1.1 INTRODUCTION

International trade is the exchange of goods and services as well as resources between countries. It involves transactions between residents of different countries. If there is a point on which most economists agree, it is that trade among nations makes the world better off. International trade reduces production cost and improves living standards of people. The foreign producer also benefits by making more sales than it could selling solely in its own market and by earning foreign exchange (currency) that can be used by itself or others in the country to purchase foreign-made products. International trade is an integral part of international relations and has become an important engine of growth in developed as well as developing countries.

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Benefits of International Trade

i. International trade is a powerful stimulus to economic efficiency and contributes to economic growth and rising incomes. The wider market made possible owing to trade induces companies to reap the quantitative and qualitative benefits of division of labour.

ii. Efficient deployment of productive resources to their best use is a direct economic advantage of foreign trade. Greater efficiency in the use of natural, human, industrial and financial resources ensures productivity gains. Since international trade also tends to decrease the likelihood of domestic monopolies, it is always beneficial to the community.

iii. Trade provides access to new markets and new materials and enables sourcing of inputs and components internationally at competitive prices. This reflects in innovative products at lower prices and wider choice in products and services for consumers. It also enables nations to acquire foreign exchange reserves necessary for imports which are crucial for sustaining their economies.

iv. International Trade necessitates increased use of automation, supports technological change, stimulates innovations, and facilitates greater investment in research and development and productivity improvement in the economy.

v. Trade also provides greater stimulus to innovative services in banking, insurance, logistics, consultancy services etc.

vi. For emerging economies, improvement in the quality of output of goods and services, superior products, finer labour and environmental standards etc. enhance the value of their products and enable them to move up the global value chain.

vii. Opening up of new markets results in broadening the productive base and facilitates export diversification so that new production possibilities are opened up.

viii. Trade can also contribute to human resource development, by facilitating fundamental and applied research and exchange of know-how and best practices between trade partners.

ix. Trade strengthens bonds between nations by bringing citizens of different countries together in mutually beneficial exchanges and, thus, promotes harmony and cooperation among nations.

Despite being a dynamic force, which has an enormous potential to generate overall economic gains, liberal global trade and investments are often criticised as detrimental to national interests. The major arguments put forth against trade openness are:

i. International trade is often not equally beneficial to all nations. Potential unequal market access and disregard for the principles of a fair trading system may even amplify the differences between trading countries, especially if they differ in their wealth.

ii. Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally. The domestic entities can be easily outperformed by financially stronger transnational companies.

iii. Substantial environmental damage and exhaustion of natural resources in a shorter span of time could have serious negative consequences on the society at large.

iv. Trade cycles and the associated economic crises occurring in different countries are also likely to get transmitted rapidly to other countries.

v. Risky dependence of underdeveloped countries on foreign nations impairs economic autonomy and endangers their political sovereignty. Such reliance often leads to widespread exploitation and loss of cultural identity. Substantial dependence may also have severe adverse consequences in times of wars and other political disturbances.

vi. Too much export orientation may distort actual investments away from the genuine investment needs of a country.

vii. Finally, there is often a lack of transparency and predictability in respect of many aspects related to trade policies of trading partners. There are also many risks in trade which are associated with changes in governments' policies of participating countries, such as imposition of an import ban, high import tariffs or trade embargoes.

1.2.1 The Mercantilists' View of International Trade

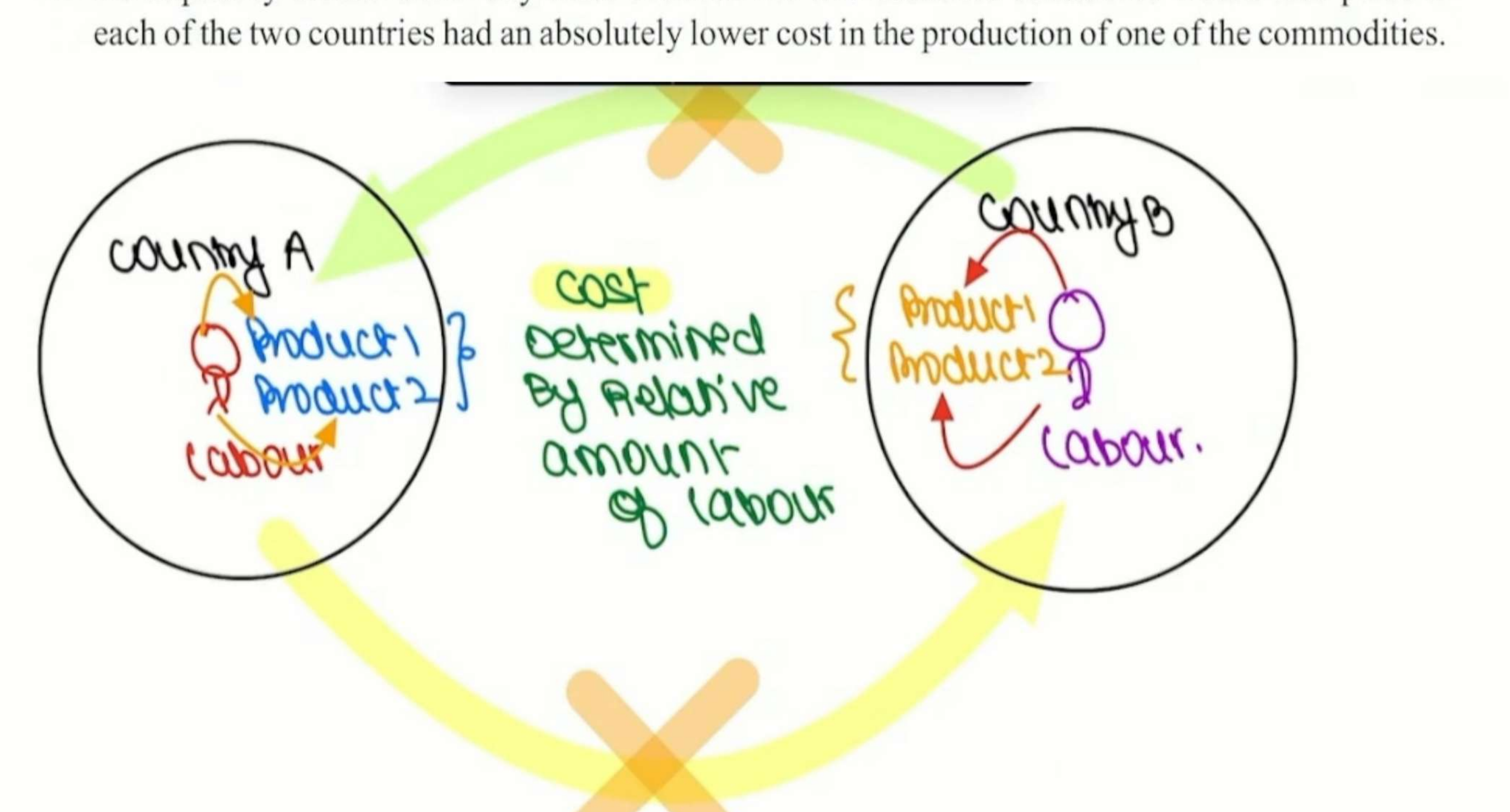
Mercantilism, which is derived from the word mercantile, "trade and commercial affairs". Mercantilism according to Microsoft Encarta Dictionary (2009), is the economic policy trending in Europe from the 16th to the 18th centuries where the government used power to control industry and trade with the theoretical belief that national power is achieved and sustained by having constant large quantities of exports over imports. Nations' human and material resources are unevenly endowed, distributed and developed. This allows flow of labour, raw materials, capital and finished products across national boundaries and markets; thus resulting in "mercantilism" as the earliest international economic system that proposes massive and aggressive export over import to accumulate wealth, to have favourable balance of payment and trade and to be still relevant in today's economy.

1.2.2 The Theory of Absolute Advantage

Adam Smith, the father of economics, thought that the basis of international trade was absolute cost advantage. According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first. In other words, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources. Adam Smith first described the principle of absolute advantage in the context of international trade, using labour as the only input. Since absolute advantage is determined by a simple comparison of labour productivity, it is possible for a nation to have no absolute advantage in anything; in that case, according to the theory of absolute advantage, no trade will occur with the other nation. It can be contrasted with the concept of comparative advantage which refers to the ability to produce specific goods at a lower opportunity cost.

Assumptions of the Absolute Advantage Theory:

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



A. Product 1 labour cost will be compared with Product 1 labour cost of country B.
A Product 1 = ↓ → B Product 1 = ↑

A. Product 2 labour cost compare with Product 2 labour cost of B.
A Product 2 = ↑ ← B Product ↓

1.2.3 The Theory of Comparative Advantage

In one of the most important concepts in economics, David Ricardo observed that trade was driven by comparative rather than absolute costs (of producing a good). One country may be more productive than others in all goods, in the sense that it can produce any good using fewer inputs (such as capital and labour) than other countries require to produce the same good. Ricardo's insight was that such a country would still benefit from trading according to its comparative advantage—exporting products in which its absolute advantage was greatest, and importing products in which its absolute advantage was comparatively less (even if still positive). Even a country that is more efficient (has absolute advantage) in everything it makes would benefit from trade. Consider an example:

Country A diverts one hour of work from producing (two) shirts. It uses that hour of work to instead produce three additional kilograms of steel.

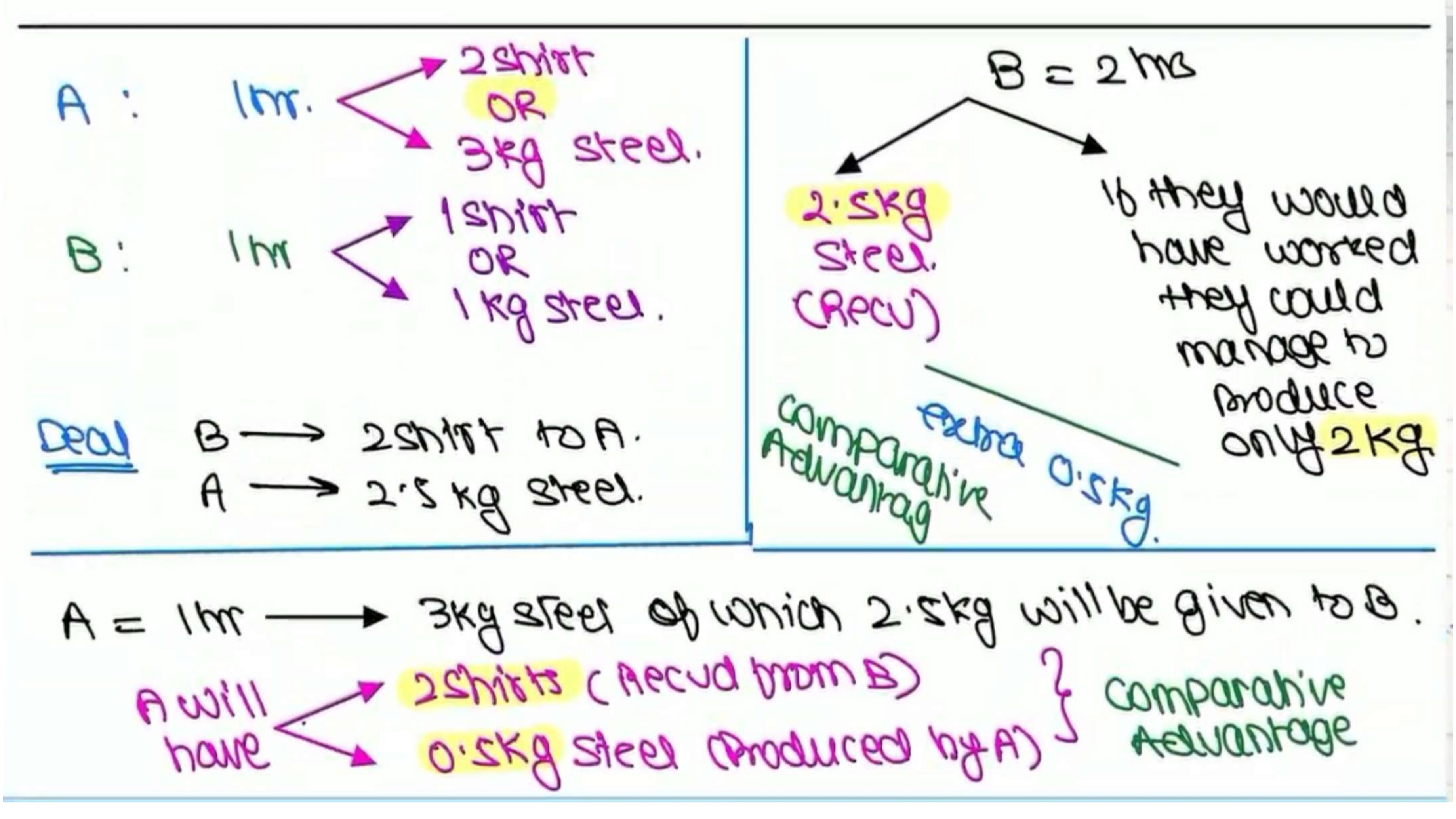
Overall, the same number of shirts is produced: Country A produces two fewer shirts, but Country B produces two additional shirts.

