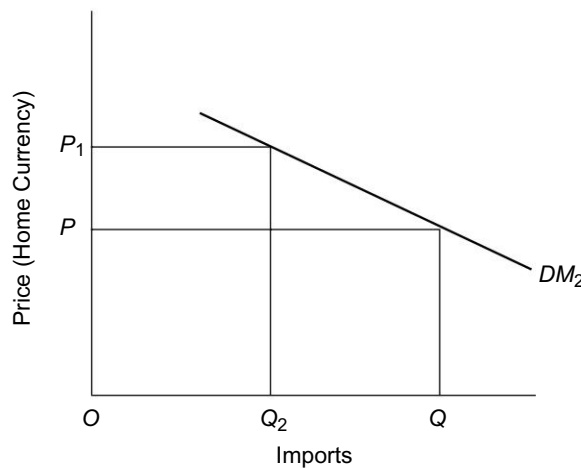


Fig. 16.11

Effect of Devaluation on Imports—Elastic Demand

In the above analysis, we have considered the effect of devaluation on exports and imports separately. The balance of payments situation is affected, however, by changes in both exports and imports. Hence, to judge the success of devaluation in improving the balance of payments, we should consider the combined net effect of changes in exports and imports on the balance of payments. When we consider the effect of

devaluation on imports as well as exports, it is not necessary that price elasticity of demand for exports is greater than unity, for the devaluation to be successful. The balance of trade position can improve even if the elasticity of demand for exports is not greater than unity, provided devaluation causes a sufficient decline in imports. Devaluation will be successful in improving the balance of trade if the Marshall-Lerner condition is fulfilled.

Marshall-Lerner Condition What will be the combined net effect of the changes in exports and imports caused by devaluation on the balance of trade (or payments)? The answer to this question is given by the *Marshall-Lerner condition* which states, in effect, that *devaluation will improve the balance of payments of a country and revaluation will worsen it if the sum of elasticities of demand for a country's exports and of its demand for imports is greater than 1.*

The net effect of devaluation on trade balance is determined by the extent of elasticities of the demand for its exports and imports.

The Marshall-Lerner condition can be expressed algebraically as follows:

$$ex + em > 1$$

where ex is the price elasticity of demand for country's exports, and em is the price elasticity demand for the imports.

- If $ex + em > 1$, devaluation will improve the country's balance of payments.
- If $ex + em < 1$, devaluation will cause further deterioration in the balance of payments.
- If $ex + em = 1$, devaluation will not have any direct effect on the balance of payments of the country.

Hence, devaluation should be resorted to only if the Marshall-Lerner condition can be satisfied, i.e. $ex + em > 1$.

It follows from the Marshall-Lerner condition that devaluation can improve the balance of payments even when the elasticity of demand for exports is zero, provided the sum of elasticities of demand for exports and imports is greater than 1. Quite obviously, when the elasticity of demand for exports is zero, the sum of elasticities will be greater than 1, only if the elasticity of demand for imports is greater than unity. Similarly, it also follows that, at the other extreme, devaluation will improve the balance of payments even when the demand for imports has zero elasticity, provided the sum of elasticities of demand for exports and imports is greater than 1 (i.e. if elasticity of demand for exports is greater than one).

Evaluation The Marshall-Lerner condition is based on some drastic simplifications. As Sodersten points out, "it assumes, roughly, that the supply elasticities are large (approaching infinity) and that the trade balance is in equilibrium when devaluation takes place."¹ These assumptions are not always true.

None of these assumptions invalidate, however, the spirit of the Marshall-Lerner condition which says that the larger the respective demand elasticities, the more favourable is the effect of a devaluation on the trade balance.²

Income-Absorption Approach

The *income-absorption approach* to the effects of devaluation, introduced by Sidney S. Alexander in 1952,³ is a very useful complement to the traditional elasticities approach. The income-absorption approach, which runs in macro terms, maintains that the foreign trade balance is equal to the difference between the total goods and services produced in that country and their absorption. *Absorption refers to the total goods and services taken off the market domestically. In other words, absorption equals the sum of consumption plus investment.*

Trade balance is equal to the difference between gross domestic production and gross domestic absorption (consumption + investment).

A trade deficit results from the people of the country *absorbing* more than what they have produced. In other words, there will be a trade deficit when the total consumption and investment exceed the national output. A trade surplus, on the other hand, is the result of *under-absorption* (i.e. consumption and investment are less than the total domestic output).

Expressed algebraically,

$$B = Y - A$$

where B is the foreign trade balance, Y is the total domestic output and A is the total absorption of goods and services.

If devaluation is to affect the foreign balance, it can do so in only two ways:

1. It can lead to a change in the production of goods and services so that the foreign balance will be altered by the difference between the change in income and the income induced change in absorption.
2. The devaluation may change the amount of real absorption associated with any given level of real income.

Change in B , Y and A may be denoted by the corresponding small letters so that the fundamental identity can be written as:

$$b = y - a$$

This equation indicates that the change in the foreign balance equals the difference between the change in output and the change in absorption of goods and services. This shows that the effect of devaluation on the absorption depends on how devaluation will affect b , y and a .

Alexander points out that ' a ' (i.e. the change in the absorption of goods and services in real terms as a result of devaluation) is made up of the following two factors:

1. Change in real consumption plus real investment that is induced by the change in real income that results from the devaluation.
2. Change in absorption which results other than through income effect.

This can be expressed as follows:

$$A = cy - d$$

where ' c ' is the propensity to absorb which is equal to the propensity to consume plus the propensity to invest, and the term ' d ' denotes the *direct effect* of devaluation on absorption. ' d ' expresses whatever tendency there may be for the devaluation to induce a change in the amount of real absorption at any level of real income.

A combination of the functional relationship ($a = cy - d$) with the fundamental identity ($d = y - a$) yields:

$$B = (1 - c)y + d$$

The above formulation makes it quite clear that to know how the devaluation affects the trade balance (i.e. to find out how large is b), we should investigate:

1. How does devaluation affect income?
2. How does a change in the level of income affect absorption (i.e. how large is c)?
3. How does devaluation directly affect absorption at any given level of income (i.e. how large is d)?

Effect of Devaluation on Income Devaluation may cause a change in income through the (a) Idle Resources Effect and (b) Terms of Trade Effect.

Idle Resources Effect If there are idle resources (i.e. if the economy is not at full employment), the increase in exports due to devaluation and the induced stimulation of domestic demand may bring about an increase in income through the *multiplier*. The extent of the expansion of output, however, depends on:

- (i) the value or the size of the *multiplier*,
- (ii) the degree to which an increased output of goods and services is forthcoming without an extensive price rise in the devaluing country, and
- (iii) the capacity and willingness of the rest of the world to absorb exports from the devaluing country.

It must be emphasised that the net effect of the recovery or the increase in income on the balance of trade is not the total amount of additional production, but the difference between this amount and the induced increase in real absorption. This difference between the real production or income and the real expenditure on goods and services is termed as real hoarding. The foreign balance is, by the fundamental identity, equal to the aggregate real hoarding of the economy as a whole. The income induced change in the balance, b , is accordingly equal to the income induced change in real hoarding, i.e. the change in real income, y , multiplied by the propensity to hoard, $1 - c$. The existence of the business cycle makes it plausible that c may be greater than unity, that an increase in income may stimulate and even greater increment in the absorption of goods and services into consumption and investment. If c is equal to or greater than unity, the foreign balance will not be improved as a result of the increased output.

Alexander concludes that *from the point of view of a devaluing country that has unemployed resources, the effect on income, as well as the favourable effect on the balance of payment, if c is less than unity must constitute the most attractive potentiality of a devaluation. If the country is at full employment, this potentiality does not exist and effects of a devaluation must depend on the more tenuous and less attractive direct effects on absorption.*

Terms of Trade Effect It is generally believed that devaluation will lead to a deterioration in the terms of trade. If real income falls, because of the adverse terms of trade, so will absorption, and this will have positive effect on the trade balance. If the reduction in real income due to deterioration in the terms of trade is denoted by ' t ' then the fall in absorption will *equal* ct . This does not constitute a net improvement in the trade balance, however, because the adverse terms of trade imply an initial deterioration in the trade balance with t . Hence the net effect on trade balance is $t - ct$ or $(1 - c)t$. A deterioration in terms of trade will, therefore, also normally entail a deterioration in the trade balance. Only if c is larger than unity will a deterioration in terms of trade produce a positive effect on the trade balance.

Direct Effect on Absorption If there is initially full employment, or if c is almost unity or greater than unity, the principal favourable influence of a devaluation on the foreign balance is through the direct effect on absorption. This direct effect is largely associated with a tendency for a high or rising price level to discourage consumption or investment out of a given level of real income. Alexander states that *the direct effect on absorption is any influence toward lower real expenditure as money income and money prices rise together as a result of the devaluation.*

The important direct absorption effects are mentioned below:

Cash Balance Effect If the money supply is inflexible, and if money-holders wish to maintain cash holdings of a certain real value, they will have to reduce their real expenditure relative to their real incomes and this will reduce absorption.

Redistribution of Income During a period of rising prices, since wages tend to lag behind prices, profits will rise faster than wages, thereby redistributing income from groups with a high propensity to absorb to those with a low propensity.

Money Illusion The 'money illusion' may contribute a favourable effect to a devaluation if it actually leads people to pay more attention to money prices than to money incomes. If at higher prices, people choose to buy and consume less even though their money income has increased in proportion, over and above what can be attributed to the cash balance effect, the result on the balance of payments will be favourable.

Miscellaneous Effects There may be other direct absorption effects, some working towards a favourable, others toward an unfavourable, change in the foreign balance. For instance, expectations of price rises may be inspired leading to increased absorption with adverse effects on the foreign balance, at least in the short run.

Alexander also points out that many of the direct absorption effects may be transitory. Thus, the money supply may respond to increased demand for cash balances, so that the cash balance effect may gradually disappear or be counterbalanced by additional absorption financed by credit creation. Similarly, some of the income-distribution effects are associated with lags, but the lagged income may eventually catch up. Further, some of the effects may be non-proportional. For example, a small devaluation may take advantage of the money illusion, whereas a larger one may shatter it.

Evaluation The absorption approach to correcting BOP disequilibrium has been subjected to the following criticisms.

1. One important drawback of the absorption approach is that it neglects the price effects of devaluation. The price effect is a very important factor that decides the success of devaluation, as explained elsewhere in this chapter.
2. Another handicap of the absorption approach is that it does not consider the impact of devaluation on the absorption in the country's trading partners which could have impact on the trade balance of the country which has devalued the currency.
3. It is difficult to estimate the extent of possible absorption as it is difficult to measure the various effects on absorption.
4. A reduction in absorption need not necessarily lead to an improvement in the BOP because there is no guarantee that the foreign markets will absorb the domestic surplus.
5. Another criticism is that it is not applicable to the flexible exchange rate system.

The J-Curve Effect and Currency Pass-Through

The time path of the response of trade flows to a devaluation may be described in terms of the *J-curve effect*. The J-curve effect refers to the possibility of a particular effect of devaluation: Devaluation will result in an initial deterioration of the trade balance and this will be followed by a subsequent improvement.

Devaluation may result in an initial deterioration and then a significant improvement in trade balance.

Empirical evidence suggests that the trade-balance effects of devaluation do not materialise until quite some time. According to this empirically observed phenomenon, if the balance of trade (or current account balance of payments) is plotted against time we will get a 'J' shaped curve showing the initial deterioration and the subsequent improvement.

Theory of the J-Curve Effect Some amount of theorising is possible as to why the J-curve phenomenon exists.⁴ One possibility could be an explanation in terms of the invoicing currency. Given a contract, the volume of exports or imports is fixed. But if the export contract is in domestic currency units less foreign exchange is earned as a result of the devaluation and the balance of payment tends to deteriorate, when measured in foreign currency. Obviously, this also depends on what happens to imports, but it is assumed that imports are invoiced in foreign currency. As long as old contracts negotiated before devaluation are important, the balance of trade continues to deteriorate. It begins to improve only when new contracts are negotiated.

Another reason could be the time lag involved in producing results by the incentives provided by devaluation.

The J-curve effect may also be explained in terms of certain time lags in a devaluation's adjustment process. The types of lags that may occur between changes in relative prices and the quantities of goods traded include the following:⁵

Recognition Lags of changing competitive conditions.

Decision Lags in forming new business connections and placing new orders.

Delivery Lags between the time new orders are placed and their impact on trade and payment flows is felt.

Replacement Lags in using up inventories and wearing out existing machinery before placing new orders.

Production Lags involved in increasing the output of commodities for which demand has increased.

Currency Pass-Through Relationship The trade effect of devaluation also depends on the currency pass-through relationship. It is theoretically assumed that a given change in the exchange rate brings about a proportionate change in import prices. In practice, however, this relationship may be less than proportionate, thus weakening the influence of a change in the exchange rate on the volume of trade. *The extent to which changing currency values lead to changes in import and export prices is known as the currency pass-through relationship.* Pass-through is important because buyers have incentive to alter their purchases of foreign goods only to the extent that the prices of these goods change in term of their domestic currency following a change in the exchange rate. This depends on the willingness of exporters to permit the change in the exchange rate to affect the prices they charge for their goods, measured in terms of the buyer's currency. The other side is that foreign buyers may try to take away a part of the profit, the exporters can get, because of devaluation by bargaining down the price.

Following devaluation, prices of goods may not change in the same proportion of the change in the currency exchange rates.

Empirical evidence suggests, however; that the more typical real-world situation is *partial pass-through*, with significant time lags. Concerning the United States, it is estimated that for every 10 per cent change in the value of the dollar, both import prices and export prices change about 6 per cent. Moreover, exchange-rate changes tend to be absorbed by profit margins for as long as two years or more before affecting product prices. These lags depend on the length of time before dollar-denominated contracts expire as well as on the extent to which businesses view exchange-rate changes as permanent rather than temporary.⁶

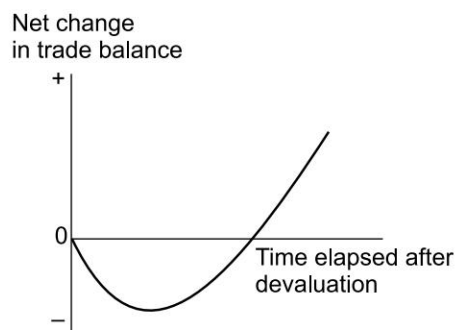


Fig. 16.12 The J-Curve Effect

DEVALUATION OF RUPEE

Devaluation of 1966

In 1966, currencies of different countries were, in the *Bretton Woods System*, under the pegged exchange rate system (par value system). Under the *Bretton Woods System*, a country had to obtain the consent of the IMF to effect any exchange rate variation of more than 10 per cent. A country with fundamental disequilibrium in the balance of payments was allowed by the IMF to devalue the currency.

Indian Rupee was drastically devalued in 1966 in a bid to improve trade balance.

Since the Second Five-Year Plan, India's trade gap began to widen. In the last year of the Third Plan, export earnings were equivalent to only 58 per cent of the import bill. The total export earnings during the Third Plan was equivalent to only 60 per cent of the import bill. Consequently, India's external payments problem became very severe, calling for drastic measures.

On June 6, 1966 the Indian Rupee was devalued 36.5 per cent (or 57.56 per cent considering the amount of Indian rupee per US dollar). It was alleged that India was forced to take such a decision because of the IMF's refusal to grant it further accommodation unless it devalued the currency.

The devaluation took place at a time when economic conditions in India were very bad due to, among other thing, several external factors. During 1965–66 and 1966–67 there was drought which severely affected the agricultural output. The war with Pakistan in 1965, before the wounds of the Chinese aggression were healed, had created its own set of problems. This had also caused the straining of the relationships with certain countries like the USA which affected the prospects of the foreign aid. It may be noted that these disturbances were so serious that the launching of the *Fourth Plan* was put off for three years.

The setback to agricultural production due to the drought had a very adverse effect on India's trade balance. It adversely affected exports by reducing the exportable surplus of agricultural products. The fall in the agricultural output also caused, on the other hand, an increase in the agricultural imports. The shortages and higher prices of imports (which resulted from devaluation) exerted inflationary pressures.

Due to the above factors and perhaps also because of the J-curve phenomenon, trade balance continued to be very precarious for two years following devaluation. The situation, however improved considerably afterwards. It may be noted that the Fourth Plan recorded the lowest trade gap among all the first eight Five Year Plans. The average annual growth rate in value of exports during 1961–62 to 1965–66 was only 3.7 per cent but it improved to 4.9 per cent over the period 1966–67 to 1970–71.

Several adversities affected the success of the devaluation.

It may be noted that the exporters did not get the full benefit of the devaluation. The benefit to the exporters depends not on the gross devaluation but on the net devaluation or the effective exchange rate. “The effective exchange rate (EER) is the number of rupees paid or received for one unit of foreign exchange. This need not necessarily be the same as the official exchange rate. Subsidies on exports would lead to the EER for exports being higher than the official exchange rate. Tariffs on imports could lead to the EER for imports being higher than the official exchange rate.”⁷

Following devaluation, several export incentives like import entitlement (Import entitlement which later came to be known as import replenishment licence or Rep. or as Exim Scrip was an entitlement for importing specified items up to a certain percentage of the export value. This entitlement was freely tradable and the incentive was that it could be sold at a premium because of the high demand for importables.) and export subsidies were withdrawn. Further, export duties were imposed on nearly 62 per cent (in value terms) of traditional exports.⁸ Conversely, the tariffs on a number of imports were reduced so as to offset the effects of devaluation on the rupee price of imported items.⁹ These considerably reduced the net devaluation. Estimates of the effects of the formal devaluation and the other measures show that the net devaluation was only 21.6 per cent for exports and only 42.3 per cent for imports,¹⁰ as against the nominal devaluation of 57.5 per cent.

Devaluation of 1991

The external value of the Indian rupee was linked to the value of certain foreign currencies. Periodic adjustment of the exchange rate of the rupee was, therefore, not unusual. But the exchange rate adjustment effected in July 1991 in two instalments was substantial and of an unusual magnitude so that it was described as devaluation.

It may be noted that exchange rate adjustments are very common. Several countries have significantly depreciated their currencies. For example, between 1985–87, the US engineered a 50 per cent fall in the external value of dollar through the Group of Seven. Many of India's other trade partners also made substantial exchange rate adjustments over the past years. Over the period end December 1980 to end December 1989, China depreciated the currency by 68 per cent and Indonesia by 65 per cent while India depreciated by only 54 per cent against the US dollar, whereas increase in consumer prices both in China and Indonesia were lower (at 100 per cent and 111 per cent, respectively) against India's 114 per cent over the same period.

A downward adjustment of about 18 per cent in the external value of the rupee was effected in two steps on July 1 and 3, 1991.

Effects of Devaluation It may appear that devaluation can help solve the problem of trade deficit by stimulating exports and curtailing imports. But in actual practice, the effect of devaluation depends on a number of intricate and, often, interdependent factors. Depending on these factors the net effect of devaluation may be favourable or unfavourable. If factors are, by and large, unfavourable, exports may

not increase sufficiently enough to improve the trade position or the high cost of imports and certain other developments resulting from devaluation may cause inflation and nullify the initial effect of devaluation on export prices.

A basic assumption related to devaluation is that the demand for the country's exports and imports is price elastic, i.e. a fall in export prices will substantially increase the demand for exports and an increase in the prices of imports will significantly reduce imports. However, these things need not necessarily happen.

The demand for many exports of the developing countries, like the primary commodities, is regarded as relatively price inelastic, that is, a fall in the price will not significantly increase the demand. On the other hand, the demand for many of the imports of the developing countries, like essential consumer goods, capital goods, technology, etc. is also relatively price inelastic, i.e. an increase in the import prices will not considerably reduce the imports.

Effect of Devaluation on Exports It should be noted that devaluation may lead to a fall in the unit value of exports and hence the total exports earnings will increase only if the quantum of exports increases more than the rate of fall in the unit value of exports following the devaluation. If the quantum of exports does not increase at least to the extent of the rate of fall in the unit value of exports, there will be a fall in the total export earnings. However, as trade balance is a function of both exports and imports, we have to consider the effect of devaluation on both exports and imports. In other words, devaluation will improve a country's trade balance only if the sum of elasticities of demand for exports and of its demand for imports is greater than one, i.e. only if the *Marshall-Lerner condition* is satisfied.

Effect of Devaluation on Imports If the demand for imports is inelastic, not only devaluation will not reduce the import bill but it will also lead to price rise in the domestic economy because of the increased cost of the imported consumer goods, capital goods, intermediate goods, raw materials, etc. This increase in domestic prices will soon wipe off the price advantage with respect to exports brought about by devaluation. If the exports have import content, as is true in many cases, the problem is further accentuated. It may be noted that the import intensity of Indian exports increased from 21 per cent in 1980–81 to around 40 per cent in the early 1990s. (Increase in import intensity is quite common when the proportion of manufactured goods, particularly, sophisticated items, increases.) Thus, the whole situation could again deteriorate to make the trade balance very adverse.

Conditions Necessary for the Success of Devaluation Even if there is good demand for a country's exports, exportable surplus is an important determinant of export earnings. Given the level of domestic absorption, exportable surplus depends on the level of domestic output which is affected by such factors as supply of imports like raw materials and power, climatic conditions which affect agricultural production, etc. While adverse factors will reduce the exportable surplus of some commodities, short supply will necessitate large imports of some other commodities.

An important condition necessary for the success of devaluation is that other countries should not retaliate or should not take measures which discourage our exports to them. For example, if an importing country enhances imports duties, the prices of our exports in that country would increase. This will defeat our objective of increasing exports by reducing prices by devaluation and in the absence of sufficient increase in the quantum of exports we might end up with a lower export earning due to the fall in the unit value of exports. Further, competitors may react by depreciating their currencies.

There are, thus, a host of factors which determine the success or failure of devaluation in improving the foreign trade balance. Against this background, let us have a look at the factors which tend to limit the success of devaluation in India.

Factors Limiting the Success of Devaluation Devaluation will stir up domestic prices because we are very import dependent. Many of our vital imports, being essential items, are price inelastic in demand. Petroleum Oil and Lubricants (POL) account for a large share of our total import bill. In the event of a devaluation, the increase in the price of imported oil will have a cascading effect on domestic prices. Chemicals are also important imports and their imports will not be considerably affected by higher prices. We spent a considerable amount on import of capital goods. There are also a number of indispensable consumer good, raw materials and intermediate good imports. The demand for many foreign goods which satisfy 'conspicuous' consumption is also relatively price inelastic.

Several internal factors can limit the success of devaluation.

Thus, devaluation is unlikely to achieve considerable import savings. On the other hand, it will raise domestic prices because of the high cost of capital goods, oil, raw materials, intermediate goods, etc. It may also encourage smuggling. Devaluation will increase the output prices of industries using imported inputs. The point is clearly demonstrated by the increase in the prices of automobiles manufactured with Japanese collaboration following the appreciation of the yen. A devaluation of the rupee will have similar effect on export prices, apart from the effect of general increase in prices in the economy. Therefore, the initial price advantage of exports imparted by devaluation will soon vanish and will usher in a further high cost domestic economy.

Agro-based products accounts for significant share of our total exports. Adverse weather and climatic conditions may affect their exportable surplus and necessitate increased import of certain agricultural based products. This unfortunate situation occurred in the year following the devaluation of 1966. Even if there will be good foreign demand for certain industrial products our ability to generate sufficient exportable surplus is constrained by inadequacy of the productive apparatus and other supply bottlenecks.

The factors described above indicate the limitations of devaluation in achieving the expected results or the conditions to be satisfied for the success of the devaluation.

The July 1991 devaluation should not be viewed in isolation. It should be seen as an important item of a package of measures introduced to reform the trade regime which is linked to the general economic policy reform introduced in the country. The evaluation of the devaluation should be made in this context.

Evaluation One of the important measures in the trade promotion package was the abolition of the Cash Compensatory Support (CCS). This was a much needed measure for two important reasons. Firstly, it was an important contributor to the surging fiscal deficit in India. If the CCS were not abolished, in 1991–92 it would have amounted to an estimated Rs. 3000 crore, or more. Secondly, the CCS, being an export subsidy, was strongly opposed by forums like GATT and retaliated by importing countries. Further, looking at the CCS which the Indian exporters were enjoying, importers of Indian goods often tried to bargain down the prices.

In addition to the above reasons, the administrative problems like the delays in dispersing the CCS, fixation of appropriate CCS rates etc., called for its replacement by a better alternative.

It was hoped that the devaluation and the partial convertibility of the rupee would more than compensate the exporters for the loss of the CCS while solving the problems created by the CCS to the nation and exporters. Further, all exporters benefited out of the new regime. More particularly, exports with least import intensity benefit the most.

We have seen that the success of devaluation in increasing exports depends on a number of factors. One of these factors is the elasticity of demand for exports. According to an econometric estimation, the elasticity of exports with respect to the Real Effective Exchange Rate (REER) is 0.66 i.e. for a one percentage point depreciation of the REER, export volume would increase by 0.66 of one per cent. Exports of manufactured goods are even more price-sensitive.¹¹ It needs to be cautioned that the quantitative estimates may not reflect the exact picture as they are not able to incorporate several relevant factors influencing the exports. These estimates, however, are indicative. Further, the change in the composition of India's exports makes the situation in the 1990s different from what it was at the time of the devaluation of 1966. The composition of India's exports has undergone significant changes since the mid-1960s and manufactured exports today constitute about 75 per cent of total exports.

It should, however, be noted that exports of several commodities continue to suffer because of supply constraints for which devaluation is no solution. There is no alternative to increases in their supply. The industrial policy liberalisations, including the policy towards foreign capital and technology, provide a much better environment for supply expansion when compared to the situation at the time of the 1966 rupee devaluation.

It has been reported that export of certain commodities has been boosted following the increased export profitability due to devaluation and other factors. Further, export of certain commodities, which was not profitable earlier, has become profitable consequent to devaluation.

Although devaluation makes imports costlier, imports of essential items cannot be contained unless the domestic production increases to bridge the demand-supply gap. Thus, on the import side also devaluation is no alternative to increase in domestic production.

Devaluation can encourage import substitution. Several such cases have been reported.

It has been pointed out that despite notions to the contrary, our imports are also sensitive to relative changes in prices. One study has shown that the price elasticities are greater than one for manufactured goods and machinery and transport equipment, which amounted to an estimated 50 per cent of total imports in 1989–90. This does not mean that consumer demand for other imports is not responsive to prices. In many cases higher import prices are not passed through to consumers because of administered prices. If imports as a whole are not price sensitive, it is because a proportion of our imports such as defence imports and bulk imports are insulated from price factors. Consequently the impact of the changes in the value of the currency is not fully reflected in imports.¹²

Devaluation, obviously, increases prices of imported goods and products with import content. The increase in the price of several imported items like petroleum products affect the general price level. Devaluation caused substantial increase in project costs in many cases.

Domestic price stability and sufficient supply of exportables are necessary for success of devaluation.

Unless the government takes effective measures to contain inflation, the favourable price effects of devaluation on exports will be soon wiped out, particularly with respect to products with import content.

An important question in this context is 'can the government control the prices'? The answer is 'Yes', if appropriate measures are taken. Apart from the general measures of price control, there are certain specific measures that could be taken to prevent a price rise due to devaluation. Devaluation does not increase the foreign exchange cost of imports. Hence, the government can hold the price of essential items like petroleum products. But the tragedy is that, to increase the revenue flow to the exchequer the government increases the administered prices. The imported price of items like capital goods can be prevented from rising due to devaluation if the government lowers the tariff wall. But, here also revenue considerations often override other considerations.

If the government does not hold the price line by these and other measures, the benefits of devaluation will be shortlived.

The export performance of India was very poor immediately after the devaluation of 1991. This, however, is no indication of the success or failure of devaluation. There were some important reasons for this poor export performance. The severe foreign exchange problems compelled the government to resort to severe import compression for a period and this had adversely affected exports as the difficulty in obtaining imported inputs affected export production. Secondly, the slow down in the expansion of the world trade and recessionary conditions in some major industrial countries has had its share of impact on the India exports. Thirdly, exports to the former USSR and Eastern Europe and the Middle East suffered a serious setback due to the internal disturbances in these regions. Exports, however, improved later.

Further, there is also the possibility of the J-curve effect (i.e. the immediate effect of a devaluation could be a deterioration in the balance of trade but trade balance will considerably improve after the initial time lag).

Devaluation cannot succeed in isolation. Its success depends on a number of complementary factors as pointed out earlier. In addition to these, to improve the export performance considerably there should be a substantial streamlining of the administrative system and India should graduate itself to international marketing from international trading.

SUMMARY

Monetary and fiscal policies are often employed to attain internal and external balances.

Internal balance connotes (1) full employment (of labour and other resources), i.e. utilising more or less the feasible productive capacity of the nation, and (2) reasonable price stability. External balance denotes that the sum of current and capital accounts on the credit and debit sides of the balance of payments should equal. When this is achieved, the country is neither losing official reserves nor is building it up.

The instruments that can be used to achieve internal and external balances are expenditure changing policies, expenditure switching policies, and direct controls. **Expenditure changing policies** seek to achieve external/internal balance by altering the aggregate level of demand for goods and services, both domestic and imported, by increasing or reducing the expenditure in the economy. **Expenditure switching policy** (devaluation), aims at causing switching of expenditure between domestic and foreign goods so that the balance of payments disequilibrium is corrected. **Direct controls** refer to government restrictions such as quotas, tariffs, production and distribution controls, price controls etc.

A major problem in achieving internal and external balances simultaneously is that in some cases the monetary and fiscal policies aimed at achieving internal balance may widen external imbalance and vice versa. The effects of fiscal and monetary policies on the balance of payments are quite similar except for their effects on interest rates. An expansionary fiscal policy pushes up interest rate because increase in expenditure and income increases the demand for money and, given the supply of money, this will lead to increase in interest rate. An expansionary monetary policy, on the other hand, bids down interest rate (because of increase in money supply).

While certain combinations of internal and external imbalances are amenable to expansionary or contractionary monetary and fiscal policies, in the other combinations of imbalances similar combinations of the policies (like expansionary monetary and fiscal policies) will help correct one of the imbalances and worsen the other imbalance. Mundell and Fleming point out that the different relative impacts of monetary and fiscal policies on internal and external balances imply that we have two policy weapons to deal with the imbalances. In other words, monetary and fiscal policies can be mixed so as to achieve any combination of aggregate demand and

overall payment balance. Mundell's **assignment rule** provides a useful guideline for assigning policy tasks to monetary and fiscal policies. The assignment rule is this: Assign to fiscal policy the task of stabilizing the domestic economy only and assign to the monetary policy the task of stabilizing the balance of payments only.

The **expenditure switching policy**, which works via changes in the external value of the currency (devaluation or revaluation) seeks to bring about desired switching of expenditure away from foreign goods to domestic goods. A country with serious problem of balance of payments deficit may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium.

The success of **devaluation**, however, depends on the fulfillment of certain conditions: Other countries do not retaliate by devaluing their currencies; the favourable effects of devaluation is not offset by domestic inflation; demand for exports and imports is sufficiently price elasticities; and, there is enough exportable surplus.

Two important determinants of the success of devaluation are the elasticities and absorption. The **elasticities approach** presents the traditional approach to the effects of devaluation on the balance of trade (or payments). According to the elasticities approach, the success of devaluation as a measure to improve the balance of trade depends upon the elasticities of demand for the devaluing country's exports and its imports. According to the **Marshall-Lerner condition** which states, in effect, that devaluation will improve the balance of payments of a country and revaluation will worsen it if the sum of elasticities of demand for a country's exports and of its demand for imports is greater than 1.

The **income-absorption approach** to the effects of devaluation maintains that the foreign trade balance is equal to the difference between the total goods and services produced in the country and their domestic absorption (absorption equals the sum of consumption plus investment). A trade deficit results from the people of the country *absorbing* more than what they have produced. In other words, there will be a trade deficit when the total consumption and investment exceed the national output. A trade surplus, on the other hand, is the result of *under-absorption* (i.e. consumption and investment are less than the total domestic output). If devaluation is to affect the foreign balance, it can do so in only two ways: (i) It can lead to a change in the production of goods and services so that the foreign balance will be altered by the difference between the change in income and the income induced change in absorption. (ii) The devaluation may change the amount of real absorption associated with any given level of real income.

It has been empirically observed that the trade-balance effects of devaluation do not materialise until quite some time. Devaluation results in an initial deterioration of the trade balance and this is followed by a subsequent improvement. This is known as **J-curve effect**. The J-curve effect is caused by certain time lags in a devaluation's adjustment process.

The trade effect of devaluation also depends on the extent to which change in the exchange rate results in changes in export and import prices. In practice, change in the exchange rate does not bring about a proportionate change in import prices; this relationship may be less than proportionate, thus weakening the influence of a change in the exchange rate on the volume of trade. The extent to which changing currency values lead to changes in import and export prices is known as the **currency pass-through** relationship.

Review Questions

1. Explain the effects of fiscal and monetary policies on internal balance.
2. Explain the effects of fiscal and monetary policies on external balance.
3. What is devaluation? Explain the objectives, conditions necessary for success and limitations of devaluation.
4. Discuss the elasticities approach to the effects of devaluation.
5. Explain the income-absorption approach to the effects of devaluation.
6. Write notes on the following:
 - (a) Marshall-Lerner condition

- (b) Mundell's assignment rule
- (c) J-curve effect and currency pass through
- (d) Recent trends in the exchange rate of the Indian Rupee
- (e) Expenditure changing and expenditure switching policies

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CHAPTER 17

17 International Monetary System

LEARNING OBJECTIVES

- ❑ To get an idea of the international monetary system from gold standard to this day.

An efficient international monetary system is a necessary precondition for the smooth functioning and expansion of international trade and the integration and expansion of the global economy. This chapter gives a brief account of the transition of the international monetary system from the early nineteenth century to this day.

THE PRE-BRETTON WOODS PERIOD

From the early nineteenth century until the post-World War I period, which was regarded as the great age of internationalism, most of the major industrialised nations of the world and their trading partners operated, at least nominally, under a fixed exchange system called the *gold standard*. Under this system, each nation defined its currency in terms of gold. In 1900, for example, the dollar was equal to 1/20 of an ounce of gold and the pound to 5/20 of an ounce (hence £1 = \$5). In addition, each nation agreed to convert its paper money into gold on demand, and there were no restrictions on the shipment of gold from one country to another.

Gold Standard System Under the gold standard, accounts between countries were settled, in theory, and to a considerable extent in practice, by the exchange of gold. If a country imported goods worth more than those it exported, gold flowed out. As, under the gold standard, money supply depended on monetary gold reserves, a reduction in these reserves due to a deficit in the balance of payments caused a contraction in money supply, resulting in a decline in prices and leading to an increase in demand for exports and a decline in demand for imports, to enable the country to restore the balance of payments equilibrium. Thus, the gold standard provided for, in theory, an automatic correction of a disequilibrium in the balance of payments through changes in the monetary gold reserves of nations. The balance of payments situation could be improved also by other such monetary measures as manipulation of the *bank rate*. For example, an increase in the bank rate encouraged *hot money*

Under gold standard money supply was directly linked to the stock of monetary gold.

movement and helped the country to improve its balance of payments position. (Hot money movement refers to the movement of short term funds to take advantage of the differences in interest rates.)

Until the outbreak of World War I, the gold standard worked remarkably well, and the stability of exchange rates was maintained with so little conscious effort that it came to be regarded as natural. During this period, nations were eager to abide by the *golden rule* of the gold standard: expand credit when gold is coming in and contract credit when gold is going out. The gold standard, however, was shattered in the first weeks of World War I (1914–1918). Every belligerent country in Europe, and many in other continents, withdrew the privilege of *conversion* and prohibited the export and import of gold within a few days of the declaration of war; in the course of the struggle, most of the neutrals followed suit. Inconvertible paper currencies became the order of the day.

Gold standard could not withstand abnormal periods like war and depression.

After the war, and the hectic boom and slump that followed it, the international gold standard was restored in nearly every country of the world. As Crowther points out,¹ two causes were responsible for this. The first was the natural wish to return to normality, the wish for “back to pre-war” conditions. Normalcy in currency arrangements meant the gold standard, and by most, if not all of those in authority, it was taken for granted that an international system of gold convertibility would follow the period of war-time inconvertibility, just as peace followed war. The second impelling force was the appalling chaos produced in continental Europe by wild post-war inflation.

As Crowther points out,³ in many ways the post-war gold standard went much further than the pre-war gold standard. It embraced, for example, many more countries, and by the middle of 1929, almost the only countries that were not on the gold standard were China, Spain and Mexico. Not all of these countries adopted the full gold standard or even the gold bullion standard but the gold exchange standard was extensively employed.

Breakdown of Gold Standard However, within a little more than a decade from the beginning of its post-war reincarnation, the gold standard had once more been abandoned by the great majority of the nations. It was one of the first casualties of the great depression (1929–33), which engulfed the entire world. Great Britain suspended the gold standard in 1931; and one by one, other countries followed suit; by 1937, there was not a single country on the gold standard, and none showed any desire to revive it.

The breakdown of the gold standard in the 1930s was followed by the era of inconvertible currencies. Some leading countries attempted to stabilise exchange rates by establishing exchange equalisation/stabilisation funds and agreements. However, with the outbreak of World War II (1939–45), nations began to impose far-reaching systems of exchange control, and monetary agreements became inoperative.

THE BRETTON WOODS SYSTEM

During World War II, eminent economists and civil servants in the *Allied Nations* were seriously planning to evolve a purposeful international economic system in the post-war period. President Roosevelt of America, in fact, assigned a high priority to planning for peace, offering every encouragement to those advisers and civil servants who were anxious to devote themselves to this cause. The United Nations Monetary and Financial Conference held at Bretton Woods, USA, in July 1944 while the war was still going on, and in which 44 nations participated, proposed the establishment of:

1. The International Monetary Fund (IMF) to achieve exchange rate stability and to help member countries to finance short-term balance of payments deficits.

2. The International Bank for Reconstruction and Development (IBRD), now popularly known as the World Bank, to assist in the post-war reconstruction and development of the member countries.
3. An International Trade Organisation (ITO) to be the focal point of cooperation in trade matters.

Of these the proposal to establish the ITO did not materialize; however later (1948), the GATT was formed and it was transformed into the WTO in 1995. The IMF and the IBRD, however, took birth. Though the negotiations at Bretton Woods ended in 1944, the IMF began its operation only in 1947.

The international monetary system introduced at Bretton Woods rested on two pillars: the maintenance of stable exchange rates and a multilateral credit mechanism institutionalised in the IMF and supervised by it.

The international monetary system that existed from 1947 to 1971 is generally known as the *par value system* or *pegged exchange rate system*. Under this system, each member country of the IMF was required to define the value of its currency in terms of gold or the US dollar and to maintain (to peg) the market value of its currency within ± 1 per cent of the defined (par) value. The value of the US dollar was set at 1/35 of an ounce of gold, and the United States promised that all US dollars in the hands of central banks would be redeemed in gold, upon demand, at the fixed price of \$35 per ounce. Every other nation then defined its currency in terms of the dollar and/or gold.

The par value system institutionalised by IMF lasted for nearly a quarter century since 1947.

At the end of the World War II, the United States held over 74 per cent of the world's monetary gold stock and accounted for about half of the world's real GNP. An important reason for this was that because of the financial dominance of the United States, it was inevitable that other countries came to regard the US dollar as international money. As a result, they accumulated dollars in official reserves and used it as an *intervention currency* to stabilise exchange rates in the market. The failure of gold, a key source of reserves in the Bretton Woods system, to provide a steady and sufficient increase in international liquidity over time also contributed to this trend. Indeed, as Gomes observes, "The dollar was not merely as good as gold, it was better than gold because dollars (as reserves) earned interest while gold did not."³

The designers of the par value system realised that the exchange rate between two currencies would not hold constant forever, but they hoped that changes would be infrequent and would be made for valid reasons, under controlled conditions. The provisions of the Agreement relating to changes in par values may be summarised as follows:

1. A member shall not propose a change except 'to correct a fundamental disequilibrium' and it shall act only after consultation with the Fund.
2. The Fund will not object to change not exceeding 10 per cent of the initial par value.
3. If a change is proposed exceeding 10 per cent, but not exceeding 20 per cent of the initial par value, the Fund may agree or object, but must declare its attitude within 72 hours.
4. If the proposed change is larger than 20 per cent, the Fund may concur or object without limit of time.
5. The Fund must agree "if it is satisfied that the change is necessary to correct a fundamental disequilibrium". It has been further laid down that, in deciding what is a fundamental disequilibrium, the Fund may not take objection to the "domestic and social or political policies of the member proposing the change."

The IMF was also meant to provide credit facilities to member countries suffering from payments problems. The credit facilities, which a member country could avail of, normally, depended on its quota i.e. the member's contribution to the Fund, which was determined on the basis of the nation's income, reserve holdings, imports, ratio of exports to income and the variability of imports. Prior to the 1976 changes, new members were required to pay part of their quota, normally 25 per cent, in gold or American dollars and the rest in the member's own currency. Now a new member pays part of its quota in foreign currencies and the rest in its own currency. The Fund also extends certain permanent, temporary and special facilities to its members, such as the compensatory financing facility and the buffer stock financing facility.

An important contribution of the IMF for an increase in the international liquidity is the creation of **Special Drawing Rights—SDRs**. The SDR is an international reserve asset created by the Fund, taking into account the global need for supplementing existing reserve assets. The allocation of SDRs was made to those member countries that were participating in this facility in proportion to their quotas.

BREAKDOWN OF THE BRETTON WOODS SYSTEM AND EMERGENCE OF MANAGED FLOATING

Let us now return to the par value system. Despite severe strains in its later years, it lasted until 1971. The stabilisation process under this system required reserve assets, just as it did under the gold system. The difference was that nations kept their reserves not only in gold but also in dollars. An expansion in trade, however, required an increase in international liquidity. Since major part of the gold and dollars, the international reserves, were in the USA, growth could come only from an outflow of gold and dollars from there.

In the early period, the supply of dollars outside the US came from the *Marshall Plan* and other American aid programmes, contributions to the World Bank, multinational investments, and American defence expenditure abroad. The small deficits in the American balance of payments in the 1950s were generally welcomed because they increased international liquidity, and it appeared that the *Bretton Woods System* by permitting the expansion of world monetary reserves at a much faster rate than a system restricted by the supply of gold, solved one of the major problems of the gold standard. But the key factor in guaranteeing the workability of the system was the acceptability of the dollar. If anything were to happen that would shake the world confidence in the ability or desire of the United States to continue exchanging dollars for gold, the system could very well collapse. And the *Bretton Woods System* did collapse in 1971, as, because of the huge accumulation of dollars abroad, the USA could neither command world confidence in her ability and willingness to exchange dollars for gold at the fixed rate, nor could it afford to undertake the conversion of dollars into gold if all the foreign dollar holdings were presented for such exchange.

The par value system ended in 1971 because of the inability of US to convert dollar into gold at the par value.

It was the burgeoning balance of payments deficits of the United States from the late 1950s that led to this situation. The United States moved from a balance of payments surplus of \$4 billion in 1947 to a deficit of over \$29 billion in 1971; and the *dollar shortage* of the 1950s turned into the *dollar glut* of the 1960s and early 1970s. The US official gold stock dropped from about \$25 billion in 1949 to around \$10 billion by 1971. However, only a part of the US deficit was financed by the export of gold. As the dollar was regarded as an international reserve, the US deficit became a significant means of expanding the total supply of international liquidity.

However, the depletion of US gold reserves and the huge accumulation of liquidity liabilities (dollars and dollar convertible assets) held by foreigners perpetuated a *crisis of confidence*. By 1971, these liabilities had risen to about \$68 billion; in 1971, the Central Bank of Germany alone held enough dollars to exhaust the entire gold stock of the US at \$35 an ounce.

Foreign exchange markets became erratic in early 1971, and central banks with the strongest currencies, had to buy massive amounts of dollars in order to maintain exchange rates at the official par value (± 1 per cent). They closed foreign exchange markets for brief periods, allowed currencies to float temporarily, imposed exchange controls and even charged *negative* rates of interest on foreign-owned deposits—all in a vain effort to stem the tide. While foreign central banks became increasingly reluctant to continue the stabilisation procedure, speculators and multinational corporations became very eager to unload dollars (which, they felt, would soon be worthless) and to acquire other currencies instead. Thus, the international monetary system was confronted with two interrelated problems. On the one hand, there was a tremendous desire to sell dollars; on the other hand, the traditional buyers of those dollars—foreign central banks—were no longer willing to purchase them. The eventual outcome was the collapse of the *par value* system. The IMF's *par value system* officially ended on August 15, 1971, when President Nixon withdrew United States' commitment to buy and sell gold at \$35 per ounce, thus abrogating the IMF agreement. This amounted to severing the link between gold and the international value of the dollar. Along with the suspension of the gold convertibility of the dollar, President Nixon imposed a surcharge of 10 per cent on dutiable imports to the US.

President Nixon justified the suspension of convertibility as necessary to "... defend the dollar against speculators" who "have been waging an all-out war on the American dollar." But, actually, it was designed to compel foreign governments to raise the value of their currencies against the dollar. The foreign governments were thus left with two alternatives: either to continue to maintain existing exchange rates by accumulating more dollars without convertibility or to revalue the *unfair* exchange rates.

However, the European and Japanese governments firmly resisted any change in the par value of their currencies, fearing the harmful consequences of revaluation on their exports and domestic economic situations. They held the view that if the US dollar were overvalued, the way out should be a unilateral devaluation of the dollar.

The immediate response to the US action of the suspension of dollar convertibility was a closing of foreign exchange markets in Europe and Japan. When they reopened, all of the major currencies were left to *float vis-à-vis* the dollar, with the exception of the French franc. Although France refused to float its currency for commercial transactions, it permitted a floating rate for financial transactions.

The floating of currencies was, however, not 'clean', for central banks intervened in the market to prevent a full appreciation. The European and Japanese governments were reluctant to let their currencies float freely because they hoped to persuade the United States to devalue the dollar.

An urgent need for putting an end to the fluid situation was felt by major countries, and international monetary negotiations were undertaken within the framework of the *Group of Ten*, which included the Finance Ministers of ten leading IMF trading nations. The first meeting of the Group in London and the second meeting in Rome (both in September 1971) failed to resolve the crisis. However, some encouraging developments resulted after its third meeting, which started on November 30 in Rome. Finally, the meeting of the Group of Ten on December 17–18, at the Smithsonian Institution in Washington, brought about an agreement for the re-alignment of exchange rate to correct the prior over-valuation of the dollar.

Following the *Smithsonian Agreement*, the United States increased the dollar price of gold by 8.57 per cent (from \$35 an ounce to \$38 an ounce) and the Yen and major European currencies appreciated relatively to the dollar—the Yen by 17 per cent, the Mark by 14 per cent and most other European currencies by something under 10 per cent. Overall, the dollar was depreciated by an average of approximately 12 per cent.

Under the Smithsonian Agreement, currencies were allowed to fluctuate within a wider 2.5 per cent range on either side of the newly-fixed rates called the *central rates*. Like the *Bretton Woods System*, the Smithsonian Agreement also required central bank stabilisation efforts but it allowed more fluctuation of rate (2.5 per cent as against 1 per cent).

The Smithsonian Agreement, however, did not last long. Renewed speculative activity in 1972 and early 1973 forced most major countries to abandon fixed rates. In February 1973, President Nixon announced a 10 per cent devaluation of the dollar from \$38 to \$42.2 an ounce. In mid-March, six leading nations of Europe (West Germany, France, Belgium, the Netherlands, Luxembourg and Switzerland) announced that they would replace the Smithsonian Agreement by a new system (the *snake in the tunnel*), under which these nations would confine stabilisation efforts to maintaining the current fixed price relationship only among their own currencies, while allowing their currencies to float against all others.

The Smithsonian Agreement, thus, lasted only for fourteen months. The collapse of the agreement resulted in a floating exchange rate system. Monetary authorities have not, however, been allowing their currency values to be determined solely by demand and supply, but have been intervening from time to time to keep the exchange rates within desired limits. This is known as the *managed float*. Some people described it as the *dirty float*, for the managed float was not a *clean float*. The managed float provided the advantages of floating exchange rates while avoiding sharp fluctuations in rates.

The *Jamaica Agreement* of January 1976 formally ratified the floating exchange rate system. The agreement recognised that although exchange rates should reflect the basic forces of demand and supply, governments should have the right to maintain their own stabilisation policies and to intervene in the foreign exchange market. All governments, however, should pursue the common goals of international stability and growth. It also eliminated the official price of gold. The IMF sold one-sixth of its gold reserves and used the proceeds to help the LDCs. The IMF has no further obligation to use gold.

Following the breakdown of the par value system, different exchange rate systems emerged.

Since 1972, the world may be said to be following flexible exchange rates, although the peggers far outnumbered the floaters. Although a number of countries peg their currencies, in trade-weighted terms, the current system is generally regarded as floating because most of the largest traders maintain more flexible forms of exchange arrangements.

During the period of flexible rates since 1973, there has been a trend away from pegged exchange arrangements, and within these, from single currency to composite pegs (with former US dollar peggers accounting for the bulk of the latter shift). Many developing countries have been pegging their currencies while the industrial countries, by and large, have been on the flexible system.

A large number of small countries have pegged their exchange rate regimes. Small Caribbean island economies, some small Central American countries and some Pacific island economies peg to the US dollar. African countries like Lesotho, Namibia and Swaziland peg to the South African Rand. Countries like Nepal and Bhutan peg their currency to the Indian rupee, while Brunei Darussalam pegs to the Singapore dollar. Developing countries that face difficulties in stabilising their economies from a situation of high inflation have also opted for pegged exchange rate systems and pursue exchange rate based stabilisation programme.

However, as stated in the preceding paragraph, the flexible currencies transact the major chunk of world trade and hence, the world is regarded to be following the flexible exchange rate system, by and large. The floating of currencies, however, is not completely free or *clean* but *dirty* (i.e. it is subject to some governmental intervention). Thus, in practice, the common exchange rate regime adopted by countries, including industrial countries, is an 'intermediate regimes of various types, such as, managed floats with no pre-announced path, and independent floats with foreign exchange intervention moderating the rate of change and preventing undue fluctuations, under which the central banks intervene in foreign exchange markets, which necessitates maintenance of adequate stock of foreign exchange reserves. Studies reveal that that many of those countries which had declared themselves as "independent floaters" in the IMF statistics were indeed heavily intervening in foreign exchange markets.⁴

A study by Rogoff et al. indicates that for countries at a relatively early stage of financial development and integration, fixed or relatively rigid schemes appear to offer some anti-inflation credibility without compromising growth objectives. As countries develop economically and institutionally, there appear to be considerable benefits to more flexible regimes.⁵

Bimal Jalan, former Governor, RBI, observes that "the debate on appropriate policies relating to foreign exchange markets has now converged around some generally accepted views: (i) exchange rates should be flexible and not fixed or pegged; (ii) countries should be able to intervene or manage exchange rates—to at least some degree—if movements are believed to be destabilising in the short run; and (iii) reserves should at least be sufficient to take care of fluctuations in capital flows and liquidity at risk."⁶

EMS, ECU AND EURO

The Common Market (EEC) countries wanted to have stability of fixed exchange rates among themselves, while at the same time, having flexibility in exchange rates with the rest of the world. They, therefore, adopted the system of common margins arrangements or the *snake*, referred to in the preceding section. However, with effect from March 13, 1979, they introduced a new arrangement known as the European Monetary System (EMS). With the introduction of EMS, the *snake* ceased to exist. All the European Common Market countries, except the United Kingdom, decided to participate in all aspects of the EMS, in particular the operational heart of the system—the exchange rate mechanism.

According to the European Council, "...the purpose of the European Monetary System is to establish a greater measure of monetary stability in the community. It should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards, and the lessening of regional disparities in the Community. The European Monetary System will facilitate the convergence of economic development and give fresh impetus to the process of European Union."

EU countries adopted a common monetary system.

The Council expected the European Monetary System to have a stabilising effect on international monetary and economic relations.

European Currency Unit

At the heart of the EMS was a system of fixed but adjustable exchange rates. Each currency had a central rate expressed in terms of the European Currency Unit (ECU). The ECU consisted of a basket of fixed amounts of currencies of the Common Market countries. The central rates determined a grid of bilateral central rates with fluctuation margins of plus or minus 2.25 per cent (6 per cent for the Italian Lira).

Intervention by the participating central banks kept the exchange rates of their currencies within the margins in EMS currencies. Intervention in other currencies (chiefly in US dollar), was allowed and had been undertaken on a substantial scale. The grid of bilateral central rates and intervention limits was supplemented by the 'divergence indicator', which showed the movement of the exchange rate of each EMS currency against the (weighted) average movement of the others. If a currency crossed a 'threshold of divergence', this led to a presumption that the authorities concerned would correct the situation by taking adequate measures.

The European Currency Unit (ECU) played a central role in the EMS. It served as the unit of account for the exchange rate mechanism and for the operations in both the intervention and the credit mechanisms. It also served as a reference point for the divergence indicator, and as a means of settlement and a reserve asset of EMS central banks. The central banks participating in the exchange rate mechanism of the EMS received an initial supply of ECUs at the start of the EMS, against the deposit of 20 per cent of both their gold holdings and gross US dollar reserves (at market related valuations) with the European Monetary Cooperation Fund, which was established as an institution of the European Community and served as the agency for operations under the *snake* and subsequently the EMS.

To finance interventions in EMS currencies, there were mutual credit lines among the participating central banks (a very short term financing facility). Claims and debts arising out of such interventions were settled according to certain rules governing, among other things, the use of ECUs, for such purposes. The 'short-term monetary support' and the 'medium-term financial assistance' mechanisms that had been established in 1970 and 1971, respectively, had been substantially enlarged. These were designed for mutual financial assistance in cases of balance of payments difficulties.

Under the provisions governing the EMS, adjustments of central rates were "subject to mutual agreement by a common procedure, which comprised all countries participating in the exchange rate mechanism and the Commission."

At the Maastricht Summit held in December 1991, leaders of member countries of the European Community (EC) concluded an agreement on the requirements and time table for European Monetary Union (EMU) and for the accompanying move to a common European monetary policy. The agreement specified a three-stage transition to EMU.

During stage one which was launched in July 1990, the free internal market of the EC would be completed and obstacles to financial integration removed. The member countries also agreed to intensify their multilateral surveillance, and coordination of monetary and fiscal policies.

In stage two which began in January 1994, the member countries worked towards a common monetary policy, establishment of the European Monetary Institute (EMI) which would develop a framework for closer coordination of monetary policies that affect the EMU area as a whole, and the establishment of the European Central Bank (ECB).

The third and final phase of the Economic and Monetary Union (EMU) was ushered in with the launch of the common currency, the Euro in 1999.

The Euro

Euro, the common currency of European Union, was launched by 11 of the 15 members of the Union, on January 1, 1999. The exchange rates per euro determined at the time of the Euro launch were about US \$1.17; British pound 0.70; Yen 133; and German mark 1.96. One euro was equivalent to about Rs 49.

The Maastricht treaty of 1991, which set the stage for the monetary union, laid down certain eligibility criteria for member countries to join the EMU, such as maintaining budget deficit, public debt, inflation, long term interest rates and exchange rate within defined limits.

Greece could not join the Euro launch as she could not satisfy these criteria. Britain, Denmark and Sweden opted out, although they satisfied the eligibility criteria, due to domestic political reasons. The parties to the Euro at the beginning were, thus, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece joined the Euro in January 2001. The countries whose currency is Euro is known as the Euroland.

Euro, intended to be the common currency of EU, is not adopted by all EU nations.

Euro currency and coins did not come into circulation until 2002, although banking and trading transactions in Euro commenced since January 1, 1999. The national currencies of the Euroland nations continued in circulation until July 1, 2002, the deadline for the withdrawal of national currencies and coins.

At the time of the launch of the Euro, its conversion ratio against other currencies—internal and external—were also decided. Internal conversion rates are the rates at which participating currencies would be converted into the Euro during the transition period, i.e. until the Euro would completely replace the national currencies of the Euroland while the external exchange rates were the exchange rates against currencies outside the Euroland. A key distinction was that the internal rates were irrevocably fixed while external values of the Euro were market determined.

The monetary policy decisions for the Euro area are made by the European Central Bank (ECB), which along with the National Central Banks (NCB) of all EU members comprise the European System of Central Banks (ESCB). The ECB is controlled by a Governing Council consisting of an Executive Board (with six members appointed by the heads of State or Governments of countries in the Euro area) and the governors of the NCBs of the Euroland. In designing the EMU, the architects laid great emphasis both on the independence of the ECB and on the simplicity and severity of its anti-inflation objective. The Maastricht Treaty directs the ECB to support the general economic policies of the Community, but, crucially, without prejudice to the objective of price stability.

Benefits of Euro The single currency will bring a single interest rate, eliminate currency risk and give equity and bond markets the necessary scope and liquidity to attract big investors. Europe will rank alongside the US as the deepest and most liquid market in the world.

The single currency reduces transaction costs, eliminates exchange rate risks and imparts price transparency.

Consumers will benefit in several ways. The single currency will impart price transparency throughout the Euroland—when there were many currencies price comparisons were not so easy. Prices now will tend to be equal throughout the Euro area.

The single currency saves a lot on the cost of hedging against exchange rate risks, estimated at \$25 billion. Companies in the Euroland benefit from the ease of outsourcing, relocation of production bases, mergers and take-overs, transportation, procedures, marketing etc. besides the savings on hedging costs. These would also help improve their global competitiveness.

Euro vs Dollar It is generally felt that an important impact of the Euro will be the decline in the dominance of the US dollar in the global economy because the Euro will increasingly replace the dollar in several spheres. Before the launch of the Euro, about 60 per cent of the foreign exchange reserves holding by central banks and governments was in US dollars. The corresponding share of the European currencies was about 20 per cent (mostly D Mark). The share of the Euro would rise in future and that of

dollar will fall. The EMU and Euroland would expand in size with more countries joining both. The Euro would also be accepted as a currency of peg by several nations. The dominance of dollar will also decline in the securities market with the increasing presence of the Euro. It may be noted that the stock exchanges of London and Frankfurt entered into a dynamic agreement for cooperation which has been widely perceived as a vanguard effort to integrate the European stock markets into a single European stock exchange. The integrated Frankfurt-London exchange with a huge plus market capitalisation would be the world's second largest stock exchange (This is roughly 48 times bigger than the Mumbai stock exchange.) There would be a substantial increase in the investments in the European securities markets (which will have both European and foreign securities) by both Europeans and foreigners. In short, the dominance of dollar will decline and a bi-polar global monetary order will emerge. A stable and growing European economy will, however, be beneficial to the US (as also to other nations) because of mutual interdependencies in the integrated global economy.

Euro will reduce the dominance of US dollar in the global economy.

Implications of Euro for India The Euro has important implications for India. The Euroland accounts for large share of India's foreign trade. Further, the EU is an important source of aid and foreign investment. Indian companies have significant investment interests in Europe and they also tap the European capital market.

Indian businessmen benefit, like their counterparts in other countries, from the benefits of a single currency instead of many. According to a study conducted by B. Bhattacharya and Vinayak Ghatate of the Indian Institute of Foreign Trade, New Delhi,⁷ the Euro will benefit Indian exports as products from this country will become cheaper in the Euroland. According to this study, 15 product groups in the country's export basket have a price elasticity which will help them to capture a significant portion of the European markets with lower prices. The product groups that will benefit include foodstuffs, fats and oils, plastics, wood articles, textiles, articles of stone, chemicals, base metals, vehicles, vegetable products, wood-pulp and pearls.

The study says that the Euro is expected to reduce the transaction costs and help in greater integration of capital markets, while resulting in a higher level of growth in the Euroland.

The Euro will also result in greater price transparency throughout the Euroland and this is expected to give a push towards a uniform pricing strategy for different markets. The Euro will not result in a uniform retail pricing structure throughout Euroland because of the divergent cost structure in businesses.

Euro presents both opportunities and challenges to Indian exporters.

The study says that the pressure to introduce uniform prices will come from the higher end of distribution channel, and Indian exporters will have to redesign their export pricing strategies accordingly.

It says that the Euro changeover requires a dual display of prices, one in the respective national currencies and the other in euros. This will necessitate several changes in the existing packaging and labelling requirements. If the Euro becomes a strong currency, it will make India's imports from Euroland costlier. However, if due to greater integration the European firms become more efficient, the exchange-rate-induced price-rise may get neutralised by higher efficiency and productivity levels.

The study opines that the advent of the Euro is both a challenge and an opportunity for Indian exporters and it will now depend on their skills to use it to their advantage.

SUMMARY

Historically, the foreign exchange system has undergone many changes and there have been many methods of determining the exchange rate.

A fixed exchange rate system known as the *gold standard*, under which each nation defined its currency in terms of gold, prevailed in the world from the early nineteenth century until the post-World War I period. Under the gold standard, accounts between countries were settled, in theory, and to a considerable extent in practice, by the exchange of gold.

Under the *par value system* or *pegged exchange rate system* established by the IMF in 1947, each member country of the IMF was required to define the value of its currency in terms of gold or the US dollar and to maintain (to peg) the market value of its currency within ± 1 per cent of the defined (par) value. The value of the US dollar was set at 1/35 of an ounce of gold, and the United States promised that all US dollars in the hands of central banks would be redeemed in gold, upon demand, at the fixed price of US \$ 35 per ounce. Every other nation then defined its currency in terms of the dollar and/or gold. The IMF's *par value system* came to an end, in 1971 when the United States withdrew its commitment to buy and sell gold at the fixed rate, abrogating the IMF agreement. This led to the emergence of a flexible exchange rate system adopted by many, particularly developed, countries under which the exchange rates are determined by the market forces of demand supply.

The EEC countries which wanted to have stability of fixed exchange rates among themselves, while at the same time, wanted flexibility in exchange rates with the rest of the world, adopted the system of common margins arrangements or the *snake*. However, with effect from March 13, 1979, they introduced a new arrangement known as the European Monetary System (EMS) and with effect from January 1, 1999, a common currency, the Euro, was introduced for most of the members of the European Union. The EU countries who have accepted Euro as their national currency are collectively known as Euroland.

The Euro is expected to reduce the transaction costs and help in greater integration of capital markets, while resulting in a higher level of growth in the Euroland. The Euro has important implications for India. The Euroland accounts for large share of India's foreign trade and the EU is an important source of aid and foreign investment. Indian companies have significant investment interests in Europe and they also tap the European capital market. The advent of the Euro is both a challenge and an opportunity for Indian exporters

Review Questions

1. What were the salient features of the international monetary system under the Brettonwoods? What were the factors responsible for its breakdown?
2. Explain Euro and its impact on the world economy.
3. Write notes on the following.
 - (i) Par value system
 - (ii) EMS
 - (iii) Managed floating

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CHAPTER 18

18 Foreign Exchange

LEARNING OBJECTIVES

- ☐ To get an overall picture of the foreign exchange market and factors affecting exchange rates.
- ☐ To understand the exchange rate systems.
- ☐ To get an idea of the foreign exchange control and FEMA.
- ☐ To examine the issue of convertibility of the Rupee.
- ☐ To understand the foreign exchange risks and measures to guard against them.

BACKGROUND

The subject of foreign exchange is, in the words of H.E. Evitt, “that section of economic science which deals with the means and methods by which rights to wealth in one country’s currency are converted into rights to wealth in terms of another country’s currency.”¹

Foreign exchange means (1) the process of converting the currency of one nation into that of another or (2) foreign currencies.

As he further observes, it “involves the investigation of the method by which the currency of one country is exchanged for that of another, the causes which render such exchange necessary, the forms which such exchange may take, and the ratios or equivalent values at which such exchanges are effected.”²

There are different interpretations of the term foreign exchange, of which the following two are most important and common:

1. Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another (Dr. Paul Einzig).³
2. Secondly, the term foreign exchange is used to refer to foreign currencies. For example, the Foreign Exchange Management Act (FEMA) defines foreign exchange as foreign currency and includes all deposits, credits and balance payable in any foreign currency and any drafts, traveller’s cheques, letters of credits and bills of exchange drawn by banks, institutions or persons outside India but payable in Indian currency.

FUNCTIONS OF FOREIGN EXCHANGE MARKET

The foreign exchange market is a market in which national currencies are bought and sold against one another.

The foreign exchange market is a market in which foreign exchange transactions take place.

A foreign exchange market performs three important functions:

Transfer of Purchasing Power

The primary function of a foreign exchange market is the transfer of purchasing power from one country to another and from one currency to another. The international clearing function performed by foreign exchange markets plays a very important role in facilitating international trade and capital movements.

Provision of Credit

The credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade, for international trade depends to a great extent on credit facilities. Exporters may get pre-shipment and post-shipment credit. Credit facilities are available also for importers. The Euro-dollar market has emerged as a major international credit market.

Provision of Hedging Facilities

The other important function of the foreign exchange market is to provide hedging facilities. Hedging refers to covering of foreign trade risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates.

METHODS OF AFFECTING INTERNATIONAL PAYMENTS

There are different important methods to effect international payments.

Transfers

Money may be transferred from a bank in one country to a bank in another part of the world by electronic or other means.

Cheques and Bank Drafts

International payments may be made by means of cheques and bank drafts. The latter is widely used. A bank draft is a cheque drawn on a bank instead of a customer's personal account. It is an acceptable means of payment when the person tendering is not known, since its value is dependent on the standing of a bank which is widely known, and not on the credit-worthiness of a firm or individual known only to a limited number of people.

Foreign Bill of Exchange

A bill of exchange is an unconditional order in writing, addressed by one person to another, requiring the person to whom it is addressed to pay a certain sum on demand or on a specified future date.

There are two important differences between inland and foreign bills. The date on which an inland bill is due for payment is calculated from the date on which it was drawn, but the period of a foreign bill runs from the date on which the bill was accepted. The reason for this is that the interval between a foreign bill being drawn and its acceptance may be considerable, since it may depend on the time taken

for the bill to pass from the drawer's country to that of the acceptor. The second important difference between the two types of bill is that the foreign bill is generally drawn in sets of three, although only one of them bears a stamp, and of course, one of them is paid.

Nowadays, it is mostly the documentary bill that is employed in international trade. This is nothing more than a bill of exchange with the various shipping documents—the bill of lading, the insurance certificate and the consular invoice—attached to it. By using this, the exporter can make the release of the documents conditional upon either (a) payment of the bill, if it has been drawn at sight, or (b) its acceptance by the importer if it has been drawn for a period.

Documentary (or Reimbursement) Credit

Under this method, a bill of exchange is necessarily employed, but the distinctive feature of the documentary credit is the opening by the importer of a credit in favour of the exporter, at a bank in the exporter's country.

To illustrate the use of the documentary credit, let us assume that Mr Menon of Cochin intends to purchase goods from Mr Ronald of New York and that the terms of the deal have been agreed upon by them. Then the transaction would be carried through the following stages.

1. Mr Menon, the importer, instructs his bank, say the State Bank of India (SBI), to open a credit in favour of Mr Ronald, the exporter, at the New York branch of the SBI (if the SBI has no branch in New York, it will appoint some other bank to act as its agent there). The SBI will then inform Mr Ronald that it will pay him a specified sum in exchange for the bill of exchange and the shipping documents.
2. Mr Ronald may now despatch the goods to Mr Menon at Cochin, draw a bill of exchange on the SBI and then present the documentary bill to the New York branch of the SBI. If all the documents are in order, the bank will pay Mr Ronald. The bank will charge for its services, and will also charge interest if the bill is not payable at sight.
3. The New York branch of the SBI then sends the documentary bill to its Cochin office for payment or acceptance, as the case may be, by Mr Menon. When the bill is paid, Mr Menon's account will be debited by that amount. Every thing being in order, the banker will release the bill of lading from the bill to enable Mr Menon to claim the goods on their arrival at the Cochin port.

TRANSACTIONS IN THE FOREIGN EXCHANGE MARKET

A very brief account of certain important types of transactions conducted in the foreign exchange market is given below.

Spot and Forward Exchanges

Spot Market The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery, or exchange of currencies on the spot. In practice, the settlement takes

In the spot market, foreign exchange transactions are completed on the spot or immediately.

place within two days in most markets. The rate of exchange effective for the spot transaction is known as the *spot rate* and the market for such transactions is known as the *spot market*.

Forward Market The forward transaction is an agreement between two parties, requiring the delivery at some specified future date 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 transactions is known as the *forward market*.

In a forward market forward contracts are delivered at a specified future date.

The foreign exchange regulations of various countries, generally, regulate the forward exchange transactions with a view to curbing speculation in the foreign exchanges market. In India, for example, commercial banks are permitted to offer forward cover only with respect to genuine export and import transactions.

Forward exchange facilities, obviously, are of immense help to exporters and importers as they can cover the risks arising out of exchange rate fluctuations by entering into an appropriate forward exchange contract.

With reference to its relationship with the spot rate, the forward rate may be at par, discount or premium.

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**.

The forward rate for a 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. The premium is usually expressed as a percentage deviation from the spot rate on a per annum basis.

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 than in the spot market. The discount is also usually expressed as a percentage deviation from the spot rate on a per annum basis.

The forward exchange rate is determined mostly by the demand for and supply of forward exchange. Naturally, when the demand for forward exchange exceeds its supply, the forward rate will be quoted at a premium and, conversely, when the supply of forward exchange exceeds the demand for it, the rate will be quoted at discount. When the supply is equivalent to the demand for forward exchange, the forward rate will tend to be at par.

Futures

While a futures contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor-made for the client by his international bank, a futures contract has standardised features—the contract size and maturity dates are standardized. Futures can be traded only on an organized exchange and they are traded competitively. Margins are not required in respect of a forward contract but margins are required of all participants in the futures market— an initial margin must be deposited into a collateral account to establish a futures position.

Futures contracts have standard features while a forward contract may be customised.

Options

While the forward or futures contract protects the purchaser of the contract from the adverse exchange rate movements, it eliminates the possibility of gaining a windfall profit from favourable exchange rate movements. For example, if an Indian exporter has forward contract to sell his future dollar receipts at \$1=Rs.48, he is protected against the risk of a depreciation of the dollar by the time he receives the payment (for example, \$1 =Rs.46). However,

Option combines advantages of futures and spot.

the forward contract prevents him from gaining the profit of possible appreciation of the dollar (say, \$1 = Rs.50). Currency options are designed to overcome this problem.

Meaning An option is a contract or financial instrument that gives holder *the right, but not the obligation*, to sell or buy a given quantity of an asset at a specified price at a specified future date. An option to buy the underlying asset is known as a *call option*, and an option to sell the underlying asset is known as a *put option*. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the *exercise* or *striking price*. The buyer of an option is known as the *long* and the seller of an option is known as the *writer* of the option, or the *short*. The price for the option is known as *premium*.

Types of Options With reference to their exercise characteristics, there are two types of options, American and European. An European option can be exercised only at the maturity or expiration date of the contract, whereas an American option can be exercised at any time during the contract.

Swap Operation

Commercial banks who conduct forward exchange business may resort to a swap operation to adjust their fund position. The term *swap* means simultaneous sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency. The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanied by a purchase or sale, respectively, of the same currency for forward delivery, are technically known as swaps or double deals, as the spot currency is swapped against forward.

Arbitrage

Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the differences between the exchange rate prevailing at the same time in different markets.

For illustration, assume that the rate of exchange in London is £1 = \$2 while in New York £1 = \$2.10. This presents a situation wherein one can purchase one pound sterling in London for two dollars and earn a profit of \$0.10 by selling the pound sterling in New York for \$2.10. This situation would, hence, lead to an increase in demand for sterling in London and consequently, an increase in the supply of sterling in New York. Such operations, i.e., arbitrage, could result in equalising the exchange rates in different markets (in our example London and New York).

Arbitrage in foreign currencies is possible because of the ease and speed of modern means of communication between commercial centres throughout the world. Thus, an operator in New York might buy dollars in Amsterdam and sell them a few minutes later in London.

Arbitrage tends to equalise exchange rates across the world.

The effect of arbitrage, as has already been mentioned, is to iron out differences in the rates of exchange of currencies in different centres, thereby creating, theoretically speaking, a single-world market in foreign exchange.

DETERMINATION OF EXCHANGE RATES

How are exchange rates between different currencies determined under the paper currency standard? There are two important theories which attempt to explain the mechanism of exchange rate determination, namely, the purchasing power parity theory and the balance of payments or the demand and supply theory.

Purchasing Power Parity Theory

According to the purchasing power parity theory, put forward by Gustav Cassel in the years following the First World War, when the exchange rates are free to fluctuate, the rate of exchange between two currencies in the long run will be determined by their respective purchasing powers. In the words of Cassel, “the rate of exchange between two currencies must stand essentially on the quotient of the internal purchasing powers of these currencies.”⁴

In a situation of free trade and free foreign exchange market, exchange rate between two currencies, in the long run, is influenced by the price levels in the two countries.

Absolute and Relative Purchasing Power Parities There are two versions of the PPP theory—absolute purchasing power parity theory and relative purchasing power parity theory. According to the absolute purchasing power parity theory, the least complicated of the two, the bilateral exchange rate is related to the differences in the level of prices between countries.

Absolute PPP The absolute PPP theory is closely related to the **law of one price** which suggests that a product that is easily and freely traded in a perfectly competitive global market should have the same price everywhere, once the prices at different places are expressed in the same currency. The law of one price proposes that the price (P) of the product measured in domestic currency will be equated to the price (P_f) of the product measured in the foreign currency through the current spot exchange rate (e):

$$P = e \cdot P_f$$

Relative PPP While absolute PPP theory is based on the absolute prices of goods in the two countries, the relative purchasing power parity between two countries states that the *percentage change* in the bilateral exchange rate is equal to the difference in the *percentage change* in the national price levels over any given period of time. In other words, while the absolute PPP is a statement about absolute prices and exchange rate *levels*, the relative PPP is a statement about price and exchange rate *changes* over time.

The essence of the PPP theory is clearly expressed by Professor S.E. Thomas as follows: “...while the value of the unit of one currency in terms of another currency is determined at any particular time by the market conditions of demand and supply, in the long run, that value is determined by the relative values of the two currencies as indicated by their relative purchasing power over goods and services (in their respective countries). In other words, the rate of exchange tends to rest at that point which expresses equality between the respective purchasing powers of the two currencies. This point is called the purchasing power parity.”⁵

Effects of PPP Thus, according to the purchasing power parity (PPP) theory, the exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at that rate of exchange are equivalent. For example, assume that a particular bundle of goods in India costs Rs. 45.00 and the same in USA costs \$1. Then the exchange rate will be in equilibrium if the exchange rate is \$1 = Rs 45.00. Once the equilibrium is established, the market forces will operate to restore the equilibrium if there are some deviations. For example, if the exchange rate changes to \$1 = Rs 46.50 when the purchasing powers of these currencies remain stable, dollar holder will convert dollars into rupees because, by doing so, they can save Rs 1.50 when they purchase a commodity worth \$1. This will increase the demand for the Indian currency and the supply of dollars will increase in the foreign exchange market and eventually, the equilibrium rate of exchange will be re-established.

A change in the purchasing power of currencies will be reflected in their exchange rates. The index number of prices may be made use of to determine the purchasing power parity. If there is a change in prices (i.e. the purchasing power of the currencies), the new equilibrium rate of exchange can be found out by the following formula.

$$ER = \frac{Er \times P_d}{P_f}$$

where

ER = Equilibrium exchange rate

Er = Exchange rate in the reference period

P_d = Domestic price index

P_f = Foreign country's price index

Evaluation Although the PPP theory has certain strengths, it has a number of drawbacks too.

Demerits The purchasing power parity theory is subject to the following criticisms:

1. The theory makes use of the price index number to measure the changes in the equilibrium rate of exchange and hence the theory suffers from the various limitations of the price index number.
2. The composition of the national income varies in different countries and hence the types of goods and services included in the index number may vary from country to country, rendering comparisons on the basis of such index numbers unrealistic.
3. The quality of goods and services may vary from country to country. Comparison of prices without regard to the quality is unrealistic.
4. The price index number may include the prices of products which are not internationally traded and hence the rate of exchange calculated on the basis of such price indices cannot be realistic.
5. The theory is rendered further unrealistic by ignoring the cost of transportation in international trade.
6. Another very unrealistic assumption made by the theory is that international trade is free from all barriers.
7. The purchasing power parity theory ignores the effects of international capital movements on the foreign exchange market. International capital movements may cause changes in the exchange rate. For example, if there is capital inflow to India from USA, the supply of the dollar and the demand for rupees increases in the foreign exchange market, causing an appreciation in the value of the rupee and depreciation in the value of the dollar.
8. Another defect of the theory is that it ignores the impact of changes in the exchange rates on the prices. For example, if, as a result of large capital inflows to India, Indian currency appreciates in terms of foreign currencies, Indian exports may decline and as a result, the supply of goods in India may exceed the demand and may cause a fall in prices.
9. The theory does not explain the demand for the supply of foreign exchange. When the exchange rate is determined largely by demand and supply conditions, any theory that does not pay adequate attention to these aspects proves to be unsatisfactory.

10. The purchasing power parity theory starts with a given rate of exchange, but fails to explain how that particular rate of exchange is arrived at. Thus, the theory only tells us how, with a given rate of exchange, changes in the purchasing powers of two currencies affect the exchange rate.
11. The theory is based on the wrong assumption that the elasticity of demand for exports and imports is equal to unity i.e. this theory is valid only if the exports and imports change in the same proportion as the change in prices. But this is a very rare occurrence.
12. No satisfactory explanation of short term changes in exchange rates is provided by the theory.
13. The theory goes contrary to general experience. Critics point out that there has hardly been any case when the rate of exchange between two currencies has been equivalent to the ratio of their purchasing powers.
14. Observers maintain that the applicability of the PPP theory is limited because exchange-rate movements are often caused by news that, by its very nature, is unpredictable. Foreign-exchange rates have been viewed to behave similarly to asset markets (such as stock markets), which incorporate new information quickly and adjust their prices continuously. However, purchasing-power-parity calculations are based on commodity prices (such as the consumer price index), which respond sluggishly to changing economic circumstances. To the extent that exchange rates respond quickly to new information and commodity prices respond slowly, departures from the purchasing-power-parity theory will occur. Most economists maintain that other factors are much more important than relative price levels for exchange-rate determination in the short run.⁶

Merits Despite its many defects and deficiencies, the purchasing power parity theory exposes some very important aspects of exchange rate determination.

1. It indicates the relationship between the internal price levels and exchange rates.
2. It explains the state of the trade of a country as well as the nature of its balance of payments at a particular time.
3. Further, the theory is applicable, to some extent, to all sorts of monetary standards.

Empirical Evidence Empirical data present a mixed picture regarding the validity of the purchasing power parity theory.

PPP and Exchange—Rate Predictions It is pointed out that for many years, the purchasing-power-parity appeared to operate reasonably well. Although precise exchange-rate predictions based on purchasing-power-parity calculations were not always accurate, nations having higher inflation rates did at least experience depreciating currencies. In the early 1980s, however, even this broke down. For example, between 1980 and 1983 the US inflation rate was much higher than Japan's and modestly higher than Germany's. Nevertheless, the dollar appreciated against both the yen and the mark during this period.⁷

PPP and Adjustment in Exchange Rate It is observed that, although the purchasing-power-parity theory is of limited value in the short run, over a sufficiently long period it is possible that economic forces work to maintain purchasing-power-parity levels. One study used annual data over the period 1869–1984 to estimate the degree to which the dollar/pound exchange rate returns to purchasing-power-parity equilibrium. Over the course of this period, the estimated speed of adjustment to purchasing

Exchange rate adjustment lags long the price changes.

power parity was 14 per cent per year. This means that 50 per cent of the adjustment toward purchasing power parity occurs after 4.5 years, and 90 percent of the adjustment occurs by the end of 15 years. These results suggest that the purchasing-power-parity theory provides a rough approximation of the long-run exchange rate if the adjustment process is analyzed over many years. A time horizon of such length, however, is of little relevance to decision makers.⁸

PPP and Trade It is found that the purchasing power parity theory provided a point of reference for the long-run exchange rate in many of the modern exchange rate theories. Empirical evidence showed that PPP performs better for those countries that are geographically close to each other and where trade linkages are high. Moreover, PPP holds better for traded goods compared to non-traded goods. Reasons for failure of PPP may be attributed to heterogeneity in the baskets of goods considered for construction of price indices in various countries, presence of transportation cost and other trade impediments like tariff, imperfect competition in goods market, and increase in the volume of global capital flows during the last few decades which led to sharp deviation from PPP.⁹

Balance of Payments Theory

The balance of payments 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. Thus, according to this theory, the price of a currency i.e. the exchange rate, is determined just like the price of any commodity is determined by the free play of the forces of demand and supply.

The value of a currency appreciates when the demand for it increases and depreciates when the demand falls, in relation to its supply in the foreign exchange market.

Demand for and Supply of Foreign Exchange The extent of the demand for and supply of a country's currency in the foreign exchange market depends on its balance of payments position. When the balance of payments is in equilibrium, the supply of and demand 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.

Foreign exchange rate is determined mostly by the demand for and supply of foreign exchange.

The demand for foreign exchange arises from demand for foreign goods, services, financial assets etc. and the supply of foreign exchange comes from the foreign demand for the home country's goods, services, financial assets etc.

In figures 18.1 and 2, D represents the demand for foreign exchange and S for the supply foreign exchange. At point E the supply and demand are equal and, therefore, E represents the equilibrium rate of exchange. If the demand shifts to D_1 (Figure 18.2), the exchange rate will increase to R_3 and if the demand falls to D_2 , the rate will fall to R_4 . Figure 18.1 shows the effect changes in the supply on the exchange rate.

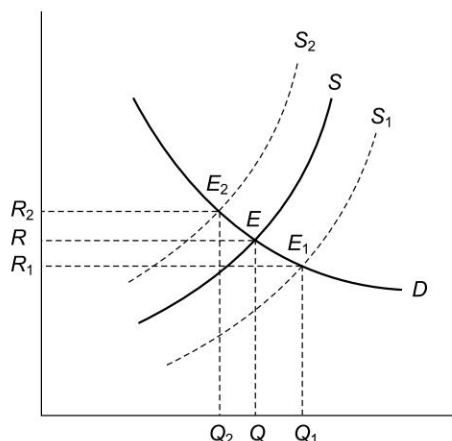


Fig. 18.1

Effect of Changes in Supply of Foreign Exchange on Exchange Rate

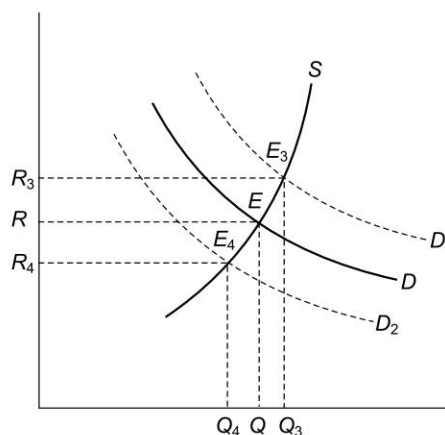


Fig. 18.2

Effect of Changes in Demand for Foreign Exchange on Exchange Rate

Evaluation The balance of payments theory provides a fairly satisfactory explanation of the determination of the rate of exchange. This theory has the following merits.

1. Unlike the purchasing power parity theory, the balance of payments theory recognises the importance of all the items in the balance of payments, in determining the exchange rate.
2. This demand and supply theory is in conformity with the *general theory of value*—like the price of any commodity in a free market, the rate of exchange is determined by the forces of demand and supply.
3. This theory brings the determination of the rate of exchange within the purview of the *General Equilibrium Theory*. That is why this theory is also called the general equilibrium theory of exchange rate determination.
4. It also indicates that balance of payments disequilibrium can be corrected by adjustments in the exchange rate (i.e. by devaluation or revaluation), rather than by internal deflation or inflation.

The main defect of the theory is that it does not recognise the fact that the rate of exchange may influence the balance of payments.

Monetary Models

The failure of the PPP theory to explain real world exchange rate behaviour gave rise to a set of monetary models which took into account the possibility of capital/bond market arbitrage apart from goods market arbitrage assumed in the PPP theory.¹⁰

According to the monetary models, the exchange rate is determined by the money supply in relation to money demand in both home and foreign country.

The most important monetary models of exchange rate determination are flexible price, sticky price and real interest differential models. A common starting point for all the three monetary models was the assumption of uncovered interest parity (UIP) condition.¹¹

Supply of and demand for money influence exchange rate.

Flexible Price Models The flexible price monetary models propounded by Frenkel, Mussa, and Bilson, basic assumptions and tenets are founded on the following basic assumptions and tenets:

1. All prices in the economy are perfectly flexible both upwards and downwards in both short and long run.
2. Inflationary expectations play an important role in the determination of the exchange rate.

According to these models, high monetary growth rate in a country could cause high inflationary expectations leading to a reduction in the demand to hold real money balances and increase in expenditure on goods, resulting in a rise in domestic price level and a depreciating currency in order to maintain PPP.

Empirical tests of the flexible price monetarist model provided weak results. One of the major deficiencies of the flexible price monetarist model was that it assumed that PPP holds continuously and that the prices were as flexible upwards and downwards as the exchange rates.¹²

Sticky Prices Model The sticky prices model, first elaborated by Dornbusch in 1976, introduced the concept of **exchange rate overshooting** and provided an explanation for both exchange rate volatility and misalignment from the purchasing power parity.

The volatility of exchange rates may be intensified by the phenomenon of overshooting.

An exchange rate is said to overshoot when its short-term response (depreciation or appreciation) to a change in market fundamentals is greater than its long-term response. Changes in market fundamentals thus exert a disproportionately large short-term impact on exchange rates. Exchange-rate overshooting is an important phenomenon because it helps explain why exchange rates depreciate or not appreciate so sharply from day to day.¹³

According to the sticky price model, there is a difference in the response pattern of exchange rate from that of goods prices and wages to developments and shocks such as changes in the money supply. According to this model, the goods and labour market are characterised by sticky prices. Prices of goods

Exchange rate responds quickly to market developments, while product price and wage are sticky-respond slowly.

and wages tend to change slowly over time in response to various shocks such as changes in the money supply. Prices are particularly downward sticky. But the exchange rate may immediately respond to new developments and shocks. Therefore, the exchange rate changes would not be matched by corresponding price changes and there could be

persistent and prolonged departure from purchasing power parity. When the real output is fixed, a monetary expansion in the short-term would lower the interest rates and cause the exchange rate to overshoot its long run depreciation, i.e. the short-term exchange rate would fall below its long run equilibrium level.

Real Interest Differential Model The real interest differential model combines the role of inflationary expectations of the flexible price monetary model with the sticky prices model.

It is pointed out that the most important weakness of the monetary models of exchange rate determination is the absence of an explicit role for the current account to influence exchange rates. Furthermore, domestic and foreign bonds were regarded as perfect substitutes—they were regarded as equally risky so there was no role for risk perception to play a part in determination of exchange rates.¹⁴

Portfolio Balance Models The portfolio balance models seek to overcome one of the weaknesses of the monetary models mentioned above by recognizing the possibility that international investors may regard domestic and foreign bonds as imperfect substitutes of each other.

In the portfolio balance models, the current account balance position finds place in the determination of exchange rate over time. A current account surplus implies an accumulation of foreign assets and the

resultant larger proportion of foreign bonds in investor's portfolio than desired. Given the imperfect substitution between domestic and foreign bonds, this results in appreciation of the exchange rate.

Although the portfolio balance model allows for the departures from the uncovered interest parity (UIP) due to existence of a risk premium, there is no strong empirical evidence to support it as an alternative to the monetary models.¹⁵

EXCHANGE CONTROL

Exchange control is one of the important means of achieving certain national objectives like an improvement in the balance of payments position, restriction of inessential imports and conspicuous consumption, facilitation of import of priority items, control of outflow of capital and maintenance of the external value of the currency.

Exchange control is a means to help achieve certain national objectives.

Scope of Exchange Control

Under the exchange control, the whole foreign exchange resources of the nation, including those currently occurring to it, are usually brought directly under the control of the exchange control authority (the Central Bank, treasury or a specially constituted agency). Dealings and transactions in foreign exchange are regulated by the exchange control authority. Exporters have to surrender the foreign exchange earnings in exchange for home currency and the permission of the exchange control authority has to be obtained for making payments in foreign exchange. It is generally necessary to implement the overall regulations with a host of detailed provisions designed to eliminate evasion.¹⁶

The allocation of foreign exchange is made by the exchange control authority, on the basis of national priorities.

Though the exchange control is administered by a central authority like the central bank, the day-to-day business of buying and selling foreign exchange is ordinarily handled by private exchange dealers, largely the exchange departments of commercial banks. For example, in India there are *authorised dealers* and *money changers*, entitled to conduct foreign exchange business.

Objectives of Exchange Control

The important purposes of exchange control are outlined below.

To Strengthen the Government Exchange control measures increase government influence in a number of areas. For instance, control over the foreign exchange transactions and resources make the augmentation of resources for certain strategic needs like defence more easy.

To Conserve Foreign Exchange The main objective of foreign exchange regulation in India, as laid down in the Foreign Exchange Regulation Act (FERA), 1973, was the conservation of the foreign exchange resources of the country and the proper utilisation thereof in the interest of the national development. This is one of the important objectives of foreign exchange regulation of many other countries too.

To Check Capital Flight Exchange control may be employed to prevent flight of capital from the country and to regulate the normal day-to-day capital movements. As Krause remarks, if adequately implemented and enforced, exchange control tends to be highly effective in curbing erratic outflows of

capital. When exchange-control authorities refuse to sell foreign exchange for this purpose, they close the only legal avenue through which capital may leave a country.¹⁷

To Improve Balance of Payments Exchange control is one of the measures available to improve the balance of payments position. This can be achieved by restricting imports by means of exchange control.

To Curb Conspicuous Consumption In the developing countries, especially, there is a craze for the consumption of imported articles, which are regarded as inessential 'luxury' goods. Exchange control may be used to prevent their import and, thereby, their consumption.

To Make Possible Essential Imports Due to the non-availability of or scarcity within the country, the developing countries generally have to import capital goods, know-how and certain essential inputs and consumer goods. By giving priority to such imports in the allocation of foreign exchange, exchange control may ensure availability of foreign exchange for these imports.

To Protect Domestic Industries Exchange control may also be employed as a measure to protect domestic industries from foreign competition.

To Check Recession-induced Exports into the Country If foreign economies are undergoing recession when the domestic economy is free from it, the decline in prices of foreign goods, due to the recession, may encourage their exports into the country not yet affected by recession. Exchange control may be employed to check such recession-induced exports into the country.

To Safeguard Domestic Programmes Exchange control may be instituted to enable a country to pursue domestic policies of an anti-deflationary nature without being disturbed by factors such as recession-induced exports, similar to that mentioned above, into the country.

To Maintain Exchange Rate Stability Maintenance of exchange rate stability is among the major objectives of exchange control.

To Control Speculation Exchange control may be employed to control speculation in the foreign exchange market.

To Regulate Foreign Companies Exchange control may also seek to regulate the business of foreign companies in the country.

To Regulate Export and Transfer of Securities Exchange control may be employed also for the purpose of controlling the export and transfer of securities from the country. The FERA, for instance, prohibited the sending or transferring of securities from the country to any place outside India, without the permission of the Reserve Bank of India.

To Facilitate Discrimination and Commercial Bargaining Exchange control offers scope for discrimination between different countries. It could be used to accord exchange concessions, on a reciprocal basis, between different countries.

To Enable the Government to Repay Foreign Loans As the system of exchange control empowers the government to acquire foreign exchange from the residents of the country, it becomes easy for the government to repay foreign loans.

To Lower the Price of National Securities held Abroad It may be possible to reduce the price of national securities held abroad by preventing nationals from buying them. This would enable the government to purchase such securities at a lower price.

To Freeze Foreign Investments and Prevent Repatriation of Funds Exchange control may be used to freeze investments, including bank deposits, of foreigners in the home country and to prevent the repatriation of funds out of the country. This is sometimes done by hostile countries.

The universal economic liberalisation has reduced the role of exchange control.

