UNIT - 1: THEORIES OF INTERNATIONAL TRADE

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 is an integral part of international relations and has become an important engine of growth in developed as well as developing countries.

Benefits of International Trade

- Boost
  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.

- 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.

- 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.

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

■ 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.

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

■ 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.

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

Limitations -The major arguments put forth against trade openness

■ 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.

■ 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.

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

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

- 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.

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

- 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.

IMPORTANT THEORIES OF INTERNATIONAL TRADE

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.

- 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.

- Mercantilists also believed that the more gold and silver a country accumulates, the richer it becomes. Mercantilism advocated maximising exports in order to bring in more "specie" (money in the form of precious metals) and minimizing imports through the state imposing very high tariffs on foreign goods.

Imp duty

- This view argues that trade is a 'zero-sum game', with winners who win, does so only at the expense of losers and one country's gain is equal to another country's loss, so that the net change in wealth or benefits among the participants is zero

available

- 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".

A . +$10
B - $10

Exports > Import
Zero Sum Game

2) The Theory of Absolute Advantage

- Adam Smith was the first to put across the possibility that international trade is not a zero-sum game. He 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

- Absolute advantage exists between nations when they differ in their ability to produce goods. Each nation can produce one good with less expenditure of human labour or more cheaply than the other. As a result, each nation has an absolute advantage in the production of one good.

Absolute advantage can be explained with a simple numerical example:

₹100

Output per Hour of Labour 1 hr. Kitne unit

Commodity	Country A	Country B
Wheat (~~bushels~~ unit/hour)	6 → Adv.	1 ✗
Cloth (~~yards~~ unit/hour)	4	5 - Adv.

As can be seen from the above table:

➡️one hour of labour time produces 6 bushels and 1 bushel of wheat respectively in country A and country B.

➡️On the other hand, one hour of labour time produces 4 yards of cloth in country A and 5 in country B.

📌**Country A is more efficient than country B, or has an absolute advantage over country B in production of wheat.**

📌**Similarly, country B is more efficient than country A, or has an absolute advantage over country A in the production of cloth.**

◾ If both nations can engage in trade with each other, each nation will specialize in the production of the good, it has an absolute advantage in and obtain the other commodity through international trade. **Therefore, country A would specialise completely in production of wheat and country B in cloth.**

[Labour hours P.u]

	A	B
Tea [Kg]	8	5 → Absolute adv.
Jeans (Qty)	2 └ Abs. adv	4

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.

3) The Theory of Comparative Advantage

- *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:

Commodity	Country A	Country B
Steel (kg)	3	1
Shirts (units)	2	1

Country A: One hour of labour can produce either three kilograms of steel or two shirts.
Country B: One hour of labour can produce either one kilogram of steel or one shirt.
Country A is more efficient in both products.

■ Now suppose Country B offers to sell Country A two shirts in exchange for 2.5 kilograms of steel.

👉To produce these additional two shirts, Country B diverts two hours of work from producing (two kilograms) of steel.

👉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.

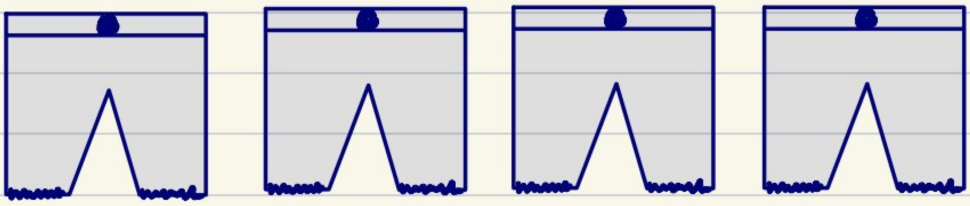
■ Its partner will gain by exporting clothes—in which it has a comparative but not absolute advantage—in exchange for these other products. opp cost ↓

■ 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

unit / hour

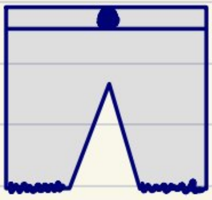


Chocolate Chocolate

Opp cost 1 chocolate → 2 jeans

1 jeans → 0.5 chocolate

Country B



Chocolate

Opp cost 1 chocolate - 1 jeans

1 jeans = 1 chocolate

Each person should produce the good for which there is a lower opportunity cost than other producers

→ Opportunity cost - Haberler

4) The Heckscher-Ohlin Theory of Trade - Modern Theory

Factor Endowment Theory

■ 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 capital- intensive products, while those well endowed with labour should export labour-intensive products.