However, more steel is now produced than before: Country A produces three additional kilograms of steel, while Country B reduces its steel output by two kilograms.

The extra kilogram of steel is a measure of the gains from trade.

Though a country may be twice as productive as its trading partners in making clothing, if it is three times as productive in making steel or building aeroplanes, it will benefit from making and exporting these products and importing clothes. Its partner will gain by exporting clothes—in which it has a comparative but not absolute advantage—in exchange for these other products. The notion of comparative advantage also extends beyond physical goods to trade in services—such as writing computer code or providing financial products.

Because of comparative advantage, trade raises the living standards of both countries. Douglas Irwin (2009) calls comparative advantage "good news" for economic development. "Even if a developing country lacks an absolute advantage in any field, it will always have a comparative advantage in the production of some goods," and will trade profitably with advanced economies.



country A capital ↑ country B labour ↑

1.2.4 The Heckscher-Ohlin Theory of Trade

Differences in comparative advantage may arise for several reasons. In the early 20th century, Swedish economists Eli Heckscher and Bertil Ohlin identified the role of labour and capital, so-called factor endowments, as a determinant of advantage.

The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production uses intensively the factor of production that is relatively abundant in the country. Countries well endowed with capital—such as factories and machinery—should export capitalintensive products, while those well endowed with labour should export labour-intensive products. Economists today think that factor endowments matter, but that there are also other important influences on trade patterns.

The increase in competition coming from foreign firms puts pressure on profits, forcing less efficient firms to contract and making room for more efficient firms. Expansion and new entry bring with them better technologies and new product varieties. Likely the most important is that trade enables greater selection across different types of goods (say refrigerators). This explains why there is a lot of intra-industry trade (for example, countries that export household refrigerators may import industrial coolers), which is something that the factor endowment approach does not encompass.

cut down in size

There are clear efficiency benefits from trade that results in more products—not only more of the same products, but greater product variety. An even greater benefit may be the more efficient investment spending that results from firms having access to a wider variety and quality of intermediate and capital inputs (think lithium battery manufacturing by China rather than manufacturing electrical cars). By enhancing overall investment and facilitating innovation, trade can bring sustained higher growth.

Indeed, economic models used to assess the impact of trade typically neglect influences involving technology transfer and pro-competitive forces such as the expansion of product varieties. That is because these influences are difficult to model, and results that do incorporate them are subject to greater uncertainty. Where this has been done, however, researchers have concluded that the benefits of trade reforms—such as reducing tariffs and other nontariff barriers to trade—are much larger than suggested by conventional models.

1.2.5 Globalization and New International Trade Theory

The revolution that swept through the theory of international trade in the first half of the 1980s-the rise of the so-called new trade theory'-left many of the insights of traditional trade theory intact. In particular, introducing imperfect competition and increasing returns into the picture does not alter the fundamental point that trade is a positive-sum game, generally carried on to countries' mutual benefit. Indeed, the new trade theory adds to the positive sum: by enlarging markets, international trade increases competition and allows greater exploitation of economies of scale, both of which represent gains over and above those due to comparative advantage.

The new trade theory suggests that in practice many traded goods are produced by industries that are both oligopolistic and subject to external economies (e.g., because of economies of scale in the production of nontraded intermediates). Thus instead of a picture of an international economy that is at a Pareto optimum, the new trade theory offers a picture of one in which markets normally lead to suboptimal results.

Pareto optimality is the state at which resources in a given system are optimized in a way that one dimension cannot improve without a second worsening.

American economist and journalist Paul Krugman received the 2008 Nobel Prize for Economics for his work in economic geography and in identifying international trade patterns. In the late 1970s, Paul Krugman noticed that the accepted model that economists used to explain patterns of international trade did not fit the data. The Heckscher-Ohlin model predicted that trade would be based on such factors as the ratio of capital to labor, with "capital-rich" countries exporting capital-intensive goods and importing labor-intensive goods from "laborrich" countries. But Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor. The auto industry in capital-intensive Sweden, for example, exports cars to capital-intensive America, while Swedish consumers also import cars from America. This is particularly true in key economic sectors in India such as electronics, IT, food, and automotive. We have cars made in India, yet we purchase many cars made in other countries.

Krugman defended free trade. He was passionate and showed deep concern for the wellbeing of people around the world. One such example is "In Praise of Cheap Labor," published in Slate in 1997. In it, Krugman told of Smokey Mountain, a huge garbage dump in Manila in which men, women, and children made a living combing through garbage for valuable items. Low-wage jobs in multinational companies' factories in the Philippines, Bangladesh, and other poor countries, he noted, are much better alternatives. Because multinational companies hired many of these poor workers, he wrote that "the result has been to move hundreds of millions of people from abject poverty to something still awful but nonetheless significantly better.

According to NTT, two key concepts give advantages to countries that import goods to compete with products from the home country:

- Economies of Scale: As a firm produces more of a product, its cost per unit keeps going down. So if the firm serves domestic as well as foreign market instead of just one, then it can reap the benefit of large scale of production consequently the profits are likely to be higher.

- Network effects refer to the way one person's value for a good or service is affected by the value of that good or service to others. The value of the product or service is enhanced as the number of individuals using it increases. This is also referred to as the 'bandwagon effect'. Consumers like more choices, but they also want products and services with high utility, and the network effect increases utility obtained from these products over others. A good example will be Mobile App such as What's App and software like Microsoft Windows.

c. **Variable Tariff:** A duty typically fixed to bring the price of an imported commodity up to level of the domestic support price for the commodity.

d. **Preferential Tariff:** Nearly all countries are part of at least one preferential trade agreement, under which they promise to give another country's products lower tariffs than their MFN rate. These agreements are reciprocal. A lower tariff is charged from goods imported from a country which is given preferential treatment. Examples are preferential duties in the EU region under which a good coming from one EU country to another is charged zero tariff rate. Another example is North American Free Trade Agreement (NAFTA) among Canada, Mexico and the USA where the preferential tariff rate is zero on essentially all products. Countries, especially the affluent ones also grant 'unilateral preferential treatment' to select list of products from specified developing countries. The Generalized System of Preferences (GSP) is one such system which is currently prevailing.

e. **Bound Tariff:** Under this, a WTO member binds itself with a legal commitment not to raise tariff rate above a certain level. By binding a tariff rate, often during negotiations, the members agree to limit their right to set tariff levels beyond a certain level. The bound rates are specific to individual products and represent the maximum level of import duty that can be levied on a product imported by that member. A member is always free to impose a tariff that is lower than the bound level. Once bound, a tariff rate becomes permanent and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade. A bound tariff ensures transparency, predictability.

f. **Applied Tariffs:** An 'applied tariff' is the duty that is actually charged on imports on a Most-Favoured Nation (MFN) basis. A WTO member can have an applied tariff for a product that differs from the bound tariff for that product as long as the applied level is not higher than the bound level.

g. **Escalated Tariff** structure refers to the system wherein the nominal tariff rates on imports of manufactured goods are higher than the nominal tariff rates on intermediate inputs and raw materials, i.e. the tariff on a product increases as that product moves through the value-added chain. For example, a four percent tariff on iron ore or iron ingots and twelve percent tariff on steel pipes. This type of tariff is discriminatory as it protects manufacturing industries in importing countries and dampens the attempts of developing manufacturing industries of exporting countries. This has special relevance to trade between developed countries and developing countries. Developing countries are forced to continue to be suppliers of raw materials without much value addition.

h. **Prohibitive tariff:** A prohibitive tariff is one that is set so high that no imports can enter.

i. **Import subsidies:** Import subsidies also exist in some countries. An import subsidy is simply a payment per unit or as a percent of value for the importation of a good (i.e., a negative import tariff).

j. **Tariffs as Response to Trade Distortions:** Sometimes countries engage in 'unfair' foreign-trade practices which are trade distorting in nature and adverse to the interests of the domestic firms. The affected importing countries, upon confirmation of the distortion, respond quickly by measures in the form of tariff responses to offset the distortion. These policies are often referred to as "trigger-price" mechanisms. The following sections relate to such tariff responses to distortions related to foreign dumping and export subsidies.

m. **Anti-dumping Duties:** An anti-dumping duty is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value. Dumping occurs when manufacturers sell goods in a foreign country below the sales prices in their domestic market or below their full average cost of the product. Dumping may be persistent, seasonal, or cyclical. Dumping may also be resorted to as a predatory pricing practice to drive out established domestic producers from the market and to establish monopoly position. Dumping is an international price discrimination favouring buyer of exports, but in fact, the exporters deliberately forego money in order to harm the domestic producers of the importing country.

Dumping is unfair and constitutes a threat to domestic producers and therefore when dumping is found, anti-dumping measures may be initiated as a safeguard instrument by imposing additional import duties/tariffs so as to offset the foreign firm's unfair price advantage. This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest (that is, the associated costs to consumers would be less than the benefits that would accrue to producers). For example: In January 2017, India imposed anti-dumping duties on colour-coated or pre-painted flat steel products imported into the country from China

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and European nations for a period not exceeding six months and for jute and jute products from Bangladesh and Nepal.

n. **Countervailing Duties:** Countervailing duties are tariffs that aim to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country. If a foreign country does not have a comparative advantage in a particular good and a government subsidy allows the foreign firm to be an exporter of the product, then the subsidy generates a distortion from the free-trade allocation of resources. In such cases, CVD is charged in an importing country to negate the advantage that exporters get from subsidies to ensure fair and market-oriented pricing of imported products and thereby protecting domestic industries and firms. For example, in 2016, in order to protect its domestic industry, India imposed 12.5% countervailing duty on Gold jewellery imports from ASEAN.

2.2.2 Effects of Tariffs

A tariff levied on an imported product affects both the exporting country and the importing country.

i. Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade. The prospect of market access of the exporting country is worsened when an importing country imposes a tariff.

ii. By making imported goods more expensive, tariffs discourage domestic consumers from consuming imported foreign goods. Domestic consumers suffer a loss in consumer surplus because they must now pay a higher price for the good and also because compared to free trade quantity, they now consume lesser quantity of the good.

iii. Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries.

iv. Producers in the importing country experience an increase in well-being as a result of imposition of tariff. The price increase of their product in the domestic market increases producer surplus in the industry. They can also charge higher prices than would be possible in the case of free trade because foreign competition has reduced.

v. The price increase also induces an increase in the output of the existing firms and possibly addition of new firms due to entry into the industry to take advantage of the new high profits and consequently an increase in employment in the industry.

vi. Tariffs create trade distortions by disregarding comparative advantage and prevent countries from enjoying gains from trade arising from comparative advantage. Thus, tariffs discourage efficient production in the rest of the world and encourage inefficient production in the home country.

vii. Tariffs increase government revenues of the importing country by the value of the total tariff it charges.