To Obtain Revenue Governments may use exchange control to obtain some revenue. The government/government agency can make profit out of the foreign exchange business by keeping certain margin between the average purchase price and the average selling price of the foreign exchange.

Methods of Exchange Control

The various methods of exchange control may be broadly classified into (1) Unilateral methods and (2) Bilateral/multilateral methods.

Unilateral Methods Unilateral measures refer to those methods which may be adopted by a country unilaterally i.e., without any reference to or understanding with other countries. The important unilateral methods are outlined below.

Regulation of Bank Rate A change in the bank rate is usually followed by changes in all other rates of interest and this may affect the flow of foreign capital. For example, when the internal rates of interest rise, foreign capital is attracted to the country. This causes an increase in the supply of foreign currency and the demand for domestic currency in the foreign exchange market and results in the appreciation of the external value of the currency. A lowering of the bank rate is expected to produce the opposite results.

Regulation of Foreign Trade The rate of exchange may be controlled by regulating the foreign trade of the country. For example, by encouraging exports and discouraging imports, a country can increase the demand for, in relation to supply, its currency in the foreign exchange market and thus bring about an increase in the rate of exchange of the country's currency.

Rationing of Foreign Exchange By rationing the limited foreign exchange resources, a country may restrict the influence of the free play of market forces of demand and supply and thus maintain the exchange rate at a higher level.

Exchange Pegging Exchange pegging refers to the policy of the government of fixing the exchange rate arbitrarily either below or above the normal market rate. When it is fixed above the free market rate, it is known as *pegging up* and when it is fixed below the free market rate, it is known as *pegging down*. Exchange pegging is resorted to, generally, during war times to prevent violent fluctuations in the exchange rate.

Multiple Exchange Rates Multiple exchange rates refer to the system of the fixing, by a country, of the different rates of exchange for the trade of different commodities and/or for transactions with different countries. The main object of the system is to maximise the foreign exchange earnings of a country by increasing exports and reducing imports. The entire structure of the exchange rate is devised

in a manner that makes imports cheaper and exports more expensive. The multiple exchange rate system has been severely condemned by the IMF.

Exchange Equalisation Fund The main object of the Exchange Equalisation Fund, also known as the Exchange Stabilisation Account, is to stabilise the exchange rate of the national currency through the sale and purchase of foreign currencies. When the demand for domestic currency exceeds its supply, the Fund starts purchasing foreign currency with the help of its own resources. This results in an increase in the demand for foreign currency and increases the supply of the national currency. The tendency of the rate of exchange of the national currency to rise can thus be checked.

When the supply of the national currency exceeds demand and the exchange rate tends to fall, the Fund sells the foreign currencies and this increases the supply of foreign currencies and arrests the tendency of the exchange rate of the domestic currency to fall. This sort of an operation may be resorted to eliminate short term fluctuations.

Blocked Accounts In the case of blocked accounts, foreigners are prevented from withdrawing money from their deposits with banks, for the purpose of remitting abroad. This measure makes the foreign exchange position of the country more comfortable. This is generally regarded as a wartime measure. Under this method, domestic debtors may be required to deposit their dues to foreign creditors into specifically designated bank accounts.

Bilateral/Multilateral Methods The important bilateral/multilateral methods are the following:

Private Compensation Agreement Under this method, which closely resembles the barter system, a firm in one country is required to equalise its exports to the other country with its imports from that country so that there is neither a surplus nor a deficit.

Clearing Agreement Normally, importers have to make payments in foreign currency and while exporters are paid in foreign currency. Under the clearing agreement, however, importers make payments in domestic currency to the clearing account and exporters obtain payments in domestic currency from the clearing fund. Thus, under the clearing agreement, the importer does not directly pay the exporter and hence, the need for foreign exchange does not arise, except for settling the net balance between the two countries.

Standstill Agreement The standstill agreement seeks to provide debtor country some time to adjust her position by preventing the movement of capital out of the country through a moratorium on the outstanding short-term foreign debts.

Payments Agreement Under the payments agreement, concluded between a debtor country and a creditor country, provision is made for the repayment of the principal and interest by the debtor country to the creditor country. The creditor country refrains from imposing restrictions on the imports from the debtor country in order to enable the debtor to increase its exports to the creditor. On the other hand, the debtor country takes necessary measures to encourage exports to and discourage imports from the creditor country.

EXCHANGE RATE SYSTEMS

Broadly, there are two important exchange rate systems, namely the fixed exchange rate system and flexible exchange rate system.

Fixed Exchange Rates

Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed, pegged rate and to change their value only at fairly infrequent intervals, when the economic situation forces them to do so.

Elimination of certain uncertainties which can seriously disturb the economic system is the greatest merit of stable exchange rate.

Under the *gold standard*, the values of currencies were fixed in terms of gold. Until the breakdown of the *Bretton Woods System* in the early 1970s, each member country of the IMF defined the value of its currency in terms of gold or the US dollar and agreed to maintain (to peg) the market value of its currency within ± 1 per cent of the defined (par) value. Following the breakdown of the *Bretton Woods System*, some countries took to managed floating of their currencies while a number of countries still embraced the fixed exchange rate system.

Arguments for the Stable Exchange Rate System The relative merits and demerits of the fixed and flexible exchange rate systems have long been a topic for debate. A number of arguments have been put forward for and against each system. The important arguments supporting the stable exchange rate system are the following:

Development and Growth Exchange rate stability is necessary for orderly development and growth of foreign trade. If exchange rate stability is not assured, exporters will be uncertain about the amount they will receive and importers will be uncertain about the amount they will have to pay. Such uncertainties and the associated risks adversely affect foreign trade. A great advantage of the fixed exchange rate system is that it eliminates the possibilities of such uncertainties and risks.

Correction of BOP Deficits Especially the developing countries, which have a persistent balance of payment deficits, should necessarily adopt the stable exchange rate system to prevent continuous depreciation of the external value of their currencies.

Foreign Capital Investment Exchange rate stability is necessary to attract foreign capital investment as foreigners will not be interested to invest in a country with an unstable currency. Thus, exchange rate stability is necessary to augment resources and foster economic growth.

Preventing Flight of Capital Unstable exchange rates may encourage the flight of capital. Exchange rate stability is necessary to prevent its outflow.

Elimination of Speculation A stable exchange rate system eliminates speculation in the foreign exchange market.

Support to RIAs A stable exchange rate system is a necessary condition for the successful functioning of regional groupings and arrangements among nations.

Encouragement to Foreign Trade Foreign trade plays a very important role in case of a number of countries. As we have seen in Chapter 3, for certain countries, the value of foreign trade exceeds GNP, while for many others the value of foreign trade is more than 50 per cent of their GNP. Exchange rate stability is especially important for such countries to ensure the smooth functioning of the economy. Its absence will give rise to uncertainties and this would disturb the foreign trade sector and, thereby, the economy.

Growth of International Financial Markets A stable exchange rate system is also necessary for the growth of international money and capital markets. Due to the uncertainties associated with unstable exchange rates, individuals, firms and institutions may shy away from lending to and borrowing from the international money and capital markets.

Flexible Exchange Rates

Flexible exchange rate system works on the market mechanism.

Under the flexible exchange rate (also known as floating exchange rate) system, exchange rates are freely determined in an open market primarily by private dealings, and they, like other market prices, vary from day-to-day.

Under the flexible exchange rate system, the first impact of any tendency toward a surplus or deficit in the balance of payments is on the exchange rate. A surplus in the balance of payments will create an excess demand for the country's currency and the exchange rate will tend to rise. On the other hand, a deficit in the balance of payments will give rise to an excess supply of the country's currency and the exchange rate will, hence, tend to fall.

Automatic variations in the exchange rates, in accordance with the variations in the balance of payments position, tend to automatically restore the balance of payments equilibrium. A surplus in the balance of payments increases the exchange rate. This makes foreign goods cheaper in terms of the domestic currency and domestic goods more expensive in terms of the foreign currency. This, in turn, encourages imports and discourages exports, resulting in the restoration of the balance of payments equilibrium. On the other hand, if there is a payments deficit, the exchange rate falls and this makes domestic goods cheaper in terms of the foreign currency and foreign goods more expensive in terms of the domestic currency. This encourages exports, discourages imports and thus helps to establish the balance of payments equilibrium. (For a simple explanation of this system, see the first few paragraphs of the chapter *Devaluation*.) Theoretically, this is how the flexible exchange rate system works.

Cases for and Against Flexible Exchange Rates A number of economists strongly advocate the adoption of the flexible exchange rate system. Nobel laureate Milton Friedman, for instance, argues, there is scarcely a facet of international economic policy for which the implicit acceptance of a system of rigid exchange rates does not create serious and unnecessary difficulties.¹⁸ He is of the view that "sooner a system of flexible exchange rates is established, the sooner unrestricted multilateral trade will become a real possibility. And it will become one without, in any way, interfering with the pursuit by each nation of domestic economic stability according to its own rights".¹⁹

A number of economists, however, point out that certain serious problems are associated with the system of flexible exchange rates. We present here some important arguments against and for flexible exchange rates.

1. Flexible exchange rates present a situation of instability, creating uncertainty and confusion. Friedman disputes this view and argues that a flexible exchange rate need not be an unstable exchange rate. If it is, it is primarily because there is an underlying instability in the economic conditions governing international trade. And a rigid exchange rate may, while itself remaining nominally stable, perpetuate and accentuate other elements of instability in the economy. The fact that a rigid official exchange rate does not change while a flexible rate does is no evidence that the former means greater stability in any more fundamental sense.²⁰
2. The system of flexible exchange rates, with its associated uncertainties, makes it impossible for exporters and importers to be certain about the price they will have to pay or receive for foreign exchange. This will have a dampening effect on foreign trade.

Friedman counters this objection by pointing out that under flexible exchange rates, traders can almost always protect themselves against changes in the rate by hedging in the future markets. Such markets in foreign currency readily develop when exchange rates are flexible.²¹ However, as Sodersten points out, it is certainly true that no market exists today that can protect against all the risks connected with a system of flexible exchanges, and it is doubtful if such a market can be established in the future, if a system of flexible exchanges were introduced. A system of flexible exchanges might, therefore, have a considerably dampening effect on the volume of foreign trade.²²

Flexible exchange rate
breeds uncertainties
and speculation.

3. Under flexible exchange rates, there will be widespread speculation, which will have a destabilising effect. Against this, it is argued that normally, speculation has a stabilising influence on exchange rates. Friedman observes that if speculation is supposed to be destabilising, it implies that speculators lose money on their activity.²³ However, Farrell question this argument and shows that it might be possible, under what seems to be fairly general assumptions, that speculation can be, at the same time, profitable and destabilising.²⁴
4. The system of flexible exchange rates gives an inflationary bias to an economy. When the currency depreciates due to payments deficit, imports become costlier and this stirs up an inflationary spiral. The supporters of the flexible exchange rates, however, counter this criticism by stating that when imports become costlier, the demand for them falls, compelling foreign suppliers to reduce prices. Though it is theoretically possible, it may not be realised. The general feeling is that flexible exchange rates may have an inflationary impact on the economy.

We have reviewed the arguments for and against the fixed and flexible systems. Which system, then, should a country adopt?

The answer will depend on circumstances. It will depend on the characteristics of the economy, and it will change with time as the economy changes. Value judgements are also involved, and ultimately the answer could depend on values and views of a political nature.²⁵

Economic and political factors and
value judgements influence the
choice of the exchange rate system.

CLASSIFICATION OF EXCHANGE RATE REGIMES AND MONETARY POLICY FRAMEWORK²⁶

This section provides the classification for exchange rate systems, based on IMF members' actual, *de facto*, arrangements, as identified by the IMF staff, which may differ from their officially announced arrangements. The scheme ranks exchange rate arrangements on the basis of their degree of flexibility, and the existence of formal or informal commitments to exchange rate paths. It distinguishes among different forms of exchange rate regimes, in addition to the arrangements with no separate legal tender, to help assess the implications of the choice of exchange rate arrangement made for the requisite degree of monetary policy independence. The system presents members' exchange rate regimes and monetary policy frameworks to provide greater transparency in the classification scheme, and to illustrate the relationship between exchange rate regimes and different monetary policy frameworks. The categories are explained below:

Exchange Arrangements with no Separate Legal Tender The currency of another country circulates as the sole legal tender (formal dollarisation). Adopting such regimes implies the complete surrender of the monetary authorities' control over domestic monetary policy. Effective January 1, 2007,

exchange arrangements of the countries that belong to a monetary or currency union, in which same legal tender is shared by all members of the union, are classified under the arrangement governing the joint currency. The new classification is based on the behaviour of the common currency, whereas the previous classification was based on the lack of a separate legal tender.

The classification thus reflects only a definitional change, and is not based on the judgment that there has been a substantive change in the exchange regime or other policies of the currency union or its members.

Currency Board Arrangements A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency, at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligation. This implies that domestic currency will be issued only against foreign exchange, and that, it remains fully backed by foreign assets, leaving little scope for discretionary monetary policy, and eliminating traditional central bank functions, such as monetary control and lender of last resort. Some flexibility may still be afforded, depending on how strict the banking rules of the currency board arrangement are.

Conventional Fixed Peg Arrangements The country pegs its currency within the margin of ± 1 per cent or less vis-à-vis another currency, a co-operative arrangement, such as the ERM II, or a basket of currencies, where the basket is formed from the currencies of major trading or financial partners, and weights reflect the geographical distribution of trade, services, or capital flows. The currency composites can also be standardised, as in the case of the SDR. There is no commitment to keep the parity irrevocably. The exchange rate may fluctuate within narrow margins of less than ± 1 per cent around a central rate—or the maximum and minimum value of the exchange rate may remain within a narrow margin of 2 per cent for at least three months. The monetary authority maintains fixed parity through either direct intervention (i.e., via sale/purchase of foreign exchange in the market) or indirect intervention (e.g., via the use of interest rate policy, imposition of foreign exchange regulations, exercise of moral suasion that constrains foreign exchange activity, or through intervention by other public institutions). Flexibility of monetary policy, though limited, is greater than in the case of exchange arrangements with no separate legal tender and currency boards, because traditional central banking functions are still possible, and the monetary authority can adjust the level of the exchange rate, although relatively infrequently.

Pegged Exchange Rates within Horizontal Bands The value of the currency is maintained within certain margins of fluctuation of more than ± 1 percent around a fixed central rate or the margin between the maximum and the minimum value of the exchange rate exceeds 2 percent. As in the case of conventional fixed pegs, reference may be made to a single currency, a currency composite, or a cooperative arrangement (such as the ERM II). There is a limited degree of monetary policy discretion, depending on the band width.

Crawling Pegs The currency is adjusted periodically in small amounts at a fixed rate, or in response to changes in selective quantitative indicators, such as past inflation differentials vis-à-vis major trading partners, differentials between the inflation target and expected inflation in major trading partners. The rate of crawl can be set to adjust for measured inflation or other indicators (backward looking), or set at a pre-announced fixed rate and/or below the projected inflation differentials (forward looking). Maintaining a crawling peg imposes constraints on monetary policy in a manner similar to the fixed peg system.

Exchange Rates within Crawling Bands The currency is maintained within certain fluctuation margins of at least ± 1 per cent around a central rate—or the margin between the maximum and minimum value of the exchange rate exceeds 2 per cent—and the central rate, or margins, are adjusted periodically at a fixed rate, or in response to changes in selective quantitative indicators. The degree of exchange rate flexibility is a function of the band width.

Bands are either symmetric around a crawling central parity, or widen gradually with an asymmetric choice of crawl of upper and lower bands (in the latter case, there may be no pre-announced central rate). The commitment to maintain the exchange rate within the band imposes constraints on the monetary policy, with the degree of policy independence being a function of the band width.

Managed Floating with No Predetermined Path for the Exchange Rate The monetary authority attempts to influence the exchange rate without defining a specific exchange rate path or target. Indicators for managing the rate are broadly judgmental (For example, balance of payments position, international reserves, parallel market developments), and adjustments may not be automatic. Intervention may be direct or indirect.

Independently Floating The exchange rate is market-determined, with any official foreign exchange market intervention aimed at moderating the rate of change, and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it.

Maximum countries have adopted conventional fixed peg arrangements, followed by managed floating with no predetermined path for the exchange rate, and independently floating.

Monetary Policy Framework

Exchange Rate Anchor The monetary authority stands ready to buy or sell foreign exchange, at given quoted rates, to maintain the exchange rate at its pre-announced level or range—the exchange rate serves as the nominal anchor, or intermediate target of the monetary policy. This type of regime covers exchange rate regimes with no separate legal tender, currency board arrangements, fixed pegs with and without bands, and crawling pegs with and without bands.

Monetary Aggregate Anchor The monetary authority uses its instruments to achieve a target growth rate for a monetary aggregate, such as reserve money, M1, or M2, and the targeted aggregate becomes the nominal anchor, or intermediate target of the monetary policy.

Inflation Targeting Framework This involves the public announcement of medium-term numerical targets for inflation, with an institutional commitment by the monetary authority to achieve these targets. Additional key features include increased communication with the public and the markets about the plans and objectives of the monetary policy-makers, and increased accountability of the central bank for attaining its inflation objectives.

Monetary policy decisions are guided by the deviation in forecasts of future inflation from the announced target, with the inflation forecast acting (implicitly or explicitly) as the intermediate target of the monetary policy.

Fund-Supported or Other Monetary Programme This involves implementation of the monetary and exchange rate policies within the confines of a framework that establishes floors for international reserves and ceilings for net domestic assets of the central bank. Indicative targets for

reserve money may be appended to this system. Countries that maintain nominal anchors, exchange rate anchors, monetary anchors, or inflation-targeting frameworks are classified under the respective rubrics.

Other The country has no explicitly stated nominal anchor, but rather monitors various indicators in conducting its monetary policy, or there is no relevant information available for the country.

Current Scenario

Different exchange rate systems prevail across the globe, with some central bank intervention in most cases.

After the breakdown of the Bretton Woods system, the world has moved to a hybrid exchange rate system.

Some countries, like the United States, allow their currencies to *float freely*, i.e., the exchange rate is determined, by and large, by the market forces of demand and supply. Many European countries appear to be leaning toward the freely floating system. A number of countries, like Canada, Japan, and many developing countries, have *managed but flexible* exchange rates. Managed float involves Government intervention (for example, buying or selling its currency) to reduce the day-to-day volatility of currency fluctuations, or to move its currency towards, what it believes to be a more appropriate level. Many countries, particularly small ones, peg their currencies to a major currency, or to a ‘basket’ of currencies in a *fixed exchange rate*. Sometimes, the peg is allowed to glide smoothly upward or downward in a system known as the *gliding or crawling peg*. A few countries have the hard fix of a currency board.

Almost all countries tend to intervene either when markets become disorderly, or when exchange rates seem far out of line with the ‘fundamentals’—that is, when they are not appropriate for the existing price levels and trade flows.

The task of determining appropriate exchange rate and market intervention policies is extremely difficult for the central banks of all countries. Both in principle and theory, there is a strong case for either the freely floating exchange rates (without intervention) or a currency board type arrangement of fixed rates. In practice, however, due to the operational realities of the foreign exchange markets, most countries have adopted intermediate regimes of various types, including crawling pegs, fixed rates within bands, managed floats with no pre-announced path, and independent floats with market intervention moderating the rate of change and preventing undue fluctuations. By and large, most countries have some variety of managed floats, and central banks intervene in the markets periodically.²⁷

Reflecting the growing role of private capital flows in the 1990s, there has been a shift in the exchange rate regimes, with a trend towards corners—either fixed regimes or floating regimes. For instance, about half of the IMF member countries, as at December, 2001, were at the corners, compared to only one-fourth as at December, 1991 over the years. This trend continued over the years. As at April, 2007, 35 countries had independent float exchange rate system (41 at the end of December, 2001), 48 countries had managed float with no pre-announced path for exchange rate (42 at the end of December, 2001), 10 countries had exchange arrangements with no separate legal tender (40 at the end of December, 2001), 70 countries had other conventional fixed pegged arrangements (40 at the end of December, 2001)—out of this, 49 countries had pegged the currency against a single currency, seven against a composite of currencies, 14 countries belonged to the CFA Franc zone, 13 countries had currency board arrangements (8 at the end of December, 2001), five countries had pegged exchange rates within horizontal bands (five at the end of December, 2001), six countries had crawling pegs (four, at the end of December, 2001), and only one country had exchange rates within crawling bands (six at the end of December, 2001).

EXCHANGE RATE OF INDIAN RUPEE, 1947–2008: POLICIES AND TRENDS

Since 1947, the rupee passed through distinctive phases of exchange rate systems—the fixed exchange system instituted by the IMF (1947–71), the currency peg system under which the value of rupee was pegged to that of pound sterling (1971–75), and later to a basket of currencies (1975–92), a transitional phase of dual exchange rate system consisting of a market determined rate and a fixed rate (1992–93), and the flexible (market determined) rate since 1993. During four and a half decades (1947–1992) of fixed exchange rate system, the rupee was devalued four times. Since the introduction of the flexible exchange rate system in 1993, though there were intermittent periods of stability and appreciation, on the whole, the rupee depreciated 44 per cent against the US dollar, until 2006–07, after which there has been an unprecedented appreciation. From a very pathetic forex reserves position in 1991, India has, over the years, accumulated the fourth largest forex hoard in the world.

A Bird's Eye View of Exchange Rate Policy and Exchange Rate Trends since 1947

As in the case of other currencies the Indian rupee had a fixed exchange rate under the par value system of the IMF that prevailed from 1947 to 1971. During this period, the rupee was devalued twice in 1947 and 1966. After the collapse of the Bretton Woods system in 1971, the major currencies were left to float (i.e. the exchange rate was to be determined by the market forces of demand and supply), and the exchange rates of currencies of a large number of countries, particularly the developing countries, were pegged to one or more strong currencies (i.e. a more or less stable exchange rate is maintained with respect to the pegged currency/currencies). In December, 1971, the rupee was pegged to pound sterling. Since sterling was fixed in terms of the US dollar, the rupee also remained stable against the dollar. In order to overcome the weaknesses associated with a single currency peg, and to ensure stability of the exchange rate, the rupee was pegged to a basket of currencies with effect from September, 1975.

The pegged exchange rate system of the rupee remained in force for more than two decades, until the early 1990s, though the exchange rate was allowed to fluctuate in a wider margin, and to depreciate modestly to maintain competitiveness. The exchange rate of rupee, in terms of the dollar, was fairly stable till 1975, as it was linked to the dollar through the pound sterling. Although the rupee was marked by modest ups and downs between 1975 and 1982, since 1982–83, rupee began to depreciate significantly, and the rate of depreciation became very steep towards the end of 1980s.

The need for adjusting the exchange rate became precipitous in the face of the external payments crisis of 1991, and as a part of the overall macroeconomic stabilisation programme, in 1991, a downward exchange rate adjustment of 20 per cent (i.e. devaluation) was in fact, undertaken to counter the massive drawdown in the foreign exchange reserves, to instill confidence among the investors and to improve domestic competitiveness.

In March, 1992, a **dual exchange rate system**, (under which 60 per cent of the foreign exchange earnings could be converted into rupee at the market rate, and the remaining 40 per cent at the official rate determined by the Reserve Bank (RBI), was introduced. The dual exchange rate system was replaced by a unified exchange rate system in March, 1993, whereby all foreign exchange receipts could be

From 1947 to 1971, the Indian rupee had a fixed exchange rate under the par value system of the IMF. From 1971 to 1975, exchange rate of the rupee was pegged to the value of pound sterling, and from 1975 to 1991, to a basket of currencies.

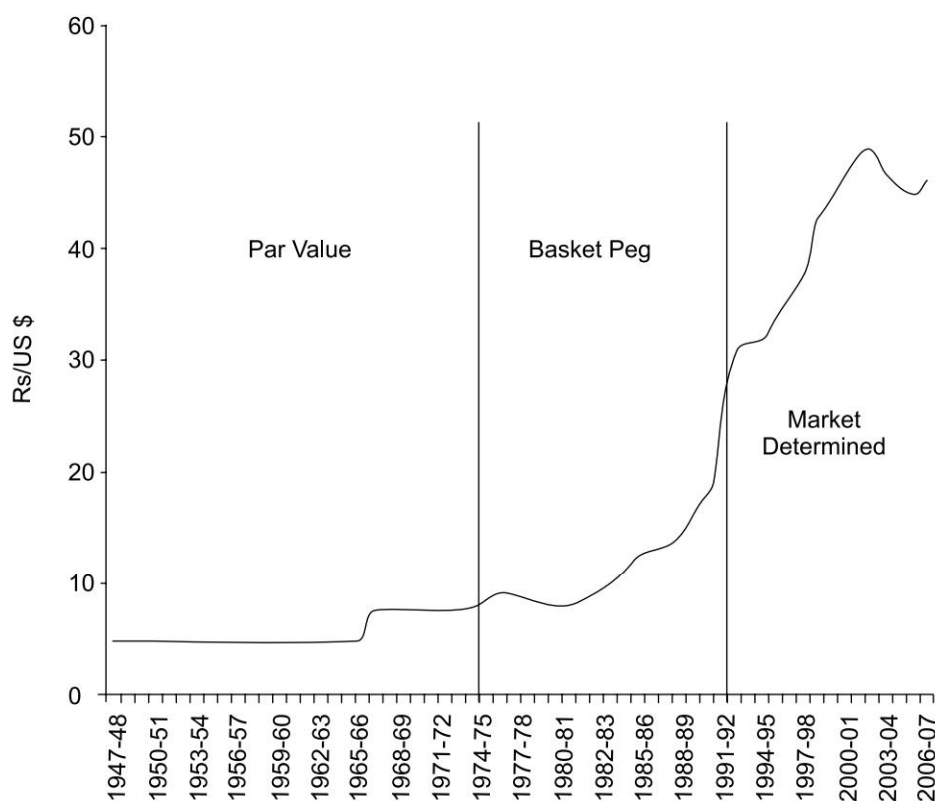
Partial convertibility of rupee, on current account, was introduced in 1992, and full convertibility in 1993.

converted at market determined exchange rates. In other words, since March, 1993, the exchange rate of rupee is determined by the market forces of demand and supply. However, occasionally RBI has intervened in the forex market, to prevent untoward movements of the exchange rate, especially appreciation, as it would harm the economy, particularly the export sector.

During the 14 years, since the introduction of the market determined exchange rate, although the rupee value was characterised by fluctuations, the long term trend was of substantial depreciation against major currencies in varying degrees. However, the rupee appreciated significantly against the dollar in 2007.

During the 14 years of the introduction of the market determined exchange rate (1993-94 to 2006-07), the rupee has depreciated by about 44 per cent against the dollar. This period was, however, characterised by intermittent periods of stability, appreciation and volatility. From (2003 to 2005), the rupee appreciated against the dollar. The average rupee value during the three years, 2004-05 to 2006-07, was higher than in the preceding four years. In the past, the tendency of the rupee to appreciate was moderated by the intervention of the RBI, (i.e. through purchase of dollars). The year,

2007, has witnessed an unprecedented appreciation (about 11 per cent) of the rupee. Such an appreciation has been facilitated by the decision of the RBI not to influence the exchange rate by intervention in the foreign exchange market.



Source: RBI, Report on Currency and Finance 2005-06.

Fig. 18.1 Trends in Rupee-Dollar Exchange Rate

Pegged Exchange Rate System (1971 to 1992) Following the breakdown of the Bretton Woods System, the rupee was linked with pound sterling in December, 1971. Since sterling was fixed in terms of the US dollar under the Smithsonian Agreement of 1971, the rupee also remained stable against the dollar. In order to overcome the weaknesses associated with a single currency peg, and to ensure stability of the exchange rate, the rupee, with effect from September, 1975, was pegged to a basket of currencies. The currencies to be included in the basket, and their weights, were left to the discretion of the Reserve Bank. These currencies, as well as their relative weights, were kept confidential in order to discourage speculation.

Thus, from December, 1971 to September, 1975, the rupee was pegged to a single currency, and from September, 1975 to March, 1992, it was pegged to a basket of currencies. It was around this time that banks in India became interested in trading in foreign exchange due to possible fluctuations in the exchange rate.

Between 1975 and 1982, there were moderate ups and downs in the exchange rate of the rupee. However, since 1982-83 rupee began to depreciate significantly, and the rate of depreciation became very steep towards the end of 1980s, as Figure 1 shows. In July 1991, there was a two step downward exchange rate adjustment by 9 per cent and 11 per cent (i.e. devaluation) undertaken 'to counter the massive drawdown in the foreign exchange reserves, to instill confidence among investors, and to improve domestic competitiveness.'

Following the devaluation, which increased the profitability of the export business, certain important export incentives, like *cash compensatory support* (CCS) and *exim scrip*, were withdrawn.

Period of Transition from Pegged to Market Determined Exchange Rate System (March 1992 to August 1994) The economic reforms ushered in India in 1991 were, in fact, very broad in scope. A credible macroeconomic, structural, and stabilisation programme, encompassing trade, industry, foreign investment, exchange rate, public finance, and the financial sector, was put in place, creating an environment conducive for the expansion of trade and investment. It was recognised that trade policies, exchange rate policies, and industrial policies should form part of an integrated policy framework to improve the overall productivity, competitiveness, and efficiency of the economic system, in general, and the external sector, in particular.²⁸

Following the recommendations of the report of the High Level Committee on Balance of Payments (under the chairmanship of Dr. C. Rangarajan) to move towards the market-determined exchange rate, the *Liberalised Exchange Rate Management System* (LERMS) was initially put in place in March, 1992, involving a dual exchange rate system. Under this system, foreign exchange receipts on current account transactions (exports, remittances, etc.) were required to be surrendered to the Authorised Dealers (ADs) in full. The rate of exchange for conversion of 60 per cent of these proceeds was the market rate quoted by the ADs, while the remaining 40 per cent of the proceeds were converted at the Reserve Bank's official rate. The ADs, in turn, were required to surrender the 40 per cent foreign currencies purchased to the Reserve Bank. They were free to retain the balance 60 per cent foreign exchange for selling in the free market for permissible transactions. One major reason for introducing partial convertibility was to make foreign exchange available, at a low price, for essential imports so that the prices of the essentials would not be pushed up by the high market price of the foreign exchange. It was felt risky with the current account showing large deficit, the Government felt that it was not advisable to introduce full convertibility.

Flexible Exchange Rate System (Since March 1993) The LERMS was essentially a transitional mechanism. While introducing the partial convertibility, the government announced its intention to introduce full convertibility on the current account in three to five years. However, full convertibility on trade account (unified market determined exchange rate regime) was introduced with effect from March 1, 1993. The fact that free market rate was fairly stable at a reasonable level, might have encouraged the government to introduce full convertibility. The restrictions on a number of other current account transactions were also relaxed. The unification of the exchange rate of the Indian rupee was an important step towards current account convertibility, which was finally achieved in August 1994, when India accepted obligations under Article VIII of the Articles of Agreement of the IMF.

As in most other EMEs, the Indian foreign exchange market has also witnessed occasional periods of volatility in the post-1993 period. However, unlike many other EMEs, where volatilities have persisted for prolonged periods, resulting in severe imbalances and crises, the Indian experience reflects an effective and timely management of volatility in the foreign exchange market. The exchange rate policy has been guided by the need to reduce excess volatility, prevent the emergence of destabilising speculative activities, help maintain adequate level of reserves, and develop an orderly foreign exchange market. With a view to reducing the excess volatility in the foreign exchange market arising from lumpy demand and supply, as well as leads and lags in merchant transactions, the Reserve Bank undertakes sale and purchase operations in the foreign exchange market. Such interventions, however, have not been governed by any pre-determined target or band around the exchange rate. The experience with the market-determined exchange rate system, since 1993, can be described as generally satisfactory, as orderliness prevailed in the Indian market during most of the period. A few episodes of volatility that emerged were effectively managed through a combination of timely and effective monetary as well as administrative measures, which ensured return of orderliness to the market, within the shortest possible time.²⁹

Rupee showed remarkable stability in the months which followed the introduction of full convertibility.

The experience with the market determined exchange rate regime has been satisfactory, although the exchange rate management had to occasionally contend with a few episodes of volatility. The period from March 1993 till August 1995 was a phase of significant stability. The surge in capital inflows during 1993-94 and 1994-95, following liberalisation in capital account in the area of foreign direct investment and portfolio investments, coupled with robust export growth, exerted upward pressure on the exchange rate. However, the Reserve Bank absorbed the excess supplies of foreign exchange. In the process, the nominal exchange rate of the rupee *vis-a-vis* the US dollar remained virtually unchanged, at around Rs.31.37 per US dollar over the extended period from March 1993 to August 1995. The real appreciation, resulting from positive inflation differentials prevailing during this period, triggered-off market expectations, and resulted in a market led correction of exchange rate of the rupee during the period September 1995-February 1996. In response to the upheavals, the Reserve Bank intervened, and also resorted to monetary tightening, so as to restore orderly conditions after a phase of orderly correction for the perceived misalignment in the market. Since 1997, the period has witnessed a number of adverse internal as well as external developments. Important internal developments include the economic sanctions imposed in the aftermath of nuclear tests conducted in May 1998, and the border conflict during May-June, 1999. The external developments include, *inter alia*, the contagion from the Asian crisis, the Russian crisis in 1997-98, sharp increase in international crude oil prices from 1999, (especially May, 2000) onwards, and the post-September 11, 2001 developments in the US. These developments created a large degree of uncertainty in the foreign exchange market at various points of time, leading to excess demand conditions. The Reserve Bank responded through appropriate intervention, supported by monetary

and other administrative measures, like variations in the bank rate, repo rate, cash reserve requirements, refinance to banks, surcharge on import finance, and minimum interest rates on overdue export bills. These measures helped in curbing destabilising speculation, while at the same time, allowing orderly correction in the value of the rupee.³¹

The purchase of foreign exchange by the RBI also enabled, besides exchange rate stabilisation, the building up of forex reserves.

The RBI observes that, as a whole, India's current exchange rate policy seems to have stood the test of time. It has focused on management of volatility without fixed rate target, while underlying demand and supply conditions are allowed to determine the exchange rate movements in an orderly way. The Reserve Bank has been following the approach of watchfulness, caution, and flexibility, by closely monitoring the developments in the domestic and financial markets, at home and abroad. It co-ordinates its market operations carefully, particularly in regard to the forex market, with appropriate monetary, regulatory, and other measures, as considered necessary from time to time.³²

The Indian rupee depreciated against all major currencies during the ten-year period, from 1993-94 to 2002-03. The rupee depreciated against the pound sterling and the Japanese yen by 37 per cent and 27 per cent, respectively, during this period. It depreciated against the euro by 6 per cent between 1999-2000 and 2002-03. It appreciated during the next three years, 2000-03 to 2005-06. Although, the rupee depreciated moderately in 2006-07, after the elapse of two months, 2007 witnessed an unprecedented strengthening of the rupee against the dollar.

In brief, since the introduction of full convertibility of the rupee for current account transactions in 1993, the value of the rupee passed through periods of stability and volatility. While the current account deficits (except for three years) increased the demand for foreign exchange, the increase in the FDI and portfolio investment increased its supply. The possibility of appreciation of the rupee was stemmed by the occasional intervention by the RBI (i.e., by purchasing the dollar, and thereby reducing its supply). Over long term, however, the rupee depreciated significantly. In the 14 years, 1993-94 to 2006-07, the rupee, generally, depreciated against dollar, except during the period, 2003 to 2005, when it appreciated on account of the general weakness of the dollar against major currencies. For the period, 1993-94 to 2006-07, as a whole, the rupee depreciated by about 44 per cent.

While the average dollar-rupee exchange rate was 48.40 (the lowest in history) in 2003-04 and 45.28 in 2006-07, the calendar year 2007 ended with a strong rupee (39.43), representing an appreciation by about 11 per cent. The nation was unprepared to face this significant currency appreciation over such a short period. The shocking realisation that appreciation of the rupee will invariably reduce exports shook the national sentiment, that was attuned to the country's export performance. This was despite the fact that fall in external value of the currency was nationally deplored.

A related issue that has figured in the literature is whether the exchange rate should be managed by monitoring Nominal Effective Exchange Rate (NEER) or Real Effective Exchange Rate (REER). (See the *Appendix* for explanation of NEER and REER.) Bimal Jalan, former Governor, RBI, observes: "From a competitive point of view, and also in the medium-term perspective, it is the REER, which should be monitored as it reflects changes in the external value of currency in relation to its trading partners in real terms. However, it is no good for monitoring short-term and day-to-day movements, as 'nominal' rates are the ones which are most sensitive of capital flows... Thus, in the short run, there is no option but to monitor the nominal rate."

Since the introduction of the market determined regime, the rupee has depreciated by about 44 per cent against the dollar, between 1993-94 to 2006-07, i.e., from Rs 31.37 to Rs 44.28 per dollar. In terms of real effective exchange rates (REER), while the REER (6 currency trade based indices) appreciated

Table 18.1 Movements of Indian rupee-US dollar exchange rate, 1993-94 to 2006-07

<i>Year</i>	<i>Range (Rs. per US\$)</i>	<i>Average Exchange Rate (Rs. per US \$)</i>	<i>Appreciation/ Depreciation (%)</i>	<i>Coefficient of Variation (%)</i>	<i>Standard deviation</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>
1993-94	31.21-31.49	31.37		0.1	
1994-95	31.37-31.97	31.40	-0.10	0.3	
1995-96	31.37-37.95	33.45	-6.13	5.8	1.93
1996-97	34.14-35.96	35.50	-5.77	1.3	0.48
1997-98	35.70-40.36	37.16	-4.47	4.2	1.57
1998-99	39.48-43.42	42.07	-11.67	2.1	0.90
1999-00	42.44-43.64	43.33	-2.91	0.7	0.29
2000-01	43.61-46.89	45.68	-5.14	2.3	1.07
2001-02	46.56-48.85	47.69	-4.21	1.4	0.67
2002-03	47.51-49.06	48.40	-1.47	0.9	0.45
2003-04	43.45-47.46	45.95	5.40	1.6	0.72
2004-05	43.36-46.46	44.93	2.16	2.3	1.03
2005-06	43.30-46.33	44.28	1.51	1.5	1.79
2006-07	43.14-46.97	45.28	-2.45	2.0	0.89

Source: Reserve Bank of India, *Report on Currency and Finance 2005-06*.

by about 5 per cent, the REER (36 currency trade based indices) recorded a depreciation of nearly 2 per cent during the same period. It is, however, important to note that REER and NEER have been showing frequent two-way fluctuations over this period (see Table 18.2).

A notable feature of the exchange rate, in the recent years, has been the two-way movement, that has increased the risk profile of such market players who maintain open positions, guided by the perception that the exchange rate can move only one way in India. However, there was reduction in volatility of rupee exchange rate during the last few years, until 2007. Among all currencies worldwide, which are not on a nominal peg, and certainly among all emerging market economies, the rupee-dollar exchange rate has been less volatile. The REER of India has been relatively stable compared with other key Asian countries. The volatility measured from the effective exchange rates, *i.e.*, 6 currency NEER and REER indices for India, was also lower as compared with other countries—such as the US and Japan—for recent period.³³

An important feature of the Indian foreign exchange market, in recent years, has been the growing correlation between the movement in exchange rate of the Indian rupee and the currencies of the Asian countries. In the last couple of years, the rupee-dollar exchange rate is increasingly getting linked to the exchange rate of some Asian currencies—such as Japanese yen *vis-a-vis* US dollar. This feature could be ascribed to the greater integration of the Asian markets, led by large trade and capital flows in the

Table 18.2 Trends in External Value of Indian Rupee

1	36-Currency Trade Based				6-Currency Trade Based			
	REER	Variation %	NEER	Variation %	REER	Variation %	NEER	Variation %
	2	3	4	5	6	7	8	9
1993-94	100.00	0.0	100.00	0.0	100.00	0.0	100.00	0.0
1994-95	104.32	4.3	98.91	-1.1	105.71	5.7	96.86	-3.1
1995-96	98.19	-5.9	91.54	-7.5	101.14	-4.3	88.45	-8.7
1996-97	96.83	-1.4	89.27	-2.5	100.97	-0.2	86.73	-1.9
1997-98	100.77	4.1	92.04	3.1	104.24	3.2	87.80	1.2
1998-99	93.04	-7.7	89.05	-3.2	95.99	-7.9	77.37	-11.9
1999-00	95.99	3.2	91.02	2.2	97.52	1.6	77.04	-0.4
2000-01	100.09	4.3	92.12	1.2	102.64	5.3	77.30	0.3
2001-02	100.86	0.8	91.58	-0.6	102.49	-0.1	75.89	-1.8
2002-03	98.18	-2.7	89.12	-2.7	97.43	-4.9	71.09	-6.3
2003-04	99.56	1.4	87.14	-2.2	98.85	1.5	69.75	-1.9
2004-05	100.09	0.5	87.31	0.2	101.36	2.5	69.26	-0.7
2005-06	102.34	2.2	89.84	2.9	106.67	5.2	71.41	3.1
2006-07 P	98.07	-4.2	85.80	-4.5	104.91	-1.6	88.13	-4.8

REER: Real Effective Exchange Rate. NEER: Nominal Effective Exchange Rate P: Provisional

(+) indicates appreciation and (-) indicates depreciation

Note: Both REER and NEER are bilateral trade weight-based indices with 1993-94 as the base year.

Source: Reserve Bank of India.

region, as well as greater interdependence of financial markets within the region. A supply chain from the Asian region is emerging, with Japan at the top of the chain, supplying high value technological products. China is the major supplier of intermediate products, while India, besides being a supplier of intellectual capital, is emerging as a supplier of intermediate products. The financial markets, (including the foreign exchange market), are increasingly taking cognisance of the growing integration of the Indian economy with the rest of the world, particularly with the Asian region.³⁴

Recent Trends in Currency Values

An unprecedented appreciation of the rupee against the US dollar, within a short period of 9 months, (about 11 per cent between the beginning of March, 2007 and beginning of November, 2007—appreciation for the year 2007 was less than 11 per cent) has created a panicky sentiment in certain quarters. However, if we compare the exchange rate changes of different currencies in recent years, it would be clear that there is nothing abnormal in the exchange rate trend of the rupee.

Table 18.3 Variations in Rupee-Dollar Exchange Rate

<i>Beginning of :</i>	<i>Rupees/Dollar</i>
January, 2007	44.20
February, 2007	44.11
March, 2007	44.27
April, 2007	43.13
May, 2007	41.18
June, 2007	40.54
July, 2007	40.66
August, 2007	40.55
September, 2007	40.88
October, 2007	39.73
November, 2007	39.32
December, 2007	39.56
January, 2008	39.43
May, 2008	40.26

Source: IMF

The appreciation of rupee in 2007 has made the value of the rupee, against the dollar, highest in last 10 years, and has created an unfamiliar, complex and very difficult situation, for the monetary authority,

The rupee-dollar exchange rate trend is part of a general trend. Substantial appreciation of rupee against dollar in future is anticipated by several experts.

the government and the corporate sector, to deal with. To add further to this anxiety, according to some forecasts, the rupee would appreciate to Rs 30 or Rs 28 per dollar by 2012. Many feel that, in 2008, the rupee could go up to Rs 35 against the dollar while some feel that it may depreciate.

The rupee-dollar exchange rate changes are but a part of the general trend. Against a range of currencies, the dollar has lost a quarter of its value in the last five years. Since peaking in 2002, it has fallen by 24 per cent against a trade-weighted basket of currencies. Much of the dollar's weakness is driven by economic fundamentals. Given America's need to borrow from abroad to finance its consumption, it is neither surprising nor sinister. By inducing Americans to import less and export more, a weaker dollar helps cut the current account deficit. If the dollar's decline has accelerated of late, it is largely because of the cyclical divergence between America's economy and the rest of the world.³⁵

The dollar's decline has been especially marked against the euro. At one point, in 2002, the euro was worth \$0.86, it was \$1.47 on January 2, 2008 compared to \$1.04 on January 2, 2003, i.e., the euro has appreciated more than 40% against dollar in the last five years. The appreciation of the rupee was about 18 per cent against the dollar during the same period (despite the fact that the rupee value, five years ago, was the lowest—more than Rs 48).

The extent of rupee appreciation in recent years has been less than that of currencies of several EMEs and other countries.

In fact, the rupee weakened against the dollar between mid 2005 and mid 2006, when other Asian currencies were strengthening.

Table 18.4 Appreciation/Depreciation Rates of Selected Currencies

Currency	Representative Exchange Rates *		Appreciation / Depreciation (-) (Percentage)
	January 02, 2003	January 02, 2008	
Euro@	1.04	1.47	41
U.K. Pound Sterling@	1.61	1.98	23
Australian Dollar@	0.56	00.88	57
Brazilian Real	3.53	1.77	49
Canadian Dollar	1.57	00.99	37
Chinese Yuan	8.28	7.30	12
Indian Rupee	48.01	39.43	18
Indonesian Rupiah	8,968.00	9,370.00	-4
Iranian Rial	7,952.91	9,280.00	-17
Israeli New Sheqel	4.79	3.86	-19
Korean Won	1,187.80	938.20	21
Malaysian Ringgit	3.80	3.31	13
Mexican Peso	10.36	10.90	-5
Singapore Dollar	1.74	1.44	17
South African Rand	8.50	6.82	20
Sri Lanka Rupee	96.74	108.70	-12

* These representative exchange rates, which are reported to the IMF by the issuing central bank, are expressed in terms of currency units per U.S. dollar, except for those indicated by @, which are in terms of U.S. dollars per currency unit.

Source: Computed from IMF data.

There is a view that the substantial appreciation of the rupee within a short period of less than a year has come as a shock. In this context, it is pointed out that had the RBI allowed rupee appreciation from July, 2005 onwards, in time with China, the change in 2007 would not have been so sudden; a gradual appreciation would have enabled corporates to adjust with the changing scenario more smoothly.³⁶ In 2007, only two important currencies appreciated more than the rupee-Canadian dollar (22 per cent) and Thai bhat (13-14 per cent).

It may also be noted that the REER of rupee has been fairly high as Table 18.5 shows.

The IMF and several economists feel that the dollar should depreciate further. The possibility of a recession, a lower interest rate, and the general sentiment against the strength of the greenback, tend to depreciate it further. The fall in the value of the dollar has helped to reduce the trade deficit of USA. But the impact of dollar depreciation on prices in the economy which imports much more than what it exports (in 2006 merchandise imports were about 80 per cent higher than the exports), and its adverse effects should be a matters of serious concern.

The dollar depreciation has serious implications for the world.

Table 18.5 REER and NEER of Select Asian Countries
(Base: 2000 = 100)

Country 1	1995 2	1997 3	2000 4	2001 5	2002 6	2003 7	2004 8	2005 9
Real Effective Exchange Rate (REER)								
China	84.7	100.4	100.0	104.3	101.9	95.2	92.7	92.5
India	101.7	103.0	100.0	100.9	96.9	96.6	98.4	103.7
Japan	108.2	85.3	100.0	89.0	83.0	83.6	84.5	79.4
Malaysia	122.7	122.6	100.0	104.0	105.0	99.2	94.9	95.2
Philippines	120.4	128.7	100.0	95.6	96.2	89.1	86.2	92.3
Singapore	106.2	110.2	100.0	100.5	97.9	94.3	93.3	92.1
Nominal Effective Exchange Rate (NEER)								
China	82.2	92.5	100.0	105.5	105.1	98.6	94.2	94.3
India	117.0	114.3	100.0	97.9	93.3	90.1	88.6	91.3
Japan	99.4	81.3	100.0	90.5	85.7	85.4	87.1	85.3
Malaysia	127.6	126.8	100.0	105.4	104.8	99.6	95.9	95.5
Philippines	145.8	142.5	100.0	90.9	89.7	81.3	75.7	76.9
Singapore	97.1	105.6	100.0	101.6	100.8	98.4	97.9	98.7

Note: Rise in index implies appreciation.

For India data pertain to 6 currency trade-based index.

Source: *International Financial Statistics*, IMF, 2006 and Reserve Bank of India.

The situation is potentially explosive. The declining confidence in dollar is similar to the one that prevailed before the breakdown of the Bretton Woods system in 1971. The big holders of dollar are nervous about the value of the dollar. Further, those countries which have pegged the value of their currencies to the dollar will have to rethink their exchange rate policy.

The dollar still accounts for merely 65 per cent of the identifiable currency stockpile, according to the latest IMF data. The actual share would be higher because some dollar hoards may not have been accounted for by the IMF data. Official foreign exchange stockpiles have almost tripled since the beginning of the decade. China has \$1.4 trillion, followed by Japan with about \$1 trillion.

The big dollar holders are in a serious dilemma-while it is risky to hold on to a currency which is losing its value (thereby reducing the value of the forex reserves), any attempt to make a substantial switchover to alternatives can cause a crash of the dollar value, aggravating the problem. "An optimist would say that central banks, having spurned the chance to diversify out of dollars, when a euro could be bought for 86 cents, are unlikely to want to switch now when the price is close to \$1.50. Against conventional benchmarks—like purchasing-power parity—the euro looks dear against the dollar. So, it could be a bad time to swap from one horse to another. To the mal cartel, then the biggest dollar-holders to start selling its huge dollar reserves—if anything it might averted if China holds fast too, because it recognizes how self-defeating dumping dollars would be to such a large owner of American assets."³⁷

The risks inherent in further stockpiling the reserves in dollar should encourage currency diversification of the forex reserves. Euro, which has increased its share of the global forex reserves from less than one fifth at the time of its launch, in 1999, to about a quarter now, is certainly the dollar's immediate rival. Many view the Chinese yuan as big reserve currency of the future.

A serious problem for India, as well as for many other countries, is the huge undervaluation of the Chinese renminbi. The extent of undervaluation of the RMB is subject to debate, but according to the assessment of Morris Goldstein and Nick Lardy of Peterson Institute, the RMB is undervalued by about 30-40 per cent. A very rough calculation of the effect of this undervaluation on India is that China and other East Asian countries, including Japan, have a weight of about 25-30 per cent in the Indian trade basket. True competitiveness depends on not just actual trade but also potential trade, i.e. in markets where these countries and India are potential competitors. A ball-park figure would suggest that these countries account for roughly one-third of Indian competitiveness. Now, if China's undervaluation were eliminated, the resulting appreciation of the RMB, and with it, other East Asian currencies would lead to *de facto* rupee depreciation of about 10 per cent. This broadly sums up the loss in competitiveness that India has suffered this year, which has caused such angst in the country.³⁸

Impact of Rupee Appreciation

The impacts of rupee appreciation are different for different categories of firms, some benefiting tremendously and others getting hit adversely. For considering the impact of appreciation of the rupee, we may classify firms into three categories, viz, export-dependent (low to 100 per cent), import-dependent (low to 100 percent), and neutral (no exports or imports and, therefore, should not be directly affected by the exchange rate fluctuations)

Changes in the exchange rate of rupee impacts different sectors differently.

The export-dependent firms suffer heavily, and if the fall in their realisation, say from Rs 45 to Rs 39 a dollar, is more than their profit margin, they can continue their business only at a loss. Although, many IT firms would be able to withstand this fall in realisation because of their fairly high margins, or their ability to renegotiate the price at least to certain extent, sectors/firms operating on thin margins will find the going very tough. It is pointed out that 2007-08 would end up with an export turnover of \$140-145 billion, as against the target of \$ 160 billion, due to the adverse impact of rupee appreciation. Although October, 2007 registered a handsome 34 per cent export growth, thanks, mainly, to the increase in the shipment of the petroleum products, and categories like gems and jewellery and engineering products, export of several items-like handicrafts, textiles, marine products and leather have fallen. November, 2007 registered an export growth of 27 per cent in dollar terms. The cumulative export growth for the first 8 months of the current fiscal year (April – November) was 22 per cent in dollars, and 8 per cent in rupees. In the six years since 2000-01, export growth was exceptionally low (–1.6 per cent), and it was exceptionally high in 2003-04 (30.8 per cent) in the remaining 4 years, it ranged between 20.3 and 23.4 per cent. Hence, the export figures, as of now, do not substantiate any adverse impact on exports due to rupee appreciation.

Rupee appreciation makes Indian goods costly in foreign markets because, at Rs 45/dollar, a product which costs Rs 1000 in India costs \$22.2 abroad; but when the exchange rate is Rs 39, the dollar price of the product is \$25.6. About 85 per cent of the Indian exports are invoiced in US dollars. The loss to the exporters in this fiscal year on account of the exchange rate variation alone, could be more than Rs 50,000 crore. This also indicates the enormous profits that would accrue to the exporters due to rupee

depreciation. Besides the loss of exports, because of the fall in the quantity of exports, as Indian goods become dearer in the foreign markets, the loss due to the fall in the rupee realisation is very heavy. It is also reported that the fall in exports is taking a heavy toll of employment. According to the Federation of Indian Export Organisations, until December, 2007, around 10 lakh people, employed in the export sector, have been laid off, and if adequate measures are not taken, this figures could go up to 80 lakh. Renowned economic journalist, Swaminathan S Anklesaria Aiyar, has strongly refuted the argument that rupee appreciation is causing millions of job losses in the export sector. He observes that if a modest rise in the rupee can kill millions of jobs, a corresponding fall in the rupee should create a similar number of jobs. Alas, that did not happen when India had big currency declines. Nor will it happen if rupee declines now by 13 per cent. He contents that the job losses would amount to thousands, not millions, as has been exaggerated. "Some job losses are inevitable, indeed desirable, in a market economy, and constitute transitional pains, and not human disaster."³⁹

Firms which are heavily dependent on exports, like several IT firms and other hundred per cent export oriented firms, face a tough time. Exports with high import intensity would not be hit as adversely as those which export 100 per cent indigenous products, *ceteris paribus*.

The rupee appreciation is a blessing for import-dependent firms. As India imports much more than what she exports, the nation, as a whole, saves much more than it loses on account of the rupee appreciation. The total savings on the import bill, in rupee terms, this fiscal, could be more than Rs. 80,000 crore, without any increase in the volume due to appreciation. The critical issue here is how this savings is distributed in the economy. Does it cause a reduction in price, or is it appropriated by a small section? Oil firms, who are large importers, have benefited substantially from rupee appreciation. For example, Indian Oil Corporation has added Rs 726 crore in the first quarter of 2007. In fact, at a time when crude oil prices have gone through the roof, it provides a little relief in imported crude oil prices.

It is also important to note that the experience of India shows that rupee value and exports do not always move in sync. In fact, despite the depreciating rupee, we could not gain the one per cent share in global exports until last year, although the target was set to be reached many years ago. During several years, when the rupee appreciated, exports registered a handsome growth, and the export growth was disappointing during several years of rupee depreciation, quite contrary to the theory of exchange rate-export link. For example, in the three years, 2003-04 to 2005-06, when the rupee appreciated (both in nominal and REER terms), exports grew, very impressively, between 21.1 and 30.8 per cent annually. On the other hand, during 1998-99 to 2001-02, when there was a significant depreciation of the rupee, the export performance was disappointing, for two years, the growth was even negative.

Contrary to the theory, India experienced good export performance when rupee appreciated, and vice versa.

The rupee appreciation makes acquisition of Indian firms by foreign firms costly, and foreign acquisitions by Indian firms cheaper. This could encourage overseas acquisitions by Indian firms. The Assocham has estimated that India Inc. would have saved to the tune of Rs 6500 crore (\$ 1.66 billion) in 70 deals done overseas in the first six months of the current fiscal year (having total value of \$14 billion).

Rupee appreciation should also help Indian firms to modernise/expand capacity, by import of capital goods and technology.

Companies which have foreign currency loans would also benefit. For example, it was estimated that IOC would save close to Rs. 150 crore on interest payments on foreign currency loans, during the first quarter of the current fiscal year.

Measures need to be taken to ensure that the benefits of import cheapness translate into lower domestic prices. Where it is unlikely to happen, government should reconsider the tariff policy so that it is not unjustifiably appropriated by importers and other firms. Further, the tariff policy should give genuine protection to the domestic firms. The Government and the RBI shall endeavour to control inflation. In fact, the huge foreign exchange reserves and the falling rupee should be helpful in this effort.

The possibility of continued appreciation of the rupee implies that government sops will have only limited impact on propping up the export sector. The problems caused by the dollar-rupee exchange rate should prompt export oriented firms to diversify markets and invoicing, improve operational efficiency and cut costs, and shift from price sensitive segments to premium segments by improving quality and features. Currency appreciation can also lead to shifting/diversifying of location of production/sourcing, either by the greenfield enterprises or acquisitions.

The RBI and the government should explore innovative schemes by which corporates can obtain foreign currency loans in India at competitive rates, rather than going for ECBs. It would enable RBI to substantially enhance the return on forex reserves.

Corporate India and economy, as a whole, have to learn to live successfully with a strong national currency, rather than over-exaggerating its negative impacts, and clamouring for sops and props forever.

CAPITAL ACCOUNT CONVERTIBILITY

Capital account refers to certain transactions on the Balance of Payments of the nation. The Balance of Payments has broadly two categories of entries, viz., current account and capital account. The current account consists of payments for trade in goods and services, payments for factor services (such as interest and dividend), remittances, etc. The capital account consists of short-term and long-term financial flows (like FDI, portfolio investment—such as FII), debt flows, etc.

Free convertibility of a currency means that the currency can be exchanged for any other convertible currency, without any restriction, at the market determined exchange rates.

Convertibility of the rupee, thus, means that the rupee can be freely converted into dollar, pound sterling, yen, euro, etc., and vice versa, at the rates of exchange determined by the demand and supply forces.

As a part of the economic policy reforms, the rupee was made partially convertible since March, 1992. The move towards convertibility of the rupee was in line with the worldwide trend towards currency convertibility. According to the IMF, 70 countries accepted current account convertibility by 1990, while another 10 joined them in 1991. The opening up of capital account became very popular among the developing countries in the 1990s.

Convertibility on the capital account is usually introduced after the lapse of a certain period of time, after the introduction of current account convertibility. Capital account convertibility can help increase the inflow of foreign capital, under certain conditions, as it enables the foreign investors to repatriate their investments whenever they want. But it could also lead to flight of capital from the country if domestic conditions are unfavourable. Hence, capital account convertibility is usually introduced only after experimenting with the current account convertibility for a reasonable time, and stabilisation programmes have been successfully carried out and favourable conditions have been ensured.

The introduction of capital account convertibility—at least convertibility for certain types of capital flows—helps attract resources from abroad. It also enables residents to hold internationally diversified investment portfolios, thereby having more risk bearing capacity. However, capital account convertibility

(CAC) cannot be introduced until certain conditions are satisfied. As the Tarapore Committee points out, "In the absence of confidence in the macroeconomic stability and the competitiveness of domestic enterprises, establishment of capital account convertibility entails the risks of capital flight and greater volatility in exchange rate, external reserves, or interest rate. It is because of this, many countries have maintained various restrictions on various types of capital flows until their economies are well developed."⁴⁰

It may be noted that under completely free capital account convertibility, an Indian can sell his property here and take the money out of the country. Due to such factors, even when capital account convertibility is introduced, several restrictions may have to be attached.

To give recommendations regarding capital account convertibility, RBI appointed, at the instance of the Government of India, a Committee on Capital Account Convertibility under the chairmanship of S.S. Tarapore.

The Report of the Tarapore Committee, submitted on May 30, 1997, which observed that there is no formal definition of CAC, has recommended a pragmatic working definition of CAC. Accordingly, *CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa, at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities, and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature.*

Merits of Convertibility

The capital account convertibility or a floating exchange rate has certain avowed merits.

It gives an indication of the real value of the rupee.

CAC encourages the exports with no or less import intensity. As the proportion of the imported inputs in the exportables increases, the profitability, because of the higher free market exchange rate, gets correspondingly reduced. This could encourage import substitution in export production. The high cost of foreign exchange could encourage import substitution in other areas also. These points assume that CAC will lead to an appreciation of the Rupee, which need not necessarily happen.

It is argued that CAC provides incentives for remittances by NRIs. The convertibility and the liberalisation of gold imports have been expected to make illegal remittances and gold smuggling less attractive, thereby increasing remittances through proper channels.

CAC is described as a self balancing mechanism because the total imports and other current account payments will be confined to the total current account receipts, imports are financed by foreign currency loans.

The Tarapore Committee on Capital Account Convertibility (1997) has pointed out that CAC has the following benefits:

There are traditional benefits of capital account liberalization, such as availability of a larger capital stock to supplement domestic resources, thereby resulting in higher growth reduction in the cost of capital, and improved access to international financial markets.

More recent arguments in favour of CAC emphasise the gains from trade in international financial assets, as CAC allows residents to hold an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic shocks. This also enables lower funding costs for borrowers and prospects of higher yields for savers.

Associated Gains from CAC are the dynamic gains from financial integration. Competition is intensified among financial intermediaries, and as margins are reduced, there is more efficient intermediation. The quality of financial assets improves as a result of greater liquidity and deeper markets. Freer capital flows enable the realisation of efficiency gains, created by specialisation in financial services. Allocative efficiency improves as a result. This can stimulate innovation and improve productivity.

CAC enables alignment of domestic financial prices with international levels, and this provides the impetus for domestic tax regimes to rationalise and converge to international tax structures, to avoid inducements for domestic agents towards evasion and capital flight.

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CAC enables alignment of domestic financial prices with international levels, and this provides the impetus for domestic tax regimes to rationalise and converge to international tax structures, to avoid inducements for domestic agents towards evasion and capital flight.

CAC has disciplining influence on domestic policies. While CAC does not eliminate the effectiveness of a monetary policy, it does not permit the monetary policy to take on an excessive burden of adjustment. Imperfect asset substitutability continues to allow the monetary policy to operate on interest differentials brought about by risk premia, and targeting of the interest rate enhances its effectiveness. Moreover, the conduct of monetary policy is strengthened by the pursuit of a realistic and appropriate exchange rate policy, which reflects fundamentals, and is flexible enough to equilibrate the balance of payments. Furthermore, CAC enhances the effectiveness of fiscal policy by (i) reducing real interest rates applicable to public sector borrowing, (ii) bringing about an optimal combination of taxes through a reduction in inflation tax, and in rates of other taxes, to international levels, with beneficial effects for tax revenues and, (iii) reducing crowding out effects in the access to funds. In fact, a prudent fiscal policy can play a major role in channelising capital flows into productive investments. An unsatisfactory fiscal policy can, however, erode credibility and create conditions for capital flight. In the ultimate analysis, consistent and coordinated macro economic policies can contribute substantially towards reaping the benefits of CAC.

CAC and Domestic Policies

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on an excessive burden of adjustment. Imperfect asset substitutability continues to allow monetary policy to operate on interest differentials brought about by risk premia, and targeting the interest rate enhances its effectiveness. Moreover, the conduct of monetary policy is strengthened by the pursuit of a realistic and appropriate exchange rate policy, which reflects fundamentals, and is flexible enough to equilibrate the balance of payments. Furthermore, CAC enhances the effectiveness of fiscal policy by (i) reducing real interest rates applicable to public sector borrowing, (ii) bringing about an optimal combination of taxes through a reduction in inflation tax, and in the rates of other taxes, to international levels, with beneficial effects for tax revenues and, (iii) reducing crowding out effects in the access to funds. In fact, a prudent fiscal policy can play a major role in channelising capital flows into productive investments. An unsatisfactory fiscal policy can, however, erode credibility and create conditions for capital flight. In the ultimate analysis, consistent and coordinated macro economic policies can contribute substantially towards reaping the benefits of CAC.

Problems of CAC

The convertibility would cause some problems unless certain conditions are satisfied.

According to Joseph Stiglitz, former Chief Economist at the World Bank and a Nobel Laureate in 2001, “Capital market liberalisation entails stripping away the regulations intended to control the flow of hot money in and out of the country—short-term loans and contracts that are usually no more than bets on exchange rate movements. This speculative money cannot be used to build factories or create jobs—companies don’t make long-term investments using money that can be pulled out at a moment’s notice—and indeed, the risk that such hot money brings with it makes long-term investments in a developing country even less attractive.” In other words, in the absence of capital controls, there is the possibility of misallocation of resources, the capital inflows going to speculation or low priority areas, like investments in the stock markets or real estates.

As indicated above, if domestic economic conditions are bad, or are anticipated to be so, large flight of capital is likely. The herd behaviour of investors often aggravates the problem. The South East Asian crisis of 1997 substantiates this point. The South East Asian countries received \$94 billion in 1996, and another \$70 billion in the first half of 1997. However, the crisis resulted in \$102 billion flowing out from the region in the second half of 1997. Renowned economist Jagdish Bhagwati has observed that it is noteworthy that both India and China escaped the Asian financial crisis as they did not capital account convertibility.

CAC can lead to the export of domestic savings because the threat of crisis, may result in domestic savings too, leaving the country, along with the foreign capital, making the crisis more severe, and depriving the nation of its own savings, which could be used for economic development.

A potential danger of CAC in developing countries is the havoc it can cause, due to manipulative or defective analyses by ‘experts’. Dani Rodrik, an eminent Harvard economist, argues that, “The greatest concern I have about canonising capital account, convertibility is that it will leave economic policy, in the typical ‘emerging market’, hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will be the one who pays less attention to developmental goals. We would have to have blind faith in the efficiency and rationality of international capital markets to believe that these two sets of priorities will regularly coincide.”

Such developments, as mentioned above, can cause violent fluctuations in the exchange rate, causing economic instability.

The flight of capital would also cause serious balance of payments problems which can lead to increase in foreign debt.

Pre-requisites of CAC

For successful functioning of the convertible system, certain essential conditions will have to be satisfied. These include:

1. Maintenance of domestic economic stability
2. Adequate foreign exchange reserves
3. Restrictions on inessential imports, till the time the foreign exchange position is not very comfortable
4. Comfortable current account position
5. An appropriate industrial policy and a conducive investment climate
6. An outward oriented development strategy, and sufficient incentives for export growth

It is pointed out that reversal of the process of capital account liberalisation can be prevented if reforms are appropriately sequenced. Appropriate sequencing of capital flows depends, *inter-alia*, on the initial conditions. It is generally agreed that capital account liberalisation should be preceded by macroeconomic stabilisation. Countries which complete the process of macroeconomic stabilisation can remove exchange controls on current account transactions to begin with, followed by capital account openness, as the benefits of domestic reforms on growth and financial stability become visible and appear durable.

Strong macro economic fundamentals are essential for success of CAC.

In general, liberalisation of capital account should follow the current account, since the former may involve real appreciation of the exchange rate, whereas the latter may require real depreciation to offset the adverse impact of dismantling of tariff and non-tariff protection on the balance of payments. Since goods market takes a longer time to clear than financial asset markets, the current account needs to be liberalised first. This is also borne out by the successful experience of Chile, as opposed to that of Argentina. Reform of domestic financial markets before capital account liberalisation is generally considered critical, since domestic financial institutions can then be better equipped to face international competition, and to act as intermediaries in movement of funds.

International Experiences

The experiences of various countries with currency convertibility present a mixed picture.⁴⁰

Britain, which introduced full convertibility in July, 1947, had to beat a hasty retreat the very next month because of large scale flight of capital. In 1958, Britain introduced restricted convertibility. South Korea, which faced problems with partial convertibility in the beginning, rescinded it in 1985, but ultimately restored it in 1989, and succeeded. Fiji introduced current account convertibility in 1985, but made a retreat in 1987. Although, Pakistan's balance of payments crisis was more severe than that of India, after convertibility, their rupee, more or less, stabilised. The experience of countries, like Mexico, Argentina, Peru and Chile, were also encouraging.

International experiences indicate mixed results of CAC.

A number of Southern Cone countries in Latin America undertook rapid liberalisation of their capital account in the late 1970s, in conjunction with a pre-announced or fixed exchange rate. Asian countries, such as Malaysia, Indonesia, and Singapore, also liberalised their capital account against the background of strong balance of payments positions. Many countries prematurely opened their capital account. There was a reversal in the process of liberalisation among many developing countries in the early 1980s. Pre-existing weaknesses in the banking system led to the emergence of serious banking problems, which in turn led to the reimposition of controls in Southern Cone countries, and debt crisis in Latin America. Restrictions in capital account were relaxed in the Latin American countries towards the end of 1980s, with the resolution of the debt crisis under the Brady Plan, and significant reorientation of macroeconomic and structural policies, leading to the restoration of international investor confidence. The process of capital account opening in developing countries accelerated in the 1990s, especially with emerging market economies substantially liberalising their capital controls in Asia, Latin America (Argentina, Venezuela), and transition economies (Czech Republic, Hungary, Estonia, Poland). Among these countries, Argentina had to reimpose controls in its capital account in December, 2001, in the wake of an unprecedented sovereign debt crisis. In the aftermath of the Asian crisis of 1997, the international perception on liberalisation of capital controls, and national policy thinking on the relative benefits of an open capital account *vis-a-vis* the associated costs have changed considerably. The policy debate now centres around the contours of an orderly liberalisation framework, and countries, like Malaysia, have even reverted to capital controls as the key instrument of crisis management.⁴¹

The Committee's survey of the international experience with CAC revealed that countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macroeconomic policies. Furthermore, these countries were less vulnerable to backtracking and the reimposition of controls. Countries with weak initial conditions were constrained to adopt drastic macroeconomic policies to facilitate the move to CAC. Some of these countries had to face interruptions and had to reintroduced capital controls in the evolution of CAC.

The Committee noted that most countries considered a strong balance of payments position a necessary precondition for the move to CAC, and universally built-up reserves. The Committee's survey of the country experiences shows that strengthening of the financial system emerged as the most important precondition for CAC. Fiscal consolidation is another important precondition for CAC among all countries. An important concomitant in the process of CAC is the conduct of an appropriate exchange rate policy.

In the specifics of capital account liberalisation, in the countries studied by the Committee, restriction on inflows and related outflows by non-residents and residents were removed first, followed by relaxation of restrictions on outflows by residents. Among residents, corporates and non-banks, usually received preferential treatment, followed by banks and individuals. Most countries maintained, or were required to impose, some controls on capital inflows during transition to CAC.

Limitations of Capital Controls

The Tarapore Committee (1997) made the following observations regarding controls on capital flows.

Capital controls can be useful in insulating the economy from volatile capital flows during transitional periods, and in providing time to authorities to pursue discretionary domestic policies to strengthen initial conditions. Over longer periods, however, the international experience shows that capital controls turn progressively ineffective, costly, and even distortive. Indeed, the massive scale and speed of global

capital movements, facilitated by the cross-border integration of financial markets, has rendered capital controls porous in the presence of opportunities for arbitrage. This brings to the fore the issue of explicit and implicit costs of maintaining capital controls, even when they have become ineffective. The existence of exchange controls in several countries has provided impetus for growth of grey segments in the economy. As new channels continuously emerge for moving funds abroad, the costs of enforcing capital controls rise. Progressively ineffective controls within appropriate macroeconomic policies sustain each other in a vicious circle. The implicit costs of capital controls are embodied in the distortions that are created, the inefficiencies in the domestic financial system, restrictions on competitive efficiency, and risk diversification and vulnerability to shocks. Ineffective capital controls create distortions in resources allocation, and consequent errors in decisions, both by the market and at the level of the authorities, compound the costs of inefficiency.

In India, the porosity of capital controls has been accentuated after the move to current account convertibility. With progressive liberalisation of current transactions, the balance of payments has recorded the realisation of exports proceeds far in excess of the value of physical shipments, as well as a surge in private unrequited transfers. At the same time, import payments have been substantially higher than the value of physical landings of goods at customs frontiers. Thus, there is reason to believe that capital movements could have adopted the guise of trade transactions and cross border movement of gold. In this context, it is necessary to recognise that CAC is a natural corollary of current account convertibility.

Towards Full Capital Account Convertibility

The Report of the Tarapore Committee (1997) had chalked out a phased road map for making the capital account convertible. Based on an assessment of the macroeconomic conditions, the committee was of the considered view that the time was apposite to initiate a move towards CAC. The Committee, however, pointed out that initial conditions contained certain weaknesses, and entrenchment of preconditions could be achieved in the Indian context only, over a period of time. The establishment of preconditions need to be viewed as processes, rather than as one time indicators. The Committee, therefore, recommended that the implementation of CAC be spread over a three year period, 1997-98, 1998-99 and 1999-2000. The Committee stressed that implementation of measures towards CAC should be sequenced along with the authorities making an assessment of the progress towards the attainment of the preconditions/signposts stipulated for the relevant year, and depending on this assessment, the implementation of measures could be accelerated or decelerated.

The Committee's report pointed out that *fiscal consolidation, a mandated inflation target, and strengthening of the financial system should be regarded as crucial preconditions/signposts for CAC in India. In addition, a few important macroeconomic indicators should also be assessed on an on-going basis. These are: the conduct of exchange rate policy, the balance of payments, and the adequacy of foreign exchange reserves.*

Recommendations for strengthening of the financial system included fully deregulating interest rates and substantially reducing the Non-Performing Assets (NPA)s.

The CAC, however, has not been pursued very seriously, as the East Asian crisis of 1997 raised alarm bells, and as the *preconditions* could not be established as laid down. With the external sector remaining robust and gaining strength every year, and the relative macroeconomic stability, with high growth, providing a conducive environment for relaxation in capital controls, RBI, in pursuance to the announcement by the Prime Minister, constituted a second Committee, under the chairmanship of S.S.

Tarapore on March 20, 2006 (known as *Tarapore Committee II*), for setting out a roadmap towards fuller capital account convertibility. The Committee submitted its Report to the RBI on July 31, 2006.

Conscious of the risks inherent in the movement towards fuller convertibility of the Rupee, as emanating from cross country experiences in this regard, the Committee calibrated the liberalisation roadmap to the specific contexts of preparedness—namely, a strong macroeconomic framework, sound financial systems and markets, and prudential regulatory and supervisory architecture.

The broad thrust of the panel's report is to make the relaxations in capital account transactions considerably more liberal in three phases. The Committee has drawn up a detailed and broad five-year time frame for movement towards fuller convertibility in following phases: Phase I (2006-07); Phase II (2007-08 to 2008-09); and Phase III (2009-10 to 2010-11). It has recommended the meeting of certain indicators/targets as a concomitant to the movement towards fuller capital account convertibility (FCAC): meeting FRBM targets; shifting from the present measure of fiscal deficit to a measure of the Public Sector Borrowing Requirement (PSBR); segregating Government debt management and monetary policy operations through the setting up of the Office of Public Debt independent of the RBI; imparting greater autonomy and transparency in the conduct of monetary policy; and a slew of reforms in the banking sector—including a single banking legislation and reduction in the share of Government/RBI in the capital of public sector banks; keeping the current account deficit to GDP ratio under 3 per cent; and evolving appropriate indicators of adequacy of reserves to cover not only import requirements, but also liquidity risks associated with present types of capital flows, short-term debt obligations and broader measures including solvency.

One of the important recommendations is the opening up of external commercial borrowing (ECB) limits for corporates. To take advantage of the larger pool of resources available globally. Individual residents will have the freedom to move abroad, upto \$100,000 in the final phase, and non-residents of all types (not only NRIs,) are permitted to invest in the Indian capital market. A similar relaxation is proposed in respect of foreign entities in the Indian debt market, subject to certain safeguards.

The report of the Tarapore Committee II has invited mixed reactions. As could naturally be expected, leftist political parties and economists have been very critical of the recommendations. Several impartial economists have also expressed apprehensions about the effects of FCAC, while a number of people argue that the roadmap laid down by the Committee is subject to too many implicit hurdles. One of the views is that FCAC would lead to a substantial capital inflow, causing an appreciation of the rupee, which will adversely affect exports, and encourage imports. Several critics repeat the problems of CAC listed above.

Although, better foreign exchange reserves and acceleration of economic growth present a more favourable situation (than in the past) to move towards FCAC, the economic situation is still potentially vulnerable: capital inflow trends can reverse any time, the export sector is not appreciably strong, and the foreign competition that the domestic firms face is very serious, so that emergence of a situation that weakens their base can be very dangerous.

CURRENCY EXCHANGE RISKS AND THEIR MANAGEMENT

One of the important problems a firm with international business may encounter is the currency exchange rate risk. *Exchange risk is the probability that a company will be unable to adjust prices and costs to offset changes in the exchange rate.*

Effects of Exchange Rate Fluctuations

Fluctuations in exchange rates may cause a loss or profit to a firm. Suppose an Indian exporter who has invoiced the exports in dollar gets paid three months after the date. If the dollar appreciates during this period, the rupee equivalent of his receipts increases, i.e. his profit goes up. For illustration, assume that the exchange rate between the dollar changes from \$1 = Rs. 48 to Rs. 50. If the export value was \$1 million, now the exporter can get Rs. 50 million instead of Rs. 48 million. A depreciation of the dollar will have the opposite effect. Appreciation of the foreign currency will adversely affect the importer. For example, an importer who had contracted for \$1 million worth of imports will have to pay Rs. 2 million more, if the exchange rate has moved as indicated above.

Consider the real cases of the dollar depreciation and appreciation of euro and pound against rupee in 2002. While the rupee appreciated by 0.3 per cent against the greenback (dollar) since April till August 2002, it weakened by 9.7 per cent against the pound sterling, 12.7 per cent against the euro, and 11.1 per cent against the Japanese yen. This meant that an Indian exporter who invoiced in pound sterling stood to gain Rs. 6.80 more per pound than he would have at the start of the fiscal. On euro invoicing, he gained Rs. 5.40 more per euro.

Though exports to the US account for less than 20 per cent of the total, nearly 70 per cent of all invoicing was in dollars. Though the EU, UK and Japan together accounted for over 30 per cent of exports, invoicing in their currencies was much lower.

When the euro was born in 1999, Indian exporters were initially reluctant to invoice their exports on this currency after watching it consistently weaken against the dollar. Those that did switch to euro invoicing did so more due to the pressure exerted on them by their buyers in the European Union. Many exporters who moved to euro invoicing suffered initially on account of the euro's weakness against the dollar. Though they wanted to switch to dollar invoicing, their buyers were reluctant to do so. They (the exporters who invoiced in euro) benefited out of the euro appreciation.

Types of Foreign Exchange Risks

There are two sorts of foreign exchange risks or exposures. (The term *exposure* refers to the degree to which a firm is affected by exchange rate changes)

- Economic exposure
- Accounting exposure (Translation exposure)

Economic Exposure The economic exposure focuses on the impact of an exchange rate change on future cash flows; that is, *economic exposure* is based on the extent to which the value of the firm—as measured by the present value of its expected future cash flows—will change when exchange rates change. Specifically, if PV is the present value of a firm, then that firm is exposed to currency risk if $\Delta PV / \Delta e$ is not equal to zero, where ΔPV is the change in the firm's present value associated with an exchange rate change, Δe . *Exchange risk*, in turn, is defined as the variability in the firm's value that is caused by uncertain exchange rate changes. Thus, exchange risk is viewed as the possibility that currency fluctuations can alter the expected amounts or variability of the firm's future cash flows.⁴²

Economic exposure refers to the risks arising from economic factors through economic transactions and other economic activities.

Types of Economic Exposure The economic exposure may be divided into its two component parts: transaction exposure and real operating exposure.

Transaction Exposure Transaction exposure arises out of the various types of transactions (such as international trade, borrowing and lending in foreign currencies, and the local purchasing and sales activities of foreign subsidiaries) that require settlement in a foreign currency.

Operating Exposure Operating exposure arises because currency fluctuations can alter a company's future revenues and costs—that is, its operating cash flows. Consequently, measuring a firm's operating exposure requires a longer-term perspective, viewing the firm as an ongoing concern with operations whose cost and price competitiveness could be affected by exchange rate changes.⁴³

Thus, the firm faces operating exposure the moment it invests in servicing a *market* subject to foreign competition or in sourcing goods or inputs abroad. This investment includes new-product development, a distribution network, foreign supply contracts, or production facilities. Transaction exposure arises later on, and only if the company's commitments lead it to engage in foreign-currency-denominated sales or purchases.⁴⁴

To illustrate, assume that a multinational has concentrated its production in one country and sells the output across the world. If the currency of this particular country appreciates considerably, the products from this country will be costly in terms of the currencies which have depreciated vis-vis that country's currency, making its goods costly in foreign markets. The international operations management, explained in chapter 9, will have to consider this aspect also. It may be noted that many multinationals, like several Japanese ones, have shifted production bases to overseas locations to guard against the adverse impact of the currency appreciation.

Accounting Exposure (Translation Exposure) Accounting exposure arises from the need, for purposes of reporting and consolidation, to convert the financial statements of foreign operations from the local currencies (LC) involved to the home currency (HC).⁴⁵

Companies with international operations will have foreign-currency-denominated assets and liabilities, revenues, and expenses. However, because home-country investors and the entire financial community are interested in home-currency values, the foreign currency balance-sheet accounts and income statement must be assigned HC values. In particular, the financial statements of an MNC's overseas subsidiaries must be translated from local currency to home currency prior to consolidation with the parent's financial statements.

If currency values change, foreign exchange translation gains or losses may result. Assets and liabilities that are translated at the current (postchange) exchange rate are considered to *be* exposed; those translated at a historical (prechange) exchange rate will maintain their historic HC values and, hence, are regarded as not exposed. *Translation exposure* is simply the difference between exposed assets and exposed liabilities. The controversies among accountants center on which assets and liabilities are exposed and on when accounting-derived foreign exchange gains and losses should be recognised (reported on the income statement).

If exchange rates have changed since the previous reporting period, this *translation*, or restatement, of those assets, liabilities, revenues, expenses, gains, and losses that are denominated in foreign currencies will result in foreign exchange gains or losses. The possible extent of these gains or losses is measured by the translation exposure figures. The rules that govern translation are devised by an accounting association such as the *Financial Accounting Standards Board* (FASB) in the United States, the parent firm's government, or the firm itself.

Methods of Foreign Currency Translation There are four methods of foreign currency translation.

Current/Noncurrent Method According to the current/noncurrent method, assets and liabilities are translated based on their maturity. Current assets and liabilities are converted at the current exchange rate and noncurrent assets and liabilities translated at the historical exchange rate, i.e. rate in effect at the time the asset or liability was first recorded on the books. Under this method, a foreign subsidiary with current assets in excess of current liabilities will cause a translation gain (loss) if the local currency appreciates (depreciates). The opposite will happen if there is negative net working capital in local terms in the foreign subsidiary.

Monetary/Nonmonetary Method Under the monetary/nonmonetary method, all monetary balance sheet items (such as cash, marketable securities, accounts payable and receivable, and long term debt) of a foreign subsidiary are translated at the current exchange rate and all the nonmonetary balance sheet items (such as inventory, fixed assets and long term investments) are translated at the historical exchange rate.

Temporal Method Under the temporal method, which is a modified version of the monetary/nonmonetary method, monetary items are translated at the current exchange rate. Other balance sheet items are translated at the current rate, if they are carried on the books at current value; if they are carried at historical costs, they are translated at the rate of exchange on the date the item was placed on the books.

Current Rate Method Under the current rate method, which is the simplest of all translation methods, all balance sheet accounts are translated at the current exchange rate, except for stockholders' equity. This is the simplest methods to apply. The common stock account and any additional paid-in capital.

Strategies for Managing Exchange Rate Risks

A firm needs to develop strategies for managing currency exchange rate risk because it often is impossible to pass along exchange rate increases in the form of higher prices.

What are the measures an importer can take to overcome the effects of an appreciation of the foreign currency in which the imports are invoiced or an international firm having foreign exchange exposure? The following are the important alternatives available.

1. Negotiate a lower price with the foreign supplier. The extent to which this can be done will depend up on the relative bargaining positions of the buyer and seller and the and profit margin which the seller enjoys.
2. Absorb the price increase by the buyer to the extent possible and pass on the rest to the consumers. The extent to which this can be done will depend up on the profit margin the buyer enjoys and the competitive and demand conditions prevailing in his market.
3. A third, and complementary, approach is to take steps to minimize exchange risk. The four most common ways of doing this are exchange risk avoidance, changing sourcing, exchange risk adaptation, and currency diversification. Of these four approaches, exchange risk adaptation is most commonly used.

Exchange Risk Avoidance Exchange risk avoidance is the elimination of exchange risk by doing business locally. The adverse effects of a devaluation of the domestic currency can be mitigated by procuring the item domestically if devaluation has made domestic good cheaper than the foreign.

Alternatively, the firm may explore the feasibility to domestically manufacturing the item. Devaluation often encourages import substitution/indigenisation. As a matter of fact, many foreign firms in India have gone in for progressive indigenisation, either by local sourcing or manufacturing of parts and components, to avoid the additional costs resulting from exchange rate fluctuations. This is true of many Indian firms too.

Change/Diversify Sourcing Another strategy is to change the source of purchasing. For example, if the US goods become costlier because of dollar appreciation, change the source of purchase from the US to countries where the product is cheaper, either because of depreciation of their currencies or other reasons. A number of companies have diversified the countries of sourcing to spread and minimize the risks of exchange rate fluctuations.

Currency Diversification Currency Diversification is the spreading of financial assets across several or more currencies so that exchange rate movements of different currencies may be evened out. This may be applicable to large MNEs that have an ongoing need for these currencies; however, it is not very feasible in respect of small firms whose international operations are not widely spread.

A global financing policy provides a natural hedge. Funding foreign operations in local currency offsets the effects of currency movements, thereby effectively protecting the value of the global company.

Exchange Risk Adaptation Exchange risk adaptation is the use of hedging to provide protection against exchange rate fluctuations.

Hedging *Hedging*, as pointed out earlier in this chapter, refers to covering of export risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates. In other words, *hedging* a particular currency exposure means establishing an offsetting currency position such that whatever is lost or gained on the original currency exposure is exactly offset by a corresponding foreign exchange gain or loss on the currency hedge. Regardless of what happens to the future exchange rate, therefore, hedging locks in a home currency value for the currency exposure. In this way, hedging can protect a firm from unforeseen currency movements.⁴⁶

One of the most common methods of hedging is the purchase of a forward contract, described earlier in the chapter.

Hedging foreign exchange risk entails taking all the necessary actions that will ensure that risk of loss from currency fluctuations is minimized.

Giddy identifies three situations when hedging may be used:⁴⁷

1. Hedging transaction exposure: this entails buying or selling foreign exchange for future delivery to match a known foreign currency payment or receipt. This is usually known as monetary or contractual hedging.
2. Hedging balance-sheet exposure: this means using short-term forward contracts to offset 'paper' gains and losses on the long-term assets and liabilities of foreign subsidiaries.
3. Hedging economic exposure: this entails estimating neither immediate transactions nor the accounting exposure but rather the effect of an exchange rate change on the firm's overall profitability.

Another method of exchange risk adaptation is to negotiate a fixed price in domestic currency terms for a period of time, say one year.

Forward Contracts, Futures and Currency Options have been outlined elsewhere in this chapter.

Money Market Hedge Money Market Hedge is a technique by which transaction exposure may be hedged by borrowing and lending in the domestic and foreign money markets. A firm may borrow (lend) in foreign currency to hedge its foreign currency receivables. For example, an American firm which has receivables in pounds may borrow the required amount in pound for a period which equals the maturity of the receivables, convert them in to dollars and invest them. The pound loan can be paid off when the pound receivables are realised.

Hedging by Lead and Lag Leading and lagging the foreign currency receipts and payments is another technique for reducing the transaction exposure. To lead means to pay or collect early and to lag means the opposite. A firm may lead soft currency (i.e. relatively weak currency, prone to depreciation) payments and lag hard currency (strong currency which is likely to appreciate) receivables to avoid the loss from depreciation of the soft currency and to gain from the appreciation of the hard currency. For the same reason, the firm will be prompted to lead hard currency payments and lag soft currency receivables. A problem, however, is that the counterpart would try to do the opposite.

Exposure Netting When a firm has a portfolio of currency positions, i.e. both receivables and payments in different currencies, it is unnecessary to hedge every position if the adverse effects of exchange rate movements in some cases are likely to be offset by the favourable movements in other cases.

Exposure netting involves offsetting exposures in one currency with exposures in the same or another currency, where exchange rates are expected to move in such a way that losses (gains) on the first exposed position should be offset by gains (losses) on the second currency exposure. This portfolio approach to hedging recognizes that the total variability or risk of a currency exposure portfolio should be less than the sum of the individual variabilities of each currency exposure considered in isolation. The assumption underlying exposure netting is that the net gain or loss on the entire currency exposure portfolio is what matters, rather than the gain or loss on any individual monetary unit.⁴⁸

In practice, exposure netting involves one of three possibilities:⁴⁹

1. A firm can offset a long position in a currency with a short position in that same currency.
2. If the exchange rate movements of two currencies are positively correlated (for example, the Swiss franc and Deutsche mark), then the firm can offset a long position in one currency with a short position in the other.
3. If the currency movements are negatively correlated, then short (or long) positions can be used to offset each other.

FOREIGN EXCHANGE MANAGEMENT ACT

The Foreign Exchange Management Act (FEMA), 1999, which came in to effect from January 1, 2000 (replacing the Foreign Exchange Regulations Act (FERA), 1973), extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India.

Objectives

The objectives of FEMA are to facilitate external trade and payments; and to promote the orderly development and maintenance of foreign exchange market.

The Reserve Bank of India is assigned an important role in the administration of this Act.

Salient Features

1. The FEMA empowers the Central Government to impose restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India.
2. The Act imposes restrictions on persons residing in India on acquiring, holding or owning foreign exchange, foreign security and immovable property abroad and on transfer of foreign exchange or security abroad.
3. The FEMA lays down that all dealings in foreign exchange or foreign security and all payments from outside the country to India shall be made only through authorised persons, except with the general or special permission of the Reserve Bank. The Act also prohibits any payment outside India except with the general or special permission of the Reserve Bank.
4. The FEMA permits dealings in foreign exchange through authorised persons for current account transactions. However, the Central Government can impose reasonable restrictions in public interest.
5. Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction permitted by the Reserve Bank. However, the Act empowers the RBI to impose a number of restrictions on capital account transactions.
6. The FEMA permits a person residing in India to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. Also, a person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.
7. The Reserve Bank is empowered by this Act to prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person residing outside India, for carrying on any activity relating to such branch, office or other place of business. However, the RBI shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.
8. The Act requires the exporters to furnish to the Reserve Bank or to such other authority certain details regarding the exports.
9. For the purpose of ensuring that export value of the goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit.
10. Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realize and repatriate it to India within the time and in the manner prescribed by the RBI. Several exemptions are, however, granted to this clause.

Any kind of contravention under this Act is liable to a penalty up to thrice the amount involved where it is quantifiable or up to Rs. 2 lakhs where it is not quantifiable and where such contraventions are of continuing nature, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. This provision is in total contrast to the respective provision in the erstwhile FERA which provided for imprisonment and no limit on fine. Under FEMA, a person will be liable to civil imprisonment only if he does not pay the fine within 90 days from the date of notice and that too after formalities of show cause notice and personal hearing. If he does not respond to the notice, there can be a warrant of arrest.

An important difference between FERA and FEMA is that while in FEMA, only the specified acts relating to foreign exchange are regulated, in FERA, anything and everything that has to do with foreign exchange was controlled. Also, the aim of FEMA is facilitating trade as against that of FERA, which was to prevent misuse. In other words, the theme of FERA was: 'everything that is specified is under control'. While the theme of FEMA is: 'everything other than what is expressly covered is not controlled'. Thus, there is a lot of deregulation.

FERA to FEMA marks a shift from control to management.

SUMMARY

The **Foreign Exchange Market** is a market in which foreign exchange transactions take place. In other words, it is a market in which national currencies are bought and sold against one another.

A foreign exchange market performs three important functions: transfer of purchasing power from one country to another and from one currency to another; provision of credit; and provision of hedging facilities.

Spot and Forward Exchanges are part of a foreign exchange market. Spot exchange refers to the class of foreign exchange transaction which requires immediate delivery, or exchange of currencies on the spot. The rate of exchange effective for the spot transaction is known as the *spot rate*, and the market for such transactions is known as the *spot market*. The forward transaction is an agreement between two parties, requiring the delivery, at some specified future date, 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 transactions is known as the *forward market*.

With reference to its relationship with the spot rate, the forward rate may be at par, discount or premium.

While a **futures** contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor-made for the client by his international bank, a futures contract has standardised features—the contract size and maturity dates are standardised. Futures can be traded only on an organised exchange, and they are traded competitively. Margins are not required in respect of a forward contract, but margins are required of all participants in the futures market.

