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9. International Trade

Unit 1 : Merits of international trade.

(i) **Efficiency and Economic Growth:** International trade promotes efficiency through division of labor, economies of scale, and competition, leading to economic growth.

(ii) **Access to Markets and Resources:** Trade provides access to new markets, materials, and inputs at competitive prices, fostering innovation and consumer choice.

(iii) **Market Expansion and Technological Advancement:** Trade expands markets, encourages specialization, and drives technological innovation and investment in research and development.

(iv) **Job Creation and Economic Development:** Exports stimulate job creation, reduce poverty, and enhance standards of living, while also fostering innovation in services.

(v) **Investment and Value Addition:** Trade attracts investment, improves product quality, and enables countries to move up the global value chain.

(vi) **Market Diversification and Stability:** Trade diversifies markets, prevents overproduction, and stabilizes prices and supply during natural disasters.

(vii) **Human Resource Development:** Trade facilitates knowledge exchange and human resource development through research and best practice sharing.

(viii) **International Relations and Cooperation:** Trade strengthens bonds between nations, promotes harmony, and encourages cooperation.

Against Trade Openness:

(i) **Labor Market Concerns:** Trade can lead to negative outcomes for unskilled workers, including job displacement and wage stagnation.

(ii) **Unequal Benefits and Exploitation:** Not all nations benefit equally from trade, leading to potential economic exploitation and unequal market access.

(iii) **Environmental Concerns:** Trade can result in unsustainable production and consumption, leading to environmental damage and resource depletion.

(iv) **Threats to Domestic Industries:** Trade may harm domestic industries, threaten infant industries, and exacerbate economic crises.

(v) **Dependence and Sovereignty:** Over Reliance on foreign trade can undermine economic autonomy, political sovereignty, and cultural identity.

(vi) **Health and Social Risks:** Trade can lead to shortages, inflation, health hazards, and environmental damage due to lack of regulation.

(vii) **Investment Distortion:** Excessive export orientation may divert investments away from genuine needs.

(viii) Rivalry and Competition: Trade competition can lead to rivalry among nations instead of cooperation.

(ix) Policy Risks and Uncertainty: Lack of transparency and predictability in trade policies can pose risks to trading partners

Important theories of international trade

Mercantilism

- Policy of Europe's great power
- According to this belief, a country can become rich by exporting more and importing less.
- Larger the stock of precious metal like gold and silver , Richer the country become According to them international trade is a zero sum game which means winners win at the cost of losers
- In simple words one country's gain is equal to another country's loss therefore net benefit from international trade will be zero
- Mercantilism was a belief that a country's wealth and power came from exporting more than it imported, especially collecting gold and silver.
- Imagine if a country only sold its goods to others but hardly bought anything from them.
- This idea thought that if a country got more gold and silver, it would be richer.
- For instance, imagine Country A only sells cars to Country B but doesn't buy anything from Country B. According to mercantilism, Country A would get richer by getting gold or silver from Country B for its cars, while Country B would lose out because it wouldn't be gaining much in return.
- But later, economists found flaws in this idea, showing that it's not the only way to grow a country's wealth, even though some big and fast-growing economies in Asia still follow similar policies.

Adam Smith absolute cost advantage theory

The theory of absolute advantage, proposed by Adam Smith, suggests that countries should specialize in producing goods they can make most efficiently, and then trade with other countries for goods they can't produce as efficiently.

Adam Smith argued that international trade can benefit countries. He believed that each country should specialize in producing goods where they have an absolute advantage, meaning they can produce those goods at a lower cost than other countries. This can be explained using a simple example:

Output per Hour of Labor

• Commodity	Country A	Country B
• Wheat	6 units	1 unit
• Cloth	4 units	5 units

In this example, Country A can produce 6 units of wheat or 4 units of cloth per hour of labor, while Country B can produce only 1 unit of wheat or 5 units of cloth. So, Country A has an absolute advantage in producing wheat, and Country B has an absolute advantage in producing cloth. This means they can specialize in these goods and trade with each other they both can benefit from international trade.

If they keep international terms of trade as one wheat is equal to 1 cloth
Country A gets 4 cloth against 6 wheat in the domestic market but internationally will get 6 clothes against 6 wheat. They can get two extra clothes from international trade.

Whereas in country B, one wheat is equal to 5 clothes which means to get 6 wheat from the domestic market they have to give 30 clothes but from the international market they can get 6 wheat by giving only 6 clothes so their benefit is saving of 24 clothes.

David ricardo's comparative cost advantage theory

According to David recordo, " the essence of international Trade is not absolute cost advantage but it is comparative cost advantage".

The theory of comparative advantage, developed by David Ricardo, says that even if one country is worse at making everything than another country, they can still benefit from trading with each other.

Each country should focus on making and selling the things they are relatively better at producing, even if they aren't the best at making anything.

Cost = 1 Labour hour

Commodity	Country A	Country B
Wheat	6 units	1 unit
Clothes	4 units	2 units

In this example, Country A can produce 6 units of wheat or 4 units of cloth per hour of labor, while Country B can produce only 1 unit of wheat or 2 units of cloth. So, Country A has an absolute advantage in producing wheat as well as cloth.

This means according to Adam Smith absolute cost advantage theory international trade between these to country is not possible

But according to David record even though country B has disadvantage of cost in production of both the commodities still both countries can participate into international trade and get benefit through comparative cost advantage.

In the above example country A has a comparative cost advantage in production of wheat rather than cloth. Whereas country B has a comparative cost advantage in production of cloth than wheat.

And country A will focus on production of wheat and country B will focus and try to get specialized in production of cloth.

If they keep international terms of trade as one wheat is equal to 1 cloth
Country A gets 6 cloth against 6 wheat in the domestic market but internationally will get 6 clothes against 6 wheat. They can get two extra clothes from international trade.

Whereas in country B, one wheat is equal to 2 clothes which means to get 6 wheat from the domestic market they have to give 12 clothes but from the international market they can get 6 wheat by giving only 6 clothes so their benefit is saving 6 clothes.

The theory of comparative advantage, introduced by Haberler in 1936, revolutionized our understanding of international trade by focusing on the concept of opportunity cost.

Opportunity cost represents the value of the next best alternative foregone when a decision is made. It's a fundamental concept in microeconomics, illustrating the trade-offs inherent in decision-making.

According to the theory of comparative advantage, the cost of producing one unit of a good is measured not just in monetary terms but also in terms of the amount of another good that could have been produced with the same resources. This is crucial because it allows countries to specialize in producing goods in which they have a lower opportunity cost, leading to more efficient resource allocation and higher overall productivity.

Let's illustrate this with an example:

Cost is 1 Labour hour

Commodity	Country A	Country B
Wheat	6 units	1 unit
Cloth	4 units	2 units

In country A, to produce one additional unit of wheat domestically, it must give up two-thirds of a unit of cloth. On the other hand, in country B, to produce one additional unit of wheat, it must give up two units of cloth.

This means that the opportunity cost of producing wheat is lower in country A compared to country B. Therefore, country A has a comparative advantage in producing wheat, while country B has a comparative advantage in producing cloth.

Now, if country A specializes in producing wheat and country B specializes in producing cloth, they can trade with each other to obtain the goods they don't produce efficiently. Country A can export wheat to country B in exchange for cloth, and vice versa. Through this specialization and trade, both countries can consume more of both goods than if they had tried to produce everything domestically.

This example demonstrates how the theory of comparative advantage leads to mutually beneficial trade between countries, allowing them to maximize their consumption possibilities and achieve higher levels of welfare.