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2.3.1 Technical Measures

i. Sanitary and Phytosanitary (SPS) Measures: SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease-causing organisms and to protect biodiversity.

These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements, production processes, and associated compliance assessments. For example; prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

ii. Technical Barriers To Trade (TBT): Technical Barriers to Trade (TBT) which cover both food and non-food traded products refer to mandatory 'Standards and Technical Regulations' that define the specific characteristics that a product should have, such as its size, shape, design, labelling / marking / packaging, functionality or performance and production methods, excluding measures covered by the SPS Agreement. The specific procedures used to check whether a product is really conforming to these requirements (conformity assessment procedures e.g. testing, inspection and certification) are also covered in TBT. This includes compulsory quality, quantity and price control of goods before shipment from the exporting country.

Just as SPS, TBT measures are standards-based measures that countries use to protect their consumers and preserve natural resources, but these can also be used effectively as obstacles to imports or to discriminate against imports and protect domestic products. Altering products and production processes to comply with the diverse requirements in export markets may be either impossible for the exporting country or would obviously raise costs, hurting the competitiveness of the exporting country. Some examples of TBT are: food laws, quality standards, industrial standards, organic certification, eco-labelling, and marketing and label requirements.

2.3.2 Non-technical Measures

These include different types of trade protective measures which are put into operation to neutralize the possible adverse effects of imports in the market of the importing country.

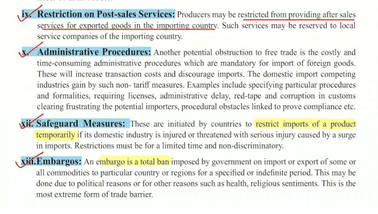
Following are the most commonly practiced measures in respect of imports:

i. **Import Quotas:** An import quota is a direct restriction which specifies that only a certain physical amount of the good will be allowed into the country during a given time period, usually one year. Import quotas are typically set below the free trade level of imports and are usually enforced by issuing licenses. This is referred to as a binding quota; a non binding quota is a quota that is set at or above the free trade level of imports, thus having little effect on trade.

Import quotas are mainly of two types: absolute quotas and tariff-rate quotas. Absolute quotas or quotas of a permanent nature limit the quantity of imports to a specified level during a specified period of time and the imports can take place any time of the year. No condition is attached to the country of origin of the product. For example: 1000 tonnes of fish import which can take place any time during the year from any country. When country allocation is specified, a fixed volume or value of the product must originate in one or more countries. Example: A quota of 1000 tonnes of fish that can be imported any time during the year, but where 750 tonnes must originate in country A and 250 tonnes in country B. In addition, there are seasonal quotas and temporary quotas.

With a quota, the government, of course, receives no revenue. The profits received by the holders of such import licenses are known as 'quota rents'. While tariffs directly interfere with prices that can be charged for an imported good in the domestic market, import quota interferes with the market prices indirectly. Obviously, an import quota always raises the domestic price of the imported good. The license holders are able to buy imports and resell them at a higher price in the domestic market and they will be able to earn a 'rent' on their operations over and above the profit they would have made in a free market.

The welfare effects of quotas are similar to that of tariffs. If a quota is set below free trade level, the amount of imports will be reduced. A reduction in imports will lower the supply of the good in the domestic market and raise the domestic price. Consumers of the product in the importing country will be worse-off because the increase in the domestic price of both imported goods and the domestic substitutes reduces consumer surplus in the market. Producers in the importing country are better-off as a result of the quota. The increase in the price of their product increases producer surplus in the industry. The price increase also induces an increase in output of existing firms (and perhaps the addition of new firms), an increase in employment, and hence an increase in profit.



ii. **Price Control Measures:** Price control measures (including additional taxes and charges) are steps taken to control or influence the prices of imported goods in order to support the domestic price of certain products when the import prices of these goods are lower. These are also known as 'para-tariff' measures and include measures, other than tariff measures, that increase the cost of imports in a similar manner, i.e. by a fixed percentage or by a fixed amount. Example: A minimum import price established for sulphur.

iii. **Non-automatic Licensing and Prohibitions:** These measures are normally aimed at limiting the quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier. These measures may take the form of non automatic licensing, or complete prohibitions. For example, textiles may be allowed only on a discretionary license by the importing country. India prohibits import/export of arms and related material from/to Iraq. Further, India also prohibits many items (mostly of animal origin) falling under 60 EXIM codes.

iv. **Restriction on Post-sales Services:** Producers may be restricted from providing after sales services for exported goods in the importing country. Such services may be reserved to local service companies of the importing country.

v. **Administrative Procedures:** Another potential obstruction to free trade is the costly and time-consuming administrative procedures which are mandatory for import of foreign goods. These will increase transaction costs and discourage imports. The domestic import competing industries gain by such non- tariff measures. Examples include specifying particular procedures and formalities, requiring licenses, administrative delay, red-tape and corruption in customs clearing frustrating the potential importers, procedural obstacles linked to prove compliance etc.

vi. **Safeguard Measures:** These are initiated by countries to restrict imports of a product temporarily if its domestic industry is injured or threatened with serious injury caused by a surge in imports. Restrictions must be for a limited time and non-discriminatory.

vii. **Embargos:** An embargo is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period. This may be done due to political reasons or for other reasons such as health, religious sentiments. This is the most extreme form of trade barrier.

iv. Financial Measures: The objective of financial measures is to increase import costs by regulating the access to and cost of foreign exchange for imports and to define the terms of payment. It includes measures such as advance payment requirements and foreign exchange controls denying the use of foreign exchange for certain types of imports or for goods imported from certain countries. For example, an importer may be required to pay a certain percentage of the value of goods imported three months before the arrival of goods or foreign exchange may not be permitted for import of newsprint.

xi. Rules of origin: Country of origin means the country in which a good was produced, or in the case of a traded service, the home country of the service provider. Rules of origin are the criteria needed by governments of importing countries to determine the national source of a product. Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports. Important procedural obstacles occur in the home countries for making available certifications regarding origin of goods, especially when different components of the product originate in different countries.

viii. Distribution Restrictions: Distribution restrictions are limitations imposed on the distribution of goods in the importing country involving additional license or certification requirements. These may relate to geographical restrictions or restrictions as to the type of agents who may resell. For example: a restriction that imported fruits may be sold only through outlets having refrigeration facilities.

v. Measures Affecting Competition: These measures are aimed at granting exclusive or special preferences or privileges to one or a few limited group of economic operators. It may include government imposed special import channels or enterprises, and compulsory use of national services. For example, a statutory marketing board may be granted exclusive rights to import wheat: or a canalizing agency (like State Trading Corporation) may be given monopoly right to distribute palm oil. When a state agency or a monopoly import agency sells in the domestic market at prices above those existing in the world market, the effect will be similar to an import tariff.

vi. Government Procurement Policies: Government procurement policies may interfere with trade if they involve mandates that the whole of a specified percentage of government purchases should be from domestic firms rather than foreign firms, despite higher prices than similar foreign suppliers. In accepting public tenders, a government may give preference to the local tenders rather than foreign tenders.

vii. Trade-Related Investment Measures: These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.

a. requirement to use certain minimum levels of locally made components, (25 percent of components of automobiles to be sourced domestically)

b. restricting the level of imported components, and

c. limiting the purchase or use of imported products to an amount related to the quantity or value of local products that it exports. (A firm may import only up to 75 % of its export earnings of the previous year)

2.4. EXPORT-RELATED MEASURES

i. Ban on exports: Export-related measures refer to all measures applied by the government of the exporting country including both technical and non-technical measures. For example, during periods of shortages, export of agricultural products such as onion, wheat etc. may be prohibited to make them available for domestic consumption. Export restrictions have an important effect on international markets. By reducing international supply, export restrictions have been effective in increasing international prices.

ii. Export Taxes: An export tax is a tax collected on exported goods and may be either specific or ad valorem. The effect of an export tax is to raise the price of the good and to decrease exports. Since an export tax reduces exports and increases domestic supply, it also reduces domestic prices and leads to higher domestic consumption.

iii. Export Subsidies and Incentives: We have seen that tariffs on imports hurt exports and therefore countries have developed compensatory measures of different types for exporters like export subsidies, duty drawback, duty-free access to imported intermediates etc. Governments or government bodies also usually provide financial contribution to domestic producers in the form of grants, loans, equity infusions etc. or give some form of income or price support. If such policies on the part of governments are directed at encouraging domestic industries to sell specified products or services abroad, they can be considered as trade policy tools.

iv. Voluntary Export Restraints: Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time. Such restraints originate primarily from political considerations and are imposed based on negotiations of the importer with the exporter. The inducement for the exporter to agree to a VER is mostly to appease the importing country and to avoid the effects of possible retaliatory trade restraints that may be imposed by the importer. VERs may arise when the import-competing industries seek protection from a surge of imports from particular exporting countries. VERs cause, as do tariffs and quotas, domestic prices to rise and cause loss of domestic consumer surplus.

Over the past few decades, significant transformations are happening in terms of growth as well as trends of flows and patterns of global trade. The increasing importance of developing countries has been a salient feature of the shifting global trade patterns. Fundamental changes are taking place in the way countries associate themselves for international trade and investments. Trading through regional arrangements which foster closer trade and economic relations is shaping the global trade landscape in an unprecedented way. Alongside, the trading countries also have devised ingenious policies aimed at protecting their economic interests. The discussions in this unit are in no way comprehensive considering the faster pace of discovery of such protective strategies. Students are expected to get themselves updated on such ongoing changes.

4.2 THE EXCHANGE RATE

A foreign currency transaction is a transaction that is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

a. buys or sells goods or services whose price is denominated in a foreign currency.

b. borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

c. becomes a party to an unperformed forward exchange contract; or

d. otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

4.3 THE EXCHANGE RATE REGIMES

Exchange rates are determined by demand and supply. But governments can influence those exchange rates in various ways. The extent and nature of government involvement in currency markets define alternative systems of exchange rates. In this section, we will examine some common systems and explore some of their macroeconomic implications.

There are three broad categories of exchange rate systems. In one system, exchange rates are set purely by private market forces with no government involvement. Values change constantly as the demand for and supply of currencies fluctuate. In another system, currency values are allowed to change, but governments participate in currency markets in an effort to influence those values. Finally, governments may seek to fix the values of their currencies, either through participation in the market or through regulatory policy.

An exchange rate regime is the system by which a country manages its currency with respect to foreign currencies. It refers to the method by which the value of the domestic currency in terms of foreign currencies is determined. There are two major types of exchange rate regimes at the extreme ends; namely:

(i) floating exchange rate regime (also called a flexible exchange rate), and

(ii) fixed exchange rate regime

In a free-floating exchange rate system, governments and central banks do not participate in the market for foreign exchange. The relationship between governments and central banks on the one hand and currency markets on the other is much the same as the typical relationship between these institutions and stock markets. Governments may regulate stock markets to prevent fraud, but stock values themselves are left to float in the market.

A free-floating system has the advantage of being self-regulating. There is no need for government intervention if the exchange rate is left to the market. Market forces also restrain large swings in demand or supply. Suppose, for example, that a dramatic shift in world preferences led to a sharply increased demand for goods and services produced in Canada. This would increase the demand for Canadian dollars, raise Canada's exchange rate, and make Canadian goods and services more expensive for foreigners to buy. Some of the impact of the swing in foreign demand would thus be absorbed in a rising exchange rate. In effect, a free floating exchange rate acts as a buffer to insulate an economy from the impact of international events.

The primary difficulty with free-floating exchange rates lies in their unpredictability. Contracts between buyers and sellers in different countries must not only reckon with possible changes in prices and other factors during the lives of those contracts, they must also consider the possibility of exchange rate changes. An agreement by an Indian distributor to purchase a certain quantity of US goods each year, for example, will be affected by the possibility that the exchange rate between the Indian rupee and the U.S. dollar will change while the contract is in effect. Fluctuating exchange rates make international transactions riskier and thus increase the cost of doing business with other countries.