An **option** is a contract or financial instrument that gives the holder *the right, but not the obligation*, to sell or buy a given quantity of an asset at a specified price, at a specified future date. An option to buy the underlying asset is known as a *call option*, and an option to sell the underlying asset is known as a *put option*. Buying or selling the underlying asset via the option is known as exercising the option. With reference to their exercise characteristics, there are two types of options, American and European. An European option can be exercised only at maturity or expiration date of the contract, whereas an American option can be exercised at any time during the contract.

Commercial banks, who conduct forward exchange business, may resort to a **swap** operation (simultaneous sale of spot currency for forward purchase of the same currency, or the purchase of spot for forward sale of the same currency) to adjust their funds position. The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanied by a purchase or sale, respectively, of the same currency for forward delivery, are technically known as swaps or double deals, as the spot currency is swapped against forward.

Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the differences between the exchange rate prevailing at the same time, in different markets.

There are some important theories which attempt to explain the mechanism of *exchange rate determination*, namely, the purchasing power parity theory and the balance of payments theory, also known as the demand

and supply theory and the general equilibrium theory. According to the purchasing power parity theory, when the exchange rates are free to fluctuate, the rate of exchange between two currencies, in the long-run, will be determined by their respective purchasing powers. According to the balance of payments theory, the foreign exchange rate, under free market conditions, is determined by the conditions of demand and supply in the foreign exchange market. The value of a currency appreciates when the demand for it increases and depreciates when the demand falls in relation to its supply in the foreign exchange market. The extent of the demand for and supply of a country's currency in the foreign exchange market depends on its balance of payments position. When the balance of payments is in equilibrium, the supply of and demand 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.

The failure of the traditional theories to explain real world exchange rate behaviour gave rise to a set of monetary models which took into account the possibility of capital/bond market arbitrage, apart from goods market arbitrage assumed in the PPP theory. According to the monetary models, the exchange rate is determined by the money supply in relation to money demand in both the home and foreign country. The most important monetary models of exchange rate determination are flexible price, sticky price, and real interest differential models. A common starting point for all the three monetary models was the assumption of uncovered interest parity (UIP) condition.

Exchange Rate and Convertibility of the Rupee: Since 1947, the exchange rate policy, in respect of the Indian rupee, passed through the following distinctive phases.

- **1947-1971:** The par value system or pegged exchange rate system of the IMF, under which the exchange rate of the rupee (as those of other currencies) remained fixed. The exchange rate of the rupee, however, changed twice (in September, 1949 and June, 1966) by devaluation with the consent of the IMF.
- **1971 to 1975:** The exchange rate of the rupee was pegged to dollar via pound sterling.
- **1975 to 1992:** The exchange rate of the rupee was pegged to a basket of currencies.
- **1992 to 1993:** Dual exchange rate system (transitional period).
- **1993 onwards:** Flexible/floating/ market determined exchange rate system.

According to the Report of the Committee on *Capital Account Convertibility* (CAC) appointed by the RBI under the chairmanship of S.S. Tarapore, submitted on May 30, 1997, CAC refers to the freedom to convert local financial assets into foreign financial assets, and vice versa, at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities, and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, co-existent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature.

Based on an assessment of the macroeconomic conditions, the Tarapore Committee was of the considered view that the time was apposite to initiate a move towards CAC. The Committee, however, pointed out that the initial conditions contained certain weaknesses, and the entrenchment of preconditions could be achieved in the Indian context, only over a period of time.

Although the Committee had laid down a three-year road map, ending in 1999-2000, for accomplishing the CAC, no significant progress has been made towards capital account convertibility, mainly because of the failure of the government to satisfy the preconditions. Further, the South-East Asian economic crisis has made many sceptic about capital account convertibility. The Tarapore Committee II has drawn up a detailed and broad five-year time frame for movement towards fuller convertibility in the following phases: Phase I (2006-07); Phase II (2007-08 to 2008-09); and Phase III (2009-10 to 2010-11). It has recommended the meeting of certain indicators/targets as a concomitant to the movement towards fuller capital account convertibility (FCAC).

The growth of *International Banking* has significantly contributed to the massive cross border movement of funds. International banks are banks which accept foreign currency deposits and finance international business, and provide associated and ancillary services, like hedging, and advisory services, and operate internationally.

A number of factors, like low marginal costs, knowledge advantage, ability to obtain more complete information on trade and financial markets, regulatory factors, and several other advantages, which large banks enjoy, have contributed to the growth of international banking.

A major contributor to the growth of international banking are the *offshore banking centres* which are either operational centres, with extensive banking activities involving short-term financial transactions, or booking centres, where little actual banking activity takes place, but where transactions are recorded to take advantage of secrecy and low (or no) tax rates.

One of the significant developments in the international economic sphere, after the World War II, is the growth of the **Eurocurrency market** (also known as Eurodollar market). Its phenomenal development, though, poses problems for the national monetary authorities, and international monetary stability has helped the growth of international trade, transnational corporations, and economies of certain countries.

In a narrow sense, Eurodollars are financial assets and liabilities, denominated in US dollars but traded in Europe. However, defined broadly, any currency internationally supplied and demanded, and in which a foreign bank is willing to accept liabilities and loan assets, may be regarded as Eurocurrency. In these markets, the commercial banks accept interest bearing deposits denominated in a currency other than the currency of the country in which they operate, and they re-lend these funds either in the same currency or in the currency of the country in which they operate, or in the currency of a third country.

The Eurocurrency market is an international market and is under no national control. It is predominantly a short-term money market. The Eurodollar market is a wholesale market in the sense that the Eurodollar is dealt only in large units. Another important feature is that it is a highly competitive and sensible market.

Participants in the Eurocurrency business include governments (including communist countries), international organisations, central banks, commercial banks, corporations, especially multinational corporations, traders, individuals, etc.

The supply of and demand for funds in the Eurocurrency market come from the above participants. Central banks of various countries are very important suppliers.

The advantages and dangers associated with the Eurocurrency market have given rise to the doubt that is it a welcome tonic or a slow poison to the international system.

The growth of the Euromarket has helped alleviate the international liquidity problem considerably, provided credit to finance the balance of payments deficits, enabled the exporters and importers to obtain credit, helped to meet the short-term credit requirements of the business corporations, and provided better opportunities for the investment of short-term funds. It has provided a market for profitable investment of funds by the central banks. However, the growth of this market has given rise to some serious problems, especially in the sphere of monetary stability.

One of the important problems, a firm with international business may encounter is the **currency exchange rate risk**. Exchange risk is the probability that a company will be unable to adjust prices and costs to offset changes in the exchange rate.

There are two types of foreign exchange risks or exposures: economic exposure and accounting exposure (translation exposure).

Economic exposure refers to the risks arising from economic factors through economic transactions and other economic activities. There are two types of economic exposure, namely, transaction exposure and real operating exposure. Transaction exposure arises out of the various types of transactions (such as international trade, borrowing and lending in foreign currencies, and the local purchasing and sales activities of foreign subsidiaries)

that require settlement in a foreign currency. Operating exposure arises because currency fluctuations can alter a company's future revenues and costs—that is, its operating cash flows.

Accounting exposure arises from the need, for purposes of reporting and consolidation, to convert the financial statements of foreign operations, from the local currencies involved, to the home currency.

A firm needs to develop strategies for managing currency exchange rate risk because it is often impossible to pass along exchange rate increases in the form of higher prices.

The measures an importer can take, to overcome the effects of appreciation of the foreign currency in which the imports are invoiced, include the following: (1) Negotiate a lower price with the foreign supplier; (2) Absorb the price increase by the buyer to the extent possible, and pass on the rest to the consumers; (3) Take steps to minimize exchange risk. The three most common ways of doing this are exchange risk avoidance, changing sourcing, exchange risk adaptation, and currency diversification. Of these four approaches, exchange risk adaptation is most commonly used.

Exchange risk avoidance is the elimination of exchange risk by doing business locally. For example, the adverse effects of devaluation of the domestic currency can be mitigated by procuring the item domestically, if devaluation has made domestic goods cheaper than the foreign goods. Another strategy is to change the source of purchasing. Currency diversification is the spreading of financial assets across several or more currencies, so that exchange rate movements of different currencies may be evened out. movements, thereby effectively protecting the value of the global company.

Exchange risk adaptation is the use of **hedging** to provide protection against exchange rate fluctuations. Hedging refers to covering of export risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates. In other words, *hedging* a particular currency exposure means establishing an offsetting currency position, such that whatever is lost or gained on the original currency exposure is exactly offset by a corresponding foreign exchange gain or loss on the currency hedge.

Giddy identifies three situations when hedging may be used: (1) Hedging transaction exposure: this entails buying or selling foreign exchange for future delivery to match a known foreign currency payment or receipt. This is usually known as monetary or contractual hedging; (2) Hedging balance-sheet exposure: this means using short-term forward contracts to offset 'paper' gains and losses on the long-term assets and liabilities of foreign subsidiaries; (3) Hedging economic exposure: this entails estimating neither immediate transactions nor the accounting exposure, but rather the effect of an exchange rate change on the firm's overall profitability.

Hedging instruments include Forward Contracts, Futures and Currency Options, Money Market Hedge, Hedging by Lead and Lag etc. When a firm has a portfolio of currency positions, i.e., both receivables and payments in different currencies, it is unnecessary to hedge every position if the adverse effects of exchange rate movements in some cases are likely to be offset by the favourable movements in other cases.

Recent decades have witnessed significant *international integration of stock markets*, and growth of cross-border equity investments. The massive cross-border portfolio investment flows very significantly impact the foreign exchange markets.

The important factors which have contributed to the cross-border portfolio investments include growing realisation by the investors of the importance of diversification of investments; liberalisation of international portfolio investments, particularly by emerging markets; attractive returns on investments in the emerging markets; the realisation by companies of the benefits of global sourcing of finance; and the developments in communication technology that enhanced the ease and efficiency of conducting transactions.

The objectives of the **Foreign Exchange Management Act (FEMA)**, 1999, which came in to effect from January 1, 2000, replacing the Foreign Exchange Regulations Act (FERA), 1973, are to facilitate external trade and payments; and to promote the orderly development and maintenance of foreign exchange market. The FEMA empowers the Central Government to impose restrictions on dealings in foreign exchange and

foreign security and payments to and receipts from any person outside India. Similarly, the Act imposes restrictions on persons resident in India on acquiring, holding or owning foreign exchange, foreign security, and immovable property abroad, and on transfer of foreign exchange or security abroad. The Reserve Bank of India is assigned an important role in the administration of this Act.

Review Questions

1. Explain how foreign exchange rates are determined.
2. Give a brief account of the currency exchange risks and their management.
3. Discuss the purchasing power parity theory.
4. What are the objectives and methods of exchange control?
5. Explain the exchange rate trends of the Rupee since 1993.
6. Discuss the impact of exchange rate fluctuations of the Rupee on the Indian economy.
7. Examine the recent trends in the exchange rate of the Rupee and their causes.
8. Explain the trends in the foreign exchange reserves of India.
9. Discuss the issue of full capital account convertibility of Rupee.
10. Write notes on the following:
 - (i) Foreign exchange
 - (ii) Foreign exchange market
 - (iii) Spot and forward exchange rates
 - (iv) Arbitrage
 - (v) Balance of Payments theory
 - (vi) Stable exchange rate system
 - (vii) Flexible exchange rate system
 - (viii) Exchange rate classifications
 - (ix) FEMA
 - (x) Foreign exchange exposures
 - (xi) Full capital account convertibility of Indian rupee.

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Appendix

Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)

The indices of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) are used as indicators of external competitiveness. NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies.

Conceptually, the REER, defined as a weighted average of nominal exchange rates adjusted for relative price differential between the domestic and foreign countries, relates to the purchasing power parity (PPP) hypothesis.

The Reserve Bank of India (RBI) had been constructing five-country and thirty six-country indices of NEER and REER as part of its communication policy, and to aid researchers and analysts. Three major developments necessitated a review of the existing indices. First, introduction of the Euro (notes and coins) with effect from January 1, 2002 necessitated the need to replace the existing national currencies of the Euro zone by the common currency for the members, which formed part of RBI's 5-country and 36-country REER/NEER indices. The European Commission (Eurostat) introduced a harmonised index of consumer prices (HICP) for the member countries, which entailed individual consumer price indices to be replaced by HICP in the construction of the REER. Second, there has been a significant shift in India's trade relations across countries/regions, mainly towards developing and emerging economies during the last decade, requiring a change in the currency basket and the weights assigned to India's trading partners included in the REER. Third, the base year of the Wholesale Price Index of India (WPI), was changed to 1993-94, necessitating a change in the base year for 36-country REER and NEER indices. Against the above backdrop, the Reserve Bank has now decided to replace its existing 5-country indices with new six-currency indices of NEER/REER. The thirty six country indices have also been revised and replaced with new 36-currency indices of NEER/REER.

The new six-currency indices represent the US, the Eurozone (comprising of 12 countries), UK, Japan, China and Hong Kong SAR. Two new currencies have been included in the new indices, both being Asian-the Chinese yuan and the Hong Kong Dollar.

The six countries/regions, represented by the six currencies, together accounted for around 40 per cent of India's total foreign trade in 2004-05.

The coverage has also been revised for the **36-country** REER/NEER indices. The old indices comprised of 36 countries, including five members of the Euro Area. With an objective to broad base the REER/NEER, and also to highlight India's changing trade pattern, countries have been chosen in the new series based on three broad criteria: (i) the share in India's exports and trade, (ii) regional representation, and (iii) the regular availability of data on exchange rates and prices on a monthly basis. The new countries included in the revised series are Hong Kong SAR, Denmark, Iran, Kuwait, Qatar, Russia, South Africa, Sweden, and the United Arab Emirates. Besides, with the inclusion of the Euro zone, the new 36-currency indices include all the twelve countries that have Euro as common currency. Thus, the revised 36-currency REER indices effectively represent 47 countries. The revised thirty-six countries/regions, represented by the thirty-six currencies, together accounted for, on an average, 77 per cent and 89 per cent of India's total foreign trade and exports respectively, during 2002-03 to 2004-05. The new six-currency indices use a 3-year moving average trade weights in place of the present fixed trade weights,

with a view to suitably reflect the dynamically changing pattern of India's foreign trade with its major trading partners. In order to calculate the weights, the geometric average of India's bilateral trade (exports plus imports) with countries/regions represented by the six-currencies during the preceding three years has been taken. This has then been normalised to arrive at the requisite weights.

As in the case of revised indices of the six-currency REER/NEER, the thirty six-currency indices also use 3-year moving average normalised weights (both exports and trade weights) in the construction of the new series, keeping in view the rapid change in the destinations of India's foreign trade in contrast to the fixed weights used hitherto for constructing REER/NEER series.

(Adopted from 'Revision of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) Indices', *Reserve Bank of India Bulletin*, December, 2005).

CHAPTER 19

19

International Liquidity and Reserves

LEARNING OBJECTIVES

- ☐ To understand the meaning of international liquidity.
- ☐ To review the trends in the composition of international reserves.
- ☐ To examine the issue of adequacy of reserves.
- ☐ To get a picture of different aspects of forex reserves of India.

International liquidity refers to the generally accepted means of international payments available for settlement of international transactions.

Thus, *international liquidity encompasses international reserves and the facilities for international borrowing for financing the balance of payments deficit*. International reserves are defined to include official holdings of gold, foreign exchange, SDRs, and reserve position in the IMF. It may be noted that international liquidity does not include private holdings of gold, private holdings of foreign exchange and long-term international financing.

COMPOSITION OF INTERNATIONAL RESERVES

International reserves consist of those external assets that are readily available to, and controlled by, monetary authorities for direct financing of international payments imbalances, for indirect regulation of the magnitude of such imbalances through intervention in foreign exchange markets to affect their currency's exchange rate, and for other purposes. The category of international reserves defined in the IMF *Balance of Payments Manual* comprises monetary gold, special drawing rights (SDRs), reserve position in the IMF, foreign exchange assets (consisting of currency and deposits and securities), and other claims.

The total official holding of reserve assets (excluding gold) increased from 117.7 billion SDRs in 1973 to 1.73 trillion SDRs at the end of 2001, and to SDR 3.8 trillion at the beginning of 2007.

The share of gold in international reserves declined and of foreign exchange went up steeply.

In 1980, gold accounted for about 58 per cent total reserves; but in 2007, it was less than 10 per cent. In 2007, foreign exchange accounted for about 90 per cent of the total reserves, including gold, and 99 per

cent of the non-gold reserves, the remaining being Fund related assets, i.e. reserve position in the IMF and SDRs.

In 2007, developing countries accounted for more than two-thirds of the foreign exchange reserves. It may be noted that India, which at the end of 2001 had the tenth largest foreign exchange stock, has become the fourth largest holder of forex reserves. A point needs to be clarified here. Some of the countries with lower forex reserves, like UAE, S. Korea, Singapore, and Norway have larger foreign asset holdings than India. This is because these countries have created a sovereign wealth fund (SWF) to enhance its (forex) investments, and part of the forex reserves has been transferred to the SWF. SWF assets do not typically get counted in reserves.

Developing countries have increased their share in the foreign exchange reserves of the world, and today, they account for more than two-thirds of the forex reserves.

In 2007, industrial countries held more than 70 per cent of the IMF related assets, and more than 80 per cent of the gold reserves.

Currency Diversification of Forex Reserves

There has been a tendency towards diversification of reserve currency holdings after the breakdown of the *Bretton Woods* par value system, with occasional reversals. A principal reason for diversifying the reserve portfolio is to reduce the perceived risk of capital losses that might arise as a result of significant exchange rate movements. However, the use of US dollar as an intervention currency, the depth and range of US dollar dominated financial markets, and the high returns on dollar assets has reduced incentives for diversification of official reserve holdings.

Table 19.1 shows the trends in the shares of different currencies in the forex reserves.

The share of reserves held as dollar denominated assets increased substantially from about 55 per cent in 1992, and peaked at 71 per cent during 1999–2001. It declined to 67 per cent in 2002, driven by both the fall in the value of U.S. dollar holdings and the reduced share of U.S. dollar assets in net purchases of reserves. In 2006, the share of dollar holdings dropped below 65 per cent, as the euro and the pound gained share owing to appreciating exchange rates vis-à-vis the dollar, as well as net reserve purchases denominated in those two currencies.

The share of the euro, which replaced 11 European currencies and the European currency unit (ECU) on January 1, 1999, increased sharply between 1999 and 2003. It increased again in 2006, to nearly 26 per cent of total foreign exchange reserves at year-end. However, the share of the euro in total foreign exchange reserves in 1999–2006 is not directly comparable with the combined share in previous years of the Deutsche mark, French franc, Netherlands guilder, and private ECU, since the reserves formerly denominated in euro-legacy currencies became domestic assets of the euro area when the euro was introduced.

In recent years, the share of dollar in the forex reserves declined while those of euro and pound increased because of the depreciation of dollar against these two currencies, and net reserve purchases denominated in euro and pound.

The share of Japanese yen in total foreign exchange reserves declined from 6 per cent in the late 1990s to 3 per cent at the end of 2006.

The share of pound sterling rose above 4 per cent at end-2006, while that of the Swiss franc remained well below 1 per cent.

Table 19.1 Share of Currencies in Total Identified Official Holdings of Foreign Exchange, at end of the year¹

(In per cent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
All countries										
U.S. dollar	65.2	69.4	71.0	71.1	71.5	67.0	65.9	65.8	66.7	64.7
Japanese yen	5.8	6.2	6.4	6.1	5.1	4.4	3.9	3.9	3.6	3.2
Pound sterling	2.6	2.7	2.9	2.8	2.7	2.8	2.8	3.4	3.6	4.4
Swiss franc	0.3	0.3	0.2	0.3	0.3	0.4	0.2	0.2	0.1	0.2
Euro ²	—	—	17.9	18.3	19.2	23.8	25.2	24.9	24.2	25.8
Deutsche mark	14.5	13.8	—	—	—	—	—	—	—	—
French franc	1.4	1.6	—	—	—	—	—	—	—	—
Netherlands guilder	0.4	0.3	—	—	—	—	—	—	—	—
ECUs ³	6.0	1.2	—	—	—	—	—	—	—	—
Other currencies ⁴	3.8	4.5	1.6	1.5	1.3	1.6	2.0	1.9	1.7	1.7
Industrial countries										
U.S. dollar	59.1	67.6	73.5	72.7	72.7	68.9	70.5	71.5	73.6	71.9
Japanese yen	5.9	6.9	6.7	6.3	5.5	4.3	3.8	3.6	3.4	3.5
Pound sterling	2.0	2.1	2.2	2.0	1.9	2.1	1.5	1.9	2.1	2.5
Swiss franc	0.1	0.2	0.1	0.2	0.3	0.6	0.2	0.1	0.1	0.2
Euro ²	—	—	16.1	17.0	17.9	22.3	21.9	20.8	19.0	20.4
Deutsche mark	16.2	13.4	—	—	—	—	—	—	—	—
French franc	0.9	1.2	—	—	—	—	—	—	—	—
Netherlands guilder	0.2	0.2	—	—	—	—	—	—	—	—
ECUs ³	11.2	2.3	—	—	—	—	—	—	—	—
Other currencies ⁴	4.4	6.2	1.5	1.7	1.6	1.8	2.0	2.1	1.6	1.4
Developing countries										
U.S. dollar	72.4	71.2	68.3	69.4	70.2	65.2	61.3	60.2	61.0	59.7
Japanese yen	5.7	5.6	6.1	5.8	4.6	4.4	4.0	4.1	3.7	2.9
Pound sterling	3.3	3.3	3.7	3.5	3.5	3.5	4.0	4.9	4.9	5.8
Swiss franc	0.6	0.5	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.1
Euro	—	—	19.9	19.7	20.5	25.3	28.5	29.0	28.5	29.6
Deutsche mark	12.5	14.3	—	—	—	—	—	—	—	—
French franc	2.1	2.1	—	—	—	—	—	—	—	—
Netherlands guilder	0.5	0.4	—	—	—	—	—	—	—	—
ECUs ³	0.0	0.0	—	—	—	—	—	—	—	—
Other currencies ⁴	3.0	2.7	1.7	1.3	1.0	1.3	2.0	1.6	1.7	1.9

(Contd.)

(In per cent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Memorandum items:										
Unallocated reserves ⁵										
All countries	21.3	22.1	22.6	21.7	23.6	25.5	26.6	29.5	32.4	33.9
Industrial countries	2.1	1.1	0.7	0.4	0.1	0.3	0.2	0.2	0.3	0.3
Developing countries	36.2	36.5	37.6	36.1	38.1	40.6	41.9	45.3	46.7	46.6

Note: Components may not sum to total because of rounding. Country coverage changes slightly every year.

1. Currency shares are calculated for the reserves of member countries that report the currency composition of their foreign exchange reserves. The data includes minimal estimation undertaken mainly for late reporters. Reserves for the currency composition not reported are shown under 'Unallocated reserves'.
2. Not comparable with the combined share of euro-legacy currencies in previous years because it excludes the euros received by euro area members when their previous holdings of other euro area members' legacy currencies were converted into euros on January 1, 1999.
3. In the calculation of currency shares, the ECU is treated as a separate currency. ECU reserves held by the monetary authorities existed in the form of claims on both the private sector and the European Monetary Institute (EMI), which issued official ECUs to European Union central banks through revolving swaps against the contribution of 20 per cent of their gross gold holdings and U.S. dollar reserves. On December 31, 1998, the official ECUs were unwound into gold and U.S. dollars; hence, the share of ECUs at the end of 1998 was sharply lower than a year earlier. The remaining ECU holdings reported for 1998 consisted of ECUs issued by the private sector, usually in the form of ECU deposits and bonds. On January 1, 1999, these holdings were automatically converted into euros.
4. Foreign exchange reserves of IMF member countries and the sum of reserves reported to be held in currencies other than those listed in the table.
5. Foreign exchange reserves whose currency composition is not submitted to the IMF, in per cent of total official holdings of foreign exchange reserves.

Source: IMF, *Annual Report 2007*.

The share of other currencies has been less than 2 per cent since 1999. No information is available on the currency composition of unallocated reserves, whose share of global reserves rose to 34 percent in 2006.

Industrial Countries The share of US dollar holdings by industrial countries moderated to 72 per cent at the end of 2006, from the high of the previous year that reflected the relative strength of the dollar at end-2005. In 2006, the share of the euro in industrial countries' foreign exchange reserves recovered, reaching 20 per cent, while the share of the yen remained below 4 per cent. The shares of pound sterling and Swiss franc have remained broadly stable.

Developing Countries The share of the US dollar in developing countries' foreign exchange reserves remained close to 60 per cent in 2006, lower than the average in preceding years. Euro holdings rose to nearly 30 per cent of those countries' foreign exchange reserves, 10 percentage points higher than the euro's share in 1999 and 2000. Over the past decade, the share of the yen gradually decreased by about 3 percentage points, to 3 per cent at the end of 2006, while the share of pound sterling increased by more than 2 percentage points, to 6 per cent in 2006. The share of the Swiss franc remained below 1 per cent over the same period.

Developing countries have diversified their forex reserves more than the industrial countries

ADEQUACY AND DETERMINANTS OF RESERVES¹

An adequate stock of reserves is one that is consistent with the smooth functioning of the international monetary system, an expansion of world trade and the absence of persistent inflation or deflation. An

The adequacy of reserves depends on several factors like factors determining demand for and supply of reserves, trends in BOP etc.

adequate level of resources may be larger or smaller than the desired holdings of reserves under a particular set of asset prices and economic conditions. For example, an effective demand for reserves that reflect a depressed level of international trade and high interest costs could be considerably smaller than the amount of reserves that would be held under more favourable

conditions.

An appraisal of adequacy of international reserves must take into account both the factors affecting the demand for reserves and those determining the supply. The expected size and volatility of payments imbalances are the principal determinants of the demand for international reserves. Of particular importance in this regard are a country's exchange rate arrangements and the pace of its adjustments to external imbalances. Moreover, the variability of private capital flows and debt service charges experienced in recent years adds to the importance of holding adequate international reserves for the purpose of accommodating temporary payments imbalances and avoiding disruptive adjustment of the domestic economy. The supply of reserves depends primarily on the financial policies of the reserve currency countries, the state of international capital markets, and, quantitatively to a much more modest extent on the policies determining the supply of fund related reserve assets.

Some key factors influencing the availability of international reserves and liquidity are the monetary policies of the reserve currency countries and the state of their respective balance of payments.

The demand for international reserves is also influenced by the access many countries have to international financial market. During the late 1970s and the 1980s, a number of countries often relied on borrowing in the international capital markets as an alternative to owning reserves. This suggests that it might be more appropriate to consider the adequacy, not of reserves alone, but of international liquidity—a broader concept that takes into account the borrowing capacity of countries.

In the 1970s, 1980s, and 1990s, international financial markets played an increasingly important role in the provision of international liquidity and the financing of the adjustment process.

Contextually, the subject of foreign exchange reserves may be broadly classified into two interlinked areas, viz., the theory of reserves and the management of reserves.

Theory of Reserves The theory of reserves encompasses issues relating to institutional and legal arrangements for holding reserve assets, conceptual and definitional aspects, objectives for holding reserve assets, exchange rate regimes and conceptualization of the appropriate level of foreign reserves. In essence, a theoretical framework for reserves provides the rationale for holding foreign exchange reserves.

Reserve Management Reserve management is mainly guided by the portfolio management consideration, i.e. how best to deploy foreign reserve assets subject to statutory stipulations? The portfolio considerations take into account *inter alia*, safety, liquidity and yield on reserves as the principal objectives of reserve management. The institutional and legal arrangements are largely country specific and these differences should be recognized in approaching the critical issues relating to both reserve management practices and policy-making.²

As in the case of money, there are three motives for holding forex reserves, viz., transaction, speculative and precautionary. International trade gives rise to currency flows, which are assumed to be handled by banks driven by the transaction motive. Similarly, speculative motive is left to individuals or corporates. Central bank reserves, however, are characterised primarily as a last resort stock of foreign currency for unpredictable flows, which is consistent with precautionary motive for holding foreign assets. Precautionary motive for holding foreign currency, like the demand for money, can be positively related to wealth and the cost of covering unplanned deficit, and negatively related to the return from alternative assets. Furthermore, foreign exchange reserves are instruments to maintain or manage the exchange rate, while enabling orderly absorption of international capital flows. Official reserves are mainly held for precautionary and transaction motives keeping in view the aggregate of national interests, to achieve balance between demand for and supply of foreign currencies, for intervention, and to preserve confidence in the country's ability to carry out external transactions.

The traditional determinants identified in the empirical literature on foreign exchange reserve holdings are presented in Table 19.2.

Table 19.2 Determinants of the Demand for Reserves

<i>Variables</i>	<i>Description</i>
Scalar variable	Imports, per capita income, GDP, population
Propensity to import	Marginal/average propensity to import
Variability measure	Exports, imports, terms of trade, receipts, payments, nominal effective exchange rate, balance of payments, reserves
Opportunity cost	Marginal product of capital (MPK) or in the absence of MPK, per capita output (as an inverse proxy for marginal product of capital), marginal utility of consumption, rate of interest on borrowing from abroad, net foreign indebtedness, the government bond yield, the spread between the government bond yield and short-term international interest rates, marginal productivity of social capital, one-year deposit rate.

Source: RBI, *Report on Currency and Finance, 2001–02*.

Lane and Burke (2001) adopted a broad approach to identify the potential determinants of reserves and found: (i) trade openness to be the most important variable along with financial deepening; (ii) smaller and more volatile industrial countries hold larger reserves than their larger, less volatile counterparts; and (iii) more indebted developing countries had smaller reserve ratios.³

According to the RBI, the objectives for maintaining reserves are: (i) maintaining confidence in monetary and exchange rate policies; (ii) enhancing capacity to intervene in foreign exchange markets; (iii) limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis including national disasters or emergencies; (iv) providing confidence to the markets, including credit rating agencies, that external obligations can always be met (thus reducing the overall costs at which foreign exchange resources are available to all the market participants), and (v) adding to the comfort of the market participants, by demonstrating the backing of domestic currency by external assets.

INDIA'S RESERVE MANAGEMENT

India's approach to reserve management, until the balance of payments crisis of 1991 was essentially based on the traditional approach, i.e. to maintain an appropriate level of import cover defined in terms of number of months of imports equivalent to reserves. However, the approach to reserve management, as part of exchange rate management, and indeed the overall external sector policy underwent a paradigm

There are a number of criteria for determining reserve adequacy.

shift with the adoption of the recommendations of the High Level Committee on Balance of Payments (C. Rangarajan Committee) in 1993. The Committee recommended that the foreign exchange reserve targets be fixed in such a way that they are generally in a position to accommodate imports of three months.

In the view of the Committee, the factors that are to be taken into consideration in determining the desirable level of reserves are: (i) the need to ensure a reasonable level of confidence in the international financial and trading communities about the capacity of the country to honour its obligations and maintain trade and financial flows; (ii) the need to take care of the seasonal factors in any balance of payments transaction with reference to the possible uncertainties in the monsoon conditions of India; (iii) the amount of foreign currency reserves required to counter speculative tendencies or anticipatory actions amongst players in the foreign exchange market; and (iv) the capacity to maintain the reserves so that the cost of carrying liquidity is minimal.

The Report of the Committee on Capital Account Convertibility (1997) suggested four alternative measures to assess reserve adequacy: (i) import cover of six months; (ii) import cover of three months plus 50 per cent of annual debt service payments plus one month's imports and exports to take into account the possibility of leads and lags; (iii) ratio of short-term debt and stock of portfolio investment related non-debt liabilities to reserves at or more than 60 per cent; and (iv) the net foreign exchange assets to currency ratio (NFA/currency ratio) at around 70 per cent with a minimum of 40 per cent for this ratio to be stipulated by the RBI Act.

Pablo Guidotti has suggested⁴ that emerging market economies must maintain usable forex reserves exceeding scheduled amortisation of foreign currency debts falling due (assuming no roll-overs) during the following year. The concept of 'usable reserves' merits particular attention in view of the developments experienced by some countries during the 1997 South-East Asian economic crisis. (An account of the South-East Asian economic crisis is available in the third edition of this book.)

With the introduction of market determined exchange rate, a change in the approach to reserve management was warranted and the emphasis on import cover had to be supplemented with the objective of smoothening out the volatility in the exchange rate, which has been reflective of the underlying market condition. Further, the prevalent national security environment further underscores the need for strong reserves. It is, therefore, necessary to ensure that, leaving aside short-term variations in reserves level, the quantum of reserves in the long run is in line with the growth of the economy, the size of risk-adjusted capital flows and national security requirements.

The overall approach to management of foreign exchange reserves reflected the changing composition of balance of payments and liquidity risks associated with different types of flows and other requirements. The policy for reserve management is built upon a host of identifiable factors and other contingencies, including, *inter alia*, the size of the current account deficit and short-term liabilities (including current repayment obligations on long-term loans), the possible variability in FDI and other types of capital flows, the unanticipated pressures on the balance of payments arising out of external shocks and movements in repatriable foreign currency NRI deposits.

As Jalan points out, in the light of volatility induced by capital flows and self-fulfilling expectations that this can generate, there is now a growing consensus among emerging market economies to maintain 'adequate' reserves.⁵ Therefore, while focusing on prudent management of foreign exchange reserves in recent years, the 'liquidity at risk' associated with different types of flows has come to the fore. With the changing profile of capital flows, the traditional approach to assessing reserve adequacy in terms of import cover has been broadened to include a number of parameters which take into account the size, composition, and risk profiles of various types of capital flows as well as the types of external shocks to which the economy is vulnerable. A sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the liquidity at risk on all accounts over a fairly long period. Taking these considerations into account, India's foreign exchange reserves had reached a very comfortable level by 2002.

As indicated earlier, India is amongst the top reserve holding nations. India's forex reserve holdings increased from \$4.7 billion in June 1991 to about \$135 billion in February 2005. As a RBI report observes, the movement in India's foreign exchange reserves since 1993–94 can be divided into three phases: (i) the period March 1993 to March 1995, when reserves increased sharply from US \$9.8 billion to US \$25.5 billion, (ii) the period March 1995 to March 1999, when reserves increased moderately to US \$32.5 billion and (iii) finally since 1999–2000, when there was a phenomenal increase in reserves.

In March 2007, India had the fourth largest foreign exchange reserves in the world.

Reserve adequacy indicators (such as reserves–imports ratio, reserves–short term external debt ratio and reserves–short term external debt ratio) also place India at a comfortable position *vis-a-vis* emerging market economies.

CAPITAL INFLOWS, FOREIGN EXCHANGE RESERVES AND GROWTH

The coexistence of slowdown in the growth rate of the Indian economy in the recent period and the sharp build-up of foreign exchange reserves, has fuelled the debate on their possible inter-relationship and has called into question, in some quarters, the extant policy of reserve accretion. A recent study by Lal, Bery and Pant, for example, has contended that India could have attained a higher growth trajectory had capital inflows been allowed to be absorbed by the economy (instead of accumulating them as foreign exchange reserves of the central bank) and had fiscal deficits not been incurred of which can increase absorption. An econometric exercise shows that the growth rate could have been higher by about 1 to 6 per cent in different years in the 1990s. The study makes the following policy recommendations: (i) the reserve management policy should be replaced by appropriate monetary and exchange rate policies that could boost growth; (ii) have a tighter fiscal policy (to contain the crowding out effect) and an easier monetary policy (by non-sterilisation of reserves—that could increase prices and lower interest rates); (iii) high reserves and low domestic inflation provide the right environment against which the Rupee can be made fully convertible on the capital account; and (iv) replace on the managed exchange rate regime by full float.⁶

The above results and policy prescriptions, however, need to be viewed with a great deal of circumspection. A RBI report⁷ makes the following observations. First, it needs to be recognised that high reserves reflect the lack of absorption/demand, and prescribing real appreciation as a means to raise domestic absorption completely disregards the importance of the trade-off between growth and stability and the role of a central bank in ensuring stability as a means to higher growth. Second, the experience

of the emerging market crises in the last decade shows the risks of low reserves. Third, it also needs to be recognised that even if REER appreciation is allowed to ensure full absorption of foreign capital, it is important to examine whether the full absorption (i.e. higher current account deficit) would result from an increase in imports or a major fall in exports. Fourth the contention that full absorption of capital flows would reduce the extent of crowding out by allowing a larger part of the fiscal deficit to be monetised, ignores the possibility of 'crowding in' effects by certain types of government expenditure which at times may dominate the crowding-out effect. Finally, it needs to be recognised that foreign capital should not be allowed either to give rise to excessive consumption or excessive investment just to ensure full absorption.

INDIA'S FOREX RESERVES

Since the economic liberalisation, ushered in 1991, there has been a remarkable turnaround in India's forex reserves position. The large capital account surpluses that resulted from the liberalisation of foreign investments, both FDI and portfolio investments, have contributed to the substantial growth of the foreign exchange reserves, making India's reserves the fourth largest in the world. The purchase of foreign exchange by the RBI for exchange rate stabilisation has also helped in the building-up of forex reserves.

Composition of Reserves

The foreign exchange reserves of India include:

The forex reserves is made up of, by and large, foreign currency assets—mostly US dollar.

1. Foreign Currency Assets (FCA), maintained by RBI as a multi-currency portfolio, comprising major currencies—such as, US dollar, Euro, Pound sterling, Japanese yen, etc.—and is valued in US dollars.
2. Special Drawing Rights (SDRs).
3. Gold holdings of the RBI. The physical stock has remained unchanged at approximately 357 tonnes; but its value has changed because of revaluations.
4. Reserve Tranche Position (RTP) in IMF. RTP has been included as part of the forex reserves since 2002-03.

The forex reserves of India is composed of, by and large, foreign currency assets. At the end of October, 2007, FCA accounted for nearly 97 per cent of the total reserves.

Adequacy of Reserves

An important concern and consideration in the foreign exchange reserves management is the adequacy of reserves to absorb external shocks.

The traditional approach of assessing reserve adequacy was in terms of import cover—An import cover of 3 to 4 months was regarded a minimum requirement. The changing profile of capital flows

Forex reserves to cover 3–4 months imports has been traditionally regarded as the minimum requirement.

have, however, given rise to new risks /challenges, like the possibility of sudden withdrawal of short-term funds, including FIIs. Therefore, the traditional approach of assessing reserve adequacy in terms of import cover has been broadened to include a number of parameters

which take into account the size, composition, and risk profiles of various types of capital flows, as well as the types of external shocks to which the economy is vulnerable.

The High Level Committee on Balance of Payments, chaired by Dr. C. Rangarajan, had suggested that, while determining the adequacy of reserves, due attention should be paid to payment obligations, in addition to the import cover requirement. In 1997, the Report of Committee on Capital Account Convertibility, under the chairmanship of Mr. S.S. Tarapore, suggested four alternative measures of adequacy of reserves which, in addition to trade-based indicators, also included money-based and debt-based indicators.⁸ In the more recent period, assessment of reserve adequacy has been influenced by the introduction of new measures that are particularly relevant for emerging market countries like India. One such measure requires that the usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts (assuming no rollovers) during the following year. The other is based on a 'Liquidity at Risk' rule that takes into account the foreseeable risks that a country could face. This approach requires that a country's foreign exchange liquidity position be calculated under a range of possible outcomes for relevant financial variables, such as, exchange rates, commodity prices, credit spreads, etc.⁹

The traditional trade-based indicator of reserve adequacy, viz, import cover of reserves, which fell to a low of 3 weeks of imports at end-December, 1990, rose to 11.5 months of imports at end-March, 2002, and it was little over 12 months at the end of March, 2007. The ratio of short-term debt to foreign exchange reserves declined tremendously, and it was 7 per cent as at end-March, 2006, compared to more than 146 per cent at end-March, 1991. Similarly, the ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to reserves declined from more than 146 per cent as at end-March, 1991, to about 43.2 per cent as at end-March, 2006.

Trends in Forex Reserves Position

The trends in India's forex reserves position, i.e. growth or decline, is led, by and large, by the movement of the foreign currency assets. As mentioned earlier, the quantity of gold has remained fixed; its increase in value is the result of increase in its price. IMF related assets fluctuate in response to India's borrowing and lending transactions with the IMF. In February, 2003, IMF designated India as a creditor under its Financial Transaction Plan (FTP), in terms of which India has participated in the IMF's financial support to several countries.

The forex reserves of India began to increase significantly around 1993-94, with the liberalisation of the capital account, which widened the door for FDI inflow, and permitted portfolio inflows (mostly by FIIs).

The foreign currency reserves of India declined more or less steadily, from the beginning of the 1950s till mid-1960s, mainly because of the trade deficit, which had shown an increasing trend. It is pertinent to note that the rupee was substantially devalued in 1966, in a bid to influence the trade trend. The forex reserves generally improved since then and continued the growth through out the 1970s. The situation, however, deteriorated in the 1980s, and in 1989-90, the reserves reached a dismal level of \$3.96 billion compared to \$7.36 billion in 1979-80. In other words, the forex reserves in 1989-90 was only a little over half of the 1979-80 figure, even without factoring in the inflation effect. By end of December, 1990, the forex reserves fell to a low of 3 weeks imports cover, as against the general view of the minimum import cover requirement of 3 to 4 months.

The surge in the foreign investment inflows, both FDI and FPI, led to substantial increase in the forex reserves recently.

The forex reserves have improved remarkably since the early 1990s. The reserves increased from \$5.83 billion in 1990-91 to over \$25 billion in 1994-95, and it crossed the \$100 billion mark in 2003-04. At the end of 2003-04, the import cover of reserves was 17 months.

Although the reserves continued to grow impressively, the import cover declined due to the fast growth of the import bill. In 2005-06, the forex reserves, at nearly \$152 billion, amounted to an import coverage of little more than 12 months. In 2006-07 too, the forex reserves (\$199 billion) was equivalent to an import cover of little more than 12 months. The reserves crossed \$200 billion in April, 2007, and reached about \$265 billion at the end of October, 2007.

The change (increase/decrease) in the forex reserves is accompanied by changes in the composition of resources, as the changes in the FCA cause changes in the reserves position; the other components of the reserves normally do not change significantly. In other words, the increase in forex reserves of India has been accompanied by an increase in the share of FCA in total reserves. Thus, the share of FCA in the forex reserves increased from about 38 per cent in 1990-91, to about 94 per cent in 2000-01, and further to nearly 97 per cent at the end of October, 2007.

Accretion to Forex Reserves

As has already been pointed out, the forex reserves of India has been built-up almost entirely by FCA.

The forex reserves of India has been boosted by capital account surplus; current account deficit has been pulling down the reserves.

The foreign currency assets are impacted by the current account balance and capital account balance. In the last three decades, except for three years in the early part of the present decade, India had a current account deficit. In other words, the current account has had a negative effect on the forex reserves of India. For example, during

the period 1991-92 to 2007-08, the current account deficit amounted to nearly \$46 billion, compared to a capital account surplus of \$264 billion. While in other countries, with large forex reserves, current account surplus made a substantial contribution, in India, the current account deficit took away a large slice of the reserves built-up by the capital account surplus.

As Table 19.2 indicates, during the period March, 1991 to September, 2007, about 50 per cent of the capital account surplus was made up of foreign investment, 11 per cent of NRI deposits, 18 per cent of external commercial borrowings, and 6 per cent external assistance. The increase in the forex reserves during these 16 years was about \$242 billion; it would have been \$288 billion if we do not account for the current account deficit (i.e. about 19 per cent more).

An examination of the sources of reserves accretion, since 1991, reveals that the increase in foreign exchange reserves has been facilitated mostly by substantial increase in FDI and FII, NRI deposits, and external commercial borrowings.

The major contributors to the increase in forex reserves are FDI, FPI, NRI deposits, and ECBs.

Net foreign direct investment increased from US\$129 million in 1991-92 to US\$8.5 billion in 2006-07. Cumulative net FII investments increased from US\$1 million at end-March, 1993, to US\$ 61.8 billion as at end-September, 2007. Outstanding NRI deposits increased from US\$ 14 billion at end-March, 1991, to nearly US\$ 44 billion as at end end-September, 2007.

There are some countries, like Russia, where the reserves are built-out of current account surplus. In countries, like China, Korea, and Taiwan, the surplus, in both current and capital account, led to accumulation of reserves. On the other hand, there are countries like India, where the reserves accretion

Table 19.2 Sources of Accretion to Forex Reserves since 1991

(US\$ billion)

Items		1991-92 to 2005-06 (up to end-March 2006)
A	Reserve outstanding as on end-March 1991	5.8
B.I.	Current Account Balance	-45.78
B.II.	Capital Account (net) (a to e)	264.1
	a. Foreign Investment of which	129.8
	(1) FDI	47.6
	(2) FII	61.8
	b. NRI Deposit	29.5
	c. External Assistance	14.6
	d. External Commercial Borrowings	48.0
	e. Other items in capital account	42.2
B.III.	Valuation change	23.5
	Total (A+BI+BII+BIII)	247.7

Source: Reserve Bank of India, *Report on Foreign Exchange Reserves*, 2007-08.

was driven more by capital account surplus and not by current account surplus, broadly implying that capital inflow was more than what could be normally absorbed in the domestic economy. Net capital flows have remained much larger than the current account deficit in India, as well as in most of Latin America and Central and Eastern Europe. In case, the reserve accumulation is due to large capital flows, it may be useful to distinguish between debt and non-debt flows, as also between foreign direct investment and generally less stable portfolio flows. In fact, the stock, as well as flow, in each category would be relevant for reserve management. While the marking-to market of the assets and liabilities may be difficult, it might not be irrelevant.¹⁰

External Liabilities vis-a-vis Forex Reserves

The accretion of foreign exchange reserves needs to be seen in the light of total external liabilities of the country.

Table 8 gives a picture of India's International Investment Position (IIP), which is a summary record of the stock of country's external financial assets and liabilities.

It is important to note that an increase in the forex reserves does not mean a favourable international assets vs liabilities position. On the other hand, the increase in the forex reserves caused by foreign investments results in an increase in the foreign liabilities in a situation of current account deficit.

Pre-payment of External Debt The significant increase in forex reserves enabled pre-payment of certain high-cost foreign currency loans of the Government of India from the Asian Development Bank (ADB) and the World Bank (IBRD).

Table 19.3 International Investment Position of India

(US \$ million)

	Item	June 2007 (P)
A	Assets	
1.	Direct investment abroad	2 9. 39
2.	Portfolio investment	0.79
3.	Other investments	16.20
4.	Foreign Exchange Reserves	213.35
	Total Foreign Assets	259.73
B	Liabilities	
1.	Direct investment in India	82.98
2.	Portfolio investment	93.96
3.	Other investments	145.74
	Total Foreign Liabilities	322.18
	Net Foreign Liabilities (B-A)	62.45

P: Provisional

Source: Reserve Bank of India, *Report on Foreign Exchange Reserves, 2007-08*.

Investment Pattern and Earnings from Foreign Currency Assets

The foreign currency assets are invested in multi-currency, multi-asset portfolios, as per the existing norms, which are similar to international practices in this regard.

Table 19.4 Deployment Pattern of Forex Reserves

(US \$ million)

		As on March 31, 2006	As on March 31, 2005
(1)	Foreign Currency Assets	145,108	135,571
	(a) Securities	35,172	36,819
	(b) Deposits with other central banks, BIS & IMF	65,399	65,127
	(c) Deposits with foreign commercial banks	44,537	33,625
(2)	Special Drawing Rights	3	5
(3)	Gold (including gold deposits)	5,755	4,500
(4)	Reserve Tranche Position	756	1,438
(5)	Total Foreign Exchange Reserves	151,622	141,514

India's forex reserves are largely invested in low-risk OECD government securities and bank deposits, yielding very low returns. For example, during the year 2004-05 (July-June), the return on foreign currency assets and gold, after accounting for depreciation, was only 3.1 per cent, and 2.1 per cent during 2003-04.

During the year 2006-07 (July-June), the return on foreign currency assets and gold, after accounting for depreciation, increased to 4.6 per cent, from 3.9 per cent during 2005-06, mainly on account of hardening of global short-term interest rates.

There is a growing view that India should invest its forex reserves to fetch a much higher return, without, of course, risking the principal. This is particularly important in the light of the large reserves, which is growing very fast. Many people advocate the creation of a sovereign wealth fund (SWF) for effectively investing the country's fast growing forex reserves.

It is observed that, with \$95 billion added to reserves in 2007 alone, Indian, policy-makers have been caught unprepared for this rapid increase in 'sovereign wealth'. With the increase in this pool of capital the cost of an overly risk-averse investment strategy has also increased. When one considers that Temasek has earned 18 per cent on its \$100 billion portfolio, and Harvard University 13 per cent on its \$35 billion endowment, since its inception, the scale of lost earning is staggering. It is, therefore, time for the Indian government to evaluate options to get the best risk adjusted return for this wealth, which ultimately belongs to the Indian citizens.¹¹

IMF AND INTERNATIONAL LIQUIDITY

A major function of the IMF is to provide international liquidity in accordance with the purpose of the fund specified in the Articles of Agreement. Part of the liquidity supplied takes the form of reserve assets that can be used for balance of payments financing (*unconditional liquidity*), while part takes the form of credit to members that is generally subject to conditions (*conditional liquidity*).

Members can draw unconditional and conditional liquidities from IMF.

Conditional liquidity is provided by the IMF under its various lending facilities. Most of the fund's credit extended under these arrangements require an adjustment programme for the member that is intended to promote a sustainable external position. In addition, it is often the case that when the member obtains fund financing under agreed conditions, its access to international capital markets is enhanced. This catalytic role of the fund has become more important in the recent period when private lending institutions have been less willing to engage in international lending.

Unconditional liquidity is supplied through the allocations of SDRs and also in the form of reserve positions in the fund which are the claims corresponding to the resources that countries have made available to the fund. Member countries holding SDRs and reserve positions in the fund can use them to finance balance of payments deficits without having to enter into policy commitments with the fund.

Provision of Liquidity through Member's Use of Fund Resources The fund makes its resources available to members, under agreed conditions, in support of efforts on their part to overcome balance of payments problems in an orderly way without undue disruption of the flows of international trade and payments. Several facilities are available for extending credit to members for varying periods up to ten years and subject to different degrees of conditionality. For example, the extended fund facility, which was set up in 1974, is designed to assist members experiencing protracted payment difficulties whose correction requires sustained effort through appropriate policies.

In credit arrangements that envisage policy actions to be taken by the member, the use of the fund's resources is normally made conditional upon continued policy action in accordance with a programme agreed between the member and the fund. However, no policy adjustment would normally be required when the need for balance of payments financing is of a temporary character resulting solely from

circumstances believed to be likely to reverse themselves in the near future, as under the compensatory financing facility designed to meet temporary shortfalls in exports earnings.

Limits Placed Upon the Use of Fund's Resources The limits placed under present policies on a member's use of fund's credit facilities are defined in terms of the member's quota in the fund. For example, to meet a shortfall in export earnings, a member may draw from the fund up to 100 per cent of the quota. On the other hand, in order to meet a protracted and structural balance of payments problem, a member may, subject to certain conditions, borrow fund resources up to 150 per cent of this quota in any year, up to 450 per cent over three years, and, in some circumstances, up to a cumulative limit of 600 per cent of its quota, apart from any amounts borrowed by the member under the compensatory financing and buffer stock facilities.

The number of member countries using fund resources has increased substantially over time. While the amount of outstanding fund credit has shown considerable cyclical variability it has shown substantial increase in the past.

The proportion of the outstanding fund credit subject to high conditionality has increased quite substantially in the past. This evolution has resulted mainly from the need for more active adjustment policies of members using fund resources in present circumstances and in the light of the continuing requirement for safeguarding the revolving nature of the fund's resources.

To enable the fund to meet the increasing resource requirements of the members additional SDR allocations and quota increases have been made. The fund's resources have been further enlarged by the General Arrangements to Borrow (GAB).

SUMMARY

International liquidity refers to the generally accepted means of international payments available for the settlement of the international transactions. Thus, *international liquidity encompasses the international reserves and the facilities for international borrowing for financing the balance of payments deficit*. International reserves are defined to include official holdings of gold, foreign exchange, SDRs and reserve position in the IMF—it does not include private holdings of gold, private holdings of foreign exchange and long-term international financing.

International reserves comprises monetary gold, special drawing rights (SDRs), reserve position in the IMF, foreign exchange assets (consisting of currency, and deposits and securities), and other claims.

Over the years, there has been a substantial fall in the share of gold and an increase in the share of foreign exchange in the total international reserves.

Now the developing countries hold the major part of the foreign exchange reserves. However, the industrial countries hold the lion's share of the IMF related assets as well as the gold reserves.

There has been a tendency towards diversification of reserve currency holdings after the breakdown of the *Bretton Woods* par value system, with occasional reversals. A principal reason for diversifying reserve portfolio is to reduce the perceived risk of capital losses that might arise as a result of significant exchange rate movements.

An adequate stock of reserves is one that is consistent with the smooth functioning of the international monetary system, an expansion of world trade and the absence of persistent inflation or deflation. However, the *adequate* level depends on several intricate factors. An appraisal of adequacy of international reserves must take into account both the factors affecting the demand for reserves and those determining the supply. The expected size and volatility of payments imbalances are the principal determinants of the demand for international reserves industrial relations. The supply of reserves depends primarily on the financial policies of the reserve

currency countries, the state of international capital markets, and, quantitatively to a much more modest extent on the policies determining the supply of fund related reserve assets. Some key factors influencing the availability of international reserves and liquidity are the monetary policies of the reserve currency countries and the state of their respective balance of payments. The demand for international reserves is also influenced by the access many countries have to international financial market.

The Report of the Committee on Capital Account Convertibility (1997) suggested four alternative measures to assess reserve adequacy: (i) import cover of six months; (ii) import cover of three months plus 50 per cent of annual debt service payments plus one month's imports and exports to take into account the possibility of leads and lags; (iii) ratio of short-term debt and stock of portfolio investment related non-debt liabilities to reserves at or more than 60 per cent; and (iv) the net foreign exchange assets to currency ratio (NFA/currency ratio) at around 70 per cent with a minimum of 40 per cent for this ratio to be stipulated by the RBI Act. Pablo Guidotti has suggested that emerging market economies must maintain usable forex reserves exceeding scheduled amortisation of foreign currency debts falling due (assuming no roll-overs) during the following year.

The IMF plays an important role in the provision of international liquidity. Part of the liquidity supplied the Fund takes the form of reserve assets that can be used for balance of payments financing (*unconditional liquidity*), while part takes the form of credit to members that is generally subject to conditions (*conditional liquidity*). Conditional liquidity is provided by the IMF under its various lending facilities. Unconditional liquidity is supplied through the allocations of SDRs and also in the form of reserve positions in the fund which are the claims corresponding to the resources that countries have made available to the fund. Member countries holding SDRs and reserve positions in the fund can use them to finance balance of payments deficits without having to enter into policy commitments with the fund.

India is amongst the top reserve holding nations. Reserve adequacy indicators (such as reserves—imports ratio, reserves—short term external debt ratio and reserves—short-term external debt ratio) also place India at a comfortable position *vis-a-vis* emerging market economies.

Review Questions

1. Discuss the nature and problems of international liquidity.
2. Examine the factors which determine the adequacy of reserves.
3. Write notes on the following:
 - (i) Composition of international reserves.
 - (ii) IMF and international liquidity.
 - (iii) Trends in the foreign exchange reserves of India.
 - (iv) Foreign exchange reserves management in India.

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CHAPTER 20

20 International Banking and Eurocurrency Market

LEARNING OBJECTIVES

- ☐ To get an idea of international banking.
- ☐ To get a broad picture of Eurocurrency market.

The development of international banking and the eurocurrency market is an important aspect of the development of the international monetary system and foreign exchange market.

INTERNATIONAL BANKING

International banks are banks which accept foreign currency deposits, finance international business and provide associated and ancillary services like hedging and advisory services and operate internationally.

As Eun and Resnick observe,¹ major distinguishing features between domestic banks and international banks are the types of deposits they accept and the loans and investments they make. Large international banks both borrow and lend in the Eurocurrency market. Additionally, they are frequently members of international loan syndicates, participating with other international banks to lend large sums to MNCs needing project financing and sovereign governments needing funds for economic development. Most of them also perform merchant banking functions.

Growth of international banking foster and is fostered by growth of international business.

Areas in which international banks typically have expertise to provide consulting services and advice to their clients are foreign exchange hedging strategies, interest rate and currency swap financing, and international cash management services. Banks that provide a majority of these services are commonly known as *universal banks* or *full service banks*.

Leading international banks include Bank of America, Citigroup, HSBC Holdings, Credit Agricole Group, Chase Manhattan, Industrial and Commercial Bank of China (ICBI), UBS, Deutsche Bank etc. Most of the world's 50 largest banks are from Japan, US, France, UK, and Germany. London, New York, and Tokyo, however, are by far the most important international finance centers because of the relatively liberal banking regulations of their respective countries. These three financial centers are

frequently referred to as *full service centers* because the major banks that operate in them usually provide a full range of services.²

Factors Leading to the Growth of International Banks

Rugman and Kamath point out the following reasons for the growth of international banking.³

Low Marginal Costs Managerial and marketing knowledge developed at home can be used abroad with low marginal costs.

Knowledge Advantage The foreign bank subsidiary can draw on the parent bank's knowledge of personal contacts and credit investigations for use in that foreign market.

Home Nation Information Services Local firms in a foreign market may be able to obtain more complete information on trade and financial markets in the multinational bank's home nation than is otherwise obtainable from foreign domestic banks.

Prestige Very large multinational banks have high perceived prestige, liquidity, and deposit safety that can be used to attract clients abroad.

Regulation Advantage Multinational banks are often not subject to the same regulations as domestic banks. There may be reduced need to publish adequate financial information, lack of required deposit insurance and reserve requirements on foreign currency deposits, and the absence of territorial restrictions (that is, US banks may not be restricted to state of origin).

Wholesale Defensive Strategy Banks follow their multinational customers abroad to prevent the erosion of their clientele to foreign banks seeking to service the multinational's foreign subsidiaries.

Retail Defensive Strategy Multinational banks prevent erosion by foreign banks of the traveller's check, tourist, and foreign business market.

Transaction Costs By maintaining foreign branches and foreign currency balances, banks may reduce transaction costs and foreign exchange risk on currency conversion if government controls can be circumvented.

Growth Growth prospects in a home nation may be limited by a market largely saturated with the services offered by domestic banks.

Risk Reduction Greater stability of earnings is possible with international diversification. Offsetting business and monetary policy cycles across nations reduces the country specific risk of any one nation.

Types of International Banking Offices

There are different types of international banking offices ranging from correspondent bank relationships, through which minimal service can be provided to a bank's customers, to branch offices and subsidiaries providing a fuller array of services.

Correspondent Bank A correspondent bank is a bank located elsewhere that provides a service on behalf of another bank, besides its normal business. The correspondent banking system enables a bank's

foreign client to conduct business worldwide through his local bank or its contacts. The most important correspondent banking service often is related to the foreign exchange transactions of the client. However, correspondent bank services also include assistance with trade financing, such as honoring letters of credit and accepting drafts drawn on the correspondent bank.

The correspondent bank mode is ideal because of its low cost when the volume of business is small. The possible disadvantage is that the clients may not receive the required level of service.

Representative Offices A Representative Office is a small service facility staffed by the parent bank personnel that is designed to assist the foreign clients of the parent bank in dealings with the bank's correspondents and to provide the clients with a level of service greater than that provided through merely a correspondent relationship.

Foreign Branches Foreign branches, which may provide full services, may be established when the volume of business is sufficiently large and when the law of the land permits it. Foreign branches facilitate better service to the clients and help the growth of business.

Subsidiaries and Affiliates A subsidiary bank is a locally incorporated bank that is either wholly or largely owned by a foreign parent and an affiliate bank is one that is only partially owned but not controlled by its foreign parent. Subsidiaries and affiliates are normally meant to handle substantial volume of business. Their autonomy, compared to branches, are more operational and have strategic management leverage.

Offshore Financial Centres

A major contributor to the growth of international banking is the offshore banking centres. "An offshore banking center is a country whose banking system is organized to permit external accounts beyond the normal economic activity of the country... The principal features that make a country attractive for establishing an offshore banking operation are virtually total freedom from host-country governmental banking regulations—for example, low reserve requirements and no deposit insurance, low taxes, a favorable time zone that facilitates international banking transactions, and to a minor extent, strict banking secrecy laws."⁴

Offshore financial centres are nodal centres of international banking operations.

The offshore financial centers "are either operational centers, with extensive banking activities involving short-term financial transactions, or booking centers, where little actual banking activity takes place but where transactions are recorded to take advantage of secrecy and low (or no) tax rates. In the latter case, individuals may deposit money offshore to hide it from their home-country tax authorities, either because the money was earned illegally—such as in drug trade—or because the individual or company does not want to pay tax. London is an example of an operational center; the Cayman Islands is an example of a booking center."⁵

International banks regard offshore financial centers as very good source for raising deposits, taking advantage of lower borrowing costs and tax rates. The offshore financial centers are centers for the Eurocurrency market. Offshore banks operate as branches or subsidiaries of the parent bank.

Offshore financial centers have one or more of the following characteristics.⁶

1. Large foreign-currency (Eurocurrency) market for deposits and loans (that in London, for example).
2. Market that is a large net supplier of funds to the world financial markets (that in Switzerland, for example).

3. Market that is an intermediary or pass-through for international loan funds (those in the Bahamas and the Cayman Islands, for example).
4. Economic and political stability.
5. Efficient and experienced financial community.
6. Good communications and supportive services
7. Official regulatory climate favorable to the financial industry, in the sense that it protects investors without unduly restricting financial institutions.

The International Monetary Fund recognises the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore as major offshore banking centers.⁷

Non-Banking Financial Companies

Non-banking financial companies (NBFCs) are financial intermediaries engaged primarily in the business of accepting deposits and making loans and advances, investments, leasing, hire purchase, etc. NBFCs are a heterogeneous lot. They include investment companies, finance corporations, mutual benefit funds, hire-purchase finance companies, loan companies and leasing companies.

The global liberalization has enabled large NBFIs to expand their business globally. The growth of FII investment in India is one of the manifestations of their expansion of business in developing countries. Foreign NBFIs are active in India in mutual funds business, hire purchase financing, insurance etc.

EUROCURRENCY MARKET

The growth of the Eurocurrency market, also known as Eurodollar market, is one of the significant developments in the international economic sphere after the World War II. Its phenomenal development, though poses problems for the national monetary authorities and international monetary stability, has helped the growth of international trade, transnational corporations and the economies of certain countries.

Meaning and Scope

In a narrow sense, Eurodollars are financial assets and liabilities denominated in US dollars but traded in Europe. True, the US dollar still predominates the market and most of the transactions are still conducted in the money market of Europe, especially London. But today, the scope of the market stretches far beyond Europe, and the dollar in the sense that the 'Eurodollar' transactions are held also in money markets other than European, in currencies interpreted other than the US dollar, and interpreted in a

Eurocurrency/Eurodollar is currency deposited outside the country of its issue.

currency deposited outside the country of issue. "Thus, any currency internationally supplied and demanded and in which a foreign bank is willing to accept liabilities and loan assets is eligible to become Eurocurrency."⁸ Interpreted in a wider sense, Eurodollar market refers,

thus, to transactions in a currency deposited outside the country of its issue. Therefore dollar deposits with banks in Montreal, Toronto, Singapore, Beirut, etc., are also Eurodollars, so are the deposits denominated in European currencies in the money markets of USA and the above centres. Thus, it is evident that the term 'Eurodollar', is a misnomer. 'Foreign currency Market' would be the appropriate term to describe this expanding market. The term 'Eurodollar' came to be used because the market had its origin and earlier developments with dollar transactions in the European money markets. Despite the emergence of other currencies and the expansion of the market to other areas, Europe and the dollar still hold the key to the market. Today, the term Eurocurrency market is in popular use.

Today, the 'Eurodollar Market' consists of Asian dollar market, Riodollar market, Euro-yen market, etc., as well as Eurosterling, Euroswiss francs, Euro-French francs, Euro-Deutsche marks, and so on.

In short, in these markets, the commercial banks accept interest bearing deposits denominated in a currency other than the currency of the country in which they operate and they relend these funds either in the same currency or in the currency of the country in which they operate or in the currency of a third country. In its Annual Report in 1966, the Bank for International Settlements (BIS) described the Eurodollar phenomenon as "The acquisition of dollars by banks located outside the United States, mostly through the taking of deposits, but also to some extent by swapping other currencies into dollars, and the re-lending of these dollars, often after redepositing with other banks, to non-bank borrowers anywhere in the world."¹⁰

The currencies involved in the Eurodollar market are not in any way different from the currencies deposited with banks in the respective home countries. But the Eurodollar is outside the orbit of the monetary policy whereas the currency deposited with banks in the respective home country is enveloped by the national monetary policy.

Important Features

The important characteristics of the Eurocurrency market are the following:

International Market Under No National Control The Eurocurrency market has emerged as the most important channel for mobilising and deploying funds on an international scale.

By its very nature the Eurodollar market is outside the direct control of any national monetary policy. "It is aptly said that the dollar deposits in London are outside United States control because they are in London, and outside British control because they are in dollars."¹¹ The growth of the market owes a great deal to the fact that it is outside the control of any national authority.

Short-Term Money Market The deposits in this market range in maturity from one day to several months and interest is paid on all of them. Although some Eurodollar deposits have a maturity of over one year, Eurodollar deposits are predominantly a short-term instrument.

It is a short-term, wholesale, competitive international money market.

"The Eurodollar market is viewed in most discussions more as a credit market—a market in dollar bank loans—and as an important accessory to the Eurobond market."¹² The Eurodollar loans are generally for short periods—three months or less, Eurobonds being employed for longer term loans. The Eurobonds developed out of the Eurodollar market to provide longer term loans than was usual with Eurodollars. These bonds are usually issued by a consortium of banks and issuing houses.

Wholesale Market The Eurodollar market is a wholesale market in the sense that the Eurodollar is a currency dealt in only large units. The size of an individual transaction is usually above \$1 million.

Highly Competitive and Sensible Market Its efficiency and competitiveness are reflected in its growth and expansion. The resiliency of the Eurodollar market is reflected in the responsiveness of the supply of and demand for funds to the changes in the interest rates *vice versa*.

Origin and Growth

The origin of this market can be traced back to the 1920s when the United States dollars were deposited in Berlin and Vienna and were converted into local currencies for lending purposes.¹³ However, the

growth of the Eurodollar market began to gain momentum only in the late 1950s. Since 1967 the growth of the market has been very rapid. The flow of the petrodollars has given it an added momentum since about the middle of the 1970s. The growth of the market since then has been substantial.

It is pointed out that¹⁴ the phenomenal development of the Eurodollar market since the beginning of 1960s can also be viewed from the viewpoint of the width, breadth and resiliency of the market. The momentum of the market development accelerated after 1968 when the international gold and currency problem developed into recurring crisis every year and the United States' balance of payments deficits supplied additional dollars to the market. More and more participants were drawn into the market due to its growing economic efficiency, competitiveness and the sure prospect of gain it confidently held out. Besides, central banks and financial intermediaries, multinational corporations, Middle Eastern Oil firms, developing countries and the communist countries also entered the market as participants. The centre of the Eurodollar market has spread from London and West European Financial centres to other less known places like Bahamas, Singapore, Lebanon and Toronto. The depth of the market is reflected in the longer terms of loans and the increased channels of obtaining them. Since the market is large, efficient and highly competitive it is highly sensitive, too. This is reflected in the fluctuations of interest rates depending on supply and demand factors, internationally.

Factors that Contributed to the Growth The following are the important factors that contributed to the growth of the Eurodollar market at different stages and times.

The Suez Crisis The restrictions placed upon sterling credit facilities for financing trade which did not touch the British shores during the Suez Crisis in 1957 provided a stimulus for the growth of the Eurodollar Market. The British banks, in search of an alternative way to meet the demand for credit on the part of the traders in this sphere, easily found a good substitute in dollars. There was already available a pool of US dollars, held by residents outside the US.

Relaxation of Exchange Controls and Resumption of Currency Convertibility The general relaxation of exchange control, the stability in the exchange market and the resumption of currency convertibility in Western Europe in 1958 provided an added impetus to the growth of the Eurodollar market. In a convertible currency system, some countries are, as a rule, in surplus and others in deficit. The money market in the surplus country being liquid, short-term funds flow to the Euromarket, attracted by the higher rate of interest. On the other hand, credit flows from the Euromarket to the deficit

A number of factors contributed to the growth of Eurocurrency market.

countries where the money market is tight. The relaxation of exchange controls not only enables the holder of dollar "...claims to retain them rather than surrendering the mighty God" called dollar to the exchange control authorities, but also increases the demand for US dollars as they could be freely converted into domestic currency to finance domestic economic activity.

The Political Factor The cold war between the United States and the communist countries also contributed to the growth of the Euromarket. Due to the fear of blocking or seizure of deposits by the US in the event of hostilities, the Russian and East European banks sought to place their dollar balances with European banks, especially British and French, rather than with banks in the United States.

Balance of Payments Deficits of the US The large and persistent deficit in the balance of payments of the US meant an increasing flow of the US dollar to those countries which had surplus with the US. The US has had a deficit in international payments every year since 1950, except in 1957. Since

1958, the deficits assumed alarming proportions. This is one of the most important factors responsible for the rapid growth of the Eurodollar market.

The Regulation 'Q' Some of the regulations of the Federal Reserve System, especially the Regulation 'Q' which fixed the maximum rate of interest payable by the banks in the US and the prohibition of payment of interest on deposits for less than 30 days very significantly contributed to the fast growth of the Eurodollar market. Although Eurodollar rates had their ups and downs, they were all the time—except for brief periods in 1958 for three months' deposits—appreciably higher than the deposit rates in the US. Unlike in the US, the Eurodollar market paid interest on deposits for less than 30 days also. Further, "Selective Controls in the United States, such as interest equalisation and the voluntary restrictions on lending and investing abroad by United States corporations and banks, have made the market larger than it otherwise would have been. Without these controls much of the market's activity would instead be carried in the New York money market."¹⁵

Innovative Banking The advent of innovative banking, spearheaded by the American banks in Europe and the willingness of the banks in the market to operate on a narrow 'spread' also encouraged the growth of the Euromarket.

Supply of Petrodollars The flow of petrodollars, facilitated by the tremendous increase in the OPEC's oil revenue following the hikes in the oil prices since 1973, has been a significant source of growth of the Eurodollar market.

The Participants

Participants in the Eurocurrency business include governments of all political categorisations, international organisations, central banks, commercial banks, corporations, especially multinational corporations, traders, individuals, etc.

Supply and Demand

The supply of and demand for funds in the Eurocurrency market come from the above participants. Central banks of various countries are very important suppliers. The bulk of the central bank funds are channelled through the BIS in Basle, Switzerland. The enormous oil revenue of the OPEC has become an important source of flow of funds to the Eurodollar market. Multinational corporations and traders place their surplus funds in the market to obtain short-term gains.

Governments have emerged as significant borrowers in the Eurocurrency market. The frequent hike in the oil prices and the consequent increase in the current account deficits of many countries compel them to increase their borrowings.

The commercial banks in need of additional funds for lending purposes may borrow from the Euromarket and relend it. At the end of the financial year, sometimes they resort to borrowing for 'window dressing' also. Business corporations, especially multinationals, and traders borrow from the market for their short-term requirements.

Evaluation of the Eurodollar Market

The advantages and dangers associated with the Eurocurrency market have given rise to the doubt whether it is a welcome tonic or a slow poison to the international system.

Advantages The growth of the Euromarket has helped to alleviate the international liquidity problems considerably, provided credit to finance the balance of payments deficits, enabled the exporters and importers to obtain credit, helped to meet the short-term credit requirements of the business corporations, and provided better opportunities for the investment of short-term funds. It has provided a market for profitable investment of funds by the central banks. The supply of funds by the Euromarket has enabled commercial banks in some countries to expand domestic credit creation and helped 'window dressing'. The Eurocurrency has helped to accelerate the economic development of certain countries including South Korea, Brazil, Taiwan and Mexico.

Disadvantages However, the growth of this market has given rise to some serious problems, especially in the sphere of monetary stability. "Central Banks and governments have been uneasy about the Eurodollar market ever since it became visible in 1958. Its explosive growth baffles them, they know that something is going on but they are seldom sure what it is. They do know that one of its attractions for the participants is that the Eurodollar market provides opportunities for avoiding many of the regulations that they try to enforce on national money markets."¹⁶

"Despite the many advantages of the Eurodollar as a 'vehicle currency' for carrying on world trade and as a source of international liquidity, there remains the unsettling prospect of a machine, controlled by no one, that can add to the world's money supply by creating dollars."¹⁷ As Milton Friedman has said "... the Eurodollar market has almost surely raised the world's nominal money supply (expressed in dollar equivalents) and has thus made the world price level (expressed in dollar equivalents) higher than it would otherwise be."¹⁸

Globalisation increases the importance of Eurodollar and Eurobond markets.

The Eurodollar and Eurobond markets have become important sources of finance for governments and private firms. The growing integration of the world economy and globalisation of business increase the importance of these markets.

Euromarket and India Government of India has made use of the Euromarket on several occasions. There is an increasing realisation of the importance of this market by the Indian companies. The change in the business environment in India increases the importance of this market for Indian business.

SUMMARY

The development of the international monetary system and foreign exchange market has been significantly influenced by the growth of international banking and the eurocurrency market.

The growth of **International Banking** has significantly contributed to the massive cross border movement of funds. International banks are banks which accept foreign currency deposits, finance international business and provide associated and ancillary services like hedging and advisory services and operate internationally. The development of international banking has been fostered by a number of factors like low marginal costs, knowledge advantage, ability to obtain more complete information on trade and financial markets, regulatory factors, and several other advantages which large banks enjoy have contributed to the growth.

Offshore banking centres have been a major contributor to the growth of international banking. These are either operational centres, with extensive banking activities involving short-term financial transactions, or booking centres, where little actual banking activity takes place but where transactions are recorded to take advantage of secrecy and low (or no) tax rates.

The post-World War II period has witnessed a significant growth of the **Eurocurrency market** (also known as Eurodollar market). Its phenomenal development, although poses problems for the national monetary authorities

and international monetary stability, has helped the growth of international trade, transnational corporations and the economies of certain countries.

In a narrow sense, Eurodollars are financial assets and liabilities denominated in US dollars but traded in Europe. However, defined broadly, any currency internationally supplied and demanded and in which a foreign bank is willing to accept liabilities and loan assets may be regarded as Eurocurrency. In these markets, the commercial banks accept interest bearing deposits denominated in a currency other than the currency of the country in which they operate and they relend these funds either in the same currency or in the currency of the country in which they operate or in the currency of a third country

The Eurocurrency market is an international market and it is under no national control. It is predominantly a short-term money market. The Eurodollar market is a wholesale market in the sense that the Eurodollar is a currency dealt only in large units. Another important feature is that it is a highly competitive and sensible market.

Participants in the Eurocurrency business include governments, international organisations, central banks, commercial banks, corporations, especially multinational corporations, traders, individuals, etc.

The supply of and demand for funds in the Eurocurrency market come from the above participants. Central banks of various countries are very important suppliers.

The advantages and dangers associated with the Eurocurrency market have given rise to the doubt whether it is a welcome tonic or a slow poison to the international system.

The growth of the Euromarket has helped to alleviate the international liquidity problem considerably, provided credit to finance the balance of payments deficits, enabled the exporters and importers to obtain credit, helped to meet the short-term credit requirements of the business corporations, and provided better opportunities for the investment of short-terms funds. It has provided a market for profitable investment of funds by the central banks. However, the growth of this market has given rise to some serious problems, especially in the sphere of monetary stability.

Review Questions

1. Explain the important features of the Eurodollar market. Examine the factors which contributed to the growth of the market.
2. Write notes on the following:
 - (a) Eurodollar market
 - (b) Problems caused by the Eurodollar market
 - (c) International banking
 - (d) Offshore financial centres

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PART SIX

International Factor Movement

6

CHAPTERS

- ❖ International Capital Flows
- ❖ Multinational Corporations
- ❖ Transfer of Technology
- ❖ Official Development Assistance
- ❖ International Debt
- ❖ International Migration

CHAPTER 21

21

International Capital Flows

LEARNING OBJECTIVES

- ☐ To understand the nature, types and pattern of international capital flows.
- ☐ To know the importance and problems of foreign capital.
- ☐ To examine the trends in international capital flows.
- ☐ To get an idea of the factors influencing international capital flows.
- ☐ To get an idea of the theories of international investment.

Although the classical economists assumed that factors of production are immobile between countries, international factor mobility has made significant contribution to the development of many a country. Economic development of a number of the present day advanced countries was assisted by foreign capital. Even today the bulk of the foreign investments take place in the industrially advanced countries. The role of foreign capital in the economic development of the developing countries is well recognised. The developing countries also receive Official Development Assistance (ODA) from the developed countries. This chapter discusses the international private capital flows. ODA is dealt with in the next chapter.

The role of private capital flows in the external financing of developing countries have substantially increased since the second half of the 1980s and this has contributed to a fall in the relative share of the external debt in the total external assistance. Whereas in 1980–1985 bank lending and suppliers' credits accounted for 69 per cent of all private capital flows to developing countries and countries in Central and Eastern Europe, this share fell to 11 per cent in 1998–2002. During the same period, the share of FDI rose from 30 per cent to 82 per cent, and that of portfolio equity investment from less than 0.1 per cent to more than 6 per cent. In 2005, the ratio between FDI; inflow and official financial flows was about 90 : 10.

CLASSIFICATION OF INTERNATIONAL CAPITAL FLOWS

International capital movements may be classified as follows.

Direct and Portfolio Investments

Foreign direct investment (FDI) refers to investment in a foreign country where the investor retains control over the investment. It typically takes the form of starting a subsidiary, acquiring a stake in an

existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together. If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That

Foreign direct investment is akin to promoters' investment and portfolio investment is similar to stock market investment.

is, in the case of portfolio investments, the investor uses his capital in order to get a return on it, but has no much control over the use of the capital. Foreign portfolio investment (FPI), thus, is investment by individuals, firms, or public bodies (like governments or government

organisations) in financial instruments (such as stocks and government bonds).

FDI may take the form of:

- Green-field investment, i.e. establishing an entirely new enterprise in the foreign market.
- M&A, i.e. merging or acquiring an existing firm in the foreign country. In recent years, cross-border M&A has been the major driver of FDI.

UNCTAD's *World Investment Report* defines foreign direct investment (FDI) as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate), FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as business entities.

The ownership level required in order for a direct investment to exist is 10 per cent of the voting shares.

There are two related but different measures of FDI: FDI *flows* and FDI *stock*. FDI flows refer to the new FDI during a specified period while the FDI stock measures the total amount of FDI exists at a point in time. These stocks are the sums of past flows of FDI.

Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. FDI has three components: equity capital, reinvested earnings and intra-company loans.

According to the World Bank, foreign direct investment is net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, re-investment of earnings, other long-term capital, and short-term capital, as shown in the balance of payments.

FDIs are governed by long term considerations because these investments cannot be easily liquidated. Hence factors like long term political stability, government policy, industrial and economic prospects etc. influence the FDI decision. However, portfolio investments, which can be liquidated fairly easily, are influenced by short term gains. Portfolio investments are generally much more sensitive than FDIs. Direct investors have direct responsibility with the promotion and management of the enterprise. Portfolio investors do not have such direct involvement with the promotion and management.

There are mainly two routes of portfolio investments in India, viz., by Foreign Institutional Investors (FIIs) like mutual funds and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs).

GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilising foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies, satisfying certain conditions, are allowed to access foreign capital markets by Euro issues.

Government, Institutional and Private Capital

Sometimes capital movement may represent government funds. For instance, government of an advanced country may give a loan or grant to finance projects in a developing country. Institutions like the World Bank and its affiliates, Asian Development Bank, etc., play a significant role in international capital movements. Private capital movements are induced purely by profit motive.

Short-Term and Long-term Capital

A period of less than one year may be regarded as short-term. Short-term capital movements are mostly speculative in nature. Short-term capital movements sometimes take the form of *hot money* movement, i.e. the movement of capital to take advantage of the international differences in interest rates. Long-term capital movements are usually for long-term investments.

Home and Foreign Capital

This distinction is usually made with reference to the Balance of Payments entries. Home capital refers to investments made abroad by residents of the country concerned, while foreign capital refers to investments made by foreigners in the home country. In other words, home capital refers to outflow of capital and foreign capital refers to inflow of capital.

Foreign Aid

Aid represents unilateral payments—they are gifts or grants which do not have to be repaid. An advanced country may give an aid to developing country to assist certain development programmes. International social organisations also provide aid. Sometimes aid is given for military purposes. Generally, an aid is given for a specific purpose and the recipient has to use it for that specific purpose. (The term ‘foreign aid’ however, is also used in a very broad sense to embrace all sorts of foreign assistance including private foreign capital and technical and personnel assistance).

SIGNIFICANCE AND ROLE OF FOREIGN CAPITAL

As mentioned earlier, foreign capital played an important role in the industrialisation of most of the advanced countries of today like the countries of Europe (including Russia) and North America. Though the problems of development of the developing countries of today are not very much similar to those faced by the advanced countries, there is a general view that foreign capital, if properly directed and utilised, can assist the development of the developing countries.

Economic growth is a function of, among other things, capital formation. In the developing countries, the per capita income and savings rate being very low, domestic capital formation is inadequate to give a ‘big push’ to the economy to take it to the ‘take-off’ stage. Hence, the domestic resources may be

supplemented with foreign capital to achieve the 'critical minimum' investment to break the vicious circle of low income-low savings-low investment-low income.

International economic integration has been fostered by large cross-border flows of finance, both private and official. While private financial flows are, invariably, commercial in nature, financial flows related to ODA are meant to serve certain social purposes, like promotion of socio-economic development of the assisted nations

The economic liberalisations that swept across the world, particularly since the late 1980s, have very significantly changed the environment for international private financial flows. At the same time, the

Investment plays a much greater role than trade in internationalising the world economy.

surging international capital flows, in its turn, are substantially impacting the business environment. The massive flow of international investment has resulted in a substantial increase in their role in global production, employment generation and trade. In the more than two and a half decades since 1980, the ratio of world FDI inflows to global gross domestic capital formation increased

from about 2 per cent to 14 per cent. Similarly, the ratio of world FDI stock to world GDP increased from 5 per cent to about 25 per cent during the same period. As renowned management guru Peter Drucker in his *Managing For the Future* observes, "increasingly world investment rather than world trade will be driving the international economy. Exchange rates, taxes, and legal rules will become more important than wage rates and tariffs."¹

Portfolio equity flows to developing countries was conspicuous by their absence prior to 1982. The average annual portfolio flows to developing countries, which was \$1.3 billion during 1983–'90 shot up substantially in the 1990s. The portfolio inflows are likely to significantly increase in future, supported by such factors as further capital market liberalisation and reforms in developing countries, growth in global financial assets, growth in developing countries' exports and capacity to service foreign liabilities, industrial and general economic growth in developing countries, increased diversification of investor portfolios, growing resources of the investors and faster equity market capitalisation in developing countries.

The fact that this very small share of the total investment by the developed country portfolio investment would amount to large chunk of investment in the developing country markets has serious implications because of the high sensitivity and volatility of the portfolio investments. The Mexican crisis and the South-East Asian crisis may be remembered here. Further, large foreign portfolio investment in companies could have other implications.

Other Benefits of Capital Inflow Following the analysis of Donald MacDougall and Paul Streeten, Gerald Meier observes² that, from the stand point of national economic benefit, the essence of the case for encouraging an inflow of capital is that the increase in real income resulting from the act of investment is greater than the resultant increase in the income of the investor. If the value added to output by the foreign capital is greater than the amount appropriated by the investor, social returns exceed private returns. As long as foreign investment raises productivity, and this increase is not wholly appropriated by the investor, the greater product must be shared with others, and there must be some direct benefits to others, and there must be some direct benefits to other income groups as mentioned below:

Domestic Labour Domestic labour may get higher real wages because of the increase in productivity. There might also be an expansion of the employment opportunities, as has been happening in China.

Consumers If foreign investment is cost-reducing in a particular industry, consumers of the product may gain through lower product prices. If the investment is product-improving or product-innovating, consumers benefit from better quality products or new products. Consumers also benefit from the increase in competition as in India.

Government The increase in production and foreign trade resulting from foreign capital might increase the fiscal revenue of the government.

External Economies Foreign capital may bring in a number of indirect gains through the realisation of external economies. For instance, if foreign investment is used for the development of infrastructure, this could stimulate domestic investment in industrial and other sectors.

Besides the above benefits, cited by Meier, FDI can have the following effects.

Spillovers In the endogenous growth framework, the sources of growth attributed to capital flows comprise the spillovers associated with foreign capital in the form of technology, skills, and introduction of new products as well as the positive externalities in terms of higher efficiency of domestic financial markets, improved resource allocation and efficient financial intermediation by domestic financial institutions.³

BOP and Forex The changes in the composition of the capital flows and the substantial increase in the magnitude of some of the flows, like FDI, have remarkably changed the balance of payments and foreign exchange reserves position of several countries. The debt creating flows as a percentage of total flows in the BOP of India averaged as much as 97 per cent during the Seventh Plan (1985–90) but declined to less than 20 per cent by mid 1990s. Eventually, India began to experience a surplus on the BOP and a very remarkable improvement in the reserves position, and has become one of the largest holders of Forex reserves.

Advantage Over ODA Foreign investment has assisted and is assisting the economic growth of many countries. As a World Bank report points out, for the developing countries FDI has the following advantages over the official development assistance (ODA):⁴

1. FDI shifts the burden of risk of an investment from domestic to foreign investors.
2. Repayments are linked to profitability of the underlying investment, whereas under debt financing the borrowed funds must be serviced regardless of the project costs.
3. Further, it has also been observed that FDI is the only capital inflow that has been strongly associated with higher GDP growth since 1970 .

Contribution to Growth The contribution of FDI to economic growth is highlighted by the fact that the ratio of FDI flow to domestic investment (gross capital formation) rose for most developed and developing countries in the past. Although the bulk of the FDI goes to developed countries, its share in their gross fixed capital formation (GFCF) is only about half of that in developing countries because of the massiveness of their GFCF.

Foreign capital, if properly regulated, can contribute to the overall economic development.

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

4 Es Addressing a session on infrastructure at the seminar on ‘moving to the market: sustaining reforms in India and Asia’ organised by the Confederation of Indian Industry (CII) and Asian society, in New Delhi on March 9, 1997, Gordon Wu has observed that foreign investment brings four ‘E’s—efficiency, equity, experience and expertise. In return, there is a fifth ‘E’—expatriation of profits.

Production Linkages The contribution of FDI to sustainable economic development of the host countries depends to a large extent on the production *linkages* between foreign affiliates and domestic firms. Such linkages can take the form of *backward, forward or horizontal*.

Backward linkages exist when foreign affiliates acquire goods or services from domestic firms, and *forward linkages* when foreign affiliates sell goods or services to domestic firms. *Horizontal linkages* involve interactions with domestic firms engaged in competing activities. Linkages, broadly defined, can also involve non-business entities like universities, training centres, research and technology institutes, export promotion agencies and other official or private institutions.⁵

The extent to which foreign affiliates establish backward linkages with domestic suppliers is usually measured by the local content of production or local sourcing by foreign affiliates, although, for many reasons, however, these measures may not accurately reflect the magnitude of backward linkages with domestic firms.

FOREIGN PRIVATE INVESTMENT

Private foreign capital mostly takes the form of direct investment. Hence, we deal here with the direct foreign investment (private). The important advantages of foreign direct investment are the following:

1. It helps increase the investment level and thereby the income and employment in the host country.
2. Foreign investment may increase the tax revenue of the government.
3. Direct foreign investment facilitates transfer of technology to the recipient country.
4. It may kindle a managerial revolution in the recipient country through professional management and the employment of highly sophisticated management techniques.
5. Foreign capital may enable the country to increase its exports and reduce import requirements.
6. Foreign investments may stimulate domestic enterprise because, to support their own operations, the foreign investors may encourage and assist domestic suppliers and consuming industries.
7. Foreign investment may also help increase competition and break domestic monopolies.
8. If foreign investment improves the quality and reduces the cost of inputs, that would benefit the domestic industry.

Studies show that in selected developed host countries, affiliates source between 10 and 20 per cent of their inputs locally (i.e. supplied by domestic or foreign-owned suppliers). In *developing* countries, the share of locally-sourced inputs by foreign affiliates varies by industry and region.⁶ (For more information on FDI and production linkages, see the author’s *International Business*—Prentice-Hall of India).

TRADE AND INVESTMENT

Foreign trade and foreign direct investment (FDI) are mutually influential. While some of the FDIs increase international trade, some decrease trade.

FDI in the natural resource sectors, including plantations, in developing countries increase trade volume. FDIs in several other sectors also increase international trade.

While on the one hand investment increases trade, as stated above, on the other hand foreign production by FDI substitutes foreign trade in many cases. Due to factors like foreign exchange problems, desire to generate employment and accelerate the pace of economic development, foreign investment is encouraged by national governments across the whole spectrum of political ideologies and development levels. The policies of many developing countries strongly prefer foreign investment (for import substitution) to imports.

Foreign investment may have mixed effect on trade.

Due to the protectionism and some other factors, large amounts of FDI have been taking place in the developed countries leading to substitution of foreign production for foreign trade. The regional integration schemes also tend to increase such investments to substitute production for trade.

It may also be pointed out that, to a considerable extent such FDIs are made possible by the past trade; the funds generated by trade are ploughed back to investment in the foreign markets. The massive foreign investments made by the Japanese companies since the mid 1980s deserves a special mention in this context.

While the international investment replaces international trade in certain products, it may generate trade in some other products. That about one-third of the world trade in manufactures is intra-company trade is an indication of the investment-trade linkage. In case of China, which has been making stupendous growth of exports, more than half the total exports are said to be generated by foreign funded enterprises.

China provides an example of what FDI can do to exports. While in 1989, foreign affiliates accounted for less than 9 per cent of Chinese exports, by 2002 they provided half. In some high-tech industries in 2000, the share of foreign affiliates in exports was over 90 per cent, for example, electronics circuits (91 per cent) and mobile phones (96 per cent). In India, given the much lower level of FDI compared to China, FDI has been much less important in driving export growth, except in information technology. FDI accounted for only 3 per cent of India's exports in the early 1990s. Even in the early years of this decade FDI was estimated to account for less than 10 per cent of India's manufacturing exports.

One of the ways by which foreign capital helps accelerate pace of economic growth is by facilitating essential imports required for carrying out development programmes, like capital goods, know-how, raw materials and other inputs and even consumer goods. The machinery, know-how and other inputs needed may not be indigenously available. Further, the demand spurt created by large investments may necessitate import of consumer goods. When the export earnings are insufficient to finance such vital imports, foreign capital could help reduce the foreign exchange gap.

LIMITATIONS AND DANGERS OF FOREIGN CAPITAL

Foreign capital, both private and official (governmental and institutional), have certain limitations. Certain additional risks are associated with the private foreign capital.

Absorptive Capacity One of the important limitations to utilise the foreign capital is the *absorptive capacity* of the recipient country, i.e. the capacity of the country to utilise the foreign capital effectively. Lack of infrastructural facilities, technical know-how, personnel, inputs, market, feasible projects, inefficiency or inadequacy of administrative machinery etc. are important factors that affect the absorptive capacity.

Sometimes 'strings' are attached to the official assistance—the recipient country may be pressurised to fall in line with the ideology or direction of the donor.