However, it's important to note that the theory of comparative advantage has its limitations. It focuses primarily on supply-side factors and assumes that resources are fully mobile between different sectors within a country. It also does not consider factors such as differences in technology, resource endowments, or government policies that can affect a country's comparative advantage.

The Heckscher-Ohlin theory, also known as the factor endowment theory and the factor-proportions theory, builds upon the theory of comparative advantage by considering differences in factor endowments between countries. The theory suggests that countries will export goods that intensively use the factors of production they possess in abundance and import goods that use factors of production they have in scarcity.

Key components of the Heckscher-Ohlin theory include:

Factors of Production: The theory identifies two primary factors of production: labor and capital. Countries are assumed to differ in the relative abundance of these factors. For example, a country with abundant capital but scarce labor will specialize in producing goods that require relatively more capital, and vice versa.

Factor Intensity: Goods can be classified based on the intensity of the factors of production they require. For instance, labor-intensive goods require more labor relative to capital, while capital-intensive goods require more capital relative to labor.

Factor Endowments: Countries have different endowments of factors of production. Some countries may have a relatively high abundance of labor compared to capital, while others may have the opposite. These differences in factor endowments drive comparative advantages in production.

Production Possibilities: Countries will specialize in producing goods that make the most efficient use of their abundant factors of production. This specialization allows countries to maximize their production possibilities and achieve higher levels of output and consumption.

Trade Patterns: According to the Heckscher-Ohlin theory, countries will export goods that intensively use their abundant factors of production and import goods that intensively use their scarce factors of production. This leads to patterns of trade based on differences in factor endowments between countries.

Overall, the Heckscher-Ohlin theory provides a more nuanced understanding of international trade by incorporating factors of production and factor endowments into the analysis. It helps explain why countries specialize in producing certain goods and how trade can lead to mutual gains by allowing countries to exploit their comparative advantages based on differences in factor endowments.

New Trade Theory (NTT) is an economic idea from the 1970s that helps us understand why countries trade certain goods and services, even if they make similar things themselves. Imagine India and another big country both make cars. Even though India makes cars, we still buy cars from other countries. Why? Because of NTT!

NTT says that because of things like making a lot of something (economies of scale) and how popular something is (network effects), it makes sense for countries to trade even if they make similar stuff. Let's break it down with examples:

Economies of Scale: Imagine a company that makes phones. The more phones it makes, the cheaper each one costs to make. So, if it sells phones not just in its own country but also in other countries, it can make a lot more phones and make more profit because each phone costs less to make. This means big companies can make a lot of phones and sell them cheaper, which is good for buyers.

Network Effects: Think about popular apps like WhatsApp. The more people use it, the more valuable it becomes. If only a few people used WhatsApp, it wouldn't be as useful because you couldn't chat with many people. But because so many people use it, it's very valuable. This is called a network effect. So, even if there are similar apps, people prefer to use WhatsApp because all their friends are already using it, making it more useful.

So, NTT says that because of these two things, countries trade even if they make similar products. It's like a big competition, and the countries that can make a lot of things cheaply and have products that lots of people want will do well in the international market.

Unit 2

Tariffs, also known as customs duties, play a crucial role in international trade by imposing taxes on goods and services imported or exported between countries. They are essentially financial charges imposed at the border, influencing the cost of imported goods in the domestic market. Tariffs come in different forms, with specific and ad valorem tariffs being the most common.

Specific tariffs are fixed amounts of money per physical unit or based on the weight or measurement of the commodity being imported or exported. For example, a specific tariff of ₹ 1000/ may be

imposed on each imported bicycle. However, the disadvantage of specific tariffs is that their protective value can diminish with changes in the price of the imported goods. For instance, if the price of an imported bicycle doubles due to inflation, the specific tariff remains the same, resulting in a lower percentage of the import's value being taxed.

On the other hand, ad valorem tariffs are levied as a fixed percentage of the value of the traded commodity. For example, a 20% ad valorem tariff on bicycles means that a constant percentage of the bicycle's monetary value is paid as a tariff. So, if a bicycle priced at 5,000/ is subject to a 20% ad valorem tariff, 1000/ would be paid on each bicycle. If the price of the bicycle rises to 10,000/, the tariff payment would increase to 2,000/.

Both specific and ad valorem tariffs serve as tools for governments to achieve various objectives, including raising revenue and protecting domestic industries. By altering the relative prices of imported goods, tariffs aim to regulate the volume of imports, stimulate domestic production, and safeguard local industries from foreign competition.

Overall, tariffs are integral to shaping the dynamics of international trade, impacting the competitiveness of goods in the global market and influencing the economic prosperity of nations.

There are various variations of tariff.

Mixed Tariffs: These tariffs can be based on either the value of imported goods or a specific measure, whichever generates more income for the nation. For example, duty on cotton could be 5% of its value or a fixed amount per tonne, whichever is higher.

Compound Tariffs: These tariffs combine both a percentage of the value of imported goods and a fixed amount. For example, duty on cheese could be 5% of its value plus a fixed amount per kilogram.

Technical/Other Tariffs: These tariffs are based on specific aspects of the imported goods, like their components. For example, a tariff could be charged on each solar panel plus an additional amount per kilogram for the battery.

Tariff Rate Quotas (TRQs): These combine quotas and tariffs. Goods within a certain quota face lower tariffs, while those above the quota face higher tariffs.

Most-Favoured Nation Tariffs (MFN): These are the tariffs countries promise to impose on imports from other World Trade Organization (WTO) members, usually at the highest rate.

Variable Tariffs: These tariffs adjust to match domestic support prices for imported goods.

Preferential Tariffs: These lower tariffs are given to certain countries under trade agreements.

Bound Tariffs: These are maximum tariff levels agreed upon by WTO members.

Applied Tariffs: The actual tariffs charged on imports.

Escalated Tariff Structure: Tariffs increase as goods move through the production process.

Prohibitive Tariffs: Extremely high tariffs that effectively block imports.

Import Subsidies: Payments or reductions given to importers.

Tariffs as Response to Trade Distortions: Tariffs imposed in response to unfair trade practices.

Anti-dumping Duties: Tariffs to counteract goods sold below fair market value.

Countervailing Duties: Tariffs to offset advantages gained from foreign government subsidies.

Effects of tariff

1. **Reduced Trade:** Tariffs make it harder to trade between countries by adding taxes on imported goods. This means fewer goods are bought and sold internationally.
2. **Higher Prices:** When imported goods cost more due to tariffs, people buy less of them. This means consumers pay more for the same products, and they might buy fewer of them as well.
3. **Protection for Domestic Industries:** Tariffs can help local industries by making foreign products more expensive. This encourages people to buy locally made goods instead, protecting domestic jobs and industries.
4. **Benefits for Producers:** Domestic producers can charge higher prices for their goods because there's less competition from cheaper imports. This boosts their profits.
5. **More Jobs:** When domestic industries thrive due to tariffs, they might need more workers to meet the demand for their products. So, tariffs can increase employment in certain industries.
6. **Disruption of Efficiency:** Tariffs can lead countries to produce things they're not very good at making, instead of focusing on what they're best at. This can make the global economy less efficient overall.
7. **Government Revenue:** Tariffs bring in money for the government, as they collect taxes on imported goods.

In recent years, countries have been focusing less on tariffs and more on other ways to control trade, like non-tariff measures (NTMs). These can also limit trade, and they're becoming more common. So, even though tariffs are less important now, other trade barriers are taking their place.