Managed Float Systems

Governments and central banks often seek to increase or decrease their exchange rates by buying or selling their own currencies. Exchange rates are still free to float, but governments try to influence their values. Government or central bank participation in a floating exchange rate system is called a managed float.

Countries that have a floating exchange rate system intervene from time to time in the currency market in an effort to raise or lower the price of their own currency. Typically, the purpose of such intervention is to prevent sudden large swings in the value of a nation's currency. Such intervention is likely to have only a small impact, if any, on exchange rates.

Still, governments or central banks can sometimes influence their exchange rates. Suppose the price of a country's currency is rising very rapidly. The country's government or central bank might seek to hold off further increases in order to prevent a major reduction in net exports. An announcement that a further increase in its exchange rate is unacceptable, followed by sales of that country's currency by the central bank in order to bring its exchange rate down, can sometimes convince other participants in the currency market that the exchange rate will not rise further. That change in expectations could reduce demand for and increase the supply of the currency, thus achieving the goal of holding the exchange rate down.

3 Fixed Exchange Rates

Demand supply ✗ GOVT = ✓

In a fixed exchange rate system, the exchange rate between two currencies is set by government policy. There are several mechanisms through which fixed exchange rates may be maintained. Whatever the system for maintaining these rates, however, all fixed exchange rate systems share some important features.

In an open economy, the main advantages of a fixed rate regime are:

i. A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks and transaction costs that can impede international flow of trade and investments. International trade and investment are less risky under fixed rate regime as profits are not affected by the exchange rate fluctuations.

Affect

system

ii. A fixed exchange rate can thus, greatly enhance international trade and investment.

iii. A reduction in speculation on exchange rate movements if everyone believes that exchange rates will not change.

iv. A fixed exchange rate system imposes discipline on a country's monetary authority and therefore is more likely to generate lower levels of inflation.

RBI

v. The government can encourage greater trade and investment as stability encourages investment.

vi. Exchange rate peg can also enhance the credibility of the country's monetary -policy.

vii. However, in the fixed or managed floating exchange rate regimes (where the market forces are allowed to determine the exchange rate within a band), the central bank is required to stand ready to intervene in the foreign exchange market and, also to maintain an adequate amount of foreign exchange reserves for this purpose.

Basically, the free floating or flexible exchange rate regime is argued to be efficient and highly transparent as the exchange rate is free to fluctuate in response to the supply of and demand for foreign exchange in the market and clears the imbalances in the foreign exchange market without any control of the central bank or the monetary authority. A floating exchange rate has many advantages:

i. A floating exchange rate has the greatest advantage of allowing a Central bank and/or government to pursue its own independent monetary policy.

ii. Floating exchange rate regime allows exchange rate to be used as a policy tool: for example, policy-makers can adjust the nominal exchange rate to influence the competitiveness of the tradable goods sector.

iii. As there is no obligation or necessity to intervene in the currency markets, the central bank is not required to maintain a huge foreign exchange reserves.

However, the greatest disadvantage of a flexible exchange rate regime is that volatile exchange rates generate a lot of uncertainties in relation to international transactions and add a risk premium to the costs of goods and assets traded across borders. In short, a fixed rate brings in more currency and monetary stability and credibility; but it lacks flexibility. On the contrary, a floating rate has greater policy flexibility; but less stability.

1$ = ₹80
Nominal Ex Rate.

4.4 NOMINAL VERSUS REAL EXCHANGE RATES

We have been discussing so far about nominal exchange rate which refers to the rate at which a person can trade the currency of one country for the currency of another country. For any country, there are many nominal exchange rates because its currency can be used to purchase many foreign currencies. While studying exchange rate changes, economists make use of indexes that average these many exchange rates. An exchange rate index turns these many exchange rates into a single measure of the international value of currency.

Nominal Exchange Rates can be used to find the domestic price of foreign goods. However, trade flows are affected not by nominal exchange rates, but instead, by real exchange rates. The person or firm buying another currency is interested in what can be bought with it.

The real exchange rate is the rate at which a person can trade the goods and services of one country for the goods and services of another. It describes 'how many' of a good or service in one country can be traded for 'one' of that good or service in a foreign country. A country's real exchange rate is a key determinant of its net exports of goods and services.

1 Bottle Juice = ₹10 ×8

1 Bottle wine

For calculating real exchange rate, in the case of trade in a single good, we must first use the nominal exchange rate to convert the prices into a common currency. The real exchange rate (RER) between two currencies is the product of the nominal exchange rate and the ratio of prices between the two countries. It is calculated as:

$$\text{Real exchange Rate} = \frac{\text{(Nominal exchange Rate) x Domestic price}}{\text{Foreign price}}$$

1$ = 80 × 160

Or

$$\text{Real exchange rate} = \text{Nominal exchange rate} \times \frac{\text{Domestic Price}}{\text{Foreign price}}$$

Real ex Rate = Nominal ex Rate × $\frac{\text{Domestic Price}}{\text{Foreign Price}}$

How many goods to be traded for 'one' good of other country.

→ For 1 Bottle of wine we need to exchange 20 Bottles of water.

India → 1 Bottle water = ₹20

USA → 1 Bottle wine = $5

USA 1 Bottle wine $\frac{5 \times 80}{20}$ = India 20 Bottles

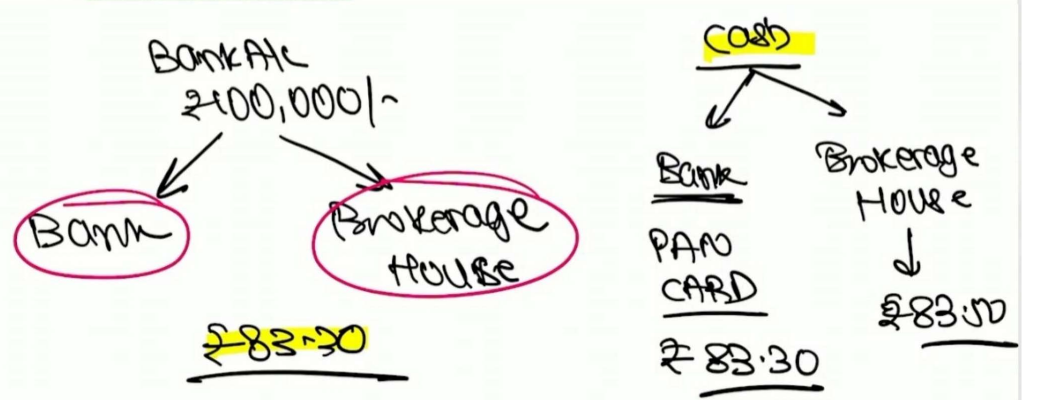
Nominal exchange Rate = 1$ = ₹80

India 1 Bottle water $\frac{20 \times 1}{5 \times 80}$ USA 0.05 wine Bottle

4.5 THE FOREIGN EXCHANGE MARKET

Forex market participants mainly are commercial banks executing orders from exporters, importers, investment institutions, insurance and retirement funds, hedgers, and private investors. Commercial banks also perform trading operations in their own interests and at their own expense. Daily turnover of the largest banks often exceeds several billions of U.S. Dollars and many make their main profit by speculative operations with currency.

Brokerage houses are also playing an important role as contractors between large numbers of banks, funds, commission houses, dealing centers, etc. Commercial Banks and Brokerage Houses do not only execute currency exchange operations at prices set by other active players but come out with their own prices as well, actively influencing the price formation process and the market life. That is why they are called market makers.



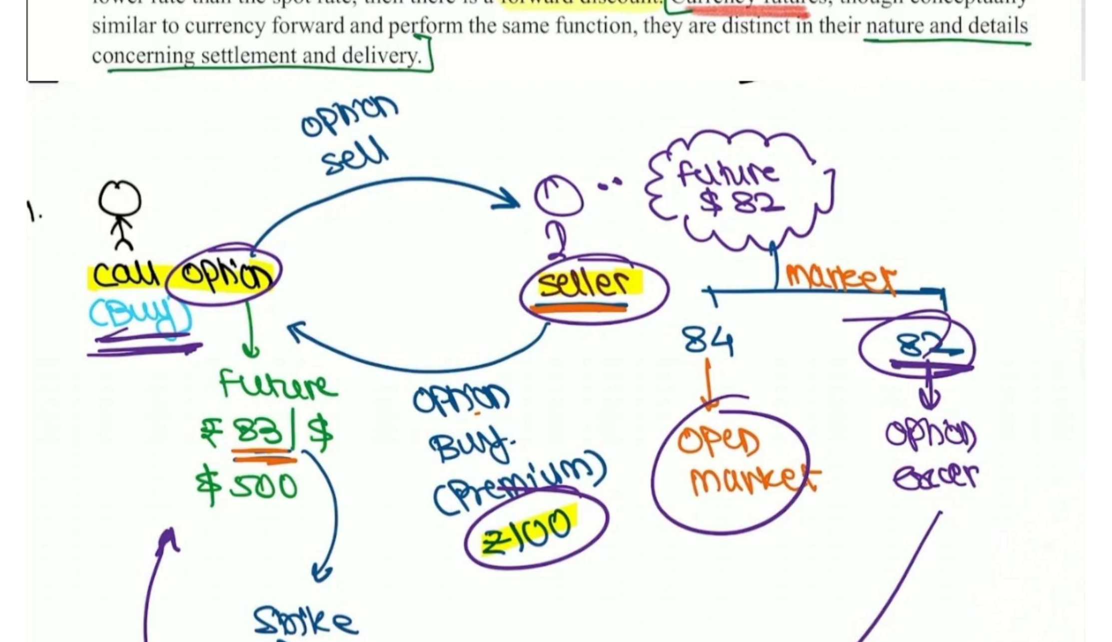
In contrast to the above, passive players cannot set their own quotations and make trades at quotations offered by active market players. Passive market players normally pursue the following aims: payment of export-import contracts, foreign industrial investments, the opening of branches abroad or the creation of joint ventures, tourism, speculation on rate difference, hedging of currency risks (insurance against losses in case of unfavorable price changes), etc.

In the foreign exchange market, there are two types of transactions:

i. current transactions which are carried out in the spot market and the exchange involves immediate delivery, and

ii. future transactions wherein contracts are agreed upon to buy or sell currencies for future delivery which are carried out in forward and/or futures markets

Exchange rates prevailing for spot trading (for which settlement by and large takes two days) are called spot exchange rates. The exchange rates quoted in foreign exchange transactions that specify a future date are called forward exchange rates. The currency forward contracts are quoted just like spot rate; however, the actual delivery of currencies takes place at the specified time in future. When a party agrees to sell euro for dollars on a future date at a forward rate agreed upon, he has 'sold euros forward' and 'bought dollars forward'. A forward premium is said to occur when the forward exchange rate is more than a spot exchange rates. On the contrary, if the forward trade is quoted at a lower rate than the spot rate, then there is a forward discount. Currency futures, though conceptually similar to currency forward and perform the same function, they are distinct in their nature and details concerning settlement and delivery.



While a foreign exchange transaction can involve any two currencies, most transactions involve exchanges of foreign currencies for the U.S. dollars even when it is not the national currency of either the importer or the exporter. On account of its critical role in the forex markets, the dollar is often called a 'vehicle currency'.

Spot Exch Rate : For Spot Trading/Txn
Forward Exch Rate: For future Txn

24th April — 1000$ Rate: ₹83.60 — 30th April

4.6 DETERMINATION OF NOMINAL EXCHANGE RATE

As you already know, the key framework for analysing prices is the operation of forces of supply and demand in markets. Usually, the supply of and demand for foreign exchange in the domestic foreign exchange market determine the external value of the domestic currency, or in other words, a country's exchange rate.