Disadvantages of Foreign Capital The following criticisms are leveled against foreign capital:

1. Private foreign capital tends to flow to the high profit areas rather than to the priority sectors.
2. The technologies brought in by the foreign investor may not be appropriate to the consumption needs, size of the domestic market, resource availabilities, stage of development of the economy, etc.
3. Through their power and flexibility, the multinational corporations can evade or undermine national economic autonomy and control, and their activities may be inimical to the national interests of particular countries.
4. Foreign investment, sometimes, have unfavourable effect on the Balance of Payments of a country because when the drain of foreign exchange by way of royalty, dividend, etc. is more than the investment made by the foreign concern.
5. Foreign capital sometimes interferes in the national politics.
6. Foreign investors sometimes engage in unfair and unethical trade practices.
7. Foreign investment in some cases leads to the destruction or weakening of small and traditional enterprises.
8. Some times foreign investment can result in the dangerous situation of minimizing/eliminating competition and the creation of monopolies or oligopolistic structures.
9. FDI can also potentially displace domestic producers by preempting their investment opportunities.
10. The evolution of private capital flows, characterised by fluctuations (which are some times violent), suggests that they are not a reliable source of financing for development, partly because portfolio equity flows are very volatile and because financial liberalization has led to an increase in short-term speculative flows. Moreover, private capital flows, including FDI, are concentrated in a small number of emerging-market economies, while most low-income and least developed countries, which are the most dependent on external financing, receive no or very small amounts of such flows.⁷
11. Often, there are several costs associated with encouraging foreign investment. Meier observes⁸ that these costs may arise from special concessions offered by the host country. Adverse effects on domestic saving, deterioration in the terms of trade, and problems of balance of payments adjustment are the costs incurred by the best country.
 - (a) The incentives (including tax concessions) services and facilities which the governments of the host countries offer to encourage foreign investment have opportunity cost and the opportunity cost tends to be very high in developing countries. The competition between countries and provinces to woo foreign investment make matters worse.
 - (b) Although foreign investment may have an income effect that will lead to a higher level of domestic savings, this effect may be offset, however, by a redistribution of income away from capital if the foreign investment reduces profits in domestic industries (because of factors like increased competition). The consequent reduction in home savings would then be another indirect cost of foreign investment. But it is unlikely to be of much consequence in practice because of the favourable effects of the foreign investment.

Foreign capital, if not properly regulated, can impair national interests.

Competitive wooing of foreign capital by nations costs them significantly.

- (c) Foreign investment might also affect the recipient country's commodity terms of trade through structural changes associated with the pattern of development that results from the capital inflow. If the foreign capital causes an increase in the exportables to such an extent of resulting in a deterioration in the terms of trade, the rise in real income of the country will be less than that in output, and the worsening terms of trade may be considered another indirect cost of the foreign investment. If the situation is too worse, it can even cause *immiserising growth* described in Chapter 9. Whether the terms of trade will turn against the capital-receiving country is problematical depending on various possible changes at home and abroad in the supply and demand for exports, import substitutes, and domestic commodities. It is unlikely, however, that private foreign investment would cause any substantial deterioration in the terms of trade. In fact private foreign investment can help bring about a favourable structural change in the countries foreign trade.
- (d) The servicing of foreign debt capital, both public and private, can cause balance of payments problems. Further, as has already been indicated above, repatriation of profits can also cause problems.

THEORIES OF INTERNATIONAL INVESTMENT

A number of attempts have been made to formulate a theory to explain the international investment. A brief outline of the important attempts in this direction is given below.

Theoretical explanations of international investment include location-specific advantage, firm-specific advantage, internalisation advantage and competitive strategies.

Theory of Capital Movements

The earliest theoreticians, who assumed, in the classical tradition, the existence of a perfectly competitive market, considered foreign investments as a form of factor movement to take advantage of the differential profit.

The validity of this theory is clear from the observation of the noted economist Charles Kindleberger that under perfect competition, foreign direct investment would not occur and that would be unlikely to occur in a world where in the conditions were even approximately competitive

Market Imperfections Theory

One of the important market imperfections approach to the explanation of the foreign investments is the *Monopolistic Advantage Theory* expounded by Stephen in 1960. According to this theory, foreign direct investment occurred largely in oligopolistic industries rather than in industries operating under near perfect competition. Hymer suggested that the decision of a firm to invest in foreign markets was based on certain advantages the firm possessed over the local firms (in the foreign country) such as economies of scale, superior technology or skills in the fields of management, production, marketing and finance.

Kindleberger also argued that market imperfections were the basis of foreign investment.

The Market Imperfections Theory does not answer several questions related to foreign investment. For example, why does a firm prefer foreign investment to other alternative market entry modes like exporting, licensing, franchising etc.?

Internalisation Theory

According to the Internationalization Theory, which is an extension of the Market Imperfections theory, foreign investment results from the decision of a firm to internalise the firm specific advantage like a superior knowledge (i.e. keeping the knowledge within the firm to maintain the competitive edge). For example, if a firm decides to externalise its know how by licensing a foreign firm, the firm (the authorising firm) does not make any foreign investment in this respect but, on the other hand, if the firm decides to internalise it may invest abroad in production facilities.

Methods of internalisation include formal ways like patents and copy rights and informal ways like secrecy and family networks.

Appropriability Theory

According to the Appropriability Theory, a firm should be able to appropriate (to keep for its exclusive use) the benefits resulting from a technology it has generated. If this condition is not satisfied, the firm would not be able to bear the cost of technology generation and, therefore, would have no incentive for research and development. MNCs tend to specialise in developing new technologies which are transmitted efficiently through their internal channels.

It is obvious that the Appropriability Theory is similar to the internalisation theory in terms of creating an internal market (internal channels) for exploiting the firm specific advantages.

Location Specific Advantage Theory

The Location Specific Advantage Theory suggests that foreign investment is pulled by certain location specific advantages.

According to Hood and Young, there are four factors which are pertinent to the Location Specific Theory. They are:

1. Labour costs
2. Marketing factors (like market size, market growth, stage of development and local competition)
3. Trade barriers
4. Government policy

The above factors have, ofcourse, very important bearing on foreign investment. However, there are also other factors like cultural factors which influence foreign investment. Further, it is the total cost, and not labour cost alone, that is important.

International Product Life Cycle Theory

According to the Product Life Cycle Theory developed by Raymond Vernon and Lewis T Wells, the production of a product shifts to different categories of countries through the different stages of the product life cycle.

According to this theory a new product is first manufactured and marketed in a developed country like the US (because of favourable factors like large domestic market, entrepreneurship and ease of organising production). It is then exported to other developed markets. As competition increases in these markets, manufacturing facilities are established there to cater to these markets and also to export

to the developing countries. As the product becomes standardised and competition further intensifies, manufacturing facilities are established in developing countries to lower production costs and due to other reasons. The developed country markets may also be serviced by exports from the production units in the developing countries [see the Chapter 6 for further elaboration and diagrammatic presentation of the international product life cycle].

Eclectic Theory

John Dunning has attempted to formulate a general theory of international production by combining the postulates of some of the other theories. According to Dunning, foreign investment by MNCs results from three comparative advantages which they enjoy, viz,

1. Firm specific advantages
2. Internalisation advantages
3. Location specific advantages

Firm specific advantages result from the tangible and intangible resources held exclusively, at least temporarily, by the firm and which provide the firm a comparative advantage over other firms.

The firm specific advantages would not result in foreign investments unless the firm internalises these advantages.

Even when a firm internalises its exclusive resources it may not be able to serve a foreign market without foreign investment (for example by exporting). Therefore, for the production to take place in the foreign country there should be some location specific advantages. One important deficiency of the Eclectic theory is that it does not explain the foreign investment for acquisitions which have become a very important route to internationalisation.

Other Theories

According to Knickerbocker's theory of Oligopolistic Reaction and Multinational Enterprise, when one firm, especially the leader in an oligopolistic industry, enters a market other firms in the industry follow as a defensive strategy i.e. to defend their market share from being taken away by the initial investor with the advantage of local production.

Graham noted that there was a tendency for cross investment by European and American firms in certain oligopolistic industries. When American firms invested in Europe the European firms retaliated by investing in America and vice versa; this was mostly a retaliatory strategy.

There are also other reasons for investment like following the customer (for example the Japanese automobile ancillary firms to foreign markets) and *seeking knowledge* (for example, Japanese and European investment in Silicon Valley.)

These theories at best explain the reasons for some of the foreign investments only.

The theories provide only a partial explanation of the reasons of foreign investment.

FACTORS AFFECTING INTERNATIONAL CAPITAL MOVEMENTS

International investments are influenced by a number of factors. The theories briefed above have sought to explain the reasons for international investment. This section gives an outline picture of the factors influencing international investment in generic terms.

Host Country Determinants of FDI

Host country determinants	Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
I. Policy framework for FDI <ul style="list-style-type: none"> • Economic, political and social stability • Rules regarding entry and operations • Standards of treatment of foreign affiliates • Policies on functioning and structure of markets (especially competition and M and A policies) • International agreements on FDI • Privatization policy • Trade policy (tariffs and NTBs) and coherence of FDI and trade policies • Tax policy 	A. Market-seeking <ul style="list-style-type: none"> • Market size and per capital income • Market growth • Access to regional and global markets • Country-specific consumer preferences • Structure of markets 	
II. Economic determinants	B. Resource/asset-seeking <ul style="list-style-type: none"> • Raw materials • Low-cost unskilled labour • Skilled labour • Technological, innovative and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • Physical infrastructure (ports, roads, power, telecommunication) 	
III. Business facilitation <ul style="list-style-type: none"> • Investment promotion (including image-building and investment-generating activities and investment-facilitation services) • Investment incentives • Hassle costs (related to corruption, administrative efficiency, etc.) • Social amenities (bilingual schools, quality of life, etc.) • After-investment services 	C. Efficiency-seeking <ul style="list-style-type: none"> • Cost of resources and assets listed under B, adjusted for productivity for labour resources • Other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • Membership of a regional integration agreement conducive to the establishment of regional corporate networks 	

Fig. 21.1

Host Country Determinants of FDI (Reproduced from: UNCTAD, World Investment Report, 1998)

Rate of Interest One of the most important stimuli to international capital movements is the difference in the rate of interest. Capital has a tendency to move from a country with low rate of interest to a country where the interest rate is high, other things being equal.

Speculation Short term capital movements may also be influenced by speculation pertaining to anticipated changes in the interest rates or foreign exchange rates.

Profitability Private foreign capital movement is influenced by the profit motive. Hence, other things being equal, private capital will be attracted to countries where the return on investment is comparatively higher.

Costs of Production Private capital movements are encouraged by lower costs of production in foreign countries. As Kreinin points out,⁹ we may distinguish between two types of cost reducing investment. The first arises from the need to obtain raw materials from abroad. Such materials may be either unavailable at home or obtainable only at extremely high costs. But they are essential to the production and sale of final products at home or abroad. Profit opportunities would remain unexploited without them. Indeed, vast investment in the extractive industries are motivated by the fact that the capital must go where the resources are. The second type of cost-reducing investment involves cost of commodities other than materials, primarily labour.

Economic Conditions Economic conditions, particularly the market potential and infrastructural facilities, influence private foreign investment. The size of the population and the income level have important bearing on the market opportunities.

Economic and political factors have strong influence on foreign investment.

Government Policies Government policies, particularly policy towards foreign investment; foreign collaboration; remittances; profits; taxation; foreign exchange control; tariff policy and monetary, fiscal and other incentives; etc. are important factors that may influence foreign investment in a country.

Political Factors Political factors like political stability, nature of important political parties, relations with other countries, etc., also influence capital movements.

The United Nations Economic Commission for Asia and Far East has drawn up the following list of conditions that have to be met if foreign capital is to be attracted to underdeveloped countries.

1. Political stability and freedom from external aggression.
2. Security of life and property.
3. Reasonable opportunities for earning profits.
4. Prompt payment of fair and transferable compensation in case of nationalisation of foreign owned enterprise.
5. Guarantee of the possibility of remittance of profits, dividends and interest, as well as of a reasonable depreciation allowance on the capital invested.
6. Facilities for immigration and employment of foreign technical and administrative personnel.
7. A system of taxation that does not impose a crushing burden on private enterprise.
8. Freedom from double taxation.
9. Absence of vexatious controls.

10. Non-discriminatory treatment of foreigners in the administration of existing controls.
11. Absence of competition between State-owned enterprises and private foreign capital.
12. A general spirit of friendliness toward foreign investors.

Foreign investment may be market seeking, resource seeking or efficiency seeking.

Figure 21.1 presents, in a little different way, the important factors which affect foreign investment. An explanation of this is available in the author's *International Business* (Prentice-Hall of India).

GROWTH AND DISPERSION OF FDI

Trends in Magnitude of Flows

Following the sweeping changes in economic policy, foreign investment has been surging in many countries.

Today, the worldwide FDI flows and stocks are about 20 times their size in the early 1980s.

Although foreign direct investment flows have had their ups and downs, the long term trend has been of fast growth. For example, between 1970 and 2000, FDI inflows, worldwide, increased more than hundred times. The growth has been the sharpest between 1990 and 2000 thanks to universal liberalisation, privatisation, and surge

in cross-border M&As driven by these developments.

After peaking in 2000, the FDI flows had a downturn. The upward trend in inflows began again in 2004. FDI inflows in 2006 (\$1,306 billion) approached the record level (about \$1,410 billion) reached in 2000.¹⁰

While the FDI flows have had their ups and downs, the stock of FDI has increased tremendously over time. Worldwide, FDI inward stock increased from \$1, 779 billion in 1990 to \$5,810 billion in 2000, and further to \$11,999 billion in 2006. FDI inward stock, as a percentage of GDP, almost tripled between 1990 and 2006—from 8.4 per cent to 24.8. For developing economies, these figures are higher than the world average—9.6 and 26.7, respectively.

The upward trend in FDI flow is punctuated in around every 10 years.

Cyclical Behaviour FDI flows are characterised by cyclical behaviour. The decline in FDI flows, after peaking in 2000, followed rapid increases during the late 1990s. As the *World Investment Reports* point out, there was a similar pattern during the late 1980s and early 1990s, and in 1982-1983. Thus, this is the third downward cycle, each punctuating a long upward trend in FDI (every ten years or so).

Factors Affecting the Trend in FDI Flows The swings in FDI flows reflect changes in several factors. The main ones are business cycles, stock market sentiment, and M&As. These short-term factors (including such factors as the terrorist attack of September 11, 2000) work in tandem with long-term factors, sometimes offsetting, while at other times, reinforcing them.

There is, on the other hand, a stable and positive relationship between global FDI flows and the level and growth of world GDP. Technological change, shrinking economic distance, and new management methods favour international production. Their impact is, however, countered by cyclical fluctuations in income and growth. The decline in FDI in 2001 reflected a slow down in the world economy. More than a dozen countries—including the world's three largest economies faced recession.

On the supply side, FDI is affected by the availability of investible funds from corporate profits or loans, which, in turn are affected by domestic economic conditions. On the demand side, growing overseas markets lead TNCs to invest, while depressed markets inhibit them. With the increase in inter-dependence of the host and home economies, recession and upward swings affect wider regions resulting in greater corresponding movements in global FDI.

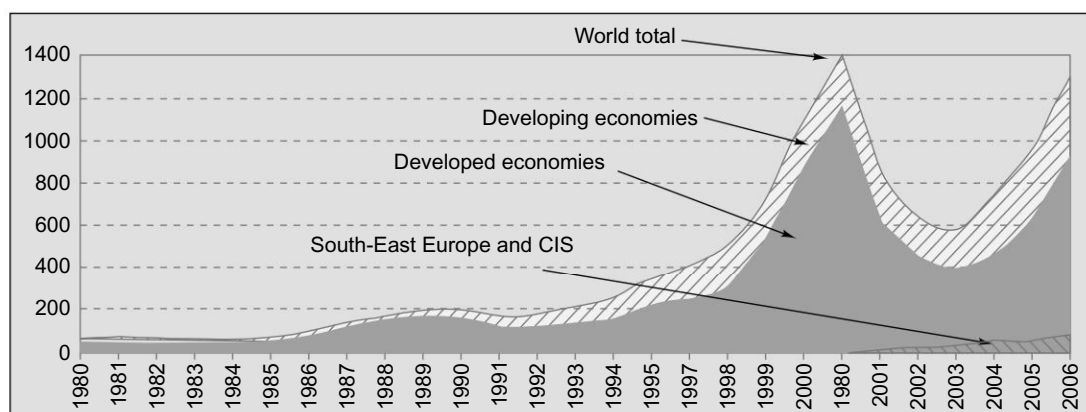
Data for 1980-2001 show that a bulge in global FDI accompanies high economic growth, and a trough accompanies low growth. However, the relationship between GDP growth and FDI is not uniform across groups of economies. Though, the relationship exists in the developed countries it is not so in the developing countries. One explanation for the different patterns of FDI flows is that business cycles spread much faster across developed countries than others. A supplementary explanation may be that some countries (as in CEE) had been cut-off from substantial FDI flows for a long time. Therefore, they have a lot of 'catching up' to do short-term cycles do not affect their attractiveness.

Fluctuations in FDI are caused by several short-term and long-term factors: economic and corporate performances are most important among them.

The rise in global FDI flows in 2006 was partly driven by the increasing corporate profits worldwide, and the resulting higher stock prices that raised the value of cross-border mergers and acquisitions (M&As). M&As continued to account for a high share of FDI flows, but greenfield investment also increased, especially in the developing and transition economies. As a result of higher corporate profits, reinvested earnings are an important component of inward FDI—they accounted for an estimated 30 per cent of the total inflows worldwide in 2006, with almost 50 per cent in developing countries alone.

One of the important determinants of the FDI trend is cross-border M&A. For example, the dramatic increases in cross-border M&As led to record flows in 1999 and 2000. Cross-border M&As too, contributed to the decline in the FDI.

Figure 21.2 very clearly shows that the fluctuations in FDI flows are by and large, caused by the fluctuations in FDI flow of the developed economies.



Source: UNCTAD, *World Investment Report 2007*.

Fig. 21.2

FDI inflows - Global and by Group of Economies, 1980-2006
(Billions of dollars)

Directional Trends

The major chunk of FDI flows take place between the developed countries. For nearly three decades, till the early 1990s, about three-quarters of the FDI had gone to the developed countries. Nearly two thirds of the flows take place between the countries of the *Triad*—the U.S., the European Union, and Japan. In 2006, the EU and the US accounted for 57 per cent of the FDI inflows and 73 per cent of the outflows.

FDI flows are highly concentrated country wise.

FDI is concentrated in a handful of countries—about a dozen countries receive nearly three-fourths of the global FDI flows. A higher degree of concentration is observed in respect of FDI flows to the developing world.

In 2006, for example, China and Hong Kong, alone, received about 30 per cent of the inflows to the developing economies.

More importantly, there are no signs that the concentration of international production across countries has been declining over time. However, in many least developed countries, that have received only small amounts of FDI, such investment is important vis-a-vis the size of domestic investment. What remains a challenge for these countries is the ability to attract not only more, but also higher quality FDI — broadly defined as investment with strong links to domestic economy, export orientation, advanced technology, and skill or spillover effects.

The largest recipient of FDI has either been the UK or the US. The US has been the largest foreign investor too. France has been one of the largest foreign investors. While UK, too has been experiencing large FDI outflow, it has been much lower than the inflow to the country.

As Table 21.1 shows, the share of the developing countries in FDI has been fluctuating.

Table 21.1 Trends in the Distribution of World FDI Inflows (Percentage)

Region	1978-80	1988 -1990	1998-2000	2003-05	2006
Developed economies	79.7	82.5	77.3	59.4	65.7
Developing economies	20.3	17.5	21.7	35.9	29.0
South, East and South-East					
Asia/South-East Europe and CIS	0.02	0.02	0.9	4.7	5.3

Source: UNCTAD, *World Investment Report 2006 and 2007*.

Investment Pattern An examination of the investment pattern of the major sources of FDI generally shows a regional bias in their investment in the developing countries. The US investments were largely concentrated in Latin America. Japan's investments went mostly to her Asian neighbours. There have, however, been some significant changes in the Japanese investments recently. Much of the United Kingdom's investments have gone to the Commonwealth nations, and France favours countries with past colonial ties, mainly Africa.

FDI streams show regional and sectoral/industry biases and historical links.

It has also been observed that direct investment is concentrated in particular economic sectors. For instance, investment by the UK and German firms has mainly been in manufacturing, while US and Japanese investment, although more evenly spread over the major economic sectors, has a bias towards manufacturing and primary industries; within manufacturing, direct investment has mainly been made in transportation equipment, chemicals and machinery (which includes electronics).

The vast expansion of the investment opportunities across the world should be expected to encourage some changes in the directional pattern of the foreign investment flows.

Sectoral Trends Although, FDI has grown, over time, in all three economic sectors—primary, manufacturing, and services—the sectoral composition has undergone significant changes, with marked shift towards services.¹¹

Primary Sector The primary sector's share in world FDI *stock* was less than 10 per cent in 1990 and 2006. However, in case of FDI *flows* between 1989-1991 and 2001-2002, the share of the primary sector did not decline—it rose from 7 per cent to 9 per cent. While, nearly all FDI in the sector continues to originate from developed countries, developing countries—many of them rich in natural resources, but lacking in internationally competitive national firms—attract considerable FDI (32 per cent of total primary-sector FDI in 2002). Within the primary sector, mining, quarrying and petroleum dominate the primary sector FDI, with over 90 per cent of inward FDI stock. During 2003-06, primary sector accounted for 13 per cent of FDI inflows, up from 7.5 per cent during 1989-91.

Manufacturing Sector The share of manufacturing in global FDI stock, fell from 42 per cent in 1990 to 30 per cent in 2005 worldwide. Manufacturing FDI is being increasingly geared to more capital- and knowledge-intensive activities because of two developments there has been a decline in labour-intensive manufacturing in general, and the share of traditional manufacturing employment has also steadily declined. Technological changes, leading to increase in replacement of labour by capital and knowledge, has been a key element in the decline of labour-intensive FDI in manufacturing. Secondly, firms in more and more countries, especially developing countries, have developed their own ownership-specific advantages based on different factor endowments, particularly low-cost labour vis-à-vis developed countries. Hence, its share in the global FDI inflow fell from 37 per cent during 1989-91 to 25 per cent during 2003-05.

The share of services in the FDI has increased sharply at the expense of manufacturing.

Services Sector During the period 1990-2002, while the global FDI stock in the primary sector nearly doubled and increased nearly threefold, in the manufacturing sector, in the services sector, it more than quadrupled. As a result of the rapid growth in this sector as compared to the other sectors, services accounted for about two-thirds of the global stock of inward FDI in 2005, compared to less than one-half in 1990, and only one-quarter in the early 1970s. During 2003-05, services accounted for about 62 per cent of the FDI inflows.

Pattern of Capital Flows to Developing Countries

As Table 20.1 indicates, the developing countries have been receiving only a small share of the global FDI flows, and their share has been widely fluctuating.

In fact, prior to the First World War, developing countries received comparatively high levels of foreign capital, and it was only in the 1990s that their foreign capital inflows reached the pre-1914 levels.

It is generally believed that the boom in capital flows of the late 20th century can in no way match the degree of integration that prevailed during the gold standard era. The current account surplus of the major creditor nations, in the 20th century, never exceeded 3-4 per cent of GDP, while during 1870-1913, Britain, the major lender, ran an average current account surplus of above 5 per cent of GDP. On the

receiving side, the current account deficit of the borrowing countries, during the late 19th century, averaged 3.8 per cent, while it was around 2.3 per cent for the period 1993-97. As a percentage of the world total, foreign investment in developing economies was 45 per cent in 1914, as against only 22 per cent in 1992, and less than 30 per cent in 2006. Many other indicators also point towards deeper integration in the late 19th century as compared with the late 20th century.¹²

In short, historically, capital flows to the developing countries followed a boom-bust pattern, with the pre-World War I period presenting comparatively very high levels of capital inflows and international economic integration compared to the later part of the twentieth century. With reference to the pattern of capital flows, the following different periods may be demarcated.¹³

Foreign capital flows to the developing countries was robust during the pre-World War I period, and their share of the global FDI was much larger than today.

1870 – 1913 A major boom in capital flows started around 1870s and continued till the outbreak of the First World War. This was the period of *laissez faire*, marked by significant international flows of goods, labour, and capital across nations, mainly directed towards infrastructure, especially utilities and railroads. Most of the foreign

investment during this period was long-term, with about two-thirds in the form of portfolio flows, and the remaining in the form of direct investment. The weak communication infrastructure and information base led investors to prefer debt instruments. This was in sharp contrast to the late 20th century scenario when direct investment became extremely important, accounting for more than 50 per cent of the private capital flows in the 1990s. The boom ended with the onset of World War I.

Post World War Period I The period, 1920-1931, saw a modest revival of capital flows, mostly to emerging market economies, to meet their developmental goals. The Great Depression and the Second World War made the ensuing period (till 1945) a highly disturbing one.

1945 to 1972 This period was marked by large capital flows among different industrialised countries. Capital flows to emerging markets was marginal.

During 1973 to 1982, foreign capital flows were dominated by bank loans

1973-82 This decade, the period of the first two oil price shocks, witnessed a boom in capital flows to developing countries, averaging at about \$163 billion per annum. The surge in capital flows during this phase was associated with the recycling of oil revenues. Bank loans to

the developing country governments, firms, and banks were the main form of capital flows, accounting for almost 57 per cent of total flows. Asia and Latin America received the maximum share. The emergence of debt servicing difficulties changed the scenario for the rest of the 1980s.

1983-89 Capital flows, during this period, to developing economies almost stagnated at around \$105-110 billion, with private sector accounting for hardly one-third of these flows. While inappropriate economic policies kept the private investors away from developing countries, the developed financial markets of the industrialised countries acted as a powerful attraction for private capital. By the end of the decade, aggregate direct investment flows into developing countries was one-eighth of the flows into

During 1983-89, there was a stagnation of capital flows to developing economies.

developed countries. Portfolio flows were rather limited, given the underdeveloped and non-existent nature of the equity markets in the developing countries. This period also witnessed development of a favourable attitude towards FDI.

1990 Onwards There was a dramatic surge in the capital flows during the 1990s, which saw a return of capital flows, to the emerging markets, to the pre-1914 levels. Net capital flows to developing economies surged from about \$ 80 billion in the late 1980s to a peak of \$344 billion in 1997.

The composition of flows, however, altered significantly over time. In 1991-92, for the first time since 1982, private flows exceeded official finance, with their share rising from about 43 per cent in 1990 to a peak 90 per cent in 1996, before dropping to 82 per cent in 1999. Also, equity flows (direct and portfolio) replaced bonds of the gold standard era and syndicated bank loans of the 1970s, thus reflecting growing securitisation and the increasing role of institutional investors, trade liberalisation, financial deregulation, financial innovation and technological revolution. This also reflected a growing preference of the developing countries for non-debt flows. While portfolio inflows remained important, FDI recorded a six-fold jump, from about \$ 35 billion in 1991 to \$185 billion in 1999. The share of FDI in developing countries' GDP rose from around 0.8 per cent to 2.5 per cent over the same period. Other private flows remained volatile. Official flows fluctuated around \$ 50 billion, with significant fall in 1996 and 1997. On the recipient side, the share of private borrowers increased dramatically in the last two decades. The private sector received more than 65 per cent of the total flows (a trend similar to the 1870-1913 period), unlike the other two periods of surges, (1920s and 1970s) when the share of the private sector had fallen to around 20 per cent. Asia and Latin America accounted for around 70 per cent of the total flows to emerging markets, with the Middle East and Sub-Saharan Africa getting a minimal share. FDI dominated Asia while portfolio flows were more significant in Latin America.

The universal economic liberalisation boosted FDI flows in the 1990s.

Some Important Trends The share of the FDI to the developing countries declined substantially, from 25 per cent during 1980-85 to 17 per cent during 1986-90. There was, however, an increase in the absolute amount of FDI flows to the developing countries. The economic liberalisations in the developing countries have helped increase the FDI to them. During 2003-06, the share of developing countries in the global FDI ranged between 26 per cent and 39 per cent. However, though the level of FDI inflow to developing countries is on the rise, the fluctuations in the FDI flows to the developed economies affect their share in the global inflow.

Since 1993, every year, FDI in developing countries has been larger than the official inflows. It was 10 times larger than bilateral official development assistance (ODA) in 2000—this contrasts with the latter half of the 1980s, when the two were almost equal. Recently, too, FDI has accounted for about 90 per cent of total financial flows to the developing countries.

The relatively developed among the developing countries, get the lion's share of the FDI. Very little FDI has gone to low income economies exceptions being China and India. In most cases, this is due to the small size of the domestic market and other adverse factors-like poor infrastructure, lack of skilled labour, etc.

The lion's share of FDI flows to the developing countries has been cornered by two regions, viz., East Asia and the Pacific and Latin America, while Sub-Saharan Africa and Middle East and North Africa got very low shares. In 2006, eight countries-China, Hong Kong, Russia, Singapore, Turkey, Saudi Arabia, Mexico, Brazil and India-attracted more than two-thirds of the total inflows to the developing countries. South Asia's share has been very dismal. The least developed countries (numbering 50) got only about 2.5 per cent of the FDI inflow to the developing countries, and less than one per cent of the world FDI inflows.

Recent FDI flows have been mostly market seeking, efficiency seeking and consolidation oriented (M&As).

One traditional attraction of foreign investment, viz., cheap labour, is becoming less important. Foreign investment today is not merely for exploitation of local resources. Foreign companies today evaluate the market potential and the production related facilities and their efficiencies, inter alia, for investment decision making. Countries with large and growing markets, fairly developed infrastructures and efficient input supplies, conducive trade policies, favourable political environment, required type of manpower supplies, etc., rank high for investment. An encouraging government policy alone is not sufficient. China has been able to attract huge FDI because its economic growth has been very good, for quite some time now, it is one of the largest potential markets in the world—due to the statist policy in force until recently, it is virtually a virgin market for many products—the labour force is ‘disciplined’ by the State, and it has favourable political and bureaucratic environment. Although India is not as attractive as China in terms of the above factors, its potential is enormous. FDI flows to India have, however, been discouraged by such factors as confusing political environment—as reflected by the Enron controversy, agitation against certain multinationals, etc.—and bureaucratic problems. It may be recalled that Motorola, disgusted by the administrative delays, has shifted a significant project originally earmarked for India to China. Countries which are at very low levels of development are not attractive to foreign investors due to factors like constraints of domestic markets and absence of infrastructural and other input supplies of the quantity and quality needed to make the enterprises competitive.

Outward FDI from Developing Countries FDI outflows from developing economies have been increasing significantly, reflecting the recognition by the firms that, in a globalising world economy,

FDI outflows from developing countries, although still very small, have been growing very fast; South – South FDI flows have also been increasing significantly.

they need a portfolio of locational assets to be competitive internationally. In fact, countries like Malaysia, the Republic of Korea and Singapore, already have an established track record, and some others—such as Chile, Mexico and South Africa—have become players relatively recently. Countries like Brazil, China and India are

at the take-off stage. Their investments span all sectors and country groups, and involve complex as well as simple industries. Annual FDI outflows from developing countries have grown very faster since the early 1990s. However, even in recent years, only about 15 per cent of the global FDI outflows originate from the developing economies. Negligible until the beginning of the 1990s, outward FDI from developing countries accounted for about 12 per cent of the world total stock in 2005.¹⁴

FDI flows between developing countries seem to be growing faster than from developing countries to developed countries. The growing importance of South-South FDI indicates that the developing countries are more financially integrated with one another than was previously believed. Thus, a typical developing country has access to more sources of investment than before. This is particularly important for small economies, as TNCs (Trans-national Corporations) from the South, because of their comparative advantages, tend to invest in countries with similar or lower levels of development than their home countries.¹⁵

CROSS-BORDER M&As

Cross-border mergers and acquisitions (M&As) have been the key driver of global FDI since the late 1980s. A very significant aspect of the recent FDI surge is that it is triggered, to a large extent, by cross border M&As. For instance, the total value of cross border M&As, with value of over \$1 billion each,

alone accounted for three-fourths of the value of global FDI inflows in 2000. During 2004–06, the share of cross-border M&As in global FDI inflow ranged between 54 and 78 per cent.

Cross-border M&As have been the prime mover of FDI.

Cross-border mergers and acquisitions (M&A) involve FDI in a host country by merging with or acquiring an existing local firm. In the latter case, the acquisition involves an equity stake of 10 per cent or more. The share of FDI, accounted for by cross-border M&As, is difficult to determine, since data sets are not directly comparable. First, the value of cross-border M&As include funds raised in local and international financial markets. Secondly, FDI data are reported on a net basis, using the balance-of-payments concept, while data on cross-border M&A purchases or sales report only the total value of the transaction. Finally, payments for cross-border M&As are not necessarily made in a single year, but may be spread over a longer period.¹⁶

As a UN report points out, one recent feature is that M&As among large or dominant TNCs, resulting in even larger TNCs, seem to impel other major TNCs to move towards restructuring or making similar deals with other TNCs. The pharmaceutical, automobile, telecommunications, and financial industries are typical example of industries in which such concentration can be observed. This trend significantly changes the industry structure. In the automobile industry, for example, the total number of major automobile makers may well decline to 5–10 by 2010, from the 1998 figure of 15. In the pharmaceutical industry, many markets are now controlled by a small number of firms. In both these industries, there have been a string of M&As. Major M&As in the pharmaceuticals include Glaxo-SmithKline Beecham, Pfizer Warner Lambert and Hoechst–Rhone.

The trend towards M&A is also accelerating the sale of non-core operations or affiliates by firms, and the acquisition of similar operations from other firms (of divisions or affiliates, or firms that have similar businesses). This indicates a strategic shift by TNCs to focus on their core activities. Unlike the 1980s, there were fewer deals among unrelated business. In addition to strategic considerations of firms, liberalisation and deregulation are the other main factors behind the dramatic increases in M&As in both developed and developing countries.

Developed countries account for the lion's share of the mega mergers (nearly 90 per cent of the total). However, an upward trend in M&A sales by developing countries, and countries in transition, is noticeable. Among developing countries, majority M&A sales in South, East and South-East Asia have been increasing recently, in particular, after the 1997 financial crisis. Latin America and Central and Eastern Europe also recorded significant increases in M&A sales.

There has been a substantial shift towards services in cross-border M&As, as it is widely used by TNCs for entry into such service industries as banking, telecommunications and water. While in the late 1980s, services accounted for less than 40 per cent of global cross-border M&As, their share rose to more than 60 per cent by the end of the 1990s, and was 58 per cent during 2002–2006.

The liberalisation and deregulation of several vital industries, in many countries across the world, have given an impetus to cross-border M&As in both the developed and the developing countries. Increasing M&As in the service sector in general, and financial industries in particular, reflect the impact of liberalisation. Privatisation has been a very important stimulant to M&As. Banking, finance, insurance, and telecommunication industries have been witnessing a spate of M&As.

FOREIGN INVESTMENT IN INDIA

The flow of direct foreign investment to India has been comparatively limited because of the type of industrial development strategy and the very cautious foreign investment policy followed by the nation.

Direct foreign investment (private) in India was adversely affected by the following factors.

Prior to 1991, government policies severely limited FDI inflow to India.

1. The public sector was assigned a monopoly, or a dominant position, in most important industries, and, therefore, the scope of private investment, both domestic and foreign, was limited.
2. When the public sector enterprises needed foreign technology or investment, there was a marked preference for foreign government sources.
3. Government policy towards foreign capital was very selective. Foreign investment was normally permitted only in high technology industries in priority areas and in export oriented industries.
4. Foreign equity participation was normally subject to a ceiling of 40 per cent, although exceptions were allowed on merit.
5. Payment of dividends abroad, repatriation of capital, etc., as well as inward remittances, were subject to stringent laws like the Foreign Exchange Regulation Act (FERA), 1973. These discouraged foreign investment.
6. Corporate taxation was high, and tax laws and procedures were complex.
7. These factors either limited the scope of, or discouraged foreign investment in India.

Government Policy

The following paragraphs give a very brief account of the Government of India's policy towards foreign capital and technology. First, the salient features of the policy followed till the economic liberalisation was introduced in July, 1991 are given. This is followed by an account of the new policy.

India was following a very restrictive policy towards foreign capital and technology. Foreign collaboration was permitted only in fields of high priority, and in areas where the import of foreign technology was considered necessary. In other areas, import of technology was considered on merits, if substantial exports were guaranteed over a period of 5 to 10 years, and if there were reasonable proposals for such exports. The government had issued lists of industries where:

- (a) (i) Foreign investment may be permitted.
- (ii) Only foreign technical collaboration (but no foreign investment) may be permitted.
- (b) No foreign collaboration (financial or technical) was considered necessary.

The government policy on foreign equity participation was, thus, selective. Such participation had to be justified with regard to factors—such as the nature of technology involved, whether it would promote exports which might not otherwise take place and the alternative terms available for securing the same or similar technological transfers. Foreign equity participation was limited to 40 per cent, although exceptions were allowed on merit. The foreign share capital was to be by way of cash, without being linked to tied imports of machinery and equipment, or to payments for knowhow, trade marks, brand names, etc.

Technical collaborations were to be considered on the basis of annual royalty payments which were linked with the value of actual production. The percentage of royalty was dependent on the nature of

technology. Whenever possible, payment of fixed amount of royalty per unit of production was preferred. Royalty payments were limited to a period of 5 years.

The *Foreign Exchange Regulation Act* (FERA), 1973, served as a tool for implementing the national policy on foreign private investment in India. The FERA empowered the Reserve Bank of India to regulate or exercise direct control over the activities of foreign companies and foreign nationals in India. A foreign company was defined as one (other than a banking company) which was not incorporated in India, or in which non-resident interest was more than 40 per cent, or any branch of such a company.

According to the FERA, non-residents (including Indian citizens), foreign citizens resident in India, and foreign companies required permission of the RBI to accept appointment, as agents or technical management advisers, in India, of any person or company, or permit the use of their trade mark.

The trading, commercial, and industrial activities in India, of persons resident abroad, foreign citizens in India, and foreign companies were regulated by the FERA. They had to obtain permission from the RBI for carrying on, in India, any activity of a trading, commercial, or industrial nature opening branches/offices or other places of business in India, acquiring any business undertaking in India, and purchasing shares of Indian companies.

RBI had given general permission for certain matters. For example, general permission was granted to foreign companies to acquire or hold any immovable property in India which was necessary for, or incidental to, any activity undertaken by them with the permission of the RBI.

The New Policy The Industrial policy statement of July 24, 1991, which observes that while freeing the Indian economy from official controls, opportunities for promoting foreign investment in India should also be fully exploited, has liberalised the Indian policy towards foreign investment and technology.

As pointed out earlier, in the pre-liberalisation era, foreign equity participation was restricted normally to 40 per cent, and foreign investment and technology agreements needed prior approval. As against this, the new policy has allowed majority foreign equity with automatic approval in a large number of industries.

The new policy has also made the import of capital goods automatic, provided the foreign exchange requirement for such import is ensured through foreign equity.

Salient features of initiatives under the new policy include the following:

Foreign investment in most of the industries is now eligible for automatic approval route (i.e., no prior approval of the government/RBI is required).

Until December, 1996, only 36 industries, as mentioned in the Annexure III of the Industrial Policy Statement of July, 1991, were eligible for automatic approval of FDI for upto 51 per cent of the total equity. The automatic route has subsequently been expanded very significantly and, now, there are different categories of industries on the basis of the ceiling of foreign equity participation, viz.,

1. Industries in which FDI does not exceed 26 per cent
2. Industries in which FDI does not exceed 50 per cent
3. Industries in which FDI does not exceed 51 per cent
4. Industries in which FDI does not exceed 74 per cent
5. Industries in which up to 100 per cent foreign equity is permitted

There are two procedural routes for approval of technical collaborations: (1) Automatic approval by RBI is available for any proposal, with lump-sum payment not exceeding US \$2 million and royalty of upto five per cent on domestic sales and eight per cent on exports; (2) In all other cases, the Project

Approval Board (PAB) considers the proposals and makes recommendations to the Industry Ministry regarding approval.

India also joined the Multilateral Investment Agency in 1994.

With increased liberalisation, as at the end of 2007, equity caps on FDI existed only in limited sectors. These are FM radio broadcasting (upto 20 per cent); insurance, defence production, petroleum refining in the PSUs, print and electronic media-covering news and current affairs (upto 26 per cent); air transport services, asset reconstruction companies, cable network, direct-to-home (DTH), hardware for uplinking, HUB, etc. (upto 49 per cent); single brand retailing (upto 51 per cent); atomic minerals, private sector banking, telecom services, establishment and operation of satellites (upto 74 per cent). FDI is prohibited in retail trading (except for single brand product retailing), gambling and betting, lottery and atomic energy. Approval for proposals for induction of equity of more than 24 per cent for manufacture of items reserved for small-scale sector, and the proposals where the foreign investor has an existing joint venture/technical collaboration/ trademark agreement in the same field of activity, and attracts the provisions of Press Note (2005 Series), are not under automatic route.

FII Investments

The Indian stock market was opened up to FII investment in 1992-93 and, since then, there has been a significant increase in portfolio investment by FIIs.

FIIs include hedge funds, insurance companies, pension funds and mutual funds. India is one of the largest recipients of portfolio investments among EMEs.

According to the IMF definition, *portfolio investment* refers to cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.

In India, FIIs cover overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, charitable societies, trustees or power of attorney holders, incorporated or established outside India, proposing to make proprietary investments or investments on behalf of a broad-based fund (*i.e.*, fund having more than 20 investors, with no single investor holding more than 10 per cent of the shares or units of the fund). India is one of the largest recipients of portfolio inflows among emerging market economies (EMEs).

The Regulations on Foreign Institutional Investors, which were notified on November 14, 1995, contain various provisions relating to definition of FIIs, eligibility criteria, investment restrictions, procedures of registration, and general obligations and responsibilities of FIIs.

According to the Regulations, FIIs may invest only in:

- (a) Securities in the primary and secondary markets, including shares, debentures and warrants of companies listed on a recognised stock exchange in India, and
- (b) Units of schemes floated by domestic mutual funds, including Unit Trust of India, whether listed on a recognised stock exchange or not.

Joint ventures between a variety of domestic and foreign securities firms have been approved in the stock broking, merchant banking, assets management and other non-bank financial services sectors. The overall effect of FII investment and financial joint ventures has been the introduction of international practices and systems to the Indian Securities industry.

FIIIs are permitted to invest in a company, upto an aggregate of 24 per cent of equity, which can be increased to 40 per cent, subject to the approval by the Board of Directors and a Special Resolution of the General Body.

In 1996-97, the Government liberalised the FII investment policy, allowing them to invest in unlisted companies, and in corporate and government securities.

FII investment has become an important determinant of the stock market trends in India.

Table 21.2 Foreign Investment Flows to India

(US \$ million)

Item 1	2003-04 2	2004-05 3	2005-06 4	2006-07 ^P 5
A. Direct Investment (I+II+III)	4,322	6,051	7,722	19,631
I. Equity (a+b+c+d+e)	2,229	3,778	5,820	16,065
(a) Government (SIA/FIPB)	928	1,062	1,126	2,156
(b) RBI	534	1,258	2,233	7,151
(c) NRI	—	—	—	—
(d) Acquisition of shares*	735	930	2,181	6,278 *
(e) Equity capital of unincorporated bodies	32	*528	260	480
II. Re-invested earnings	1,460	1,904	1,676	2,936
III. Other capital [#]	633	369	226	530
B. Portfolio Investment (a+b+c)	11,377	9,315	12,492	7,003
(a) GDRs/ADRs	459	613	2,552	3,776
(b) FIIs [@]	10,918	8,686	9,926	3,225
(c) Off-shore funds and others	—	16	14	2
C. Total (A+B)	15,699	15,366	20,214	26,534

P: Provisional

—: Nil/Negligible.

*: Relates to acquisition of shares of Indian companies by non-residents under section 6 of the FEMA, 1999.

±: Include Swap of shares of US \$ 3.1 billion.

#: Data pertain to inter-company debt transactions of FDI entities.

@: Data represent net inflow of funds by FIIs.

Note : 1. Data on reinvested earnings for 2005-06 and 2006-07 are estimates.

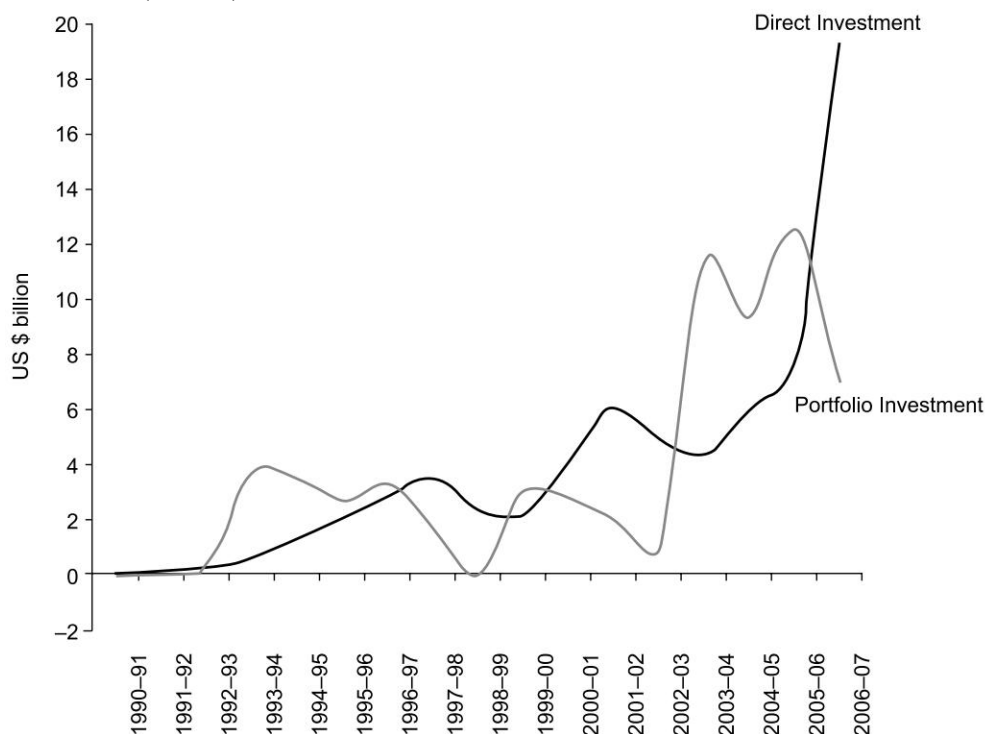
2. Data on foreign investment presented in this table represent inflows into the country and may not tally with the data presented in other tables. They may also differ from data relating to net investment in stock exchanges by FIIs.

Source: RBI, Annual Report, 2006-07.

FDI inflow, as a percentage of gross fixed capital formation, of India increased from about 3 per cent in 2004 to nearly 9 per cent in 2006.

Euro /ADR Issues

As mentioned earlier, since 1992-93, Indian companies, satisfying certain conditions, are allowed to access foreign capital markets by Euro-issues of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs).



Source: RBI, Annual Report, 2006-07.

Fig. 21.3 Foreign Investment into India

“A Depository Receipt is basically a negotiable certificate, denominated in US dollars, that represents a non-US company’s publicly-traded local currency (Indian Rupee) equity shares. DRs are created when the local currency shares of an Indian company (for example) are delivered to the depository’s local custodian bank, against which the Depository Bank (such as the Bank of New York) issues DRs in US dollars. The Depository Receipts may trade freely in the overseas markets like any other dollar denominated security, either on a foreign stock exchange, or in the over-the-counter market, or among a restricted group-such as qualified institutional buyers”¹⁷

The prefix ‘global’ implies that the ADRs are marketed globally rather than in a specific country or market.

Companies with good track record of three years may avail of Euro-issues for approved purposes. According to the revised guidelines issued in November, 1995, companies investing in infrastructure projects—including power, petroleum exploration and refining, telecommunications, ports, roads and airports are exempted from the condition of ‘three-year track record. It is expected to help companies in the infrastructure sectors to access cheap overseas funds.

Earlier, companies had to raise funds through Euro-issues in foreign currency deposits with banks and public financial institutions in India, to be converted into Indian rupees as and when required, for expenditure on approved end uses—upto 25 per cent of the Euro-issue proceedings for meeting corporate restructuring and working capital requirements. Companies are also permitted to raise funds through issue of Foreign Currency Convertible Bonds (FCCBs) and ADRs.

Mergers and Acquisitions

The liberalisation—the privatisation, delicensing, liberalisation of foreign investment policy, scrapping of MRTP restrictions on M&A *et.al.* – and the SEBI Takeover Code have opened the doors for cross-border M&As in India. Foreign MNCs have been using M&A as market entry strategy and competitive strategy. Several MNCs have acquired the partner's stake in their joint ventures, or have hiked their stake in the joint ventures and subsidiaries.

The FDI inflow to India, on account of acquisition of shares, increased from \$11 million in 1995–96 to over \$ 2 billion in 2005-06, and more than 6 billion in 2006-07.

Definitional Change

In the past, items like reinvested earnings used to be excluded from the estimation of FDI in India. However, in June, 2003, the government has aligned the methodology of compilation of FDI with international best practices, and India now follows the internationally accepted definition of FDI. In line with international best practices, FDI includes both equity capital, reinvested earnings (retained earnings of FDI companies), and 'other direct capital' (inter-corporate debt transactions between related entities). Data on equity capital include equity of unincorporated entities (mainly, foreign bank branches in India and Indian bank branches operating abroad), besides equity of incorporated bodies.

An Evaluation of the New Policy

Although, liberalisation has increased the inflow of foreign capital to India, it is much lower than what several other developing countries have been receiving. Until recently, the FDI inflow was nowhere near the annual target of \$10 billion set by the Government long ago. This was because of the poor infrastructure, high cost of several factors, and the unconducive policy and procedural environment in several respects. However, recently, there has been a spurt in the FDI inflow to India, as Table 20.2 shows.

There are many ardent critics of foreign investment and technology. Foreign investment and technology is not without problems. However, the opening up of the economies of a number of nations for foreign companies and the several measures to woo foreign companies are clear indicators of the positive contribution that foreign capital and technology can make.

Important Sectors/Industries of Investment One important criticism of the liberalisation of foreign investment has been that foreign investment mostly takes place in non-priority sectors. However, the lion's share of foreign investment in India, since liberalisation, has gone to priority sectors. Now, several priority sector industries, including the infrastructural sector, which were earlier exclusively reserved for the public sector, have been opened to foreign investment. From January, 1991 to September, 2006, the following sectors/industries accounted for about 60 per cent of the FDI: electrical equipment

FDI in India has been market seeking, efficiency seeking and resource seeking.

(including computer software & electronics); telecommunications; energy; transportation; services sector; chemicals (other than fertilizers); drugs and pharmaceuticals; food processing; and metallurgical industries. The services sector attracted maximum FDI inflows in 2006-07.

Regional Dispersion The inward FDI is highly concentrated in a few areas. As Table 21.3 shows, two regions—Delhi (consisting of Delhi, Parts of UP and Haryana) and Mumbai (consisting of Maharashtra, Dadar and Nagar Haveli, Daman and Diu)—attracted half of the total FDI inflow to India until end of September, 2006. Karnataka, Tamil Nadu, and Pondicherry and Andhra Pradesh received about 17 per cent of the total.

Table 21.3 Region-wise/State-wise Break-up of Cumulative FDI Inflows until September 2006

Rank	RBI's Regional Office	State covered	Amount of FDI Inflows		Share of FDI inflows in rupees (in per cent)
			Rupees in crore	US\$ million	
1	New Delhi	Delhi, Part of UP and Haryana	27,369.16	6,053.2	24.00
2	Mumbai	Maharashtra, Dadra and Nagar Haveli, Daman and Diu	24,545.44	5,399.1	21.52
3	Bangalore	Karnataka	7,809.7	1,727.5	6.85
4	Chennai	Tamil Nadu and Pondicherry	7413.15	1,630.67	8.50
5	Hyderabad	Andhra Pradesh	4,412.80	970.6	3.87

Source: Government of India, *Economic Survey, 2007–08*.

Sources of FDI to India Country-wise, Mauritius and the UK are the major FDI investors in India. Large flows from Mauritius could be attributed to its use by investors in other countries for channeling FDI flows into India. Other important sources of FDI into India are the US, the Netherlands, Singapore, Japan, France, Switzerland, and South Korea.

Attractiveness of India as an Investment Destination Although there is a lot of talk about the procedural simplification, foreign companies still find the procedures very perplexing and unbearably time-consuming. China's FDI procedures are easier, and decisions can be taken rapidly. According to a Government of India publication, China has more flexible labour laws, a better labour climate, and better entry and exit procedures for business. A confidence tracking survey in 2002 indicated that China was the top FDI destination, displacing the United States for the first time in the investment plans of the TNCs surveyed. India came 15th.

However, recently, there has been a surge in FDI flow to India. Among the developing countries, India has emerged as the second most preferred FDI destination after China. India's share in global FDI flows increased from 2.3 per cent in 2005 to 4.5 per cent in 2006.

FOREIGN INVESTMENT BY INDIAN COMPANIES

Until 1991, Indian companies made very little investment abroad. Although the Government of India's policy had been one of encouraging foreign investment by Indian companies, subject to certain conditions,

several factors—like the domestic economic policy and the domestic economic situation—were deterrents to foreign investment by Indian companies.

By restricting the areas of operation and growth, the government policy seriously constrained the potential of Indian companies to make forays into foreign countries through investment. Added to this was the attraction of the protected domestic market, which was, in many cases, a seller's market, and this made the Indian companies ignore the foreign markets.

Indian companies have established subsidiaries and joint ventures in a number of countries in different manufacturing industries and service sectors.

Spurt in FDI Outflow

Foreign investment, both in greenfield enterprises and mergers and acquisitions (M&A), is clearly a part of the globalisation strategy of many Indian companies. Recently, there has been a spurt in FDI by Indian companies.

Recently, there has been a spurt in corporate India's foreign investment. There were several spectacular overseas acquisitions.

Strategic M&As have been finding favour with corporate India too. M&As, by Indian companies, involving foreign firms, fall into three categories, viz., acquisition of foreign firms, acquisition of MNC affiliates in India, and acquisition of foreign brands. Overseas direct investment from India jumped from \$1.5 billion in 2003–04 to \$4.5 billion during 2005–06, and further to \$11.0 billion during 2006–07—reflecting large overseas acquisition deals by Indian corporates—to gain market shares and reap economies of scale, amidst progressive liberalisation of the external payments regime.

FDI Destinations

An UNCTAD report observes that India also stands out among Asian investors, not so much because of its recent and significant increase in outward FDI and its potential to be a large outward investor, but

Table 21.4 India's Direct Investment Abroad

(US \$ million)

Industry I	2003-04 2	2004-05 3	2005-06* 4	2006-07* 5
Manufacturing	893	1,068	2,933	1,913
Financial Services	1	7	159	21
Non-Financial Services	456	283	881	7,382
Trading	113	181	361	613
Others	31	108	195	1079
Total	1,494	1,647	4,529	11,008

* Based on the latest reported revised data. Therefore, these may differ from the data earlier published as part of balance of payments.

Note : Data include equity and loan components.

Source: RBI, Annual Report, 2006-07.

because of the new trend set by some of its information technology (IT) firms. Most Indian outward FDI is in manufacturing (about 55 per cent), but non-financial services also account for a significant share (25 per cent). FDI in IT services, in particular, has begun to grow rapidly. The growing technological capabilities of Indian firms and their rising exports, particularly in IT services and pharmaceuticals, are driving the FDI growth. Access to markets, distribution networks, foreign technology and strategic assets—such as brand names—are the main motivations. Securing natural resources is also becoming an important driver for FDI in the oil and gas industries and mining.¹⁸

The most important destination for Indian FDI has been the United States, accounting for nearly one-fifth of its total outward flows since the mid 1990s to 2003, followed by the Russian Federation (with 18 per cent) due, mainly, to the acquisitions in the oil and gas industries. Overall, however, about half of the total Indian outward FDI has gone to other developing countries.¹⁹

SUMMARY

Foreign capital plays a very important role in the economic development, both of the developed and the developing nations. Encouraged by the favourable business environment fostered by global liberalisation, the international private capital flows have been increasing rapidly, with periodic down-turns. Cross-border M&As have been the major driver of the recent surge in FDI.

Although, foreign capital has many beneficial effects, it also has several limitations, and can have adverse effects too. However, foreign capital now contributes a significant share for domestic investment, employment generation, industrial production, and exports, in a number of economies.

Broadly, there are two types of foreign investment: (1) Foreign direct investment (FDI), where the investor has control over/participation in the management of the firm. (2) Portfolio investment, where the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad. In the case of portfolio investments, the investor uses his capital to get a return on it, but does not have much control over the use of capital. The major portfolio investment in the Indian capital market is by foreign institutional investors (FIIs).

There have been several attempts to provide a theoretical explanation for foreign investment. The earliest theoreticians, who assumed, in the classical tradition, the existence of a perfectly competitive market, considered foreign investments as a form of factor movement, to take advantage of the *Differential Profit*. According to some theories, international investment takes place due to *Market Imperfections*. According to the *Internalisation Theory*, which is an extension of the Market Imperfections theory, foreign investment results from the decision of a firm to internalise superior knowledge (i.e., keeping the knowledge within the firm to maintain the competitive edge). Methods of internalisation include formal ways—like patents and copy rights—and informal ways—like secrecy and family networks. According to the *Appropriability Theory*, a firm should be able to appropriate (to keep for its exclusive use) the benefits resulting from a technology it has generated. MNCs tend to specialise in developing new technologies which are transmitted efficiently through their internal channels. The *Location Specific Advantage Theory* suggests that foreign investment is pulled by certain location specific advantages, labour costs, market attractions, trade barriers, and Government policy. According to the *Eclectic Theory*, foreign investment by MNCs results from three comparative advantages they enjoy, viz, (i) Firm specific advantages which result from the tangible and intangible resources held exclusively, at least temporarily, by the firm, and which provide the firm a comparative advantage over other firms; (ii) Internalisation advantages; (iii) Location specific advantages. According to the theory of *Oligopolistic Reaction and Multinational Enterprise*, when one firm, especially the leader in an oligopolistic industry, enters a market other firms, in the industry follow, as a defensive strategy. i.e., to defend their market share from being taken away by the initial investor, with the advantage of local production. Graham noted that there was a tendency for across investment by

European and American firms in certain oligopolistic industries. When American firms invested in Europe the European firms retaliated by investing in America and vice versa, this was mostly a *retaliatory strategy*. There are also other reasons for investment, like *following the customer* (for example the Japanese automobile ancillary firms to foreign markets) and *seeking knowledge* (for example, Japanese and European investment in Silicon Valley.). Another explanation for international investments is provided by the *International Product Life Cycle Theory*.

Broadly, there are three economic motives of FDI, viz., resources seeking (e.g., exploiting the natural resources of the host country), market seeking (i.e., to exploit the market opportunities of the host countries) and efficiency seeking (like, low cost of production deriving from cheap labour).

The presence of any (or even all) of these determinants alone need not attract FDI. Several other factors—like the political environment, government policies, bureaucratic culture, social climate, infrastructural facilities, etc., are also important determinants of FDI.

Although international capital flows to the developing countries have increased substantially in the last one decade or so, the FDI flow is still predominantly between the developed countries. A small number of countries account for the lion's share of the international capital inflows to the developing world. There has also been a significant increase in FDI flows between the developing economies.

Although India has substantially liberalised its foreign investment policy, the FDI inflows had been much below the targets until recently. Recently, there has been a spurt in India's inward and outward FDI flows.

Review Questions

1. Discuss the role of foreign capital in developing countries.
2. Examine the trends in the international capital flows.
3. Discuss the factors affecting international investment.
4. Give a brief account of the theories of foreign investment.
5. Discuss the trends in foreign private capital flows to India. Evaluate the impact of foreign investment in India.
6. Discuss the important features and trends in cross-border M&As.
7. Write notes on the following:
 - (i) Foreign investment policy of Government of India.
 - (ii) Portfolio investment
 - (iii) Factors affecting international capital investments
 - (iv) FDI
 - (v) International transplant of production facilities
 - (vi) Foreign investment by Indian companies

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Suggested Readings

CHAPTER 22

22 Multinational Corporations

LEARNING OBJECTIVES

- ☐ To get an idea of the growing role of MNCs.
- ☐ To understand the important characteristics of different organisational models of international firms.
- ☐ To know the positive and negative aspects of MNCs.
- ☐ To examine the views regarding code of conduct for MNCs.

BACKGROUND

The multinational corporations (MNC), also known as multinational enterprise, transnational corporation (TNC), global corporation, international corporation (or firm, enterprise or company) etc. has been regarded as “the most important and most visible innovation of the postwar period in the economic field.”¹ The relevance of MNCs to the subject of international trade is expressed in the following statement: “All of the issues we have examined—trade theory, commercial policy, foreign exchange and the balance of payments, and the international economics of development—are profoundly influenced by the MNCs, which actually do on a transnational basis all of the things that concern the international economic and financial position of nation states. They do them quickly, efficiently and this is where many of the MNCs’ costs and benefits to the international economy lie.”²

(The term TNC is increasing in usage in Economic and Business literature. In this book MNC and TNC are used interchangeably.)

The rapidity with which the MNCs are growing is indicated by the fact that while according to the *World Investment Report (WIR) 1997* there were about 45,000 MNCs with some 280,000 affiliates, according to the *WIR 2007*, there were at least 78,000 of them, with over 7.8 lakh foreign affiliates, representing an FDI stock of about \$7 trillion. According to the *WIR 2007* only one-third of these affiliates were in the developed countries. China was host to 2.8 lakh of the affiliates (i.e. more than one-third of the total and nearly 60 per cent of them in developing countries) compared to less than 1800 in India.

MNCs have been fast proliferating the world economy.

The MNCs account for a significant share of the world’s industrial investment, production, employment and trade.

Although the multinational corporation took birth in the early 1860's it was after the Second World War that multinationals have grown rapidly. In the early days, the United States was the home of most of the MNCs. Now there are a large number of European, Japanese and other Asian multinationals.

The universe of TNCs is quite diverse, and includes a growing number of small and medium-sized enterprises, like TNCs from countries in Central and Eastern Europe that have only recently begun to engage in international production, and large TNCs based in the developing world. Although less transnational overall than the world's top 100 TNCs, some of the developing-country TNCs are quite sizeable.

Almost 90 per cent of the top 100 TNCs are headquartered in the *triad* (the EU, Japan, the United States). The EU leads with more than half of the top 100. The United States accounts for slightly more than a quarter, while Japan's share has decreased over the years to fewer than ten. The number of TNCs

In 2007, there were six *Fortune 500* Indian companies: Indian Oil, Reliance Industries, Bharat Petroleum, Hindustan Petroleum, ONGC and SBI with the following ranks: 13 to 269, 325, 336, 369 and 495.

from non-Triad countries has risen to more than ten over the years. Altogether, the top 100 TNCs now come from 19 countries. Although non-Triad TNCs, including a number from smaller economies, account for a relatively small proportion of the top 100 TNCs, their average *Transnationality Index* is higher.

MNCs of the US are more focused, i.e. they confine their business to one industry or product category. In fact, several American MNCs which attempted diversification, mostly by the acquisitions route, reverted to focus, after bitter experiences with the diversification. Compared with the US MNCs, most European companies have a much broader product line. Japanese companies, generally, have product lines that are much too broad. Of the top ten corporations in the US, only one (General Electric) is a classic conglomerate, while in Japan eight are conglomerates and only two are not (Toyota Motor and Nippon Telegraph & Telephone). The MNCs of developing countries span a wide range of activities.

DEFINITION AND MEANING

As the concept of multinationality has several dimensions, there is no single criterion that can define the multinational and, therefore, there is no single universally agreed definition of the term multinational corporation.

Definitional Dimensions Some of the criteria often used to define the MNC are given below.

Definition by Size The term MNC implies massive proportions. But massive also has a number of dimensions. Such factors as market value, sales, profits, and return on equity, when used to identify the largest multinationals, will yield varying results.³

It should, however, be noted that the extent of internationalization need not depend on the size. Many small firms are, indeed, much more global than larger ones. However, firms below certain size are normally excluded from the definition of multinational.

Definition by Structure According to Aharoni, an MNC has at least three significant dimensions: performance, and behavioral. Structural requirements for definition as an MNC include the number of countries in which the firm does business and the citizenship of corporate owners and top managers.⁴

Definition by Performance Definition by performance depends on such characteristics as earnings, sales, and assets. These performance characteristics indicate the extent of the commitment of corporate resources to foreign operations and the amount of rewards from that commitment.⁵

Definition by Behavior This is a somewhat abstract measure of multinationalisation and it refers mostly to the behavioral characteristics of top management. Globalisation, basically, is a mind-set that reflects the global orientation of the company.

In conclusion, as Onkvisit and Shaw point out, being international or multinational is a matter of degree. Furthermore, internationalisation is not a one-dimension concept, and it may not be reliable to employ a single-variable measure (e.g., foreign sales as a proportion of total sales) to characterize the internationalization concept.⁶ Sullivan has proposed⁷ utilizing the structural, performance, and attitudinal dimensions to construct an aggregate index of the degree of internationalisation. This index comprises five variables: The ratio of foreign sales to total sales; the ratio of foreign assets to total assets; proportion of overseas subsidiaries to total subsidiaries; top managers' international experience; and, psychic dispersion of international operations.

Some Popular Definitions According to an ILO report, "the essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country (referred to for convenience as the "home country") while the enterprise carries out operations in a number of other countries as well ("host countries").⁸ Obviously, what is meant is "a corporation that controls production facilities in more than one country, such facilities having been acquired through the process of foreign direct investment. Firms that participate in international business, however large they may be, solely by exporting or by licensing technology are not multinational enterprises."⁹

The ratio of foreign investment, production, sales and employment and the number of countries of business are important criteria to regard a firm as MNC.

Among the various other benchmarks sometimes used to define 'multinationality' are that the company in question must:¹⁰

- Produce (rather than just distribute) abroad as well as in the headquarters country
- Operate in a certain minimum number of nations (six for example)
- Derive some minimum percentage of its income from foreign operations (e.g. 25 per cent)
- Have a certain minimum ratio of foreign to total number of employees, or of foreign total value of assets
- Possess a management team with geocentric orientations
- Directly control foreign investments (as opposed simply to holding shares in foreign companies).

The definitions of the terms transnational corporation (used to mean the same thing as MNC and similar terms) foreign affiliate, subsidiary and branch given in the UN's *World Investment Report* are as follows.

Transnational Corporations *Transnational Corporations* are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A *parent enterprise* is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as a threshold for the control of assets (In some countries such as Germany and United Kingdom, the threshold is a stake of 20 per cent or more.)

Foreign Affiliate It is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise or its equivalent for an unincorporated enterprise). In the *World Investment Report*, subsidiary enterprise, associate enterprise and branches are all referred to as *foreign affiliates*.

Subsidiary It is an incorporated enterprise in the host country in which another entity directly owns more than a half of the shareholders voting power and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body.

Associate It is an incorporated enterprise in the host country in which an investor owns a total of at least 10 per cent, but not more than a half, of the shareholders' voting power.

Branch It is a wholly or jointly owned unincorporated enterprise in the host country which is one of the following: (i) a permanent establishment or office of the foreign investor; (ii) an unincorporated partnership or joint venture between the foreign direct investor and one or more third parties; (iii) land, structures (except structures owned by government entities), and/or immovable equipment and objects directly owned by a foreign resident; (iv) mobile equipment (such as ships, aircraft, gas or oil-drilling rigs) operating within a country other than that of the foreign investor for at least one year.

As the *World Investment Report 1999* observes, transnational corporations (TNCs) establish, under the common governance of their headquarters, international production systems in which factors of production move, to a greater or lesser extent, among units located in different countries. These systems increasingly cover a variety of activities, ranging from research and development (R&D) to manufacturing to service functions such as accounting, advertising, marketing and training, dispersed over host-country locations and integrated to produce final goods or services. They are also increasingly being established, especially in developed countries, through mergers between existing firms from different countries or the acquisition of existing enterprises in countries by firms from others. Once internationally dispersed production units under common governance are established, mobile and location bound factors of production to which a TNC has access in home and host countries (and sometimes even third countries) are combined in each unit in ways and for production that contribute the most to the firm's economic and strategic objectives. From the perspective of factor use—as distinct from that of location as host or home country for enterprises engaged in international production—all of the production that takes place in these TNC production systems (in parent firms or home-country units as well as foreign affiliates or host-country units) constitutes international production.

ORGANISATIONAL MODELS

As stated earlier, terms such as international corporation, multinational corporation, transnational corporation and global corporation are often used as synonyms. However, several multinationals have evolved into certain advanced stage of transnational organisation and operations that it becomes necessary to draw some distinction between these terms.

However, the interpretations of these terms given by different authors are not same. Sometimes the differences arise from the differences in the context.

With reference to the configuration of resources and responsibilities, parent subsidiary relationship, and the mentality towards the overseas operations, the salient characteristics of these corporations pointed out by Bartlett and Ghoshal are highlighted below.¹¹ Some of these descriptions are at variance with

Organisational models are distinguished on the basis of configuration of resources, extent of centralisation/decentralisation, attitude towards foreign business etc.

those given by some other authors. The following account, however, is very useful in understanding the distinctive features of these different types of organisations. In other sections of this book these terms are used interchangeably.

Multinational Corporation

This was the type of the corporation popular when many European companies were internationalised during the pre-war (1920s and 1930s), when the trade barriers were very high. According to Bartlett and Ghoshal, the multinational organisation is defined by the following characteristics: a decentralised federation of assets and responsibilities, a management process defined by simple financial control systems overlaid on informal personal coordination, and a dominant strategic mentality that viewed the company's worldwide operations as a portfolio of national businesses. In a multinational organisation, the decisions, obviously, are decentralised.

International Organisation Model

This organisational structure was predominant in the case of the American companies which were internationalised in the early postwar years.

In the international organisation, the structural configuration of which is described as coordinated federation, many assets, resources, responsibilities and decisions are decentralised but controlled from the headquarters. The overseas operations are regarded essentially as appendages to a central domestic corporation. In this model, the headquarters transfers knowledge and expertise to overseas environments that were less advanced in technology or market development. While local subsidiaries are often free to adapt the new products or strategies, their dependence on the parent company for new products, processes, or ideas dictated a great deal more coordination and control by the headquarters than in the classical multinational organisation.

Global Organisation Model

The Japanese companies which were internationalised since the mid 1960s through the 1970s and 1980s, adopted a global organisational model. The global configuration is based on centralisation of assets, resources and responsibilities; overseas operations are used to reach foreign markets in order to build global scale. The role of local subsidiaries is to assemble and sell products and to implement plans and policies developed at headquarters. Compared with subsidiaries in multinational or international organisations, they have much less freedom to create new products or strategies or even to modify existing ones.

In the global model, management treats overseas operations as delivery pipe lines to a unified global market.

The rapid decline in tariffs, coupled with dramatic improvements in transportation and communication of this period made a truly export-based strategy feasible.

The global organisation model, where authority and decision making are centralised and subsidiaries are used basically as implementing agencies, is described as a centralised hub.

Transnational

The transnational organisation and model seeks to eliminate some of the drawbacks of the other models. It endeavours to achieve global competitiveness through, inter alia, multinational flexibility and worldwide learning.

In a transnational, the specialised resources and capabilities are dispersed among the various operating units globally. These units are interdependent and integrated and have large flows of components, products, resources, people and information among them. An important feature of the transnational, therefore, is the complex process of coordination and cooperation in an environment of decision making.

Table 22.1 Characteristics of Different Organisational Models*

Organisational characteristics	Multinational	Global	International	Transnational
Configuration of assets and capabilities	Decentralised and nationally self-sufficient	Centralised and globally scaled	Sources of core competencies centralised, others decentralised	Dispersed, interdependent and specialised
Roles of overseas operations	Sensing and exploiting local opportunities	Implementing parent company strategies	Adapting and leveraging parent company strategies	Differentiated contributions by national units to integrated worldwide operations
Development and diffusion of knowledge	Knowledge developed and retained within each unit	Knowledge developed and retained at the centre	Knowledge developed at the centre and transferred to overseas units	Knowledge developed jointly and shared worldwide

* Reproduced from Christopher A Bartlett and Sumantra Ghoshal, *Managing Across Borders*, Boston, Harvard Business School Press, 1998.

IMPORTANCE AND DOMINANCE OF MNCs

Economic Clout International production by Transnational Corporations (TNCs), now numbering some 78,000 parent firms with over 7.8 lakh foreign affiliates and a plethora of inter-firm arrangements, spans virtually all countries and economic activities, rendering it a formidable force in today's world economy.

The economic clout of the MNCs is indicated by the fact that the GDP of most of the countries is smaller than the value of the annual sales turnover of the multinational giants. The value of the annual sales of Wal-Mart Stores, the largest TNC, in 2007 was \$351 billion. Only a very small number of developing countries like China, Mexico, Brazil, Russia, Republic of Korea and India, had GNI which was higher than this figure. There were also several developed countries whose value of GNI was less than this.

The GNI of most nations is lower than the annual turnover of the giant MNCs.

MNCs and International Production The global liberalisation has paved the way for fast expansion and growth of the MNCs.

The following paragraphs excerpted from the *World Investment Reports 2000* and *2002* provide some indications of the economic dominance of the multinationals.

Evidence on the expansion of international production over the past two decades abounds. Gross product associated with international production and foreign affiliate sales worldwide, two measures of international production, increased faster than global GDP and global exports, respectively. Sales of foreign affiliates are now nearly-twice as high as global exports, and the gross product associated with international production is about one-tenth of global GDP, compared with one-twentieth in 1982.

The output value of foreign affiliates of MNCs as a percentage of global GDP doubled in the last two decades.

Employment In 2006, foreign affiliates of MNCs employed over 73 million people, compared to 25 million in 1990. The greater part of the increase of employment in foreign affiliates in recent years has taken place in developing countries. A considerable share of the increase was concentrated in East and South East Asia, in particular in China, and in export processing zones in those regions and elsewhere. In addition, the indirect employment effect of the TNC activities are at least equal to the direct effects and probably much larger. The largest employment by MNCs affiliates is in China—24 million.

MNCs and International Trade Peter Drucker remarks that multinationalism and expanding world trade are two sides of the same coin. He points out that the period of most rapid growth of multinationals—the fifties and sixties—was the period of most rapid growth of multinational trade. Indeed, during this period the world trading economy grew faster—at an annual rate of 15 per cent or so in most years—than even the fastest growing domestic economy, that of Japan.¹²

Foreign affiliates of MNCs account for about one-third of the world exports. More importantly, the sale of foreign subsidiaries in the host countries in which they are located are three to four times as large as total world exports.¹³

There was a very significant increase in the export intensity (i.e. the percentage of exports to total sales) of the foreign affiliates of many MNCs. The export intensity of foreign affiliates of US MNCs, for example, increased from less than 20 per cent in the mid sixties to over 40 per cent in the early 1990s for all economies; it doubled from about 20 to 40 per cent in the case of developed economies; jumped from about six to 22 per cent in the case of the Latin American affiliates and from 23 to 64 per cent for developing Asia. The average export intensity of all the affiliates has, however, remained between 21–24 per cent for a long time. In the case of India, however, it has been very low. More than 50 per cent of the total exports of China is done by MNC affiliates.

Apart from trade in commodities, other transactions also take place extensively between the different parts of these enterprises—for example the granting of loans, the licensing of technology and the provision of services. In all such transactions, transfer prices may be settled, which are different from the price which would have been the case between independent parties operating at arm's length. Such differences may reflect the legitimate concerns of the companies and are also capable of being used in order to shift profits from high to low tax countries or to get around exchange or price controls or customs duties. As the Brandt Commission observes, the ability of multinationals to manipulate financial flows by the use of artificial transfer prices is bound to be a matter of concern to Governments. The monitoring and control of transfer prices involves inter-Governmental cooperation and measures to secure due disclosure of relevant information by companies. This is necessary to make effective tax laws covering transfer prices which exist in many countries. Intra-firm trade also opens up the possibility for corporations to impose restrictive business practices within their own organisation; they can limit the exports of their affiliates; allocate their markets between nations or restrict the use of their technology or that developed

by their affiliates. Such practices, although best pursued in the best business interests of the companies, may conflict with the developmental objectives and national interests of host countries.¹⁴

Benefits of MNCs

As the preface to the ILO report on *Multinational Enterprises and Social Policy* observes, “for some, the multinational companies are an invaluable dynamic force and instrument for wider distribution of capital, technology and employment; for others, they are monsters which our present institutions, national or international, cannot adequately control, a law to themselves with no reasonable concept, the public interest or social policy can accept.”¹⁵

MNCs, it is claimed, help the host countries in the following ways:

1. MNCs help increase the investment level and thereby the income and employment in host country.
2. The transnational corporations have become vehicles for the transfer of technology, especially to the developing countries.
3. They also kindle a managerial revolution in the host countries through professional management and the employment of highly sophisticated management techniques.
4. The MNCs enable the host countries to increase their exports and decrease their import requirements.
5. They work to equalise the cost of factors of production around the world.
6. MNCs provide an efficient means of integrating national economies.
7. The enormous resources of the multinational enterprises enable them to have very efficient research and development systems. Thus, they make a commendable contribution to inventions and innovations.
8. MNCs also stimulate domestic enterprise because to support their own operations, the MNCs may encourage and assist domestic suppliers.
9. MNCs help increase competition and break domestic monopolies.

MNCs can help accelerate economic growth in different ways.

Problems

MNCs have, however, been subject to a number of criticisms, like those mentioned below.

1. As Leonard Gomes points out, the MNC's technology is designed for world wide profit maximisation, not the development needs of poor countries, in particular employment needs and relative factor scarcities in these countries. In general, it is asserted, the imported technologies are not adapted to (a) the consumption needs, (b) the size of domestic markets (c) resource availabilities, and (d) stage of development of many of the LDCs.¹⁶
2. Through their power and flexibility, MNCs can evade or undermine national economic autonomy and control, and their activities may be inimical to the national interests of particular countries.
3. MNCs may destroy competition and acquire monopoly powers.
4. The tremendous power of the global corporations poses the risk that they may threaten the sovereignty of the nations in which they do business. On Political involvement, MNCs have been accused on occasions, of:¹⁷ supporting repressive regimes; paying bribes to secure political influence; not respecting human rights; paying protection money to terrorist groups; and, destabilizing national governments of which they do not approve.

MNCs may impair national interests.

5. MNCs retard growth of employment in the home country.
6. The transnational corporations cause fast depletion of some of the non-renewable natural resources in the host country. They have also been accused of the following environmental problems:¹⁸ polluting the environment; not paying compensation for the environmental damages; causing harmful changes in the local living conditions; and, paying little regard to the risks of accidents causing major environmental catastrophes.
7. The *transfer pricing* enables MNCs to avoid taxes by manipulating prices on intra-company transactions.
8. The MNCs have been criticised for their business strategies and practices in the host countries. They undermine local cultures and traditions, change the consumption habits for their benefit against the long term interests of the local community, promote conspicuous consumption, dump harmful products in the developing countries etc.

Perspective

Future holds out an enormous scope for the growth of MNCs. The changes in the economic environment in a large number of countries indicate this. For instance, the number of bilateral treaties that promote and/or protect FDI has increased markedly in recent times.

The universal economic liberation increases the scope of MNCs.

A United Nation's report described several developments that points to a rapidly changing context for economic growth, along with a growing role for transnational corporations in that process. These include:¹⁹

1. Increasing emphasis on market forces and a growing role for the private sector in nearly all developing countries.
2. Rapidly changing technologies that are transforming the nature of organisation and location of international production.
3. The globalisation of firms and industries.
4. The rise of services to constitute the largest single sector in the World economy.
5. Regional economic integration, which involve both the World's largest economies as well as selected developing countries.

CODE OF CONDUCT

It is widely felt that there must be a code of conduct to guide and regulate the MNCs.

The proliferation of MNCs make norms governing their performance all the more important.

Brandt Commission According to the Brandt Commission, the principal elements of an international regime for investment should include:

1. A frame work to allow developing countries as well as transnational corporations to benefit from direct investments on terms contractually agreed upon. Home countries should not restrict investment or the transfer of technology abroad, and should desist from other restrictive practices such as export controls or market, not restrict current transfers such as profits, royalties and dividends, or the repatriation of capital, so long as they are on terms which were agreed when the investment was originally approved or subsequently negotiated.

2. Legislation promoted and coordinated in home and host countries, to regulate the activities of transnational corporations in such matters as ethical behaviour, disclosure of information, restrictive business practices, cartels, anti-competitive practices and labour standards. International codes and guidelines are a useful step in that direction.
3. Cooperation by Governments in their tax policies to monitor transfer pricing and to eliminate the resort to tax havens.
4. Fiscal and other incentives and policies towards foreign investment to be harmonized among host developing countries, particularly at regional and sub-regional levels, to avoid the undermining of the tax base and competitive positions of host countries.
5. An international procedure for discussions and consultations on measures affecting direct investment and the activities of transnational corporations.

Recommendations of the UN The Code of Conduct for MNCs, drawn up by the Commission on Transnational Corporations, set up by the UN's Economic and Social Council, required MNCs, *inter alia*, to:

1. Respect the national sovereignty of host countries and observe their domestic laws, regulations and administrative practices.
2. Adhere to host nations' economic goals, development objectives and sociocultural values.
3. Respect human rights.
4. Not interfere in internal political affairs or in intergovernmental relations.
5. Not engage in corrupt practices.
6. Apply good practice in relation to payment of taxes, abstention from involvement in anti-competitive practices, consumer and environmental protection and the treatment of employees.
7. Disclose relevant information to host country governments.

OECD Code of Practice for MNCs According to the 1976 declaration of the OECD Code of Practice on MNC operations, MNCs should contribute positively to economic and social progress within host nations. Its main provisions were that MNCs should:

1. Contribute to host countries' science and technology objectives by permitting the rapid diffusion of technologies.
2. Not behave in manners likely to restrict competition by abusing dominant positions or market power.
3. Provide full information for tax purposes.
4. Consult with employee representatives regarding major changes in operations, avoid unfair discrimination in employment and provide reasonable working conditions.
5. Consider the host nation's balance of payments objectives when taking decisions.
6. Regularly make public significant information on financial and operational matters, host countries themselves should, the Code insists, possess the absolute right to nationalise foreign-owned assets within their frontiers, but must pay proper compensation.

It is very interesting to note that the demands by developing countries that the Code become legally binding were rejected by the UN General Assembly, at the behest of economically advanced countries.

MULTINATIONALS IN INDIA

Comparatively very little foreign investment had taken place in India due to several reasons, as stated in the previous chapter (like the dominant role assigned to the public sector in the industrial policy and the restrictive Government policy towards foreign investment). Some multinationals, Coca Cola and IBM, even left India in the late 1970s as the Government conditions were unacceptable to them.

A common criticism against the MNCs is that they tend to invest in the low priority and high profit sectors in the developing countries, ignoring the national priorities. However, in India the Government policy confined the foreign investment to the priority areas like high technology and heavy investment sectors of national importance and export sectors. Firms which had been established in non-priority areas prior to the implementation of this policy have, however, been allowed to continue in those sectors.

The controversial Foreign Exchange Regulation Act (FERA), 1973, required the foreign companies in India to dilute the foreign equity holding to 40 per cent (exceptions were allowed in certain cases like high technology and export oriented sectors).

An often heard criticism is that multinationals drain the foreign exchange resources of the developing countries. However, Aiyar's study indicates that, contrary to the popular belief, foreign companies are less of a drain on foreign exchange reserves than Indian ones. He also points out that the public sector has a higher propensity to use foreign exchange on a net basis than multinationals. In fact, the foreign exchange outgo of the public sector alone was greater than the entire trade deficit of the country.²⁰

It is not a right approach to estimate the net impact of multinationals on the foreign exchange reserves by taking the net foreign exchange outflow or inflow. If a multinational is operating in an import substitution industry, the net effect on the foreign exchange reserves could be favourable even if there is a net foreign exchange outflow by the company.

Multinationals in several developing countries make substantial contribution to export earnings. The performance in the case of India has, however, been very dismal. This is attributed mostly to the Government policy. "We have consistently followed policies in India that discriminate against export production and in favour of production for the local market. In this milieu it has not made sense for the Indian private sector or public sector to focus on exports. Naturally, it has not made sense for foreign companies either. In 1947, foreign companies did not have an anti-export image. Indeed, the most prominent ones were engaged in the export of tea and jute manufactures. Only after Jawaharlal Nehru decided to emphasise import-substitution at the expense of exports did foreign (and Indian) companies shun exports."²¹

Although export promotion has been pursued since the Third Plan, the highly protected domestic market and the unrealistic exchange rate made the domestic market much more attractive than exports. However, since the mid 1980s with the economic liberalisation that increased domestic competition and the steady depreciation of the rupee, exports began to become attractive and several foreign companies and companies with foreign participation, as well as Indian companies, have become serious about exports. This was reflected in the acceleration of the export growth.

The economic liberalisation has enormously increased the scope of MNCs in India.

The new policy is expected to give a considerable impetus for MNC's investment in India. However, foreign companies find the policy and procedural environment in India still perplexing and disgusting.

Since the economic liberalisation ushered in 1991, many multinationals in different lines of business have entered the Indian market. A number of multinational which were in India prior to this have expanded their business. Recently, FDI in India has surged.

SUMMARY

The multinational corporations (MNC), also known as multinational enterprise, transnational corporation (TNC), global corporation, international corporation (or firm, enterprise or company) etc., do on a transnational basis all of the things that concern the international economic and financial position of national states. These corporations, with their large number of foreign affiliates and a plethora of inter-firm arrangements, span virtually all types of countries and economic activities, rendering it a formidable force in today's world economy.

Transnational corporations have been spreading and growing across the globe very rapidly. Although the MNCs from the developed countries still dominate the scene, more and more MNCs are emerging from the developing countries.

There is no universally accepted definition of the term multinational corporation. As an ILO report observes, "the essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country (referred to for convenience as the "home country") while the enterprise carries out operations in a number of other countries as well "host countries"). Obviously, what is meant is "a corporation that controls production facilities in more than one country, such facilities having been acquired through the process of foreign direct investment. Firms that participate in international business, however large they may be, solely by exporting or by licensing technology are not multinational enterprises."

The world's top 100 (non-financial) TNCs, based almost exclusively in developed countries, are the principal drivers of international production. The universe of TNCs, however, is quite diverse, and includes a growing number of small and medium-sized enterprises.

As a result of the liberalizations, MNCs have been spreading fast in the developing countries. Most of the foreign affiliates of the MNCs are in the developing countries, China hosting the largest number.

The warm welcome accorded to the MNCs by national governments of all political shades is an indication of their role in the economic development. They help the host countries to increase domestic investment and employment generation, boost exports, transfer technology and accelerate economic growth. While the host countries can reap several benefits from the MNCs, these giants pose many problems particularly to the developing countries. They may destroy domestic firms through unfair competition, acquire market dominance through acquisition of domestic firms or other means. The MNC's technology which is designed for world wide profit maximization may not be adapted to the consumption needs, the size of domestic markets, resource availabilities, and the stage of development of many of the developing countries. They may cause fast depletion of some of the non-renewable natural resources in the host country. The transfer pricing may be so designed as to avoid or minimise taxes. All these emphasise the need for a code of conduct for the MNCs and an effective competition policy and law in the host countries. Several MNCs are also accused of political maneuvering and neglect of human rights. A code of contact for the MNCs is therefore essential.

The liberalization has paved the way for easy entry and growth of MNCs in India. At the same time a number of Indian firms have been becoming multinational.

**Review
Questions**

1. Examine the pros and cons of the growth of the multinational corporation.
2. Discuss the role of MNCs in the global economic integration.
3. Discuss the role of MNCs in developing countries.
4. Analyse the reasons for the growing dominance of the MNCs.
5. Discuss the role of MNCs in India.
6. Explain the organisational characteristics of multinational, global, international and transnational corporations.

7. Write notes on the following.
 - (a) Meaning of multinational corporation
 - (b) MNCs and international trade
 - (c) Investment motives and patterns of MNCs
 - (d) Code of conduct for MNCs.

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Appendix 22.1

TRANSNATIONALITY INDEX AND NETWORK SPREAD INDEX

To measure the extent of transnationalisation of firms, UNCTAD's *World Investment Report* has been constructing a *transnationality index* which is the average of three ratios:

- Foreign assets/total assets
- Foreign sales/total sales
- Foreign employment/total employment

The transnationality index, thus, captures the foreign dimension of the overall activities of a firm.

Between 1990 and 1999, the average transnationality index of the world's top 100 TNCs rose from 51 per cent in 1990 to 55 per cent in 1997 but declined to 53 per cent in 1999 because of the gradual emergence in the listings of top 100 TNCs of large transnational utility, retailing and telecommunication companies with their traditionally large portfolio of domestic assets. If these three industries were excluded, the index in 1999 would stand at 56 per cent. Given the increasing liberal policy environment in which such companies operate, their transnationality can be expected to increase over the next decade. As can be expected, the transnationality index is often high for firms from countries with small domestic markets because firms from such countries have to go abroad if they want to overcome the constraints of their domestic market size, and to reach the economies of scale needed to make optimal use of their ownership advantages and to stay competitive. Transnationality by industry varies to a great extent.

World Investment Report since 1998 has also been using a complementary concept of measuring the transnationalisation of companies, viz., the Network Spread Index (NSI). This index focuses on the extent to which companies locate their activities in foreign countries, and thus the extent to which they follow strategies of cross-border geographical diversification. The index is calculated as a ratio of the number of foreign countries in which a TNC locates its activities as a percentage of the number of foreign countries in which it could, potentially, have located. The latter is taken as the number of countries that have inward stocks of FDI (minus 1, excluding the home country of the TNC) in the particular year to which the calculations refer.

TNCs from small home countries are generally spread over more countries than TNCs from large home countries. TNCs from industries with consumer orientation have a higher spread than TNCs from other industries. The country-specific analysis of the top 100 TNCs shows TNCs from countries with a long history of FDI (Switzerland, Netherlands, United Kingdom and France) exhibiting an above average NSI. TNCs from the two largest economies in terms of GNP (United States and Japan) have a lower than average NSI, most likely because the size of their domestic economy allows their TNCs to concentrate more on home markets in comparison with TNCs of similar size from smaller home countries.

The UNCTAD has also developed an index to compare the *transnationality of countries* in which TNCs operate. It attempts to measure the transnationalisation of economic activity of host countries in real terms, taking into consideration both the production potential created through inward FDI and the results of this investment. The transnationality index for a country is based on two FDI variables and two variables related to foreign firms' operations in a host country:

1. FDI inflows as a percentage of gross fixed capital formation
2. FDI inward stock as a percentage of GDP
3. Value added by foreign affiliates as a percentage of GDP
4. Employment by foreign affiliates as a percentage of total employment

The simple average of these four shares results in the Transnationality index of a host country. The first two shares indicate the importance of inward FDI flows and stocks in an economy. A larger capital base, corresponding to larger FDI indicates the potential to produce more. The last two shares capture the significance of foreign affiliates. The two sets of variables are correlated: high FDI shares are normally reflected in more activities by foreign affiliates in a country. The world's most transnational host economy is Hong Kong (China), followed by Belgium and Luxembourg, Trinidad and Tobago and Nigeria. Regionally most host countries with a high Transnationality Index are in Latin America. In general, the average index, by group of economies, is higher for developing (19.5 in 1999) than for developed countries (18.0) and for Central and Eastern Europe (CEE) (11.2). The low index number for CEE reflects the fact that this region opened its markets to foreign investors only in the 1990s.

CHAPTER 23

23

Transfer of Technology

LEARNING OBJECTIVES

- ☐ To understand the meaning and scope of transfer of technology.
- ☐ To get an idea of the types and levels of technology transfer.
- ☐ To know the channels of technology transfer.
- ☐ To examine the issues in technology transfer.

MEANING AND SCOPE

Technology is an important ingredient for development and an important aspect of the international economic gap is the technological gap. While the developing countries are generally characterised by technological backwardness and a slow pace of technological progress, the advanced countries boast of a rich stock of technology and fast technological progress. Transfer of technology from the developed to the developing countries, therefore, is a necessary measure to speed up the pace of the economic development and modernisation process in the LDCs. Indeed, “transfer of technology to developing countries is a major area of concern in the discussions on the establishment of a NIEO. It is given so much importance that there is a talk of building a New International Technological Order (NITO) as an integral part of the NIEO.”¹

One of the important ways by which MNCs can contribute to the development of the host countries is by transfer of technology to them. A general complaint, however, is that the required technology transfer to the developing countries is not taking place. When the technology transfer by the MNCs is *internalised* it does not help the domestic firms much.