■ The labour-abundant countries have comparative cost advantage in the production of goods which require labour-intensive technology and by the same reasoning; capital-abundant countries have comparative cost advantage in the production of goods that need capital-intensive technology.

Country

A - Abundant Labour → Goods Which require labour

B - Abundant cap → Goods Which require Cap

Comparison of Theory of Comparative Costs and Modern Theory

Theory of Comparative Costs - Ricardo	Modern Theory - H.O
The basis is the difference between countries is comparative costs	Explains the causes of differences in comparative costs as differences in factor endowments
Based on labour theory of value	Based on money cost which is more realistic.
Considered labour as the sole factor of production and presents a one-factor (labour) model	Widened the scope to include labour and capital as important factors of production. This is 2-factor model and can be extended to more factors.
Treats international trade as quite distinct from domestic trade	International trade is only a special case of inter-regional trade.
Studies only comparative costs of the goods concerned	Considers the relative prices of the factors which influence the comparative costs of the goods
Attributes the differences in comparative advantage to differences in productive efficiency of workers	Attributes the differences in comparative advantage to the differences in factor endowments. Labour & cap
Does not take into account the factor price differences	Considers factor price differences as the main cause of commodity price differences
Does not provide the cause of differences in comparative advantage.	Explains the differences in comparative advantage in terms of differences in factor endowments.
Normative; tries to demonstrate the gains from international trade	Positive; concentrates on the basis of trade

Should

what is - explains the diff

Globalization and New International Trade Theory

■ 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 "labor- rich" countries. But Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor.

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 well- being of people around the world. One such example is "In Praise of Cheap Labor," published in Slate in 1997.

■ 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.

Unit over :)

THE INSTRUMENTS OF TRADE POLICY

INTRODUCTION

- As we know, under free trade, buyers and sellers from separate economies voluntarily trade with minimum of state interference. The free interplay of market forces of supply and demand decides prices.

- Protectionism, on the other hand, is a state policy aimed to protect domestic producers against foreign competition through the use of tariffs, quotas and non-tariff trade policy instruments.

- Trade liberalization refers to opening up of domestic markets to goods and services from the rest of the world by bringing down trade barriers.

- Trade policy encompasses all instruments that governments may use to promote or restrict imports and exports. The instruments of trade policy that countries typically use to restrict imports and/ or to encourage exports can be broadly classified into price-related measures such as tariffs and non-price measures or non-tariff measures (NTMs).

TARIFFS

- **Tariffs**, also known as customs duties, are basically taxes or duties imposed on goods and services which are imported or exported.
- They are the most visible and universally used trade measures that determine market access for goods.
- Import duties being pervasive than export duties, tariffs are often identified with import duties and in this unit, the term 'tariff' would refer to import duties.
- Tariffs are aimed at altering (Change) the relative prices of goods and services imported, so as to contract the domestic demand and thus regulate the volume of their imports.
- Tariffs leave the world market price of the goods unaffected; while raising their prices in the domestic market.
- The main goals of tariffs are to raise revenue for the government, and more importantly to protect the domestic import-competing industries.

Forms of Import Tariffs

Bicycle - ₹5000 — ₹1000 - 20%
↑ ₹100,000 - ₹1000 - 1% ↓

1) **Specific Tariff**: Fixed ~~amount~~ per unit of money per physical unit or according to the weight or measurement of the commodity imported or exported.
Example, a specific tariff of Rs. 1000/ may be charged on each imported bicycle.