Individuals, institutions and governments participate in the foreign exchange market for a number of reasons. On the demand side, people desire foreign currency to:

- Purchase goods and services from another country (Import)
- For unilateral transfers such as gifts, awards, grants, donations or endowments
- To make investment income payments abroad
- To purchase financial assets, stocks or bonds abroad
- To open a foreign bank account
- To acquire direct ownership of real capital, and
- For speculation and hedging activities related to risk-taking or risk-avoidance activity

India — Import — $ Demand. Export — Supply $

INTERNATIONAL TRADE

1$ = 80 — 1$ = 75 — 1$ = 85

4.7 CHANGES IN EXCHANGE RATES

₹: Appreciate $: Dep — ₹: Depreciate $: App.

Changes in exchange rates portray depreciation or appreciation of one currency. The terms, 'currency appreciation' and 'currency depreciation' describe the movements of the exchange rate. Currency appreciates when its value increases with respect to the value of another currency or a basket of other currencies. On the contrary, currency depreciates when its value falls with respect to the value of another currency or a basket of other currencies. We shall try to understand this with the help of an example.

For example, the Rupee dollar exchange rate in the month of January is $1 = ` 70. and, we find that in the month of April it is $1 = ` 75. What does this indicate? In April, you will have to exchange a greater amount of Indian Rupees (`75) to get the same 1 unit of US dollar. As such, the value of the Indian Rupee has gone down or Indian Rupee has depreciated in its value. Rupee depreciation here means that the rupee has become less valuable with respect to the U.S. dollar. Simultaneously, if you look at the value of dollar in terms of Rupees, you find that the value of the US dollar has increased in terms of the Indian Rupee. One dollar will now fetch `75 instead of `70 earlier. This is called appreciation of the US dollar. You might have observed that when one currency depreciates against another, the second currency must simultaneously appreciate against the first.

To put it more clearly:

- Home-currency depreciation (which is the same as foreign-currency appreciation) takes place when there is an increase in the home currency price of the foreign currency (or, alternatively, a decrease in the foreign currency price of the home currency). The home currency thus becomes relatively less valuable.
- Home-currency appreciation (or foreign-currency depreciation) takes place when there is a decrease in the home currency price of foreign currency (or alternatively, an increase in the foreign currency price of home currency). The home currency thus becomes relatively more valuable.

4.8 DEVALUATION (REVALUATION) VS DEPRECIATION APPRECIATION)

Fixed Exch. Rate — Floating Exch Rate

Devaluation is a deliberate downward adjustment in the value of a country's currency relative to another country's currency or group of currencies or standard. It is a monetary policy tool used by countries that have a fixed exchange rate or nearly fixed exchange rate regime and involves a discrete official reduction in the otherwise fixed par value of a currency. The monetary authority formally sets a new fixed rate with respect to a foreign reference currency or currency basket. In contrast, depreciation is a decrease in a currency's value (relative to other major currency benchmarks) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy actions.

Revaluation is the opposite of devaluation and the term refers to a discrete official increase of the otherwise fixed par value of a nation's currency. Appreciation, on the other hand, is an increase in a currency's value (relative to other major currencies) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy interventions.

4.9 IMPACTS OF EXCHANGE RATE FLUCTUATIONS ON DOMESTIC ECONOMY

The fact that among the macroeconomic variables, exchange rates are perhaps the most closely monitored, analysed and manipulated economic measure, highlights the overwhelming importance of exchange rates in an economy. The unpredictability of the markets caused by exchange rate fluctuations can profoundly determine a country's economic performance. Knowledge about the possible effects of exchange rate fluctuations enables us to have an understanding of the appropriateness of exchange rate policy, especially in developing countries. In the discussion that follows, we shall examine the impact of exchange rate fluctuations on the real economy.

The developments in the foreign exchange markets affect the domestic economy both directly and indirectly. The direct impact of fluctuations in rates is initially felt by economic agents who are directly involved in international trade or international finance.

i. Fluctuations in the exchange rate have a significant role in determining the nature and extent of a country's trade.

₹ App. export ↑ import↓ — ₹ Dep export↓ Imp↑

ii. Fluctuations in the exchange rate affect the economy by changing the relative prices of domestically-produced and foreign-produced goods and services. All else equal (or other things remaining the same), an appreciation of a country's currency raises the relative price of its exports and lowers the relative price of its imports. Conversely, depreciation lowers the relative price of a country's exports and raises the relative price of its imports. When a country's currency depreciates, foreigners find that its exports are cheaper and domestic residents find that imports from abroad are more expensive. An appreciation has opposite effects i.e foreigners pay more for the country's products and domestic consumers pay less for foreign products. For example; assume that there is devaluation or depreciation of Indian Rupee from $1=` 65/ to $1=` 70/. A foreigner who spends ten dollars on buying Indian goods will, post devaluation, get goods worth ` 700/ instead of ` 650/ prior to depreciation. An importer has to pay for his purchases in foreign currency, and, therefore, a resident of India, who wants to import goods worth $1 will have to pay ` 70/ instead of ` 65/ prior to depreciation. Importers will be affected most as they will have to pay more rupees on importing products. On the contrary, exporters will be benefitted as goods exported abroad will fetch dollars which can now be converted to more rupees.

iii. Exchange rate changes affect economic activity in the domestic economy. A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods. Increased demand, both for domestic import-competing goods and for exports, encourages economic activity and creates output expansion. Overall, the outcome of exchange rate depreciation is an expansionary impact on the economy at an aggregate level. The positive effect of currency depreciation, however, largely depends on whether the switching of demand has taken place in the right direction and in the right amount, as well as on the capacity of the home economy to meet that increased demand by supplying more goods.

₹ Dep — Domestic ✓ — Export ✓ } Expansion

iv. For an economy where exports are significantly high, a depreciated currency would mean a lot of gain. In addition, if exports originate from labour-intensive industries, increased export prices will have positive effect on employment and potentially on wages.

v. Depreciation is also likely to add to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods. The impact will be greater if the composition of domestic consumption baskets consists more of imported goods. Indirectly, cost push inflation may result through possible escalation in the cost of imported inputs. In such an inflationary situation, the central bank of the country will have no incentive to cut policy rates as this is likely to increase the burden of all types of borrowers including businesses.

Expensive ↑ — Domestic of Supply × → Price ↑

vi. The fiscal health of a country whose currency depreciates is likely to be affected with rising export earnings and import payments and consequent impact on current account balance. A widening current account deficit is a danger signal as far as growth prospects of the overall economy is concerned. If export earnings rise faster than the imports spending then current account balance will improve.

Deficit — Imports > Exports — Surplus — Imports < Exports

1$ = 80
1$ = 85

Import	Export	Deficit
100$ × 80	50$ × 80	50$ × 80 — 4000
₹85	₹85	50 $ × 85 — 4250

vii. Companies that have borrowed in foreign exchange through external commercial borrowings (ECBs) but have been careless and did not sufficiently hedge these loans against foreign exchange risks, would also be negatively impacted as they would require more domestic currency to repay their loans. A depreciated domestic currency would also increase their debt burden and lower their profits and impact their balance sheets adversely. These would signal investors who will be discouraged from investing in such companies.

1$ = 80 — 1000$ = 80000
1$ = 85 — 85000

viii. Countries with foreign currency denominated government debts, currency depreciation will increase the interest burden and cause strain to the exchequer for repaying and servicing foreign debt. Fortunately, India's has small proportion of public debt in foreign currency.

ix. Exchange rate fluctuations make financial forecasting more difficult for firms and larger amounts will have to be earmarked for insuring against exchange rate risks through hedging.

x. With growth of investments across international boundaries, exchange rates have assumed special significance. Investors who have purchased a foreign asset, or the corporation which floats a foreign debt, will find themselves facing foreign exchange risk. Exchange rate movements have become the single most important factor affecting the value of investments at international level. They are critical to business volumes, profit forecasts, investment plans and investment outcomes. Depreciating currency hits investor sentiments and has radical impact on patterns of international capital flows.

movement — Not able to decide — careful

xi. Foreign investors are likely to be indecisive or highly cautious before investing in a country that has high exchange rate volatility. Foreign capital inflows are characteristically vulnerable when local currency weakens. Therefore, foreign portfolio investment flows into debt and equity as well as foreign direct investment flows are likely to shrink. This shoots up capital account deficits affecting the country's fiscal health.

An appreciation of currency or a strong currency (or possibly an overvalued currency) makes the domestic currency more valuable and, therefore, can be exchanged for a larger amount of foreign currency. An appreciation will have the following consequences on real economy:

i. An appreciation of currency raises the price of exports and, therefore, the quantity of exports would fall. Since imports become cheaper, we may expect an increase in the quantity of imports. Combining these two effects together, the domestic aggregate demand falls and, therefore, economic growth is likely to be negatively impacted.

ii. The outcome of appreciation also depends on the stage of the business cycle as well. If appreciation sets in during the recessionary phase, the result would be a further fall in aggregate demand and higher levels of unemployment. If the economy is facing a boom, an appreciation of domestic currency would trim down inflationary pressures and soften the rate of growth of the economy.

iii. An appreciation may cause reduction in the levels of inflation because imports are cheaper. Lower price of imported capital goods, components and raw materials lead to decrease in cost of production which reflects on decrease in prices. Additionally, decrease in aggregate demand tends to lower demand pull inflation. Living standards of people are likely to improve due to availability of cheaper consumer goods.

With increasing export prices, the competitiveness of domestic industry is adversely affected and therefore, firms have greater incentives to introduce technological innovations and capital-intensive production to cut costs to remain competitive.

v. Increasing imports and declining exports are liable to cause larger deficits and worsen the current account. However, the impact of appreciation on current account depends upon the elasticity of demand for exports and imports. Relatively inelastic demand for imports and exports may lead to an improvement in the current account position. Higher the price elasticity of demand for exports, greater would be the fall in demand and higher will be the fall in the aggregate value of exports. This will adversely affect the current account balance.

vi. Loss of competitiveness will be insignificant if currency appreciation is because of strong fundamentals of the economy.

From the discussions in this unit, we understand that all countries would desire to have steady exchange rates to eliminate the risks and uncertainties associated with international trade and investments. However, nations may sometimes go for trade-offs with weaker exchange rate to stimulate exports and aggregate demand, or a stronger exchange rate to fight inflation. Learners may keep themselves well-informed on contemporary exchange rate developments and their implications on the economic welfare of countries.

5.3 FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment (FDI), according to IMF manual on 'Balance of payments' is "all investments involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the direct investor". This typically occurs through acquisition of more than 10 percent of the shares of the target asset. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise, but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

According to the IMF and OECD definitions, the acquisition of at least ten percent of the ordinary shares or voting power in a public or private enterprise by non-resident investors makes it eligible to be categorized as foreign direct investment (FDI). India also follows the same pattern of classification. FDI has three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises.

Foreign direct investors may be individuals, incorporated or unincorporated private or public enterprises, associated groups of individuals or enterprises, governments or government agencies, estates, trusts, or other organizations or any combination of the above-mentioned entities. The main forms of direct investments are the opening of overseas companies, including the establishment of subsidiaries or branches, the creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

Direct investments are real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities. The investor retains control over the use of the invested capital and also seeks the power to exercise control over decision making to the extent of its equity participation. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

Based on the nature of foreign investments, FDI may be categorized as horizontal, vertical or conglomerate.

i. A horizontal direct investment is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.

ii. A vertical investment is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way

supplements its major activity. For example; an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.

iii. A conglomerate type of foreign direct investment is one where an investor makes a foreign investment in a business that is unrelated to its existing business in its home country. This is often in the form of a joint venture with a foreign firm already operating in the industry, as the investor has no previous experience.

Yet another category of investment is 'two- way direct foreign investments' which are reciprocal investments between countries. These investments occur when some industries are more advanced in one nation (for example, the computer industry in the United States), while other industries are more efficient in other nations (such as the automobile industry in Japan).

5.4 FOREIGN PORTFOLIO INVESTMENT (FPI)

Foreign portfolio investment is the flow of what economists call 'financial capital' rather than 'real capital' and does not involve ownership or control on the part of the investor. Examples of foreign portfolio investment are the deposit of funds in an Indian or a British bank by an Italian company, the purchase of a bond (a certificate of indebtedness) of a Swiss company or the Swiss government by a citizen or company based in France. Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effects on balance of payments or exchange rates rather than on production or income generation.