Technology transfer is the process by which commercial technology is disseminated. This will take the form of a technology transfer transaction, which may or may not be a legally binding contract,² but which will involve the communication, by the transferor, of the relevant knowledge to the recipient.

Technology transfer is an important factor that can help accelerate economic development.

Types of TT

Among the types of transfer transactions that may be used, the Draft TOT Code by UNCTAD has listed the following.³

1. The assignment, sale and licensing of all forms of industrial property, except for trade marks, service marks and trade names when they are not part of transfer of technology transactions.

2. The provision of know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, guides, formulae, basic or detailed engineering designs, specifications and equipment for training, services involving technical advisory and managerial personnel, and personnel training.
3. The provision of technological knowledge necessary for the installation, operation and functioning of plant and equipment, and turnkey projects.
4. The provision of technological knowledge necessary to acquire, install and use machinery, equipment, intermediate goods and/or raw materials which have been acquired by purchase, lease or other means.
5. The provision of technological contents of industrial and technical cooperation arrangements.

The list excludes non-commercial technology transfers, such as those found in international cooperation agreements between developed and developing states. Such agreements may relate to infrastructure or agricultural development, or to international cooperation in the fields of research, education, employment or transport.

Forms of Technology Transfer

Broadly, there are two forms of TT, viz., internalized and externalised forms of technology transfer. Internalised forms refer to investment associated TT, where control resides with the technology transferer. The transferer, normally, holding the majority or full equity ownership. Externalised forms refer to all other forms, such as joint ventures with local control, licensing strategic alliances and international subcontracting.

The distinguishing feature between these two modalities of resource transfer is that in internalised TT, the transferor has a significant and continuing financial stake in the success of the affiliate, allows it to use its brand names and to have access to its global technology and marketing networks, exercises control over the affiliate's investment, technology and sales decisions, and sees the affiliate as an integral part of its global strategy. Externalised forms lack one or all of these features, with repercussions on the TT process. Over time, the array of TT arrangements has diversified and particular modes have also become more flexible. Thus, the dividing lines between externalised and internalised modes are becoming less easy to draw.⁴

LEVELS OF TT

A simplified treatment of the subject would suggest four levels of TT.⁵

Operational Level At the bottom level are the simplest ones, needed for operating a given plant: these involve basic manufacturing skills, as well as some more demanding troubleshooting, quality control, maintenance and procurement skills.

Duplicative Level At the intermediate level are duplicative skills, which include the investment capabilities needed to expand capacity and to purchase and integrate foreign technologies.

Adaptive Level At this technological self-reliance level, imported technologies are adapted and improved, and design skills for more complex engineering learned.

Innovative Level This level is characterised by innovative skills, based on formal R&D, that are needed to keep pace with technological frontiers or to generate new technologies.

CHANNELS OF TECHNOLOGY FLOW

The most important channels for the flow of technology are Foreign Investment and Technology Licence Agreements and Joint Ventures.

Foreign Investment Traditionally, the flow of technology to developing countries has been an integral part of direct foreign investment. Multinational corporations and other firms have resorted to foreign direct investment for a variety of reasons like protection and development of foreign markets, utilisation of local resources (in the host country) including cheap labour, overcoming or lessening of the impact of tariff restrictions and tax laws. The flow of sophisticated technology, in particular, has thus been associated with direct investment.

Technology Licence Agreements and Joint Ventures Technology transfer has been taking place on a significant scale through licensing agreements and joint ventures. There has been a fairly rapid growth of joint ventures, encouraged by government restrictions on foreign investment and foreign trade or the perceived advantages of such ventures. When foreign capital participation in joint ventures is below 50 per cent, technological agreements assume considerable significance.

METHODS OF TECHNOLOGY TRANSFER

Transfer of technology takes a variety of forms depending on the type, nature and extent of technological assistance required. The following are the important methods of technology transfer:

Training or Employment of Technical Expert Fairly simple and unpatented manufacturing techniques/processes, can be transferred by imparting the requisite training to suitable personnel. Alternatively, such technology can be acquired by employing foreign technical experts.

Contracts for Supply of Machinery and Equipment Contracts for supply of machinery and equipment, which normally provide for the transfer of operational technology pertaining to such equipment, is often quite adequate for manufacturing purposes not only in small scale projects but also in a number of large scale industries where the nature of technology is not particularly complex.

Licensing Agreements Licensing agreements, under which the authorising country enters into an agreement with a licensee in another country to use the technical expertise of the former, is an important means for the transfer of technology. Licensing agreements are usually entered into when foreign direct investment is not possible or desirable.

Turnkey Contracts Transfer of complex technology often takes place through turnkey project contracts, which include the supply of such services as design, creation, commissioning or supervision of a system or a facility to the client, apart from the supply of goods.

Many times, a combination of two or more of the above mentioned methods is used. Turnkey contracts, obviously, are the most comprehensive of such combinations.

ISSUES IN TRANSFER OF TECHNOLOGY

Cost, appropriateness, dependence and obsolescence are the four important issues associated with the transfer of technology.

Cost In many cases, the developing countries obtain foreign technology at unreasonably high prices. In a number of cases of foreign direct investment associated with technology transfer, the net outflow of capital by way of dividend, interest, royalties and technical fees has been found to be much higher than the corresponding inflow.

Appropriateness The appropriateness of the foreign technology to the physical, economic and social conditions of the developing countries is an important aspect to be considered in technology transfer. It has been argued that there are a large number of cases where the foreign technology transferred has been irrelevant or inappropriate to the recipient country's socio-economic priorities and conditions.

Developing countries should ensure that the technology is appropriate, relevant, dependable and the cost is justifiable.

Dependence Further, heavy reliance on foreign technology may lead to technological dependence.

It is pointed out that the import of modern sophisticated technology has tended to displace the traditional indigenous technology which have been improved under a different set of policies. The steady stream of new products and processes introduced by multinationals into developing countries has been unfavourable to the promotion of domestic technological capacities and has discouraged local scientists and technicians from devoting themselves to practical development problems. It creates an attitude of subservient dependence, which may inhibit the capacity to do even relatively minor adaptive research or to adopt processes which are developed locally.⁶

Obsolescence It has also been observed that there is a tendency to transfer outdated technology to the developing countries. Thus, they would not enjoy the advantages of the latest technology and would still technologically lag behind. It is unfortunate that the owners of modern technology view the developing countries as a means to salvage technology that is obsolescent in the advanced countries, even when they possess more advanced technology.

PROMOTION AND REGULATION

Despite the problems or shortcomings of foreign technology, it is widely recognised that if properly regulated and promoted it can play a positive role, particularly in the technologically backward LDCs. The governments of India and a number of other countries have, therefore, taken a number of regulatory and promotional measures to take advantage of foreign technology without sacrificing national interests.

Areas of Regulation A number of regulatory measures have been taken by different countries to ensure that the technology chosen is the best available, appropriate to domestic conditions and that indiscriminate and unnecessary import of foreign technology is not undertaken. The following are the aspects of technology commonly regulated.

The Extent and Terms of Equity Participation These are generally determined by the priorities of the technology-using industry in the nation's economy, supply conditions of the technology and its type and nature.

Phasing of Domestic Manufacturing Where foreign technology is employed, many governments, including that of India, insist upon indigenisation on a phased manner. The government of India in the past also insisted that suitable provisions should be made for the training of Indians in the fields of production and management. Further, there should be adequate arrangements for research and

development, engineering design, training of technical personnel and other measures for the absorption, adaptation, and development of the imported technology.

The Appropriateness of the Technology Permission to import a particular technology is generally based on considerations such as suitability of the technology to the socio-economic and ecological conditions in the country and the priority of the technology using industry in the national economy. According to the guidelines issued by the Government of India, the entrepreneurs should, to the fullest extent possible, explore alternative sources of technology, evaluate them for a techno-economic point of view and furnish reasons for preferring the particular technology and source of import.

Payment Terms and Foreign Exchange Outflow Most governments take measures to ensure that disproportionately high payments are not paid for any technology. Restrictions were imposed also on dividend payments and pricing.

The Government of India's guidelines clearly laid down that there should be no requirement for the payment of minimum guaranteed royalty, regardless of the quantum and value of production.

Restrictive Terms in the Agreement Technology imports with highly restrictive terms on the importing parties are not generally favoured. For instance, according to the Government of India's policy, to the fullest extent possible, there should be no restrictions on free exports to all countries. Further agreements or clauses which in any manner bind the Indian party with regard to the procurement of capital goods, components, spares, raw materials, pricing policy and selling arrangements should be avoided.

Appropriate regulation and promotion can make TT more beneficial.

Promotional Measures To take full advantage of the positive role of foreign technology, it is necessary to take certain promotional measures. These include:

1. Assessing technological requirements of various sectors and identifying areas where foreign technology is required.
2. Dissemination of information in foreign countries regarding foreign investment potentials and scope for technical collaboration in the domestic economy, government policy and regulation in respect of foreign capital and technology, institutional assistance and infrastructural and other facilities for industrial development. The Indian Investment Centre, established in 1961, has been playing such a role.
3. Provision of advisory services to domestic entrepreneurs in respect of foreign technology including the techniques and process of technology transfers.

International technology transfer is a great facilitator of global socio-economic development. Technology transfer is the process by which commercial technology is disseminated.

Broadly, there are two forms of TT, viz., internalised and externalised forms of technology transfer. In actual practice the technology transfer by the MNCs, however, is mostly *internalised* and therefore it does not help the domestic firms much. Internalised forms refer to investment associated TT, where control resides with the technology transferer; the transferer, normally, holding the majority or full equity ownership. Externalised forms refer to all other forms, such as joint ventures with local control, licensing, strategic alliances and international subcontracting.

There are different channels for technology transfer. The most important channels for the flow of technology are foreign investment, technology licence agreements and joint ventures.

There are several important issues associated with the transfer of technology such as cost, appropriateness, dependence and obsolescence.

Despite the problems or shortcomings of foreign technology, it is widely recognised that if properly regulated and promoted it can play a positive role, particularly in the technologically backward LDCs. The governments of India and a number of other countries have, therefore, taken a number of regulatory and promotional measures to take advantage of foreign technology without sacrificing national interests.

To take full advantage of the positive role of foreign technology, it is necessary to take certain promotional measures. These include (1) assessing technological requirements of various sectors and identifying areas where foreign technology is required (2) dissemination of information in foreign countries regarding foreign investment potentials and scope for technical collaboration in the domestic economy, government policy and regulation in respect of foreign capital and technology, institutional assistance and infrastructural and other facilities for industrial development. (3) provision of advisory services to domestic entrepreneurs in respect of foreign technology including the techniques and process of technology transfers.

Review Questions

1. Discuss the importance of transfer of technology. Describe the channels and methods of technology transfer.
2. Write notes on the following:
 - (a) Issues in transfer of technology.
 - (b) Promotion of technology transfer.
 - (c) Regulation of technology transfer.
 - (d) Benefits and drawbacks/limitations of foreign technology.

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**Suggested
Readings**

CHAPTER 24

24 Official Development Assistance

LEARNING OBJECTIVES

- ☐ To understand the meaning of ODA.
- ☐ To examine the motives of ODA.
- ☐ To review the trends in ODA.
- ☐ To know the deficiencies of ODA.
- ☐ To consider the measures for improving the ODA flow.

MEANING AND SCOPE

Dearth of domestic capital is a major constraint to the socio-economic development of developing countries. They, therefore, have to seek external finance to promote their development. The poor countries, however, are not able to raise much funds on commercial terms. Official Development Assistance (ODA) or Aid is, therefore, very important for them.

Official development assistance or official aid from the high-income members of the Organisation for Economic Cooperation and Development (OECD) are the main source of official external finance for developing countries, but official development assistance (ODA) is also disbursed by some important donor countries that are not members of OECD's Development Assistance Committee (DAC).

The DAC has three important criteria for ODA:

- It is undertaken by the official sector.
- It promotes economic development or welfare as a main objective.
- It is provided on concessional terms, with a grant element of at least 25 percent on loans.

ODA represents grants and concessional loans extended by developed nations for the socio-economic development of poor nations.

Official development assistance comprises grants and loans, net of repayments, that meet the DAC definition of ODA and are made to countries and territories in the DAC list of eligible ODA recipients. Bilateral grants are transfers in money or in kind for which no repayment is required. Bilateral loans are loans extended by governments or official agencies that have a grant element of at least 25 percent and for which repayment is required in convertible currencies or in kind.

MOTIVES

The recipient countries might seek aid for developmental, political or some other purposes. The donor countries provide aid with any one or more of the following motives, namely, economic, humanitarian and political. Besides, official assistance is sometimes supplied to maintain historical and cultural ties.

ODA may be encouraged by economic, humanitarian or political motives.

The *Economic Motive* seeks foreign markets and supplies. The *Humanitarian Motive* aims at the alleviation of poverty and disease, often conveying in the process the donor's focuses on military, ideological, historical, cultural or other considerations. The strength of motives and their mix are different for each donor, recipient and period.¹

Recent studies have demonstrated the role of *non-developmental considerations* in determining the distribution of ODA. The influence of non-developmental motives for aid is highlighted by a comparison of bilateral and multilateral programmes. During 1980–82, only 40 per cent of bilateral aid from the Development Assistance Committee (DAC) countries and less than 20 per cent of OPEC bilateral aid went to low income countries, whereas two-thirds of all multilateral aid went to them.²

Among the non-developmental motives, political interests and commercial considerations usually dominate. Recent studies reveal that political interests undoubtedly played an important role in the allocation of assistance by some important donors. In certain cases commercial interests are dominant. The mineral resources of Zaire and Zambia are often cited as a significant commercial reason for US aid to these countries.³

It has also been found that donors try to take advantage by *tying* aid. The results of tying can be a lower quality of goods and services, often more expensive and less appropriate to the needs of the recipient. Studies on costs of aid tying suggest that it reduces the value of development loans by about 15 to 20 per cent, and in individual cases by much more.⁴ Tying of aid covers a much larger share of

Donors recycle aid by insiting that the amount, part or whole, is spent on purchases from their countries.

bilateral ODA from Development Assistance Committee (DAC) donors(OECD countries). There is a feeling that the figures on the percentage of tied aid probably understate the volume of tied aid, since informal arrangements often exist to place orders with donors.

It is said that the developed countries have a vested economic interest in helping the poor countries—development of the poor economies is necessary for the expansion of markets for the firms of the developed countries.

The tying of aid helps achieve certain economic motives of the donors. William Gand, a former US aid official has candidly put it: “The biggest single misconception about the foreign aid programme is that we send money abroad. We don’t. Foreign aid consists of American equipment, raw materials, expert services, and food—all provided for specific development projects which we ourselves review and approve.... Ninety three per cent of AID funds are spent directly in the United States to pay for these things. Just last year some 4,000 American firms in 50 states received \$1.3 billion in AID funds for products supplied as part of foreign aid programme.”⁵

A recent World Bank study has estimated that tied aid is 25 per cent less effective than untied aid. Members of the OECD’s DAC have agreed to reduce tied aid, and it has declined to about one-fifth of the overall assistance; but still remains very high for some countries.⁶

In contrast to the disadvantages of aid tying, most procurements resulting from multilateral assistance are subject to international competitive bidding procedures. Multilateral assistance is generally far less influenced by non developmental interests than is bilateral aid.

MIXED CREDITS

The desire of the donors to protect their commercial interests, mainly, has led to an increase in mixed credits in recent years.

The term mixed credit usually refers to loans that are a combination of aid and government (or government guaranteed) trade credits that are given to finance specific exports from the lending country.

Mixed credits gained importance in the late 1970s and early 1980s when the industrial countries, afflicted by recession and balance of payments difficulties, came under increasing domestic pressure to promote exports.

Disadvantages

As the World Bank observes, since mixed credits are largely based on commercial considerations, they could easily dilute the development impact of a donor's programme. Mixed credits can divert funds to capital-intensive and import-intensive projects—transportation, telecommunications and power generation. They have a built-in bias against projects and programmes with a low import content, such as rural development of primary health care, and in particular local cost financing. Exporters are keen to extend mixed credits to middle and high-income countries where trade competition is greatest, which would shift aid away from the low income countries.⁷

Advantages

Supporters of mixed credits, however, argue that mixed credits can promote development by 'stretching' ODA; increase the total flow of finance to the developing world; improve the quality of export credits by bringing the adjustments and monitoring of aid agencies to bear; reduce the cost of finance for countries with limited debt servicing capacity; and provide more appropriate, less concessional financing terms for middle-income countries. As the World Bank observes, the merits of these points, however, remain in dispute. Not only is there little evidence that aid stretching actually occurs, but also opponents have argued that such effects could be attained more effectively through other mechanisms, such as the direct allocation of a limited volume of aid to a country.⁸

TARGETS AND PERFORMANCE TRENDS

In 1970s, the United Nations resolved on the objective of one per cent of the GNP of the developed countries for the net transfer of resources to developing countries and within it 0.7 per cent as a target for official development assistance. The ratio between these two figures reflected the relative flows at that time. At the time these targets were discussed, most of the industrialised countries accepted it, some with a time frame (e.g., Belgium, The Netherlands, Sweden) and others in principle (e.g., Federal Republic of Germany). But some others, most notably the United States, did not commit themselves to the target.

While the one per cent norm for overall net flows (including private investment and commercial lending) has been reached, the hopes for the ODA target have been dashed.

ODA Trends

ODA to all developing countries and countries in Central and Eastern Europe grew steadily, in nominal terms, between the mid-1980s and the early 1990s, but then declined until 2001. In particular, assistance to Africa fell both in absolute terms and as a share of the total. While official development assistance to

African countries fell by one third, flows to countries in Central and Eastern Europe more than tripled between 1990 and 2001.

Although, the ODA flow from the developed to the developing nations has fallen substantially, other flows have shown a robust increase. ODA received by the developing countries as a percentage of their GDP dropped from 1.6 in 1990 to 0.9 in 2005. During the 1990s foreign direct investment grew faster

In the total financial flows to developing countries, the share of FDI sharply increased and that of ODA declined steeply.

than other financial flows to developing countries, from 0.9 per cent of their GDP to 2.5 per cent. Developing countries—especially the poorest countries—still receive only a tiny fraction of total foreign direct investment, but that inflow is now greater than official development assistance. ODA receipts by the least developed countries declined

drastically from nearly 13 per cent of their GDP to about 9 per cent during 1990–2005, while the FDI increased from nearly nothing to 2.6 per cent of the GDP in 2000. The drop mainly occurred in the early and mid-1990 and by the end of the decade, aid had increased considerably. During 2001 and 2002 it increased by 5 per cent. Yet, the aid flow is very much below the target, far short of what is needed, particularly to achieve the Millennium Development Goals.

The per capita aid receipts by the developing countries declined from \$15 in 1990 to \$8 in 2001. For the least developed countries the drop was from \$33 to less than 25. The ODA received by developing countries as a percentage of their GDP has fallen from 1.5 to 0.7 during this period. The fall was very sharp for the least developed countries—from 11.7 per cent to 8.9.

The ODA received by India declined from 0.4 per cent of the GDP in 1990 to 0.2 in 2005. India's per capita ODA was about \$1.6 in 2005.

The *Human Development Report, 2003*, points out that the OECD per capita subsidies for cows and cotton bolls are considerably higher than OECD per capita aid for Sub-Saharan Africa. In 2000, the annual subsidy per cow was \$913 in the European Union and \$2700 in Japan when the per capita income in sub-Saharan Africa was \$490 and per capita aid received by people of this poor region was \$8 from the EU and \$1.47 from Japan.

Declining aid has hit hardest the region and countries in greatest need. For example, sub-Saharan Africa and South Asia saw dramatic drops in per capita aid in the 1990s.

Performance

Donors have been increasingly failing in fulfilling the ODA obligations.

The average performance of the DAC donors has been deeply disappointing. The ODA disbursed by them had fallen from 0.33 per cent of their GNP in 1990 to 0.23 per cent in 2002 and then improved to 0.33 per cent in 2005—only one-third of the target. However, some

countries such as Denmark, Netherlands, Sweden, Norway and Luxembourg have exceeded the target. In the case Netherlands, Sweden and Norway there also was, however, a drop from the past position. However, it increased from 0.94 to 1.06 in the case of Denmark (the only country which now has more than one per cent of the GNP going towards ODA) and Luxembourg.

Some countries, generally smaller, however have bucked the recent trend of diminishing aid. During the 1990s Ireland doubled its aid from 0.16 to 0.30 per cent of GNP, and Luxembourg tripled its from 0.21 to 0.71 per cent.

The large economies give the most of ODA in absolute terms but not as a percentage of GNP.

The OPEC countries in the past gave substantial aid, ranging between 3 and 5 per cent of the GNP in case of some countries. This effort is especially noteworthy because in their case aid does not result in export orders to donors. In recent years, there has, however, been a steep fall in their ODA-GNP ratio. Their own difficulties have been an important reason.

The share of the least developed countries in the total ODA declined from 26 per cent to 22 per cent during 1990 – 2000.

The South Commission observes that the countries which exceeded the aid target of 0.7 per cent did so without impairing their economic vitality and without their governments forfeiting public support on account of their commitment to global development and that the performance of all these countries serves to question the validity of the economic and political difficulties cited by larger countries to justify their own failure.⁹

As the *Brandt Commission* observes, relative performance between different countries in meeting this target is a matter on which hard and fast comparisons may not be in order. Some donors have argued that while their trade policies are liberal; some who have recorded a better performance also include the expenditure on overseas commitments which in a proper reckoning should not qualify as aid; some donors allocate their aid as far as possible on need-based criteria while some others concentrate on countries with whom they have specialised historical, commercial or other ties. Assistance from the Eastern countries had been available for public sector, industrial and resource sectors for which aid from other sources had been unavailable and they took goods in repayment of debt. These clarifications are important but they do not contradict the position that the industrialised countries as a whole, and the major ones among them, have failed to fulfill expectations and commitments.

DEFICIENCIES

The official development assistance system, as it exists today, has several deficiencies. Some of the important ones are the following:

The ODA flow has been inadequate, inequitous and allocatively irrational.

Inadequacy

The actual ODA flow has been only about half of the target of 0.7 per cent of the GNP which itself is quite inadequate to make a dent on the poverty of the developing countries. The gross inadequacy of the present ODA flows is very well exposed by the *Human Development Report 1992*: “Donor countries consider it necessary to recycle about 25 per cent of their incomes to meet the needs of their people, including 100 million of those who fall below poverty line incomes of around \$5000. But to help meet the needs of more than one billion of the absolute poor in developing countries, they allocate just 0.35 per cent.”¹⁰ One may argue that the developing countries should find out their own ways and means for their development and that the developed countries should not be blamed for not shouldering the burden of alleviating the poverty of others. In this context, it should be noted that the international economic system, as it operates today, causes a transfer of huge amount of resources from the developing to the developed countries through terms of trade factors and imposes heavy costs to the developing nations through other factors as well. Further, it must not also be forgotten that many of them were subject to long periods of colonial exploitation. The developed countries, therefore, have a moral responsibility to help the poor nations.

Absence of Equity

Not only that the ODA contributions do not progressively increase with the per capita income of the donors, some of the richest nations give a lower share of their GNP than the less wealthy ones. In fact, some 80 per cent of the shortfall of \$51 billion from the overall 0.7 per cent target is due to just two wealthy nations—the United States and Japan.¹¹ Further, the target of 0.7 per cent applied uniformly to all countries is arbitrary.

Misallocation

Statistics make it quite clear that there have not been rational criteria for the allocation of the aid, with the result that the better off among the developing countries often receive much higher per capita aid than the poorer ones. Thus, while aid-receiving countries in the Middle East (with more than three times South Asia's per capita income) received many times more the per capita aid received by South Asia, India that has about one-third of the world's absolute poor, receives only a very small fraction of the total ODA.

Further, the countries that get the most aid are often those using their resources unwisely; high military spenders get roughly twice as much aid per capita as moderate spenders, and over 25 per cent more than low military spenders.¹² Again, nor is aid allocated to what should be human priority concerns. Basic education, primary health care, safe drinking water and nutrition programmes get only 10 per cent of multilateral ODA and 6.5 per cent of the bilateral ODA.¹³

MEASURES FOR IMPROVEMENT

The *Brandt Commission* has made the following recommendations in respect of ODA.

There must be a substantial increase in the transfer of resources to developing countries in order to finance:

1. Projects and programmes to alleviate poverty and to expand food production, especially in the least developed countries.
2. Exploration and development of energy and mineral resources.
3. Stabilisation of the prices and earnings of commodity exports and expanded domestic processing of commodities.

The flow of official development finance should be enlarged by:

1. An international system of universal revenue mobilisation, based on a sliding scale related to national income, in which East European and developing countries—except the poorest countries—would participate.
2. The adoption of timetables to increase ODA from industrialised countries.
3. Introduction of automatic revenue transfer through international levies on some of the following: international trade; arms production or exports; international travel; the global 'commons', especially seabed minerals.

The *Human Development Report 1992* observes: "If ODA is to genuinely serve as a social safety net for the world's poor, it will have to be based on a new framework—where commitments to the aid effort are treated as firm obligations, where annual flows move predictably, where the burden is distributed

progressively, and where aid allocations are made rationally and equitably in accord with agreed global goals. This aid should preferably be channeled through multilateral organisations, which can operate without the political pressures which determine much bilateral aid. And the distribution of the ODA aid should be based on a new policy dialogue stressing that aid should be directed to human priority concerns and encourage recipients to reduce their military spending and respect human rights.

Such a fundamental restructuring of ODA can take place only if it is based on international agreements that permit both rich and poor nations to protect their legitimate interests. What is needed is a new global contact.”¹⁴

Strategy for Improving ODA

According to Peter S. Heller and Sanjeev Gupta, an optimal strategy for improving the ODA regime would be based on the following five elements.¹⁵

Reconsidering the Distributional Criteria for Expanded ODA Donors could channel some of the increased ODA funds to countries that are not normally counted among the poorest but that nonetheless have large numbers of absolute poor. This would mean a significant expansion of ODA to countries in South and East Asia.

Carefully Monitoring the Macroeconomic Situation and the Use of ODA Some macroeconomic pressures in the form of inflation and real exchange rate appreciation are probably inevitable, but care needs to be taken that such effects are not so severe as to undermine the sustainability of development efforts. Gradual augmentation of ODA levels may need to be considered for some countries, particularly if simply increasing imports does not target their development needs.

Increasing Technological Innovations to Benefit the Poorest Countries Some ODA could be used to produce and provide global public good. Emphasis should be given to research and development (R&D) effort directed at the principal diseases affecting the poorest countries, alternative energy sources to replace fossil fuels, agricultural technologies facilitating adaptation by tropical countries to the already foreseeable extent of climate change etc.

Setting up Trust Funds for the Accumulation of ODA Resources Although most industrial countries are likely to have more budgetary room for an expanded ODA effort now than in the future, the poor countries' current limited ability to absorb large ODA flows may undermine the effectiveness of expanded aid. The international community could, therefore, consider developing mechanisms like global trust funds that allow aid to be disbursed years before it will be spent.

Reducing Trade Barriers that Keep Exports from the Poorest Countries out of Industrial Country Markets The opening up of industrial country markets to the products of the developing world is as essential as additional ODA for engendering self-sustaining development. Poor countries also need to address the anti-export bias in their own policies.

MILLENNIUM DEVELOPMENT GOALS AND ROLE OF ODA

At the Millennium Summit in September 2000, the world's leaders set seven goals for the international community to meet by the year 2015 that add up to an ambitious agenda for reducing poverty and its

causes and manifestations. An eighth goal was added the following year. They are: Eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria, and other diseases; ensure environmental sustainability; and develop a global partnership for development.

A substantial step up in ODA is needed to achieve the millennium development goals.

It is estimated that to achieve the millennium development goals, the aid flow should go up to \$96 – \$116 billion a year—nearly double the 2000 level of \$56 billion. It may be noted that if the industrial world were to be successful in meeting its ODA targets, financial aid would increase to about \$175 billion, more than three times current levels.

CONCLUSION

As a UNDP report observes, more aid may be needed to achieve the goals, but there is no guarantee it will have the right impact in the right places. For transfers to hit the targets laid out in the Millennium Declaration, there needs to be not only more aid, but better aid.¹⁶

Disbursement of Aid While there is justification for the policy of the donors' of concentrating aid in countries with a demonstrated ability to monitor and use it effectively, it means that the countries falling behind in achieving the goals, and in greatest need of resources, are least likely to receive aid.

Large aid to small poor economies is a very complex matter because of their low capital absorptive capacity and other problems. Governments may become lavish in spending, unviable or inessential projects may be implemented using the aid and there may also be 'leakages, at different levels. Large increase in spending can cause increase in money supply and inflation. Considering the constraints of capital absorptive capacity, experts have suggested that it makes sense to allocate the lion's share of the total aid to countries like China and India which have demonstrated inherent strength to steadily develop the economy and where majority of the world's poorest live.

Right Channalization of Aid Further, not only does aid need to be directed to the countries that need it most, it must also go to the right sectors. For example, only \$2 billion of the annual aid from DAC countries is directed towards education. To achieve the goals for education, this will have to increase by \$9–\$12 billion, from about 3.5 per cent of aid to well over 10 per cent. Similarly, a larger proportion of aid will need to go to other basic social services to achieve the goals. But that raises tough issues of setting priorities and reaching an understanding of how best to distribute aid among competing areas.¹⁷

Aid and Trade It is argued that what developing countries really need is a more fair trade than more aid. But global trade is highly regulated, with the powerful holding sway and the playing field far from level. The developing country exporters to the developed countries confront barriers twice as high as the developed country exporters. In industrial countries where agricultural subsidies alone are about \$1 billion a day—more than six times the total aid. These barriers and subsidies cost developing countries more in lost export opportunities than the \$56 billion in aid they receive each year. If there were a levelling of the global playing field, many of the gains would come in low-income, low-skill areas such as agriculture, textiles and clothing. So in many cases both the poorest countries and the poorest people would benefit. Eliminating trade barriers and subsidies in industrial countries that inhibit imports from developing countries is therefore an urgent priority, and potentially a route to greatly

What developing countries need is a new international order, not merely more and better aid.

accelerated development. The Millennium Declaration's call for a non-discriminatory trading system places a dearer responsibility on the world's richer countries, but it is a small step towards changing the system.¹⁸

In developing countries, the role of FDI is growing in comparison with ODA in assisting economic development. This is true of LDCs too. In 27 out of 50 LDCs, FDI flows grew between 1990 and 2002, while ODA declined

Better and more aid (assuming their judicious and efficient utilization) and a fairer trade can significantly help developing countries.

SUMMARY

Official Development Assistance (ODA) or Aid can play a great role in the socio-economic development of developing countries. Official development assistance or official aid from the high-income members of the Organisation for Economic Co-operation and Development (OECD) are the main source of official external finance for developing countries, but official development assistance (ODA) is also disbursed by some important donor countries that are not members of OECD's Development Assistance Committee (DAC). DAC has three criteria for ODA: it is undertaken by the official sector; it promotes economic development or welfare as a main objective; and it is provided on concessional terms, with a grant element of at least 25 percent on loans.

There are different **motives** for ODA. The recipient countries might seek aid for developmental, political or some other purposes. The donor countries provide aid with any one or more of the following motives, namely, economic, humanitarian and political. Besides, official assistance is sometimes supplied to maintain historical and cultural ties.

Studies have revealed the role of non-developmental considerations in determining the distribution of ODA. Among the non-developmental motives, political interests and commercial considerations usually dominate. It has also been found that donors try to take advantage by *tying* aid, resulting in a lower quality of goods and services, often more expensive and less appropriate to the needs of the recipient. It is also alleged that the developed countries have a vested economic interest in helping the poor countries – development of the poor economies is necessary for the expansion of markets for the firms of the developed countries. The desire of the donors to protect their commercial interests, mainly, has led to an increase in **mixed credits**, i.e. loans that are a combination of aid and government (or government guaranteed) trade credits that are given to finance specific exports from the lending country, in recent years.

Not only that the ODA has not reached the target of 0.7 per cent of the GNP of the developed countries set by the United Nations but also there has been a decline in the ODA-GNP ratio and the per capita receipt of ODA.

The official development assistance system, as it exists today, has several **deficiencies**. Some of the important ones are the following: Inadequacy: The actual ODA flow has been only about half of the target. Absence of Equity: Not only that the ODA contributions do not progressively increase with the per capita income of the donors, but also some of the richest nations give a lower share of their GNP than the less wealthy ones. Misallocation: There have not been rational criteria for the allocation of the aid, with the result that the better off among the developing countries often receive much higher per capita aid than the poorer ones. Further, the countries that get the most aid are often those using their resources unwisely.

Several measures are called for increasing the quantity and improving the quality of ODA.

ODA has a great role in to play the **Millennium Development Goals**. It is estimated that to achieve the millennium development goals, by 2015 the aid flow should nearly double the 2000 level. In fact, if the industrial world were to be successful in meeting its ODA targets, financial aid would increase to more than three times. To realise goals, there needs to be not only more aid, but also better aid.

Review Questions

1. Discuss the role, trends and deficiencies of official development assistance.
2. Examine the deficiencies of the ODA as it exists today and suggest measures for betterment.
3. Write notes on the following:
 - (a) Motives of ODA
 - (b) Mixed credits
 - (c) Millennium development goals and role of ODA.

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CHAPTER 25

25 International Debt

LEARNING OBJECTIVES

- ☐ To get an idea of the debt-growth interrelationship.
- ☐ To know the magnitude of the debt problems.
- ☐ To examine the causes of growth of debt.
- ☐ To get an idea of the debt relief initiatives.
- ☐ To get a picture of the debt problem of India.

Shortage of capital is a major constraint in the progress of developing countries. External resources, therefore, assumes great importance. Developing countries, in general, have resorted to heavy external borrowing leading to very high indebtedness, causing severe problems.

DEBT-GROWTH LINK

Debt, upto a certain level, can help accelerate growth, but as debt increases further growth slows and may even turn negative.

A developing country suffering from shortage of capital would be able to accelerate its economic growth by increasing the productive investment by reasonable levels of borrowing and would normally be able to make timely repayment of the debt. However, large debt

may hinder growth.

The **debt overhang theories** seek to explain the reasons for large levels of accumulated debt leading to lower growth. These theories suggest that if there is some likelihood that, in the future, debt will be larger than the country's repayment ability, expected debt-service costs will discourage further domestic and foreign investment and thus harm growth. Potential investors will fear that the more a country produces, the more it will be "taxed" by creditors to service the external debt, and thus they will be less willing to incur costs today for the sake of increased output in the future. This argument is represented in the debt "Laffer curve" in figure 25.1 which posits that larger debt stocks tend to be associated with lower probabilities of debt repayment. On the upward-sloping or "good" section of the curve, increases in the face value of debt are associated with increases in expected debt repayment, while increases in debt reduce expected debt repayment on the downward-sloping or "bad" section of the curve.¹

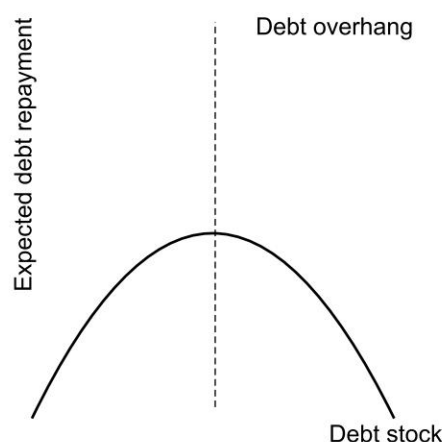


Fig. 25.1 Debt Laffer Curve

(Adopted from Catherine Pattillo *et al.*, “External Debt and Growth”, *Finance and Development*, June 2002)

IMF economists Pattillo, Ricci, and Poirson conducted a study, of 100 developing nations over a 30-year period,² that examined the link between the debt and growth. They found that debt does indeed seem to have an inverted-U relationship with growth (figure 25.1). When countries open up to foreign capital and start borrowing, the impact on growth is likely to be positive (moving from zero indebtedness to point A as shown in figure 25.2.) As debt ratio increases beyond point A, additional debt eventually slows growth down even though the overall debt level continues to make a positive contribution to growth. Thus, point A can be considered as the growth-maximizing level of debt. When debt reaches point B, however, the overall contribution to debt turns negative: the country becomes worse off than in the case of no indebtedness.

Besides confirming this inverted-U relationship between debt and growth, this study also quantified the two critical turning points: the overall contribution of debt to growth appears to become negative (point B) at 160–170 percent of exports and 35–40 percent of GDP (in net present value terms). The marginal impact appears to become negative (point A) at about half these levels, although the results do not allow us to estimate those levels precisely. The results also indicate that the growth differential between countries with low indebtedness (less than 100 per cent of exports or 25 percent of GDP) and those with the highest indebtedness (more than 367 percent of exports or 95 percent of GDP) is, on average, in excess of 2 percent a year.

There is significant difference in the economic growth rates between low indebted and high indebted nations.

A further study by Poirson, and Ricci using a data, of 61 developing countries spanning sub-Saharan Africa, Asia, Latin America, and the Middle East, for over period of three decades (1969–98), suggests, consistent with their previous study, that debt could have negative effects on growth, either through capital accumulation or productivity growth. The impact of debt on growth is very different at low and high levels of debt. At high levels, debt has a large negative impact: on an average, doubling debt from any initial debt level at or above the threshold where the impact of further debt accumulation starts to turn negative will reduce per capita growth by about one percentage point.

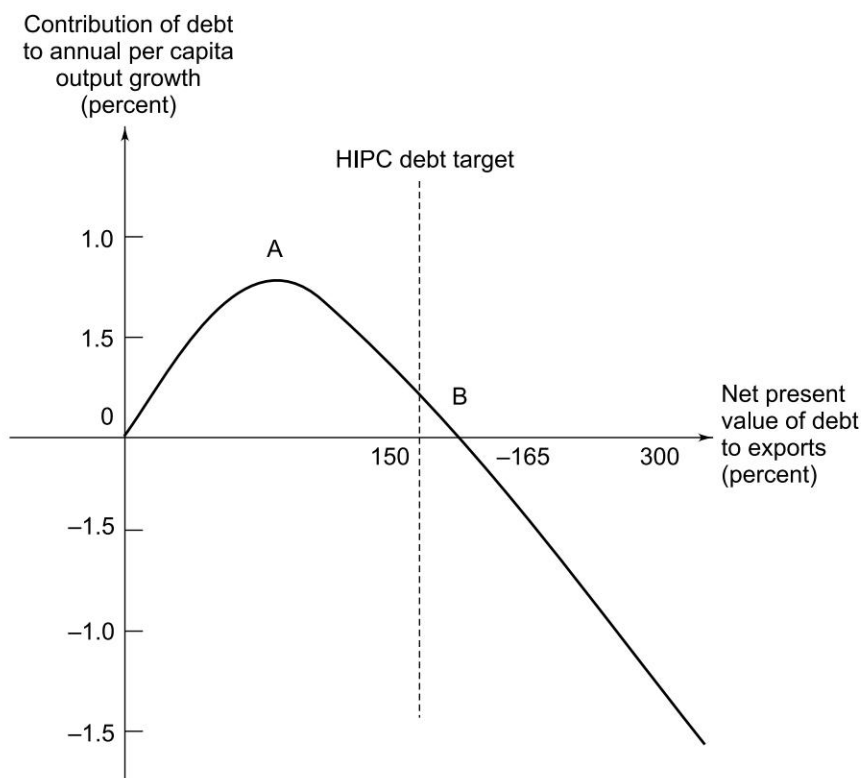


Fig. 25.2 Debt-Growth Link

(Adopted from Catherine Pattillo *et al.*, "External Debt and Growth", *Finance and Development*, June 2002)

The conclusion, thus, is that at low levels, external debt has positive effects on growth but, above a certain threshold, this effect turns negative.

MANGNITUDE OF DEBT PROBLEM

The external debt of the developing countries became the most talked about international economic problem when the flames of the towering inferno, the mounting external debt of developing countries, threatened to engulf the creditors in the early 1980s. Mexico announced in 1982 that it would be suspending the interest and principal payments. Brazil and Argentina soon followed suit. Joint efforts of the debtors and creditors for about a decade since then succeeded in defusing the 'debt bomb'. The external debt of the developing countries, however, has been on rapid rise.

Total external debt is debt owed to non-residents repayable in foreign currency, goods, or services. It is the sum of public, publicly guaranteed, and private non-guaranteed long-term debt, use of IMF credit and short term debt. Short term debt includes all debt having an original maturity of one year or less and interest in arrears on long term debt.

The external debt of the developing countries increased from \$100 billion in 1970 to around \$650 billion in 1980 and around \$1350 billion in 1990. It was over \$2350 billion in 2000.

In the last three decades of the 20th century, the external debt of the developing countries increased more than 23 times.

Much of this debt is concentrated in a relatively small number of countries. The major impact is felt in Sub-Saharan Africa and in Latin America—with social and economic damage that will persist long into the future, paralysing economic initiatives and blocking the much needed expenditure on human development.³

There are a large number of Heavily Indebted Poor Countries (HIPCs), i.e. countries which face an unsustainable debt burden, beyond available debt-relief mechanisms.

In short, as the South Commission observes, “Paramount among the issues on which action is urgent is that of debt. Achieving durable solution to this problem has become an absolute prerequisite for any resumption of growth, not only in the heavily indebted countries, but in most parts of the South.”⁴

The external debt ratios are very high for many countries. A large share of the export earnings of the developing countries is eaten away by debt service (Debt service is the sum of principal repayments and interest payments on the debt. Debt service ratio i.e. the sum of the debt service payments expressed as a percentage of the export earnings from goods and services, is one of the several conventional measures used to assess a country's stability to service debt). During mid-1980s, around one-fifth of the total export earnings of the developing countries were drained away by debt service. Due to several measures, this ratio has improved for many countries.

In 2002, Brazil was the most highly indebted country in the world, followed by China, Russia and Mexico. However, among the 15 top debtor countries, the debt-GNP ratio in 2000 was the worst in respect of Argentina, although in terms of the size of the debt its position was fifth. Although China was the second largest debtor its debt-GNP ratio was the most favourable among the top debtor countries, followed by India.

CAUSES

Although the international debt problem is quite an old one, the external debt of the developing countries began to mount up very rapidly since about the mid-1970s. The major reasons have been the following:

The debt crisis was caused mostly by oil price hike, high interest rate, increase in the proportion of commercial borrowing, fall in the average maturity of loans and bad management of domestic economy.

Oil Price Hike

The manifold increase in the oil price since the early 1970s and the consequent surge in the import bills has been an important reason for the debt crisis. The surging external payment obligations naturally compelled these countries to resort to more and more borrowings.

Pattern of Financing

The changes in the pattern of financing of the payments deficits and the changes in the terms of loans contributed significantly to the debt crisis.

The financing requirements caused by the huge deficits of the developing countries were so large that the resources of the IMF were nowhere close to meeting the needs. The developing countries found an

alternative in commercial borrowing. The international banking system went enthusiastically into the game of 'recycling' the surpluses of oil exporters into loan for the importers. The thesis of Walter Wriston, the then chairman of Citibank, that sovereign lending was inherently safe as countries could not go bankrupt, reflected the general mood of the bankers.

Commercial borrowing, however, had an inherent problem—the high rates of interest. Added to this was the problem of decline in the flow of concessional finance from the World Bank group while loans from the World Bank on market terms increased sharply. Further, the average maturity of the multilateral loans declined.

In short, "The floating-rate bank loans that poured into the region in 1970s heaped upon borrowing countries every imaginable risk: the interest rates might rise, that debtors' currencies might fall, capital might be squandered on unproductive projects."⁵

High Interest Rates

The increase in the proportion of commercial loans to concessional finance naturally increases the average interest rate on debt. To make matters worse, interest rates rose sharply in the 1980s. In the eighties, the real interest rates in the US were five times higher than their average for the preceding 25 years. When the global rates are high everyone pays more. But in the 1980s, the developing countries effectively paid more than most, partly because they were considered high risk borrowers and were charged a commensurate premium. While real interest rate in industrial countries averaged around 4 per cent in the first half of the 1980s, in developing countries it was effectively around 17 per cent.⁶ Indeed "It is a commentary on the working of the international financial markets that poor countries and their people have to pay interest rate four times as much as in rich countries."⁷

In short, the debt crisis was the result, by and large, of the sharp increase in the total debt, the sharp increase in the average interest rates and the fall in the average maturity period of the loans.

Trade Factors

Trade related factors are also a substantial reason for the growth of the debt problem. The growth of protectionism, particularly the non-tariff barriers, has adversely affected the exports of developing countries and aggravated the payments problem. It is estimated that the cost to developing economies in terms of forgone exports due to protectionism in developed countries more than the ODA they receive each year.

The deterioration in terms of trade of the developing countries has caused them huge losses, adding significantly to their payments problem. The transfer of resources from the developing to the developed countries on account of the deterioration in the terms of trade has been massive, and is pointed out in the chapter on *Trade and Development*.

The trade strategy a country follows could also affect its payments and external debt positions. For example, the inward looking policy followed by India is generally regarded as one of the reasons for India's problems.

Domestic Economic Management

The external debt also has something to do with the management of the domestic economy and the economic policies. Expansionary macroeconomic policy, for example, can increase domestic demand and inflation, adversely affecting the balance of trade position. Several factors like political stability, economic stability etc. affect capital flows. Further, industrial and trade policies affect imports, exports and external borrowings.

Economic health also depends on the choice of projects and the efficient utilisation of funds. Further, a liberal policy which permits the private sector indiscriminate commercial borrowing from abroad could also lead to problems.

An IMF study has shown that domestic and external debt are closely linked in some countries.

DEBT RELIEF INITIATIVES

Background

By the beginning of the 1980s, the debt problem assumed explosive proportions. In 1982 the debt service ratio for Latin America (excluding Panama) hit a record high of 41 per cent and when, in that year, “Mexico led a string of developing countries into default, the debt crisis seemed to threaten the poor world’s stability and the rich world’s banking system.”⁸

Some even wondered whether the debt problem which was a problem of liquidity was threatening to become one of solvency. And the critics of the IMF-World Bank system and the industrial countries began to speak more eloquently, about the ‘debt-trap’.

The management of the crisis and restoration of economic vitality were no easy tasks. The problem was so grave that nine US banks stood the chance of going bankrupt as a group if just three countries—Argentina, Brazil and Mexico—defaulted on their foreign debt.

The adjustment process was very painful. Riots broke out against IMF in Brazil and Argentina following the Fund’s demand for severe cutbacks in government spending, money supply and wages. There was but no soft option for the indebted nations. The decade witnessed a 20 per cent drop in the per capita income and widespread unemployment in Latin America. Banks lost billions of dollars in loan write-offs.

Different strategies have been tried to mitigate the debt problem and to put the indebted countries back on normal path of economic growth.

Debt Reschedule

The traditional approach to debt relief is to reschedule—interest payments are postponed or arrears are added to the capital. But this is not of much help to the countries which are deep in debt. A more realistic approach is for the creditors to forgive part of the debt.

In the beginning, the banks hoped to recover all their money and the lenders resisted the idea that debts should be reduced, offering only to reschedule payments. The problems, however, was too deep that the traditional approach was not of any use.

At the annual IMF-World Bank meeting in 1985 the US Treasury Secretary, James Baker, announced a plan for world debt. The Baker Plan emphasised growth-oriented structural economic reforms in debtor countries. It envisaged the banks to make new loans (\$20 billion over three years) to the debtor countries. At the same time the World Bank was brought into the fray; until then the debt strategy had been dominated principally by the IMF.

The total disbursement in net loans by banks amounted to \$13 billion over the three year period against the target of \$20 billion. “That the \$20 billion mark was not reached says as much about the inability of some countries to make the necessary structural adjustment as it does about the banks’ occasional unwillingness to lend.”⁹ Some debtor countries also found it difficult to accept, let alone conform, to IMF conditionality.

The Baker Plan was only for the Western hemisphere countries and hence it has been alleged that it was more of a vested interest scheme than a general plan. In short, the Baker Plan had only a limited impact.

In 1989, the World Bank set up a new facility of \$100 million, known as the *Debt Reduction Facility*, to provide grants to poorer countries carrying out structural adjustment programmes so that they can buy back, or exchange, their commercial debt for a relatively small percentage of its face value. The scope of the facility was limited; it was confined to those countries which were eligible for IDA assistance and the maximum amount of grant per country was \$10 million.

Debt Write-Off

The proposal for debt write-off got the official stamp in the meeting of the Group of Seven industrial countries at Toronto in 1988. Nine industrial countries in the OECD announced plans to help the low-income African countries either by writing off bilateral loans or converting loans into grants.

Brady Plan Debt write-offs got further support in the proposals made in 1989 by the US Treasury Secretary, Nicholas Bradey. The Brady Plan, which followed proposals on the same subject from France and Japan, primarily aimed at helping debtor nations maintain growth oriented adjustment programmes. The main mechanisms were various forms of debt and debt-service reductions—including debt buybacks, exchange of old debt at a discount for new collateralised (secured by assets) bonds, and exchange of old debt for new bonds at par value (with reduced interest rates)—along with policies to encourage repatriation of flight of capital and foreign direct investment. Commercial banks were expected to provide debt reduction and new money, as well as temporarily and conditionally reduce the terms at which the current debt was contracted. The IMF and World Bank were expected to provide up to \$20–25 billion for use in reduction of principal and reduction of interest payments. Brady style plans have been implemented for several countries. Mexico, The Philippines, Costa Rica and Venezuela were among the first ones.

The South Commission observes, “The implementation of the Brady initiative clearly reveals its limitations. The conditions for its use are unduly restrictive: The plan applies solely to the debt owed to commercial banks. The currently available pool of \$30 billion is clearly inadequate to achieve a significant measure of debt reduction. There is no official target for debt reduction, nor are there even agreed criteria for determining whether the amount of debt reduction is adequate for particular countries. And the banks fully retain the right to choose between debt reduction and new lending, the latter being in many cases intended only, or mainly, to maintain the service of the old debt without any alleviation of the debt burden as such. Unless these arrangements involve substantial reductions in the net transfer of capital from developing to developed countries, allowing vigorous growth to take place, they will do no more than add to the debt burden for the future.”¹⁰

Trinidad Debt Reduction Proposals At a meeting of Commonwealth Finance Ministers in Trinidad in 1990, modifications were proposed to the ‘Toronto Terms’. The salient features of the Trinidad debt reduction proposals are: (i) Instead of negotiating new terms as debts mature each year, the total debt of each country should be dealt with in one long-term operation, (ii) Two-thirds of debt of the poorest nations should be written-off (instead of the Toronto proposal of one-third). This would mean writing off about \$18 billion of the debt stock of the poorest countries in Africa, (iii) The repayment period should be lengthened to 25 years, (iv) Interest payments due in the first five years should be capitalised. Principal and interest could then be repaid in a phased manner—increasing along with the debtor’s capacity to repay.

Paris Plan In December 1991, the Paris Club agreed on enhanced concessions in bilateral debt—restructuring agreements for low-income developing countries. The new terms provide for a 50 per cent reduction in the net present value of the consolidated debt-service payments on debt not associated with official development assistance.

IGIE Although many proposals have been made to widen the scope of the Brady Plan and to increase its impact, the most important proposal has come from an international group of independent experts. The group proposed establishing a team of independent experts for each debtor country. The team would be headed by a prominent person in finance, economics or political life. It would make proposals on debt reorganisation and the restoration of economic growth in the country concerned as well as on the domestic measures needed to achieve this. The team's proposals would be put to debtors and creditors who would then decide whether to accept them. As such agreements would take time to agree on and implement, the group has also proposed a series of interim bridging measures that, without prejudicing the outcome of the final settlement, could provide immediate relief to debtors. These include the postponement of amortisation and the payment of interest in three fractions—to be paid, as usual, in foreign currency; to be paid in local currency; and, to be capitalised into new loans.

Limitations of Debt Mitigating Strategies

In spite of several attempts to mitigate the debt problem, many developing countries continue to accumulate interest arrears. "That arrears should continue to accumulate while the debt-service ratio is falling illustrates the limitations of using debt-service ratios alone as an index of progress."¹¹ The South Commission observes: "What is needed is a concerted approach to achieve a substantial reduction of debt and debt service simultaneously. Negative transfers of resources—from poor to rich—should be ended, and the service of the debt should be related to the ability of the economy to pay and to grow. The amount of debt service that a country can bear—and is required to pay—should be linked to the level of resources it needs to keep income per head rising at a rate of at least 2–3 per cent a year. The necessary level of resources can be determined with reasonable accuracy through macro-economic analysis for individual countries. The policies for achieving this target could then be negotiated, taking into account the various forms of debt and the circumstances of the debtor country concerned. The central point, though, is that the reduction of debt and of debt service should be the subject of multilateral inter-governmental negotiation."¹²

The South Commission has also emphasised the need for an International Debt Conference with the participation of the debtor governments, the governments of the creditors, and the international financial institutions, whose mandate would be to arrive at a binding international arrangement on a framework solution.

Factors Limiting the Debt Relief Schemes The success of the various debt relief schemes has been constrained by certain flaws in the approach of the debtors and donors, and some other factors.

Inconsistencies in Economic Policies For example, inconsistencies in economic policies marred the reforms in countries like Brazil and Zambia. In the Philippines, the major concern was political stability. Mexico's reforms, on the other hand, have been fairly successful because of consistency in the policies and political stability.

Donor's Irresponsibility The donors are also to blame. During the 1980s they urged the indebted countries to boost their exports by devaluing and deregulating. "The debtors duly did so only to find that many of their natural exports were kept out of the rich world by tariffs and quotas. Aid to African farmers coupled with farm protection is supreme hypocrisy."¹³

Achievement

Despite the manifold problems of finding out solutions and translating them into practice, remarkable achievement has been made in easing the debt burden.

Aggregate measures of the developing countries' debt burden have declined substantially since 1986, reflecting reduced borrowing, improved economic performance, and the impact of debt reduction operations. However, the improvement has been only marginal in sub-Saharan Africa and some other small low-income countries. There are also some countries like India whose debt problem became more critical by early 1990s, but improved later.

Comparing the situations of the Latin American countries in the early 1980 and early 1990s, "... it looks like a splendid victory." However, adjustment process, inevitably, has been painful for both the debtors and creditors. The structural adjustment meant strenuous belt tightening for the debtors causing economic contraction and unemployment. Normalcy was restored in a number of countries by early 1990s and as their economies began looking up, large foreign investments have also started flowing in making things look more optimistic.

However, what is true of Latin America is not true of other parts. The sub-Saharan African countries have been in problem. External debt made its own contribution to the South-East economic crisis of the late 1990s.

On the whole, the situation is still not all that comfortable. "After all, the 1980s debt crisis in Latin America was the fifth since 1720s, each one occurring at 50 or 60 year intervals with Elliott Wave regularly. The reckless lending to real estate sector by most of the same banks who were so active in international lending, makes it difficult to be optimistic about the bankers' ability to learn from past mistakes—another debt crisis in the 2030s?

What about the borrower governments? To be sure, no government has ever repaid debt on a sustained basis except through fresh and larger borrowings. The illusion of solvency persists so long as the fresh loans continue to be funded."¹⁴

HIPC Initiative

It has been well recognised that the external debt situation for a number of low-income countries, mostly in Africa, has become extremely difficult. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction—together with continued provision of concessional financing and pursuit of sound economic policies—may not be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. Therefore, in 1996 the IMF and the World Bank launched the Heavily Indebted Poor Countries (HIPC) Initiative to address this situation. The Initiative has been designed to provide exceptional assistance to eligible countries following sound economic policies to help them reduce their external debt burden to sustainable levels.

The HIPC Initiative is a comprehensive approach to debt reduction for poor countries that requires the participation of all creditors. It aims to ensure that no poor country faces a debt burden it cannot

manage. Central to the HIPC Initiative is the country's continued effort toward macroeconomic adjustment and structural and social policy reforms. In addition, the Initiative focuses on ensuring additional finance for social sector programs—primarily basic health and education.

To be considered for HIPC Initiative assistance, a country must satisfy a set of criteria. Specifically, it must: (1) face an unsustainable debt burden, beyond available debt-relief mechanisms; (2) establish a track record of reform and sound policies through IMF- and World Bank-supported programs.

The total cost of providing assistance to 34 countries under the enhanced HIPC Initiative is estimated to be about \$39 billion in 2002 net present value terms. A little over half of this will be provided by bilateral creditors, and the rest will come from multilateral lenders. Because the IMF and other multilaterals are financial intermediaries, it has been important to find funding for this part of the Initiative. Good progress has been made in financing the multilateral components of the Initiative through bilateral pledges to the HIPC Trust Fund, administered by the World Bank.

The international community has put substantial effort, not to mention financial resources, into debt reduction for poor countries. For the 26 countries that have benefited, it is expected that debt service will fall by about half in relation to exports or GDP between 1998–99 and 2001–2005 and will decline from 24 percent to about 11 percent of government revenue by 2005.

The Initiative is not a panacea. Even if all of the external debts of these countries were forgiven, most would still depend on significant levels of concessional external assistance; their receipts of such assistance have been much larger than their debt-service payments for many years.

SDRM

Strategic Debt Restructuring Mechanism” (SDRM) refers to the IMF proposal for a scheme which seeks to ensure the “prompt” and “orderly” resolution of problems of unsustainable debt, advocated by Anne Kreuger, its Deputy Managing Director.

The scheme has three components. The first is a mechanism to ensure that when creditors provide credit to emerging markets they explicitly sign into a commitment to be bound by any restructuring exercise that a majority of creditors might agree to. The second is to put in place mechanisms to ensure that debtors can request for a stay on debt service payments till they restructure debt, and use this facility in a manner that does not prove detrimental to creditors. Third, during and after the restructuring process there must be means to ensure that private lenders provide additional financing with the assurance that they would be repaid in advance of existing creditors.

REMEDIAL AND PREVENTIVE MEASURES

A number of debt relief measures, taken or proposed, have been mentioned above. Mentioned below are some measures that will help lessen the debt problem or prevent further growth or occurrence of the problem.

Foreign Investment

Policies which encourage foreign direct investment and which will help invigorate the economy and increase net exports or effective import substitution will be highly beneficial. Furthermore, as developing country capital markets deepen, equity investments may play a greater role in development finance. It

may be noted that the foreign investment flow has helped to very substantially improve the foreign exchange position of India.

Invisibles Receipts

Many developing countries can mitigate their foreign exchange problem to a considerable extent by taking effective measures to increase the invisibles receipts, particularly from emigrant remittances and travel.

Exports

A substantial increase in exports and the discouragement of imports to a desirable extent can go a long way in solving the problems. This, however, requires an appropriate economic policy and other earnest measures.

Official Development Assistance

One important contributor to the debt problem is the heavy dependence on loans on commercial terms. A substantial step-up in the concessional finance is necessary to lessen the severity of this problem.

Prerequisites for the Success of the Plans

There are certain conditions to be satisfied for the above things to happen. For example, to attract foreign investment, there must be political and economic stability, a fair rate of sustainable economic growth, required infrastructures and a conducive government policy. The emigrant remittances and tourist arrivals also depend on a number of factors. For example, the emigrant remittance depend on profitable investment avenues, political stability etc. Tourist travels are affected by internal peace, tourist facilities, etc.

Further, exports and imports are affected by the macroeconomic policy in general and the trade strategy in particular.

ODIOUS DEBT

Many developing countries are carrying debt incurred by rulers who borrowed without the people's consent and used the funds either to repress the people or for personal gain. Numerous regimes have evinced odiousness. Some potential recent examples include Anastasio Somoza (Nicaragua) reportedly looted \$100–500 million; Ferdinand Marcos (Philippines) amassed a \$10 billion fortune; the Apartheid government (South Africa), widely condemned by the international community, spent heavily on police and military to repress the African majority.

It is felt that a new approach is warranted to prevent dictators from running up debts, looting their countries, and passing on their debts to the population.

Under the law in many countries, individuals do not have to repay if others fraudulently borrow in their name, and corporations are not liable for contracts that their chief executive officers or other agents enter into without the authority to bind the corporations. The legal doctrine of odious debt makes an analogous argument that sovereign debt incurred without the consent of the people and not benefiting

the people is odious and should not be transferable to a successor government, especially if creditors are aware of these facts in advance. However, this doctrine has gained little momentum within the international legal community.¹⁵

INDIA'S EXTERNAL DEBT

When the debt problem of the Latin American countries became explosive in the early 1980s, India's position was not very serious. In 1980, India's debt-service ratio was comparatively very low: less than 10 per cent (as against 63 per cent for Brazil 50 per cent of Mexico, 47 per cent for Peru, 43 per cent for Chile and 37 per cent for Argentina).

Despite early warning, India failed to prevent alarming growth of external debt.

Thus, the experience of a number of countries had given India an early warning. Bimal Jalan, who held several top positions under, and on behalf of Indian Government in economic and financial matters, points out that the Indian planners were aware of the chances of India getting into a debt crisis in due course if preventive measures were not taken.¹⁶ However, the subordination of principles of economic soundness to populist and politically motivated actions, the power of pressure groups and deficiencies of economic policies have led to a failure in preventing the emergence of the crisis.

Total external debt of India increased from nearly \$8 billion in 1970 to nearly \$18 billion in 1981 and further to over \$70 billion in 1990. Foreign debt as a percentage of GNP more than doubled from about 12 per cent in 1980 to 25 per cent in 1990. The debt-service ratio more than tripled, from 9.3 per cent to 28.8 per cent, and debt as a percentage of exports more than doubled, from 136 per cent to 282 per cent, during this period. The ratio of debt stock to exports increased to 303 per cent in 1991–92 and debt-service ratio in that year was 26.2 per cent.

There were several special factors responsible for the emergence of the debt crisis in early 1990s:

India's external debt problem became very severe by the early 1990s.

1. The sharp increase in the oil price due to the Gulf crisis following the annexation of Kuwait by Iraq and the sharp increase in India's oil import bill.
2. Fall in exports to West Asia due to the Gulf crisis.
3. Fall in the emigrant remittances following the Gulf crisis.
4. Drying up of short-term credits due to loss of confidence in the government's ability to manage the situation.
5. Net outflow of NRI deposits which started in October 1990 and continued until the end of 1992, mostly due to the loss of confidence.

By the end of June 1991, the foreign exchange reserves declined to \$1.1 billion which was barely enough to finance two weeks of imports (as against the generally suggested safe minimum of three months imports) and the balance of payments crisis had become overwhelmingly a crisis of confidence—of confidence in the government's ability to manage the balance of payments. The loss of confidence had itself undermined the government's capability to deal with the crisis by closing off all recourse to external credit. For the first time in India's history a default on payments had become a serious possibility in June 1991. The new government, therefore, moved rapidly to implement a programme of macroeconomic stabilisation and arrange external loans. It also undertook a far-reaching

The foreign exchange crisis of 1991 prompted drastic economic reforms in India.

programme of structural reform, which included bold initiatives in trade and industrial policies aimed at improving the efficiency of the economy and increasing its international competitiveness.

Jalan points out that in some respects the situation in India at the dawn of the 1990s had some similarities with the situation which prevailed in several heavily indebted Latin American countries at the beginning of the eighties. The crisis was brought about by an excessive dependence of the economy on 'new money' from commercial sources. India's total debt and debt-servicing burden in relation to the size of its economy was substantially lower than that of the heavily indebted Latin American countries at the beginning of the 1980s. However, as a proportion of exports, the ratios were similar. Further, India has been having large trade deficit. Latin American countries, such as Mexico, Brazil and Venezuela, on the other hand, had a trade surplus, even though the current account was in deficit on account of interest payments. The fiscal crisis in India was also similar to that of the heavily indebted countries in Latin America.¹⁷

CAUSES

The important causes for the sharp increase in India's external debt were the following:

Increase in Trade Deficit

The enormous increase in trade deficit has been a very important reason for the sharp increase in India's external debt. The impact of oil price hike has already been pointed out earlier. The poor export performance of India has also been responsible for the large trade deficit.

Decline in the Net Invisibles

During the 1980s, there was a gradual decline in the invisible surplus. Invisibles surpluses had traditionally financed a large part of India's deficit. There was a steep fall in this since the beginning of the eighties. Net invisibles financed nearly 73 per cent of the trade deficit in 1980–81. During the Sixth Plan (1980–85), on an average it financed more than 60 per cent of the trade deficit. By 1990–91 it dropped to 13 per cent, compelling the nation to take increasing recourse to external sources for meeting the payments obligation.

This falling trend in the net invisibles had been caused by the adverse trends in the invisibles payments on the one hand and invisibles receipts on the other.

The rise in the net invisibles payments had been chiefly fuelled by accumulation of interest and service payments on foreign loans and credits. The rate of increase in the interest and service payments was several times higher than that of the receipts of the invisibles. For example, while gross private remittances and travel receipts, the major components of the invisibles receipts, increased at an average annual compound growth rate of less than 7 per cent during 1980–81 to 1987–88, interest and service payments expanded at nearly 32 per cent per annum. Interest payments as a percentage of export earnings increased from about 4 per cent in 1980 to about 16 per cent in 1990.

During the eighties, there was a sharp fall in the gross invisibles receipts as a percentage of the GDP, mainly because of the levelling off of private transfers representing mainly remittances by non-resident Indians. Net invisibles which averaged 2.2 per cent of the GDP during the Sixth Plan (1980–85) declined to an average of

Invisibles receipts-GDP ratio has shown wide fluctuations.

one per cent during the Seventh Plan (1985–90). By 1990–91, it declined to 0.4 per cent. It improved to 2.3 per cent by 1997–98 and 5.3 per cent in 2005–06.

Change in the Composition of the Debt

One important source of the BOP problem in the 1980s and afterwards is the change in the source of financing the large current account deficit. In the earlier period, i.e. until the beginning of the 1980s, almost the entire deficit was financed through inflows of concessional assistance, which kept the debt-service burden low. As against this, the eighties were marked by a reduction in flows of concessional assistance to India, particularly from the World Bank Group. The credits from the IDA on soft terms declined, while loans from the World Bank on market terms increased sharply. As a result, the average interest rate on India's official debt increased from 2.4 per cent in 1980 to 6.1 per cent in 1982. The debt service payments on multilateral loans tripled from \$371 million in 1984 to \$1106 million in 1989. Further, the average maturity of loans declined from 40.8 years in 1980 to 24.4 years in 1989. Between 1980 and 1989, the debt to private creditors, including commercial banks and non-residents increased almost ten-fold, from \$2.3 billion to \$22.8 billion. The debt service as a percentage of export earnings nearly tripled during this period, from 9.1 per cent to 26.3 per cent.

Change in the pattern of financing the payments deficit has increased the debt problem.

Economic Policies and Domestic Economic Management

Poor management of the domestic economy is one of the important factors which aggravated the problem. As observed earlier, despite the early warning which India got from the plight of the Latin American countries, a very liberal and indiscriminate public expenditure policy was followed in India. During the 1980s, the macro-economic policy was highly expansionary. The combined fiscal deficit of Centre and States was continuously rising and reached 10.5 per of GDP in 1989–90 from less than 6 per cent prior to the mid-1970s. The money supply grew rapidly. The expansionary fiscal policy resulted in an expansion of internal demand for the home market without generating adequate exports during a period when the external environment for aid to India was deteriorating.¹⁸

There is a view that the industrial and import liberalisation of the 1980 contributed to the economic crisis that emerged in the early 1990s. This view has been countered by arguing that these liberalisation have led to the acceleration of industrial and export growth in the second half of the 1980s. As against the first view it has been pointed out that the import intensity of domestic production in India has not really increased, and the ratio of imports to GDP has hovered around 8 to 9 per cent during the period 1985–90. Imports have increased because growth has been faster. After allowing for the depreciation of the rupee, the average rate of growth in imports was 3.4 per cent per annum (in SDR terms). The growth rate of non-oil imports was 7.1 per cent per annum. This was mainly on account of a faster growth in export related imports in 1988–89 and 1989–90 when exports were buoyant.¹⁹

The inward looking policy has had an adverse effect on India's balance of payments. As pointed out in the chapters on *Trade Strategies* and *India's Trade Policy*, the indiscriminate import permission in the name of import substitution became a drain on the country's foreign exchange resources. "External commercial borrowings were permitted liberally to meet foreign exchange requirements of capital-intensive investments. Commercial borrowing became a substitute for domestic savings to finance low-productivity investments, with no export potential, in public and private sectors."²⁰ In short, "Such

liberalisation as there was, was 'inward looking', and the higher growth of the domestic economy was financed by external loans on hard terms. This has proved to be a mistake."²¹

EXTERNAL DEBT MANAGEMENT

The crisis situation prompted India to pay concentrated attention to external debt management.

Apart from the need to contain current account deficit to sustainable level, one of the lessons from the external payment crisis of 1991 was to avoid excessive reliance on commercial debt especially of short-term maturity to finance the current account deficit. The approach to the external debt management was broadly based on the recommendations of the Rangarajan Committee, 1993. Following these recommendations, the strategy for external debt management during the 1990s has been guided by:

1. The continuation of an annual cap, minimum maturity restrictions and prioritising the use of ECBs (external commercial borrowings).
2. LIBOR based ceilings on interest rates and minimum maturity requirements on foreign currency denominated NRI deposits to discourage the volatile component of such deposits.
3. Reduction of short-term debt together with controls to prevent its undue increase in future.
4. Retiring/ restructuring/ refinancing of more expensive external debt.
5. Measures to encourage non-debt creating financial flows such as FDI and FPI.
6. Incentives, and schemes to promote exports and other current receipts.
7. Conscious build-up of foreign exchange reserves to provide effective insurance against external sector uncertainties.

India's Performance in Managing External Debt

Due to prudent external debt management, India's debt indicators remarkably improved since the early 1990s.

India's achievement in the external debt management has been commendable. Although the absolute size of the debt increased, very significant improvement has been achieved in respect of debt related parameters.

Although, in nominal terms, India's total outstanding external debt increased from US \$83.8 billion at end-March 1991 to US \$126.4 billion (Rs. 564,591 crores) at end March 2006, external debt to GDP ratio declined sharply from about 28 per cent at end-March 1991 to 16 per cent at end-March 2006. Prudent external debt management is also reflected in the proportion of short-term debt to total debt declining from about 10 per cent in 1991 to about 6 per cent at the end of March 2005 and in the ratio of short-term debt to foreign currency assets from a high of over 380 per cent in the crisis period of 1991 to less than 6 per cent. The debt service ratio declined from about 35 per cent at the end of March 1991 to about 13 per cent in 2002 and further to about 6 per cent in 2005. Interest payments to current receipts ratio also declined very sharply.

Thus, the decade of 1990s witnessed a steady move towards consolidation of India's external debt statistics in terms of size, composition and indicators of solvency and liquidity. Containing the increase in the size of external debt to a modest level in the face of tremendous growth in foreign exchange reserves during the decade definitely points towards the success of India's debt management strategy.

Reflecting this, in terms of indebtedness classification, the World Bank has categorised India as a *less indebted country* since 1999. Among the top 15 debtor countries of the world, India improved its rank

from third debtor after Brazil and Mexico in 1991 to eighth in 2002. Moreover, among them, key external debt indicators such as short-term debt to total debt and short-term debt to forex reserve ratios are the lowest for India: the concessional to total debt ratio is the highest, while debt to GNP ratio is the second lowest after China.

In short, the improvement in India's external debt position is attributed to Government's initiative to encompass policy issues that focus on concentrating on concessional and less expensive debt from multilateral and bilateral sources, keeping the maturity structure of the total external debt under manageable limits, limiting short-term debt, prepaying more expensive external debt and encouraging non-debt creating financial flows on capital account, exports and invisibles on current account. New initiatives in this direction would include an increased coverage and computerization of external debt statistics, better co-ordination among agencies reporting debt and further steps towards refinancing of costly debts, prepayment of identified high cost debt and exploring the possibility of using the financial products for hedging of risks for active management of sovereign debt.²²

Table 25.1 International Comparison of External Debt – 2004

Sl. No.	Country	Total external Debt (US \$ billion)	Debt sustainability indicators			
			Debt to GNI	Debt service	Short term debt to total external debt	Concessional debt to total debt
				(ratio as per cent)		
1.	China	248.9	12.9	3.5	47.2	15.5
2.	Brazil	222.0	38.0	46.8	11.4	1.5
3.	Russian Federation	197.3	34.7	9.8	17.8	0.0
4.	Argentina	169.2	117.4	28.5	16.2	0.8
5.	Turkey	161.6	53.6	35.9	19.7	2.9
6.	Indonesia	140.6	56.5	22.1	17.4	27.7
7.	Mexico	138.7	20.8	22.9	6.6	1.0
8.	India*	122.7	17.9	6.1**	6.1	35.0
9.	Poland	99.2	41.7	34.6	17.0	6.0
10.	Hungary	63.2	66.8	25.2	19.2	0.3

* According to World Bank data.

** As World Bank did not provide debt service ratio for India for 2004, information has been taken from India' External Debt: A Status Report.

Source: *Global Development Finance 2005*, The World Bank (cited by Government of India, *Economic Survey, 2007–08*).

SOME OBSERVATIONS ON THE DEBT PROBLEM

It is pointed out that “people who have worked on these issues for many years have frequently arrived at the conclusion that debt is not a financial or an economic problem at all but in every way a political one.

It is the best instrument of power and control of North over South [and now East] ever invented; far superior to colonialism which requires an army, a public administration and attracts a bad press. Control through debt not only requires no infrastructure but actually makes people pay for their own oppression.”²³

Even the HIPC initiative has met with a lot of criticism for not actually helping the countries it is supposed to be helping (the indebted nations) while helping those it wasn’t necessarily meant to (the rich nations): “The most glaring problem with the Heavily Indebted Poor Country (HIPC) initiative for debt relief is that it will not provide lasting relief from debt for the highly indebted countries of the south. The HIPC process is aimed not at canceling debts, but at ensuring that they can be repaid. It has little to do with enhancing human development, reducing poverty, or even increasing economic growth in the debtor countries. Rather, it is designed to massage debt figures down to a level where they would be deemed “sustainable” again according to the criteria of the International Monetary Fund (IMF).”²⁴

The HIPC policy has long been criticized by many organizations for not actually amounting to much relief in real terms due to it being tied to certain conditionalities that are recommended by the IMF and World Bank, which prescribed the problems of the poorer countries in the first place. The European Network on Debt and Development, for example, point out in a report that the HIPC is unlikely to free up resources to tackle poverty for three main reasons:

1. Threshold levels to measure debt sustainability are arbitrary and still too high and that sustainability is defined in economic terms and not in terms of human and social development. As a result, they point out, several least developed countries with significant debt burdens have not been included in the HIPC initiative.
2. The debt reduction on offer is too small. They point out, for example, that Zambia and Niger will actually pay more after the initiative than they did before.
3. The “piling up” of different sets of conditionalities slows down the process. Conditionalities such as the much-criticized Poverty Reduction Strategy Papers (PRSPs) from the IMF and World Bank do not succeed in aligning macro-economic issues and poverty issues more closely than in the past and macro-economic frameworks haven’t changed significantly as a result of PRSPs.

G-8 Initiative

In the above context the recent G-8 initiative is important to note. The Group of Eight countries (Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States) made a proposal on June 11, 2005, that the World Bank, IMF, and African Development Bank cancel their claims on 18 countries that have reached the completion point under the HIPC Initiative and other HIPC countries as they reach the completion point.

Bilateral contributions from the G-8 countries and other donors would cover the costs of debt relief to the World Bank and the African Development Bank; current IMF resources would cover the costs of debt relief for obligations to the IMF. For countries whose existing and projected debt-relief obligations cannot be met through existing IMF resources, donors commit-under the G-8 proposal-to provide the extra resources necessary: It is proposed to invite voluntary contributions, including from the oil-producing states, to a new trust fund to support poor countries facing commodity price and other exogenous shocks.

On September 25, 2005, the IMF and World Bank accepted this proposal. Accordingly, an estimated \$40 billion of debt of at least 18 poor countries, mostly in Africa, would be forgiven. As many as another 20 countries could be eligible if they meet certain conditions. This would push the total amount of debt cancellation to more than \$55 billion.

SUMMARY

Constrained by scarcity of domestic resources, developing countries, in general, have resorted to heavy external borrowing leading many of them to very high indebtedness causing severe problems.

According to the **debt overhang theories**, which seek to explain the reasons for large levels of accumulated debt leading to lower growth, if there is some likelihood that, in the future, debt will be larger than the country's repayment ability, expected debt-service costs will discourage further domestic and foreign investment and thus harm growth. This is corroborated by a study, by two IMF economists, which found that debt does indeed seem to have an **inverted-U relationship** with growth. When countries open up to foreign capital and start borrowing, the impact on growth is likely to be positive. But as debt ratio increases beyond a certain point, additional debt eventually slows growth down even though the overall debt level continues to make a positive contribution to growth. When debt exceeds a certain point, however, the overall contribution to growth turns negative and the country becomes worse off than in the case of no indebtedness.

The external debt of some Latin American countries in the early 1980s reached such an explosive situation that they announced that they would be suspending the interest and principal payments. Joint efforts of the debtors and creditors for about a decade since then have succeeded in defusing the **debt bomb**. The external debt of the developing countries, however, has been on rapid rise. Much of this debt is concentrated in a relatively small number of countries. The major impact is felt in Sub-Saharan Africa and in Latin America—with social and economic damage that will persist long into the future, paralysing economic initiatives and blocking the much needed expenditure on human development. The external debt ratios are very high for many countries. A large share of the export earnings of the developing countries is eaten away by debt service.

There are a large number of **Heavily Indebted Poor Countries (HIPC)**s, i.e. countries which face an unsustainable debt burden, beyond available debt-relief mechanisms.

The **major reasons** for the rapid rise in the external debt have been the following: The manifold increase in the oil price since the early 1970s and the consequent surge in the oil import bills; changes in the pattern of financing of the payments deficits (decline in the flow of concessional finance and the average maturity of the multilateral loans, and increased reliance on commercial borrowing); increase in the interest burden due to increase in the proportion of commercial loans to concessional finance and the sharp increase in the interest rates; trade related factors such as growth of protectionism which have very adversely affected the developing countries' exports and the deterioration in terms of trade; mismanagement of the domestic economy; and improper and inefficient utilisation of funds.

Different **strategies to mitigate the debt problem** and to put the indebted countries back on normal path of economic growth have been tried. The traditional approach to debt relief is to reschedule debt wherein the interest payments are postponed or arrears are added to the capital. The Baker Plan emphasised growth-oriented structural economic reforms in debtor countries. It envisaged the banks to make new loans to the debtor countries. At the same time the World Bank was brought into the fray; until then the debt strategy had been dominated principally by the IMF. The *Debt Reduction Facility* introduced by the World Bank sought to provide grants to poorer countries carrying out structural adjustment programmes so that they could buy back, or exchange, their commercial debt for a relatively small percentage of its face value. Another relief measure was debt write-offs.

The success of the various debt relief schemes has been constrained by certain flaws in the approach of the debtors and donors, and some other factors. However, despite the manifold problems of finding out solutions and translating them into practice, remarkable achievement has been made in easing the debt burden. Aggregate

measures of the developing countries' debt burden have declined substantially since the mid 1980s, reflecting reduced borrowing, improved economic performance, and the impact of debt reduction operations.

As the external debt situation for a number of low-income countries became extremely difficult, in 1996 the IMF and the World Bank launched the **HIPC Initiative**, designed to provide exceptional assistance to eligible countries following sound economic policies to help them reduce their external debt burden to sustainable levels. The HIPC sought to coordinate and harmonize official debt relief by the multilateral financial institutions and bilateral creditors for HIPCs.

An IMF proposal known as Strategic Debt Restructuring Mechanism (**SDRM**) is a scheme which seeks to ensure the "prompt" and "orderly" resolution of problems of unsustainable debt.

Increase in foreign investment; measures to increase merchandise exports and the invisible receipts and increase in the official development assistance can go a long way to lessen the severity of the debt problem.

Total **external debt of India** increased very substantially since the 1970s. India's external debt problem became very severe by the early 1990s, mainly due to the following factors: enormous increase in trade deficit; decline in the invisible surplus; change in the pattern of financing the payments deficit; and poor management of the domestic economy.

Since the 1990s, India's achievement in external debt management has been commendable. Although the absolute size of the debt increased, very significant improvement has been achieved in respect of debt related parameters. Reflecting this, the World Bank has categorised India as a *less indebted country* since 1999. Among the top 15 debtor countries of the world, India improved its rank from third debtor 1991 to eighth in 2002. Moreover, among them, key external debt indicators such as short-term debt and total debt ratio and short-term debt and forex reserve ratios are the lowest for India: while debt and GNP ratio is the second lowest after China.

The improvement in India's external debt position is attributed to Government's initiative to encompass policy issues that focus on concentrating on concessional and less expensive debt from multilateral and bilateral sources. The factors include keeping the maturity structure of the total external debt under manageable limits, limiting short-term debt, prepaying more expensive external debt and encouraging non-debt creating financial flows on capital account, exports and invisibles on current account.

Review Questions

1. Explain the nature and causes of the international debt problem.
2. Discuss the foreign debt problem of India.
3. Give a brief account of the external debt problem of India and explain the measures of external debt management.
4. Review the efforts made to mitigate the debt problem of developing countries.
5. What measures do you suggest to solve the debt problem of the developing countries?
6. Write notes on the following:
 - (a) HIPC Initiative
 - (b) Debt relief measures
 - (c) Odious debt
 - (d) Alternatives to foreign debt

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**Suggested
Readings**

CHAPTER 26

26

International Migration

LEARNING OBJECTIVES

- ☐ To understand the types and causes of migration.
- ☐ To review the trends in international migration.
- ☐ To get an idea of brain drain.
- ☐ To examine the effects of international migration.

MIGRATION

Global redistribution of population could have far reaching implications. Migration, in fact, is much more than redistribution of human resources. International migration has demographic, economic, social, political and ecological effects. International migration, however, is often subject to restrictions due to economic, political or social reasons. Such restrictions affect, particularly, the developing countries with large labour surpluses. Estimates indicate that immigration controls deny developing countries massive income flows (direct and indirect). This does not, however, mean that the international migration has been insignificant. There have been large international migration flows—legal and illegal, voluntary or forced, and temporary or permanent.

Types of Migration

The last few centuries have witnessed large international migration streams.

Many of these migration streams were free or voluntary. Large population transfers have, however, occurred due to compelling reasons too. Such forced transfers of population included the slave trade, repatriations and fleeing of people due to political or religious persecution.

Human history since the very ancient days is replete with examples of population movement across national borders due to economic, socio-cultural, geo-physical and political reasons.

Voluntary Migration The major reason for voluntary migration is economic. Almost all studies confirm that most of the migrants (excluding forced and sequential migrations) have moved in search of better economic opportunities. This is true of both international and internal migrations. Hence, “migration is normally viewed as an economic phenomenon. Though non-economic factors obviously have some bearing, most studies concur that migrants leave their area of origin primarily because of lack of economic opportunities, in the hope of finding better opportunities elsewhere.”¹

Reasons for Voluntary Migration Migration flows are generally pronounced from economically backward or stagnating areas to prosperous or dynamic areas. In the absence of administrative or other barriers that prevent or restrict migration, it tends to be large from comparatively less developed countries to developed countries like the United States and oil-rich Middle East countries.

The most important economic factors that motivate migration may be grouped as push factors, and pull factors.

Push Factors The *push factors* or the impelling factors refer to the poor economic conditions and the resultant economic misery or lack of opportunities for advancement which push people out of the region in search of a livelihood or better opportunities. The push factors are, thus, the factors which more or less compel people to leave the place.

Pull Factors *Pull factors* refer to those factors which encourage migration to an area —employment and other economic opportunities, facilities, amenities, etc. Opportunities for better employment, higher wages, facilities and amenities of modern life etc. attract people to certain areas.

The migration of persons with professional and highly skilled qualifications from developing countries to developed countries is largely caused by the pull factors. Pull factors have also played a major role in the large-scale migration of unskilled labour from the developing countries to the oil-rich Middle East countries. It is felt that today wage differences are the main driving force for international migration.

LEE'S THEORY

According to Everett Lee,² the decision to migrate and the process of migration are influenced by four important sets of factors. They are:

1. Factors associated with the area of origin
2. Factors associated with the area of destination
3. Intervening factors
4. Personal factors

In every area, there are usually two or three sets of factors that influence the decision to migrate. One set of factors attract people to it, the other set of factors, on the other hand, tend to repel people from the area. There may also be another set of factors to which people are usually indifferent. Migration is influenced by these sets of factors in combination with the intervening obstacles and personal factors.

The first three factors (factors associated with the areas of origin and destination and intervening factors) are schematically represented in Fig. 26.1. In the figure, the factors that attract people to an area are represented by '+' signs and the factors that repel are represented by '-' signs. 'O's represent factors to which people are indifferent.

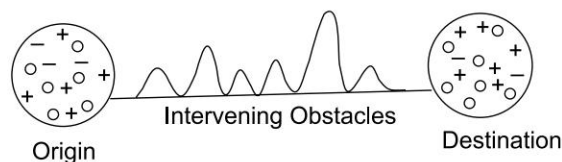


Fig. 26.1

Factors at the Origin and Destination and Intervening Obstacles in Migration

While migration may result from the comparative strengths of the plus and minus factors at the origin and destination, a simple calculus of the '+' and '-'s does not decide the act of migration. The balance in favour of the move must be strong enough to overcome the intervening obstacles and the natural inertia.

The intervening obstacles may not be difficult to overcome in some instances but they may be insurmountable in certain cases. They may be insurmountable like the Berlin Wall (in the past) or laws prohibiting migration. Some obstacles obstruct different people differently. For instance, cost of transport may appear to be prohibitive for some people whereas they may not be important for others.

Factors Affecting Migration

Besides the factors associated with the areas of origin and destination and the intervening obstacles, there are many personal factors that affect individual thresholds and facilitate or retard migration. It is not so much the actual factors at origin and destination as the perception of these factors which result in migration. Personal sensitiveness, intelligence and awareness of conditions elsewhere enter into evaluation of the situation at the origin and knowledge of the situation at the destination may depend upon personal contacts or upon sources of information which are not universally available. In addition, personal characteristics like attitude towards change, adventurism, enterprise, emotional factors, ambitions, etc., also affect the decision to migrate. It may also be mentioned here that in case of a large number of people, the migration is *associational migration* (like wife migrating with the husband or children migrating with parents).

Lee's conceptualisation of migration as involving a set of factors at origin and destination, a set of intervening obstacles and a series of personal factors is generally regarded as a simple one which may be accepted as self-evident.

TEMPORARY AND PERMANENT MIGRATIONS

Voluntary migration may be temporary or permanent. One may be a temporary migrant either because he is unwilling to settle down permanently in the host country or because the circumstances in the host country do not permit him to be a permanent immigrant. Many migrants to the Middle East, for example, have no inclination to settle down permanently. They would rather prefer to work there for some time and return home with their accumulated savings. On the other hand, there are a large number of immigrants in different countries, including in the Middle East countries, who cannot extend their stay even if they would like to do so. Immigrant workers who are recruited on contract basis will have to return once the contract period is over unless they succeed in getting another job and are permitted to extend their stay. Some countries hire labour from other countries for seasonal agricultural operations. Many of them may be regular seasonal migrants. Many countries admit temporary migrant labour on a systematic basis.

Throughout history, there has been movement of people across national borders for settling down in new places. However, the nineteenth and early twentieth centuries witnessed permanent inter-continental migration on an unprecedented scale.

FORCED AND REFUGEE MIGRATION

Many international movements of population involving very large numbers have occurred due to compelling reasons of political, religious or racial character. An outstanding example was the movement into

The Indian subcontinent was the scene of the largest population movement in the 20th century.

Germany after World War I of Germans who had lived in Alsace-Lorraine provinces of France, and in areas ceded to Poland—it was estimated that over a million people were involved in this move. Then there was the exchange of populations between Greece and Turkey decreed by the Treaty of Lausanne in 1923. Over a million Greeks were moved out of Asia Minor and Eastern Thrace, and about 4,00,000 Turks had to leave Greece.³ Similarly, “the campaigns of World War II and the Nazi war machine resulted in a vast movement of refugees and forced labour, and the collapse of Germany set in motion a colossal chain of redistribution.”⁴

As Jones observed, perhaps the largest movement of people in the last century has occurred in the Indian subcontinent.⁵ The partition of the country on the eve of Independence in 1947 into the Indian Union and Pakistan led to large exodus of refugees into each nation from the other. Estimates indicate that not less than 7 million people went to Pakistan from India and more than 8 million came to India from Pakistan. In 1971, there was an influx of over 10 million people from East Pakistan, (now Bangladesh) to India following the suppression of independence movement in 1971 by the Pakistan Government. Most of them, however, returned to their homeland after the establishment of Bangladesh.

Problems Associated with Refugee Exodus

The large magnitude and the various political, economic and social dimensions of the exodus of refugees create many problems particularly for the asylum-giving countries.

The United Nations’ documents define “a refugee as every person, who, owing to a well-founded fear of being persecuted for reasons of race, religion, nationality, membership of a particular social group, or political opinion, is outside the country of his nationality and is unable or, owing to such fear, is unwilling to avail himself of the protection of that country.”⁶

Of the world refugee population of approximately 10 million, the majority is the result, at least in countries of first asylum, of mass movements across national frontiers into the territory of neighbouring States. The refugee prototype—the isolated individual or family fleeing from political persecution—has become numerically insignificant compared to the exodus of major population groups. In recent years such groups, whether of Latin American, Indo-Chinese, African, Afghan or other origin, have dominated the refugee landscape with serious implications for development both in their countries of origin and most urgently, in the countries in which they seek asylum.⁷

The United Nations is seriously concerned with the problem of refugees. However, as the non-political humanitarian arm of the international community, the Office of the United Nations High Commissioner for Refugees (UNHCR) has a mandate only to protect, grant relief assistance and seek durable solutions for refugees and displaced persons who, as a result of so-called ‘man-made’ disasters in their native lands have been forced to flee across borders to other States. As a result of successive General Assembly resolutions, these ‘displaced persons’ are also of concern to the High Commissioner and can be assisted with voluntary funds at his or her disposal. But here the mandate ends. The UNHCR cannot be directly involved with the underlying causes of refugee movements and can do nothing overtly to prevent them. Once they have taken place, it cannot act as a kind of developmental agency that sponsors country programmes for the benefit of one sector or another of the national society to which the refugees have come.⁸

ILLEGAL MIGRATION

There has been a large illegal movement of population across several national borders. The very fact that illegal migrations are undocumented and given the very nature of this population flow, accurate estimates of the magnitude of illegal migration is impossible. Most estimates of illegal migration are, therefore, 'guesstimates'.

Various estimates, however, show that illegal migration is very heavy. The countries with large illegal immigrants include the United States, Venezuela, Hong Kong and Italy. Besides Hong Kong, some other countries in the ESCAP region, especially some labour-short, high economic growth countries comprising ASEAN, have also not discouraged flows of illegal worker migration.

TRENDS

The introduction of systematic regulation of immigration to suit the manpower requirement of the host countries coupled with the differences in the supply response of various emigrant countries resulted in a change in the nationality composition of the immigrant population in several countries. In some countries, the refugees have affected the ethnic composition of immigrants. Some countries have also favoured changes in the ethnic composition of immigrants due to political and strategic considerations.

Regulation and Changes in the Nationality Composition

Legislation in many of the countries having long standing immigration problems has accorded preference to immigrants possessing certain qualifications or skill in short supply among the native labour force. The United States, Canada and Australia—all of which had previously favoured immigrants from Europe and discriminated against those from other continents, particularly Asia—introduced changes in their immigration legislation which shifted the emphasis away from national origin of the immigrants to the skills which the potential immigrants possess. These change have occurred partly as a response to various pressures against racial or national origin discrimination, and partly because of the need for well defined industrial and professional skills and the disappearance of traditional European sources of skilled workers.⁹ Data provided elsewhere in this chapter give some indication of the changes in the nationality composition of the immigrants in the major host countries of North America, Oceania and Europe. The changes in the immigration policy of the developed countries which opened up a larger avenue of emigration from the developing countries have resulted in a brain drain from these countries.