👉The disadvantage of specific tariff as an instrument for protection of domestic producers is that its protective value varies inversely with the price of the import

2) **Ad valorem tariff** (Value): Duty is levied as a fixed percentage of the value of the traded commodity.
Example: A 20% ad valorem tariff on any bicycle generates a Rs. 1000/ payment on each imported bicycle priced at Rs. 5,000/ in the world market; and if the price rises to Rs. 10,000, it generates a payment of Rs. 2,000/

👉It gives incentives to deliberately undervalue the good's price on invoices and bills of lading to reduce the tax burden.

100/-unit
10%

P=50 Q=10

$100 \times 10 + \frac{10}{100} \times (50 \times 10)$

There are many other variations of the above tariffs, such as:

Mixed Tariffs: Mixed tariffs are expressed either on the basis of the value of the imported goods (an ad valorem rate) or on the basis of a unit of measure of the imported goods (a specific duty) depending on which generates the most income (or least income at times) for the nation.

For example, duty on cotton: 5 per cent ad valorem or Rs. 3000/per tonne, whichever is higher.

of value

Compound Tariff or a Compound Duty is a combination of an ad valorem and a specific tariff.

- It is generally calculated by adding up a specific duty to an ad valorem duty.
- Thus, on an import with quantity q and price p, a compound tariff collects a revenue equal to tsq + tapq, where ts is the specific tariff and ta is the ad valorem tariff.

For example: duty on cheese at 5 per cent advalorem plus 100 per kilogram.

Technical/Other Tariff: These are calculated on the basis of the specific contents of the imported goods i.e. the duties are payable by its components or related items.

For example: Rs. 3000/ on each solar panel plus Rs. 50/ per kg on the battery.

Tariff Rate Quotas: Tariff rate quotas (TRQs) combine two policy instruments: quotas and tariffs. Imports entering under the specified quota portion are usually subject to a lower (sometimes zero) tariff rate. Imports above the quantitative threshold of the quota face a much higher tariff.

Quota - Max Limit

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.

Rice - ₹40/-Kg

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

Most-Favoured Nation Tariffs: MFN tariffs refer to import tariffs which countries promise to impose on imports from other members of the WTO.

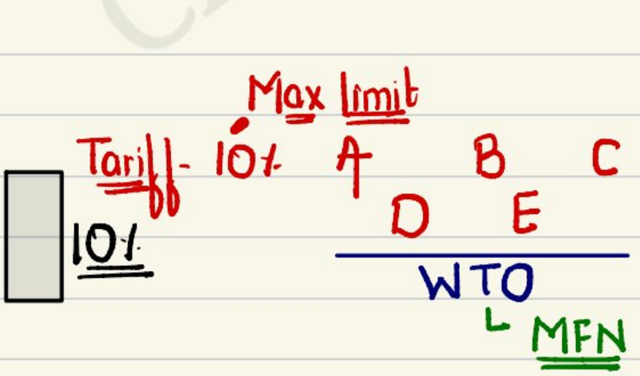
- This means that, in practice, MFN rates are the highest (most restrictive) that WTO members charge each other.
- Some countries impose higher tariffs on countries that are not part of the WTO.

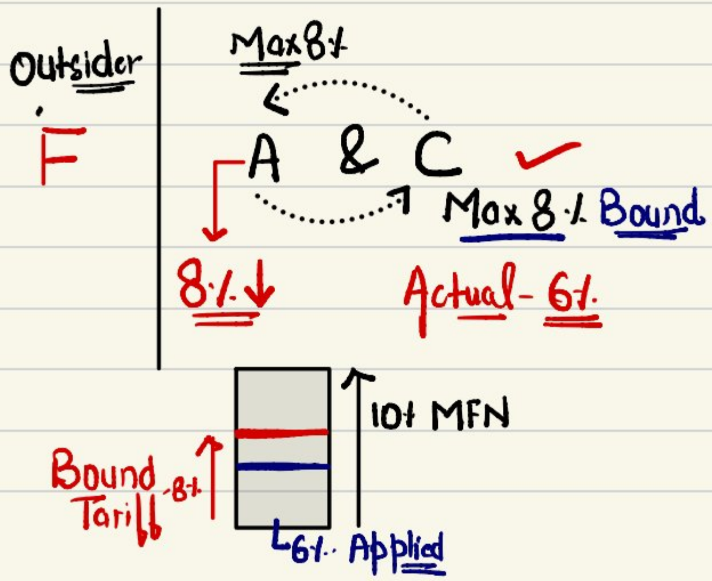
Bound Tariff: Under this, a WTO member binds itself with a legal commitment not to raise tariff rate above a certain level.