Foreign portfolio investment (FPI) is not concerned with either manufacture of goods or with provision of services. Such investors also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest. The sole intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities and is primarily concerned about the safety of their capital, the likelihood of appreciation in its value, and the return generated. Logically, portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

Following international standards, portfolio investments are characterised by lower stake in companies with their total stake in a firm at below 10 percent. It is also noteworthy that unlike the FDIs, these investments are typically of short term nature, and therefore, are not intended to enhance the productive capacity of an economy by the creation of capital assets.

Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects. Therefore, portfolio investments are, to a large extent, expected to be speculative. Once investor confidence is shaken, such capital has a tendency to speedily shift from one country to another, occasionally creating financial crisis for the host country.

Foreign direct investment (FDI) VS Foreign portfolio investment (FPI)

Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not inclined to be speculative	Speculative in nature
Often accompanied by technology transfer	Not accompanied by technology transfer
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages
Enduring interest in management and control	No abiding interest in management and control
Securities are held with significant degree of influence by the investor on the management of the enterprise	Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise

5.5 REASONS FOR FOREIGN DIRECT INVESTMENT

As we know, economic prosperity and the relative abundance of capital are necessary prerequisites for export of capital to other countries. Many economies and organisations have accumulation of huge mass of reserve capital seeking profitable use. The primary aim of economic agents being maximisation of their economic interests, the opportunity to generate profits available in other countries often entices such entities to make investments in other countries.

The chief motive for shifting of capital between different regions or between different industries is the expectation of higher rate of return than what is possible in the home country. Investment in a host country may be considered as profitable by foreign firms because of some firm-specific knowledge or assets (such as superior management skills or an important patent) that enable the foreign firm to gainfully outperform the host country's domestic firms. There are many other reasons (as listed below) for international capital movements which have found adequate empirical support. Investments move across borders on account of:

- The increasing interdependence of national economies and the consequent trade relations and international industrial cooperation established among them
- Internationalisation of production and investment of transnational corporations in their subsidiaries and affiliates.
- Desire to reap economies of large-scale operation arising from technological growth
- Lack of feasibility of licensing agreements with foreign producers in view of the rapid rate of technological innovations
- Necessity to retain direct control of production knowledge or managerial skill (usually found in monopolistic or oligopolistic markets) that could easily and profitably be utilized by corporations

- Desire to procure a promising foreign firm to avoid future competition and the possible loss of export markets
- Risk diversification so that recessions or downturns may be experienced with reduced severity
- Shared common language or common boundaries and possible saving in time and transport costs because of geographical proximity
- Necessity to retain complete control over its trade patents and to ensure consistent quality and service or for creating monopolies in a global context
- Promoting optimal utilization of physical, human, financial and other resources
- Desire to capture large and rapidly growing high potential emerging markets with substantially high and growing population
- Ease of penetration into the markets of those countries that have established import restrictions such as blanket bans, high customs duties or non-tariff barriers which make it difficult for the foreign firm to sell in the host-country market by 'getting behind the tariff wall'.
- Lower environmental standards in the host country and the consequent relative savings in costs
- Stable political environment and overall favourable investment climate in the host country
- Higher degree of openness to foreign capital exhibited by the recipient country and the prevalence of preferential investment systems such as special economic zones to encourage direct foreign investments
- The strategy to obtain control of strategic raw material or resource so as to ensure their uninterrupted supply at the lowest possible price; usually a form of vertical integration
- Desire to secure access to minerals or raw material deposits located elsewhere and earn profits through processing them to finished form (Eg.FDI in petroleum)
- The existence of low relative wages in the host country because of relative labour abundance coupled with shortage and high cost of labour in capital exporting countries, especially when the production process is labour intensive.
- Lower level of economic efficiency in host countries and identifiable gaps in development.
- Tax differentials and tax policies of the host country which support foreign direct investment. However, a low tax burden cannot compensate for a generally fragile and unattractive FDI environment.
- Inevitability of defensive investments in order to preserve a firm's competitive position.
- High gross domestic product and high per capita income coupled with their high rate of growth. There are also other philanthropic objectives such as strengthening of socio-economic infrastructure, alleviation of poverty and maintenance of ecological balance of the host country, and
- Prevalence of high standards of social amenities and possibility of good quality of life in the host country.

Reasons for FDI.

Friday, 26 April 2024 1:22 PM

a) Control
i. Retain control of production knowledge & skill
ii Retain complete control of patents, Quality of serv.
iii Obtain control of strategic Raw mat. / Resource.
iv. Secure access to minerals or Raw mat.

b) Host country

Unfavourable	Favourable
i. Low level of economic efficiency	1. High stds of social amenities & good quality of life
ii Low wages	ii High: GDP / PCI / Growth
iii Lower Environmental stds	iii Tax Differentials & Tax policies
iv. Tariff walls ↑	iv. Openness to foreign capital
	v. Stable political Env. & Favourable investment climate.
	vi. Emerging market

c) Firm
i. Economies of large scale
ii Procure a promising foreign firm
iii Risk diversity
iv. Optimal utilisation of Resources
v. Inevitability of Defensive investment to preserve competitive position of firm.

d) Global effect
i. Interdependence
ii Internationalisation of production
iii common language / common Boundaries

Host Country Determinants of Foreign Direct Investment

a) Economic Determinants	d) Policy Framework
Market -seeking FDI:	Economic, political, and social stability
Market size and per capita income	Rules regarding entry and operations
Market growth	Standards of treatment of foreign affiliates
Access to regional and global markets	Policies on functioning and structure of markets (e.g., regarding competition, mergers)
Country-specific consumer preferences	International agreements on FDI
Structure of markets	Privatization policy
b) **Resource - or asset-seeking FDI:**	Trade policies and coherence of FDI and trade policies
Raw materials	Tax policy
Low -cost unskilled labor	e) **Business Facilitation**
Availability of skilled labor	Investment promotion (including image building and investment generating activities and investment facilitation services)
Technological, innovative, and other created assets (e.g., brand names)	Investment incentives
Physical infrastructure	"Hassle costs" (related to corruption and administrative efficiency)
c) **Efficiency -seeking FDI:**	Social amenities (e.g., bilingual schools, quality of life)
Costs of above physical and human resources and assets (including an adjustment for productivity)	After-investment services
Other input costs (e.g., intermediate products, transport costs)	
Membership of country in a regional integration agreement, which could be conducive to forming regional corporate networks	

5.6 MODES OF FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investments can be made in a variety of ways, such as:

i. Opening of a subsidiary or associate company in a foreign country,
ii. Equity injection into an overseas company,
iii. Acquiring a controlling interest in an existing foreign company,
iv. Mergers and acquisitions(M&A)
v. Joint venture with a foreign company.
vi. Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).
vii. Brownfield investments (a form of FDI which makes use of the existing infrastructure by merging, acquiring or leasing, instead of developing a completely new one. For e.g. in India 100% FDI under automatic route is allowed in Brownfield Airport projects.

5.9 FOREIGN DIRECT INVESTMENT IN INDIA

Foreign Direct Investment (FDI), in addition to being a key driver of economic growth, has been a significant non-debt financial resource for India's economic development. Foreign corporations invest in India to benefit from the country's particular investment privileges such as tax breaks and comparatively lower salaries. This helps India develop technological knowhow and create jobs as well as other benefits. These investments have been coming into India because of the government's supportive policy framework, vibrant business climate, rising global competitiveness and economic influence.

The government has recently made numerous efforts, including easing FDI regulations in various industries, PSUs, oil refineries, telecom and defence. India's FDI inflows reached record levels during 2020-21. The total FDI inflows stood at US$ 81,973 million, a 10% increase over the previous financial year. According to the World Investment Report 2022, India was ranked eighth among the world's major FDI recipients in 2020, up from ninth in 2019. Information and technology, telecommunication and automobile were the major receivers of FDI in FY22. With the help of significant transactions in the technology and health sectors, multinational companies (MNCs) have pursued strategic collaborations with top domestic business groupings, fuelling an increase in cross-border M&A of 83% to US$ 27 billion.

5.10 OVERSEAS DIRECT INVESTMENT BY INDIAN COMPANIES

India is primarily a domestic demand-driven economy, with consumption and investments contributing to 70% of the economic activity. With an improvement in the economic scenario and the Indian economy recovering from the Covid-19 pandemic shock, India is relatively well placed than the rest of the world. Despite major headwinds that continue to pose risks in the short term, the Indian economy has remained strong owing to robust policy measures in place. This gives Indian businesses an advantage to make investments abroad and broaden their operational footprint in such nations. New innovations from abroad would be brought to India with the help of knowledge spillover, and India itself would contribute to the growth of other nations. In this manner, a mutual benefit is achieved. In this regard, there have been several overseas investments made by Indian companies. Some of the key overseas investments and developments that have taken place in the recent past are mentioned as follows:

According to data released by the Reserve Bank of India (RBI), overseas direct investment stood at US$ 1,922.51 million in September 2022.

The critical investments are as follows:

- In June 2022, Tata Steel announced plans to invest 7 million pounds (US$ 837.95 billion) for its Hartlepool Tube Mill in North-East England.
- Tata Communications invested US$ 690 million in its wholly-owned subsidiary in Singapore.
- Jindal Steel and Power invested US$ 366 million in its wholly owned subsidiary in Mauritius
- Wipro invested US$ 204.96 million in its wholly-owned subsidiary in Cyprus.
- Jindal Saw invested US$ 64.5 million in its wholly-owned subsidiary in the United Arab Emirates.
- Restaurant Brand Aisa and Lupin Ltd invested US$ 141.34 million and US$ 131.25 million in their JVs in Indonesia and the US, respectively.
- Reliance New Energy invested US$ 87.73 million in its wholly owned subsidiary in Norway.
- Mohalla Internet Pvt. Ltd. invested US$ 86 million in its fully owned unit in Mauritius.
- ONGC Videsh invested US$ 83.31 million in a joint-venture in Russia.
- ICICI Bank ties up with Santander in Britain in a pact aimed at facilitating the banking requirements of corporates operating across both countries.
- ANI Technologies, the promoter of OLA, invested US$ 675 million in its wholly-owned subsidiary in Singapore.
- Dr Reddy invested US$ 149.99 million in a joint- venture (JV) in the US.
- A total of US$ 168.9 million was invested by Reliance New Energy in a JV and whollyowned subsidy in Germany and Norway.
- Gail India, energy PSU invested US$ 70.17 million in a JV and wholly-owned unit in Myanmar and the US.
- ONGC invested US$ 74.15 million during the month in various countries in 5 different ventures.
- In July 2022, Reliance Brands Ltd. signed a distribution agreement with Maison Valentino, an Italian luxury fashion house, to open its first boutique in Delhi, followed by a flagship store in Mumbai.
- In July 2022, Reliance Retail Limited entered into a long-term partnership with Gap Inc. to bring the iconic American fashion brand, Gap, to India.
- In July 2022, Tata Steel signed a Memorandum of Understanding (MoU) with BHP, a leading global resources company, with the intention to jointly study and explore lowcarbon iron and steelmaking technology.
- In January 2022, Ola Electric, the ride-hailing company's electric vehicle (EV) subsidiary, announced its plans to establish Ola Futurefoundry, a global hub for advanced engineering and vehicle design in the UK, investing US$ 100 million over the next 5 years.
- In January, Essar Group of India announced that it had created a joint venture with Progressive Energy of the UK to invest US$ 1.34 billion in a hydrogen manufacturing plant at its Essar Stanlow refinery complex.
- In January, Hindalco Ltd's US subsidiary, Novelis, announced its plans to invest US$ 365 million in a state-of-the-art vehicle recycling facility in North America.