There was remarkable change in the nationality composition of the population in the Middle East as well. The non-Arab migrants in the Middle East came from countries further away like Pakistan, India, Bangladesh, the Philippines and Korea, counter to the general tendency (at least in the case of temporary workers for host countries) to attract workers from immediately neighbouring and culturally more similar countries. In many Gulf States, more Asians were hired despite public statements of preferences for Arabs.¹⁰

Factors Affecting Changes in Composition This change in the nationality composition of the migrant workers was brought about by more than one factor. *Firstly*, the inability of the Arab labour exporters to meet the growing demand for labour increased the scope for participation in the labour markets of the oil rich countries by non-Arabs. *Secondly*, the increase in the Asian workers was encouraged by their willingness to accept job and living conditions and wages that Arabs resisted.¹¹ *Thirdly*, many

Gulf countries have feared that Arab migrants bring unwelcome "... political ideologies and cleavages that characterise other countries in the region."¹² In contrast, Asians are seen as outsiders and as apolitical. They are expected not to interact with the local population, are less likely to stay permanently and they can be expelled with fewer political repercussions than a similar expulsion of Arabs.¹³

Developed Countries and Migratory Population Until the early 1960s, about 80 per cent of immigrants to the United States, Canada and Australia came from other industrial countries, with the rest coming from the developing countries. By the end of the 1980s, the position was almost reversed in the case of the US with more than 80 per cent of the immigrants coming from the developing countries. The share of the developing countries in the immigrants to Canada, Australia and Europe has been rapidly increasing, although the trend is not as pronounced as in the case of the US. In the US, during the 1980s, immigrants accounted for about a quarter of the increase in the population; about a half of them came from Asia.

The population growth rate having fallen to very low levels, in the developed countries, and the population still booming in the developing countries, the impulse for migration from the developing countries to the developed ones would continue to be strong.

BRAIN DRAIN

Emigration of professionals and skilled people amount to drain of resources and development potential of developing countries.

International migration has been depriving many developing countries of a large number of professionals and other skilled personnel. Several developed countries admit large number of such people, most of whom come from developing countries.

Disadvantages

Many developing countries lose a significant share of their highly qualified people by migration. This amounts to the developing countries educating and training these persons at very high social costs, utilising their scarce resources, for the benefit of the advanced countries.

Emigration of professional and skilled personnel means, for the sending country, waste of public funds involved in developing human capital. Further, the pace of development may be affected due to the brain drain.

It is also important to note that "A country may also put a high social value on the services of professional migrants such as doctors and nurses, so that their emigration involves a higher loss than can be measured solely by loss of the money value of their services. Emigration also prevents 'internal diffusion'—skilled people moving to backward areas within a country."¹⁴

As a *World Development Report* points out, countries that import skilled manpower gain on two counts.¹⁵

1. Since professional education is highly subsidized, receiving countries save on such public subsidies.
2. Since countries can select immigrants, they can adjust more quickly to changes in demand.

To mitigate the adverse effects of emigration, governments may tax the income of the emigrants. The United States and the Philippines, for example, tax their citizens when they live abroad. There is also a view that there is no justification for subsidising higher education when the beneficiaries are the richer elite or when the probability of their emigrating is high.¹⁶

Benefits

Brain drain, however, has some beneficial effects too. The sending countries benefit from the emigrant remittances. Further, some of the professionals and other skilled personnel may return home with better knowledge and experience which could contribute to national development. In countries like India, though brain drain has caused shortage of certain categories of personnel, many doctors, engineers and other skilled personnel find it difficult to find a suitable job. The substantial increase in the seats for courses like medical science, engineering, etc. increase the supply of such human resources at rates faster than their absorption in the employment sector. Hence, it would be prudent for the government to devise policies that would facilitate the better utilisation of human resources for national development. Measures should also be taken to ensure that the emigrant will pay the nation the public expenditure incurred for his education and will make some further contribution.

Apart from monetary factors, discouragement and disillusion in the professional field are also responsible for brain drain. Therefore, to check brain drain it is also necessary to remedy this situation.

As the UNESCO succinctly points out, “brain drain or the migration of educated and talented people, is part of the wider issue of development and differences in levels of development between countries. For this reason, brain drain cannot be treated realistically as a subject on its own. The means of responding to the problem, where it is a problem, are for the large part associated with aspects of national activity of which migration is by no means always the first concern—education planning, human resource assessment, bringing about the conditions conducive to creative scientific work or even ensuring a favourable social and political climate.”¹⁷

EFFECTS OF INTERNATIONAL MIGRATION

International migration has demographic, economic, social, political and ecological effects.

Population Growth

Like internal migration, international migration also results in population redistribution. Migration affects population growth not only through the population redistribution but also through its impact on the natural increase.

Immigration has made significant contribution to the population growth of a number of countries including Australia, New Zealand, United States, Canada, Argentina, Israel, Uruguay, Venezuela, Switzerland, France, etc. Immigration has helped to accelerate the economic development of a number of countries which had shortage of manpower. It should be noted that a number of advanced countries today admit considerable skilled manpower, besides unskilled labour.

Expatriate workers constituted, in the 1970s and 80s, about one-third of the total labour force in the oil-rich Arab nations.

Effect on Unemployment and Excess Manpower

Emigration enables some countries to relieve their excess manpower and unemployment. The emigrant labour form quite a significant portion of the total labour force of several countries.

In some of the European countries, emigration helped to reduce employment demand which otherwise could not have absorbed domestically.

Effect on Wages

Large emigration has also caused wage increases in some labour sending countries. In some parts of India, such as Kerala, emigration has pushed up wages of carpenters, masons etc. This was caused not only due to the emigration of such manpower but also due to the lavish expenditure of the emigrants' earnings in their native place, like being very liberal in paying higher wages to agricultural labour and skilled workers like carpenters. Such expenditure has also raised wages of agricultural labour in some places. It has also caused an increase in the prices of items such as fish and meat.

Inflow of Emigrant Remittances

A significant benefit to the manpower exporting countries, however, is the inflow of emigrant remittances. A number of developing countries receive fabulous amounts of emigrant remittances. In the past two decades, workers' remittances from developed countries, and the developing countries with higher levels of per-capita income, have become an increasingly important source of external development finance, both in absolute terms and relative to other sources of external finance. Remittances rose steadily in the 1990s, reaching more than \$60 billion in 2001. During the 1990s, they were the most stable source of external finance, and, unlike foreign aid, they are not a burden on public budgets.¹⁸

India is the largest recipient of emigrant remittances. Other countries for whom workers' remittances is an important source of include Mexico and the Philippines. However, in relation to GDP, such flows are even more important for smaller economies such as El Salvador, Jamaica, Jordan, Nicaragua and Yemen. In absolute terms, the United States is the most important country of origin of workers' remittances to developing and other countries, but these flows constitute only a small item in that country's balance of payments. Expressed as a percentage of total imports, the outflow of remittances is particularly large in Saudi Arabia, where they correspond to almost 30 per cent of the total import bill, and some other resource-rich countries in the Middle East.¹⁹

Socio-political Effects

International migration also has important social and political implications. Changes in the ethnic composition of the population can have socio-political repercussions. It has been pointed out that immigration can create social tensions, often concentrated locally. Whole neighbourhoods exist in European countries and in the United States where adults are predominantly first generation immigrants. Large immigration of plantation labour in the past has caused a serious ethnic problem in Sri Lanka.

SUMMARY

Large cross border movement of population due to economic, socio-cultural, geo-physical and political reasons has been taking place for centuries now. International migration flows are of different nature —legal and illegal, voluntary or forced, and temporary or permanent.

International labour movement, however, is often subject to restrictions due to economic, political or social reasons. Such restrictions affect, particularly, the developing countries with large labour surpluses.

The major reason for voluntary migration is economic. Almost all studies confirm that most of the migrants (excluding forced and sequential migrations) have moved in search of better economic opportunities. Although non-economic factors too influence migration, most studies concur that migrants leave their area of origin primarily because of lack of economic opportunities, in the hope of finding better opportunities elsewhere.

Migration flows are generally pronounced from economically backward or stagnating areas to prosperous or dynamic areas.

Migration may be caused by push factors or pull factors. The **push factors** are the impelling factors which more or less compel people to leave the place, such as poor economic conditions and the resultant economic misery or lack of opportunities for advancement which push people out of the region in search of a livelihood or better opportunities. **Pull factors** refer to those factors which encourage migration to an area—employment and other economic opportunities, facilities, amenities, etc.

According to **Lee's theory**, the decision to migrate and the process of migration are influenced by four important sets of factors, viz, factors associated with the area of origin; factors associated with the area of destination; intervening factors; and personal factors.

Many countries have policies for **systematic regulation** immigration to suit the manpower requirement of the host countries. Some countries have also favoured changes in the ethnic composition of immigrants due to political and strategic considerations. Legislation in many of the countries having long standing immigration problems has accorded preference to immigrants possessing certain qualifications or skill in short supply among the native labour force.

With the population tending to stagnate or fall drastically in the developed countries while still booming in the developing countries, the impulse for migration from the developing countries to the developed ones would continue to be strong.

International migration has been depriving many developing countries of a large number of professionals and other skilled personnel. This drain amounts to the developing countries educating and training these persons at very high social costs, utilising their scarce resources, for the benefit of the advanced countries. **Brain drain**, however, has some beneficial effects too. The sending countries benefit from the emigrant remittances. Further, some of the professionals and other skilled personnel may return home with better knowledge and experience which could contribute to national development.

International migration has demographic, economic, social, political and ecological effects. Migration affects population growth not only through the population redistribution but also through its impact on the natural increase. Immigration has helped to accelerate the economic development of a number of countries which has shortage of manpower. Emigration enables some countries to relieve their excess manpower and unemployment. A significant benefit to the manpower exporting countries, however, is the inflow of emigrant remittances.

International migration also has important social and political implications.

Review Questions

1. Explain the trends in international migration.
2. Discuss the impact of international migration.
3. Write notes on the following:
 - (a) Push and pull factors
 - (b) Lee's theory of migration
 - (c) Forced and refugee migration
 - (d) Illegal migration
 - (e) Brain drain

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PART SEVEN

International Economic Organisations

CHAPTERS

- ❖ IMF and Development Organisations
- ❖ World Trade Organisation

CHAPTER 27

27

IMF and Development Organisations

LEARNING OBJECTIVES

- ❑ To understand the role and functions of IMF, the World Bank group, ADB, UNCTAD, UNIDO and ITC.
- ❑ To evaluate the role and performance of IMF and World Bank.

There are several international organisations, funding and assisting the development, particularly, of developing economies. The influence of some of them—IMF, World Bank and Regional Development Banks like the Asian Development Bank (ADB)—is, indeed, very profound. The economic policies and programmes of member countries which take financial assistance from these organisations may be influenced by the policies and conditions of assistance of these organisations. The IMF has several schemes of financial assistance for countries with balance of payment problems. It also provides different types of technical assistance. Assistances from the World Bank and Regional Development Banks are substantial sources of public investment in a number of countries.

National economic policies and global economic integration are influenced by international economic organisations.

INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF), which was established on December 27, 1945 with 29 countries and which began financial operations on March 1, 1947, is the result of the Bretton Woods Conference of nations held in 1944 to discuss the major international economic problems, including reconstruction of the economies ravaged by the World War II, and to evolve practical solutions for them. At the beginning of May 2008, IMF had 185 members.

IMF endeavours to maintain international monetary and national macro economic stability and to promote orderly development of global trade.

The IMF is the central institution of the international monetary system—the system of international payments and exchange rates among national currencies. It aims to prevent crises in the system by encouraging countries to adopt sound economic policies; it is also—as its name suggests—a fund that can be tapped by members needing temporary financing to address balance of payments problems.

Membership in the IMF is open to every country that controls its foreign relations and is able and prepared to fulfil the obligations of membership. Membership of the Fund is a prerequisite for membership

in the World Bank (IBRD) and close working relationships exist between the two organisations, as well as between the Fund and the WTO and the Bank for International Settlements (BIS).

The IMF had a membership of 184 countries in 2005. India is one of the founder members of IMF and World Bank. India, a traditional borrower from the IMF, has emerged as a creditor by contributing about \$292 million to the IMF in two tranches in May and June 2003.

Purposes

The IMF's **statutory purposes** include promoting the balanced expansion of world trade, the stability of exchange rates, the avoidance of competitive currency devaluations, and the orderly correction of a country's balance of payments problems.

According to the Articles of Agreement, the purposes of the International Monetary Fund are:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. 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 objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
4. To assist in the establishment of a multilateral 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.
5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.

To serve these purposes, the IMF:

- **Monitors** economic and financial developments and policies, in member countries and at the global level, and gives *policy advice* to its members based on its nearly six decades of experience.
- **Lends** to member countries with balance of payments problems, not just to provide temporary financing but to support adjustment and reform policies aimed at correcting the underlying problems.
- **Provides** the governments and central banks of its member countries with technical assistance and training in its areas of expertise.

Functions of IMF

As the only international agency whose mandated activities involve active dialogue with virtually every country on economic policies, the IMF is the principal forum for discussing not only national economic policies in a global context, but also issues important to the stability of the international monetary and

financial system. These include countries' choice of exchange rate arrangements, the avoidance of destabilizing international capital flows, and the design of internationally recognized standards and codes for policies and institutions.

While overseeing the economic policies of its member countries, the IMF looks mainly at the performance of an economy as a whole—often referred to as its macroeconomic performance. This comprises total spending (and its major components like consumer spending and business investment), output, employment, and inflation, as well as the country's balance of payments.

The IMF focuses mainly on a country's macroeconomic policies—that is, policies relating to the government's budget, the management of money and credit, and the exchange rate—and *financial sector* policies, including the regulation and supervision of banks and other financial institutions. In addition, the IMF pays due attention to *structural* policies that affect macroeconomic performance—including labor market policies that affect employment and wage behavior. The IMF advises each member on how its policies in these areas may be improved to allow the more effective pursuit of goals such as high employment, low inflation, and *sustainable* economic growth—that is, growth that can be sustained without leading to such difficulties as inflation and balance of payments problems.

Vision

According to the vision set out for the future of the IMF, it would:

- Strive to promote sustained non-inflationary economic growth that benefits all people of the world
- Be the centre of competence for the stability of the international financial system.
- Focus on its core macroeconomic and financial areas of responsibility, working in a complementary fashion with other institutions established to safeguard global public goods.
- Be an open institution, learning from experience and dialogue, and adapting continuously to changing circumstances.

Organisation and Management

The **Board of Governors**, on which all member countries are represented, is the highest authority governing the IMF. It usually meets once a year, at the Annual Meetings of the IMF and the World Bank. Each member country appoints a Governor—usually the country's minister of finance or the governor of its central bank—and an Alternate Governor. The Board of Governors decides on major policy issues but has delegated day-to-day decision-making to the *Executive Board*, which consists of 24 Executive Directors, with the Managing Director as chairman. The Executive Board usually meets three times a week, in full-day sessions, and more often if needed, at the organization's headquarters in Washington, D.C. The IMF's five largest shareholders—the United States, Japan, Germany, France, and the United Kingdom—along with China, Russia, and Saudi Arabia, have their own seats on the Board. The other 16 Executive Directors are elected for two-year terms by groups of countries, known as constituencies.

Key policy issues relating to the international monetary system are considered twice-yearly in a committee of Governors called the *International Monetary and Financial Committee*, or IMFC (until September 1999 known as the Interim Committee). A joint committee of the Board of Governors of the IMF and World Bank called the *Development Committee* advises and reports to the Governors on development policy and other matters of concern to developing countries.

Unlike some international organizations that operate under a one-country-one-vote principle (such as the United Nations General Assembly), the IMF has a weighted voting system: the larger a country's quota in the IMF—determined broadly by its economic size—the more votes it has. But the Board rarely makes decisions based on formal voting; rather, most decisions are based on consensus among its members and are supported unanimously.

Resources

Quotas and Subscriptions Every member of the Fund is required to subscribe to the Fund an amount equivalent to its quota. The Fund's system of quotas is one of its central features. Each member is assigned a quota expressed in Special Drawing Rights (SDRs). Quotas are used to determine the voting power of members, their contribution to the Fund's resources, their access to these resources, and their share in allocations of SDRs. A member's quota reflects its economic size in relation to the total membership of the Fund. For example, in 2008, the United States of America, the world's largest economy, accounted for the largest share (17.9 per cent) of total quotas and Seychelles, the world's smallest economy contributed 0.004 percent. Each member pays a subscription to the Fund equivalent to its quota, and the Board of Governors decides on the proportion to be paid in SDRs or in the member's currency. A member is generally required to pay about 25 per cent of its quota in SDRs or in currencies of other members selected by the IMF; it pays the remainder in its own currency.

The resources of the IMF come from subscription by members borrowings.

Quotas of all Fund members are reviewed at intervals of not more than five years. Several general increases have been agreed in the past to bring Fund quotas in line with the growth of the world economy and the need for additional international liquidity, while special increases from time to time have been agreed to adjust for differing rates of growth among members and for changes in their relative economic positions.

As the quota is based on the economic size of the nation and the voting right of a nation is determined by the size of its quota, the IMF is dominated by the industrial nations.

As a result of members' payments of subscriptions, the Fund holds substantial resources in members' currencies and SDRs, which are available to meet member countries' temporary balance of payments needs.

Borrowings The quota subscriptions of the member countries are the primary source of financial resources for the IMF. However, if necessary, the IMF may borrow to supplement the resources available from its quotas. The IMF has two sets of standing arrangements to borrow if needed to cope with any threat to the international monetary system: the *General Arrangements to Borrow (GAB)*, set up in 1962, which has 11 participants (the governments or central banks of the Group of Ten industrialised countries and Switzerland), and the *New Arrangements to Borrow (NAB)*, introduced in 1997, with 25 participating countries and institutions.

FINANCING FACILITIES AND POLICIES

The main function of the IMF is to provide loans to countries experiencing balance-of-payments problems so that they can restore conditions for sustainable economic growth. The financial assistance provided

IMF provides loans to countries with BOP problem to help stabilise their currencies and economies.

by the IMF enables countries to rebuild their international reserves, stabilise their currencies, and continue paying for imports without having to impose trade restrictions or capital controls. Unlike development banks, the IMF does not lend for specific projects.

The Process of IMF Lending

IMF loans are usually provided under an “arrangement,” which stipulates the conditions the country must meet in order to gain access to the loan. All arrangements must be approved by the Executive Board. Arrangements are based on economic programs formulated by countries in consultation with the IMF, and presented to the Executive Board in a “letter of intent.” Loans are then released in phased installments as the program is carried out.

The volume of loans provided by the IMF has fluctuated significantly over time. The oil shock of the 1970s and the debt crisis of the 1980s were both followed by sharp increases in IMF lending. In the 1990s, the transition process in Central and Eastern Europe and the crises in emerging market economies led to another surge in the demand for IMF resources.

Concessional and Non-concessional Lending Over the years, the IMF has developed a number of loan instruments, or “facilities,” that are tailored to address the specific circumstances of its diverse membership. Low-income countries may borrow at a concessional interest rate through the Poverty Reduction and Growth Facility (PRGF). Non-concessional loans are provided through five main facilities: Stand-By Arrangements (SBA), the Extended Fund Facility (EFF), the Supplemental Reserve Facility (SRF), the Contingent Credit Lines (CCL), and the Compensatory Financing Facility (CFF).

Except for the PRGF, all facilities are subject to the IMF’s market-related interest rate, known as the “rate of charge” (which includes an adjustment for deferred charges and arrears) and some carry an interest rate premium, a “surcharge.” The rate of charge is based on the SDR interest rate, which is revised weekly to take account of changes in short-term interest rates in the major international money markets. The IMF discourages excessive use of its resources by imposing a surcharge on large loans, and countries are expected to repay loans early if their external position allows them to do so.

IMF Facilities

Poverty Reduction and Growth Facility (PRGF) The IMF for many years provided assistance to low-income countries through the Enhanced Structural Adjustment Facility (ESAF). In 1999, however, a decision was made to strengthen the focus on poverty, and the ESAF was replaced by the PRGF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper (PRSP), which is prepared by the country in cooperation with civil society and other development partners, in particular the World Bank. The interest rate levied on PRGF loans is only 0.5 percent, and loans are to be repaid over a period of 5½–10 years.

Stand-By Arrangements (SBA) The SBA is designed to address short-term balance-of-payments problems and is the most widely used facility of the IMF. The length of a SBA is typically 12–18 months. Repayment is normally expected within 2¼–4 years unless an extension is approved. Surcharges apply to high levels of access.

Extended Fund Facility (EFF) This facility was established in 1974 to help countries address more protracted balance-of-payments problems with roots in the structure of the economy. Arrangements under the EFF are thus longer (3 years). Repayment is normally expected within 4½–7 years unless an extension is approved. Surcharges apply to high levels of access.

Supplemental Reserve Facility (SRF) The SRF was introduced in 1997 to meet a need for very short-term financing on a large scale. The sudden loss of market confidence experienced by emerging market economies in the 1990s led to massive outflows of capital, which required loans on a much larger scale than anything the IMF had previously been asked to provide. Countries are expected to repay loans within 1–1½ years, but may request an extension by up to 1 year. All SRF loans carry a substantial surcharge of 3–5 percentage points.

Contingent Credit Lines (CCL) The CCL differs from other IMF facilities in that it aims to help members prevent crises. Established in 1999, it is designed for countries implementing sound economic policies, which may find themselves threatened by a crisis elsewhere in the world economy—a phenomenon known as “financial contagion.” The CCL is subject to the same repayment conditions as the SRF, but carries a smaller surcharge of 1½–3½ percentage points.

Compensatory Financing Facility (CFF) The CFF was established in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. The financial terms are the same as those applying to the SBA, except that CFF loans carry no surcharge.

Emergency Assistance The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict. Emergency loans are subject to the basic rate of charge and must be repaid within 3¼–5 years.

Conditionality

IMF often insists on certain macro economic stabilisation measures by borrowing countries.

When the IMF provides financial support to member countries, it must be sure the members are pursuing policies that will improve or eliminate their external payments problems. The explicit commitment that members make to implement corrective measures in return for the IMF’s support is known as “conditionality.” Fund conditionality requirements, linking the financial assistance to the adoption of economic adjustments policies by members, seek to ensure that the member’s policies are adequate to achieve a viable balance of payments position over a reasonable period. This commitment also ensures that members are able to repay the IMF in a timely manner, which in turn allows the IMF’s limited pool of financial resources to be made available to other members with balance of payments problems. IMF financing, and the important role it plays in helping a country secure other financing, enables the country to adjust in an orderly way without resorting to measures that would harm its own or other countries’ prosperity.

Conditions for IMF financial support may range from general commitments to cooperate with the IMF in setting policies, to the formulation of specific, quantified plans for financial policies. IMF financing from its general resources in the “upper credit tranches” (that is, where larger amounts are provided in return for implementation of remedial measures) is disbursed in stages.

The IMF requires a “letter of intent” or a “memorandum of economic and financial policies,” in which a government outlines its policy intentions during the period of the adjustment program; the policy changes it will make before the arrangement can be approved; performance criteria, which are objective indicators for certain policies that must be satisfied on a quarterly, semiannual, or in some

instances monthly basis in order for drawings to be made; and periodic reviews that allow the Executive Board to assess whether the member's policies are consistent with the program's objectives.

Conditionality is flexible. The Executive Board's guidelines on conditionality encourage members to adopt corrective measures at an early stage; stress that the IMF should take into consideration members' domestic social and political objectives, as well as their economic priorities and circumstances; permit flexibility in determining the number and content of performance criteria; and emphasize that IMF arrangements are decisions of the IMF that set out, in consultation with members, the conditions for its financial assistance.

The IMF recognizes that no one reform model suits all members and that individual countries—both governments and civil society—must have “ownership” of their programs. Thus, each member country, in close collaboration with the IMF staff, designs its IMF-supported programme. The process involves a comprehensive review of the member's economy, including the causes and nature of the balance of payments problems and an analysis of the policies needed to achieve a sustainable balance between the demand for, and the availability of, resources.

IMF-supported programs emphasize certain key aggregate economic variables—domestic credit, the public sector deficit, international reserves, and external debt—and crucial elements of the pricing system—including the exchange rate, interest rates, and, in some cases, wages and commodity prices—that significantly affect the country's public finances and foreign trade and the economy's supply response.

Although macroeconomic policies designed to influence aggregate demand (the total amount of national planned expenditure in an economy) continue to play a key role in many IMF-supported adjustment programs, it is widely recognized that measures to strengthen an economy's supply side (production of goods and services) are frequently essential to restore and maintain external viability and sound growth. Among the IMF-supported policy adjustments that member countries make to enhance the growth potential and flexibility of their economies are measures to remove distortions in the external trade system and in domestic relative prices, improve the efficiency and soundness of the financial system, and foster greater efficiency in fiscal operations.

Structural reforms in these areas have been particularly important in programs under the Extended Fund Facility and the Poverty Reduction and Growth Facility (PRGF), and the latter focuses particularly on poverty reduction as well. Given the emphasis on structural reforms in IMF-supported programs, close collaboration with the World Bank has been important.

Critic During a Stand-By Arrangement, an Extended Arrangement, or an arrangement under the PRGF, the IMF monitors a member's reform program through performance criteria selected according to the economic and institutional structure of the country, the availability of data, and the desirability of focusing on broad macroeconomic variables, among other considerations. Performance under IMF-supported reform programs is also monitored through periodic reviews by the IMF Executive Board.

Criticisms have been levelled from several corners on the fund conditionality. One important criticism is that the conditionalities endanger the nation's sovereignty.

Conditionalities are not something peculiar to the IMF. Any responsible financial institution will lend only after satisfying itself about the repaying capacity of the borrower and it will impose conditions necessary to ensure proper utilisation of the loan and its repayment. It is very much true of the public sector financial institutions in India too. The IMF and World Bank cannot be exceptions to this long-standing, well-accepted, and sound financing principle. However, just as the rehabilitation package drawn up by the public sector financial institutions in India for sick units need not necessarily be the

most appropriate one, the IMF-Bank prescriptions need not necessarily be the most appropriate ones. A nation should, of course, ensure that it does not accept any conditionality which harms its interests. At the same time, there is no reason to hesitate to take their assistance as and when required because they have been established to help needy member countries. In fact, it is the right of every member country to obtain legitimate assistance from these institutions. It may be noted that, although, in the past, communists had a tendency to describe IMF and World Bank as organs of capitalist imperialism, the communists countries have themselves come to seek large assistance from these institutions. China and Russia are now among the largest borrowers from the World Bank.

While conditionality is essential, the appropriateness of any particular set of conditionalities for a country needs to be carefully evaluated. Joseph E. Stiglitz, a Nobel laureate and former chief economist and senior vice president of World Bank, has vehemently criticised the IMF policies prescribed for several developing countries (and for the US too). He observes that the IMF is not particularly interested in hearing the thought of its “client countries” on such topics as development strategy or fiscal austerity.

The IMF conditionalities many a time are inappropriate and some times even ridiculous.

All too often, the Fund’s approach to developing countries has had the feel of a colonial ruler and that the IMF some times confuses ends with means.¹

It has been observed that the IMF’s conditionality has generally been monetarist and deflationary, obliging governments to reduce their demand for imports by curtailing overall demand—cutting back on both private and public spending. These cutbacks have often reduced consumption, investment and employment. “An alternative strategy would have been adjustment with growth, which would have aimed more at promoting production, both to increase exports and to meet a higher proportion of local demand from local production. Although there have been indications of a change of IMF policy in this direction, there is as yet no well articulated agenda of reform.”

Technical Assistance

The IMF provides technical assistance in areas within its core mandate—namely, macro-economic policy, monetary and foreign exchange policy and systems, fiscal policy and management, external debt, and macroeconomic statistics.

The objective of IMF technical assistance is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial policy. In practice, the IMF fulfills this objective by providing support to capacity building and policy design. It helps countries strengthen their human and institutional capacity, as a means to improve the quality of policy-making, and gives advice on how to design and implement effective macroeconomic and structural policies.

The IMF provides technical assistance in three broad areas: (i) Designing and implementing fiscal and monetary policies; (ii) drafting and reviewing economic and financial legislation, regulations, and procedures, thereby helping to resolve difficulties that often lie at the heart of macroeconomic imbalances; and (iii) institution and capacity building, such as in central banks, treasuries, tax and customs departments, and statistical services.

In addition, the IMF provides training to officials from its member countries through courses offered at its headquarters in Washington, as well as at the Joint Vienna Institute, the Singapore Training Institute, the Joint Africa Institute, and other regional and sub-regional locations. Assistance is provided through several IMF departments.

External Cooperation

In recent years, technical assistance projects have grown both larger and more complex, requiring multiple sources of financing to support activities. Large projects now commonly involve more than one IMF department and more than one development partner. Donors with which the IMF cooperates include the United Nations Development Program; the governments of Australia, Denmark, Japan, and Switzerland; the World Bank; and the European Union. These partners currently support nearly one-third of the IMF's technical assistance and about one-half of the cost of short- and long-term experts in the field. The government of Japan also makes generous annual contributions to IMF technical assistance programs and scholarship support. Such cooperative arrangements with multilateral and bilateral donors not only support activities financially, but also help avoid conflicting advice and redundant activities and have led to a more integrated approach to the planning and implementation of technical assistance. As the demand for technical assistance in macroeconomic and financial management grows, such arrangements will become even more valuable.

SDRs

The special drawing right (SDR), is an international reserve asset introduced by the IMF in 1969 (under the First Amendment to its Articles of Agreement) out of concern among IMF members that the current stock, and prospective growth, of international reserves might not be sufficient to support the expansion of world trade. The main reserve assets were gold and U.S. dollars, and members did not want global reserves to depend on gold production, with its inherent uncertainties, and continuing U.S. balance of payments deficits, which would be needed to provide continuing growth in U.S. dollar reserves. The SDR was introduced as a supplementary reserve asset, which the IMF could "allocate" periodically to members when the need arose, and cancel, as necessary.

SDRs—sometimes known as "paper gold" although they have no physical form—have been allocated to member countries (as book-keeping entries) as a percentage of their quotas. So far, the IMF has allocated SDR 21.4 billion (about \$29 billion) to member countries. The last allocation took place in 1981, when SDR 4.1 billion was allocated to the 141 countries that were then members of the IMF. Since 1981, the membership has not seen a need for another general allocation of SDRs, partly because of the growth of international capital markets. In September 1997, however, in light of the IMF's expanded membership—which included countries that had not received an allocation—the Board of Governors proposed a Fourth Amendment to the Articles of Agreement. When approved by the required majority of member governments, this will authorize a special one-time "equity" allocation of SDR 21.4 billion, to be distributed so as to raise all members' ratios of cumulative SDR allocations to quotas to a common benchmark.

A proposal for a *special one-time allocation of SDRs* was approved by the IMF's Board of Governors in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. This allocation would double cumulative SDR allocations to SDR 42.8 billion. Its intent is to enable all members of the IMF to participate in the SDR system on an equitable basis and correct for the fact that countries that joined the Fund subsequent to 1981—more than one fifth of the current IMF membership—have never received an SDR allocation. The Fourth Amendment is to become effective when three fifths of the IMF membership (111 members) with 85 percent of the total voting power accept it.

IMF member countries may use SDRs in transactions among themselves, with 16 "institutional" holders of SDRs, and with the IMF. The SDR is also the IMF's unit of account. A number of other

international and regional organizations and international conventions use it as a unit of account, or as a basis for a unit of account.

Valuation of SDR

The value of the SDR was initially defined as equivalent to 0.888671 grams of fine gold. As this was the par value of the US dollar under the Bretton Woods system, the SDR was also equivalent to one US dollar. With the collapse of the Bretton Woods system in 1973, the rationale for defining the SDR in terms of gold was weakened, however, and in 1974 the SDR was redefined as a *basket of currencies*. Today, that basket consists of the euro, Japanese yen, pound sterling, and US dollar.

The SDR's value is set daily using a basket of four major currencies: the euro, Japanese yen, pound sterling, and US dollar.

The basket is reviewed every five years to ensure that the currencies included are representative of those used in international transactions, and that the weights assigned to them reflect their relative importance in the world's trading and financial systems.

On March 14, 2008, US \$1 = SDR 1.00000000; 1 SDR = Rs 40.45000000

What Next?

Six decades are over since the Bretton Woods Conference which led to the foundation of IMF and the environment in which the IMF functions is quite different from the early days. Many developing countries became independent and members of the Fund only years after its formation. The number of successful, mature economies has grown from a handful at the end of World War II to a significant number now. The number of 'emerging markets'—countries with substantial international trade and at least some access to private international capital—has also grown from a small handful to more than 50. Some countries will no longer need to borrow from the IMF, others will occasionally need to borrow quite large amounts, and still others will graduate from borrowing on concessional terms to drawing on the Fund's ordinary resources on market terms. Both the private markets and official agencies such as the IMF will have to be prepared for these and other developments.

The need for constant adaptation to an evolving world economy by IMF is undiminished. Four key issues stand out as calling for attention in the years ahead.²

1. The IMF's surveillance over its members' economic and financial policies must be strengthened so that the institution can provide more effective early warnings when economic trouble looms so that countries will have more incentives to heed those warnings before trouble actually hits.
2. The IMF needs to ensure more effectively that its lending to help resolve financial crises restores countries' access to capital markets and supports a revival of economic growth.
3. The IMF must do more to ensure that its policy advice and financial support for low-income countries are appropriately directed toward helping those countries emerge from poverty.
4. Finally, reform of the IMF must address the equity and effectiveness of the way the institution is governed. As the economic importance and role of various countries and regions ebb and flow, and as their dependence on the IMF for financing and advice varies, so should their role and influence within the IMF if the institution is to retain its political credibility and legitimacy. An open and meritocratic selection process for the position of Managing Director will help, as will the IMF's more general shift toward transparency.

WORLD BANK

The World Bank Group, originated as a result of the Bretton Woods Conference of 1944. It is one of the world's largest sources of development assistance and it has extended assistance to more than 100 developing economies, bringing a mix of finance and ideas to improve living standards and eliminate the worst forms of poverty. For each of its clients, the Bank works with government agencies, nongovernmental organizations, and the private sector to formulate assistance strategies.

The World Bank group consists of five institutions.

The World Bank Group consists of five closely associated institutions, each institution playing a distinct role in the mission to fight poverty and improve living standards for people in the developing world. The term World Bank refers specifically to two of the five, The International Bank for Reconstruction and Development (IBRD) and The International Development Association (IDA). The other institutions are The International Finance Corporation (IFC), The Multilateral Investment Guarantee Agency (MIGA), and The International Centre for Settlement of Investment Disputes (ICSID). While all five specialize in different aspects of development, they use their comparative advantages to work collaboratively toward the same overarching goal—poverty reduction. At the beginning of May 2008, the IBRD had 185 countries as members.

The **IBRD**, whose capital is subscribed by its member countries, finances its lending operation primarily from its own borrowings in the world capital markets. A substantial contribution to the Bank's resources also comes from its retained earnings and the flow of repayments on its loans. IBRD loans generally have a grace period of five years and are repayable over twenty years, or less. They are directed toward developing countries at more advanced stages of economic and social growth. The interest rate the IBRD charges on its loans is calculated in accordance with a guideline related to its cost of borrowing.

The World Bank is owned by the member countries whose views and interests are represented by a Board of Governors and a Washington-based Board of Directors. Member countries are shareholders who carry ultimate decision-making power in the World Bank.

Under the Articles of Agreement of the Bank, all powers are vested in the Bank's Board of Governors, consisting of the Governor for each member country. With the exception of certain powers specifically reserved for them by the Articles of Agreement, the Governors of the Bank have delegated their powers to a Board of Executive Directors that performs its duties on a full-time basis at the Bank's headquarters. There are twenty-one Executive Directors, each Director selects an Alternate Director. As provided for in the Articles of Agreement, five Directors are appointed by the five members having the largest number of shares of capital stock, and the rest are elected by Governors representing other member countries.

The Executive Directors are responsible for the conduct of the general operations of the Bank. They decide on Bank policy in the framework of the Articles of Agreement. They also decide on all loan and credit proposals. In practice they reach most of their decisions by consensus.

The Bank's President is, by tradition, a national of the largest shareholder, the United States. Elected for a five-year renewable term, the President chairs meetings of the Board of Executive Directors and is responsible for overall management of the World Bank.

Mission and Principles

The mission of the Bank is to:

- Fight poverty with passion and professionalism for lasting results.

- Help people help themselves and their environment by providing resources, sharing knowledge, building capacity, and forging partnerships in the public and private sectors.
- Be an excellent institution able to attract, excite, and nurture diverse and committed staff with exceptional skills who know how to listen and learn.

The principles of the Bank: Client centric, working in partnership, accountable for quality results, dedicated to financial integrity and cost-effectiveness, inspire and innovative.

Purposes

The purposes of the Bank, as laid down in its Articles of Agreement, are:

- To assist in the reconstruction and development of the territories of the members, by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace time needs, and the encouragement of the development of productive facilities and resources in less developed countries.
- To promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors, and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital funds raised by it and other resources.
- To promote the long-range balanced growth of international trade and the maintenance of equilibrium in the balance of payments, by encouraging international investment of the productive resources of members, thereby assisting in raising productivity, the standards of living and conditions of labour in their territories.

Orientations

The main focus is on helping the poorest people and the poorest countries, but for all its clients the Bank emphasises the need for:

- Investing in people, particularly through basic health and education.
- Focusing on social development, inclusion, governance and institution-building as key elements of poverty reduction.
- Strengthening the ability of the governments to deliver quality services, efficiently and transparently.
- Protecting the environment.
- Supporting and encouraging private business development.
- Promoting reforms to create a stable macroeconomic environment, conducive to investment and long-term planning.

Through its loans, policy advice and technical assistance, the World Bank supports a broad range of programmes aimed at reducing poverty and improving living standards in the developing world.

The global fight against poverty is aimed at ensuring that people everywhere in this world have a chance for a better life for themselves and for their children. Over the past generation, more progress has been made in reducing poverty and raising living standards than during any other period in history in developing countries:

Guiding Principles

In its lending operations, the Bank is guided by certain policies which have been formulated on the basis of the Articles of Agreement.

First, the Bank should properly assess the repayment prospects of the loans. For this purpose, it should consider the availability of natural resources and existing productive plant capacity to exploit the resources, and operate the plant and the country's past debt record.

Secondly, the Bank should lend only for specific projects which are economically and technically sound and of a high priority nature. As a matter of general policy, it concentrates on lending for projects which are designed to contribute directly to productive capacity, and normally does not finance projects which are primarily of social character, such as education, housing, etc. Most Bank loans have been made for basic utilities, such as power and transport, which are prerequisites for economic development. Besides, the Bank places considerable emphasis upon the proper management of the projects.

Thirdly, the Bank lends only to enable a country to meet the foreign exchange content of any project cost; it normally expects the borrowing country to mobilise its domestic resources.

Fourthly, the Bank does not expect the borrowing country to spend the loan in a particular country; in fact, it encourages the borrowers to procure machinery and goods for Bank financed projects in the cheapest possible market consistent with satisfactory performance.

Fifthly, it is the Bank's policy to maintain continuing relations with borrowers with a view to check the progress of projects and keep in touch with financial and economic developments in borrowing countries. This also helps in the solution of any problem which might arise in the technical and administrative fields.

Finally, the Bank indirectly attaches special importance to the promotion of local private enterprise.

Lending Programmes

While the World Bank has traditionally financed all kinds of capital infrastructure such as roads and railways, telecommunications, and ports and power facilities, its development strategy also places an emphasis on investments that can directly affect the well-being of the masses of poor people of developing countries by integrating them as active partners in the development process. Some time back, the Bank has stepped up its lending for energy development; lending for power forms the largest part of the Bank's energy programme, but commitments for oil and gas developments have shown the greatest increases.

Structural Adjustment Lending The Bank, in response to the deteriorating prospects for the developing countries during the 1980s, inaugurated a programme of structural adjustment lending (SAL). This lending supports programmes of specific policy changes and institutional reforms in developing countries designed to achieve a more efficient use of resources and thereby: (a) Contribute to a more sustainable balance of payments in the medium and long term and to the maintenance of growth in the face of severe constraints; and (b) Lay the basis for regaining momentum for future growth.

Special Action Programme In 1983, the Bank initiated its Special Action Programme (SAP), designed to increase assistance to countries that were making efforts to cope with the exceptionally difficult economic environment brought on by a global recession. The SAP, established for a two year period, was composed of financial measures, combined with policy advice, to help countries implement adjustment measures and high-priority projects needed to restore credit worthiness and growth. According

to the Bank, the SAP had been highly successful in meeting its objectives, surpassing in most respects, the expectations set for it.

B-Loan and Export Credit In January 1983, the Executive Directors authorised the establishment of a new set of financing instruments to help the Bank's borrowers increase and stabilise flows of private capital on approved terms by linking part of commercial bank flows to IBRD operations. These instruments, which comprise the B-Loan pilot programme, include three options: (a) Direct Bank participation in the late maturities of a B-Loan; (b) Bank guarantee of the late maturities, with the possibility of release from all or a part of its share; and (c) Bank acceptance of a contingent obligation to finance an element of deferred principal at final maturity of a loan with level debt-service payments with floating-rate interest and variable amounts of principal repayment. A fourth approach was also approved by the Board—the prearranged sale of participations in Bank loans arranged on commercial terms.

INTERNATIONAL DEVELOPMENT ASSOCIATION

The IDA provides soft loans to poor nations.

The International Development Association (IDA), a member of the World Bank group, was established in 1960 to provide concessional assistance to countries that are too poor to borrow at commercial rates. IDA helps to promote growth and reduce poverty in the same ways as does the IBRD, but IDA uses interest-free loans (which are known as IDA “credits”), technical assistance, and policy advice. IDA credits account for about one-fourth of all Bank lending. Borrowers pay a fee of less than 1 percent of the loan to cover administrative costs. Repayment is required in 35 or 40 years with a 10-year grace period. IDA's assistance is, concentrated on the very poor countries.

The funds of the IDA come mostly in the form of subscriptions, general replenishments from IDA's more industrialised and developed members, and transfers from the net earnings of the IBRD.

Developing countries can avail themselves of IDA loans on very liberal terms for projects which are not eligible for assistance from the World Bank either because loans for such projects do not carry the guarantee of the government of the borrowing country or because such projects do not contribute directly and immediately to the productive capacity of the borrowing country. Examples of such projects are water supply, urban development, housing, slum clearance, education, sanitation and health facilities, etc.

Approval criteria In approving an IDA credit, three criteria are observed.

Poverty Test IDA'S assistance is limited to the poorest countries which continue to face such severe handicap as excessive dependence on volatile primary products markets, heavy debt servicing burdens, and often, rates of population growth that outweigh the gains of production.

Performance Test Within the range of difficulties of establishing objective standards of performance, these factors serve as the yardstick for an adequate performance test: Satisfactory overall economic policies and past success in project execution.

Project Test The purpose of the IDA is to advance soft loans, *not finance soft projects*. IDA projects are appraised according to the same standard as that applied to the Bank projects—the test essentially requires that the proposed projects yield financial and economic returns which are adequate to justify the use of scarce capital.

The Board of Governors of the IDA approved the fourteenth replenishment of IDA's resources on April 18, 2005. Under the IDA 14, approximately \$33 billion is made available to the world's 81 poorest countries during the next three years. Of this amount, about \$18 billion will come from new contributions from 40 donor countries. This represents an approximately 25 percent increase in overall resources over the previous replenishment, and is the largest expansion of IDA resources in two decades.

IDA's financial support to poor countries will now take systematic account of vulnerability to debt. The countries facing the toughest debt problems—most of them in Sub-Saharan Africa—will get all of their support in the form of grants, while less debt-burdened countries will receive IDA's highly concessional long-term loans (interest-free credits with a maturity period of 40 years and a grace period of 10 years), or in a few cases a mixture of grants and credits. It is expected that, as a result, around 30 percent of total IDA support in the coming three years will be on grant terms. At the same time, donors agreed on measures to help offset the financial impact of grants on IDA's ability to support poor countries in the future.

In another innovative step is the decision to put development results at the center of IDA's program. Systematic indicators, based on the Millennium Development Goals and on countries' own statistical systems, will monitor development progress and link outcomes to IDA country programs and projects, enabling better assessment of how both countries and IDA are doing, and quicker and more flexible responses to changes on the ground.

WORLD BANK ASSISTANCE TO INDIA

Until China became a member of the World Bank in 1980, India was the largest beneficiary of the World Bank assistance. Now there are a number of larger beneficiaries than India. In 1997, the total World Bank assistance to India amounted total about five per cent of the total Bank assistance.

India, one of the founder members of the IBRD and IMF, is one of the largest beneficiaries of the IBRD-IDA assistance.

Over the years, the roles of the World Bank and the IDA almost reversed as regards the assistance to India. In 1974–75, of the total IBRD-IDA aid to India, IDA accounted for three-fourths and the World Bank for one-fourth. In 1998, the World Bank accounted for nearly two-thirds and the IDA about one-third of the total assistance. This decline in the share of soft loan naturally increases India's debt burden.

India's share in the IDA's global credit has declined over the years. Until 1979–80, IDA's aid to India accounted for, on an average, about 40 per cent of its total aid. Thereafter there was decline in this share.

Apart from the resource crunch IDA has been facing, China's entry into the World Bank has seriously affected the fund flow to India. Although the World Bank assistance to India is very large in absolute terms, the per capita assistance has been low. India, with about a third of the world's poor needs a substantial increase in the concessional finance to accelerate the programmes of poverty alleviation and economic development.

EVALUATION OF IMF—WORLD BANK

The contribution made by IMF and World Bank in helping the member countries in different ways cannot be ignored. Studies show that the projects assisted by the World Bank group could make significant impact in the respective countries. IMF has played an important role in providing international liquidity and in the structural adjustment programmes. There is, however, a wide gap between the aspirations and

There is a general dissatisfaction and a lot of anguish about the performance of IMF-World Bank.

achievements. A criticism often made is that these institutions, which are dominated by the developed countries, have not been paying adequate attention to the needs of the developing countries.

The objective of the Bretton Woods Conference was to establish a global monetary and financial system to promote stable exchange rates, foster the growth of world trade, and international movement of capital in the desired directions.

At the time of the establishment of these institutions, most of the developing countries were colonies and, therefore, not represented at the Bretton Woods. The major concern of these institution was, naturally, the major problems of the main participants, i.e. the developed countries, and "...there was an almost inevitable lack of concern for the interests of developing countries."³ Even after the developing countries have far outnumbered the developed ones in the total membership of these institutions, the dominance of the developed countries continues because of the voting system which gives clear control to the large contributors.

However, as the South Commission observes⁴, concern for developing countries was not completely absent; the mandate of the World Bank included the provision of development assistance. But in the early post-war years, financing the reconstruction of war-devastated Europe and Japan received much more attention than the crying development needs of the developing countries. The proposal for a Special United Nations Fund for Economic Development (SUNFED), which would offer large-scale aid on easy terms to developing countries, was rejected in the 1950s mainly because developed countries objected to the United Nations becoming involved in financial aid to developing countries.

The view that in the international management of balance of payments disequilibrium, there should be pressure to adjust on both surplus countries and deficit countries, rather than only on those in deficit, was also ignored. In fact, Keynes' original proposal for an International Clearing Union (the prototype for the IMF) included the possibility of a penalty on surplus countries—one per cent of the surplus per month to encourage them to make adjustments, too.

Again, only very little could be done by the IMF in solving the international liquidity problem of the developing countries in comparison with those of the developed countries. Indeed developing countries need much larger attention of the multilateral institutions than the developed countries for various reasons. The developed countries have the capability for, and ready access to commercial borrowing whenever their reserves run short. The United States, which has had the largest deficit among the developed countries, has also had option of running permanent deficit since other countries have been content to hold dollars.

The situation for the developing countries is quite different. Due to their poor economic conditions, the relative burden of their payments deficit is much more than that of the absolute burden; the absolute deficit itself has been huge. Not only that the commercial borrowing capability of these nations are limited, the accessibility has also been limited because of their poor creditworthiness. It may be recalled here that, in the early 1990s when India's foreign exchange reserves position became very critical, the sources of short-term commercial borrowings dried up due to the fall in the credit rating. To make matters worse, because of the poor credit ratings, the developing countries have had to pay an average rate of interest which was about four times the rate applied to the developed countries on commercial borrowings.

Against this background, the IMF system has been ironic as far as the developing countries are concerned. The unconditional borrowing rights based on the quota highly discriminate against the developing countries. What is more draconic has been the allocation of the SDRs, the created liquid

assets, in proportion to the quota. This is like giving away the lion's share of a cake received as a gift to the fairly well fed, ignoring the severe hunger of those who have been in a abject starvation.

One of the important problems of the developing countries is the increase in the debt service due to the payment commitments of the past debt. There has been a transfer of large amounts of funds from the developing countries to the creditors as debt service. This has not been compensated by an increased flow from the IMF to the developing countries. During certain periods, IMF was actually withdrawing funds from the developing countries. "The Bretton Woods institutions thus failed many developing countries at their times of great need."⁵

Stiglitz very categorically observes that a half century after its founding, it is clear that the IMF has failed in its mission. It has not done what it was supposed to do—provide funds for countries facing an economic downturn, to enable the country to restore itself to close to full employment. In spite of the fact that our understanding of economic processes has increased enormously during the last fifty years, and in spite of IMF's efforts during the past quarter century, crises around the world have been more frequent and (with the exception of the Great Depression) deeper, by some reckonings, close to a hundred countries have faced crises. Worse, many of the policies that the IMF pushed, in particular premature capital market liberalization, have contributed to global instability. And once a country was in crisis, IMF funds and programs not only failed to stabilize the situation but in many cases actually made matters worse, especially for the poor. The IMF failed in its original mission of promoting global stability; it has also been no more successful in the new missions that it has undertaken, such as guiding the transition of countries from communism to a market economy.⁶

One problem, as far as the proper functioning of the IMF is concerned, has been that it has not had any control over the rich nations. It could not, therefore, avert the breakdown of the Bretton Woods monetary system. It has been rightly observed that "the World Bank is no closer to meeting its mandate, either. It was established to borrow the savings of the rich nations and to lend them to poor nations—to finance sound development projects and programmes, particularly where private investment failed or was inadequate. In fact, it has done little to recycle global surplus to deficit nations."⁷

Only a small portion of the total World Bank assistance is in the form of soft loans (IDA credits). The IDA now represent only 30 per cent of the World Bank lending. The major part of the World Bank lending to many developing countries like India is on commercial terms. This is one of the reasons for the increase in their debt-service problem.

The IBRD lending rates now 'float' in line with the world market rates. "This is a major shift from the Bank's original role of cushioning developing countries against fluctuations in market interest rates. The Bank was supposed to raise capital and lend it at rates that it could afford to subsidise because of its own strength and that of its industrial country partners."⁸

Another limitation is the size of the funds available to the Bank. The availability of funds depends on, *inter alia*, the willingness of the developed countries to contribute. It is pointed out that the United States which is the largest contributor, is not only reluctant to increase its own contribution, but also reluctant to let other countries (like Japan which would be able to offer a lot more) to do so since its own voting power would be correspondingly reduced.⁹

In short, "... the quantity and composition of World Bank lending is clearly inadequate for the challenges it faces in developing countries."¹⁰

Some of the failures of IMF-World Bank have been highlighted above. One should at the same time recognise the useful role they have played all these years by extending different types of assistance to the different categories of countries. The increase in the membership of these institutions is a clear evidence of their utility. Although the communists in the past had described these institutions as organs of capitalist imperialism, several communist countries have become members of these institutions and recently all the states of the former Soviet Union and East European countries have become members.

Suggestions

Some suggestions to make the IMF-World Bank more effective, particularly for the developing countries, are given below:

1. Dismantling the dominance of the developed countries in the management of these institutions. But this would be very difficult to realise as the contribution by the developed countries is the major source of funds for these institutions. Only a change in the attitude of the developed nations can help achieve a smooth transformation.
2. An increase in the international liquidity of the developing countries brooks no delay. There should be a substantial review of the SDRs and this additional SDRs should be allocated completely to the developing countries. An addition or alternative to this would be to allow countries below a certain per capita income to have a larger reserve tranche at the IMF.
3. The IMF should evolve into a World Central Bank. "This was its original *raison d'être*. though developments in the ... years have conspired to usurp this function."¹¹
4. The developing countries taking World Bank loans have now to fall into one of two categories: developed enough to afford the stiff terms demanded by the IBRD, or poor enough to qualify for concessionary funds from the IDA. But many countries, such as those in Asia, are poised uncertainly between the two. It is, therefore, suggested ¹² to create a new loan window—an Intermediate Assistance Facility (IAF) which could help countries ready to graduate from the extremely concessional IDA terms but not yet sufficiently robust to meet the tough terms of IBRD—such as India and Pakistan. This would enable the World Bank to concentrate its IDA resources on the long terms development of the least developed countries and the IBRD funds on the most creditworthy of the newly industrialising countries.
5. It is also pointed out that so far the Bretton Woods Institutions have often focused more on the means of development—GNP growth—and tended to exclude human beings from their calculations. They will need to refocus their work on human development if they are to make a constructive contribution in the future.¹³

As Stiglitz points out, "development is about transforming societies, improving the lives of the poor, enabling everyone to have a chance at success and access to health care and education... This sort of development won't happen if only a few people dictate the policies a country must follow. Making sure that democratic decisions are made means ensuring that a broad range of economists, officials, and experts from developing countries are actively involved in the debate. It also means that there must be broad participation that goes well beyond the experts and politicians. Developing countries must take charge of their own futures. But we in the West cannot escape our responsibilities."¹⁴

INTERNATIONAL FINANCE CORPORATION

The International Finance Corporation, an affiliate of the World Bank, was established in 1956. Although membership in the World Bank is a prerequisite for membership in the IFC, legally and financially, the IFC is a separate entity. The Corporation has its own operating and legal staff, but draws upon the Bank for administrative and other services.

The IFC promotes private sector investment, both foreign and domestic, in developing member countries. Its investment and advisory activities are designed to reduce poverty and improve people's lives in an environmentally and socially responsible manner. Its work includes activities in some of the riskiest sectors and countries. IFC serves as an investor and an honest broker to balance each party's interest in a transaction, reassuring foreign investors, local partners, other creditors, and government authorities. IFC advises businesses entering new markets and governments trying to provide a more hospitable business environment, to create effective and stable financial markets, or to privatize inefficient state enterprises.

Mission and Objectives

The mission of IFC is to contribute to the World Bank Group's overall purpose of reducing poverty and improving living standards by playing a leading role in the development of a sustainable private sector. The goal of IFC, in partnership with others, is to deliver development impact.

IFC's basic tools to achieve this goal remain loan and equity financing of private enterprises, mobilisation of external capital alongside its own resources, and provision of related advisory and technical assistance services. But the context of the Corporation's work has dramatically altered, opening many new areas of activity.

The objective of IFC is to assist the economic development of less developed countries by promoting growth in the private sector of their economies and helping mobilise domestic and foreign capital for this purpose.

The IFC's role is to stimulate the flow of private capital into productive private, mixed private/public enterprises. It acts as a catalyst in bringing together entrepreneurship, investment capital and production.

The origin of the IFC lay in the recognition by the industrial countries that the provision of essential infrastructure for development alone would not be enough to attract private investment flows to countries where underdevelopment was pronounced. It was necessary, in addition, to encourage the growth of productive private investment and saving in the developing world. These broad objectives were translated into specific objectives that were embodied in the IFC's Articles of Agreement.

Main Features of Assistance

The main features of IFC's assistance are:

1. The IFC makes its investments in partnership with private investors from the capital-exporting country or from the country in which the enterprise is located, or both.
2. It is envisaged that the Corporation's investments will never be more than half of the capital requirements of the enterprise.
3. The minimum investment the IFC will make in an enterprise is fixed at \$ 1.00,000 or its equivalent, but no upper limit is fixed.

4. The enterprises eligible for loans from the Corporation should be predominantly industrial and contribute to the economic development of the country.
5. The rate of interest in each case would be a matter of negotiation depending on the risks and other investments.
6. The IFC will not seek or accept a government guarantee for the repayment of any of its investments, nor will it seek formal government approval of any proposed financing, except when such approval is required by law in any country.

Distinguishing Features of IFC One important feature that distinguishes the IFC from commercial financial institutions is its commitment to provide project sponsors with the necessary technical assistance that will help ensure that their ventures are potentially productive and financially sound. In addition, the Corporation provides policy assistance to its member governments in support of their efforts to develop the necessary investment climate that will encourage productive as well as beneficial domestic and foreign investment.

Recognising the important contributions of financial markets to economic development, the IFC has a specialised department that is the focal point of the capital market development activities of the IFC and the World Bank. The Department provides specialised resources for addressing the financial market needs and problems of developing countries. In response to the economic situation, in 1984 the IFC began to expand its operation in a new area—assisting in the physical and financial restructuring of existing firms (corporate restructuring). In addition to corporate restructuring, IFC expanded its activities into several other new areas. For example, it helped create a bonding facility for construction firms operating outside their own country, helped establish a secondary mortgage marketing institution, and provided financing for a regionally oriented venture—capital company.

The privatisation trend all around the world has greatly increased the role of the IFC.

IFC and India

The IFC has assisted a number of projects in India. The new economic policy of India which has substantially enhanced the role of the private sector implies a greater role for the IFC in the industrial development of the country.

The Corporation has identified five priority areas in India where it plans to beef up its activities. The five identified areas for strengthened activities include *capital markets development, direct foreign investment, access to foreign markets, equity investments in new and expanding companies to finance capital investments and infrastructure*. The IFC opened a mission in Mumbai to speed up the assessment of the project proposals. India is the first of the IFC's member countries to benefit from such a decentralisation.

First, IFC will invest in a range of financial service companies and provide technical assistance to help develop India's capital market. *Secondly*, with its global network of contacts, IFC could act as a catalyst in bringing together Indian and foreign companies, stimulating the flow of foreign investment and technology into India.

Thirdly, IFC will intensify its efforts to help Indian companies gain access to funding in the international financial market through loan syndications and underwriting of securities issues.

Fourthly, Indian companies need to strengthen their balance sheets by increasing equity and reducing debt levels if they were to survive in a more competitive market. The IFC is giving special emphasis to equity investments in companies that are internationally competitive.

MIGA and ICSID

As foreign direct investment is an important driver of growth in emerging economies, the Multilateral Investment Guarantee Agency (MIGA)'s mandate is to promote foreign direct investment by offering political risk insurance (guarantees) to investors and lenders, and by providing skills and resources to help emerging economies attract and retain this investment. Projects MIGA supports typically convey many direct benefits to host countries, including jobs created for local workers; accompanying and enduring investments in skills and training for employees; and a general impact on the national economy as a whole, as provided by tax revenues and foreign exchange earnings through exports.

The International Centre for Settlement of Investment Disputes (ICSID) provides facilities for the settlement—by conciliation or arbitration—of investment disputes between foreign investors and their host countries.

ASIAN DEVELOPMENT BANK

Some regional development banks have been established to assist the development of the developing countries of the respective regions—the African Development Bank, the Asian Development Bank, the Caribbean Development Bank and the Inter-American Development Bank.

The importance of the regional banks is growing as they are becoming more responsive to the special needs of their own constituencies.

The Asian Development Bank (ADB) was set up in December 1966 under the auspices of the United Nations Economic Commission for Asia and Far East (ECAFE) to foster economic development of Asian countries, with its headquarters at Manila. (It also has about two dozen other offices around the world) ADB is a multilateral development finance institution dedicated to reducing poverty in Asia and the Pacific. In 2002, 61 nations, mostly from the region were members of ADB.

The funds of the ADB are contributed by developed countries such as Japan, USA, Canada, West Germany, Australia, etc.

Objectives

ADB's overarching goal is to reduce poverty in Asia and the Pacific. It helps improve the quality of people's lives by providing loans and technical assistance for a broad range of development activities. ADB is a non-profit, multilateral development finance institution that engages in mostly public sector lending for development purposes in its developing member countries.

The main objectives of the ADB are:

1. To promote investment in the ESCAP region of public and private capital for development.
2. To utilise the available resources for financing development, giving priority to those regional, sub-regional as well as national projects and programmes which contribute more effectively to the harmonious economic growth of the region as a whole.

In the 23rd Annual Meeting of the Board of Governors of the ADB, the President has pointed out that the Bank's most appropriate response to Asian and Pacific development in future lies in following three broad directions:

1. Greater priority must be placed on alleviating poverty and protecting the environment.
2. The Bank must strengthen its assistance to the private sector to improve productivity and efficiency.
3. The Bank must work with its developing members to create a policy framework that makes the most efficient use of human and capital resources.

The adoption of poverty reduction as a strategy gave primacy to ADB's fight against poverty. ADB continues to carry out activities to promote economic growth, develop human resources, improve the status of women, and protect the environment, but these strategic development objectives now serve its poverty reduction agenda. Its other key development objectives, such as law and policy reform, regional cooperation, private-sector development, and social development, also contribute significantly to this main goal.

Focus

ADB focuses on poverty reduction. In doing so, it emphasises:

- Promotion of pro-poor, sustainable economic growth
- Social development
- Good governance

In support of the above, ADB concentrates on:

- Protection of the environment
- Promotion of gender and development
- Private sector development
- Regional cooperation

A major problem which the ADB is facing is shortage of funds. The Western donors now show a lot of interest in the development of Eastern Europe.

UNCTAD

UNCTAD aims at promoting trade and economic development of developing nations.

The United Nations Conference on Trade and Development (UNCTAD) was created in 1964 as an expression of the belief that a cooperative effort of the international community was required to integrate developing countries successfully into the world. The UNCTAD, which is a plenary body of a large number of countries, is a permanent organ of the UN General Assembly. The conference, which is UNCTAD's highest decision-making body, meets every four years to set priorities and guidelines for the organization, and provides an opportunity to debate key economic and development issues. Eleven conferences have been so far held under the auspices of UNCTAD.

The UNCTAD:

- Aims at the development-friendly integration of developing countries into the world economy.
- Is the focal point within the United Nations for the integrated treatment of trade and development and the interrelated issues in the areas of finance, technology, investment and sustainable development.
- Is a forum for intergovernmental discussions and deliberations, supported by discussions with experts and exchanges of experience, aimed at consensus-building. UNCTAD undertakes research, policy analysis and data collection in order to provide substantive inputs for the discussions of experts and government representatives.
- In co-operation with other organizations and donor countries, it provides technical assistance tailored to the needs of the developing countries, with special attention being paid to the needs of the least developed countries, and countries with economies in transition.

Functions

The principal functions of UNCTAD are:

1. To promote international trade with a view to accelerating economic development;
2. To formulate principles of and policies on international trade and related problems of economic development
3. To negotiate multinational trade agreements
4. To make proposals for putting its principles and policies into effect.

The major activities of UNCTAD include research and support of negotiations for commodity agreements, technical elaboration of new trade activities designed to assist developing countries in the areas of trade and capital.

Basic Principles

UNCTAD's action programme and priorities have been laid down in the various recommendations adopted by the first conference in 1964. These recommendations are based on the following basic principles;

1. Every country has the sovereign right to freely dispose of its natural resources in the interest of the economic development and well-being of its own people and to freely trade with other countries;
2. Economic relations between countries, including trade relations, shall be based on respect for the principles of sovereign equality of states, self-determination of people, and non-interference in the internal affairs of other countries; and
3. There shall be no discrimination on the basis of differences in socio-economic systems and the adoption of various trading methods and trading policies shall be consistent with this principle.

UNCTAD XI

UNCTAD XI, the latest session of UNCTAD, was held in São Paulo in June 2004. The week long Conference focused on *enhancing the coherence between national development strategies and global economic processes towards economic growth and development, particularly for developing countries*.

UNCTAD XI adopted a declaration entitled the *Spirit of São Paulo*, as well as the *São Paulo Consensus*, a negotiated document providing more detail on the role of UNCTAD in a globalising world.

The UNCTAD XI declaration focuses on key issues, currently faced by the developing countries. Although globalisation has brought unprecedented wealth and progress to the world, its benefits have not been equally distributed.

The Spirit of São Paulo recognises that most developing countries, especially African countries and least developed countries, have remained on the margins of the globalisation process. There is a need to focus on the ability of international trade to contribute to poverty alleviation".

The São Paulo Consensus focuses on four topics:

- Development strategies in a globalising world
- Building productive capacities and international competitiveness
- Assuring development gains from the international trading system and trade negotiations
- Partnership for development.

During the negotiations, delegates also vigorously debated the role of UNCTAD and implications of the ongoing UN reform programme. Original proposals by some developed countries recommended

UNCTAD merely provide technical assistance at the national level. Developing countries pushed for a stronger role for the institution, including targeted policy research and analysis of global issues. The agreed text notes UNCTAD's "special responsibility to contribute to the achievement of the international development goals, including those contained in the Millennium Declaration," in addition to UNCTAD's role of participating effectively in "the ongoing UN reform process, which is aimed at inter alia deepening coherence and enhancing the effectiveness and impact of UN development activities. The organisation's participation in that reform process will be reviewed through the existing intergovernmental mechanisms of UNCTAD."

The São Paulo Consensus received mixed reviews from civil society organisations. Among other reactions, the Institute for Agricultural and Trade Policy found a decision to establish an international task force on commodities to study mechanisms for recuperating and stabilising commodity prices "promising". A proposal to set up a fund to help countries reliant on single or dual commodities to diversify exports also received positive feedback, although some groups felt this initiative would depend on "countries that have money".

Environmental organisation *Friends of the Earth and Third World Network* expressed disappointment with the lack of emphasis on corporate responsibility and accountability in the Consensus. Some organisations also would have liked to see a firmer stance against multilateral trade agreements that affect development and the conditionalities imposed by the World Bank and the International Monetary Fund through their loan schemes.¹⁵

Review of the Functioning of UNCTAD

UNCTAD has made significant contribution to the efforts of developing countries to participate more fully and to adapt to changes in the world economy. UNCTAD has also provided an invaluable forum for advancing the interrelationship between trade and development, from both a national and an international perspective, across the three pillars of its mandate.

Despite the debates and disagreements over the years, UNCTAD played a key role in the emergence of :

1. The Generalised System of Preferences (GSP)
2. A maritime shipping code
3. Special international programmes to help the least developed countries
4. International aid targets

During the 1970s, in line with the major changes in the international economic environment—the breakdown of the Bretton Woods System, oil price shocks, inflation and accumulation of debt by many developing countries—UNCTAD became a central forum for debates between the North and the South. Its negotiations became politically charged and most of its sessions during the 1970s and 1980s reflected sharp divisions between participants, even as global consensus seemed to be emerging in the 1980s.¹⁶

UNIDO

The United Nations Industrial Development Organisation (UNIDO), which was set up in January 1967, is an organ of the UN General Assembly. The primary function of UNIDO is to promote industrialisation in developing countries by encouraging the mobilisation of national and international resources. Particular

attention is given to manufacturing industries. Unlike UNCTAD, UNIDO works directly with business firms, generally on an industry basis. The major activities of UNIDO fall into the following three categories.

Operational Activities

These include direct technical assistance to industries (at the request of the governments of the developing country) and in-plant training programmes whereby groups of technicians and engineers from developing countries facing a common industrial problem are brought together to consider how industry in the more advanced countries avoids or solves similar problems.

Research

In this area, UNIDO conducts feasibility studies on the requirements and potential industry in developing countries. Export-oriented industries are given special attention.

Coordination

The coordinating activities of UNIDO include mostly the organisation and sponsoring of inter-regional and international meetings, seminars and symposia.

INTERNATIONAL TRADE CENTRE

The International Trade Centre (ITC) is the focal point in the United Nations System for technical cooperation with developing countries in trade promotion. ITC was created by the General Agreements on Tariffs and Trade (GATT) in 1964 and since 1968 has been operated jointly by GATT (now WTO) and the UN, the latter acting through the United Nations Conference on Trade and Development (UNCTAD). As an executing agency of the United Nations Development Programme (UNDP), ITC is directly responsible for implementing UNDP financed projects in developing countries related to trade promotion.

The ITC assists developing countries to formulate trade development strategies.

ITC can advise developing countries on their overall approach to marketing communications, as well as on individual information and publicity activities. This entails establishing a strategy with broad communications objectives that are in line with the firm's international marketing goals and defining specific actions to achieve those objectives. Trade fairs are one such specific activity. For instance, ITC can provide guidelines on choosing the most appropriate fairs for the firms and products concerned, preparing the exhibition budget, designing the stand, producing publicity material, briefing the participants, manning the stand, following up on business inquiries and evaluating exhibition performance. Similar ITC services are available for planning and executing trade missions, solo exhibitions and store promotions, which all call for skills in conducting marketing research, selecting participants and products, preparing promotional material, making detailed arrangements and following through with business contacts.

For trade promotion publications, ITC can give advice on developing a publications plan and determining specific types of publications to be part of it, such as product and company brochures; export directories, and trade promotion bulletins, newsletters and magazines. Suggestions on contents, graphics, production and distribution are part of this service. Briefly, the ITC assists the developing countries by working with them in:

Developing a national trade promotion strategy, including analysing export potential, choosing priority markets and setting export targets.

Establishing appropriate government institutions and services, such as a central trade promotion organisation and services for exporters in trade information, export financing, export quality control, export costing and pricing, export packaging trade fairs and commercial publicity, the legal aspects of foreign trade, international physical distribution of goods, trade promotion services for small and medium-size enterprises, and commercial representation abroad.

Finding market opportunities for current export products, both nontraditional items and elected primary commodities, and using effective marketing techniques to promote them abroad; adapting other products to foreign market requirements and developing new items for export; and promoting exports of technical consulting services.

Training government trade officials, businessmen and instructors in export marketing and trade promotion, and establishing a national framework for developing export training over the long term.

Improving import operations and techniques to optimise scarce foreign exchange resources.

SUMMARY

The global economic integration and even the development strategy of many nations are influenced by several international organisations such as the IMF, World Bank, regional development banks and WTO.

The main objectives of the IMF are to alleviate the problems of international liquidity (i.e. to help the member countries meet their balance of payments deficits) and to achieve international monetary and macro economic stability. The IMF has different schemes of financial and non-financial assistances for the needy member countries.

The World Bank—International Bank for Reconstruction and Development (IBRD)—was established to help the reconstruction and development of various national economies by providing long-term capital assistance. The World Bank has an affiliate namely International Development Association (IDA), established in 1960 to provide assistance for the same purpose as the IBRD, but primarily in the poorer developing countries and on terms that would bear less heavily on their balance of payments than IBRD loans. IDA'S assistance, therefore, concentrated on the very poor countries. The International Finance Corporation (IFC), another affiliate of the World Bank, is established to contribute to the World Bank Group's overall purpose of reducing poverty and improving living standards by playing a leading role in the development of a sustainable private sector.

There are also some regional development banks established with the objective of assisting the development of the developing countries of the respective regions, like the Asian Development Bank (ADB).

The contribution made by IMF and World Bank in helping the member countries in different ways cannot be ignored. Studies show that the projects assisted by the World Bank group could make significant impact in the respective countries. IMF has played an important role in providing international liquidity and in the structural adjustment programmes. There is, however, a wide gap between the aspirations and achievements.

India is one of the founder members of the World-IMF and is one of the largest beneficiaries of the IBRD-IDA assistance.

It is often criticized that World-IMF which are dominated by the developed countries, have not been paying adequate attention to the needs of the developing countries. Further, they are accused of making unwarranted interference in the economic policies of the borrowing developing countries, besides the fact that they failed to give adequate and timely assistance to the poor nations.

The United Nations Conference on Trade and Development (UNCTAD) aims, mainly, at the development-friendly integration of developing countries into the world economy by promoting international trade, among other things, with a view to accelerating their economic development.

The main objective of the United Nations Industrial Development Organisation (UNIDO) is to promote industrialisation in developing countries by encouraging the mobilisation of national and international resources

The International Trade Centre (ITC), which is the focal point in the United Nations system for technical cooperation with developing countries in trade promotion, helps them to develop national trade promotion strategies, including analysing export potential, choosing priority markets and setting export targets.

Review Questions

1. Discuss the functions and role of IMF.
2. Give a brief account of IMF's financing policies and facilities.
3. Evaluate IMF's policies and assistance in respect of developing countries.
4. "IMF and World Bank serve the interests of industrialised nations rather than those of the developing countries". Comment.
5. Discuss the functions and role of World Bank.
6. Discuss the role of IMF vis-à-vis India.
7. Evaluate World Bank's assistance to India.
8. Write notes on the following:

(a) IMF conditionalities	(b) SDRs
(c) IDA	(d) Soft loans
(e) International Finance Corporation	(f) Asian Development Bank
(g) UNCTAD	(h) UNCTAD XI
(i) UNIDO Centre	(j) International Trade

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Suggested Readings

CHAPTER 28

28 World Trade Organisation

LEARNING OBJECTIVES

- ☐ To get an idea of the multilateral trade negotiation system.
- ☐ To review the performance of GATT.
- ☐ To understand the role and functioning of WTO.
- ☐ To evaluate the performance of WTO.
- ☐ To examine some issues of importance to developing nations, with special reference to India

The World Trade Organization (WTO) the successor to the GATT, that came into being on January 1, 1995, is the only international organisation dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business fairly.

The objective of WTO, the successor of GATT, is to provide a framework of principles and rules for globalisation of business to achieve all round economic prosperity.

GATT

The General Agreement on Tariffs and Trade (GATT), the predecessor of WTO, was born in 1948 as result of the international desire to liberalise trade.

The establishment of an International Trade Organisation (ITO) had also been recommended by the Bretton Woods Conference of 1944 which had recommended the IMF and World Bank. Although the IMF and World Bank were established in 1946, because of objections that its enforcement provisions would interfere with the autonomy of domestic policy making, the ITO charter was never ratified. Instead the GATT, which had been drawn up only as an interim agreement to fill the gap until the ITO charter was ratified, became the framework for international trading system since it came into being in 1948. The international trading system since 1948 was, at least in principle, guided by the rules and procedures agreed to by the signatories to the GATT which was an agreement signed by the contracting nations which were admitted on the basis of their willingness to accept the GATT disciplines.

The GATT was transformed into a World Trade Organisation (WTO) with effect from January, 1995. Thus, after about five decades, the original proposal of an International Trade Organisation took shape as the WTO. The WTO which is a more powerful body than the GATT has an enlarged role than the GATT.

India is one of the founder members of the IMF, World Bank, GATT and the WTO.

Objectives

The primary objective of GATT was to liberalise and expand international trade in goods so as to bring about all-round economic prosperity.

The Preamble to the GATT mentioned the following as its important objectives.

1. Raising standard of living.
2. Ensuring full employment and a large and steadily growing volume of real income and effective demand.
3. Developing full use of the resources of the world.
4. Expansion of production and international trade.

Rules Governing International Trade

GATT embodied certain conventions and general principles governing international trade among countries that adhere to the agreement. The rules or conventions of GATT required that:

1. Any proposed change in the tariff, or other type of commercial policy of a member country should not be undertaken without consultation of other parties to the agreement.
2. The countries that adhere to GATT should work towards the reduction of tariffs and other barriers to international trade, which should be negotiated within the framework of GATT.

For the realisation of its objectives, GATT adopted the following principles:

Non-discrimination The principle of non-discrimination requires that no member country shall discriminate between the members of GATT in the conduct of international trade. To ensure non-discrimination the members of GATT agree to apply the principle of most favoured nation (MFN) to all import and export duties. This means that “each nation shall be treated as well as the most favoured nation.” As far as quantitative restrictions are permitted, they too, are to be administered without favour.

However, certain exceptions to this principle were allowed. For instance, GATT did not prohibit economic integration such as free trade areas or customs union, provided the purpose of such integration was “to facilitate trade between the constituent territories and not to raise barriers to the trade of other parties.” The GATT also permitted the members to adopt measures to counter dumping and export subsidies. However, the application of such measures had to be limited to the offending countries.

Prohibition of Quantitative Restrictions GATT rules sought to prohibit quantitative restrictions as far as possible and limit restrictions on trade to the less rigid tariffs. However, certain exceptions to this prohibition were granted to countries confronted with balance of payments difficulties and to developing countries. Further, import restrictions were allowed to apply to agricultural and fishery products if domestic production of these articles was subject to equally restrictive production or marketing controls.

Consultation By providing a forum for continuing consultation, it sought to resolve disagreements through consultation. Eight rounds of trade negotiations had been held under the auspices of the GATT. Each round took several years. The Uruguay Round, the latest one, took more than seven years to conclude, as against the originally contemplated four years. This shows the complexity of the issues involved in the trade negotiations.

EVALUATION OF GATT

The growing acceptance of GATT/WTO, despite their shortcomings, is evinced by the increase in the number of the signatories. When the GATT was signed in 1947, only 23 nations were party to it. It increased to 99 by the time of the Seventh Round and 117 countries participated in the next, i.e. the Uruguay Round. In July 1995, there were 128 signatories. In May 2008, 151 countries were members of WTO, and a number of nations have been negotiating for membership. It is interesting to note that the Peoples Republic of China, which was one of the original signatories to the GATT, quit it in the late 1940s following the assumption of power by the communist party, but got admitted to the WTO, after prolonged negotiations, with effect from January 1, 2002. The WTO members now account for over 97 per cent of the international trade indicating the potential of the WTO in bringing about an orderly development of the international trade.

GATT achieved considerable trade liberalisation with the notable exceptions of agriculture and textiles.

Effect of GATT on World Trade

The 50 years preceding the dawn of the present century have seen an exceptional growth in world trade. Merchandise exports grew on average by 6% annually. Total trade in 2000 was 22-times the level of 1950. GATT and the WTO have helped to create a more liberal trading system contributing to unprecedented growth. The system was developed through a series of trade negotiations, or rounds, held under GATT. The first rounds dealt mainly with tariff reductions but later negotiations included other areas such as anti-dumping and non-tariff measures. The last round—the 1986–94 Uruguay Round—led to the creation of WTO and provided for global economic and business liberalisations of very wide scope and ramifications.

One of the principal achievements of GATT was the establishment of a forum for continuing consultations. “Disputes that might otherwise have caused continuing hard feeling, reprisals, and even diplomatic rupture have been brought to the conference table and compromised”.

GATT and Trade Liberalisation

GATT could achieve considerable trade liberalisation. There were, of course, several exceptions.

Agricultural trade was clearly an exception to the liberalisation. Far from becoming freer, trade in agriculture became progressively more distorted by the support given to farmers (which took the form of severe barriers to imports, and subsidies to exports) in the industrial nations.

Similarly, another exception was textiles. Trade in textiles was restricted by the Multifibre Arrangement (MFA). Under the MFA imports of textile items to a number of developed countries were restricted by quotas.

Besides agriculture and textiles, two exceptions to the general trend of trade liberalisation have been trade of developing countries and economic integration. Developing countries with balance of payments problems have been generally exempted from the liberalisation. Even the Uruguay Round has granted such exemptions to developing countries.

Although the picture of trade liberalisation has to be qualified with such exceptions, the GATT achieved very commendable trade liberalisation. The average level of tariffs on manufactured products in industrial countries was brought down from about 40 per cent in 1947 to nearly three per cent after the Uruguay Round.

Indeed the period of 1950–1973 is conspicuous by the splendid results of progressive trade liberalisation. The 275 years since 1720 witnessed the highest average annual growth rates in output and international trade. These rates were substantially higher than for any other period. Indeed, the 1950s and 1960s are described as the golden decades of capitalism. The output levels of companies using newer and newer technologies in many cases were much larger than the domestic markets could absorb. Expansion of markets to other countries enabled even companies in other industries to increase their output. There was also a surge in international investments.

The progressive liberalisation of trade, however, suffered a setback since 1974; although the elimination of tariff barriers continued, even the developed countries have substantially increased non-tariff barriers since then.

The collapse of the Bretton Woods system in the early 1970s and the oil crisis made matters very difficult for many countries, both developing and developed, and, as a result of these, demands for protection increased dramatically. The developing country exports have been hit very hard by the NTBs.

Further, the exports of developing countries gained significantly less from the GATT Rounds than did exports of the industrial nations. In case of agricultural commodities not only was that there was no liberalisation, but also there was an increase in protection. Manufactured products of interest to developing countries like textiles and clothing, footwear etc. have been subject to increasing non-tariff barriers. While the developed countries enjoy a more liberalised trading environment, the growing NTBs have been severely affecting the exports of developing countries. Ironically, the developed countries are increasing the protectionism when the developing countries are liberalising. This is indeed a sad commentary on the GATT and other multilateral organisations.

The trade liberalisation has been confined mostly to goods of interest to the developed countries.

THE URUGUAY ROUND

The special feature of the UR was the inclusion of services, TRIPs and TRIMs in MTNs.

Uruguay Round (UR) is the name by which the eighth round of the multilateral trade negotiations (MTNs) held under the auspices of the GATT, because it was launched in Punta del Este in Uruguay, a developing country, in September 1986.

Because of the complexities of the issues involved and the conflicts of interests among the participating countries, the Uruguay Round could not be concluded in December 1990 as was originally scheduled. When the negotiations dragged on, Arthur Dunkel, the then Director General of GATT, presented a Draft Act embodying what he thought was the result of the Uruguay Round. This came to be popularly known as the Dunkel Draft. This was replaced by an enlarged and modified final text which was approved by delegations from the member countries of the GATT on 15th December 1993. This Final Act was signed by ministers of 125 governments on 15th April 1994. The results of the Uruguay Round were to be implemented within ten years since 1995. Different time periods are given for effecting the different agreements.

The first six Rounds of MTNs concentrated almost exclusively on reducing tariffs, while the Seventh Round (Tokyo Round-1973–79) moved on to tackle non-tariff barriers (NTBs). The UR sought to broaden the scope of MTNs far wider by including new areas such as:

- Trade in services
- Trade related aspects of intellectual property (TRIPs)
- Trade related investment measures (TRIMs).

Because of the inclusion of these new aspects in the GATT negotiations, the developing countries had serious apprehensions about outcome of the Uruguay Round.

The Uruguay Round took up three basic subjects for discussion:

1. Reducing specific trade barriers and improving market access.
2. Strengthening GATT disciplines.
3. Problems of liberalisation of trade in services, trade related aspects of intellectual property rights (TRIPs) and trade related investment measures (TRIMs).

Some of the important features of the Uruguay Round Agreements are given below.

The UR went beyond the traditional subject of GATT, i.e. goods, to services, technology, investment and information.

WORLD TRADE ORGANISATION

Following the UR Agreement, GATT was converted from a provisional agreement into a formal international organisation called World Trade Organisation (WTO) with effect from January 1, 1995. WTO now serves as a single institutional framework encompassing GATT and all the results of the Uruguay Round. It is directed by a Ministerial Conference that will meet at least once every two years and its regular business is overseen by a General Council. The WTO Secretariat, based in Geneva, Switzerland.

The WTO, which replaced the GATT on January 1, 1995, is a more powerful organisation than GATT with much larger role.

GATT and WTO

The old GATT system allowed, under what was known as the 'grandfather clause', existing domestic legislation to continue even if it violated a GATT agreement that a member country had accepted by being a signatory to GATT. The WTO, specially rules this out.

The situation, after the coming into effect of WTO, may be described as *the GATT is dead, long live the GATT*.

GATT the organisation is replaced by WTO but GATT the agreement continues.

Under the old system, there were two GATTs : (i) GATT the Agreement—i.e. the agreement between contracting parties (governments) setting out the rules for conducting international trade; (ii) GATT the Organisation—an international organisation created to facilitate discussions and administration related to the Agreement (ad hoc, though, continued to exist until the establishment of the WTO). GATT the organisation ceased to exist with the establishment of WTO; GATT the agreement, which always dealt with (and still does) trade in goods, continues to exist, in amended form, as part of the WTO alongside two new agreements, viz., General Agreement on Trade in Services (GATS) and General Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). The old text is now called 'GATT 1947' and the updated version is called 'GATT 1994'.

FII investment has become an important determinant of the stock market trends in India.

Table 28.1 Difference Between GATT and WTO

<i>GATT</i>	<i>WTO</i>
GATT was Adhoc and provisional	WTO and its agreements are permanent
GATT had contracting parties	WTO has members
GATT system allowed existing domestic legislation to continue even if it violated a GATT agreement	WTO does not permit this
GATT was less powerful, dispute settlement system was slow and less efficient, its ruling could be easily blocked	WTO is more powerful than GATT, dispute settlement mechanism is faster and more efficient, very difficult to block the rulings.

The WTO is GATT plus a lot more.

GATT (the institution) was small and provisional, and not even recognized in law as international organization. GATT (the agreement) has been amended and incorporated into the new WTO Agreements. GATT deals only with trade in goods. The WTO Agreements now cover services and intellectual property as well.

The WTO is a more powerful body with enlarged functions than the GATT and is envisaged to play a major role in the world economic affairs. To become a member of the WTO, a country must completely accept the provisions of the Uruguay Round.

Functions

WTO's overriding objective is to help trade flow smoothly, freely, fairly and predictably.

The WTO achieves its objectives by:

1. Administering the WTO trade agreements.
2. Providing the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreements.
3. Administering the mechanism for settling trade disputes between the member countries.
4. Monitoring national trade policies.
5. Providing technical assistance and training for developing countries.
6. Cooperating with other international organizations like the IMF and IBRD and its affiliated agencies with a view to achieving greater coherence in global economic policy making.

WTO Principles

The WTO agreements have three main objectives:

- To help trade flow as freely as possible
- To achieve further liberalization gradually through negotiation
- To set up an impartial means of settling disputes

A number of simple, fundamental principles run throughout all the WTO agreements. They are the foundation of the multilateral trading system. They include:

- Non-discrimination (“most-favoured-nation” treatment and “national” treatment)
- Freer trade, predictable policies, encouraging competition
- Extra provisions for less developed countries.

These are described under the *objectives* of GATT above.

Organisational Structure

Decisions in the WTO are made by the entire membership. This is typically by consensus. A majority vote is also possible but it has never been used in the WTO, and was extremely rare under the WTO’s predecessor, GATT. The WTO’s agreements have to be ratified in all members’ parliaments.

The WTO’s top level decision-making body is the *Ministerial Conference* which meets at least once every two years.

Below this is the *General Council* (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members’ capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body.

At the next level, the *Goods Council*, *Services Council* and *Intellectual Property (TRIPS) Council* report to the General Council.

Numerous *specialized committees*, *working groups* and *working parties* deal with the individual agreements and other areas such as the environment, development, membership applications and regional trade agreements.

All WTO members may participate in all councils, committees, etc., except Appellate Body, Dispute Settlement panels, Textiles Monitoring Body, and plurilateral committees.

THE WTO AGREEMENTS—A BIRD’S EYE VIEW

The WTO endeavours to ensure that trade is as fair as possible and as free as practicable by negotiating rules and abiding by them. The WTO’s rules—the agreements—are the result of negotiations between the members. The current set were the outcome of the 1986–94 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 WTO agreements are intended to ensure that the members operate a non-discriminatory trading system that spells out their rights and their obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other countries’ markets. Each promises to do the same for imports into its own market. The system also gives developing countries some flexibility in implementing their commitments.

Goods

Trade in goods was the focus of GATT until the Uruguay Round negotiations. 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-discrimination.

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 actions taken against dumping.

Services

Service firms such as banks, insurance firms, telecommunications companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of freer and fairer trade 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 to foreign competition, and how open those markets are.

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.

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. Judgements 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 a ruling by a panel of experts, and a chance to appeal the ruling on legal grounds. Confidence in the system is borne out by the number of cases brought to the WTO—almost 250 cases in seven years compared to some 300 disputes dealt with during the entire life of GATT (1947–94).

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.

Development and Trade

Over three quarters of WTO members are developing or least-developed countries. All WTO agreements contain special provision for them, including longer time periods to implement agreements and

commitments, measures to increase their trading opportunities and support to help them build the infrastructure for WTO work, handle disputes, and implement technical standards.

The 2001 Ministerial Conference in Doha set out tasks, including negotiations, for a wide range of issues concerning developing countries. Some people call the new negotiations the Doha Development Round.

Before that, in 1997, a high-level meeting on trade initiatives and technical assistance for least-developed countries resulted in an “integrated framework” involving six intergovernmental agencies, to help least-developed countries increase their ability to trade, and some additional preferential market access agreements.

A WTO committee on trade and development, assisted by a sub-committee on least-developed countries, looks at developing countries’ special needs. Its responsibility includes implementation of the agreements, technical cooperation, and the increased participation of developing countries in the global trading system.

Technical Assistance and Training

The WTO organises around 100 technical cooperation missions to developing countries annually. It holds on average three trade policy courses each year in Geneva for government officials. Regional seminars are held regularly in all regions of the world with a special emphasis on African countries. Training courses are also organized in Geneva for officials from countries in transition from central planning to market economies.

The WTO set up reference centres in over 100 trade ministries and regional organizations in capitals of developing and least-developed countries, providing computers and internet access to enable ministry officials to keep abreast of events in the WTO in Geneva through online access to the WTO’s immense database of official documents and other material. . Efforts are also being made to help countries that do not have permanent representatives in Geneva.

SALIENT FEATRURE OF UR AGREEMENT ¹

The UR expanded the scope of liberalisation of trade in goods by the inclusion of textiles and agriculture in the MTNs.

Liberalisation of Trade in Manufactures

Liberalisation of trade in manufactures is sought to be achieved mostly by reduction of tariffs and phasing out of non-tariff barriers.

Tariff Barriers The major liberalisations in respect of trade in manufactures, regarding tariffs, are:

1. Expansion of tariff bindings
2. Reduction in the tariff rates
3. Expansion of duty-free access

The UR Agreement envisages substantial tariff reductions in both industrial and developing countries.

The main liberalisations by industrial countries include the expansion of tariff bindings (i.e. commitment not to exceed a particular level of tariff) and the reduction of trade weighted average tariff.

However, the gains to developing countries from the tariff cuts by industrial countries is less impressive. The reduction in the average tariffs on their exports to industrial markets is comparatively low and the labour intensive manufactures (textiles, clothing, leather goods) and certain processed primary products (like fish products) which are regarded as sensitive have below average tariff cuts.

Industrial countries have been expected to eliminate tariffs in several sectors like steel, pharmaceuticals and wood and wood products.

Developing countries agreed to bind their tariffs on major part of their imports of industrial products. They also offered to reduce their trade-weighted average bound tariff on imports from industrial countries significantly. The offers of tariff reduction on manufactures by developing countries were estimated to amount to over a third of the world total. The expansion of tariff binding by the developing countries, which rules out future increases in tariffs, is regarded as a significant achievement.

India has bound tariffs at 40 per cent (where they were above 40 per cent in 1993–94) on industrial raw materials, components and capital goods and at 25 per cent in other cases.

Non-tariff Barriers In the area of NTBs, the Agreements to abolish voluntary export restraints (VERs) and to phase out the Multifibre Arrangements (MFA) by the end of 2004 are regarded as landmark achievements for developing countries.

According to some estimates, the phasing out of MFA would contribute about 20 per cent of the total welfare gains from the UR. The largest gains will go to the MFA importers who will be able to import basic clothing and textiles from the more efficient suppliers in ASEAN, China, South Asia and other regions. A very large share of the gains will accrue to China, Indonesia, Thailand and South Asian exporters. India will also significantly gain. Some less competitive exporters will suffer from the loss of their preferential access to industrial country markets unless they are able to increase their efficiency, and some currently unrestricted importers will lose as the exports currently diverted toward them by restrictions elsewhere can flow freely to the other markets.

End of MFA is expected to boost textile exports of developing countries.

Liberalisation of Agricultural Trade

As mentioned earlier, one of the salient features of the UR was the inclusion, for the first time, of agriculture in the MTN. The exclusion of agriculture from the previous Rounds and its effective exemption from the GATT discipline made agriculture a highly protected sector in the developed countries. The depressing impact of this on world prices prevented efficient producers from realising the benefits of their comparative advantage. Developing country exports suffered a lot.