- 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. MFN Tariff
- 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.

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.





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.

A → B
Developed ← Under-developed

- 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 (developed) 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.

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. Raw Material ↓ Int. Goods ↓ FG ↑

- 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.

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).

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.

a) 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 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.

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

A - Govt. → Subsidy → Producers - Cost ₹100
(-) Sub. 20
₹80

b) **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.

Effects of Tariffs

1) Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade.

2) Tariffs discourage domestic consumers from consuming imported foreign goods. Domestic consumers suffer a loss in consumer surplus. $MU_x - P_x \uparrow$

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

4) 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.

Imported Goods P↑ ⟶ Domestic Goods Demand ↑ → Price↑ Profit ↑

5) 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.

6) 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.

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

NTB

NTM

NTB

NON–TARIFF MEASURES (NTMs)

◼ The non- tariff measures which have come into greater prominence than the conventional tariff barriers, constitute the hidden or 'invisible' measures that interfere with free trade.

◼ Non-tariff measures comprise all types of measures which alter the conditions of international trade, including policies and regulations that restrict trade and those that facilitate it.

◼ It should be kept in mind that NTMs are not the same as non-tariff barriers (NTBs).

avoid

👉NTMs are sometimes used as means to circumvent free-trade rules and favour domestic industries at the expense of foreign competition. In this case they are called non-tariff barriers (NTBs). In other words, non-tariff barriers are discriminatory non-tariff measures imposed by governments to favour domestic over foreign suppliers.

👉NTBs are thus a subset of NTMs that have a 'protectionist or discriminatory intent'.

◼ According to WTO agreements, the use of NTMs is allowed under certain circumstances.

Examples of this include :

📝Technical Barriers to Trade (TBT) Agreement and

📝Sanitary and Phytosanitary Measures (SPS) Agreement,

Technical - Product specific
Non Technical

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

I. Technical Measures

I. Technical Measures: Technical measures refer to product-specific properties such as characteristics of the product, technical specifications and production processes.

- These measures are intended for ensuring product quality, food safety, environmental protection, national security and protection of animal and plant health.

A) 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.

B) 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 involves compulsory quality, quantity and price control of goods before shipment from the exporting country.
- 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.

II. Non-technical Measures: Non-technical measures relate to trade requirements; for example; shipping requirements, custom formalities, trade rules, taxation policies, etc. These are further distinguished as:

(a) Hard measures (e.g. Price and quantity control measures),

(b) Threat measures (e.g. Anti-dumping and safeguards) and

(c) Other measures such as trade-related finance and investment measures.

Furthermore, the categorization also distinguishes between:

(i) Import-related measures which relate to measures imposed by the importing country, and

(ii) Export-related measures which relate to measures imposed by the exporting country itself.

(iii) In addition, to these, there are procedural obstacles (PO) which are practical problems in administration, transportation, delays in testing, certification etc which may make it difficult for businesses to adhere to a given regulation.

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.

100,000 units - Free Trade

Binding Quota - 80,000 units
Non Binding Quota - 1,20,000 units

👉 **Absolute quotas**: 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 Fruits 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 fruits that can be imported any time during the year, but where 750 tonnes must originate in country A and 250 tonnes in country B.

- 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'.

Quota
A — 10.000
B — 20.000

-

- 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 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.

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.

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
- 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.

Govt - -Exclusive right to import ...... Domestic Market
Price ↑

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)

A - Export. ₹100
└ 75% - 750 Import

(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.

(ix) **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.

(x) **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.

(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.

(xii) 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.

(xiii) 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.

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.