Non-tariff measures (NTMs)

Non-tariff measures (NTMs) are rules and regulations, besides tariffs, that can affect international trade by changing the quantity or price of goods traded. These measures can be anything from laws to standards that either make trade easier or harder. They're set by governments and can include things like product standards or health regulations. Sometimes, these measures are used to protect local industries from foreign competition, which is called non-tariff barriers (NTBs). NTBs are a type of NTM with a bias towards domestic businesses. However, not all NTMs are meant to be unfair; some are legitimate regulations necessary for safety or quality. It's often tricky to tell the difference between fair and unfair NTMs because the same rule might serve multiple purposes.

Depending on their scope and/or design NTMs are categorized as:

Technical Measures: These are rules or standards that focus on specific aspects of a product, like how it's made, what it contains, and how it's labeled. They're meant to make sure products are safe, high-quality, and don't harm the environment or people.

A) **Sanitary and Phytosanitary (SPS) Measures:** These rules are all about protecting human, animal, and plant health. They cover things like banning certain imports to prevent diseases, setting standards for how food is processed to keep it safe, and limiting the amount of harmful chemicals in food.

B) **Technical Barriers to Trade (TBT):** These rules define exactly what a product should be like, from its size and shape to how it's packaged and labeled. They also include the procedures for checking if a product meets these requirements, like testing and certification. These rules are important for ensuring products are safe and meet certain standards, but they can also make it harder for imports to enter a country, which can protect domestic products but might also make it tough for exporters to compete.

In simpler terms, technical measures make sure products are safe and high-quality, but they can also make it harder for products from other countries to come in, which can be good or bad depending on the situation.

Non technical Measures

Non-technical measures in trade are about the rules and requirements for trading goods, like how they're shipped, customs paperwork, trade regulations, and taxes.

These measures can be divided into different types:

Hard measures: These are concrete rules that directly control prices or quantities of goods, like setting a specific price or limiting how much of a product can be imported.

Threat measures: These are actions taken to protect a country's industries from unfair practices, like dumping goods at unfairly low prices or safeguarding industries from sudden surges in imports.

Other measures: These include things like trade-related financial policies and rules about investment.

Additionally, these measures can be either:

(i) Import-related: These are rules imposed by the country where the goods are being brought in.

(ii) Export-related: These are rules imposed by the country that's sending out the goods.

i) Import related non tariff Measures

Import Quotas: These are limits on how much of a certain product can be brought into a country within a specific time, usually a year. If the limit is set lower than what would be freely traded, it can raise the prices of imported goods, benefiting domestic producers but making things more expensive for consumers.

Price Control Measures: These are steps taken to keep the prices of imported goods from getting too low. For example, imposing taxes or charges to make imports more expensive and support the prices of domestic products.

Non-automatic Licensing and Prohibitions: These are rules that limit the amount of certain goods that can be brought into a country, regardless of where they come from. This could involve needing special permission to import certain items or completely banning their import.

Financial Measures: These measures aim to increase the cost of imports by regulating how foreign currency can be used to buy them, like requiring payment in advance or limiting the use of foreign currency for certain imports.

Measures Affecting Competition: These measures give certain groups special advantages in trade, like exclusive rights to import certain goods or using only national services for certain tasks.

Government Procurement Policies: These policies require governments to buy a certain percentage of goods from domestic companies, even if they cost more than foreign alternatives.

Trade-Related Investment Measures: These rules require a portion of the final product to be made domestically or restrict the level of imported parts used.

Distribution Restrictions: These are rules that control how imported goods are sold in the country, like requiring specific licenses or only allowing certain types of sellers to distribute them.

Restriction on Post-sales Services: These rules limit who can provide services for imported goods after they've been sold, often favoring local service providers.

Administrative Procedures: These are time-consuming and costly processes required for importing goods, like getting licenses or dealing with customs paperwork, which can discourage imports and benefit domestic industries.

Rules of Origin: These are criteria used by importing countries to determine where a product comes from, which can affect duties and restrictions on imports.

Safeguard Measures: These are temporary restrictions on imports when domestic industries are harmed by a sudden increase in imports.

Embargos: These are complete bans on importing or exporting certain goods to specific countries or regions, often for political or health reasons.

These measures can impact international trade by either making it easier or harder for goods to move between countries, affecting prices, competition, and the overall economy.

ii) Export related non tariff measures

Ban on exports: This means a government stops or restricts the export of certain goods, like onions or wheat, especially when there's a shortage in the country. For instance, if a country doesn't have enough wheat for its people, it might ban exporting wheat so that more is available for its citizens.

Export Taxes: This is a tax collected on goods being exported out of a country. Imagine a country sells oranges abroad and puts a tax on each orange exported. This tax makes oranges more expensive for foreign buyers and reduces the number of oranges being sold overseas.

Export Subsidies and Incentives: Governments sometimes give benefits or financial support to companies that export goods. For example, a government might give money to a company that sells cars overseas to help them compete with other carmakers from different countries.

Voluntary Export Restraints (VERs): This happens when a country agrees to limit the amount of goods it exports to another country. It's like when a company agrees to only sell a certain number of products to another company. For instance, if Country A is selling a lot of TVs to Country B, Country A might agree to sell fewer TVs to Country B to avoid causing problems.

Overall, these measures can impact both domestic and international markets, affecting prices, supply, and demand for various goods.

Unit 3

Various Types of Regional Trade Agreements

Unilateral Trade Agreements: These are deals where one country offers trade benefits to another country to encourage them to boost their international trade and improve their economy. An example is the Generalized System of Preferences.

Bilateral Agreements: These are agreements between two countries or blocs that set rules for trading certain goods or services and may involve reducing barriers to market entry. Examples include the EU-South Africa Free Trade Agreement and ASEAN–India Free Trade Area.

Regional Preferential Trade Agreements: These agreements involve a group of countries reducing trade barriers among themselves on a preferential basis. Only members of the group benefit from these reduced barriers. An example is the Global System of Trade Preferences among Developing Countries (GSTP).

Trading Bloc: This refers to a group of countries that have a free trade agreement among themselves and may also apply the same external tariffs to other countries. Examples include the Arab League (AL) and the European Free Trade Association (EFTA).

Free Trade Area: A group of countries in a free trade area eliminate tariffs and quotas on trade among themselves while maintaining their own tariffs on trade with non-members. The USMCA is an example.

Customs Union: In a customs union, countries eliminate tariffs on trade among themselves but maintain a common external tariff on trade with countries outside the union. Examples include the European Union and the Gulf Cooperation Council (GCC).

Common Market: This goes beyond a customs union by allowing the free movement of goods, services, and factors of production (like labor and capital) among member countries. There are also common barriers against non-members. Examples include the EU and ASEAN.

Economic and Monetary Union: This involves sharing a common currency among member countries, which requires closer coordination of economic policies. An example is the European Union's adoption of the euro.

The General Agreement on Tariffs and Trade (GATT) played a significant role in shaping international trade relations from 1948 to 1994. It served as a framework for negotiations aimed at reducing barriers to international trade and promoting economic cooperation among nations.

Origins of GATT: GATT emerged from the post-World War II efforts to rebuild the global economy and prevent the kind of protectionism that had contributed to the Great Depression. It aimed to create a forum for countries to negotiate trade agreements and reduce tariffs and other barriers to trade.

Multilateral Negotiations: GATT operated through a series of multilateral negotiations, often referred to as "trade rounds." These rounds involved member countries coming together to negotiate agreements on various aspects of trade policy, such as tariff reductions, dispute resolution mechanisms, and rules governing trade practices like dumping and subsidies.