The specific agreement which provides framework for multilateral trade in agriculture, is the Agreement on Agriculture (AoA). The three principal commitments incorporated in the AoA to establish fair and market oriented agricultural trading system and to more operationally effective GATT rules and disciplines are: (i) market access, i.e. the discipline on import restraints and import limitations (ii) domestic support, i.e. to rationalise the support allowed by the governments to domestic producers and to eliminate trade distorting supports, and (iii) export subsidies, i.e. to phase out the support given by governments on agricultural exports. Apart from AoA, a few other Agreements such as the Agreement on Trade Related aspects of Intellectual Property Rights (TRIPS), the Agreement on the Application of Sanitary and Phytosanitary (SPS) Measures and Agreement on Technical Barriers to Trade influence the agricultural trade in varying measures.

The important aspects of the UR Agreement on agriculture include:

1. Tariffication
2. Tariff binding
3. Tariff cuts
4. Reduction in subsidies and domestic support

Tariffication and Tariff Cuts Tariffication means the replacement of existing non-tariff restrictions on trade such as import quotas by such tariffs as would provide substantially the same level of protection.

From the first year of the Agreement's implementation, nearly all border protection was to be bound by tariffs, which (in principle) were to be no higher than the tariff equivalent of the protection levels prevailing in the base periods. Tariff binding means fixing the maximum rate of import duty, above which the country shall not raise the duty unilaterally.

On agricultural tariffs, developing countries have had the flexibility of indicating maximum ceiling binding. India had indicated ceiling bindings of 100 per cent on primary products and 300 per cent on edible oils.

Subsidies and Domestic Support Policies The UR Agreement deals with three categories of subsidies.

Prohibited subsidies Prohibited subsidies are those contingent upon export performance or the use of domestic instead of imported goods.

Actionable subsidies Actionable subsidies are those that have demonstrably adverse effects on other member countries.

Non-actionable subsidies Non-actionable subsidies include those provided (with stipulated limitations) to industrial research and procompetitive development activity to disadvantaged regions, or to existing facilities to adapt themselves to new environmental requirements.

The Agreement also puts restrictions on the use of countervailing measures against competitors' subsidies. To prevent undue hardships, developing countries and countries in transition from centrally planned to market economies are allowed extra time to bring the subsidies into conformity with the new rules.

The UR agreement has brought the domestic support policies also under the multilateral trade discipline. However, domestic support measures that have almost a minimal impact on trade ("green box" policies) such as general government services in the areas of research, disease control, infrastructure and food security as also certain direct payments such as certain income support policies, structural adjustment assistance, payment under environmental programmes and regional assistance programmes are exempted. The non-exempted types of subsidies included in the aggregate measure of support (AMS) required to be reduced include assistance in the form of production-limiting subsidies and assistance given for growth of agriculture and rural development like procurement at support prices and subsidies on inputs and credit. However, even these subsidies are required to be reduced only if their total amount as a proportion of the value of agricultural production exceeds five percent in case of developed countries and 10 per cent in case of developing countries.

According to Government of India, India's total AMS is negative (without taking into account exemptions available on input subsidies to low income and resource poor farmers) and there are no reduction commitments. Nor does India have any minimum market access commitments in agriculture. (the UR Agreement provides for the establishment of minimum access tariff quotas, at reduced tariff rates, where the access is less than 3 per cent of the domestic consumption. The minimum access tariff quotas are to be expanded to five per cent over the implementation period).

Assistance for 'food security' such as the food subsidy under the public distribution system (PDS) will be exempted to the extent they confine to the poor.

Non-agricultural Export Subsidies Countries whose per capita income is less than \$1000 is not bound to phase out export subsidies. (India's per capita income in 2003 was only \$530). However, even such countries will have to phase out export subsidies on products where the share in the world exports is 3.25 percent or more in two consecutive years.

Liberalisation of Services Trade

Services were included in the MTNs for the first time by the UR.

The General Agreement on Trade in Services (GATS) which extends multilateral rules and disciplines to services is regarded as a landmark achievement of the UR, although it achieved only little in terms of immediate liberalisation.

Because of the special characteristics and the socio-economic and political implications of certain services, they have been generally subject to various types of national restrictions. Protective measures include visa requirements, investment regulations, restrictions on repatriation, marketing regulations, restrictions on employment of foreigners, compulsions to use local facilities etc. Heavily protected services in different countries include banking and insurance; transportation; television, radio, film and other forms of communication; and so on.

Meaning The GATS defines services as the supply of a service from the territory of one member (country) into the territory of any other member; in the territory of one member to the service consumer of any other member; by a service supplier of one member, through commercial presence in the territory of any other member; or by a service supplier of one member, through presence of natural persons of a member in the territory of any other member.

In short, the GATS covers four modes of international delivery of services:

1. Cross-border supply (transborder data flows, transportation services)
2. Commercial presence (provision of services abroad through FDI or representative offices)
3. Consumption abroad (tourism)
4. Movement of personnel (entry and temporary stay of foreign consultants)

While industrial countries have offered market access commitment of some kind on over half (about 54 per cent) of their service activities, developing countries did so only on less than one-fifth (about 17 per cent) of their service categories. Tourism and travel related services are the only activities in which a substantial number of developing countries made commitments.

The Framework of GATS The framework of GATS includes basic obligation of all member countries on international trade in services, including financial services, telecommunications, transport, audio visual, tourism, and professional services, as well as movement of workers.

Among the obligations is a most favoured nation (MFN) obligation that essentially prevents countries from discriminating among foreign suppliers of services.

Important features of GATS include MFN obligation and transparency requirements.

Another obligation is the transparency requirements according to which each member country shall promptly publish all its relevant laws and regulations pertaining to services including international agreements pertaining to trade in services to which the member is a signatory. Further, each member shall also respond promptly to all requests for specific information, by any other member, pertaining to any aspect of the service covered by the GATS. Each member shall also establish one or more enquiry points to provide specific information to other members. However, no member needs to provide any confidential information, the disclosure of which would impede law enforcement, or otherwise be contrary to public interest, or which would prejudice legitimate commercial interests of particular enterprise, public or private.

The GATS lays down that increasing participation of developing countries in world trade shall be facilitated through negotiated commitments on access to technology, improvements in access to distribution channels and information networks and the liberalisation of market access in sectors and modes of supply of export interest to them.

With reference to domestic regulation, the Agreement lays down that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner. There would be a requirement that parties establish ways and means for prompt reviews of administrative decisions relating to the supply of services.

It is recognised that particular pressures on the balance of payments of a member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

A member country may, therefore, apply restrictions on international transfers and payments for current transactions under certain circumstances envisaged under the GATS. In the event of serious balance of payments and external financial difficulties or threat thereof, a member country may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments including on payments or transfers for transactions related to such commitments.

The commitments of member countries under the GATS also include national treatment (that is, to treat foreign suppliers of services like domestic suppliers) and provision of market access.

The Agreement on Trade in Services also establishes the basis for progressive liberalisation of trade in services through successive rounds of negotiations, which also applies to other agreements under the Final Act.

As stated earlier, the fear of the developing countries is that the liberalisation of trade in services will lead to the domination of the services sector of the developing countries by the multinationals of the industrialised countries. As a matter of fact, the trade in services is already dominated by the developed countries. The developing countries are net importers of services and their deficit has been growing. The apprehension is that a liberalisation of trade in services will accentuate the problem.

Although many services are labour intensive and, therefore, the developing countries should be expected to have an advantage here, there have been several constraints in benefiting from this advantage. These include, technical, organisational, financial and legal. Moreover, immigration laws of developed

Developing countries' gains of services liberalisation are limited because of lopsided liberalisation and their internal weaknesses.

countries restrict the manpower flow from the developing to developed countries. This severely limits the scope of developing countries in benefiting from their comparative advantage. It may be noted that the industrial countries did not like to bring this issue in the Uruguay Round.

TRIMS

TRIMs Agreement limit the freedom of countries to regulate foreign investment.

Trade Related Investment Measures (TRIMs) refer to certain conditions or restrictions imposed by a government in respect of foreign investment in the country. TRIMs were widely employed by developing countries.

The Agreement on TRIMs provides that no contracting party shall apply any TRIM which is inconsistent with the WTO Articles. An illustrative list identifies the following TRIMs as inconsistent.

1. Local content requirement (i.e. a certain amount of local inputs be used in products)
2. Trade balancing requirement (i.e. imports shall not exceed a certain proportion of exports)
3. Trade and foreign exchange balancing requirements
4. Domestic sales requirements (i.e. a company shall sell a certain proportion of its output locally)

The Agreement requires the notification of all WTO-inconsistent TRIMs and their phasing out within two, five and seven years by industrial, developing and least developed countries respectively. Transition period can be extended for developing and least developed countries if they face difficulties in eliminating TRIMs.

A number of TRIMs were employed in India prior to the liberalisation ushered in 1991 and many of them had been phased out since then.

TRIPS

One of the most controversial outcomes of the UR is the Agreement on Trade Related Aspects of Intellectual Property Rights including Trade in Counterfeit Goods (TRIPS). TRIPs along with TRIMs and services were called the “new issues” negotiated in the Uruguay Round.

Protection of intellectual property rights has become an issue of wide and serious discussion with the formation of the General Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs) under the Uruguay Round (UR) Agreement of the GATT (now the WTO) in 1994.

Meaning

Intellectual property rights may be defined as “information with commercial value”. IPRs have been

IPRs are the exclusive rights given to persons over the innovations/creations for their use for a certain period of time.

characterised as a composite of “ideas, inventions and creative expression” plus the “public willingness to bestow the status of property” on them and give their owners the right to exclude others from access to or use of protected subject matter”.

Intellectual property rights (IPRs) include patents, trademarks, copyrights, geographic indications, undisclosed information (such as trade secrets), industrial designs, and layout designs of integrated

circuits, and plant variety protection. Special (*sui generis*) forms of protection have also emerged to address specific needs of knowledge-producers as in the case of plant breeder's rights and the protection of layout designs of integrated circuits. A number of countries also have trade secret laws to protect undisclosed information that gives a competitive advantage to its owner.

Objectives The main objectives of protection of IPRs are:

The main objective of protection of IPRs is to encourage R&D and creative works so as to benefit the society.

To Encourage and Reward Creative Work The main social purpose of protection of copyright and relating rights is to encourage and reward creative work. This is also relevant to protection in other areas (e.g. industrial designs and patents).

To Encourage Innovation Intellectual property rights are designed to provide protection for the results of investment in the development of new technology, thus giving the incentive and means to finance research and development activities.

To Promote Fair Competition The protection of distinctive signs and other IPRs aims to stimulate and ensure fair competition among producers.

To Help Consumer Protection The protection of distinctive signs should also protect consumers, by enabling them to make informed choices between various goods and services.

To Facilitate Transfer of Technology A functioning intellectual property regime should also facilitate the transfer of technology in the form of foreign direct investment, joint ventures and licensing.

While the basic social objectives of intellectual property protection are as outlined above, it should also be noted that the exclusive rights given are generally subject to a number of limitations and exceptions, aimed at fine-tuning the balance that has to be found between the legitimate interests of right holders and of users.

IPRS AND DEVELOPING COUNTRIES

A strong IPRs regime often provides an opportunity for the developed country firms to exploit the developing countries.

Disadvantages/Limitations

The major disadvantages/limitations of a strong regime of IPRs, as regards developing countries, are the following.

The developing countries, particularly the very poor among them, are ill equipped for significant R&D. In a world order where the industrial countries are the major producers of technology and developing countries heavily depend on imports of technology, IPRs turn out to be, generally, more beneficial to industrial countries than to developing countries. Developed countries enormously benefit from the benefits of higher prices resulting from the market power provided by IPRs, at the expense of developing countries; while industrial countries gain huge amounts of net transfers from TRIPs, developing countries, including India, are expected to experience net outward transfers on account of TRIPs.

A strong IPRs regime without adequate safeguards to protect interests of weaker sections can create very serious problems in developing countries. Exorbitant prices will make patented essential drugs beyond the reach of common man.

Developing countries, generally, don't have adequate institutional mechanism and resources to properly administer IPRs regime. For example, a proper competition law and its efficient enforcement are required to combat the potential anticompetitive abuse of IPRs. While in many industrial countries such abuses are dealt with by general competition law, IPR statutory provisions, or other regulations and guidelines, the developing countries are generally handicapped by the weakness of their regulatory system. A World Bank publication, therefore, cautions that "unless developing countries rapidly establish adequate competition frameworks and regulatory institutions that also address monopoly abuse of IPRs, it is possible that increasing IPR protection could result in welfare losses from monopoly behavior."²

Developing countries are also adversely affected by bilateral agreements on IPRs. Since bilateral agreements usually provide for stronger IPRs than TRIPs—which mandates only minimum standards—these agreements may impede the ability of developing countries to implement the flexibility permitted in TRIPs. For example, in 1998 the United States had signed bilateral agreements on IPRs with 21 countries and had included many IPR provisions in science and technology agreements and bilateral investment treaties. In general, the validity of international agreements and standards loses force if bilateral agreements proliferate, superseding the international agreement. The political and economic balance of power does not usually tip in favor of poorer developing countries in negotiating cross-border agreements, and this imbalance is probably accentuated when they enter bilateral agreements.³

Benefits

Developing nations shall take advantage of the IPRs regime by protecting their traditional knowledge and enormous biological resources and investing in human capital and R&D.

Protection of IPRs is not without gains to developing countries.

Stronger IPR protection may encourage investment, both foreign and domestic.

Stronger IPR protection could be expected to give a boost to R&D in countries like India whose potential intellectual capital may be expected to grow in great width and in depth.

IPR system provides a great opportunity to developing countries to benefit from protection of indigenous property rights and traditional knowledge. Developing countries hold approximately 90 percent of world biological resources, which are particularly important in the development of new pharmaceuticals. Mechanisms for sharing the proceeds from commercialising genetic resources can be written into the IPR law, or alternatively, institutions can be built to protect the collective intellectual property rights for traditional knowledge held by cultural groups.

Experiences and Practices

The empirical evidence on the potential benefits of IPRs is weaker than might be expected. Research in industrial countries does not provide strong evidence that IPRs are necessary to stimulate R&D or innovation in most sectors. Some studies show that a realistically designed IPRs system becomes beneficial after a country has attained a certain level of technological development and R&D capability. Further, an IPRs system becomes beneficial when it incorporates the required safeguards having regard to the conditions and needs of the country. It is observed that although ensuring a core level of IPR protection may increase developing country access to foreign technologies by safeguarding returns for foreign technology producers, excessively strong IPRs can inhibit the diffusion of knowledge. In developing countries, knowledge is built more through access, imitation, and diffusion of foreign

technologies rather than only local research. Legitimate ways to transfer technology under some IPR systems such as reverse engineering or inventing around patents are restricted under strong IPRs. The importance of adopting appropriate policies that allow access to technologies can be seen for some East Asian countries in their early stages of development. This principle is generally followed worldwide, with countries adopting more flexible IPRs at lower levels of per capita income. In Malaysia and Korea, growth in industrial sectors took place under weak IPR- regimes, and in later periods governments emphasised incentives for innovation in IPRs as sophisticated local technology sectors developed. Japan introduced patents in the early 20th century after reviewing IPR systems in Europe and the United States. The Japanese system adapted other patent regimes to suit local needs. Emphasis was placed on securing access to foreign technologies, incremental technology development, and diffusion of innovation, through features such as strong antitrust guidelines for technology licensing and a central licensing office as a countervailing influence on foreign bargaining power pressuring for change in its IPR system.⁴

A strong IPRs system may retard the development of developing economies.

Maximizing Developing Country Benefits from TRIPS

Having committed to implement TRIPS, to maximize their net gains developing countries need to take advantage of the flexibility built into TRIPS. There are several areas of flexibility within TRIPS that provide the potential for developing countries to maximize benefits by promoting access to technology and preventing anticompetitive abuses while maintaining incentives to innovate, tackle piracy, and still meet TRIPS minimum standards. The *World Development Report 2002* makes the following suggestions in this regard.

Scope and Exclusion Developing countries can narrow the scope of what falls under IPRs in the following areas in conformity with TRIPS. *First*, developing countries can adopt a narrow interpretation of what constitutes an invention and hence what needs to be patented. For example, Argentina, Brazil, and China have elected not to extend patent protection to soft ware. *Second*, developing countries can take advantage of the TRIPS article that allows limitations and exceptions to copyright. For example, some countries permit unauthorized use for social purposes such as education and scientific research. *Third*, developing countries can avoid patenting life forms and can apply special provisions under TRIPS to exempt public goods from IPR protection. *Finally*, developing countries can expand IPR scope to protect genetic resources, traditional knowledge and folklore, as is promoted by the World Intellectual Property Organization.

Compulsory Licensing Countries can use compulsory licensing, allowed by TRIPS under some circumstances, to control anticompetitive behavior that results from IPRs or in national emergencies, such as public health crises. The license, issued by national authorities, authorizes the use of IPR-protected subject matter without the consent of the rights holder, with compensation to the latter to be determined by the government.

Parallel Imports Parallel imports refers to IPR- protected products imported into a country after being released legitimately in another country. Free trade in IPR-protected goods ensures competition in product markets, reduces prices, and enhances consumer access to new technologies. But trade in IPR-protected products may restrict access to new technologies for developing countries. TRIPS neither endorses nor prohibits parallel imports.

Price Regulation Some countries regulate price levels and price increases—as is allowed under TRIPS—to ensure that IPRs do not restrict consumer access through excessively high prices, particularly in pharmaceutical products. But price regulations are often fraught with problems.

Competition Law Anticompetitive abuse of IPRs can be controlled by an effective competition law.

Complementary Actions The impact of IPRs depends on the broader institutional and policy environment. More liberal trading rules also reduce the risk of monopoly abuse of IPRs by domestic firms. Human capital development is also important; IPRs are more likely to increase technology transfer and encourage domestic innovation in countries with higher levels of human capital.

Another factor is the promotion of national innovation systems. Integration of IPR rules with complementary policies to foster innovation such as public sector research involvement where appropriate can stimulate growth by increasing the commercialization of inventions.

Although, under TRIPS Article 67, industrial country members are obligated to provide technical and financial support for implementing the agreement, only limited assistance has been provided to fulfill this commitment: mostly training and technical assistance in drafting IPR laws. More technical support that is geared toward helping developing countries take advantage of the flexibility allowed in the TRIPS agreement is needed. Concrete financial assistance targets and grants of patents to developing countries (especially for emergency human development needs such as HIV/AIDS treatment) are some of the proposals made for better implementation of Article 67. Others include increased technology transfer assistance and fiscal incentives, such as guaranteed purchase of new drugs for developing countries.

On copyrights and related rights, the Agreement requires compliance with the provisions of *Bern Convention* to which India is a signatory and the new Copyright Act of India already meets the requirements of the TRIPS Agreement. Trade and Merchandise Marks Act of 1958 was replaced by a new Act, namely, The Trade Marks Act, 1999, so as to provide for the protection of service marks also.

PATENTS

A patent is a legal protection granted for an invention that is new, non-obvious and useful. The patent grants the patent holder the exclusive right to make use or sell the patented products or process. The main purpose of the patent system is to benefit the society. Patents, by providing an opportunity to recoup the cost of invention (which is quite substantial in many cases) and to make profit out of the invention, encourage research and development and thereby contribute to the well being of the society.

An invention, to be patentable, must satisfy the following three conditions.

- It is new.
- It is useful to the society.
- It is non-obvious to a person possessed of average skill in the art.

Exclusion of an invention from patentability for commercial exploitation is permitted if it is necessary to protect public order or morality, including to protect human, animal or plant life or health or to avoid serious prejudice to the environment. A nation may also exclude from patentability (a) diagnostic, therapeutic and surgical methods for the treatment of humans or animals; (b) plants and animals other

than microorganisms and essentially biological process for the production of plants or animals other than non-biological and micro-biological process. However, members shall provide for the protection of plant varieties either by patents or by an effective *sui generis* system or by any combination thereof.

INDIAN PATENT LAW

Patent protection in India has a long history. Patent protection was introduced in India in the 18th century. Formal patent protection was ushered in by the Patents Act, 1911. The Patents Act, 1970 amended and consolidated the law related to patents.

Some very significant amendments to India's patent law was, however, necessitated by the Agreement on Intellectual Property Rights that emerged from the Uruguay Round of multilateral trade negotiations that brought into being the WTO. Being a member of the WTO, India was obliged to align its patent law with the stipulations under the WTO with effect from January 1, 2005. Accordingly, the Indian Patents Act, 1970 and the Patent Rules 1972 were amended.

The Indian Patents Act, 1970, as amended and effective from January 1, 2005, lays down:

- The eligibility, procedures and conditions for grant of patents
- Inventions and other subjects not patentable
- Rights and obligations of patentee
- Grounds for revocation of patents
- Matters related to working of the patent and compulsory licensing
- Rights of government regarding patented products

I. Grant and Revocation of Patents

The Patents Act lays down the eligibility, procedures and conditions for grant of patents and grounds for revocation of patent.

Under the Act, a patent may be granted to an invention, subject to the provisions of the Act. According to the Act, an *invention* means a new product or process involving an inventive step and capable of industrial application. (An *inventive step* means a feature of an invention that involves technical advance as compared to the existing knowledge or having economic significance or both and that makes the invention not obvious to a person skilled in the art.)

There is also provision for the grant of patents of addition to the patentee (i.e. granting of patent in respect of any improvement in or modification of an invention which is patented. The grant of patent of addition shall be for a term equivalent to that of the patent for the main invention.

The Act also provides for revocation of patents on certain grounds such as any claim made for the grant of patent has been found invalid, or the Central government feels that a patent or the mode in which it is exercised is mischievous to the state or generally prejudicial to the public interest.

2. Items not Patentable

A list of inventions and other subjects not patentable is provided in the Patents Act. Some examples of those which are not patentable: Inventions which are frivolous or contrary to public interest; method of agriculture or horticulture; any process of treatment of human beings or animals; plants and animals (other than microorganisms but including seeds, varieties and species and essentially biological processes

for production or propagation of plants and animals); a mathematical or business method or a computer program *per se* or algorithms; the mere discovery of a scientific principles or the formulation of an abstract theory or discovery of any living thing or non-living substance occurring in nature; a mere scheme or rule or method of performing mental act or method of playing game; a presentation of information; topography of integrated circuits; an invention which, in effect, is traditional knowledge or which is an aggregation or duplication of known properties of traditionally known component or components.

3. Product Patent

The amended Act provides for grant of product patent. Previously, for food, pharmaceutical and chemical products only process patent was granted in India. This meant that any body was free to manufacture the same or similar product by a process different from the patented one. This is no more allowed because of the adoption of the product patent.

4. Patent Period

For food, pharmaceutical and chemical products, previously the patent period was 14 years. Now patents are granted for all products for a period of 20 years from the date of application.

5. Rights and Obligations of Patentee

The Act lays down the rights and obligations of patentee. A Patent granted under this Act confers on the patentee the exclusive right to use, make, sell or import the patented process/ product. The Act normally prevents third parties from using, making, selling or importing the patented process/ product without the consent of the patentee.

The Patents Act makes it clear that patents are not granted merely to enable patentees to enjoy a monopoly but to encourage inventions and to secure that the inventions are worked in India on a commercial scale and to the fullest extent that is reasonably practicable without undue delay; and to make the benefit of the patented invention available at reasonably affordable prices to the public.

6. Working of the Patent

As pointed out above, a patent is granted subject to certain considerations which ensure that it is properly worked in the country to serve the interests of the society. Working of patent means that the patented product is produced in India and made available sufficiently at reasonable prices within reasonable time.

The Act makes it clear that a patent is granted to encourage inventions and to secure that the inventions are worked in India on a commercial scale and to the fullest extent that is reasonably practicable without undue delay; the patent shall not be deemed a monopoly right to import the patented article in to the country. It is also expected that a patent contributes to the promotion of technological innovation and to the transfer and dissemination of technology to the mutual advantage of the producers and users of the technological knowledge.

7. Compulsory Licensing

The Act provides for compulsory licensing of the patent and revocation of the patent if it is not worked in the country.

A serious concern in India and elsewhere has been that product patents will result in exorbitant prices for drugs, seriously impairing the health and nutritional requirements of the large majority of the population. The considerations regarding the working of patents, laid down in the Act, seek to safeguard the public interest in this respect. To protect the interests of the public, Indian Patents Act provides for grant of compulsory licence on grounds such as failure to work the patent in the country. Compulsory licensing means grant of licence to third party to work the Patent in the country.

The compulsory licensing sections of the Act are intended to check the abuse of patent rights. They can be invoked if the reasonable requirements of the public with respect to patented inventions have not been satisfied and the patented invention is not available for public at a reasonably affordable price, and if the patented invention is not worked in the territory of India. Section 92 of this law provides for action in case of national emergency, extreme urgency and public non-commercial use, and can be invoked without the grace period of 3 years from grant of patent.

The Act also has a provision for enabling grant of compulsory licence for export of medicines to countries which have insufficient, or no manufacturing capacity, to meet emergent public health situations (in accordance with the Doha Declaration on TRIPs and Public Health).

8. Parallel Import

The Act also provides for parallel import so that patented product can become available at the lowest international price.

9. Exceptions

The Patents Act also lays down certain exceptions to the rights of the patentee.

Any patented product or process may be made, imported or used by or on behalf of the government for its own use or purpose. The Central Government may also acquire a patent for public purpose, if necessary.

Any patented medicine or drug may be imported by the Government for the purpose merely of its own use or for distribution in any dispensary, hospital or other medical institution maintained by or on behalf of the Government or any other dispensary, hospital or other medical institution specified by the government in public interest.

Any patented process or product may be used or made by any person, for the purpose merely of experiment or research including the imparting of instructions to pupils.

Evaluation

When there is a long established international organization for intellectual property (World Intellectual Property Organisation), inclusion of IPRs under the GATT/WTO negotiations was unwanted and unjustifiable. It is not difficult to think that powerful vested interests were behind it.

The amendments to the Patents Act has come in for scathing criticism in India. The 1970 Act was regarded as a skillfully drafted piece of legislation which sought to protect the infant drugs & pharmaceuticals and chemicals industries from foreign monopolies in these fields. The critics fear that the adoption of product patent will enable the multinational drug firms to exploit the Indian consumers. While it is true that patent confers monopoly power on the patentee, in the absence of product patent the patentee does not get sufficient protection. However, the patent protection period of 20 years is too long a period. Five to seven years may be a reasonable period.

According to Government sources, the apprehensions that the Patent Amendment will drive up drug prices by ruling out access and availability of medicines at low cost are unfounded. "In the first place, the fact remains that 97 per cent of all drugs manufactured in India are off-patents and so will remain unaffected. These cover most of the life saving drugs, as well as medicines for common ailments. In patented drugs also, in most of the cases there are always alternatives available. Further, the country has 13 Sections under Chapter XVI pertaining to Compulsory Licensing in place; and the Act has strong provisions under Chapter XVII for outright acquisition of patents to meet national requirements. Besides, there is also the Drug Price Control Order administered by the National Pharmaceuticals Price Authority. With such a framework in place, the concerns and fears relating to rise in drug prices are misplaced. Besides, there are adequate safeguards to protect the interests of domestic industry and the common man from any increase in the prices of drugs."

However, the fact that patented drugs, by and large, are vital ones makes the situation very serious. If the government does not make effective use of the safeguards in the Act to protect the interests of the consumers, their plight could become miserable.

It is also pointed out that, apart from manufacture of drugs, the product patent regime will help the pharmaceutical industry to tap outsourcing of clinical research. By participating in the international system of IPR protection, India, with its vast pool of scientific and technical personnel, and well-established expertise in medical treatment and health care, has unlocked vast opportunities in both exports and outsourcing and has the potential to become a global hub in the area of R&D based clinical research. The Patent Ordinance also provides adequate safeguards to protect the interest of the domestic industry, and the citizen from any increase in prices of drugs.

The Patent Act needs further fine-tuning. It is observed that we should fine-tune patentability, pre-grant opposition and compulsory licensing, besides providing for revocation of patent as a measure of WTO compatible trade penalty. True the present Act has tightened patentability and pre-grant opposition, but not enough. For one, the pre-grant window is available for a period of six months from the date of publication. The paucity of time could mean many frivolous cases getting patents and causing damage by the time a post-grant appeal is entertained. In the case of patentability, it would be useful to accept the Mashelkar panel's recommendation on restricting patentability to new chemical entities and limiting the amplitude of novelty and utility, characteristics that make for patentability, through clear enunciation.¹⁶

That compulsory license application be allowed three years after the grant of a patent is fine in the normal course. However, a national emergency should not be the only consideration for deviating from this time frame. Moreover, this application is to be entertained only after the CL applicant has made reasonable efforts to obtain a licence from the patentee over a reasonable period, defined as six months. In effect, three and half years must pass before a CL application is considered. And there is no saying how long patent office will take to deal with the issue.¹⁷

DISPUTE SETTLEMENT

A proper mechanism for settling disputes is essential for effective and smooth functioning of a rules-based system. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. The system is based on clearly-defined rules, with timetables for completing a case.

WTO members have agreed that if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally. That means abiding by the agreed procedures, and respecting judgements.

Typically, a dispute arises when one country adopts a trade policy measure or takes some action that one or more fellow—WTO members considers to be breaking the WTO agreements, or to be a failure to live up to obligations. A third group of countries can declare that they have an interest in the case and enjoy some rights.

Procedure

A procedure for settling disputes existed under the old GATT, but it had no fixed timetables, rulings were easier to block, and many cases dragged on for a long time inconclusively. The Uruguay Round agreement introduced a more structured process with more clearly defined stages in the procedure. It introduced greater discipline for the length of time a case should take to be settled, with flexible deadlines set in various stages of the procedure. The agreement emphasises that prompt settlement is essential if the WTO is to function effectively. It sets out in considerable detail the procedures and the timetable to be followed in resolving disputes. If a case runs its full course to a first ruling, it should not normally take more than about one year—15 months if the case is appealed. The agreed time limits are flexible, and if the case is considered urgent (e.g. if perishable goods are involved), then the case should take three months less.

The Uruguay Round agreement also made it impossible for the country losing a case to block the adoption of the ruling. Under the previous GATT procedure, rulings could only be adopted by consensus, meaning that a single objection could block the ruling. Now, rulings are automatically adopted unless there is a consensus to reject a ruling—any country wanting to block a ruling has to persuade all other WTO members (including its adversary in the case) to share its view.

Although much of the procedure does resemble a court or tribunal, the preferred solution is for the countries concerned to discuss their problems and settle the dispute by themselves. The first stage is therefore consultations between the governments concerned, and even when the case has progressed to other stages, consultation and mediation are still always possible.

ANTI-DUMPING MEASURES

The UR Agreement provides greater clarity and more detailed rules concerning the method of determining dumping and injury, the procedure to be followed in anti-dumping investigations, and the duration of antidumping measures. It also clarifies the role of dispute-settlement panels in conflicts relating to anti-dumping actions taken by national authorities.

Antidumping measures may be taken if dumping injures the domestic industry.

Dumping occurs when the price at which the goods are exported to India is lower than their normal value. The difference between this export price and the normal-value is known as the margin of dumping. It is generally expressed as a percentage of the export price. In the ordinary course of trade, the normal value is the comparable price at which goods under complaint are sold in the domestic market of the exporting country or territory. If the normal value cannot be determined this way, the following two alternative methods are provided for: (i) Comparable representative export price to an appropriate third country, (ii) Cost of production in the country of origin with reasonable addition for administrative, selling and general costs and for profits.

Anti-dumping measures can be employed only if dumped imports are shown to cause serious damage to the domestic industry in the importing country. Further, antidumping measures are not allowed if the 'margin of dumping (i.e. the price differences) is *de minimis* (defined as 2 per cent of the export price of the product) or the volume of dumped imports is negligible (less than 3 per cent of imports of the product in question).

In India, anti-dumping actions are taken by the Directorate of Anti-Dumping and Allied Duties, Ministry of Commerce, as per the Customs Tariff Act, 1975, as amended in 1995, based on Article VI of GATT 1994. For the government to initiate anti-dumping action, the Indian industry must be able to show that dumped imports are causing or threatening to cause material injury to the Indian domestic industry. Obviously, the ability of India to do so depends on proper environmental monitoring, database and procedural familiarity.

Indian industry and Government should equip themselves with proper monitoring mechanism and administrative system to guard against dumping.

Material retardation to the establishment of an industry, is also regarded as injury. For anti-dumping actions, a causal link between the material injury being suffered by the Indian industry and the dumped imports must be established.

The economic and financial impact of the dumped imports on the concerned Indian industry can be demonstrated, *inter alia*, by decline in output, loss of sales, loss of market share, reduced profits, decline in productivity, decline in capacity utilization, reduced return on investments, price effects, and adverse effects on cash flow, inventories, employment, wages, growth, investments, ability to raise capital, etc. Anti-dumping action is not applicable if the margin of dumping is insignificantly small (less than two per cent of the export price) or the volume of imports is negligible (i.e. the volume from one country is less than three per cent of the total imports of that product), provided the aggregate imports from such countries do not account for more than seven per cent of total imports.

Anti-dumping duty shall not exceed the margin of dumping. It is suggested that it would be desirable if the appropriate authorities impose a lesser duty which is adequate to remove the injury caused to the domestic industry. The Government of India has accepted this principle.

Anti-dumping actions may be suspended or terminated if the exporter concerned furnishes an undertaking to revise the price to remove the dumping or the injurious effect of dumping. The rules also provide for retrospective measures in certain cases.

SAFEGUARD ACTIONS

Members may take safeguard actions, i.e. import restrictions to protect a domestic industry from the negative effects of an unforeseen import surge, if a domestic industry is threatened with serious injury. The UR Agreement, however, prohibits the use of such actions where they constitute grey-area measures, including voluntary export restraints, orderly marketing arrangements or other similar measures applied on either exports or imports. Further, the Agreement provides for discipline on the use of all safeguard measures, including time limits, requirements for safeguard investigation, and non-discrimination (generally) among sources of supply.

Safeguard measures would not be applicable to developing countries where their share in the member country's imports of the product concerned is relatively small.

EVALUATION OF THE URUGUAY ROUND

The Uruguay Round was by far the most complex and controversial one. The fact that it took more than seven years to complete the negotiations as against the originally contemplated more than four years indicates the complexities involved. It is the inclusion of new areas like TRIPs, TRIMs, services and the attempts to liberalise agricultural trade and the elimination of NTBs like MFA that increased the complexity of the negotiations.

The success of the UR Agreement will depend upon the spirit with which it will be translated into practice. The tariffication of trade barriers was claimed to be a significant success of the UR. However, because of the way the NTBs were converted into tariffs, the so called dirty tariffication, many of the tariff bindings exceeded the protection rate applying during the base period (which itself was one of generally high level of protection), some by as much as 200 per cent..

Gains

Several estimates of the gains from the UR Agreement are available. They vary widely. According to some estimates the real world income (in constant 1992 US dollar) would increase by between \$212 billion and \$274 billion in 2005. Further, such annual increases will follow. This amounts to around one percent of World GDP. According to a GATT study the gain will be as high as \$510 billion.

The gains of trade liberalisation are cornered mostly by the developed countries.

Most of the gains will accrue to the developed countries. Some developing countries in the category of least developed countries and net food importers are expected to lose because of the Uruguay Round package.

According to some estimates the increase in real income will be roughly 1.6 per cent of GDP for the European Union, 0.2 per cent for the US and 0.9 for Japan. As a single country, the largest gain in absolute terms will accrue to the US (between \$28 and \$67 billion). It will be between \$27 and \$42 billion for Japan, between \$61 and \$98 billion for the EU and between \$36 and \$78 billion for the developing countries. The gains would amount to about 2.5 per cent of the GDP for China, 0.5 per cent for India, 0.6 per cent for South Africa and 0.3 per cent for Brazil.

The GATT had estimated that world trade would increase by 12 percent (on top of the normal growth rate), if the UR package is completely implemented. In constant 1992 US dollars, this represents an increase of \$745 billion. The value of world exports (including services) will increase by around 10 percent. Exports of North America will increase by 8 per cent and European union by 10.3 per cent. Some of the largest projected increases in world trade are in areas that are of interest to developing countries. For instance, world trade in textiles is projected to grow by 34 per cent, that in clothing by 60 per cent and that in agricultural, forestry and fishery products by 20 per cent.

According to the estimates made by the World Bank, OECD and the GATT Secretariat the income effects of the implementation of UR package will add between \$213 to \$274 billion annually to world income. The GATT Secretariat's estimate of the overall trade impact is that the level of merchandise trade in goods will be higher by \$745 billion in the year 2005, than it would otherwise have been. The largest increase would be in the areas of clothing (60 per cent), agriculture, forestry and fishery products (20 per cent) and processed food and beverages (19 per cent). Since India's existing potential export competitiveness lies to a significant extent in these product groups, India could be expected to obtain gains in these sectors.

It was estimated that, cuts in protection on total merchandise trade will increase real incomes in developing countries by \$55 to 90 billion (or 1.2 to 2 per cent of their GDP in 1992) while the gains to the world as a whole will be in the order of \$200 billion.

Factors Limiting the Gains

The tragedy, however, is that not only that the developed countries are not earnestly implementing the provisions of the UR Agreement which will benefit the developing countries, but also they tend to become more protectionist in several respects. Joseph E. Stiglitz, a Nobel laureate and former chief

While the developing countries have been increasingly opening up their markets, the developed countries have been increasing the barriers to the developing countries in several respects.

economist and senior vice president of World Bank (who had been on the Council of Economic Advisors under President Clinton) observes that “the level of pain in developing countries created in the process of globalization and development as it has been guided by the IMF and the international economic organizations has been far greater than necessary.

The backlash against globalization draws its force not only from the perceived damage done to developing countries by policies driven by ideology but also from the inequities in the global trading system. Today, few—apart from those with vested interests who benefit from keeping out the goods produced by the poor countries—defend the hypocrisy of pretending to help developing countries by forcing them to open up their markets to the goods of the advanced industrial countries while keeping their own markets protected, policies that make the rich richer and the poor more impoverished—and increasingly angry.”⁶

EVALUATION OF WTO

WTO has come to play a very important role in the global, and thereby, national economies. National economic policies are significantly influenced by the principle, policies and agreements of WTO. Because of this there are severe criticisms against WTO, particularly in the developing countries. In fact WTO has both positive and negative impacts. The growing acceptance of GATT/WTO, despite their shortcomings, is evinced by the increase in the number of member countries. When the GATT was signed in 1947, only 23 nations were party to it, The membership of the WTO increased from 128 in July 1995 to 151 countries at the beginning of 2008 and several more nations are negotiating membership. It is interesting to note that the Peoples Republic of China, which was one of the original signatories of the GATT quit it in the late 1940s following the assumption of power by the communist party, but got admitted to the WTO, after a prolonged negotiations, with effect from January 1, 2002. The WTO members now account for over 97 per cent of the international trade indicating the potential of the WTO in bringing about an orderly development of the international trade.

Benefits of WTO

1. GATT/ WTO has made significant achievements in reducing the tariff and non-tariff barriers to trade. Developing countries too have been benefiting significantly out it.
2. The liberalisation of investments has been fostering economic growth of a number of countries.
3. The liberalisation of trade and investment has been resulting in increase in competition, efficiency of resource utilisation, improvement in quality and productivity and fall in prices and acceleration of economic development.
4. WTO provides a forum for multilateral discussion of economic relations between nations.
5. It has a system in place to settle trade disputes between nations.
6. WTO has a mechanism to deal with violation of trade agreements.
7. WTO does considerable research related to global trade and disseminates a wealth of information.

Drawbacks/Criticisms

As mentioned above, the WTO has been subjected to a number of criticisms. Important drawbacks/ criticisms include the following.

1. Negotiations and decision making in the WTO are dominated by the developed countries.
2. Many developing countries do not have the financial and knowledge resources to effectively participate in the WTO discussions and negotiations.
3. Because of the dependence of developing countries on the developed ones, the developed countries are able to resort to arms-twisting tactics.
4. Many of the policy liberalisations are done without considering the vulnerability of the developing countries and the possible adverse effect on them.
5. The WTO has not been successful in imposing the organization's disciplines on the developed countries.

The developing countries have, in general, been getting a raw deal from the WTO.

It may also be noted that it has become a trend to blame WTO even for matters for which it is not responsible.

It is necessary that the developing countries do their home work properly before they go to the negotiating table, stand united to protect their common interests and formulate and implement strategies to combat the threats and to take advantage of the opportunities of the emerging world order.

WTO AND DEVELOPING COUNTRIES

As in the case of the previous Rounds, the developing countries, in general, are dissatisfied with the outcome of the Uruguay Round. The Wall Street Journal has reported that while the US and the EC are getting the best pieces of the world trade pie, the developing countries are getting the crumbs.

Developing nations have not been getting a fair deal in the WTO system.

Some of the areas like TRIPs, TRIMs and services have been very sensitive as far as the developing countries are concerned as the Uruguay Round Agreements in them mean that the developing countries will have to lower the protection against competition from the unequal developed economies. However, as in the previous Rounds, the UR also gives special considerations to developing countries, particularly to the least developed countries and to those with balance of payments problems. The Agreement, however, lays down that member countries imposing trade restrictions for balance of payment purposes should do so in a way that causes minimum disruption to international trade and quantitative restrictions should be avoided as far as possible.

Indeed, it would be the developed countries who would suffer most by liberalisation of the agricultural sector. But to argue that the developed countries should completely liberalise agriculture without any reciprocity on part of the developing countries is clearly illogical. As a matter of fact, the UR proposals in respect of agriculture, as in several other cases, give special consideration to the developing countries. Developed countries will, however, be hit hard. For example, agricultural subsidies in the European countries have been of the order of 30 to 50 per cent.

While the liberalisation of agricultural trade and the increase in agricultural prices due to cut in producer subsidies in the developed countries would benefit agricultural exporters, the increase in food prices due to cut in subsidies may adversely affect the food importers. More than 100 of the developing nations are reported to be net food importers. However, the increase in food prices should be expected to make food production in these countries more competitive leading to an increase in production. It may be noted here that it has been alleged that the subsidisation of production and export of farm production in the developed countries would have the effect of discouraging their production in the developing

countries where farmers have not been able to compete with the imported stuff bearing artificially low price because of the subsidies. It is estimated that since subsidised agricultural exports cannot be dumped on the world market, international agricultural prices could go up by as much as 10 per cent.

International trade in textiles was estimated to be worth \$240 billion a year. Estimates were that after the phasing out of MFA, world exports of textiles would go up by \$25 billion a year. With a 2.2 per cent share in the world textile trade, India's share in the additional exports could be \$0.55 billion. But the real gain will depend on the country's ability to compete with countries like China, Hong Kong, Taiwan, South Korea, etc. which are considered leaders in the textile trade.

Developing countries were very apprehensive about the proposal to liberalise trade in services. However, fortunately for them, the differences of opinion between the US and EU on this issue left the service sector largely unaffected.

The effect of the UR is not the same on all countries. For example, a measure which favourably affects one developed country may unfavourably affect another developed country. Further, the extent of the favourable or unfavourable impact may also vary. It is, therefore, quite natural that conflicts of interest have occurred both among developed and developing countries. Latin American countries were perhaps not very interested in liberalising the trade in textiles because they calculated that if they could gain a direct entry to the NAFTA through some regional arrangement, it would provide them an edge over competitors like India and Pakistan.

Some studies also show that sub-Saharan Africa, Indonesia and some Caribbean islands will be poorer as a result of the UR Agreement. However, if liberalisation leads to higher productivity, they would also gain.

No country is, therefore, entirely pleased with the UR proposals. "The surest proof of the success of the Uruguay Round is that no country is entirely happy at the outcome." Although India is quite dissatisfied that the textile trade is not adequately liberalised, some people in the US are angry over the liberalisation move, alleging that two million jobs in the US would now hang in balance.

As the foreign minister of Uruguay remarked, all nations which signed the Uruguay Round Trade Agreement have "a sense of shared dissatisfaction." As the GATT Director General Peter Southerland stated, the signing of the Uruguay Round trade pact does not mean the end of disputes. Southerland remarked that it marked the start of disputes. There will be disputes between developed and developing countries, between developing countries and between developed countries. "There are more than 5 billion people competing for their share of the pie, and that makes conflicts all the more inevitable."

One of the achievements of the UR is the making of the rules and regulations more transparent, thus making trade harassment and unilateral actions more difficult. The results of the UR will be implemented by the newly set up World Trading Organisation (WTO) making dispute settlement and arbitration easier.

Because of the unequal participation and lack of bargaining power, the developing countries have not been getting a fair deal from the WTO and other international organizations. To make matters worse, as observed earlier, while the developing countries have been increasingly opening up their markets, the developed countries have been increasing protection and denying justice to the developing countries in several respects. As Stiglitz candidly observes, "the international institutions must undertake the perhaps painful changes that will enable them to play the role they *should* be playing to make globalization work, and work not just for the well off and the industrial countries, but for the poor and the developing nations.. The developed world needs to do its part to reform the international institutions that govern globalization. We set up these institutions and we need to work to fix them. If we are to address the legitimate concerns of those who have expressed a discontent with globalization, if we are to make

globalization work for the billions of people for whom it has not, if we are to make globalization with a human face succeed, then our voices must be raised. We cannot, we should not, stand idly by.”⁷

Unequal Participation

Although it was expected that significant benefits would accrue to the developing countries from the UR Agreement, they have been encountering many road blocks.

Developing nations have serious inherent weaknesses in effectively participating in the negotiations.

The developing countries are disadvantaged in the WTO system because of their inability to effectively participate in the negotiation process. They suffer from lack of intellectual and financial capability to meaningfully participate in the discussions and negotiations. They are not able to understand the implications and possible impacts of different proposals and agreements because of their analytical deficiencies. According to Dubey, “most of the agreements and understandings reached during the Uruguay Round trade negotiations are unequal and unbalanced from the point of view of developing countries. This was mainly because of the weak bargaining position of these countries, their general state of unpreparedness for the negotiations, their dearth of skilled manpower and financial resources to participate effectively, and the lack of transparency in the negotiating process. Some of the agreements are inherently unequal and unbalanced.”⁸

Besides, lack of earnestness on the part of the governments is also responsible for the suffering of the developing countries. For example, the delay in taking protective measures in respect of geographical indications by Government of India is responsible for the *basmati* rice issue and the like.

An IMF publication observes that while small and poor countries have acquired a very significant say in decision making in the WTO, their ability to participate in the “reciprocity game” at the heart of the WTO remains limited. These countries also pose a challenge for the WTO because their interest in the broader trade liberalization agenda is more limited as a result of their existing preferential access to rich country markets.⁹

The solidarity of the developing countries can strengthen their position in the WTO system because of the one member-one vote principle.

One of the underlying reasons for the developing countries not benefiting much out of WTO is “that it is a mercantilist institution in the sense that countries trade off one another’s protection—you give me better access to your market, and I’ll give you better access to my market. The currency for these negotiations is market size. However, the small and poor countries don’t have much to offer either individually or collectively to the rest of the world in terms of market access”¹⁰

Implementation Issues

The developing countries are virtually deceived in several cases as the UR Agreements have not been implemented in letter and spirit by the developed countries. They have resorted to covert measures to deny the developing countries the legitimate benefits of the proposed trade liberalisations.

The developed nations deceive developing nations by not implementing several of their commitments in letter and spirit.

Dubey points out that, subsidies normally maintained by developed countries have been made non-actionable, while several of those given by developing countries in pursuit of an export-led development strategy have either been prohibited or put in the actionable category. Subsidies to farmers maintained by major developed countries have, instead of coming down, gone up primarily because these countries were able to switch over to subsidies permissible under the Agreement on Agriculture, before the

commencement of its implementation.¹¹ Liberalisation of textiles trade has hailed as a boon for the developing countries. However, here also the developing countries have been deceived because developed importing countries have sought to comply with the targets of liberalisation set out in the Agreement on Textiles and Clothing (ATC) by taking credit for the items already outside restriction.¹²

As an UNCTAD Report points out, rich countries, despite their commitment in the TRIPS agreement, have taken no real steps to share their technology in the interests of reducing poverty. The TRIPS agreement includes provisions for technology transfers, but with few details and no discussion on implementation. The TRIPS agreement does not provide intellectual property protection for indigenous knowledge such as those used in traditional medicine... The TRIPS agreement introduces a global minimum standard for promoting invention. Intellectual property regimes are intended to balance the two social goals of promoting inventions and promoting the use of inventions. Thus the TRIPS agreement incorporates provisions in the interests of users, such as compulsory licensing or parallel imports that give governments flexibility to allow local manufacturing or imports of goods under patents. But the wording of these provisions is so vague that they are difficult to apply—so clarifying them would be a first step.¹³

Another way rich countries tilt the playing field for trade seems, on its face, to have little to do with trade. Rich countries, to varying degrees, pay large subsidies to their domestic food producers. These subsidies are so large—totalling \$311 billion a year—that they affect world market prices of agricultural goods, causing direct harm to poor countries. EU-subsidized exports have contributed to the decline of the dairy industries in Brazil and Jamaica and the sugar industry in South Africa.” West African cotton producers have increased the efficiency of their cotton sector, achieving competitive production costs. But they cannot compete against subsidized farmers in rich countries. Annual agricultural subsidies in rich countries considerably exceed the national income of all of Sub-Saharan Africa.¹⁴

Developing countries have identified various instances of inequalities and imbalances in the Uruguay Round Agreements and submitted a large number of formal proposals for rectifying them. These proposals have been known as the implementation issues. It is argued that the implementation issues should be urgently resolved and any new round of MTN shall be taken up only after that. However, the developed countries want the new round of MTN soon.

“The implementation issues are not a spanner thrown by a group of developing countries to ape a new round of trade negotiations. Their attempt to resolve them is designed to safeguard their most vital trading interests and to restore a modicum of balance in WTO agreements after an unfortunately belated realization that developing countries were short-changed in the Uruguay Round negotiations. What is at stake here, is the very credibility of the international trading system in the eyes of the developing countries. Resolution of the implementation issues is the only way to restore credibility.”¹⁵

THE DOHA DECLARATION

The conflict between the interests of the developed and developing nations was very obvious at the Doha meet.

The fourth ministerial meeting of the WTO was held in Doha in November 2001 in which Ministers from the 142 member countries participated. The meeting had attracted a lot of attention because of the conflict of interests of the developed and developing countries.

Singapore Issues

The developed countries wanted a new round of multilateral trade negotiation to be launched soon, covering what are known as the *Singapore Issues* (a list of seven items which were proposed at the meeting in Singapore in 1996 for future negotiations. These included: investment, competition policy,

trade facilitation, transparency in government procurement, environment, agriculture and trade related aspects of intellectual property rights (TRIPs).

Developing countries like India on the other hand held that the *Implementation Issues* should be resolved before a new Round. India had to almost single handedly fight against the developed countries.

Doha Development Agenda

The Doha meet concluded by drawing up the 'Doha Development Agenda' for new trade liberalisation talks; with India approving the ministerial declaration only after it was satisfied that the conference Chairman's statements had addressed the country's concerns in the four Singapore issues of foreign investment, competition policies, transparency in government procurement and trade facilitation.

Although, the developed nations, as expected, won the upper hand, India's bold stand has had a commendable impact. Because of India's refusal to approve the agenda unless it was modified, the Chairman of the meeting announced that an explicit consensus would be required at the fifth ministerial conference in 2003, before negotiations could begin on the highly controversial Singapore issues. It is an indication that when the strong position taken by a single developing country can have such positive effects, collective action by the developing countries can have profound impact.

The Doha Ministerial adopted three major declarations: (i) on the negotiating agenda for the new WTO round, (ii) on some 40 implementation concerns of the developing countries and (iii) on the political statement dealing with patents and public health.

The strong stand taken by India at Doha had its beneficial impact for developing countries.

Doha and TRIPs

One remarkable achievement of the Doha Ministerial for developing countries is that in the case of TRIPs and public health, it allowed waiver of the patent law to face a national emergency. Now it will be possible for developing countries to set aside the patent laws if they have to face epidemics such as malaria, tuberculosis, and AIDS. Each country has been given the freedom to define a national emergency.

The Doha declaration on TRIPs and public health was a milestone that recognized that intellectual property rights were subservient to public health concerns. It clearly stated that the TRIPs agreement does not and should not prevent members from taking measures to protect public health. It specifically recognizes the flexibility that countries have to use compulsory licensing for local production. The declaration also set a timetable of December 2002 to find a solution for countries that did not have adequate manufacturing capacity. But negotiations ran aground—reopening them is urgent.¹⁶

In agriculture, it is conceded by all countries that subsidies need to be reduced and should be ultimately phased out. However, in the case of food security concerns, exception is permitted. All forms of export subsidies will be phased out. This is big problem for the developed countries which have been providing mounting subsidies.

The success or failure of developing countries will depend on to what extent India can muster the support of other developing countries to fight for their common cause as well as how well it will do its own home work to be effective at the negotiation table.

WTO AND INDIA

The Uruguay Round Agreements and WTO have come in for scathing criticisms in India. Many politicians and others have argued that India should withdraw from the WTO. Many of the criticisms are either

baseless or due to lack of knowledge of the international trading environment, and misinformation, or are just meant to oppose the government by the opposition parties.

It is true that the Uruguay Round mostly benefits the developed countries. That does not mean that developing countries like India are losing—their gain is limited as compared to that of the developed countries and further liberalisation by developed countries is needed for the developing countries to take advantage of globalisation.

Accepting the demand of some of the critics, that India should withdraw from the WTO will be a great blunder that the nation can commit. By being a part of WTO India enjoys the most favoured nation (MFN) status with all the other members of the WTO. Opting out of the system would mean an infinitely laborious task of entering into bilateral negotiations with each and every one of the trading partners which would amount to “having one’s arms twisted bilaterally by the US, the EC and Japan, turn by turn, on everything from intellectual property rights to NPT, human rights and environmentally clean technologies for packaging.”¹⁷ It may be noted at this juncture that China got readmitted to the system after a long wait and lobbying.

Agricultural Subsidies

One major controversy pertains to the agricultural subsidies. Much hue and cry have been raised in India about this factor. However, it needs to be mentioned that the Agreement would not adversely affect India’s agricultural subsidies and its agriculture exports. Developing countries were expected to largely benefit because of the lowering of the agricultural protection by the developed countries, in spite of the fact that the wish of the developing countries that the major Western nations would totally drop subsidies for their producers, substantially lower tariffs, and open markets did not materialize. However, the developed nations, in general, have not brought about the expected liberalisation.

India's Global Trade Gain

Assuming that India’s market share in world exports improves to one per cent, and that she is able to take advantage of the opportunities that are created, the trade gains may consequently be placed at \$2.7 billion exports per year. More generous estimates range from \$3.5 to 7 billion worth of extra exports.

However India’s gain will be much less than those of several other developing countries like China and the newly industrialised economies because: (i) India’s share in the world trade is very low (ii) The foreign trade-GDP ratio of India is low. The gain will also depend on the rate of growth of India’s exports.

India and Compliance Issues

India has taken several measures to comply with the TRIPs Agreement. On copyrights and related rights, the Agreement requires compliance with the provisions of *Bern Convention* to which India is a signatory and the new Copyright Act of India already meets the requirements of the TRIPs Agreement. Trade and Merchandise Marks Act of 1958 was replaced by a new Act, namely, The Trade Marks Act, 1999, so as to provide for the protection of service marks also.

For the protection of Geographical Indications of Goods, a *sui generis* legislation, viz., the Geographical Indications of Goods (Registration & Protection) Act, 1999 has been enacted in order to comply with the requirements under the TRIPs Agreement and to protect products of Indian origin as well. The Act primarily intends to protect the valuable geographical indications of our country. The protection under the Act is available only to the geographical indication registered under the Act and to the authorized

users. The Act permits any association of persons or producers or any organization or authority established by law representing the interest of the producers of goods to register a geographical indication. It may be possible to argue that the holders of the traditional knowledge in goods produced and sold using geographical indication can register and protect their traditional knowledge under this law.

The Indian Parliament has passed the Protection of Plant Varieties and Farmers' Rights Act, 2001, with the objective of giving a significant thrust to agricultural growth by providing an effective system for the protection of plant varieties and farmers' rights. This is expected to stimulate investments for research and development both in the public and the private sectors for the development of new plant varieties by ensuring appropriate returns on such investment. The Indian legislation acknowledges that the conservation, exploration, collection, characterization, evaluation of plant genetic resources for food and agriculture are essential to meet the goals of national food and nutritional security as also for sustainable development of agriculture for the present and future generations. It also acknowledges that the plant genetic resources for food and agriculture are the raw material indispensable for crop genetic improvement. The concept of effective benefit sharing arrangement between the provider and the recipient of the plant genetic resources forms an integral part of our Act.

India provides for the protection and enforcement of different fields of intellectual property through both specific national legislation as well as the Code of Civil Procedure and the Code of Criminal Procedure by way of civil remedies and criminal penalties. These provide effective deterrent to the infringement of IPRs. The criminal cases and civil suits for the infringement of IPRs lie in the judicial system for other cases.

The amended patent law of contains provisions for mandatory disclosure of source and geographical origin of the biological material used in the invention while applying for patents in India. Provisions have also been incorporated to include non-disclosure or wrongful disclosure of the same as grounds for opposition and for revocation of the patents, if granted. To protect traditional knowledge from being patented, provisions have also been incorporated in the law to include anticipation of invention by available local knowledge, including oral knowledge, as one of the grounds for opposition as also for revocation of patent. In order to further strengthen these provisions, a new provision has been added to exclude innovations which are basically traditional knowledge or aggregation or duplication of known properties of traditionally known component or components from being patented.

India is a party to the Convention on Biological Diversity (CBD), which came into force in December 1993. The CBD offers opportunities to India to realise the benefit of these resources. A Bill introduced in Parliament in December 2002 addresses the basic concerns of access to, collection and utilization of biological and knowledge by foreigners and sharing of benefits arising out of such success.

Various suggestions have been advanced in India to extend protection to knowledge, innovations and practices. These include: (i) documentation of TK; (ii) registration of innovation under patent system; and (iii) development of a *sui generis* system. It is sometimes believed that proper documentation of associated TK, could help in checking bio-piracy. Documentation could be a double-edged sword. It is assumed that if the material/knowledge is documented, it can be made available to patent examiners the world over so that prior art in the case of inventions based on such materials/knowledge are/is readily available to them. (Adapt here *Benefits and Drawbacks/Criticisms* of WTO given under subsection *Evaluation of WTO*.)

SUMMARY

The Principles and Agreements of WTO have very significant impact on national economies and globalisation. Figure 28.1 provides a bird's eye view of the important impacts.

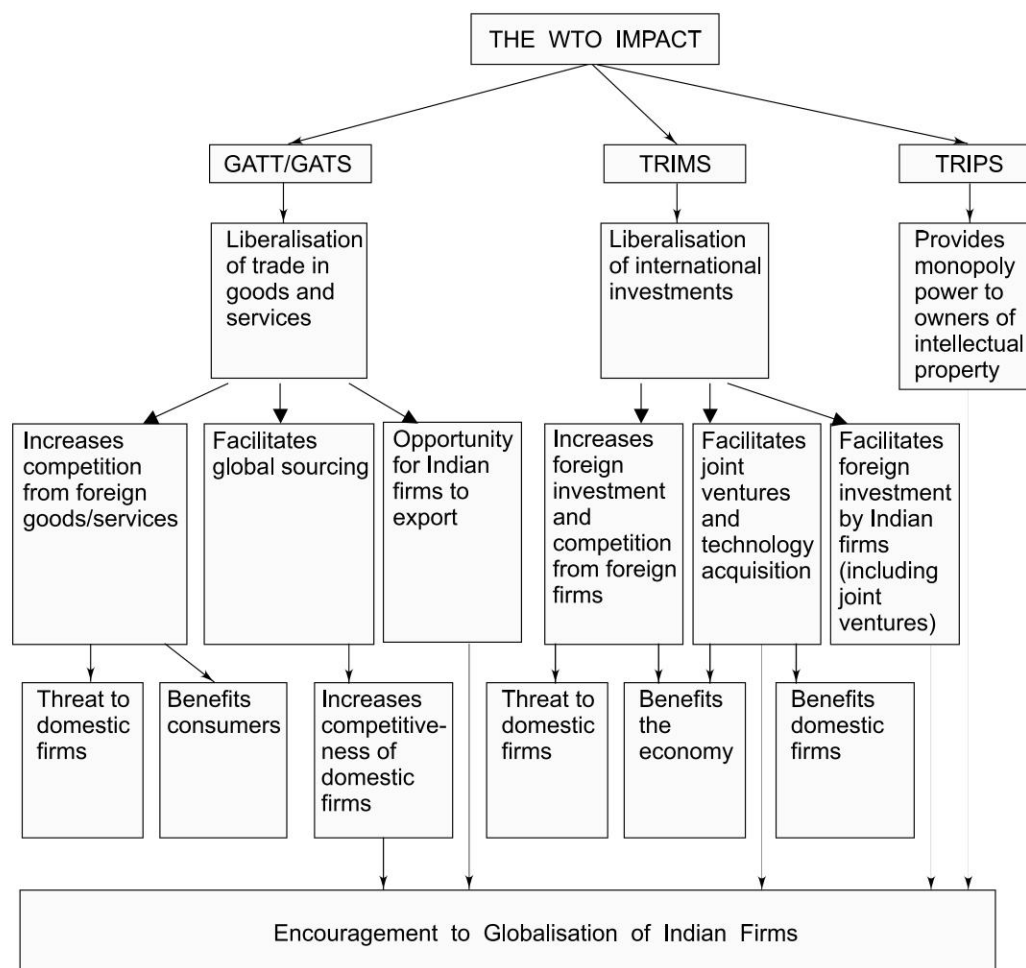


Fig. 28.1 The WTO Impact

The salient features of the Uruguay Round Agreement are given below.

1. The Uruguay Round substantially expanded the scope of multilateral trade negotiation by including services, intellectual property rights (TRIPs) and trade related aspects of investment measures (TRIMs), as against only goods in the past.
2. With effect from January 1, 1995, GATT (which was temporary and adhoc) was replaced by a permanent organisation, the WTO.
3. WTO is GATT plus a lot more. Under the GATT there was only one major agreement—GATT. Under the WTO, there are agreements related to three major areas—GATT, GATS and TRIPs.
4. WTO is a more powerful and effective organisation than GATT. It has a more effective dispute settlement mechanism.
5. The Uruguay Round Agreement seeks to liberalise trade in manufactures by enlarging tariff bindings, reducing tariffs and removing tariffs.

6. A significant achievement of the UR is the measures to liberalise trade in agriculture, which was a highly protected sector, particularly in the developed countries. These measures are tariffication, tariff bindings, tariff cuts and reduction in subsidies and domestic support.
7. All member countries are required to adopt product patent (as also process patent). India had only process patent for drugs, food and chemical substances for which the patent period was 7 years and 14 years, for other products. Under the WTO regime the patent period for all products is 20 years.
8. As under GATT, under WTO also, developing countries, particularly least developed countries, are accorded a number of concessions and favours. Their liberalisation requirements are lower and they are allowed longer period to fulfil the liberalisation commitments. The WTO also calls upon the developed nations to grant special preferences to imports from developing countries. There are also some committees under the WTO to look after the interests and special needs of the developing countries.
9. There is a general complaint that the fruits of the liberalisation accrue mostly to the developed countries. It is pointed out that the industrialized countries, which make up only 20 percent of the membership, will appropriate about 70 percent of the additional income generated by the implementation of the UR agreements. The losers, mostly in Africa and Caribbean, are some of the poorest countries in the world. The developed countries gain substantially because of their higher level of participation in trade and because of the fact that significant part of liberalisations has been in respect of goods of interest to them. Liberalisation of trade in textiles, by phasing out MFA, however, will substantially benefit the developing countries.
10. Even after all UR concessions are fully implemented by the industrialised countries, significant trade barriers in the form of high tariff peaks (exceeding 12 per cent but in some cases reaching or exceeding 300 per cent) will continue to affect many exports from developing countries. The removal of such barriers needs to be given high priority. There are several other areas of critical importance to the developing countries.
11. Developing countries are terribly disadvantaged due to the *participation gap*.
12. India has taken several measures to comply with the TRIPs Agreement: these include amendments to some laws and new legislations.
13. Estimates of India's possible gain from the trade liberalisation vary very widely—between \$2 billion and \$7 billion a year. Although the liberalisation of trade in textiles will benefit the developing countries, India's gain will depend a lot on her competitive strength vis-a-vis other textile exporters.

India's gain from the trade liberalisation will be much less than that of many other developing countries, such as the South East Asian economies and China, because India's share in the world trade is very low (less than one per cent) and her foreign trade-GDP ratio is very low.

(More elaborate and illustrative treatment of WTO is available in the new edition of the author's *International Business*—Prentice Hall of India).

Review Questions

1. Evaluate the performance of GATT.
2. Discuss the role of WTO in international economic integration.
3. Examine the drawbacks in the functioning of WTO.
4. Give a critical account of the Uruguay Round Agreement.
5. Explain the implications of the Uruguay Round Agreement for developing countries.
6. Evaluate the Uruguay Round Agreement with special reference to India.
7. Write an essay on the protection of intellectual property rights.

8. Write notes on the following.
 - (a) Difference between GATT and WTO
 - (b) Patents
 - (c) IPRs
 - (d) TRIPs
 - (e) Trade in services.
 - (f) Implementation issues. Unequal participation of countries in the WTO.
 - (g) Anti-dumping measure under WTO.

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Suggested Readings

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PART EIGHT

Trade Policy and Performance of India

8

CHAPTERS

- ❖ Trade Regulation and Promotion
- ❖ Trade and BOP of India

CHAPTER 29

29 Trade Regulation and Promotion

LEARNING OBJECTIVES

- ☐ To get an idea of foreign trade regulation of India.
- ☐ To examine the Foreign Trade Policy of India.
- ☐ To get a picture of the export promotion measures in India.
- ☐ To evaluate the import substitution strategy.

India's trade policy has already been discussed in the chapter on *Trade Strategy*. It is being supplemented by this chapter which briefly reviews the trade policy.

EXTERNAL SECTOR REFORMS

As pointed out in the Chapter 9, in the first four decades of development planning, India followed a very restrictive trade policy. Imports were very highly restricted; although several measures were taken to promote exports, the inherent anti-export bias of the inward looking strategy hampered export development (See the chapter *Trade Strategy* for details). However, the external payments crisis of 1991 led to the ushering in of a far reaching trade reform.

The dissatisfaction with the ISI strategy of the 1950s and 60s gave way to an outward oriented trade strategy in many nations since the late 1970s.

As a RBI Report observes, perceptions on the role of foreign trade in growth have changed dramatically in the last five decades or so. During the 1950s and the 1960s import substitution-based industrialisation represented the dominant growth strategy pursued by several developing countries. In the 1970s, the growth experiences of individual countries led to scepticism regarding the virtues of import substitution. The resultant shift in policy stance in favour of outward-oriented trade strategies that started towards late 1970s gathered momentum in the subsequent years as a large number of cross-country studies validated the positive relationship between export growth and output growth. Some evidence demonstrating the superior growth performance of countries with export-oriented trade strategies is also available.¹

Reform Measures

Removal of or substantial reduction in non-tariff and tariff barriers to imports has been a significant feature of India's trade reform.

External sector reform measures introduced since the early 1990s include transition to a market determined exchange rate regime, removal of quantitative trade restrictions, tariffication (i.e. replacing quantitative restrictions (QRs) by tariffs), substantial reduction in the tariff rates, removal of negative lists of exports and imports, substantially reducing licensing, introduction of current account convertibility, liberalisation of capital inflows, simplification of procedures, broadening the reach of the export incentives, extending the benefits of various export-promotion schemes to a large number of non-traditional and non-manufactured exports, strengthening the export production base etc.

Removal of QRs While removing QRs, the Government has taken several safeguard measures (adjustment of tariffs, imposition of temporary QRs, safeguard duties, anti-dumping duties and restricting the import of certain agricultural products) in order to guard against any surge in imports on account of dumping.

Reduction in Import Duty The import duty levels have been substantially reduced. The peak import duty rate sharply declined from 355 to 45 per cent between 1990–91 and 1998–99. The peak rate of import duty on non-agricultural imports was gradually reduced from as high as 150 per cent in 1991–92 to 25 per cent (excluding agriculture and dairy products) by 2003–04. The weighted average import duties on various goods, even though reduced from the high levels prevailing earlier, are still higher than that of some of the East Asian countries. Although the average tariff rate declined steadily from 1991–92 to 1996–97, thereafter, it edged up again, *inter alia*, due to the imposition of various surcharges. The increase in the weighted average tariff rates since 1998–99 was predominantly in agriculture and consumer goods sectors.

The Government, however, is committed to reducing tariffs to levels comparable with those prevailing in East Asian economies. The Finance Minister, in the Union Budget for 2001–02, had stated that there would be a progressive move within three years to reduce the number of rates to the minimum with a peak rate of 20 per cent. This was reiterated in the Union Budget for 2002–03, wherein it was stated that by 2004–05, there would be only two basic rates of customs duties, namely 10 per cent covering raw materials, intermediates and components and 20 per cent covering final products. Keeping in line with these announcements, the Union Budget for 2003–04 while reducing the customs duties on several products, brought down the peak tariff rate to 25 per cent (excluding agriculture and dairy products).

It is expected that these measures will make domestic industry cost-efficient by enhancing efficiency in resource use under international competition and this would lead to a better export performance in the long-run. Consumer welfare is expected to improve because of the availability of better quality products at globally competitive prices and by providing greater freedom of choice to residents to undertake current transactions on a global scale.

The overall objective of the reform process has been to achieve higher growth and efficiency without exposing the system to greater vulnerability.

REGULATION AND PROMOTION OF FOREIGN TRADE

The Foreign Trade Policy of India is implemented mostly by means of a regulatory framework provided by the Foreign Trade (Development and Regulation) Act, 1992.

Control of foreign trade in India dates back to the early years of the Second World War. Import Control was introduced in 1940 as a war-time measure under the Defence of India Rules with the primary

objective of conserving foreign exchange resources and restricting physical imports so as to reduce the pressure on the limited shipping space available. Initially, the import of only 68 commodities, mainly consumer goods, were brought under control. Subsequently, with increasing pressure on foreign exchange resources, import control was extended to other commodities as well.

After the end of the war, the Defence of India Rules lapsed and hence in September 1946, the Emergency Provisions (Continuance) Ordinance, 1946, was promulgated to continue the import trade control. This was ultimately replaced by the Imports and Exports (Control) Act, 1947, which came into force with effect from March 25, 1947. This Act gave the government enormous powers of control over the foreign trade of India. The imports and exports were controlled by the Government under the Imports (Control) Order and Exports (Control) Order issued under this Act.

The broad objectives of foreign trade control in India were:

1. To conserve the foreign exchange resources and to allocate the scarce foreign exchange resources in accordance with national priorities.
2. To control the import of inessential and harmful items.
3. To ensure adequate availability of required goods within the country.
4. To protect domestic industries.
5. To prevent anti-social activities.

As part of the economic reforms, the foreign trade regulation has also undergone a significant transformation. The Imports and Exports (Control) Act, 1947, was replaced by the Foreign Trade (Development and Regulation Act), 1992 (FTDRA).

Besides the FTDR Act, there are some laws which control the trade in certain items. For instance, the export of antiquities is regulated under the Antiquities and Art Treasures Act 1972; export of coffee is regulated by the Coffee Board under the Indian Coffee Act 1942; export of tea is regulated under Tea Act, 1953, etc. The export and import of currency notes, bank notes and coins were controlled by the Reserve Bank of India under the Foreign Exchange (Regulation) Act, 1973 (FERA).

The major concern of the government in the past was restriction of imports with a view to controlling the trade deficit and protection of domestic industries against foreign competition. Imports were, therefore, very much restricted by prohibition of imports of many items, import licensing, very high import duties and foreign exchange restrictions. The foreign trade policy was characterised by an overtone of negativism.

The Foreign Trade (Development and Regulation) Act, 1992

This Act which replaced the Imports and Exports (Control) Act, 1947, came into force on June 19, 1992.

No export or import shall be made by any person except in accordance with the provisions of this Act, the orders and rules made under this Act and the export and import policy.

The emphasis of India's trade law has shifted from prohibition and control to development.

Objective The objective of the Act is to *provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India and for matters connected therewith or incidental thereto.*

A drastic and welcome change in the attitude of the government is reflected in the statement of objective of the new law, the Foreign Trade (Development and Regulation) Act, 1992, which has replaced the Imports and Exports (Control) Act, 1947. The objective of this Act is to *provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India and for matters connected there with or incidental thereto*. Contrast this with the objective of the 1947 Act: *to prohibit or control imports and exports*. The objective of the new Act reflects a positive and dynamic attitude in contrast to the negative attitude of the old Act. However, the bureaucracy is yet to imbibe the spirit of the new attitude which is laid down in the paper.

The FTDR empowers the Central Government to take measures for the development and regulation of foreign trade by facilitating imports and increasing exports.

Main Provisions The main provisions of the FTDR Act are the following.

Prohibition and Restriction The Act also empowers the Central Government to make provisions for prohibiting, restricting or otherwise regulating the import or export of goods as and when required. All goods which are so regulated under this sub-section shall be deemed to be goods the import or export of which has been prohibited under Section 11 of the Customs Act, 1962, and all the provisions of that Act shall have effect accordingly.

It may be noted that it is according to this sub-clause that the Government has provided for negative lists of exports and imports in the Exim policy.

Exim Policy The Act lays down that the Central Government may, from time to time, formulate and announce the export and import policy and may also amend that policy.

Director General of Foreign Trade The Act provides for the appointment by the Central Government, of a Director General of Foreign Trade for the purpose of this Act. The DGFT shall advise the Central Government in the formulation of the export and import policy and shall be responsible for carrying out that policy. [The corresponding authority under the Imports and Exports Control Act, 1947, was called the Chief Controller of Imports and Exports (CCIE)].

Importer-Exporter Code Number The Act lays down that no person shall make any import or export except under an Importer-Exporter Code (IEC) Number granted by the DGFT or the Officer authorised by him in his behalf.

The Director General is empowered to suspend or cancel the Importer-Exporter Code Number granted to any person if there is valid reason to do so, like contravention of law relating to Central excise or customs or foreign exchange or having conducted import/export in a manner gravely prejudicial to the trade relations of India with any foreign country or in a way detrimental to the interests of the country.

Issue and Suspension/Cancellation of Licence The Director General or any other officer authorised under this Act is empowered to suspend or cancel a licence issued for export or import of good in accordance with this Act for good and sufficient reasons, after giving the licence holder a reasonable opportunity of being heard.

Search, Inspection and Seizure Where any contravention of any condition of the licence of authority under which any goods are imported is suspected or made, any person authorised by the Central Government may search, inspect and seize such goods, documents, things and conveyances subject to such requirements and conditions as may be prescribed.

Penalty for Contravention Where any person makes or abets or attempts to make any export or import in contravention of any provisions of this Act or any rules or orders made under this Act or the Exim policy, he shall be liable to a penalty not exceeding one thousand rupees or five times the value of the goods involved, whichever is more.

FOREIGN TRADE POLICY

The Foreign Trade Policy plays a very important role in directing, regulating and promoting the foreign trade. Government of India used to announce five year Export-Import Policy (Exim Policy). The Exim Policy 2002–07 put in place by the NDA Government was replaced by the Foreign Trade Policy, 2004–09, announced by the UPA Government.

The Foreign Trade Policy, 2004–09, is effective from September 1, 2004.

The Foreign Trade Policy 2004–09 aims at achieving about 1.5 per cent share for India in global merchandise trade by 2009.

Scope

It is for the first time that a comprehensive foreign trade policy was announced for the nation. The preamble of the Policy states: “For India to become a major player in world trade, an all encompassing, comprehensive view needs to be taken for the overall development of the country’s foreign trade. While increase in exports is of vital importance, we have also to facilitate those imports which are required to stimulate our economy. Coherence and consistency among trade and other economic policies is important for maximizing the contribution of such policies to development. Thus, while incorporating the existing practice of enunciating an annual Exim Policy, it is necessary to go much beyond and take an integrated approach to the developmental requirements of India’s foreign trade. This is the context of the new Foreign Trade Policy.”

The Policy states that exports and imports shall be free, except in cases where they are regulated by the provisions of this Policy or any other law for the time being in force. Restrictions are called when necessary for protection of public morals; protection of human, animal or plant life or health; protection of patents, trademarks and copyrights and the prevention of deceptive practices; prevention of use of prison labour; protection of national treasures of artistic, historic or archaeological value; conservation of exhaustible natural resources; protection of trade of fissionable material or material from which they are derived; and prevention of traffic in arms, ammunition and implements of war.

Objectives

The Policy statement observes that trade is not an end in itself, but a means to economic growth and national development. The primary purpose is not the mere earning of foreign exchange, but the stimulation of greater economic activity. The Foreign Trade Policy is rooted in this belief and built around two major objectives. These are:

1. To double our percentage share of global merchandise trade within the next five years; and
2. To act as an effective instrument of economic growth by giving a thrust to employment generation.

Strategy

The export development strategy involves development of physical and organisational infrastructure, procedural simplifications, focus area development, rationalisation of duty structure, government-industry partnering etc.

These objectives are proposed to be achieved by adopting, among others, the following strategies:

1. Unshackling of controls and creating an atmosphere of trust and transparency to unleash the innate entrepreneurship of our businessmen, industrialists and traders.
2. Simplifying procedures and bringing down transaction costs.
3. Neutralizing incidence of all levies and duties on inputs used in export products, based on the fundamental principle that duties and levies should not be exported.
4. Facilitating development of India as a global hub for manufacturing, trading and services.
5. Identifying and nurturing special focus areas which would generate additional employment opportunities, particularly in semi-urban and rural areas, and developing a series of 'Initiatives' for each of these.
6. Facilitating technological and infrastructural upgradation of all the sectors of the Indian economy, especially through import of capital goods and equipment, thereby increasing value addition and productivity, while attaining internationally accepted standards of quality.
7. Avoiding inverted duty structures and ensuring that our domestic sectors are not disadvantaged in the Free Trade Agreements/Regional Trade Agreements/Preferential Trade Agreements that we enter into in order to enhance our exports.
8. Upgrading our infrastructural network, both physical and virtual, related to the entire Foreign Trade chain, to international standards.
9. Revitalising the Board of Trade by redefining its role, giving it due recognition and inducting experts on Trade Policy.
10. Activating our Embassies as key players in our export strategy and linking our Commercial Wings abroad through an electronic platform for real time trade intelligence and enquiry dissemination.

The Trade Policy has set an export target of \$150 billion each for merchandise and services by the end of this decade.

Partnership

The new Policy envisages merchant exporters and manufacturer exporters, business and industry as partners of Government in the achievement of its stated objectives and goals. Prolonged and unnecessary litigation vitiates the premise of partnership. In order to obviate the need for litigation and nurture a constructive and conducive atmosphere, a suitable Grievance Redressal Mechanism has been proposed to be established which, it is hoped, would substantially reduce litigation and further a relationship of partnership.

The dynamics of a liberalized trading system sometimes results in injury caused to domestic industry on account of dumping. When this happens, effective measures to redress such injury will be taken.

Roadmap

This Policy is essentially a roadmap for the development of India's foreign trade. It contains the basic principles and points the direction in which we propose to go. By virtue of its very dynamics, a trade policy cannot be fully comprehensive in all its details. It would naturally require modification from time to time. The government proposes to do this through continuous updation, based on the inevitable changing dynamics of international trade. It is in partnership with business and industry that we propose to erect milestones on this roadmap.

Special Focus Initiatives With a view to doubling India's 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 and leather sectors. Government proposes to make concerted efforts to promote exports in these sectors by specific sectoral strategies that shall be notified from time to time. Further Sectoral Initiatives in other sectors will also be announced from time to time.

A new scheme called the Vishesh Krishi Upaj Yojana (Special Agricultural Produce Scheme) for promoting the export of fruits, vegetables, flowers, minor forest produce, and their value added products has been introduced. The Agri Export Zones (AEZ) scheme introduced under the previous policy has been offered several additional measures of support.

Besides proposing to earmark specific funds under MAI/MDA Scheme, several incentives and support measures have been announced for promoting handloom exports. Further, new towns of export excellence with a threshold limit of Rs 250 crore shall be notified.

Besides some other incentives and support measures, it is proposed that new Handicraft SEZs shall be established which would procure products from the cottage sector and do the finishing for exports.

In order to showcase our industrial and trade prowess to its best advantage and leverage existing facilities to enhance the quantity of space and service, Pragati Maidan, in Delhi, will be transformed into a world-class complex with visitor friendliness ingress and egress system. The complex utilisation will be improved, increased and diversified. There shall be brand new, state-of-the-art, environmentally-controlled, air-conditioned exhibition areas, and Permanent Exhibition Marts. In addition, a large Convention Centre to accommodate ten thousand delegates will be developed, with multiple and flexible hall spaces, auditoria and meeting rooms with hi-tech equipment. A year-round Food and Beverage destination will be developed, with a large number of outlets covering all cuisines and pricing levels. There will be a multi-level park to accommodate over nine thousand vehicles within the envelope of Pragati Maidan.

Promotional Measures

Assistance to States for Infrastructure Development for 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. The States shall utilise this amount for developing infrastructure such as roads connecting production centres 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.

The Trade Policy has proposed several measures to promote export production and international marketing.

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 per cent of the total cost depending upon the activity and the implementing agency, as indicated in the detailed guidelines.

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 with effect from April 1st, 2004, assistance under MDA is available for exporters with annual export turnover upto Rs 5 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.

Towns of Export Excellence A number of towns in specific geographical locations have emerged as dynamic industrial clusters contributing handsomely to India's exports. The previous Policy had granted recognition to these industrial clusters as Towns of Exports Excellence 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 Rs. 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 Rs 250 crores.

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.

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.

Target Plus Scheme The objective of the scheme is to accelerate growth in exports by rewarding Star Export Houses who have achieved a quantum growth in exports. High performing Star Export Houses shall be entitled for a duty credit based on incremental exports substantially higher than the general annual export target fixed.

Duty Entitlement Passbook Scheme (DEPB) The objective of DEPB is to neutralise the incidence of customs duty on the import content of the export product. The neutralisation shall be provided by way of grant of duty credit against the export product.

The DEPB scheme will continue to be operative until it is replaced by a new scheme which will be drawn up in consultation with exporters.

Under the DEPB, an exporter may apply for credit, as a specified percentage of FOB value of exports, made in freely convertible currency.

The credit shall be available against such export products and at such rates as may be specified by the Director General of Foreign Trade by way of public notice issued in this behalf, for import of raw materials, intermediates, components, parts, packaging material etc.

Export Promotion Capital Goods Scheme The EPCG Scheme allows import of capital goods for pre production, production and post production (including CKD/SKD thereof as well as computer software systems) at 5% Customs duty subject to an export obligation equivalent to 8 times of duty saved on capital goods imported under EPCG scheme to be fulfilled over a period of 8 years reckoned from the date of issuance of licence. Capital goods would be allowed at 0% duty for exports of agricultural products and their value added variants.

However, in respect of EPCG licences with a duty saved of Rs.100 crore or more, the same export obligation shall be required to be fulfilled over a period of 12 years.

Export Houses

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. Recognition will be granted depending on the exporter's total FOB/FOR export performance during the current plus the previous three years as laid down below.

An export house is a registered exporter who satisfies certain criteria laid down in the Foreign Trade Policy. An export house is entitled for certain facilities and incentives.

Table 29.1 Categories of Export House

Category	Performance (in rupees)
One Star Export House	15 crore
Two Star Export House	100 crore
Three Star Export House	500 crore
Four Star Export House	1500 crore
Five Star Export House	5000 crore

On the basis of the export turnover there are five categories of export houses.

A Star Export House shall be eligible for several facilities like fast track clearance procedures, exemption from furnishing of bank guarantee, entitlement for consideration under the Target Plus Scheme etc.

Services exports

In order to give proper direction, guidance and encouragement to the Services Sector, it is proposed to set up an exclusive Export Promotion Council for Services.

The Services Export Promotion Council shall:

1. Map opportunities for key services in key markets and develop strategic market access programmes for each component of the matrix.
2. Co-ordinate with sectoral players in undertaking intensive brand building and marketing programmes in target markets.

3. Make necessary interventions with regard to policies, procedures and bilateral/ multilateral issues, in co-ordination with recognised nodal bodies of the services industry.

Government will promote the establishment of Common Facility Centres for use by home-based service providers, particularly in areas like Engineering & Architectural design, Multi-media operations, software developers etc. in State and District-level towns, to draw in a vast multitude of home-based professionals into the services export arena.

EOUs, EHTPs, STPs and BTPs

Units undertaking the export of their entire production of goods and services (except permissible sales in the DTA), may be set up under the Export Oriented Unit (EOU) Scheme, Electronic Hardware Technology Park (EHTP) Scheme, Software Technology Park (STP) Scheme or Bio-Technology Park (BTP) scheme for manufacture of goods, including repair, re-making, reconditioning, re-engineering, and rendering of services. Trading units, however, are not covered under these schemes.

An EOU/EHTP/STP/BTP unit may export all kinds of goods and services except items that are prohibited in the ITC (HS). Export of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) shall be subject to fulfillment of the conditions indicated in the ITC (HS).

An EOU/EHTP/STP/BTP unit may import and/or procure from domestic tariff area (DTA) or bonded warehouses in DTA/international exhibition held in India without payment of duty all types of goods, including capital goods, required for its activities, provided they are not prohibited items of import in the ITC (HS). Any permission required for import under any other law shall be applicable. The units shall also be permitted to import goods including capital goods required for the approved activity, free of cost or on loan/lease from clients. The import of capital goods will be on a self certification basis.

EOU/EHTP/STP/BTP units may import/procure from DTA without payment of duty certain specified goods for creating a central facility which will be used by software units. These software units can be EOU/ DTA units who will use the facility for export of software.

Second hand capital goods without any age limit, may also be imported duty free.

EOU/EHTP/STP/BTP unit shall be a positive net foreign exchange earner. Net Foreign Exchange Earnings (NFE) shall be calculated cumulatively in blocks of five years, starting from the commencement of production.

Special Economic Zones (SEZ)

The Policy provides for establishment and promotion of Special Economic Zones (SEZ) which are growth engines that can boost manufacturing, augment exports and generate employment. The private sector has been actively associated with the development of SEZs. The SEZs require special fiscal and regulatory regime in order to impart a hassle free operational regime encompassing the state of the art infrastructure and support services. The proposed legislation on SEZs to be enacted in the near future would cover the concepts of the developer and co- developer, incorporate the provision of virtual SEZs, have fiscal concessions under the Income Tax and Customs Act, provide for Offshore Banking Units (OBUs) etc. (See a separate sub-section in this chapter for details.)

Free Trade and Warehousing Zones

The objective Free Trade & Warehousing Zones (FTWZ) is to create trade-related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transactions in free

currency. The scheme envisages creation of world-class infrastructure for warehousing of various products, state-of-the-art equipment, transportation and handling facilities, commercial office-space, water, power, communications and connectivity, with one-stop clearance of import and export formality, to support the integrated Zones as 'international trading hubs'. These Zones would be established in areas proximate to seaports, airports or dry ports so as to offer easy access by rail and road. The FTWZ shall be a special category of Special Economic Zones with a focus on trading and warehousing.

Evaluation

The new policy has been widely hailed for its endeavour to improve export infrastructure and export production, garnering of export surplus, removal of quantitative restrictions on exports, attempts to reduce transaction costs, procedural simplification, focused attention on export promotion etc.

The Policy will not be able to produce the desired results unless we radically deviate from the 'business as usual approach'.

As stated in the beginning, it is claimed that for the first time the nation has been presented with a comprehensive Foreign Trade Policy. However, there is nothing significant in the Policy about import development.

The Policy has been praised for going micro. For, beyond setting the impressive export target of \$150 billion each for merchandise and services by the end of the decade, the policy aims to broadbase the export effort by co-opting small exporters. By this the Government has recognised that an export drive cannot be meaningful unless the policy reaches out to the smallest of business houses. The new Policy should also be appreciated for its efforts to further build upon the initiatives of the past to boost the exports of our traditional items like handlooms and handicrafts, and agricultural products. Services exports have also received attention of the policy.

"Merely extending the trade policy benefits to small exporters cannot be effective unless accompanied by a simplification of procedures. The new Policy has also tried to address this with measures to prune procedural requirements and reduce transaction costs. The delegation of powers to zonal and regional offices of the Directorate-General of Foreign Trade to speed up electronic data interchange is also to be welcomed."

The disadvantages arising from the state of infrastructure, power tariffs, interest rates, taxation structure etc. are well known. The initiatives taken in the past to tackle some of them are sought to be further carried forward by the present Policy. However, they are not at all adequate to stand India in good stead in comparison with other better performing nations. Further, the serious issue of Industrial relations is not all addressed. This, of course, is a larger issue with macro ramifications. "The policy, ambitiously, proposes setting up free-trade warehousing zones to facilitate the emergence of India as a global trading hub. Similarly, allowing 100 per cent foreign direct investment in free-trade zones looks an attractive idea, but its implementation will depend on various operational conditions, importantly labour relations. The Foreign Trade Policy has nothing much to say on this."

EXPORT PROMOTION

Importance and Objectives Governments all over the world actively promote exports for various reasons.

Export development can help achieve domestic economic stability and growth.

When the domestic market is small, the foreign market provides opportunities to achieve economies of scale and growth. *Second*, the supply of many commodities, as in

the case of a number of agricultural products in India, is more than the domestic demand. *Third*, exports enable certain countries to achieve export-led growth. *Fourth*, export markets may help mitigate the effects of domestic recession. *Fifth*, a country may need to boost its exports to earn enough foreign exchange to finance its imports and service its foreign debt. It may be noted that many countries are suffering from trade deficit and foreign debt. *Sixth*, even in the case of countries with trade surplus, export promotion may be required to maintain its position against the international competition and the level of domestic economic activity. *Last*, higher exports facilitate larger imports and help increase consumption levels and economic welfare.

Most of the benefits of exports mentioned above call for a vigorous export promotion in India.

The important objectives of export promotion are:

1. To provide organisational and infrastructural facilities for development of export.
2. To provide production, marketing and financial support for the development of exports.
3. To compensate the exporters for the high domestic cost of production.
4. To provide necessary assistance to the new and small exporters to develop export businesses.
5. To increase the relative profitability of the export business vis-à-vis the domestic business.

Export promotion includes measures to increase export production, establishment of organisations to assist exporters in different ways, export marketing assistance and measures to reduce business risks and increase profitability.

Export Promotion Measures

A brief account of the measures taken by the Government of India for export promotion is given below.

Organisational Set-Up The government has established or sponsored a number of organisations to provide different types of assistance to the export sector. While some of these organisations are product specific, others are general. Apart from the organisations set up exclusively for export promotion, there are also a number of others which assist the export sector in different ways.

Assistance provided by these organisations cover areas such as identification of markets and market development; identification of products with export potential and product development; financing of foreign trade; education and training in export marketing; export intelligence, including research and collection and dissemination of information; insurance covers against export risks; organisation of, and participation in, trade fairs and exhibitions; packaging; pre-shipment inspection and quality control; export documentation and procedures; and so on.

Incentives Export incentives are a widely employed strategy of export promotion. The main aim of these incentives is to increase the profitability of export business.

Important export incentives in India include rebate of duties, income tax concession, interest subsidies, freight subsidy, etc. However, as the Abid Hussain Committee has observed, they are more of a compensation for the comparative disadvantages faced by the Indian exporter than incentives. A brief account of these 'incentives' is given below.

Duty Exemption/Drawback Duty exemption as an export promotion measure had its origin in India during the Second Plan. Over the years, the scheme has been enlarged and modified.

The scheme of duty exemption is designed to avoid the incidence of commodity taxes like excise duty and customs duty on the exports so as to make the exports more price competitive. The exporters are

either exempted from the payment of duty while procuring inputs like raw materials and intermediates or, in cases where the duty is paid on the inputs, the duty paid is refunded. Thus, under the duty drawback system, the exporters are reimbursed for tariff paid on the imported raw materials and intermediates and central excise duty on domestically procured inputs which enter into export production.