कम करना

(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. Indian Domestic Inc.
- 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. Supply ↓ - Prices ↑

Unit over :)

TRADE NEGOTIATIONS

TAXONOMY OF REGIONAL TRADE AGREEMENTS

Regional Trade Agreements (RTAs) are defined as groupings of countries, 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 discussed below-

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. GSP

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)

A B C D

5%

Imp
A BC Duty D

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**: The next stage in the integration sequence of common market 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

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).

THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

- The workings of the GATT agreement are the responsibility of the Council for Trade in Goods (Goods Council)
- 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.

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.

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.

■ 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.

THE WORLD TRADE ORGANIZATION (WTO)

■ The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations.

■ 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 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.

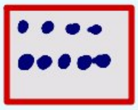
👉The next level is the General Council which meets several times a year at the Geneva headquarters.

👉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. Around 24 others are negotiating membership.

The Guiding Principles of World Trade Organization (WTO)

1) Trade without Discrimination- Most-favoured-nation (MFN)



A B C D

- 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.
- It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods.

- 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 that are considered to be traded unfairly from specific countries.

- 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 locally- produced 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.

- 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) 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.

4) 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.

- 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.

- 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.

5) 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.

6) 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.

3/4

- 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 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.

■ The current Doha Development Agenda includes developing countries' concerns about the difficulties they face in implementing the Uruguay Round agreements.

WTO Agreements

■ The WTO agreements cover goods, services and intellectual property and the permitted exceptions.

■ These agreements are often called the WTO's trade rules, and the WTO is often described as "rules-based", a system based on rules.

Following are the important agreements under WTO:

1) <u>Agreement on Agriculture</u> aims at strengthening GATT disciplines and improving agricultural trade. It includes specific and binding commitments made by WTO member governments in the three areas of market access, domestic support and export subsidies.

2) <u>Agreement on the Application of Sanitary and Phytosanitary</u> (SPS) Measures establishes multilateral frameworks for the planning, adoption and implementation of sanitary and phytosanitary measures to prevent such measures from being used for arbitrary or unjustifiable discrimination or for camouflaged restraint on international trade and to minimize their adverse effects on trade.

3) Agreement on Textiles and Clothing replaced the Multi-Fibre Arrangement (MFA) which was prevalent since 1974. ATC provides that textile trade should be deregulated by gradually integrating it into GATT disciplines over a 10-year transition period.

4) Agreement on Technical Barriers to Trade (TBT) aims to prevent standards and conformity assessment systems from becoming unnecessary trade barriers by securing their transparency and harmonization with international standards. Often excessive standards or misuse of standards in respect of manufactured goods, and safety/ environment regulations act as trade barriers.

5) Agreement on Trade-Related Investment Measures (TRIMs) expands disciplines governing investment measures in relation to cross-border investments.

- It stipulates that countries receiving foreign investments shall not impose investment measures such as requirements, conditions and restrictions inconsistent with the provisions of the principle of national treatment and general elimination of quantitative restrictions.

Imp. Exp

- For example: measures such as local content requirements and trade balancing requirements should not be applied on investing corporations.

6) Anti-Dumping Agreement seeks to tighten and codify disciplines for calculating dumping margins and conducting dumping investigations, etc. in order to prevent anti-dumping measures from being abused or misused to protect domestic industries.

7) Customs Valuation Agreement specifies rules for more consistent and reliable customs valuation and aims to harmonize customs valuation systems on an international basis by eliminating arbitrary valuation systems.

Co Insp 400 B

8) **Agreement on Pre-shipment Inspection (PSI)** intends to secure transparency of pre- shipment inspection wherein a company designated by the importing country conducts inspection of the quality, volume, price, tariff classification, customs valuation, etc. of merchandise in the territory of the exporting country on behalf of the importing country's custom office and issues certificates. The agreement also provides for a mechanism for the solution of disputes between PSI agencies and exporters.

9) **Agreement on Rules of Origin** provides for the harmonization of rules of origin for application to all non-preferential commercial policy instruments. It also provides for dispute settlement procedures and creates the rules of origin committee.

10) **Agreement on Import Licensing** Procedures relates to simplification of administrative procedures and to ensure their fair operation so that import licensing procedures of different countries may not act as trade barriers.