Evolution of Trade Rounds:

Early Rounds: The early rounds of GATT focused primarily on reducing tariffs. However, as the global economy evolved, subsequent rounds addressed a broader range of issues, including non-tariff barriers to trade and trade in services.

Kennedy Round: Held in the mid-1960s, the Kennedy Round resulted in significant tariff reductions among participating countries.

Tokyo Round: In the 1970s, the Tokyo Round further liberalized international trade by addressing non-tariff barriers, such as quotas and import licensing requirements.

Uruguay Round: The Uruguay Round, spanning from 1986 to 1994, was the most comprehensive and consequential of all GATT rounds. It led to the establishment of the World Trade Organization (WTO) and the creation of new agreements covering services, intellectual property, agriculture, and trade-related aspects of intellectual property rights (TRIPS).

Transition to WTO: The failure to establish the International Trade Organization (ITO) alongside the World Bank and the International Monetary Fund (IMF) led to the strengthening of GATT and ultimately the creation of the WTO. The WTO, established in 1995, replaced GATT as the primary international body governing trade.

Legacy and Impact: The GATT negotiations resulted in significant reductions in trade barriers, contributing to the expansion of global trade and economic growth. However, challenges such as protectionism, trade disputes, and disparities in economic development continue to shape international trade relations.

Overall, GATT's evolution and the subsequent establishment of the WTO represent significant milestones in the promotion of international trade and economic cooperation. These institutions continue to play a crucial role in facilitating trade negotiations, resolving disputes, and promoting a rules-based international trading system
The General Agreement on Tariffs and Trade (GATT) indeed faced numerous challenges by the 1980s, which ultimately led to its diminished relevance:

Obsolete Framework: GATT's framework was ill-equipped to handle the complexities of a rapidly globalizing world economy. For instance, the rise of global supply chains and the increasing interdependence of economies required a more comprehensive and adaptable trade regime.

Expanding International Investments: As international investments grew, GATT's focus solely on tariffs and trade in goods became insufficient. Issues such as investment protection and trade in services were not adequately addressed under GATT.

Lack of Coverage for Intellectual Property and Services: GATT did not provide adequate protection for intellectual property rights or regulations for trade in services. This omission became increasingly problematic as these sectors became more significant in global trade.

Scope Limitations: GATT's scope was limited primarily to merchandise trade, failing to address emerging areas such as digital trade and non-tariff barriers, which became prominent features of the global trade landscape.

Ambiguities and Exploitation: The ambiguities within GATT's multilateral system allowed countries to exploit loopholes, undermining the effectiveness of its provisions. This led to trade disputes and challenges in enforcement.

Institutional Inadequacies: GATT's institutional structure and dispute settlement system were not robust enough to handle the growing complexities and disputes in global trade. This lack of effectiveness weakened its credibility and enforcement mechanisms.

Non-binding Nature: GATT was not a treaty but rather a provisional agreement, which meant its terms were only binding to the extent that they did not conflict with a nation's domestic laws. This made enforcement challenging and led to inconsistencies in trade practices across nations.

WORLD TRADE ORGANISATION

The WTO replaced the GATT and manages global trade. Its main aim is to make international trade run smoothly and fairly. It achieves this by setting rules for trade, providing a platform for countries to discuss and negotiate further trade agreements, resolving disputes between nations regarding trade, ensuring transparency in decision-making processes, collaborating with other international economic institutions, and assisting developing countries in navigating trade policies through technical support and training. The ultimate goal is to improve living standards, employment, income, and trade in goods and services worldwide.

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 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

Principles of WTO agreements.

Trade without discrimination (MFN): This means treating all trading partners equally. For example, if Country A reduces tariffs on cars from Country B, it must also do the same for cars from Country C.

National Treatment Principle (NTP): This principle ensures that foreign products are treated the same as domestic ones. For instance, once imported apples are in a country, they should be treated equally in terms of marketing and visibility as locally produced apples.

Free trade: This involves lowering barriers like tariffs to encourage more trade. Countries gradually make changes to their trade policies to open up markets. Developing countries often get more time to adapt.

Predictability: Businesses want stability, so WTO encourages stable trade policies. Tariff rates are "bound," meaning they can't be raised suddenly without negotiation. This helps investors feel confident about long-term trade.

Prohibition of quantitative restrictions: This means limiting the use of restrictions like quotas, which can distort trade more than tariffs.

Greater competitiveness: WTO discourages unfair practices like export subsidies or dumping (selling goods below cost). It sets rules to define what's fair and allows action against unfair trade.

Tariffs for protecting domestic industries: Tariffs are allowed for protection, but they should be reduced gradually. Members agree on maximum rates and can't raise tariffs beyond that without negotiation.

Transparency in Decision Making: WTO decisions affecting trade must be transparent and shared with all members. Any objections must be addressed, and affected members compensated if necessary.

Progressive Liberalization: Controversial trade issues are left for future rounds of discussion to liberalize gradually.

Market Access: WTO aims to increase trade by converting non-tariff barriers into tariffs. Specific targets are set in agreements like the Agreement on Agriculture.

Special privileges for less developed countries: Developing countries get flexibility and transition periods to adjust to WTO rules.

Protection of Health & Environment: WTO supports measures to protect health and the environment, as long as they're not discriminatory or used as a cover for protectionism.

Dispute settlement mechanism: Disputes are resolved through consultation and a structured process involving expert panels. The decisions are final and binding.

THE DOHA ROUND

The Doha Round, also known as the Doha Development Agenda, is the ninth round of negotiations under the World Trade Organization (WTO). Launched in 2001, its primary goal is to make significant changes to the global trading system by reducing trade barriers and updating trade regulations. This round covers various areas of trade, including agriculture, services, non-agricultural market access, trade facilitation, environment, geographical indications, and intellectual property. Agriculture trade has been particularly contentious within the negotiations, highlighting the challenges and complexities of addressing trade issues on a global scale.

25 YEARS OF THE WTO ACHEIVEMENTS AND CONCERNS

WTO's Impact on Trade:

- World trade in goods and services has grown significantly.
- Dollar value of world trade increased by almost four times since 1995.
- Real volume of world trade expanded by 2.7 times, surpassing the growth of world GDP.

Tariff Reduction:

- Average tariffs decreased by almost half, from 10.5% to 6.4%.

Global Value Chains (GVCs):

- GVCs expanded due to predictable market conditions and improved communication.
- Businesses can now move components and services across locations easily.
- GVC trade accounts for nearly 70% of total merchandise trade.
- Impact on Developing Economies:
- GVCs facilitated catch-up growth in developing economies.
- Increased purchasing power and consumer choice globally.

WTO Accession and Reforms:

- Economies joining WTO underwent reforms and market-opening commitments.
- Research suggests lasting income boost for these economies.

Poverty Reduction:

- Fastest poverty reduction in history over the past 25 years.
- Extreme poverty rate dropped from over one in three people to less than 10%.

the problems and challenges faced by the World Trade Organization (WTO) and the global trading system:

- Negotiating trade deals among many countries is slow and hard because everyone needs to agree, so countries are turning to regional agreements instead.
- Regional deals make the global trade system unclear and uncertain.
- While tariffs on manufactured goods have gone down, things like agriculture and textiles still have high tariffs.
- Big trade deals like the Doha Round are stuck and might not succeed.
- Many countries, especially poorer ones, are unhappy with the WTO because it hasn't delivered on its promises to boost global trade.
- Developing countries have lots of complaints, like not getting fair access to markets, facing high tariffs, and struggling to follow the WTO's rules.
- There are also new problems, like some countries putting tariffs on imports and others retaliating, which makes trade uncertain.
- Some big players, like the U.S. and China, are breaking the rules by putting tariffs on goods and using "national security" as an excuse.
- The system for settling trade disputes is stuck because there aren't enough people to make decisions.