5.7 BENEFITS OF FOREIGN DIRECT INVESTMENT

The benefits from and concerns about FDI are widely discussed and well documented. While recognizing the fact that there are also benefits and costs to the home country from capital outflow, in this unit we focus only on host-country effects of FDI with particular attention to the developing countries. Following are the benefits ascribed to foreign investments:

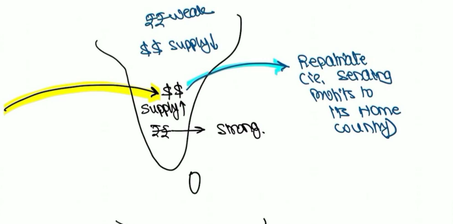
1. Entry of foreign enterprises usually fosters competition and generates a competitive environment in the host country. The domestic enterprises are compelled to compete with the foreign enterprises operating in the domestic market. This results in positive outcomes in the form of cost-reducing and quality-improving innovations, higher efficiency and increasing variety of better products and services at lower prices ensuring wider choice and welfare for consumers.
2. International capital allows countries to finance more investment than can be supported by domestic savings. The provision of increased capital to work with labour and other resources available in the host country can enhance the total output/GDP (as well as output per unit of input) flowing from the factors of production.
3. From the perspective of emerging and developing countries, FDI can accelerate growth and foster economic development by providing the much needed capital, technological know-how, management skills, marketing methods and critical human capital skills in the form of managers and technicians. The spill-over effects of the new technologies usually spread beyond the foreign corporations. In addition, the new technology can clearly enhance the recipient country's production possibilities.
4. Competition for FDI among national governments also has helped to promote political and structural reforms important to attract foreign investors, including legal systems and macroeconomic policies.
5. Since FDI involves setting up of production base (in terms of factories, power plants, etc.), it generates direct employment in the recipient country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream projects that come up in multitude of other services, generate multiplier effects on employment and income/GDP.
6. FDI not only creates direct employment opportunities but also, through backward and forward linkages, generate indirect employment opportunities. This impact is particularly important if the recipient country is a developing country with an excess supply of labour caused by population pressure.
7. Foreign direct investments also promote relatively higher wages for skilled jobs. More indirect employment will be generated to people in the lower-end services sector occupations thereby catering to an extent even to the less educated and unskilled persons engaged in those units.
8. Foreign corporations provide better access to foreign markets. Unlike portfolio investments, FDI generally entails people-to-people relations and is usually considered as a promoter of bilateral and international relations. Greater openness to foreign capital leads to higher national dependence on international investors, making the cost of discords higher.
9. There is also greater possibility for the promotion of ancillary units resulting in job creation and skill development for workers.
10. Foreign enterprises possessing marketing information with their global network of marketing are in a unique position to utilize these strengths to promote the exports of developing countries. If the foreign capital produces goods with export potential, the host country is in a position to secure scarce foreign exchange needed to import capital equipments or materials to assist the country's development plans or to ease its external debt servicing.
11. If the host country is in a position to implement effective tax measures, the foreign investment projects also would act as a source of new tax revenue which can be used for development projects.
12. It is likely that foreign investments enter into industries in which economies of scale can be realized so that consumer prices may be reduced. Domestic firms might not always be able to generate the necessary capital to achieve the cost reductions associated with large-scale production.
13. Increased competition resulting from the inflow of foreign direct investments facilitates weakening of the market power of domestic monopolies resulting in a possible increase in output and fall in prices.
14. Since FDI has a distinct advantage over the external borrowings, it is considered to have a favourable impact on the host country's balance of payment position, and
15. Better work culture and higher productivity standards brought in by foreign firms may possibly induce productivity related awareness and may also contribute to overall human resources development.

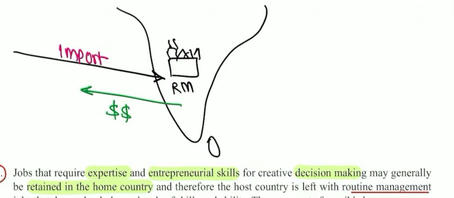
5.8 POTENTIAL PROBLEMS ASSOCIATED WITH FOREIGN DIRECT INVESTMENT

In the above section, we have seen that a wide variety of benefits may result from an inflow of foreign direct investment. These gains do not occur in all cases, nor do they occur in the same magnitude. Despite the arguments in favour of FDI, many are highly critical of the impact of foreign capital, especially on developing economies. They argue that foreign entities are highly focused on profits and have an eye on exploiting the natural resources and are almost always not genuinely interested in the development needs of host countries. Foreign capital is perceived by the critics as an instrument of imperialism, perpetrator of dependence and source of inequality between and within the nations.

Following are the general arguments put forth against the entry of foreign capital:

1. FDIs are likely to concentrate on capital-intensive methods of production and service so that they need to hire only relatively few workers. Such technology is inappropriate for a labour-abundant country as it does not support generation of jobs which is a crucial requirement to address the two fundamental areas of concern for the less developed countries namely, poverty and unemployment
2. The inherent tendency of FDI flows to move towards regions or states which are well endowed in terms of natural resources and availability of infrastructure has the potential to accentuate regional disparity. Foreign capital is also criticized for accentuating the already existing income inequalities in the host country.
3. In the context of developing countries, it is usually alleged that the inflow of foreign capital may cause the domestic governments to slow down its efforts to generate more domestic savings, especially when tax mechanisms are difficult to implement. If the foreign corporations are able to secure incentives in the form of tax holidays or similar provisions, the host country loses tax revenues.
4. Often, the foreign firms may partly finance their domestic investments by borrowing funds in the host country's capital market. This action can raise interest rates in the host country and lead to a decline in domestic investments through 'crowding-out' effect. Moreover, suppliers of funds in developing economies would prefer foreign firms due to perceived lower risks and such shifts of funds may divert capital away from investments which are crucial for the development needs of the country.
5. The expected benefits from easing of the balance of payments situation might remain unrealised or narrowed down due to the likely instability in the balance of payments and the exchange rate. Obviously, FDI brings in more foreign exchange, improves the balance of payments and raises the value of the host country's currency in the exchange markets. However, when imported inputs need to be obtained or when profits are repatriated, a strain is placed on the host country's balance of payments and the home currency leading to its depreciation. Such instabilities jeopardize longterm economic planning. Foreign corporations also have a tendency to use their usual input suppliers which can lead to increased imports. Also, large scale repatriation of profits can be stressful on exchange rates and the balance of payments.





6. Jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability. The argument of possible human resource development and acquisition of new innovative skills through FDI may not be realized in reality.
7. High profit orientation of foreign direct investors tend to promote a distorted pattern of production and investment such that production could get concentrated on items of elite and popular consumption and on non-essential items.
8. Foreign entities are usually accused of being anti-ethical as they frequently resort to methods like aggressive advertising and anticompetitive practices which would induce market distortions.
9. A large foreign firm with deep pockets may undercut a competitive local industry because of various advantages (such as in technology) possessed by it and may even drive out domestic firms from the industry resulting in serious problems of displacement of labour. The foreign firms may also exercise a high degree of market power and exist as monopolists with all the accompanying disadvantages of monopoly. The high growth of wages in foreign corporations can influence a similar escalation in the domestic corporations which are not able to cover this increase with growth of productivity. The result is decreasing competitiveness of domestic companies which might prove detrimental to the long-term interests of industrial development of the host country.
10. FDI usually involves domestic companies 'off-shoring', or shifting jobs and operations abroad in pursuit of lower operating costs and consequent higher profits. This has deleterious effects on employment potential of home country.
11. The continuance of lower labour or environmental standards in host countries is highly appreciated by the profit seeking foreign enterprises. This is of great concern because efforts to converge such standards often fail to receive support from interested parties.
12. At times, there is potential national security considerations involved when foreign firms function in the territory of the host country, especially when acute hostilities prevail.
13. FDI may have adverse impact on the host country's commodity terms of trade, defined as the price of a country's exports divided by the price of its imports). This could occur if the investments go into production of export-oriented goods and the country is a large country in the sale of its exports. Thus, increased exports drive down the price of exports relative to the price of imports.
14. FDI is also held responsible by many for ruthless exploitation of natural resources and the possible environmental damage.
15. With substantial FDI in developing countries there is a strong possibility of emergence of a dual economy with a developed foreign sector and an underdeveloped domestic sector.
16. Perhaps the most disturbing of the various charges levied against foreign direct investment is that a large foreign investment sector can exert excessive amount of power in a variety of ways so that there is potential loss of control by host country over domestic policies and therefore the less developed host country's sovereignty is put at risk. Mighty multinational firms are often criticized of corruption issues, unduly influencing policy making and evasion of corporate social responsibility.

3.1 INTRODUCTION

The recent years have seen intense bilateral and multilateral negotiations among different nations in the international arena. India, for example, has already become part of 19 such concluded agreements and is currently negotiating more than two dozens of such proposals. Major events in the year 2020, such as Britain's exit from the European Union, the new free trade agreement [which is a successor of the North American Free Trade Agreement (NAFTA)] concluded between Canada, Mexico, and United States, namely United States–Mexico–Canada Agreement (USMCA) and many other unpredictable developments in the trade front due to trade war between the US and China and the global pandemic, make trade negotiations a highly relevant area of study.

National governments are not the sole stakeholders in a trade negotiation. Many interest groups, lobbying groups, pressure groups and Non-Governmental Organizations (NGO) exert their influence on the process. As anyone can guess, the positions taken by each of the negotiating parties would represent their underlying agenda of interests. For example, in trade negotiations, when one of the parties seems to be bargaining for market access through reduction in tariffs, the other (s) may be clamouring on the issue of possible grant of protection to domestic industries.

Before we go into the discussion on multilateral trade negotiations and the related institutions, it is relevant to understand the nature of regional as well as free trade agreements which evolve through negotiations.

Summary:
2020: Britain's Exit from European Union.
NAFA: Northern American Free Trade Agreement
It Replaced USMCA → United States - Mexico - Canada Agreement.

3.2 TAXONOMY OF REGIONAL TRADE AGREEMENTS (RTAS)

Regional Trade Agreements (RTAs) are defined as groupings of countries (not necessarily belonging to the same geographical region), which are formed with the objective of reducing barriers to trade between member countries. In other words, a regional trade agreement (RTA) is a treaty between two or more governments that define the rules of trade for all signatories. As of 1 February 2021, 339 RTAs were in force.

Trade negotiations result in different types of agreements which are shown in the chart below-

Types of RTA
- Unilateral trade agreements
- Bilateral Agreements
- Regional Preferential Trade Agreements
- Trading Bloc
- Customs union
- Common Markets
- Economic and Monetary Union

1. **Unilateral trade agreements** under which an importing country offers trade incentives in order to encourage the exporting country, to engage in international economic activities that will improve the exporting country's economy. E.g. Generalized System of Preferences.

2. **Bilateral Agreements** are agreements that set rules of trade between two countries, two blocs or a bloc and a country. These may be limited to certain goods and services or certain types of market entry barriers. E.g. EU-South Africa Free Trade Agreement; ASEAN–India Free Trade Area.

3. **Regional Preferential Trade Agreements** among a group of countries reduce trade barriers on a reciprocal and preferential basis for only the members of the group. E.g. Global System of Trade Preferences among Developing Countries (GSTP)

4. **Trading Bloc** has a group of countries that have a free trade agreement between themselves and may apply a common external tariff to other countries. Example: Arab League (AL), European Free Trade Association (EFTA)

5. **Free-trade area** is a group of countries that eliminate all tariff and quota barriers on trade with the objective of increasing exchange of goods with each other. The trade among the member states flows tariff free, but the member states maintain their own distinct external tariff with respect to imports from the rest of the world. In other words, the members retain independence in determining their tariffs with non-members.

Example: The ASEAN–India Free Trade Area (AIFTA) is a free trade area among the ten member states of the Association of Southeast Asian Nations (ASEAN) and India. it came into force on 1 August 2005

6. **A customs union** is a group of countries that eliminate all tariffs on trade among themselves but maintain a common external tariff on trade with countries outside the union (thus, technically violating MFN). The common external tariff which distinguishes a customs union from a free trade area implies that, generally, the same tariff is charged wherever a member imports goods from outside

the customs union. The EU is a Customs Union; its 27 member countries form a single territory for customs purposes. Other examples are Gulf Cooperation Council (GCC), Southern Common Market (MERCOSUR).