11) **Agreement on Subsidies and Countervailing Measures** aims to clarify definitions of subsidies, strengthen disciplines by subsidy type and to strengthen and clarify procedures for adopting countervailing tariffs.

12) **Agreement on Safeguards** clarify disciplines for requirements and procedures for imposing safeguards and related measures which are emergency measures to restrict imports in the event of a sudden surge in imports.

13) **General Agreement on Trade in Services (GATS)**: This agreement provides the general obligations regarding trade in services, such as most- favoured-nation treatment and transparency.

- In addition, it enumerates service sectors and stipulates that in the service sectors for which it has made commitments, a member country cannot maintain or introduce market access restriction measures and discriminatory measures that are severer than those that were committed during the negotiations.

14) **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)**: This agreement stipulates most-favoured-nation treatment and national treatment for intellectual properties, such as copyright, trademarks, geographical indications, industrial designs, patents, IC layout designs and undisclosed information.

■ In addition, it requires member countries to maintain high levels of intellectual property protection and to administer a system of enforcement of such rights. It also stipulates procedures for the settlement of disputes related to the agreement.

15) **Trade Policy Review Mechanism (TPRM)** provides the procedures for the trade policy review mechanism to conduct periodical reviews of members' trade policies and practices conducted by the Trade Policy Review Body (TPRB).

16) **Plurilateral Trade Agreements**: Multilateral negotiations are those negotiations involving the entire WTO contracting parties.

■ The Plurilateral trade agreements involve several countries with a common interest but do not involve all WTO countries. Not all the plurilateral agreements are negotiated within the WTO framework.

■ All the above-mentioned agreements entered into by the members are not static; they are renegotiated from time to time and new agreements evolve from negotiations. Example: Many agreements were negotiated under the Doha Development Agenda, launched by WTO trade ministers in Doha, Qatar, in November 2001.

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.

G 20 ECONOMIES: FACILITATING TRADE

- The G-20 is a group comprising of 20 countries, representing around 85% of global GDP.
- 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.

- 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.

*

- 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

Unit over :)

EXCHANGE RATE AND ITS ECONOMIC EFFECTS

Direct Quote → 1\$ = ₹83 ↓ Depreciate
[European Currency Quotation] 1\$ = ₹85 ↓ Export ↑

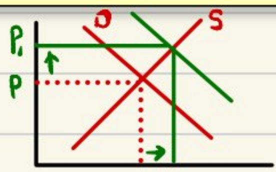
THE EXCHANGE RATE

Exchange rate or Foreign Exchange rate is the rate at which the currency of one country is exchanged for the currency of another country. Indirect Quote → 1₹ = \$0.012 [American Currency Quot]

■ 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.

THE EXCHANGE RATE REGIMES



D>S P↑
D<S P↓

■ 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:

1) Fixed exchange rate regime
(also called a pegged exchanged rate)

2) Floating exchange rate regime
(also called a flexible exchange rate)
— Free
— Managed

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.

₹↓ Depreciate
Exports ↑ ← → Imports ↓ [Payment - $100 → ₹80/$ - ₹8000, → ₹85/$ - ₹8500
₹ will appre to ← Demand for ₹ ↑

Advantages

▪ 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.

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

▪ 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.

▪ 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.

👉 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

Disadvantages

- 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.

- 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.

US —— India - 1\$ = ₹83

\$100 + Risk premium

P↑

Buy- ₹ Supply↓ - Price↑ - Currency Appreciate
Sell- ₹Supply↑ - Price↓ - Current Depreciate

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.

Currency Demand ↑ → Exports↓

How Government Intervenes?

P↑

- 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.

Fixed

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.

Fixed Exchange Rates

▪ In a fixed exchange rate system, the exchange rate between two currencies is set by government policy.

Advantages

(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.

(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.

(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.

▪ 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.

📌 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 ········→ 1\$ = ₹90

Devalue - 1\$ = ₹90

1\$= ₹85 - NER

NOMINAL VERSUS REAL EXCHANGE RATES

Nominal exchange rate - 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. \$100 x85 = ₹8500
- 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.