Exchange rate

Foreign Exchange: Money denominated in a currency other than the domestic currency.

Exchange Rate: The price of one currency expressed in terms of units of another currency.

Representation: Represents the number of units of one currency that exchanges for a unit of another.

Definition: It's the rate at which the currency of one country is exchanged for the currency of another country.

Minimum Units: Indicates the minimum number of units of one country's currency required to purchase one unit of the other country's currency.

Relative Value: The value of a currency is always given in terms of another currency, making it relative.

Direct Quote: Also known as European Currency Quotation, it's the number of units of a local currency exchangeable for one unit of a foreign currency.

Example: 76/US$ means that ₹76 is needed to buy one US dollar or ₹76 will be received while selling one US dollar.

Indirect Quote: Also known as American Currency Quotation, it's the number of units of a foreign currency exchangeable for one unit of local currency.

Example: $0.0151 per rupee indicates that $0.0151 is needed to buy one Indian Rupee.

Conversion: A quotation in direct form can be converted into a quotation in indirect form, and vice versa, by taking the reciprocal of the given rate.

Think of exchange rates like prices for different currencies. There are two main currencies in an exchange rate: the one you have (which you want to exchange) and the one you want to get in return.

In a direct quotation, you're saying how much of the foreign currency you can get for one unit of your own currency. For example, if you're in the US and want to know how many euros you can get for one US dollar, that's a direct quotation.

In an indirect quotation, it's the opposite. You're saying how much of your own currency you need to get one unit of the foreign currency. So, if you're in the US and want to know how many US dollars you need to get one euro, that's an indirect quotation.

Sometimes, you might not have a direct exchange rate between two currencies, but you have rates between each of them and a common currency. You can use these rates to figure out the exchange rate between the two currencies directly. This is called a "cross rate".

Now, when you go to exchange money, you'll see two rates: the selling rate and the buying rate. The selling rate is what the currency exchange place will give you if you're selling your currency to them. The buying rate is what they'll charge you if you're buying their currency. Usually, the selling rate is higher because the exchange place needs to make a profit.

Exchange rate regimes

Floating Exchange Rate: The value of the currency is decided by the market – demand and supply. The government or central bank doesn't set a specific rate. They might step in to prevent big changes but don't control the rate directly. Most big countries follow this, like the US and many others.

Fixed Exchange Rate: Here, the government or central bank decides the value of the currency compared to another currency or a set measure, like gold. They actively control the rate by buying or selling their own currency to keep it stable. Some countries, like China, use this system.

There are also in-between systems where the exchange rate is somewhat flexible, but the government still plays a role in keeping it stable. These systems vary in how much control the government has over the exchange rate.

When a government intervenes
in the foreign exchange market so that the exchange rate of its currency is different from what the market forces of demand and supply would have decided, it is said to have established a “peg” for its currency). In order to sustain a fixed exchange rate, it is not enough that a country pronounces a fixed parity: it must also make concentrated efforts to defend that parity by being willing to buy (or sell) foreign reserves whenever the market demand for foreign currency is lesser (or greater) than the supply of foreign currency. In other words, in order to maintain the exchange rate at the predetermined level, the central bank intervenes in the foreign exchange market.

In an open economy, the choice between fixed and flexible exchange rate regimes entails various advantages and disadvantages, each impacting economic stability, policy flexibility, and trade dynamics differently.

Fixed Exchange Rate Regime Advantages:

Stability: A fixed exchange rate regime provides stability by pegging the value of the domestic currency to a foreign currency or a basket of currencies. This stability reduces uncertainty for businesses engaged in international trade and investment, as they can predict exchange rates with greater certainty.

Reduced Exchange Rate Risk: Businesses and investors are shielded from exchange rate fluctuations, eliminating the risk of currency devaluation or appreciation affecting profits and investment returns.

Enhanced Trade and Investment: The stability offered by a fixed exchange rate regime can foster increased international trade and investment since businesses are more willing to engage in cross-border transactions without the fear of currency fluctuations impacting their bottom line.

Monetary Discipline: Under a fixed exchange rate system, the central bank is constrained in its ability to manipulate the money supply to control inflation. This discipline can lead to lower inflation rates, as the central bank must maintain the exchange rate peg by adjusting interest rates and managing foreign exchange reserves effectively.

Flexible Exchange Rate Regime Advantages:

Monetary Policy Autonomy: In a floating exchange rate regime, the central bank has full control over its monetary policy, allowing it to adjust interest rates and money supply according to domestic economic conditions without being bound by the need to maintain a specific exchange rate target.

Policy Flexibility: Policy-makers can use the exchange rate as a policy tool to influence the competitiveness of the tradable goods sector. For example, they can adjust the nominal exchange rate to stimulate exports or curb imports.

Reduced Intervention Needs: Since the exchange rate is determined by market forces in a flexible regime, there's less need for central bank intervention in currency markets, reducing the burden of maintaining large foreign exchange reserves.

Market Efficiency: Floating exchange rates allow the market to clear imbalances in the foreign exchange market without the need for central bank intervention, leading to greater market efficiency.

Disadvantages of Flexible Exchange Rate Regime:

Uncertainty: The main drawback of a flexible exchange rate regime is the volatility it introduces, leading to uncertainty for businesses engaged in international transactions. Fluctuating exchange rates can increase the risk premium on cross-border trade and investments, impacting profitability and investment decisions.

In summary, the choice between fixed and flexible exchange rate regimes involves trade-offs between stability and flexibility. While a fixed exchange rate regime provides stability and credibility, it sacrifices policy flexibility. Conversely, a flexible exchange rate regime offers policy autonomy and market efficiency but comes with increased uncertainty and risk. Countries must carefully consider their economic priorities and external circumstances when choosing between these two regimes.

Nominal Exchange Rate:

- The nominal exchange rate is the rate at which one currency can be exchanged for another.
- It's essentially the price of one currency in terms of another. For example, if 1 US dollar can be exchanged for 100 Japanese yen, the nominal exchange rate would be 1 USD = 100 JPY.
- Nominal exchange rates are what you typically see quoted in the financial news and are used for transactions in the foreign exchange market.

Real Exchange Rate:

- The real exchange rate takes into account the relative prices of goods and services between two countries.
- It tells you how much of a good or service in one country can be exchanged for the same amount of a good or service in another country, after adjusting for differences in price levels.
- In essence, it reflects the purchasing power of one currency relative to another.
- The real exchange rate is calculated by adjusting the nominal exchange rate for the relative price levels of the two countries.

Importance:

- While nominal exchange rates are important for international trade and financial transactions, real exchange rates are crucial for understanding competitiveness and trade flows.
- Real exchange rates affect a country's competitiveness in international markets. If the real exchange rate is high, it means that domestic goods and services are relatively expensive compared to foreign goods and services, which can hurt exports and boost imports.
- On the other hand, a low real exchange rate can make domestic goods and services cheaper for foreigners, potentially boosting exports and reducing imports.