7. **Common Market:** A Common Market deepens a customs union by providing for the free flow of output and of factors of production (labour, capital and other productive resources) by reducing or eliminating internal tariffs on goods and by creating a common set of external tariffs. The member countries attempt to harmonize some institutional arrangements and commercial and financial laws and regulations among themselves. There are also common barriers against non-members (e.g., EU, ASEAN)

8. **Economic and Monetary Union:** For a common market, the free transit of goods and services through the borders increases the need for foreign exchange operations and results in higher financial and administrative expenses of firms operating within the region. The next stage in the integration sequence is formation of some form of monetary union. In an Economic and Monetary Union, the members share a common currency. Adoption of common currency also makes it necessary to have a strong convergence in macroeconomic policies. For example, the European Union countries implement and adopt a single currency.

There has been significant growth in international trade since the end of the Second World War, mostly due to the multilateral trade system which is both a political process and a set of political institutions. It is a political process because it is based on negotiations and bargaining among sovereign governments based on which they arrive at rules governing trade between or among themselves. The political institutions that facilitate trade negotiations, and support international trade cooperation by providing the rules of the game have been the former General Agreements on Tariffs and Trade (GATT) and the World Trade Organization (WTO).

3.3 THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

The General Agreement on Tariffs and Trade (GATT) covers international trade in goods. The workings of the GATT agreement are the responsibility of the Council for Trade in Goods (Goods Council) which is made up of representatives from all WTO member countries. The Goods Council has 10 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures, and so on). Again, these committees consist of all member countries.

Also reporting to the Goods Council are a working party on state trading enterprises, and the Information Technology Agreement (ITA) Committee.

The GATT lost its relevance by the 1980s because

- It was obsolete to the fast-evolving contemporary complex world trade scenario characterized by emerging globalisation
- International investments had expanded substantially
- Intellectual property rights and trade in services were not covered by GATT
- World merchandise trade increased by leaps and bounds and was beyond its scope.
- The ambiguities in the multilateral system could be heavily exploited
- Efforts at liberalizing agricultural trade were not successful

- There were inadequacies in institutional structure and dispute settlement system
- It was not a treaty and therefore terms of GATT were binding only insofar as they are not incoherent with a nation's domestic rules.

3.4 THE URUGUAY ROUND AND THE ESTABLISHMENT OF WTO

The need for a formal international organization which is more powerful and comprehensive was felt by many countries by late 1980s.Having settled the most ambitious negotiating agenda that covered virtually every outstanding trade policy issue, the Uruguay Round brought about the biggest reform of the world's trading system. Members established 15 groups to work on limiting restrictions in the areas of tariffs, non-tariff barriers, tropical products, natural resource products, textiles and clothing, agriculture, safeguards against sudden 'surges' in imports, subsidies, countervailing duties, trade related intellectual property restrictions, trade related investment restrictions, services and four other areas dealing with GATT itself, such as, the GATT system, dispute settlement procedures and implementation of the NTB Codes of the Tokyo Round, especially on anti-dumping.

The Round started in Punta del Este in Uruguay in September 1986 and was scheduled to be completed by December 1990. However, due to many differences and especially due to heated controversies over agriculture, no consensus was arrived at. Finally, in December 1993, the Uruguay Round, the eighth and the most ambitious and largest ever round of multilateral trade negotiations in which 123 countries participated, was completed after seven years of elaborate negotiations. The agreement was signed by most countries on April 15, 1994, and took effect on July 1, 1995. It also marked the birth of the World Trade Organization (WTO) which is the single institutional framework encompassing the GATT, as modified by the Uruguay Round.

3.5 THE WORLD TRADE ORGANIZATION (WTO)

The World Trade Organization (WTO) is the only global international organization 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 ensure that trade flows as smoothly, predictably, and freely as possible. The principal objective of the WTO is to facilitate the flow of international trade smoothly, freely, fairly, and predictably.

The WTO has six key objectives:

1. To set and enforce rules for international trade,
2. To provide a forum for negotiating and monitoring further trade liberalization,
3. To resolve trade disputes,
4. To increase the transparency of decision-making processes,
5. To cooperate with other major international economic institutions involved in global economic management, and
6. To help developing countries benefit fully from the global trading system.

The objectives of the WTO Agreements as acknowledged in the preamble of the Agreement creating the World Trade Organization, include "raising standards of living, ensuring full employment and a

large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services. The WTO, whose primary purpose is to open trade for the benefit of all, does its functions by acting as a forum for trade negotiations among member governments, administering trade agreements, reviewing national trade policies, assisting developing countries in trade policy issues, through technical assistance and training programmes and cooperating with other international organizations

3.5.1 The Structure of the WTO

The WTO activities are supported by a Secretariat located in Geneva, headed by a Director General. It has a three-tier system of decision making. The WTO's top-level decision-making body is the Ministerial Conference which can take decisions on all matters under any of the multilateral trade agreements. The Ministerial Conference meets at least once every two years. The next level is the General Council which meets several times a year at 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. These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialisation. The WTO Secretariat maintains working relations with almost 200 international organisations in activities ranging from statistics, research, standard-setting, and technical assistance and training. 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.

The WTO accounting for about 95% of world trade currently has 164 members, of which 117 are developing countries or separate customs territories. Around 24 others are negotiating membership. The WTO's agreements have been ratified in all members' parliaments.

WTO Structure:
Headquarters: · Geneva · Headed By Secretariat (Director Gen)
levels:
i. Top level: · Decision making Body · can take decision on all matters · meets atleast 2 twice a year.
ii Next level · General council · Meets several times a year @ Geneva · Meet - Trade policy Review Body - Dispute settlement Body
iii Next level: Goods council, services council, intellectual property council
Other points:
- 95% of world Trade
- 164 members: 117 developing, 47 Developed
- 24 under Negotiation

3.5.2 The Guiding Principles of World Trade Organization (WTO)

Right from its inception, the WTO has been driven by a number of fundamental principles which are the foundations of the multilateral trading system. Following are the major guiding principles:

Trade without discrimination

1. Most-favoured-nation (MFN): treating other people equally Under the WTO agreements, countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members.

This principle is known as most-favoured-nation (MFN) treatment (see box). It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

Some exceptions are allowed. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products

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that are considered to be traded unfairly from specific countries. And in services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners — whether rich or poor, weak or strong.

2. National treatment: Treating foreigners and locals equally Imported and locallyproduced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of "national treatment" (giving others the same treatment as one's own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these.

National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax. 3.5.3 Overview of the WTO agreements

Freer trade: gradually, through negotiation

Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. From time to time other issues such as red tape and exchange rate policies have also been discussed.

The WTO agreements allow countries to introduce changes gradually, through "progressive liberalization". Developing countries are usually given longer to fulfil their obligations.

Predictability: through binding and transparency

Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices.

In the WTO, when countries agree to open their markets for goods or services, they 'bind' their commitments. For goods, these bindings amount to ceilings on customs tariff rates. Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. In developed countries, the rates actually charged and the bound rates tend to be the same.

A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In agriculture, 100% of products now have bound tariffs. The result of all this: is a substantially higher degree of market security for traders and investors.

The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports — administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries' trade rules as clear and public ("transparent") as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

Promoting fair competition

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

The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.

Many of the other WTO agreements aim to support fair competition: in agriculture, intellectual property, services, for example. The agreement on government procurement (a "plurilateral" agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries. And so on.

Encouraging development and economic reform

The WTO system contributes to development. On the other hand, developing countries need flexibility in the time they take to implement the system's agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries.

Over three-quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programmes autonomously. At the same time, developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round, and they are even more so in the current Doha Development Agenda.

At the end of the Uruguay Round, developing countries were prepared to take on most of the obligations that are required of developed countries. But the agreements did give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions — particularly so for the poorest, "least-developed" countries. A ministerial decision adopted at the end of the round says better-off countries should accelerate implementing market access commitments on goods exported by the least-developed countries, and it seeks increased technical assistance for them. More recently, developed countries have started to allow dutyfree and quota-free imports for almost all products from least-developed countries. On all of this, the WTO and its members are still going through a learning process. The current Doha Development Agenda includes developing countries' concerns about the difficulties they face in implementing the Uruguay Round agreements.

3.6 THE DOHA ROUND

The Doha Round, formally the Doha Development Agenda, which is the ninth round since the Second World War was officially launched at the WTO's Fourth Ministerial Conference in Doha, Qatar, in November 2001. The round seeks to accomplish major modifications of the international trading system through lower trade barriers and revised trade rules. The negotiations include 20 areas of trade, including agriculture, services trade, market access for non-agricultural products (NAMA), trade in services, trade facilitation, environment, geographical indications and certain intellectual property issues. The most controversial topic in the Doha Agenda was agriculture trade.

3.7 G 20 ECONOMIES: FACILITATING TRADE

While some trade-restrictive measures have been lifted by G20 countries, the report indicates that the trend has been going in the wrong direction. Export restrictions contribute to shortages, price volatility, and uncertainty. G20 economies must build on their collective pledges from the 12th Ministerial Conference and demonstrate leadership to keep markets open and predictable, so that food and fertilizer in particular can flow to where they are needed," said WTO Director-General Ngozi Okonjo-Iweala, who will be attending the G20 Leaders' Summit in Bali, Indonesia, on 15-16 November.

The report indicates that supply chains on the whole have thus far proved to be resilient, despite the war in Ukraine, the continuing impacts of the COVID-19 pandemic, the highest inflation many countries have experienced in decades, and the impacts of monetary tightening by central banks seeking to limit price increases. That said, specific industries and regions have been differently impacted.

Overall, the pace of implementation of new export restrictions by WTO members has increased since 2020, first in the context of the pandemic and subsequently with the war in Ukraine and the food crisis. Some of these export restrictions have been gradually lifted, but several still remain in place.

As of mid-October 2022, WTO members still had in place 52 export restrictions on food, feed and fertilizers, in addition to 27 export restrictions on products essential to combat COVID- 19. Of these, 44% of the export restrictions on food, feed and fertilizers, and 63% of the pandemic-related export restrictions, were maintained by G20 economies.

During the review period, G20 economies introduced 66 new trade-facilitating measures (covering trade worth USD 451.8 billion) and 47 trade-restrictive measures on goods (with a trade coverage of USD 160.1 billion). These measures were not related to the pandemic.

At the same time, the accumulated stockpile of G20 import restrictions continued to grow. By mid-October, 11.6% of G20 imports were affected by trade-restricting measures implemented since 2009 and still in force.

Initiations of trade remedy investigations by G20 economies declined sharply during the review period (17 initiations), after a peak in 2020 that was the highest since the beginning of the trade monitoring exercise in 2009. Anti-dumping measures continued to be the most frequent trade remedy action in terms of initiations and terminations.

Similarly, the implementation of new COVID-19-related trade measures by G20 economies decelerated over the past five months, with four new such measures recorded on goods and one on services. The number of new COVID-19-related support measures to mitigate the social and economic impacts of the pandemic also fell sharply over the past five months.

Since the beginning of the pandemic, 201 COVID-19 trade and trade-related measures in goods were implemented by G20 economies. Most (61%) were trade facilitating, while the rest (39%) could be considered trade restrictive.

G20 economies also continued to phase out pandemic-related import and export measures. By mid-October 2022, 77% of export restrictions had been repealed, leaving 17 restrictions in place. Although the number of the pandemic-related trade restrictions in place decreased, their trade coverage remained significant, at USD 122.0 billion.

The WTO trade monitoring reports have been prepared by the WTO Secretariat since 2009. G20 members are: Argentina; Australia; Brazil; Canada; China; the European Union; France; Germany; India; Indonesia; Italy; Japan; the Republic of Korea; Mexico; the Russian Federation; Saudi Arabia; South Africa; Türkiye; the United Kingdom; and the United States.