Due to a series of modifications in the import policy for registered exporters, particularly with the introduction of the advance licensing system, the exporter can now make most of the import of inputs without payment of customs duty. Eligible exporters are entitled to interest-free bank credit against the duty drawback applicable to them up to a period of 90 days or up to the time they realise the drawback, whichever is earlier.

Other Incentives Other important export promotion measures include the following.

Income Tax Concession Besides the exemption or rebate of indirect taxes, a special fiscal treatment granted to exports is in the form of certain tax concessions with respect to income from exports. Such income tax rebates have been provided to exporters in India since the early 1960s.

IPRS The International Price Reimbursement Scheme was designed to make specified inputs, like steel and aluminium, available to the exporters at international prices. Under this scheme, the difference between price of the indigenously procured material and its international price was reimbursed to the exporter to offset the cost difference because of the difference in the input prices. The IPRS has been replaced by the Engineering Products Exports (Replenishment of Iron and Steel Intermediates) Scheme.

Other Schemes In addition, schemes were put in place for imports undertaken by exporters so as to neutralise the impact of any duties on those imports. Such schemes are Export Promotion Capital Goods (EPCG), Duty Free Replenishment Certificate (DFRC), Duty Remission Scheme and the Duty Entitlement Passbook (DEPB) Scheme.

Awards A number of awards have been instituted to encourage exports and to recognise excellence in exports. There are separate awards for different categories of exporters. Awards are given on the basis of certain specified criteria such as development of a market for products which have not been exported previously, substantial increase in exports, successful introduction of new products, product development, successful breakthrough in foreign markets where conditions have been especially difficult, etc.

Some incentives like the Cash Compensatory Support Scheme (CCS), Replenishment Licence (REP) / Exim Scrip were abolished following the economic reforms.

References to some other incentives are made in the subsection on Marketing Assistance.

Marketing Assistance A number of steps have been taken to assist the exporters in their marketing efforts. These include conducting, sponsoring or otherwise assisting, market surveys and research; collection, storage and dissemination of marketing information, organising and facilitating participation in international trade fairs and exhibitions; credit and insurance facilities; release of foreign exchange for export marketing activities; assistance in export procedures; quality control and pre-shipment inspection; identifying markets and products with export potential; helping buyer-seller interaction, etc.

Export Credit From time to time, the Reserve Bank has undertaken several measures to ensure adequate and timely availability of credit for exports at competitive interest rates. The RBI's export credit refinance schemes have played a pivotal role in this area. Commercial banks have been providing credit to exporters at pre-shipment and post-shipment stages, both in rupees as well as foreign currency.

The rupee export credit has been generally available at rate of interest linked to the Prime Lending Rate (PLR). The export credit in foreign currency is provided at internationally competitive interest rates linked to London Inter-Bank Offer Rate (LIBOR) or similar interest rates. The Reserve Bank has been adjusting interest rates on rupee export credit from time to time taking into account the need to maintain competitiveness by looking at interest rate differentials, as also other factors like inflation and developments in financial markets. The Reserve Bank has also taken measures to support institutional arrangements for export promotion, such as policy initiatives to provide a liberalised environment for the operations of SEZ units. These measures include: (i) exemption from interest rate surcharge on import finance; (ii) release of foreign exchange to DTA units for buying goods from EOU/EPZ/SEZ units; (iii) permitting 100 per cent retention of foreign exchange in Exchange Earners Foreign Currency (EEFC) accounts; (iv) permitting overseas investment by SEZ units from the EEFC accounts through the automatic route, write-off of unrealised export bills and (v) permitting SEZ units to enter into a contract with overseas commodity exchanges or markets to hedge the price risk in the commodity on export/import provided that the contract is made on a 'stand alone' basis.

Production Assistance/Facilities Exports depend, *inter alia*, on exportable surplus and the quality and price of the goods. The government has, therefore, taken a number of measures to enlarge and strengthen the production base, improve the productive efficiency and quality of products and to make the products more price competitive. Measures in these directions include making available raw materials and other inputs of required quality at reasonable prices; facilities to establish and expand productive capacity, including import of capital goods and technology; facilities to modernise production facilities; provision of infrastructure and incentives for the growth of export oriented industries, etc.

The policy thrust on exports during the 1980s and 1990s was promoted through several schemes. These schemes have been refined further during the 1990s and new schemes have also been introduced. They include the following.

1. Export Processing Zones (EPZs) were set up as enclaves separated from the Domestic Tariff Area (DTA) by fiscal barriers and intended to provide an internationally competitive duty free environment for export production at low cost. Eight of the EPZs have since been converted into Special Economic Zones (SEZs).
2. The Export Oriented Units (EOUs) Scheme, which is complementary to the EPZ scheme, was set up in 1981 under which a unit can be set up in any of the EPZs or at any other location in the country and be eligible for a host of liberal package of incentives which include same entitlements as given to EPZs.
3. In order to fully exploit the potential in the Information Technology (IT) sector and to promote IT related exports, the Central Government has set up Software Technology Parks (100 per cent EOUs) since 1991.
4. To build a strong and efficient electronics industry with good export potential, Electronic Hardware Technology Parks (EHTPs) were also set up.
5. The SEZ Scheme was announced in March 2000 in order to promote export production in a hassle-free atmosphere (Box VII.2).
6. The proposal to set up Agriculture Economic Zones (AEZs) was announced in March 2001 to promote the export of agro and agro-based products, and a number of AEZs have been sanctioned. The Central Government would assist the State Governments in the development of necessary infrastructure, flow of credit and other facilities for promoting agro exports.

Special Economic Zones (SEZs)

Earlier, India had export processing zones (EPZs) which were later converted in to SEZs. EPZs are industrial estates which form enclaves from the national customs territory of a country and are usually situated near seaports or airports. Almost the entire production of such zones is normally intended for exports, according to the original concept.

An export processing zone is different from a free port. An EPZ is normally an area within or near a port. As against this, a free port (or free trade port) encompasses a port or whole city isolated from the rest of the country for customs purposes (examples include Hong Kong, Singapore and Dubai). Obviously, a free port is also a free trade zone.

Only those imports which are meant for export processing (like capital goods, raw materials, components, etc, used for production of exportables), are freely (i.e. without restriction) allowed to a purely export processing zone. The exports from an EPZ should satisfy the condition that the export products have undergone certain specified minimum value addition by way of processing activities to become eligible for 'free' export. There are no such conditions with respect to free ports which are not export processing zones. Thus, an item which is imported to a free port may be re-exported even in the same condition, i.e. without any modification to the product. The condition of value addition is insisted upon to realise the objectives like increase in net foreign exchange earnings, employment generation and overall economic growth.

The EPZs/ SEZs provide the required infrastructural facilities freely or at concessional rates.

Objective The general objectives of the SEZs are:

1. Increase export earnings
2. Encourage foreign investment in the export sector
3. Encourage transfer of technology
4. Generate employment
5. Promote economic development in general

The Kandla Free Trade Zone (KAFTZ), set up in 1965 with the triple objective of earning foreign exchange, generating more employment in the backward areas of Kutch and fuller utilisation of the facilities provided by the major port of Kandla, is India's first export processing zone. This multi-product zone is located 10 kms away from the Kandla Port, Gujarat. The second one is the Santa Cruz Electronics Export Processing Zone (SEEPZ) set up in 1974 under the Ministry of Commerce, Government of India. It is situated near the Santa Cruz Airport, Mumbai. Four more export processing zones were set up later in the country at Chennai, Cochin, Noida (UP) and Falta (West Bengal) and they commenced exports during the Seven Plan (1985–86). Export processing zones have been developed in some other places too, like Vizag. Now Special Economic Zone (SEZ), which has replaced export processing zone, is allowed to be developed by private sector too.

The Special Economic Zone (SEZ) Scheme was announced on March 31, 2000 in order to promote export production in a hassle-free atmosphere. A separate chapter on SEZ was added to the EXIM Policy for the five-year period 1997–2002 in April 2001. SEZs are specifically delineated duty-free enclaves, deemed as foreign territory for the purposes of trade operations and application of duties and tariffs. SEZs can be set up for the manufacture of goods and the rendering of services, production, processing, assembling, trading, repair, remaking, reconditioning, re-engineering including making of gold/silver/platinum jewellery and articles thereof or in connection therewith. Units for generation/distribution of power can also be set up in the SEZs. Goods going into the SEZ area from the Domestic

Tariff Area (DTA) are treated as deemed exports and goods coming from the SEZ area into DTA are treated as if the goods are being imported. The existing export promotion zones have been converted into SEZs.

As a RBI Report² observes, the economic rationale for establishing Special Economic Zones (SEZs) is not clearly laid down in trade theory. It is, however, obvious that these Zones can be justified either on considerations of equity where a less developed area is accorded special tax and non-tax benefits or on considerations of efficiency, where a region has a spatial advantage in terms of costs. SEZ, as an institutional measure, supports the economic policy shift from import substitution to export promotion with a view to promoting export-led growth to facilitate larger incomes and employment. For these reasons, a large number of countries have taken initiatives to set up SEZs over the last half century or so. India followed suit in recent years, with a view to improve its competitive position.

The incentives offered under the SEZ Scheme include duty-free importation and domestic procurement of goods for the development of SEZ and setting up of units, 100 per cent Foreign Direct Investment (FDI) in manufacturing sector under the automatic route, 100 per cent income tax exemption for the first five years and 50 per cent tax for two years thereafter. Other incentives include sub-contracting of a part of production abroad, reimbursement/exemption of Central Sales Tax on domestic purchases by the SEZ units and retention of 100 per cent foreign exchange earnings in the Exchange Earners Foreign Currency (EEFC) Account.

In the EXIM policy for 2002–07 as announced in March 2002, SEZs were given the following concessions: Overseas Banking Units (OBUs) which would, *inter alia*, be exempt from CRR and SLR requirements would be permitted to be set up in SEZs. These OBUs would give access to SEZ units and SEZ developers to international finance at international rates. SEZ units would be extended income tax exemptions and would be exempt from External Commercial Borrowing (ECB) restrictions and would be allowed to make overseas investment and carry out commodity hedging. SEZs would be exempted from Central Sales Tax in respect of supplies from DTA and transactions from DTA to SEZs would be treated as exports under the Indian Income Tax and Customs Acts.

Evaluation of EPZs A number of developing countries have pinned great hopes in EPZs/EoUs as a means to increase export, achieve transfer of technology, inter-industry linkages, employment generation and economic development. Special Economic Zones, where even 100 per cent foreign investment is allowed, has been among the measures taken in the People's Republic of China too, to increase exports.

EPZs/SEZs, in general, have not succeeded in achieving their objectives.

In 1998, there were over 850 EPZs in the world, the US and Mexico having the largest number of them (213 and 197). Of the 225 zones in Asia, China had 124.

The achievement of the objectives, however, have been limited in several developing countries.

The MNCs have not been enthusiastic to effect transfer of technology. It is mostly the assembly stage of production that is relocated to the EPZs; the R and D and technology oriented pre-assembly stage of production being done in the developed countries. Further, there has not been scope for forward linkages as the entire output is meant for exports. The scope for backward linkages has been very limited because of heavy reliance on imports for inputs.

According to an ILO report, while many zone-operating countries had anticipated that the low-skilled processing and assembling of imported parts would be a necessary, but temporary, first step up the ladder towards higher value-added manufacturing, only a few such as Malaysia, Mauritius and Singapore,

have managed to develop domestic export industries on the basis of EPZ investment. The generally high import intensity of the exports of EOU/EPZ units limit the net foreign exchange earnings.

The report said that “it is a regrettable feature of many zones that both male and female workers are trapped in low-wage and low-skill jobs”.

It noted that the workforce in EPZs worldwide is usually female in majority and in certain activities, notably textiles, garment manufacturing and electronics assembly, women account for 90 per cent or more of the workers.

Instances of exploitation/
unfair treatment of labour
are common in EPZs/SEZs.

It said that the generous incentives and low costs to entry attract simple processing industries to invest in the zones. Such companies often lack professional management, particularly in human resources management. They also tend to be reluctant to invest in new skills, technology or productivity improvements.

The labour-intensive nature of much of the processing and assembly work meant that enterprises compete largely on the basis of price.

The report concluded that “labour relations and human resource development remain two of the most problematic aspects of zone functioning”.

The principal author of the report, Aurret Van Heedren, said “the frequent absence of minimal standards and poor labour-management relations have predictable outcomes, such as high labour turnover, absenteeism, stress and fatigue, low rates of productivity, excessive wastage of materials and labour unrest which are still too common.”

The move to develop SEZs in India was inspired by the success of the SEZs in China which contribute to about 40 per cent of her exports. The Indian EPZs have contributed hardly four per cent to the country’s exports. The SEZs are expected to bring about a major breakthrough. It is pointed out that one important reason for the success of the Chinese SEZs is the absence of trade union rights there. A democratic country like India cannot think of denying the labour rights.

Salient Features of the Foreign Trade Policy, 2004–09, Related to SEZs

- Goods and services going into the SEZ area from DTA shall be treated as exports and goods coming from the SEZ area into DTA shall be treated as if these are being imported.
- SEZ units may be set up for manufacture of goods and rendering of services.
- SEZ units may export goods and services including agro-products, partly processed goods, sub-assemblies and components except prohibited items of exports in ITC (HS). The units may also export by-products, rejects, waste scrap arising out of the production process. Export of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) shall be subject to fulfillment of the conditions indicated in the ITC (HS) Classification of Export and Import Items.
- SEZ units, other than trading/service unit, may also export to Russian Federation in Indian Rupees against repayment of State Credit/Escrow Rupee Account of the buyer, subject to RBI clearance, if any.
- SEZ unit may import/procure from the DTA without payment of duty all types of goods and services, including capital goods, whether new or second hand, required by it for its activities or in connection therewith, provided they are not prohibited items of imports in the ITC(HS). However, any permission required for import under any other law shall be applicable. Goods shall include raw

material for making capital goods for use within the unit. The units shall also be permitted to import goods required for the approved activity, including capital goods, free of cost or on loan from clients.

- SEZ units may procure goods required by it without payment of duty, from bonded warehouses in the DTA set up under the Policy and/or under Section 65 of the Customs Act and from International Exhibitions held in India.
- SEZ units, may import/procure from DTA, without payment of duty, all types of goods for creating a central facility for use by units in SEZ. The Central facility for software development can also be accessed by units in the DTA for export of software. SEZ units may import/procure goods and services from DTA without payment of duty for setting up, operation and maintenance of units in the Zone.
- SEZ unit shall be a positive Net Foreign exchange Earner. Net Foreign Exchange Earning (NFE) shall be calculated cumulatively for a period of five years from the commencement of production according to the formula specified in the Policy.
- SEZ unit may sell goods, including by-products, and services in DTA in accordance with the import policy in force, on payment of applicable duty. DTA sale by service/trading unit shall be subject to achievement of positive NFE cumulatively. Similarly for units undertaking manufacturing and services/ trading activities against a single LOP, DTA sale shall be subject to achievement of NFE cumulatively.

Progress and Performance of SEZs in India

Tables 29.2 and 29.3 give some idea of the progress and performance of SEZs in India.

Table 29.2 Exports from the Functioning SEZs during 2003-04 to 2007-08

<i>Year</i>	<i>Value (Rs. crore)</i>	<i>Growth Rate (percentage increase over previous year)</i>
2003-2004	13,854	39
2004-2005	18,314	32
2005-2006	22 840	25
2006-07	34,787	52
2007-08 (projection)	67,088	93

Source: Dept. of Commerce, Ministry of Commerce and Industry,
Govt. of India, "Special Economic Zones in India"

Investment and Employment in the SEZs About 1087 units were in operation in the SEZs established prior to the SEZ Act, 2005, which coming into force, providing direct employment to over 1.85 lakh persons; about 40% of whom are women. Private investment by entrepreneurs in these SEZs, established prior to the SEZ Act is of the order of over Rs. 5661 crore. The estimates of investment and employment in the SEZs notified under the SEZ Act, 2005, are given in the following Table.

Table 28.3 Investment and Employment in the SEZs

Current Investment and Employment	
Investment	: Rs. 43,123 crores
Employment:	35053 persons
Expected Investment and Employment (by December 2009)	
Investment	Rs. 2,59,159 crores
Employment	17,43,530 additional jobs
Expected Investment and Employment if 341 Formal Approvals become Operational	
Investment	: Rs. 3,00,000 crores
Employment	4 million additional jobs

Evaluation of Export Promotion Measures

The success of export promotion measures should be judged by the growth of exports and the dynamism of the export sector.

The export promotion system of India has not succeeded to produce the expected results.

No doubt, India's total exports have been growing and the export sector has achieved some diversification and sophistication. However, the achievements have been, as noted earlier, far below the requirements and potentials and have been very poor in comparison with those of several developing countries. Thus, export development measures in India have not been successful in producing the required results. The infrastructure for international marketing is not efficient enough.

An effective export promotion should compensate for the disadvantages of the national exporters and should make the export business profitable enough to lure entrepreneurs to this sector and achieve the ultimate objective of boosting the exports.

The general feeling is that the export promotion regime in India has not succeeded in achieving these objectives.

It has also been pointed out that one of the drawbacks of the export incentive regime in India is that it is largely transparent in character, inviting retaliations and disputes.

"While foreign buyers have sharp eyes for them, these constitute an eye sore for the governments particularly of the industrialised importing countries. The importers try to grab these incentives almost in their entirety on the pretext of growing competition, thus depriving the Indian exporters of the benefits of the promotional measures. In fact these tend to create an unsatiable urge for more and more incentives in extent and magnitude. On the other hand, the governments of the developed countries viewing these as subsidies invoke the provisions of the anti-dumping and countervailing duty laws.... The effectiveness and purposiveness of incentives thus lie in their non-transparent character. This could be possible only by devising a policy framework with inherent and inbuilt, albeit latent, promotional incentives."³

A major factor necessitating large incentives is the structural weakness and high cost of the Indian economy. It is, therefore, necessary to remove these handicaps to reduce the needs for the exogenous incentives. Further, the institutional inadequacies and procedural complexities and delays need to be urgently attended to. Absence or lack of dynamism and innovativeness in policies, procedures, product development and marketing continue to hamper India's export development.

Import Substitution Industrialisation (ISI) was an important facet of India's development strategy, particularly in the 1950s and 1960s.

IMPORT SUBSTITUTION

Definition

Import substitution may be defined as the substitution of a domestic source of supply for a foreign source of supply. Thus, it implies:

1. The development of domestic source of supply where there is no domestic supply.
2. An expansion of the domestic production if the domestic production is insufficient.
3. Protection of the domestic industry against foreign competition if it is the competitive disadvantage of the domestic industry that is discouraging the domestic production.

Types of Import Substitution

Absolute and Relative IS Import substitution may be absolute or relative. Absolute Import Substitution means an increase in the quantity of the indigenous supply. Relative Import Substitution takes place when the increase in the domestic production results in an increase in the proportion of the domestic production to the total domestic consumption.

Direct and Indirect IS Import substitution may be direct or indirect. *Direct Import Substitution* means substitution of the import of a commodity by the domestic production of the same commodity. *Indirect Import Substitution* means substituting the imported commodity by a domestically produced substitute (for example, substituting a natural fiber by synthetic fiber).

The export pessimism envisaged in the writings of several economists like Hans Singer, Ragnar Nurkse, Gunnar Myrdal and Raul Prebisch in the 1950s and their advocacy of import substitution industrialisation as a strategy for the rapid development encouraged a number of developing countries to adopt the ISI strategy.

Trends in Import Substitution

In the post-war period, several developing countries pursued import substitution-led development strategies. Poor growth resulting from such strategies, however, led to a policy reorientation in the early 1960s. While one set of countries started giving more incentives for the export sector even while persisting with a moderate form of import substitution (for instance, Brazil, Argentina and Mexico), another set of countries made a more fundamental shift in favour of outward orientation (for instance Korea, Singapore and Taiwan).⁴

Import substitution gained importance in India particularly since the Second Five Year Plan.

It is common that after a period of time, the rate of import substitution and the contribution of import substitution to growth slow down because the scope for import substitution is limited. This was true of India too. It has been pointed out that, by and large, there was a slow down in import substitution after the mid-sixties, with the significant exception of capital goods industries. Again, the contribution of import substitution to the growth of the industrial sector declined after the mid-sixties for most industry groups, the important exceptions being the capital goods and consumer durable goods industries.⁵

As mentioned above, some of the relatively fast growing economies such as Korea, Singapore and Taiwan have also gone through an initial phase of import substitution and subsequent slow down without

a deterioration in industrial growth performance. The slowing of import substitution in these economies has been accompanied by a rapid growth of exports.⁶ However, this has not happened in India because of the inward looking policy, high cost economy, certain characteristics of the economic policy and inadequacy of the export promotion measures.

Import substitution strategy certainly has advantages for a developing country at a certain stage of its development. However, the ultimate success of the strategy followed by a country will depend upon several factors like the scope for import substitution justified by economic considerations and the extent to which the import substitution is stretched, the content of the strategy and the choice of the industries, the policy regarding the implementation of the strategy etc.

Import Substitution in India

The import substitution strategy in India has given rise to a number of problems, some of which have already been highlighted in the chapter on *Trade Strategy*.

One mistake was that it was carried too far and industries were set up to cater to the domestic market in which India had less and less comparative advantage with rest of the world. Bhagwati and Srinivasan point out that “Every item of indigenous production, no matter how much its cost of production exceeded the land c.i.f. price, was automatically shielded from competition through imports, indeed the onus being put on the buyer to show conclusively that he could not procure the item from the indigenous producers” and “... the policy of anticipatory and automatic protection that inhered in the working of import policy served to divorce market determined investment decisions from any guidelines that international opportunity costs (with suitable modifications) might have otherwise provided.”⁷

Further, as indicated earlier, experience of successful countries shows that, after the first phase of import substitution, emphasis should shift to export promotion. Sethi argues that “nations such as India which did not pursue export-orientation as part of natural evolution of the development pattern and appropriate policies thereof were condemned to adopt ‘vigorous’ export-promotion later on. Had they thought of import-substitution and export promotion as two sides of the same problem right at the beginning, subsequent crises of growth of foreign exchange could have been avoided.”⁸ He observes that “...in reality India’s import substitution was aid induced instead of being trade promoting. Thus, it slowly and persistently built up external obligation.”⁹ Again, “the Indian import substitution, in contrast of that of Japan and South Korea, essentially remained an ‘imported’ import substitution and ultimately became a kind of export substitution. Imported import substitution means dependence on imported technologies almost totally and repeatedly, instead of accompanying imports by its indigenisation, adaptation, modernisation, and after a while its complete replacement through domestic R and D. Importers of technologies were not obliged to show results in indigenisation. Surprisingly, they were freely permitted to import (and from specified sources) as a result of the way foreign aid was tied and administered. As India was flushed with aid acquired at cheap rates in the early decades, it let the importers import whatever technology they got (and of whatever quality) but under conditions that thwarted the development of domestic technologies.”¹⁰

Raghavan observes that in the Indian context, the emphasis on import substitution has often run counter to the objective of technology developments. To substantiate his view, the following aspects of a policy of emphasising import substitution rather than technology development have been cited:¹¹

1. It had led to a multiplicity of collaborations for the same basic products, however simple it may have been. For example, there were some 20 foreign collaborations in the country for water meters and 25 for electric hoists/cranes.

2. It has led to repeated renewal of the same collaboration; usually without any updating of technology.
3. Proposals for updating technology were evaluated as if the complete production envisaged was a substitution of imports.
4. The claims of import substitution were often exaggerated or other manipulations hidden (e.g. the role of many MNCs in importing bulk drugs at inflated prices).

The general drawbacks of India's import substitution strategy have been widely recognised. The new economic policy which is almost an antithesis of the old policy represents a move towards a more open economy.

SUMMARY

The inward looking trade strategy of India has undergone a very significant change since the early 1990s in tune with the liberalisation. The **External sector reform** measures include transition to a market determined exchange rate regime, removal of quantitative restrictions, tariffication, substantial reduction in the tariff rates, removal of negative lists of exports and imports, substantially reducing licensing, introduction of current account convertibility, liberalisation of capital inflows, simplification of procedures, broadening the reach of the export incentives, extending the benefits of various export-promotion schemes to a large number of non-traditional and non-manufactured exports, strengthening the export production base etc.

The foreign trade of India is regulated mostly by the **Foreign Trade (Development and Regulation Act), 1992 (FTDRA)**, which replaced the erstwhile Imports and Exports (Control) Act, 1947. Besides the FTDR Act, there are some laws which control the trade in certain items.

The objective of the FTDR Act is to provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India and for matters connected therewith or incidental thereto. The FTDRA empowers the Central Government to make provision for the development and regulation of foreign trade by facilitating imports and increasing exports. Accordingly, the Central Government may make provision for prohibiting, restricting or otherwise regulating the import or export of goods as and when required.

The Act provides for the appointment, by the Central Government, of a Director General of Foreign Trade for the purpose of this Act. The DGFT shall advise the Central Government in the formulation of the export and import policy and shall be responsible for carrying out that policy.

The **Foreign Trade Policy** plays a very important role in directing, regulating and promoting the foreign trade.

The Foreign Trade Policy, 2004–09, effective from September 1, 2004, states that exports and imports shall be free, except in cases where they are regulated in the public interest. The two major objectives of the Policy are to double our percentage share of global merchandise trade within the next five years; and to act as an effective instrument of economic growth by giving a thrust to employment generation. A number of measures have been taken under the policy to develop exports of India and to streamline and simplify procedures.

A number of steps have been taken by Government of India for **export promotion**. The principal objectives of export promotion measures in India have been to: compensate the exporters for the high domestic cost of production; provide necessary assistance to the new and infant exporters to develop the export business and increase the relative profitability of the export business vis-a-vis the domestic business.

Government has established or sponsored a number of organisations to provide different types of assistance to the exporters. While some of these organisations are product specific, others are general. Apart from the organisations set up exclusively for export promotion, there are also a number of them which assist the export sector in different ways.

Assistance provided by these organisations cover areas such as identification of markets and market development; identification of products with export potential and product development; financing of foreign trade; education and training in export marketing; export intelligence, including research and collection and dissemination of information; insurance covers against export risks; organisation of, and participation in, trade fairs and exhibitions; packaging; pre-shipment inspection and quality control; export documentation and procedures; and so on.

Export incentives are a widely employed strategy of export promotion. The main aim of these incentives is to increase the profitability of export business. Important export incentives in India include rebate of duties, cash compensatory support, income tax concession, interest subsidies, freight subsidy etc. Although it has been common to describe these as incentives, they are really more a compensation for the comparative disadvantages faced by the Indian exporter than incentives.

As a part of the export promotion drive, the Government has, from time to time, introduced several schemes to promote units primarily devoted to exports. These include Export processing Zones (EPZs), Hundred Per cent Export-Oriented Industrial Units (**EOUs**), and different categories of Technology Parks (TPs). In 2000, a scheme of Special Economic Zones (**SEZs**) was also introduced.

Although a number of measures have been taken by the Government from time to time to promote exports, they have not been successful in producing the needed results.

Review Questions

1. Give a critical account of the current Export-Import Policy of India.
2. Give a brief account of the export promotion measures in India.
3. Evaluate India's export promotion efforts.
4. Write notes on the following:
 - (a) Rationale of export promotion
 - (b) Special economic zones
 - (c) Export/Trading Houses.
 - (d) Import substitution in India.
 - (e) Foreign Trade (Development & Regulation) Act.

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5. Isher Judge Ahluvalia, *Industrial Growth in India*, Oxford university Press, 1987, pp. 119–22.
6. *Ibid.*, p.126.
7. Cited by Ahluvalia, *ibid.*, p. 114.
8. J D Sethi, *Indian Economy Under Siege*, Vikas Publishing House, New Delhi, 1992, pp. 52–53.

9. *Ibid.*, p. 52.
10. *Ibid.*, p. 51.
11. S V S Ragavan, "Public Enterprise and Transfer of Technology," in *Issues in Public Enterprise Development* (Report of a Seminar organized by Commonwealth secretariat and Government of India, New Delhi, February 27 – March 3, 1978).

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CHAPTER 30

30 Trade and BOP of India

LEARNING OBJECTIVES

- ☐ To evaluate the trade performance of India.
- ☐ To understand the determinants of exports and imports.
- ☐ To get an idea of the trends in the direction and composition of India's trade.
- ☐ To know the trends in invisible exports and current account of India.
- ☐ To review the trends in India's BOP.
- ☐ To examine the major problems of India's export sector.

The performance of India on the trade and Balance of Payments front in the last five decades is a reflection, naturally, of the economic policies followed and the pattern of economic development that took place. This chapter reviews, briefly, India's performance in respect to merchandise trade, invisibles and the overall balance of payments trends.

AN OVERVIEW OF MERCHANDISE TRADE

Comparative Export Performance of India

With a very low share of world exports, a low export-GDP ratio, huge trade deficits, weakened position of traditional exports and with no commendable achievement of market position in new areas, India's export performance is considered very poor, particularly in comparison with the export performance of several developing countries.

India's export performance has been disappointing in relation to both its potential and needs.

In fact, in the early 1950s India's, economic position was much better than that of many countries. Among the developing countries, India had a relatively broad based industrial structure and significant export market share for several commodities such as tea, jute and cotton textiles. However, advantage could not be taken of this favourable position due to the absence of an effective export development strategy.

This failure on the export development front had resulted in the gradual decline of India's position in the international market. See Table 30.1.

Table 30.1 Share of India in World Exports

Year	Share (%)
1950	2.0
1960	1.2
1970	0.7
1980	0.4
1990	0.5
2000	0.7
2006	1.0

Japan, which, in 1950, ranked only 19th in terms of the size of exports compared to the 13th rank of India, rapidly moved up to become the third largest exporting nation by 1971. On the other hand, India's share in the world exports more or less steadily declined from 2 per cent in 1950 to 0.4 per cent by 1980.

There was a secular decline in India's share in global exports in the first three decades of planned development. It has been rising very slowly since mid 1980s.

At the end of the 1990s, India's exports were about 0.6 per cent of the world exports, and the value of Indian exports in 1996 amounted to only about 8 per cent of that of Japan (In 1950 India's exports were 139 per cent of that of Japan.). While South Korea, which is relatively poor in industrial raw materials, by virtue of being a 'huge transformation site', was able to achieve a spectacular export growth as to increase the export-GDP ratio from less than 2 per cent in 1961 to about 32 per cent in 2003. In case of India, which launched its economic planning about one decade ahead of South Korea, exports were stagnating at about 6 per cent of the GDP until the early 1990s. India's export-GDP ratio compares very poorly with several other developing countries too. Although there has been some improvements after the economic reforms introduced in India in 1991, even in 2007 it was less than 15 per cent. The export-

For quite some time now, the growth rate of Indian exports has been higher than the world average.

GDP ratio of China, which was near to that of India at the end of 1970s, was about 33 per cent in 2005.

Table 30.2 presents a comparative picture of the export growth rates of India and some East Asian economies.

Table 30.2 Export Growth and Share in World Exports of Select Countries

Country	Value (US\$ billion) 2006	Growth rate (%)				Share in world exports (%)				Change in shares 2007/2001
		CAGR 2000-04	Annual			2001	2005	2006	2007*	
1 China	969	24.2	28.6	27.2	27.6	4.3	7.3	8.0	8.4	4.1
2 Hong Kong	317	6.4	11.6	9.7	10.0	3.1	2.8	2.6	2.4	-0.7
3 Malaysia	161	6.4	12.1	14.0	7.7	1.4	1.4	1.3	1.3	-0.1
4 Indonesia	104	2.0	22.9	19.0	18.6	0.9	0.8	0.9	0.8	-0.1
5 Thailand	131	8.6	14.8	19.1	13.7	1.1	1.1	1.1	1.1	0.0
6 Singapore	325	10.2	11.8	14.4	36.2	2.4	2.7	2.7	2.7	0.3
7 India	120	15.9	29.8	21.0	14.5	0.7	1.0	1.0	1.0	0.3

Contd....

Country	Value (US\$ billion) 2006	Growth rate (%)			Share in world exports (%)					Change in shares 2007/2001
		CAGR 2000-04	Annual 2005 2006		2007*	2001	2005	2006	2007**	
8 Brazil	138	15.2	22.7	16.0	19.6	0.9	1.1	1.1	1.1	0.2
9 Mexico	250	3.2	13.2	16.8	4.8	2.6	2.1	2.1	2.0	-0.6
10 Russia	305	14.7	33.9	26.0	8.4	1.7	2.3	2.5	2.4	0.7
11 Korea	272	9.6	15.8	18.4	-8.7	2.0	2.2	2.3	2.2	0.2
12 Developing countries	5458	12.1	22.0	19.7	15.5	36.8	43.8	45.3	45.0	8.2
13 World	12040	9.4	14.1	15.7	13.8	100	100	100	100	0.0

* January-June 2007.

** January-December 2007, DGCI&S data.

Source: IFS statistics, October, 2007 IMF (cited by Government of India: *Economic Survey, 2007-08*).

India's share in global exports of some items, like tea, jute and spices, declined sharply over the decades.

In conclusion, we may say that the growth of India's exports has been poor in comparison with those of many, including developing, countries. While many countries have achieved commendable progress through economic policy reforms and other measures, India has continued with its conservative and inward-looking policies. In 1985, the trade deficit of China was much more than double the deficit of India. But by 1990, China enjoyed a surplus which was nearly equivalent to the large trade deficit India had and at the end of 1990s the trade surplus was much larger than the value of India's total exports. Economic policy reforms and the infusion of foreign capital and technology significantly contributed to the spectacular achievement of China.

India's share of several items in global exports declined sharply.

Highlights of India's Trade Performance

A review of India's foreign trade since the commencement of planning reveals the following important points.

In all but two years since 1950 India imported more than it exported.

- Both exports and imports have grown considerably.
- Except for two years, in all the years since 1951, imports were larger than exports.
- Until about the mid 1980s, the export performance of India was very poor in comparison with other countries in general; it was very poor even in comparison with several other developing countries. This is clear from the following facts.
 - The share of India in the total world exports fell from about 2 per cent in 1950 to 0.4 per cent in 1980. Since the mid eighties, there has, however, been some improvement. In 2006 it was 1.0 per cent.
 - India was the 13th largest exporter in 1950, but there are more than two dozen countries above India now.
 - India's exports as a percentage of the GDP had been stagnating around 5 per cent. Although it has improved since the liberalisation, it is still very low (about 15 per cent) even in comparison with many other developing countries.

4. The terms of trade has, on the whole, been favourable to India. (There was a deterioration for several years due to the oil price hike, and in some years prior to that and after that).
5. There has been a very significant change in the composition of India's exports. Manufactured products now account for over three-fourths of the exports as against the dominance of primary commodities in the early period.
6. There have been significant changes in the direction (i.e. the source of imports and destination of exports) of India's foreign trade.
7. The export-import ratio has improved in the recent period.

FOREIGN TRADE THROUGH THE PLANS

Trade performance of India has not been impressive.

The First Five Year Plan period, 1951–56, actually witnessed a fall in India's exports and imports. This was attributed mainly to: (i) in the initial years of planning the developmental and investment activities were still in doldrums causing both imports and exports to fall, and (ii) after the Korean war boom, unit prices of exports and imports were falling.

During the First Plan, 89 per cent of the imports could be paid for by exports. Only during the Fourth Plan, when as much as 92 per cent of the imports were financed by the exports, the situation was better than in the First Plan.

During the ten-year period covering the Second and Third Plans, imports more than doubled from Rs. 1,024 crores in 1955–56 to Rs. 2,194 crores in 1965–66, as against a mere 37 per cent increase in the exports during the same period. The *Mahalanobis model* which gave much importance to the basic and heavy industries necessitated large capital goods imports. The large development and the ancillary and consequential expenditures increased the demand for consumer goods and necessitated considerable import of consumer goods also. During the above-mentioned one decade, while the imports grew at an average annual rate of 7.9 per cent, growth of export was a tardy : 3.2 per cent annually, on an average.

The balance of payments crisis necessitated a devaluation of the Rupee in 1966.

During the Second Plan, the export earnings were sufficient to meet only about 63 per cent of the import bill; during the Third Plan it was still lower at 60 per cent. The Fourth Five year Plan which should have commenced in 1966 was put off by three years (during which we had *annual plans*).

The situation further improved during the Fourth Plan (1969–70 to 1973–74). As much as 92 per cent of the import bill could be met by the export earnings—a ratio never reached in any other Plan. In 1972–73, for the first time in the history of independent India, there was a trade surplus. But the oil price hikes since 1973 had been creating serious problem. However, in 1976–77, once again there was a small trade surplus. Thereafter, India always had a trade deficit. Thus, in the last more than five decades, in all years, except 1972–73 and 1976–77, India had an adverse balance of trade.

Despite the oil crisis, during the Fifth Plan (1974–75 to 1978–79—the period originally envisaged for the Fifth Plan) the situation was on the whole better compared to the Second, Third and Annual Plans; export earnings were equivalent to about 83 per cent of the import bill.

Trade deficit burgeoned since the late 1970s. The oil price hike was a major reason. The deficit much more than doubled in 1979–80 (Rs. 2725 crores) from the previous year's figure (Rs. 1085 crores). It further, more than doubled in 1980–81 to Rs. 5838 crores. Throughout the Sixth Plan (1980–81 to

1984–85) the trade deficit remained at very high levels. Although during the Seventh Plan (1986–89 to 1989–90) trade deficit was much larger than during the Sixth Plan in absolute terms, the deficit declined to 31 per cent of the imports from 39 per cent during the Sixth Plan. The export-import ratio was about 85 per cent during the decade 1990–91 to 1999–2000, but declined to 82 per cent in 2003–04 and further to 68 per cent in 2006–07.

Trade Ratios

The export –GDP ratio which was almost stagnant for a very long time had almost doubled during the one decade following the initiation of the liberalisation, indicating that the Indian economy has become more globally competitive. The import ratio also grew but at a lower pace than the exports. The trade GDP ratio, a measure of integration of the economy with the global economy, has improved substantially from less than 12 per cent in the 1980s to over 25 per cent in 2003–2004 and to 35 per cent in 2006–07.

India's trade ratios have improved after the liberalisation.

Table 30.3 India's Foreign Trade Ratios

(Per cent)

Period Average	X/GDP	M/GDP	T/GDP	X/M
1980–81 to 1989–90	4.6	7.2	11.8	64.0
1990–91 to 1999–00*	8.0	9.5	17.4	84.1
1990–91 to 1994–95 *	7.3	8.4	15.7	86.9
1995–96 to 1999–00	8.5	10.4	18.9	81.8
2000–01 to 2001–02	9.4	10.8	20.2	86.7
2001–02 to 2002–03	11.3	13.1	24.4	83.4
2003–04 to 2004–05	11.6	14.2	25.8	80.7
2005–06 to 2006–07	14.0	20.9	34.9	68.0

* Excluding 1991–92.

Note: X = Exports, GDP = Gross Domestic Product at current market prices in rupees.

Sources: Directorate General of Commercial Intelligence & Statistics (as presented in RBI, *Report on Currency and Finance, 2001–02*), and Government of India, *Economic Survey* (various years)

The average export-import ratio, an indicator of the import financing capacity of exports, improved sharply from 64.0 per cent to 84.1 per cent, between the 1980s and 1990s and further to nearly 87 per cent in 200–02; but declined later (See table 30.3).

The trade deficit as a percentage of GDP recorded a decline since the early eighties. In 1990–91, the trade deficit was three per cent of the GDP compared to 4.6 per cent in 1980–81. The average figure for the Seventh plan period was 3.2 per cent compared to 3.4 per cent for the Sixth Plan. During 2000–01 to 2003–04, it ranged between 2.1 and 2.7 per cent but increased to nearly 7 per cent in 2006–07.

Terms of Trade

India's terms of trade have been fluctuating but has generally improved over long term.

Another important indicator of export performance is the terms of trade. The Prebisch-Singer thesis says that there is a secular deterioration in the collective terms of trade of developing countries. However, India could maintain, with the exception of some years, a favourable terms of trade until the onslaught of the oil price rise in the 1970s. The hike in the oil price resulted in a deterioration in India's terms of trade. However, after some years there was an improvement although there were setbacks in many years.

The net terms of trade, which measure the relative change in export and import prices, have generally fluctuated during the 1990s and the present decade. With 1978–79 as the base, India's net terms of trade was about 142 in 2006–07, which indicates that during this period the export prices rose faster than the country's import prices. The unit value index of India's exports in 2006–07 stood at 863 compared to 608 of imports. The import purchasing power of exports as measured by the income terms of trade have consistently improved during the 1990s on account of strong export growth in volume terms. The income terms of trade increased on an average from 141.5 in the 1980s to phenomenally 439.4 in the 1990s and further to 165.3 in 2006–07 (See Chapter 7 for explanation of the terms of trade terms).

Table 30.4 Exports, Imports and Trade Balance of India

(Rs. crore)

Year	Exports (Including re-exports)	Imports	Trade Balance	Rate of change	
				Export	Import
				(per cent)	
1	2	3	4	5	6
1949–50	485	617	–132		
1950–51	606	608	–2	24.9	–1.5
1951–52	716	890	–174	18.2	46.4
1952–53	578	702	–124	–19.3	–21.1
1953–54	531	610	–79	–8.1	–13.1
1954–55	593	700	–107	11.7	14.8
1955–56	609	774	–165	2.7	10.6
1956–57	605	841	–236	–0.7	8.7
1957–58	561	1035	–474	–7.3	23.1
1958–59	581	906	–325	3.6	–12.5
1959–60	640	961	–321	10.2	6.1
1960–61	642	1122	–480	0.3	16.8
1961–62	660	1090	–430	2.8	–2.9
1962–63	685	1131	–446	3.8	3.8
1963–64	793	1223	–430	15.8	8.1
1964–65	816	1349	533	2.9	10.3
1965–66	810	1409	–599	–0.7	4.4

Contd....

(Rs. crore)

Year	Exports (Including re-exports)	Imports	Trade Balance	Rate of change	
				Export	Import
1	2	3	4	(per cent)	
				5	6
1966-67	1157	2078	-921	42.8	47.5
1967-68	1119	2008	-809	3.6	-3.4
1968-69	1358	1909	-551	13.3	-4.9
1969-70	1413	1582	-169	4.1	-17.1
1970-71	2031	2162	-131	8.8	3.5
1971-72	2153	2443	-290	6.0	13.0
1972-73	2550	2415	134	18.4	-1.1
1973-74	3209	3759	-549	25.9	55.6
1974-75	4174	5666	-1492	30.1	50.8
1975-76	4665	6084	-1420	11.7	7.4
1976-77	5753	5677	77	23.3	-6.7
1977-78	6316	7031	-715	9.8	23.9
1978-79	6978	8300	-1322	10.5	18.0
1979-80	7947	11321	-3374	13.9	36.4
1980-81	6711	12459	-5883	4.6	37.3
1981-82	7806	13608	-5802	16.3	8.4
1982-83	8803	14283	-5490	12.8	5.0
1983-84	9771	15831	-6060	11.0	10.8
1984-85	11744	17134	-5390	20.2	8.2
1985-86	10895	19658	-8763	-7.2	14.7
1986-87	9745	20096	-7644	14.3	2.2
1987-88	12089	22244	-6570	25.9	10.7
1988-89	13970	28235	-8003	29.1	26.9
1989-90	16612	35328	-7670	36.7	25.1
1990-91	32553	43198	-10645	17.7	22.3
1991-92	44041	47851	-3810	35.3	10.8
1992-93	53688	63375	-9687	21.9	32.4
1993-94	69751	73101	-3550	29.9	15.3
1994-95	82674	89971	-7297	18.5	23.1
1995-96	106363	122678	-16325	28.6	36.4
1996-97	118817	138920	20103	11.7	13.2
1997-98	130100	154176	-24076	9.5	11.0
1998-99	139752	178332	-38580	7.4	15.7
1999-2000	159561	215236	-55675	14.2	20.7
2000-01	203571	230873	-27302	27.6	7.3

Contd....

(Rs. crore)

Year	Exports (Including re-exports)	Imports	Trade Balance	Rate of change	
				Export	Import
				(per cent)	
1	2	3	4	5	6
2001-02	209018	245199	-36181	2.7	6.2
2002-03	255137	297206	-42069	22.1	21.2
2003-04	293367	359108	-65741	15.0	20.8
2004-05	356069	481064	-124995	27.9	39.5
2005-06	456418	660409	-203991	21.6	31.8
2006-07	571779	840506	-268727	25.3	27.3

Source: Tables 30.4, 30.5 and 30.7 are from Government of India, *Economic Survey*, 2002-03 and 2007-08.

Table 30.5 Exports, Imports and Trade Balance of India

(US \$ Million)

Year	Exports (Including re-exports)	Imports	Trade Balance	Rate of change	
				Export	Import
				(per cent)	
1	2	3	4	5	6
1949-50	1016	1292	-276		
1950-51	1269	1273	-4	24.9	-1.5
1951-52	1490	1852	-362	17.4	45.5
1952-53	1212	1472	-260	-18.6	-20.5
1953-54	1114	1279	-166	-8.1	-13.1
1954-55	1233	1456	-233	10.7	13.8
1955-56	1275	1620	-345	3.3	11.3
1956-57	1259	1750	-491	-1.2	8.0
1957-58	1171	2160	-989	-7.0	23.4
1958-59	1219	1901	-682	4.2	-12.0
1959-60	1343	2016	-674	10.1	6.0
1960-61	1346	2353	-1007	0.3	16.7
1961-62	1381	2281	-430	2.6	-3.1
1962-63	1437	2372	-446	4.0	4.0
1963-64	1659	2558	-430	15.5	7.8
1964-65	1701	2813	533	2.6	10.0
1965-66	1693	2944	-599	-0.5	4.7
1966-67	1628	2923	-921	-3.9	-0.7
1967-68	1586	2656	-809	-2.6	-9.1
1968-69	1788	2513	-551	12.7	-5.4

Contd....

(US \$ Million)

Year	Exports (Including re-exports)	Imports	Trade Balance	Rate of change	
				Export	Import
				(per cent)	
1	2	3	4	5	6
1969–70	1866	2089	–169	4.4	–16.9
1970–71	2031	2162	–131	8.8	3.5
1971–72	2153	2443	–290	6.0	13.0
1972–73	2550	2415	134	18.4	–1.1
1973–74	3209	3759	–549	25.9	55.6
1974–75	4174	5666	–1492	30.1	50.8
1975–76	4665	6084	–1420	11.7	7.4
1976–77	5753	5677	77	23.3	–6.7
1977–78	6316	7031	–715	9.8	23.9
1978–79	6978	8300	–1322	10.5	18.0
1979–80	7947	11321	–3374	13.9	36.4
1980–81	8486	15869	–7383	6.8	40.2
1981–82	8704	15174	–6470	2.6	–4.4
1982–83	9107	14787	–5679	4.6	–2.6
1983–84	9449	15311	–5861	3.8	3.5
1984–85	9878	14412	–4534	4.5	–5.9
1985–86	8904	16067	–7162	–9.9	11.5
1986–87	9745	15727	–5982	9.4	–2.1
1987–88	12089	17156	–5067	24.1	9.1
1988–89	13970	19497	–5526	15.6	13.6
1989–90	16612	21219	–4607	18.9	8.8
1990–91	18143	24075	–5932	9.2	13.5
1991–92	17865	19411	–1546	–1.5	–19.4
1992–93	18537	21882	–3345	3.8	12.7
1993–94	22238	23306	–1068	20.0	6.5
1994–95	26330	28654	–2324	18.4	22.9
1995–96	31797	36678	–4881	20.8	28.0
1996–97	33470	39133	–5663	5.3	6.7
1997–98	35006	41484	–6478	4.6	6.0
1998–99	33218	42389	–9171	–5.1	2.2
1999–2000	36822	49671	–12849	10.8	17.2
2000–01	44560	50536	–5976	21.0	1.7
2001–02	43827	51413	–7586	–1.6	1.7
2002–03	52719	61412	–8693	20.3	19.4
2003–04	63843	78149	–14307	21.1	27.3
2004–05	83535	111516	–27982	30.8	42.7
2005–06	103092	149167	–46076	23.4	33.8
2006–07	126360	185747	–53387	22.6	24.5

DETERMINANTS OF EXPORTS

Trade performance is influenced by several external and internal factors.

Analysis of empirical data reveals that India's export performance is affected by certain important factors. They include a set of external factors, a set of internal factors and the real exchange rate.

External Factors

1. The rate of growth of the economies of the importing countries.
2. The rate of growth of the world trade.
3. The rate of change in the price level in the importing country.

Internal Factors

1. The rate of growth of the Indian economy
2. The rate of change in the domestic price level.

The most favourable condition for the growth of the Indian exports is a combination of the high growth rates for all the three external factors, a high growth rate with price stability for the Indian economy and a fall in the real exchange rate for exports (RERx). If some of the above conditions are satisfied and other conditions are not favourable, the export performance should be expected to be determined by the relative strengths of the favourable and unfavourable factors. We will have the worst situation when the reverse of the ideal combination of conditions occurs.

Inter-relationship of the Factors

The analysis of the impact of the inter-relationship of the above mentioned variables on India's exports for a period of nearly two decades by G.C. da Costa¹ has revealed the following :

1. Good growth in the economies of the industrial countries has been associated with good growth in India's exports. This has been very pronounced in those years characterised by good growth in the world trade, sharp fall in the RERx, relative price stability in India.
2. Low growth or recessionary conditions in the economies of the industrial countries, along with depressed world trade together with even moderate increases in the RERx did not provide any competitive edge to the country's exports, the volume of India's exports broadly kept pace with the growth in the economies of the industrial countries.
3. In some years, even when the growth in the economies of the industrial countries was low, the country experienced good growth in the volume of exports because of the sharp decline in the RERx.
4. During certain periods, despite modest growth in the industrial countries and in world trade, the volume of India's exports fell because of the rise in the RERx.

DETERMINANTS OF IMPORTS

Besides import regulations, the important factors which determine the volume of India's imports are :

1. The rate of growth of the Indian economy - High rate of growth, *ceteris paribus*, is associated with rise in imports.

2. The relative price of imports (i.e. the relative change in the prices of imports and domestic goods). An increase in the imports, *ceteris paribus*, is associated with a fall in the relative price of imports.

From the above two factors, it can be inferred that the volume of imports tends to be very high when there is a conjuncture of high rate of economic growth and a sharp fall in the relative price of imports and vice versa.

The study by da Costa, referred to above, has revealed that:

1. In a number of years, the volume of imports was kept down by moderate growth of the economy together with relatively high price of imports.
2. For over a fairly long period of 12 years since 1977–78, higher growth of the economy together with a downward trend in the relative prices of imports (and with import liberalisation) were associated with rising imports to India.
3. A sharp decrease in the volume of imports was noticed when there was a combination of low growth of the economy and a sharp increase in the relative price of imports.
4. On the other hand, there was a large increase in imports when there was a combination of good growth of the Indian economy and a sharp decrease in the relative price of imports.
5. Large imports in several years were associated with moderate growth of the economy and substantial fall in the relative price of imports.
6. When change in the relative price of imports has been moderate, low growth of the Indian economy has been associated with low growth in the volume of imports.

MAJOR EXPORTS

After Independence, India has achieved considerable diversification in exports, both product-wise and country-wise.

Reflecting the evolving pattern of economic and industrial development, as also the policy thrust India has gradually transformed from a predominantly primary products exporting country into an exporter of manufactured goods. Today, manufactures account for about three-fourths of the total exports compared to 45 per cent in 1960–61. The share of manufactured goods in India's total exports increased from about 71 per cent during 1987–90 to 75 per cent during 1992–97 and to 78 per cent in 2000–01 but declined to 69 per cent in 2006–07. It may be noted that the diversification of exports was more prominent in the 1970s. The progress has been very tardy thereafter. This can be attributed to two factors. After a certain level, as a general rule, further improvement would be at a very low pace and may eventually tend to stagnate. Second, the deficiencies and failures of the development strategy in achieving the objectives.

The growth of non-traditional exports deserves special mention. In 1960–61, four major non-traditional items, viz, engineering goods, iron and steel, iron ore and chemicals and allied products contributed only about one fifth of the total exports in 2003–04. The above four items along with other three non-traditionals, namely, gems and jewellery, marine products and leather and leather manufactures today made about 60 per cent of India's export earnings; about two and a half decades ago this share was about one-third.

About 60 per cent of India's export earnings is contributed by four categories of manufactured items, viz., textiles, engineering goods, gems and jewellery, and chemicals and allied products.

In recent years, readymade garments came second (first being gems and jewellery) in export earnings. Nearly two-thirds of India's export earnings are contributed by the eight product groups mentioned above. Exports of petroleum products have also increased in the recent years.

Though there has been a significant growth of non-traditional items, a number of traditional items continue to have considerable weightage in India's export basket. These include tea, jute, tobacco, coffee, sugar, cashew kernels, spices, oil cake etc.

The commodity composition within the major groups has also undergone a considerable transformation. Within the 'primary products' group, the share of 'ores and minerals' in total exports has declined while

Proper development of export of agricultural products can help stabilise the agrarian economy.

the share of 'agricultural and allied products' has remained almost unchanged at around 18 per cent between 1990–91 and 1998–99 but declined thereafter to 13.4 per cent in 2000–01; but improved to about 16 per cent during 2002–03 to 2003–04 and declined to about 10 per

cent during 2005–06 to 2006–07. The falling share of 'ores and minerals' has been offset by the increase in share of 'engineering goods' within the manufactured products group—an indication of upward movement of India's exports in the value-addition chain. Similarly, exports of processed agricultural products has also showed marked improvement in the post-reform years whereas the shares of traditional

The share of petroleum in India's exports increased from less than 5 per cent in 2000–01 to 15 in 2006–07 at the expense of manufactures

export items such as tea, coffee, cereals, handicrafts and carpets have declined. Among other major manufactured products, the share of 'chemicals and allied products' has improved while that of 'leather and manufactures' has declined between the years 1990–91 and 2006–07. Recently India emerged as a major exporter of rice.

Table 30.6 shows the share (percentage) of major items in the total exports of India.

Table 30.6 Commodity Composition of India's Exports
(Percentage Share)

Commodity group	2000–01	2005–06	2006–07
I. Primary products	16.0	15.4	15.1
Agriculture & allied	14.0	10.2	10.3
Ores & minerals	2.0	5.2	4.8
II. Manufactured goods	78.8	72.0	68.6
Textiles incl. RMG	23.6	14.5	12.5
Gems & jewellery	16.6	15.1	12.6
Engineering goods	15.7	20.7	23.3
Chemicals & related products	10.4	11.6	11.2
Leather & leather manufactures	4.4	2.6	2.4
Handicrafts			
(Incl. carpet handmade)	2.8	1.2	1.1
III. Petroleum, crude & products (including coal)	4.3	11.5	15.0
Total exports	100.0	100.0	100.0

a Growth rate in US dollar terms.

Source: Government of India: *Economic Survey*, 2007–08

As indicated earlier, the desired pattern of progress of diversification could not be achieved by India, because of, inter alia, the deficiencies and failures of the development strategy. The areas in which South-East Asian countries have achieved their highest export growth during the 1980s have been typically labour intensive, relatively low technology products such as textiles, clothing, shoes, toys, sport goods and the like. Subsequently, during the 1990s they have graduated up to somewhat higher technology consumer goods and then even higher technology and capital-intensive sectors such as capital goods and petro-chemicals. Over the same period, the Indian export pattern has remained stationary with persistent dominance of labour-intensive low technology products such as clothing, textiles, shoes and other leather goods. Adequate quality upgradation has been absent and unit prices have stagnated. The attainment of both higher volume growth and of higher unit value realisation will require both larger scale of operation and higher quality. It is, therefore, essential to loosen constraints in these sectors so that they can grow freely in volume, utilise better machinery, graduate up to higher technology levels, and utilise better international marketing channels. What is observed in other countries in Asia is that production of such consumer goods may be achieved through final assembly operations that are large in scale, but where a great deal of out-sourcing to small enterprises is undertaken to preserve their competitiveness. Consequently, freeing of restrictions on the size of small-scale industries through de-reservation is likely to lead to the growth of many more small-scale enterprises than is currently the case, along with a much higher potential for growth in manufacturing employment.²

MAJOR IMPORTS

Petroleum oil and lubricants now account for considerable part of India's import bill. POL which accounted for 6 per cent of the total imports in 1960–61 and 8 per cent in 1970–71 amounted to 43 per cent in 1980–81. The increase in domestic output enabled to reduce it; however even today this is the single item contributing to the largest share (31 per cent in 2000–01 and 34 per cent in 2006–07) to the import bill). While the share and absolute value of these imports showed sharp fluctuations over the years mainly on account of the large movements in international crude prices, the volume of such imports has grown significantly on account of increase in domestic consumption and the stagnation in domestic crude oil production. Given the large swings in international crude prices, as also a rising trend in the oil import bill, there is a need for a comprehensive review of energy policy of the country covering the demand-supply aspects, as well as the price policy. Renewed efforts to improve energy supply from domestic sources by encouraging explorations, and stepping up of production and refining capacities are necessary to bring about a structural change in this area.

Although there had been a decline in the share of capital goods in the total import (32 per cent in 1960–61, 25 per cent in 1970–71 and 15 per cent in 1980–81), in the years following the initiation of liberalisation there was a sharp increase. It was, however, only 11 per cent during 2000–01 and 2001–02 and nearly 15 per cent during 2005–06 and 2006–2007. The drop in the import of capital goods may be a reflection of lack of investment demand associated with the sluggish pace of domestic industrial activity.

Seven categories, viz., oil, pearls, precious and non-precious stones; capital goods; gold and silver, electronic goods; edible oils and chemicals account for nearly three-fourth of India's imports

Table 30.7 | **Share of Major Items in India's Imports**
(Percentage)

	2000-01	2005-06	2006-07
Food & allied products	3.3	2.5	2.9
1. Cereals	0.0	0.0	0.7
2. Pulses	0.2	0.4	0.5
3. Edible oils	2.6	1.4	1.1
Fuel (of which)	33.5	32.1	33.2
4. POL	31.3	29.5	30.8
Fertilisers	1.3	1.3	1.6
Capital goods (of which)	10.5	15.8	15.4
5. Machinery except electrical & machine tool	5.9	7.4	7.5
6. Electrical machinery	1.0	1.0	1.1
7. Transport equipment	1.4	5.9	5.1
Others (of which)	46.3	43.7	43.8
8. Chemicals	5.9	5.7	5.2
9. Pearls, precious & semi precious stones	9.6	6.1	4.0
10. Gold & silver	9.3	7.6	7.9
11. Electronic goods	7.0	8.9	8.6
Grand total	100.0	100.0	100.0

a Growth rate in US dollar.

Source: Calculated on the basis of data from DGCI&S, Kolkata (cited by Government of India: *Economic Survey, 2007-08*)

Among other import items, the relative shares of fertilisers, non-ferrous metals, 'metalliferous ores and metal scrap' and 'iron and steel' generally showed a declining trend.

Pearls and precious stones account for a large share of the import bill. These imports are mostly for export processing.

Reflecting the impact of a series of policy measures undertaken in the post-reform years starting with the repeal of the Gold Control Order in 1991 for liberalising the imports of gold and silver, these imports showed a sharp pick-up from 1992–93.

Other important import items, in terms of value, are edible oils, fertilizers and fertilizer materials; chemicals, iron and steel, cereals and pulses and nonferrous metals.

Quite obviously India's imports have been, by and large, very essential items, either of mass consumption, or of need in export production, and industrial development.

There are noticeable changes in the sources of India's imports and in country shares. While the share of the OECD countries and the Eastern Europe in India's imports declined over the years, that of the developing countries and the OPEC group increased. The increase in share of the imports from the OPEC region has been mainly on account of the increase in the oil import.

DIRECTION OF TRADE

The direction of India's foreign trade has also undergone some notable changes.

In the early 1950s, the UK accounted for over one-fifth of India's foreign trade; in recent years it has been about 5 to 6 per cent.

As a single country USA has been our largest trading partner. In 1950–51, the US accounted for 18 per cent of our imports and 19 per cent of the exports. In 2006–07 the share of US in India's exports was about 15 per cent but its share in India's imports has declined considerably (only about 6 per cent recently).

The share of Japan in India's foreign trade was very low in the early 1950s. However, Japan's share in India's trade rose significantly and then has fallen.

During 2006–07, the European Union accounted for about one-fifth of India's exports and more than 17 per cent of imports.

The USSR was one of the major trading partners of India. Between 1960–61 and 1990–91, the share of India's exports to Eastern Europe had more than doubled (from 7 per cent to 17 per cent). The political and economic policy changes in the Eastern Europe has disrupted the trade with this region. It may be noted that India was not earning hard currency by exporting to this region. It was unprudent on the part of India to pay too much attention to trade expansion with this region. Communist China has been concentrating on exports to the developed economies and she has become one of the largest trading partners of USA. There was a steep erosion in the relative position of the Eastern Europe in India's exports. With the break-up of the Soviet Union, the share of the East European countries fell dramatically from about 18 per cent in 1990–91 to below 2 per cent in 2003–04, primarily on account of the termination of Rupee trade and its adverse impact on exports of agricultural products such as tea, tobacco and spices to this region. The loss of this market share was, however, made up by increasing the shares in developing countries and the OPEC region, both of which doubled between the years 1987–88 and 2001–02.

Although the US is India's major export market, the share of India in the total imports of USA is negligible. The industrial market economies have recently accounted for less than half of India's exports compared to about two-thirds around 1960. Of late, China emerged as the largest source of India's imports, increasing its share in India's imports from 7.3 per cent in 2005–06 to 9.1 per cent in 2006–2007.

Recently, more than one-third of India's imports have originated from the industrial market economies; about 30 per cent each has come from OPEC countries and Non-OPEC developing countries. About 16 per cent of the exports has gone to non-OPEC developing countries and about 40 per cent to the OPEC countries.

While the share of OECD countries in India's trade has sharply declined, that of developing countries sharply increased.

TRENDS IN INVISIBLES AND THE CURRENT ACCOUNT

The year 2001–02, which recorded a current account surplus for the first time in 23 years, is a landmark year in the history of the balance of payments of India. This resulted from the vibrant trends with respect

to the invisibles over the past one decade or so. However, after three years of surplus, the current account reverted to the previous situation with a deficit of \$6.4 billion in 2004–05, compared to the surplus of \$10.6 billion in the previous year and \$6.3 billion in 2002–03. This was caused by a 147 per cent increase in merchandise trade deficit which far outstripped the increase in invisibles surplus.

Emigrant remittances and software exports are the major contributors to India's invisible receipts and surplus.

Table 30.8 India's Trade and Export/Import Ratio with Major Trading Partners

Trd Rnk	Country	Share in total trade (per cent)						Export/Import ratio ^a			
		April- September						April- September			
		2001	2002	2005	2006	2006	2007	2001	2006	2006	2007
		-02	-03	-06	-07	-07	-08	-02	-07	-07	-08
1	USA	12.3	13.5	12.8	9.8	9.7	8.9	2.7	1.6	1.9	1.6
3	UAE	3.6	3.8	6.2	6.6	7.1	7.4	2.7	1.4	1.4	1.2
7	UK	5.0	4.6	4.3	3.1	3.1	3.0	0.8	1.3	1.4	1.2
5	Singapore	2.4	2.5	4.2	3.7	4.2	3.6	0.7	1.1	1.3	0.9
12	Belgium	4.4	4.7	3.6	2.4	2.4	2.5	0.5	0.8	0.8	0.8
6	Germany	4.0	4.0	4.6	3.7	3.7	3.6	0.9	0.3	0.5	0.5
10	Australia	1.8	1.6	2.7	2.6	2.6	2.7	0.3	0.1	0.1	0.1
11	Nigeria	0.7	0.5	0.5	2.5	2.9	2.3	6.5	0.1	0.1	0.1
9	Iran	0.6	0.8	0.9	2.9	3.1	3.2	0.9	0.2	0.2	0.3
8	Switzerland	3.4	2.4	3.3	3.1	2.8	3.5	0.1	0.1	0.1	0.0
2	China	3.1	4.2	8.4	8.3	7.7	8.9	0.5	0.5	0.4	0.3
4	Saudi Arabia	1.4	1.3	1.6	5.1	5.6	5.3	1.8	0.2	0.2	0.2
	Total (1 to 12)	42.6	43.7	53.0	53.8	55.0	54.8	1.0	0.6	0.6	0.5

^a The coefficient of export import ratio between 0 and 1 implies that India's imports are greater than exports and if the coefficient is greater than one, India exports more than what it imports.

Source: Government of India: *Economic Survey*, 2007-08.

Table 30.9 Share of India's Major Exports (with 1% or more share) in World Exports*

HS rev.1	Product	2002	2005	2006
57	Carpets and other textile floor coverings	7.3	9.6	11.1
26	Ores, slag and ash	4.1	6.4	6.8
14	Vegetable plaiting materials, vegetable products n.e.s.	3.9	5.7	6.4
67	Bird skin, feathers, artificial flowers, human hair	2.0	3.7	3.8
46	Manufactures plaiting material, basketwork, etc.	0.3	0.1	2.0
23	Residues, wastes food industry, animal fodder	1.4	3.8	3.0
79	Zinc and articles thereof	0.2	0.5	1.7
13	Lac, gums, resins. vegetable saps and extracts n.e.s.	10.0	11.4	11.3
68	Stone, plaster, cement. asbestos, mica, etc articles	2.0	2.3	2.8
63	Other made textile articles, sets, worn clothing etc.	6.1	7.1	6.8
41	Raw hides and skins (other than furskins) and leather	2.2	2.4	2.8
29	Organic chemicals	1.3	1.8	1.9
64	Footwear, gaiters and the like, parts thereof	1.3	1.6	1.8

Contd....

HS rev.1	Product	2002	2005	2006
50	Silk	12.9	12.3	10.2
71	Pearls, precious stones, metals, coins, etc.	7.6	8.2	6.4
52	Cotton	5.9	6.3	5.4

*Only items with either 5 per cent share in 2006 or increase in share of 0.5 per cent are shown here.

Source: Government of India: *Economic Survey*, 2007-08.

Emigrant remittances, the single most important source of India's invisible earnings for long, exhibited a robust growth, registering a more than 6-fold from \$2 billion at the start of 1990s to \$23.5 billion by 2006-07, forming 2.6 per cent of GDP.³

Between 1992 and 2003, India's service exports increased more than five fold, from \$4.9 billion to \$25 billion.

Following the heavy inflow of invisibles receipts, India's of current account deficit narrowed down considerably during the decade of the 1990s and the nation enjoyed a current account surplus in 2001-02 when the merchandise trade deficit of \$12.7 billion (about Rs.6043 crore) was more than offset by the invisibles surplus of over \$14 billion (about Rs.6715 crore) In 2001-02, when India had a negative merchandise trade balance equivalent to 2.4 per cent of the GDP, she had a positive invisibles balance of 3.1 per cent, giving rise to a current account surplus equivalent to 0.7 per cent of the GDP compared to a deficit of 0.5 per cent in 2000-01. The current account surpluses in 2002-03 and 2003-04 were 1.2 and 2.3 per cent of GDP. 2005-06 and 2006-7 had a CAD of 1.1 per cent each.

The general paradigm shift in services trade in the 1990s also helped in the emergence of new sources of forex earnings in the services account in India's balance of payments, providing a significant source of comfort. While the period up to the 1980s was dominated by tourism earnings, the second half of the 1990s witnessed an unprecedented jump in India's earnings from newer activities like software service exports and other IT-related skill-intensive exports. Software services have shown spectacular growth while also emerging as the most important source of miscellaneous services earnings, increasing from \$0.3 billion in 1993-94 to \$1.8 billion in 1997-98 and further to \$31.3 billion in 2006-07, with its share rising from less than 3 per cent to over 20 per cent of total invisibles receipts during this period. Reflecting the strong growth emanating from software exports, the traditional sources of services exports, viz., travel and transportation have declined in relative importance.

The growth in receipts from information and communication related services (services relating to computer software, hardware, internet, e-commerce and telecommunication sector) experienced over the last decade has been unprecedented. The growth in gross invisible earnings outpaced growth in merchandise exports during the 1990s, with the ratio of invisible earnings to merchandise increasing from 40 per cent in 1990-91 to almost 75 per cent in the recent years reflecting the shifting comparative advantage of India in favour of services. As a result, despite significant liberalisation of current account transactions, net invisible surplus has continued to improve during the 1990s. As against a deficit of \$0.2 billion in 1990-91 that partly exacerbated the external payments imbalances during that year, the net invisible surplus grew phenomenally over time, imparting resilience and sustainability to current account deficits and overall balance of payments during the 1990s and the present decades.

With the shift in the competitiveness towards services, in particular the technology related services, India has emerged as one of the fastest growing exporters of services in the world outstripping the growth rate of industrial countries as well as all countries taken together. Reflecting this, gross invisible receipts (comprising services, transfers and income) increased substantially over the years. Within services,

Software exports now constitute about 40 per cent of India's service exports compared to 10 per cent in 2006-07.

miscellaneous services receipts, which encompasses communication services, construction services, financial services, software services, news-agency services, royalties, copyright and license fees, management services and others, increased impressively.

The strong performance of the software exports, however, has created concerns about a possible *Dutch disease* effect which may erode the competitiveness of traditional exports. (See Chapter 6 for an explanation of the concept Dutch disease) The export performance across commodity groups shows that most of the export groups have performed well so far, and apparently have not been affected by any Dutch disease effect.⁴

Table 30.10 Export of Major Services as Per Cent of Total Services Exports

<i>Year</i>	<i>Travel</i>	<i>Transportation</i>	<i>Software</i>	<i>Miscellaneous*</i>
1995-96	36.9	27.4	10.2	22.9
2000-01	21.5	12.6	39.0	21.3
2001-02	18.3	12.6	44.1	20.3
2002-03	16.0	12.2	46.2	22.4
2003-04	18.7	11.9	47.6	19.2
2004-05	15.4	10.8	40.9	29.9
2006-07	11.6	9.9	38.5	38.2

* Miscellaneous Service excluding software

Source: Government of India, *Economic Survey 2004-05* and RBI, *Annual Report 2006-07*.

BALANCE OF PAYMENTS

The trade balance is often a major determinant of the payments balance. Trade deficit has often caused balance of payments deficits for India. However, the effects of the trade deficit has been mitigated to a considerable extent by the invisibles surplus. Fall in the invisibles surplus had its impact on the BOP.

India has experienced balance of payments problems of varying intensity in twenty nine out of thirty five years since the beginning of the Second Five Year Plan. The cost for India of this prolonged BOP problem, caused by the poor export performance, has been heavy. As Jalan observes, "periodic crises have upset the planning process and reduced the room for maneuverability in fashioning macro-economic policies in response to the changing domestic and international environment. These crises have also increased the country's dependence on external capital markets and increased the country's vulnerability to external shocks."⁵

During the First Five Year Plan, India was mostly free from BOP problem because of the large sterling balance India had at the time of Independence which could be drawn down to meet the payment obligations. In 1950-51, the reserves amounted to about 158 per cent of the merchandise imports. Because of the using up of the foreign exchange at levels much higher than the earnings, by 1957-58, the reserves in nominal rupee terms had come down to about one-third of the level in 1950-51. The BOP problem developed since then, necessitated aid from the Aid India Consortium and drawals from the IMF. Stringent import controls were also introduced. It may be recalled here that the Rupee was devalued in 1966 in a

bid to improve the trade and payments positions. Although there was a slight improvement in the reserves position between 1968–69 and 1973–74, the overall situation remained difficult.

With a trade surplus of Rs. 104 crores in 1972–73, the nation became more optimistic about the future. But the first oil shock, the four-fold increase in the international crude oil price between September 1973 and April 1974, which burgeoned India's oil import bill, was a bolt from the blue. Contrary to most expectations, however, the Indian economy coped remarkably well with these developments, and the period 1976–77 to 1979–80 saw a sharp turn-around in India's balance-of-payments position. Reserves increased from about Rs. 600 crores in 1974–75 to Rs. 5160 crores in 1979–80. In 1979–80 reserves were 54 per cent of imports. During this period, the export growth was good, and in 1976–77, there was a small trade surplus of Rs. 72 crores. The primary reason for the sharp improvement in the BOP, however, was a dramatic improvement in the net invisibles, mainly on account of the large inflow of emigrant remittance.

This 'golden' period for India's BOP did not, however, last long. Problems began to develop in 1979–80, because of the second oil shock. The trade deficit burgeoned from Rs. 2200 crores in 1978–79 to Rs. 6200 crores in 1980–81. Gradual decline in the net receipts from invisibles, as the trade deficit was growing, aggravated the situation and a crisis situation emerged by the dawn of the present decade.

One important source of the BOP problem in the 1980s and afterwards has been the change in the source of financing the large current account deficit. In the earlier period, i.e. until the beginning of the 1980s, almost the entire deficit was financed through inflows of concessional assistance, which kept the debt-service burden low. As against this, the eighties were marked by a reduction in the inflows of concessional assistance and an increase in the debt to private creditors, including commercial banks and NRIs.

Invisibles surpluses have traditionally financed a large part of India's trade deficits. There was a steep fall in this since the beginning of the 1980s. Net invisibles financed nearly 73 per cent of the trade deficit in 1980–81. On an average it financed more than 60 per cent of the trade deficit during the Sixth plan (1980–85). By 1990–91 it dropped to about 13 per cent, compelling the nation to take increasing resource to external sources for meeting the payments obligations. The position improved in recent years, and in 2006–07 invisibles surplus financed about three-fourths of the trade deficit.

This falling trend in respect of the net invisibles was caused by the adverse trends in the invisibles payments on the one hand and invisibles receipts on the other hand. The rise in the invisibles payments has been chiefly contributed by cumulation of interest and service payments on foreign loans and credits.

In short, the BOP problem of India in the decade preceding the early 1990s was caused by:

1. Large trade deficit
2. Fall in the invisibles surplus, caused by :
 - (a) Sharp increase in the invisibles payments due to the increase in the debt service.
 - (b) Set back to the invisibles receipts, mainly the emigrant remittances and travel income.
3. Sensitive behaviour of foreign creditors, including NRI foreign currency depositors.
4. The declining role of concessional external finance.

The economic liberalisation has, however, brought about significant changes. There has been a noticeable structural change towards a more stable and sustainable balance of payments.

As pointed out earlier, there was a marked improvement in the coverage ratio (i.e. the ratio of export bill to import bill) and in the flow of invisible receipts. Together, these changes brought about turn around in the current account. As stated earlier, in 2001–02 there was a current account surplus.

Sharp increases in foreign capital inflows and invisibles receipts turned India's BOP favourable.

The capital account has shown a significant structural change. The debt creating flows as a percentage of total capital flows in the balance of payments averaged as much as 97 per cent during the Seventh Plan but declined to less than 18 per cent in 1994–95. The non-debt creating flows like foreign investments rose substantially. These developments will considerably ease India's debt servicing burden. A major turn around in India's BOP was that the current account has turned from deficit to surplus in 2001–02 but reverted to deficit after 3 years.

The substantial increase in the foreign investment, as a result of the liberalization has been generating significant capital account surplus. Capital account surplus increased from less than \$4 billion during the 1980s to \$8.6 billion during 1992–2002, resulting in huge accumulation of foreign exchange reserves. As a proportion of GDP, capital flows increased from 1.6 per cent during 1980s to 2.3 per cent during 1992–2002 and to nearly 5 per cent in 2006–07.

The trends in the capital flows over the 1990s reflects a shift in importance from debt to non-debt flows with the declining importance of external assistance and external commercial borrowings (ECBs) and the increased share of foreign investment—both direct and portfolio.

The increase in capital inflows coupled with the improvement in the current account position resulted in a surplus in the overall balance of payments of India from 1993–94 onwards, excepting 1995–96. The BOP surplus has significantly increased over the years. The key indicators of balance of payments as indicated in table 30.12 shows considerable improvement in India's balance of payments since 1991.

Table 30.11 Balance of Payments—Key Indicators

(Per cent)					
Item	1990–91	1995–96	1999–00	2000–01	2006–07
1. Trade					
i) Exports/GDP	5.8	9.1	8.4	9.8	13.9
ii) Imports/GDP	8.8	12.3	12.4	12.9	21.1
iii) Trade Balance/GDP	–3.0	–3.2	–4.0	–3.1	–7.1
2. Invisibles Account					
i) Invisible Receipts/GDP	2.4	5.0	6.8	7.5	13.0
ii) Invisible Payments/GDP	2.4	3.5	3.8	4.9	7.0
iii) Invisibles (Net)/GDP	–0.1	1.6	3.0	2.6	6.0
3. Current Account					
i) Current Receipts [@] / GDP	8.0	14.0	15.1	17.2	26.9
ii) Current Receipts Growth [@]	6.6	18.2	12.9	17.1	28.0
iii) Receipts [@] / Current Payments	71.5	88.8	93.0	96.4	96.0
iv) CAD/GDP	–3.1	–1.7	–1.0	–0.5	–1.1
4. Capital Account					
i) Foreign Investment / GDP	—	1.4	1.2	1.1	2.9
ii) Foreign Investment / Exports	0.6	14.9	13.8	11.4	20.8

Contd....

(Per cent)

Item	1990–91	1995–96	1999–00	2000–01	2006–07
5. Others					
i) Debt-GDP Ratio	28.7	27.0	22.2	22.3	16.4
ii) Debt Service Ratio	35.3	24.3	16.2	17.3	4.8
iii) Liability Service Ratio	35.6	24.7	17.0	18.3	7.9
iv) Import Cover of Reserves (in months)	2.5	6.0	8.2	8.6	12.9

@ Excluding official transfers.—Negligible. n.a. Not available

Source: RBI, *Report on Currency and Finance, 2001–02 and Annual Report 2006–07.*

MAJOR PROBLEMS OF INDIA'S EXPORT SECTOR

A brief account of the major drawbacks of India's export sector is given below.

Export growth of India has been hindered by a number of inherent weaknesses of the export sector.

Lack of Integrated Approach

An important reason for the poor export performance of India has been the absence of an integrated view of the development potentials and development objectives and a long term strategy based on such an integrated approach. Needless to say, absence of proper environmental analysis and definite objectives and policy directions are crux of the problem. Had there been a realistic assessment of the overall effect of modernisation and economically efficient development of a sector on export earnings, employment, income generation etc. the development of several sectors would not have been made to suffer by such policies as reservation for small scale sector, import controls, size and growth restrictions, etc. A proper understanding of the multiple benefits of development of a sectors would lead to formulation of comprehensive and integrated development plans for the realisation of multiple benefits. Such an integrated development strategy would avoid wasteful fragmentation of development efforts and distortions. Support to exports by such a development strategy would give more respectability to export development because of the realisation and appreciation of the other socio-economic benefits. For example, an understanding of the effects of value added exports on employment and income generation as well as higher foreign exchange earnings would lead to due attention to the development of such exports. However, such a comprehensive and integrated view of development benefits was not always present under the Indian planning.

Problem Recognition and Action Lags

A major hurdle in India's progress in many fields has been lag in problem/need recognition and the lag in proper action even after the recognition of the need for action.

The role of industrialisation in India's economic development had been well recognised even much before the Independence; an Industrial Policy Resolution was made shortly after the attainment of

Independence and it was reformulated in 1956. However, no such enthusiasm was shown to deviate from the colonial trade regime and to formulate a comprehensive export development strategy. It was only in 1970, about two decades after the launching of the development planning and 22 years after making the first Industrial Policy Resolution, that the Government of India made an Export Policy Resolution, despite facing severe problems like stagnant export earnings and foreign exchange crisis (which led to the devaluation of the Rupee in June 1966) and despite the fact that the Import and Export Policy Committee (Mudaliar Committee), 1961, and several people had pointed out the need for active export promotion.

Innovation Innovativeness is, undoubtedly, one of the very important factors that affects competitive situation. One of the major failures of India has been in this respect. Success through pioneering innovation had hardly been a part of the Indian export strategy. The maximum we have aimed at has been to follow the trend. Even in following the trend we often lag very much behind. The failure to keep pace with the trends, let alone leading them, led to the loss of India's market position in several traditional exports and to the unsatisfactory performance of several non-traditionals. The tardiness in the progress of value added exports is a reflection of this fact.

Value Added Exports Value added exports help better utilisation of domestic resources and maximise export earnings. There is a lot of scope for increasing our export earnings from spices and certain other agricultural products, marine products, leather etc. through value addition. Our failure to market many products in consumer packs, under our brand names, to foreign consumers has caused huge loss of foreign exchange. Several products, unprocessed, semiprocessed or processed, exported from India in bulk are processed or repacked by foreign firms, mostly in developed countries, and sold in consumer packs under their brand names. To establish a hold over the foreign market and to get better prices for our products, we must have an effective strategy to get over this problem of our *faceless presence* in the foreign market.

The Task Force on Spices has observed⁶ that India has been very traditional in its approach to export of spices. With the progress of time and development of the industry and improved standard of living, India as the largest spice producing country in the world failed to ensure that the modern development are extended to the field of spices. Similarly, although India has been regarded as the world leader in tea, in product research and formulation we have played virtually no role—instant tea, tea bags, tea drinks have all been developed abroad by the consuming countries.

Technological Factors

Technological problems have had very serious effect on India's exports. The Tandon Committee and Alexander Committee have referred to the adverse impact of technological backwardness on India's exports through poor quality, low productivity, high costs etc.

High Costs

In a large number of cases, high domestic costs is an inhibiting factor. This problem has been succinctly stated by Abid Hussain Committee: "India is often at a disadvantage vis-à-vis competing countries because its costs of production, hence export prices, are higher than in competing countries, not only because of the higher prices of importable and non traded inputs, or because of time and cost over-runs

implicit in managerial inefficiency, but also because of much lower level of productivity, all of which stem from the aforesaid problems.”⁷

References has already been made, in the preceding section, to the high costs and poor quality of inputs and technological backwardness. Besides the material costs, certain other costs like interest rates, port charges etc. are also very high in India. Supply bottlenecks and high inventory requirements also increase costs.

Technological factors and low productivity also contribute to the high cost of production in India. It has been pointed out that productivity in resource use “in a large number of export industries is still very low compared to the levels observed in many other developing and developed countries. Analysis of productivity measured as value added per unit of labour for select sectoral categories and select countries brings out that productivity levels in India are way behind those in many developed and developing countries. Even with regard to productivity of traditional exports, our productivity performance is not satisfactory. The growth rate of productivity in India is also lower than that in many other countries. Further, the advantage of the economies of scale and ability of bulk supplies are not available to the Indian exporters.”⁸

Poor Quality Image

India has a poor quality image abroad. Despite the measures taken under the Exports (Quality Control and Inspection) Act and other laws, our exports continue to suffer because of the quality problems. Occasional blacklisting by the US of shrimp and pepper exports from India is a manifestation of the inadequacy of the quality control and lags in the preshipment inspection system in India. The credibility of this system is a suspect abroad.

Poor quality/inadequacy of inputs, technology and facilities affect the quality. On several instances, carelessness or lack of commitment on the part of the exporters are also responsible. Adulteration and duping are also not uncommon. There is a general impression that a proper export culture is lacking in India.

Unreliability

Besides quality, Indian exporters have been regarded as unreliable on certain other factors. As the Tandon Committee has observed, a very important black mark on the Indian exporters is reneging—a term used in the USA to refer to going back on a contract and refusing to fulfill it on its original terms.

Indian exporters have been regarded as unreliable also because of their inability to provide prompt after sale service.

The Tandon Committee remarks: “unreliable quality and deliveries to importers abroad, with finely balanced production and sales schedules, can prove as embarrassing as non-delivery. The reasons of power, raw materials, transport and shipping, strikes and port delay; to which we can add those we do not admit, poor production planning; optimistic acceptance of orders against an inadequate supply base: but endemic and acceptable as these factors may be to our buyers at home, they make little sense to an importer, who naturally compare us with small totally dependable countries of no comparable resource endowments, the Korea and the Taiwan.”⁹

Supply Problems

A serious drawback of the Indian export sector is its inability to provide continuous and smooth supply in adequate quantities in respect of several products. The problem is that “much of the exporting is the result of the residual approach rather than conscious effort of producing for export. The tendency for exporting what we produce rather than producing for export still continues to characterise the export behaviour.”¹⁰

The Committee on Export Strategy for the 1980s has observed that the “stop-go” exports are considered abroad as causing much avoidable damage to the Indian export effort; one which can be avoided through careful planning of supplies where possible through buffer stocks—in the case of a new product and some sacrifice by domestic consumer in an unforeseen shortage; and a permissiveness towards importers with valid contracts for fortuitous gains.¹¹

Faceless Presence

Although India is an important supplier of several commodities in foreign markets, her presence in these markets is *faceless* in the sense that the consumers do not know that these commodities are Indian. Major export items of India like seafood, leather manufacturers, spices etc., have in many cases, a faceless presence in foreign markets. Although these exports may undergo further processing or repacking in many cases, in several cases the Indian exports are sold in the foreign markets in the same condition as they are exported but under foreign brand name sometimes it fetches a much higher price than the same product with an Indian name.

This is indeed a vicious circle. The poor quality image of the Indian products, many a time apparent than real, makes it difficult to sell under Indian brand names. The faceless presence, on the other hand, perpetuates the problem. Infact, most bulk importers of Indian goods want this situation to be perpetuated as this enables them to hold control over the market while the exporters, being at the mercy of the foreign traders, lose bargaining power.

The failure of India to keep pace with the market dynamics has also contributed to the perpetuation of this situation. For example, failure of India to offer spices in consumer packs and in product forms the consumers demand provided an opportunity for foreign traders to import spices in bulk and resell them in suitable forms, and thus keep the market under their control.

The faceless presence is also the result of the failure of the exporters and export promotion agencies in India to build up an image for Indian goods abroad.

Infrastructural Bottlenecks

The following observations made by the National Convention on Exports organised by the Federation of Indian Chamber of Commerce and Industry is indeed a recapitulation of the indisputably held view of the infrastructural situation in India. “Infrastructural shortages such as energy shortages, inadequate and unreliable transport and communication facilities hinder growth in exports. Power shortages and breakdowns disrupt production schedules, increase cost and adversely affect timely shipments. The continental size of the country necessitates that the inland haulage of export cargo as also its shipment at ports is done efficiently and at reasonable cost. Exports also suffer for want of efficient and economic communication facilities.”¹²

Improving the transportation system, including the expansion and modernisation of the port facilities, rationalisation of the charges, improving the procedural system etc. are very much essential for the development of the export sector. However, the administrative lethargy continues to plague the Indian scenario causing heavy damage to export development.

Structural Weakness

A major handicap of the Indian export sector is its structural weakness. Two of the important factors responsible for this, viz. low efficiency and productivity in resource use and poor technology have already been described. Another very important factor is the absence of a systems approach to the process of management, marketing, information, planning and decision making.

It is important to note that “India’s exports do not pick up in periods of boom conditions in the world economy to the same extent as the exports of many other competitors. On the other hand, India is quick to pick up sluggishness in exports in response to sluggishness in world trade much more quickly than other exporters. This asymmetry in the response of the export activity to world market conditions is a reflection of structural weakness of the export sector as a whole.”¹³

Uncertainties, Procedural Complexities and Institutional Rigidities

One of the defects of our trade policy regime has been the uncertainty about future policies, incentive scheme etc.

The procedural complexities of the Indian trade regime have been indisputably acknowledged. The Government appointed the Committee on Import-Export Policies and Procedures (Alexander Committee) which in its Report (1978) made a number of recommendations for improving the regime. The Tandon Committee and the Abid Hussain Committee Reports too have suggested rationalisation and simplifications of policies and procedures. Although several measures have been taken recently, still much remains to be done in this respect. There is a general feeling that not only that there are too many controls and overlapping of policies but also “the principle of Indian policy is to elaborate rules (and exceptions) to them, which are not only detailed and specific, but also subject to wide discretion.”¹⁴ These are vindicative of the structural weakness of the institutional system in India.

There have been reports of loss of exports worth hundreds of crores of rupees due to the problem of interdepartmental coordination. All these happen in a country which is said to be giving exports one of the high national priorities and which is facing serious foreign exchange problems.

Inadequacy of Trade Information System

An efficient Trade Information System is essential for success in the dynamic global market. But, “our marketing infrastructure as well as marketing techniques are neither effective nor efficient. We do not have any machinery to keep prompt track of business information overseas, as done by JETRO in Japan, KOTRA in Korea, CETDC in HongKong and STDB in Singapore with wide network of offices abroad. These organisations have evolved an efficient system which help them to get information pertaining to tenders and the like much before these are released officially. In India, we get these informations, at times, after the expiry date. India has, no doubt, a plethora of organisations-governmental, semi-governmental as also non-governmental-engaged in this task in one way or other. Yet we do not have an easy access to market intelligence and information.”¹⁵

The Tandon Committee has pointed out that our exporters often “miss the opportunity of participating in global tenders because of late receipt of tenders, sometimes, changes in policies and procedure in overseas countries do not reach them in time the information is not available on a continuing basis from any source.”¹⁶ The Task Force on Export Services and the Abid Hussain Committee also drew attention to this problem. However, the situation still is not satisfactory.

SUMMARY

India presents a mixed picture of trade performance. The comparative **export performance** of India, on the whole, has not been satisfactory. The share of India in the total world exports fell from about 2 per cent in 1950 to 0.4 per cent in 1980. Since the mid eighties, there has, however, been some improvement. In 2005 it was 0.8 per cent and a target has been set by the Ministry of Commerce to double this figure by 2009.

Like several other developing countries, India has achieved considerable **diversification** in exports, both product-wise and country-wise. Today, manufactures account for about three-fourths of the total exports while in the beginning primary commodities dominated the export. Though there has been a significant growth of non-traditional items, a number of traditional items continue to have considerable weightage in India's export basket. These include tea, jute, tobacco, coffee, sugar, cashew kernels, spices, oil cake etc.

Petroleum oil and lubricants now account for considerable part of India's import bill. Another two very important import categories, in value terms, are capital goods and pearls and precious stones. Other important import items, in terms of value, are edible oils, fertilizers and fertilizer materials; chemicals, iron and steel, cereals and pulses and nonferrous metals. Quite obviously, India's imports have been, by and large, very essential items, either of mass consumption, or of need in export production, and industrial development.

The **direction** of India's foreign trade has also undergone some notable changes. In the early 1950s, the UK accounted for over one-fifth of India's foreign trade; in recent years it has been about 5 to 6 per cent. As a single country USA has been our largest trading partner. The European Union now accounts for nearly one-fifth of India's foreign trade.

Recently, slightly over half of India's imports have originated from the industrial market economies; about a fifth each has come from OPEC countries and Non-OPEC developing countries. Over one-fifth of the exports has gone to Non-OPEC developing countries and about one-tenth to the OPEC countries.

India has experienced **balance of payments** problems of varying intensity in most of the years in the past. However, thanks to the favourable impact of liberalisation (like large foreign capital inflow and improved current account balance), in recent period she has experienced a favourable BOP. India in early 2004 emerged as the sixth largest holder of foreign exchange reserves.

The major **drawbacks of India's export sector** are lack of an integrated approach; problem recognition and action lags; technological problems; high costs; poor quality image; unreliability; supply constraints; faceless presence of Indian products abroad; infrastructural bottlenecks; structural weaknesses; uncertainties, procedural complexities and institutional rigidities; and, inadequacy of trade information system.

Review Questions

1. Evaluate India's export performance since 1950.
2. Examine the trends in India's exports since 1950.
3. Examine the trends in India's foreign trade since 1950.
4. Analyse the trends in India's Balance of Payments since 1950.
5. Analyse the recent trends in India's foreign trade.

6. Analyse the trends in the composition and direction of India's exports.
7. Analyse the trends in India's imports.
8. Give a brief account of the major problems of India's export sector.
9. It is not primarily because of the fault of exporters that India's export performance has been very poor". Discuss.
10. Write notes on the following:
 - (a) Traditional exports.
 - (b) Non-traditional exports.
 - (c) Export product—country matrix.
 - (d) Trends in India's invisibles account.
 - (e) Trends in the current account balance of India.
 - (f) Determinants of exports.
 - (g) Determinants of imports.
 - (h) Importance of quality for exports.
 - (i) Role of trade information system.
 - (j) Supply constraints as a factor affecting exports.
 - (k) Export development planning.

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