Calculating Real Exchange Rate:

- To calculate the real exchange rate, you need to adjust the nominal exchange rate for differences in price levels between the two countries.
- This adjustment can be done using a price index or inflation rates. The formula for calculating the real exchange rate is:

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

  OR

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

  OR

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

- Essentially, it compares the relative cost of a basket of goods in one country to the cost of the same basket of goods in another country, using the nominal exchange rate as a conversion factor.
- In summary, while nominal exchange rates are important for transactions and financial markets, real exchange rates provide a more accurate picture of the true value of one currency relative to another, considering differences in price levels between countries.

Foreign Exchange Market

The foreign exchange market is like a big marketplace where people trade different currencies. It's not a physical place but more like an online network where banks, dealers, and brokers connect to buy and sell currencies. People participate in this market to exchange one currency for another, like trading dollars for euros. It's the biggest market in the world for trading money.

People involved include big institutions like central banks, commercial banks, governments, and companies that do business internationally. They use this market to manage their money and deal with currency fluctuations.

Some people, like speculators, try to make money by predicting how currency values will change. Others, like banks, trade currencies for themselves or their clients.

The prices of currencies change all the time, and people can make money by buying currencies in one place where they're cheaper and selling them where they're more expensive. This helps keep the prices of currencies similar everywhere.

There are two main types of transactions: spot transactions, where you exchange money right away, and future transactions, where you agree to exchange money at a later date.

The U.S. dollar is often used in these transactions because it's widely accepted and stable. That's why it's called a "vehicle currency" in the foreign exchange market.

Determination of nominal exchange rate

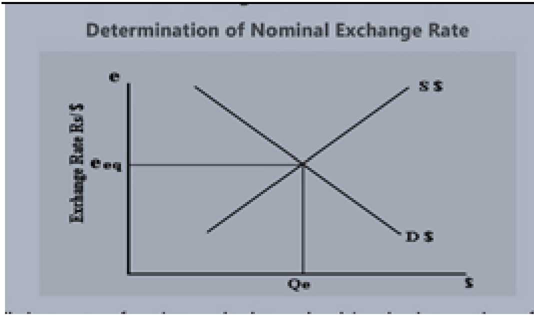
As you already know, the key framework for analysing prices is the operation of forces of supply and demand in markets. Usually, the supply of and demand for foreign exchange in the domestic foreign exchange market determine the external value of the domestic currency, or in other words, a country's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

The participants on the supply side operate for similar reasons. Thus, the supply of foreign currency to the home country results from purchases of home exports, unilateral transfers to home country, investment income payments, foreign direct investments and portfolio investments, placement of bank deposits and
speculation.

We shall now look into how the foreign exchange markets work. Similar to any standard market, the exchange market also faces a downward-sloping demand curve and an upward-sloping supply curve.



The equilibrium rate of exchange is determined by the interaction of the supply and demand for a particular foreign currency. In figure 4.4.1, the demand curve (D$) and supply curve (S$) of dollars intersect to determine equilibrium exchange rate eq with Qe as the equilibrium quantity of dollars exchanged

Devaluation and revaluation are deliberate changes in a country's currency value, often fixed. Depreciation and appreciation are changes driven by market demand under a floating exchange rate, not government actions.

impacts of exchange rate fluctuations on the domestic economy:

Trade Volume: Exchange rate changes affect import and export prices, leading to changes in trade volumes and spending.

Relative Prices: Appreciation or depreciation of a currency affects the relative prices of domestically-produced and foreign-produced goods, influencing consumption and production patterns.

Economic Activity: Depreciation can stimulate economic activity by increasing demand for domestic goods and promoting exports.

Export Competitiveness: Currency depreciation can enhance the competitiveness of domestic industries, leading to increased export volumes and potentially improving trade balance.

Cost of Production: Depreciation may increase the cost of imported inputs, affecting domestic production costs and output.

Employment: Depreciation can benefit labor-intensive industries by increasing export prices, potentially leading to increased employment and wages.

Inflation: Depreciation may lead to short-term inflation due to higher prices of imported goods and increased demand for domestic goods.

Resource Allocation: Currency fluctuations influence resource allocation between tradable and non-tradable goods sectors, potentially leading to economic inefficiencies.

Terms of Trade: Depreciation affects a country's terms of trade, depending on whether export prices rise more than import prices.

Current Account Balance: Currency depreciation can impact the fiscal health of a country by affecting export earnings, import payments, and current account balance.

Foreign Borrowings: Companies with foreign currency denominated debts may face higher repayment costs and decreased profits due to currency depreciation.

Government Debt: Currency depreciation increases the burden of servicing foreign currency denominated government debts.

Financial Forecasting: Exchange rate fluctuations make financial forecasting more challenging and require firms to allocate more resources for hedging against exchange rate risks.

Investment: Exchange rate movements significantly impact international investments, affecting business volumes, profit forecasts, and investment outcomes.

Investor Sentiments: High exchange rate volatility may discourage foreign investors, leading to reduced capital inflows and affecting fiscal health and domestic investment levels.

The other impacts of currency depreciation are:

(i) Windfall gains for export-oriented sectors (such as IT sector, textile, pharmaceuticals, gems and jewellery in the case of India) because depreciating currency fetches more domestic currency per unit of foreign currency.

(ii) Remittances to homeland by non-residents and businesses abroad fetches more in terms of domestic currency

(iii) Depreciation would enhance government revenues from import related taxes, especially if the country imports more of essential goods

(iv) Depreciation would result in higher amount of local currency for a given amount of foreign currency borrowings of government.

(v) Depreciation also can have a positive impact on country's trade deficit as it makes imports more expensive for domestic consumers and exports cheaper for foreigners.

(vi) Depreciation also can have a positive impact on controlling spiralling gold imports (mostly wasteful) and thereby improve trade balance. consequences of currency appreciation:

Impact on Exports and Imports:

Export prices rise, leading to a decrease in export quantity. Cheaper imports increase, causing an increase in import quantity. Overall, domestic aggregate demand falls, negatively impacting economic growth. Effect on Business Cycle:

During a recession, appreciation worsens aggregate demand and unemployment. During a boom, it curbs inflation and moderates economic growth. Inflation Reduction:
Cheaper imports lead to lower inflation. Reduced demand decreases demand-pull inflation. Living standards may improve due to cheaper consumer goods. Competitiveness Impact:

Higher export prices reduce domestic industry competitiveness. Firms may innovate and adopt cost-cutting measures to remain competitive. Current Account Effects:

More imports and fewer exports worsen the current account. Impact depends on the demand elasticity for exports and imports. Significance of Currency Appreciation:

If appreciation is due to strong economic fundamentals, loss of competitiveness may be minimal.

Unit 5

Foreign capital encompasses various forms of capital inflows into a country from abroad, encompassing both movement of capital and foreign investment. Let's delve into each component:

Foreign Aid or Assistance:

- **Bilateral Aid:** Direct grants from one government to another for specific purposes, such as infrastructure development or humanitarian assistance. Example: The United States providing aid to Afghanistan for rebuilding infrastructure.
- **Multilateral Aid:** Funds pooled by multiple governments and international organizations like the World Bank, often for projects in developing countries. Example: World Bank financing a sanitation project in Kenya.
- **Tied Aid:** Assistance with conditions attached, specifying how the funds should be used, often for the purchase of goods or services from the donor country. Example: Japan providing aid to Indonesia with the condition that the funds be used to purchase Japanese-made machinery.

- **Untied Aid:** Assistance with no conditions attached, giving the recipient country more flexibility in how they use the funds. Example: Canada providing aid to Haiti without specifying how the funds should be utilized.
- **Foreign Grants:** Voluntary transfers of resources by governments, institutions, agencies, or organizations to support various initiatives. Example: European Union providing grants to support education programs in African countries.

Borrowings:

- **Direct Inter-government Loans:** Loans provided directly between governments for various purposes, such as infrastructure development or budget support. Example: China extending a loan to Sri Lanka for the construction of a port.
- **Loans from International Institutions:** Loans obtained from organizations like the World Bank, IMF, or Asian Development Bank for development projects. Example: India securing a loan from the World Bank for a renewable energy project.
- **Soft Loans:** Loans with concessional terms, such as low interest rates or extended repayment periods, often provided by institutions like the International Development Association (IDA), an affiliate of the World Bank. Example: Bangladesh receiving a soft loan from the IDA for poverty alleviation programs.
- **External Commercial Borrowing:** Borrowing from foreign commercial sources, such as banks or bond markets, by governments or corporations. Example: Argentina issuing bonds in international markets to raise funds for infrastructure projects.
- **Trade Credit Facilities:** Financing provided by foreign suppliers to facilitate trade, allowing importers to defer payment for goods and services. Example: a Chinese manufacturer offering trade credit to an Indian importer for the purchase of machinery.

Deposits from Non-Resident Indians
(NRI):

- Funds deposited by Indian citizens living abroad into banks or financial institutions in India. Example: An Indian expatriate working in the United States depositing money in an Indian bank account.

Investments:

- **Foreign Portfolio Investment (FPI):** Investment in financial assets like stocks, bonds, or securities of a foreign country by individuals or institutions. Example: A US hedge fund investing in Indian stocks listed on the Bombay Stock Exchange.

- **Foreign Direct Investment (FDI):** Investment in a foreign country's businesses or assets with a significant ownership stake, giving the investor control or influence over the operations. Example: Toyota establishing a manufacturing plant in Mexico to produce cars for the North American market.

foreign direct investment (FDI)

Definition of FDI:

- FDI involves a long-term relationship and lasting interest of a resident entity in one economy in an enterprise resident in another economy.
- It typically includes acquiring more than 10% of the shares of the target asset.

Components of FDI:

- Equity capital: Direct investment in the form of purchasing shares.
- Reinvested earnings: Profits reinvested in the enterprise.
- Other direct capital: Such as intra-company loans between parent enterprises and affiliates.

Criteria for FDI classification:

- Acquisition of at least 10% of ordinary shares or voting power in a public or private enterprise by non-resident investors.

Examples of FDI:

- Opening overseas companies: Establishing subsidiaries or branches abroad.
- Joint ventures: Partnering with local companies for mutual benefit.
- Acquisition of companies: Purchasing or annexing firms in the host country.
- Direct investments in real assets: Investing in factories, land, inventories, etc.

Investor Types:

- Individuals, private or public enterprises, government entities, trusts, or other organizations. Characteristics of FDI:
- Involves foreign ownership of production facilities.
- Allows investors to retain control over invested capital and influence decision-making.
- Implies a long-term relationship and significant influence on enterprise management.

Example:
Let's consider a hypothetical scenario involving FDI:

- A multinational corporation based in the United States decides to expand its operations into India by establishing a subsidiary.
- The corporation invests in building a manufacturing facility in India to produce electronic devices.
- They acquire 70% ownership in the Indian subsidiary, making it a foreign direct investment.
- Over time, the corporation reinvests profits earned by the subsidiary back into expanding its production capacity.
- The corporation also provides intra-company loans to the subsidiary for further growth.
- As a result, the multinational corporation maintains control over the Indian subsidiary's operations and decision-making processes, reflecting a lasting interest and long-term relationship.

Types of FDI

- Horizontal Direct Investment: This occurs when a company sets up the same type of business in a foreign country as it operates in its home country. For example, a US-based cell phone service provider expanding to India.

- Vertical Direct Investment: This happens when a company establishes or acquires a business activity in a foreign country that complements its main business but is different. For instance, an automobile manufacturer investing in a foreign company supplying parts or raw materials.

- Conglomerate Foreign Direct Investment: This involves investing in a business unrelated to the investor's existing business in the home country. It often takes the form of a joint venture with a foreign firm in a different industry.
- Two-way Direct Foreign Investments: These are reciprocal investments between countries, where certain industries are more advanced in one nation, while others are more efficient in other nations.

Foreign portfolio investment:

- **Nature of Investment:** Foreign portfolio investment involves the flow of financial capital rather than real capital. It doesn't entail ownership or control by the investor.
- **Examples:** Examples include depositing funds in a foreign bank, purchasing bonds of foreign companies or governments, and investing in financial instruments through capital markets.
- **Impact:** FPI affects balance of payments and exchange rates more immediately than production or income generation.
- **Focus:** Unlike FDI, FPI is not concerned with manufacturing goods or providing services. Investors don't aim to exercise voting power or control over the company.
- **Investor Intentions:** Foreign portfolio investors seek a remunerative return, prioritize safety of capital, potential appreciation, and return generation.
- **Characteristics:** FPI typically involves lower stakes in companies (below 10%), short-term nature, and doesn't contribute to enhancing productive capacity or creating capital assets.
- **Speculative Nature:** Portfolio investors evaluate individual prospects and may shift capital accordingly, making FPI largely speculative. Confidence fluctuations can lead to rapid capital shifts and potential financial crises for host countries.

Reasons for Foreign Direct Investment

Increasing interdependence of national economies: With globalization, countries are more interconnected economically. For example, the trade relationship between the United States and China has led to significant investment flows between the two countries.

Internationalization of production by transnational corporations: Companies like Toyota and Samsung have set up manufacturing plants in various countries to take advantage of different factors like labor costs and market proximity.

Desire for economies of scale: Apple's production of iPhones in China allows them to benefit from the country's large-scale manufacturing capabilities and lower labor costs.

Lack of feasibility of licensing agreements: Instead of licensing its technology, Google directly invests in research centers in various countries to maintain control over its intellectual property.

Necessity to retain direct control of production knowledge: Coca-Cola invests in bottling plants globally to maintain control over its production processes and quality standards.

Procurement of promising foreign firms: Facebook's acquisition of Instagram was driven by the desire to prevent future competition and gain access to a growing market segment.

Risk diversification: By investing in multiple markets, Johnson & Johnson mitigates the risk of downturns in any single market affecting its overall profitability.

Geographical proximity: European companies investing in neighboring countries like Germany investing in Poland benefit from reduced transport costs and shared language.

Necessity to retain control over trade patents: Pharmaceutical companies invest in research facilities in various countries to protect their patents and maintain quality control.

Promoting optimal resource utilization: Tesla's investment in Gigafactories around the world ensures efficient production and distribution of electric vehicles.

Desire to capture emerging markets: Starbucks' expansion into countries like India and China targets the growing middle class and their increasing demand for coffee.

Penetration of markets with import restrictions: Walmart's investment in India involved navigating import restrictions and establishing a presence in a lucrative market.

Lower environmental standards: Some industries invest in countries with less stringent environmental regulations to reduce production costs, like clothing manufacturing in Bangladesh.

Stable political environment: Multinational companies invest in countries with stable governments and favorable business climates, such as Singapore or Switzerland.

Prevalence of preferential investment systems: Many countries offer incentives like tax breaks and infrastructure support to attract foreign investment, like the special economic zones in China.

Control of strategic resources: Oil companies invest in drilling operations in oil-rich countries to secure access to crucial resources.

Access to raw material deposits: Mining companies invest in countries with significant mineral deposits to extract and process resources for profit.

Low relative wages: Textile manufacturers invest in countries with low labor costs to produce goods at competitive prices.

Lower economic efficiency: Foreign companies may invest in developing countries to improve efficiency and bridge development gaps.

Tax differentials: Some countries offer lower corporate tax rates to attract foreign investment, like Ireland's low corporate tax rate.

Defensive investments: Companies may invest defensively to protect their market share or fend off competitors, like Microsoft investing in new technologies to stay ahead in the software industry.

High GDP and per capita income: Luxury goods companies invest in countries with high GDP and incomes to target affluent consumers.

Philanthropic objectives: Companies may invest in social infrastructure projects in developing countries to improve living standards and foster goodwill, like Microsoft's investment in education initiatives in Africa.

High standards of social amenities: Tourism companies invest in countries with high-quality amenities to attract visitors and generate revenue, such as luxury resorts in the Maldives.

Benefits of FDI

Competition and Innovation: When foreign enterprises enter a market, they bring new ideas and technologies, forcing domestic companies to innovate to stay competitive. For example, when multinational fast-food chains entered the Indian market, local eateries had to improve their quality and service to keep customers.

Increased Investment: Foreign investment provides additional capital for projects that might not be feasible with domestic savings alone. For instance, China's infrastructure development was greatly accelerated by foreign investment, leading to increased GDP and employment opportunities.

Accelerated Growth: Developing countries benefit from FDI by gaining access to capital, technology, and managerial expertise. For example, Vietnam's economic growth was propelled by foreign investment in manufacturing, which created jobs and boosted exports.

Promotion of Reforms: Governments often implement reforms to attract foreign investment, such as improving infrastructure and streamlining regulations. For instance, India's liberalization policies in the 1990s attracted FDI, leading to economic growth and modernization.

Direct Employment: FDI creates jobs in the host country through the establishment of new businesses and expansion of existing ones. For example, automobile manufacturers like Toyota and Honda have set up factories in Thailand, creating thousands of jobs.

Multiplier Effect: FDI generates additional employment opportunities in related industries, such as transportation and services. For example, the construction of a new factory may lead to increased demand for local suppliers and service providers.

Higher Wages: Foreign companies often offer higher wages for skilled jobs, raising standards across industries. For instance, technology firms in Silicon Valley offer competitive salaries, attracting talent from around the world.

Access to Foreign Markets: Foreign firms provide access to global markets, helping local businesses export their products. For example, partnerships with multinational corporations can help small-scale farmers in Africa sell their produce internationally.

Promotion of Ancillary Units: FDI can stimulate the growth of supporting industries, leading to job creation and skill development. For example, the establishment of a steel plant may lead to the development of metal fabrication workshops.

Export Promotion: Foreign companies can leverage their global networks to promote exports from the host country. For example, garment factories in Bangladesh produce clothing for international brands, earning foreign exchange for the country.

Tax Revenue: Foreign investment projects contribute to tax revenue, which can be used for infrastructure development and social programs. For example, oil companies in Nigeria pay taxes that fund education and healthcare initiatives.

Economies of Scale: Foreign investments often involve large-scale production, leading to cost reductions that benefit consumers. For example, multinational beverage companies can produce soft drinks at lower costs, resulting in lower prices for consumers.

Weakening Monopolies: Increased competition from foreign firms can reduce the market power of domestic monopolies, leading to lower prices and increased consumer choice. For example, telecommunications deregulation in Mexico led to lower phone tariffs and improved services.

Balance of Payments: FDI is considered more stable than external borrowing, as it does not need to be repaid immediately. For example, investments in Brazilian oil fields provide steady income through exports, helping to stabilize the country's balance of payments.

Work Culture and Productivity: Foreign firms often introduce higher standards of professionalism and efficiency, improving overall productivity. For example, Japanese manufacturing companies in Malaysia implement rigorous quality control measures, raising standards in the local industry.

Potential problems associated with FDI

Capital-intensive methods: Foreign firms may prefer capital-intensive methods over labor-intensive ones, which can hinder job creation in labor-abundant countries. For example, a foreign manufacturing company investing in a developing country might automate its production processes, reducing the need for manual labor.

Regional Disparity: Foreign investment may concentrate in regions with abundant natural resources or existing infrastructure, exacerbating regional inequalities. For instance, a multinational mining company might invest heavily in one region of a country, leaving other regions underdeveloped.

Impact on Domestic Savings: Inflows of foreign capital might discourage domestic savings efforts, especially if foreign corporations receive tax incentives. For example, if a government offers tax holidays to attract foreign investment, it may lose potential tax revenue that could have been used for domestic savings initiatives.

Crowding-out effect: Foreign firms may borrow funds from the host country's capital market, leading to higher interest rates and reduced domestic investment. For instance, if a foreign firm borrows extensively from local banks, it may increase competition for funds, making it harder for domestic businesses to access capital for growth.

Balance of Payments Instability: While FDI can initially improve a country's balance of payments, it can also lead to instability if profits are repatriated or imported inputs are needed. For example, if a multinational corporation repatriates a significant portion of its profits, it can strain the host country's balance of payments and lead to currency depreciation.

Skill Retention: Foreign firms may retain high-skilled jobs in their home countries, leaving lower-skilled positions in the host country. For example, a technology company might keep research and development functions in its home country while outsourcing manufacturing to a developing country.

Production Distortion: Foreign investors may prioritize products for elite or popular consumption, neglecting essential items or industries. For instance, a luxury fashion brand might invest in a host country's manufacturing sector, focusing on high-end products rather than basic necessities.

Unethical Practices: Some foreign entities may engage in aggressive advertising or anticompetitive behavior, distorting the market. For example, a multinational corporation might use its financial resources to undercut local competitors or engage in predatory pricing strategies.

Market Dominance: Large foreign firms may outcompete local industries, leading to monopolistic practices and displacement of domestic firms and labor. For example, a multinational retailer might drive local shops out of business by offering lower prices and greater variety.

Offshoring and Job Loss: Foreign investment may lead to offshoring of jobs from the home country, reducing employment opportunities. For instance, a multinational corporation might move its call center operations to a developing country to take advantage of lower labor costs, resulting in job losses in the home country.

Lower labor or environmental standards: For instance, a multinational company might establish manufacturing facilities in a developing country where labor laws are lax, allowing them to pay lower wages and evade strict environmental regulations.

National security considerations: In situations of acute hostilities, foreign firms operating within a country could be seen as potential threats to national security. For example, during a conflict, a foreign-owned infrastructure project might be suspected of being used for espionage activities.

Adverse impact on terms of trade: If a foreign direct investment (FDI) inflow focuses heavily on export-oriented industries in a country with a significant export base, it can lead to an imbalance in the terms of trade. For instance, if a large portion of a country's FDI goes into producing goods for export, it can drive down the prices of those exports relative to the prices of imports.

Exploitation of natural resources: Multinational corporations are often accused of exploiting natural resources in host countries without adequate regard for environmental sustainability. For example, mining companies might extract resources without proper environmental safeguards, leading to pollution and ecological damage.

Emergence of a dual economy: Substantial FDI in developing countries can lead to the development of a dual economy, with a highly developed foreign sector and a comparatively underdeveloped domestic sector. For example, in some African countries, the presence of multinational corporations in extractive industries has led to significant economic disparities between urban centers with foreign investment and rural areas with little development.

Loss of host country sovereignty: Large foreign investment sectors can exert significant influence over a host country's domestic policies, potentially undermining its sovereignty. For example, multinational corporations may pressure governments to enact policies favorable to their interests, such as tax breaks or deregulation, which can lead to accusations of corruption and erosion of democratic governance.