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.
- 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:

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

When studying the economy as a whole, we use price indices which measure the price of a basket of goods and services. Real exchange rate will then be:

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

1\$ = ₹85

Watch

India

₹34000

USA

\$800

→ ₹68000

2 Watch

1 watch in USA = 2 watches in India

$$RER = NER \times \frac{\text{Foreign price}}{\text{Domestic price}}$$

$$RER = 85 \times \frac{800}{34000} \rightarrow \underline{\underline{2}}$$

₹ appreciates ⇒ 1\$ = ₹80

$$RER = 80 \times \frac{800}{34000} = \underline{\underline{1.88}}$$

Inc. in RER

- Exports ↓
- Imports ↑

1$ ₹80] App — Exp ↓ ₹1000 → 12.5 $ 14.28 $
1$ ₹70

Inflation adj Index

Another exchange rate concept, the Real Effective Exchange Rate (REER) is the nominal effective exchange rate (a measure of the value of a domestic currency against a weighted average of various foreign currencies) divided by a price deflator or index of costs. An increase in REER implies that exports become more expensive and imports become cheaper; therefore, an increase in REER indicates a loss in trade competitiveness.

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.

- 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.

C.B. B.H.
Market players

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.
- A forward premium is said to occur when the forward exchange rate is more than a spot exchange rates. 1\$ = ₹83 < 1\$ = ₹85 ✓
- On the contrary, if the forward trade is quoted at a lower rate than the spot rate, then there is a forward discount.

- 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’. – U.S \$

DETERMINATION OF NOMINAL EXCHANGE RATE

- The key framework for analysing prices is the operation of forces of supply and demand in markets.
- Individuals, institutions and governments participate in the foreign exchange market for a number of reasons.

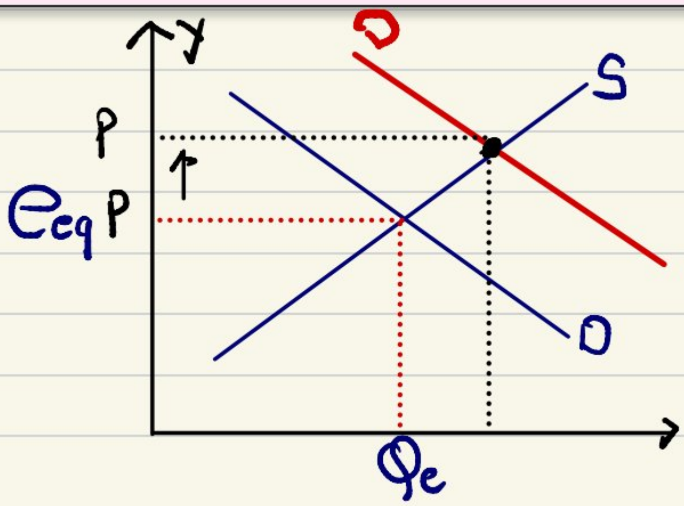
👉On the demand side, people desire foreign currency to:

- purchase goods and services from another country
- for unilateral transfers such as gifts, awards, grants, donations or endowments
- to make investment abroad
- to purchase financial assets, stocks or bonds abroad
- to open a foreign bank account — Tangible Assets
- 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.

- 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.

CHANGES IN EXCHANGE RATES

- Changes in exchange rates portray depreciation or appreciation of one currency.

- **Currency appreciates** when its value increases with respect to the value of another currency or a basket of other currencies. 1\$ = ₹80 → 1\$ = ₹70

- On the contrary, **currency depreciates** when its value falls with respect to the value of another currency or a basket of other currencies.

For example, the Rupee dollar exchange rate in the month of January is \$1 =Rs. 70. and, we find that in the month of April it is \$1 =Rs. 75. What does this indicate?

👉In April, you will have to exchange a greater amount of Indian Rupees (Rs. 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 Rs. 75 instead of Rs. 70 earlier. This is called appreciation of the US dollar.

1\$ - ₹70 → 1\$ - ₹75

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.

1\$ - ₹80 → 1\$ - ₹70 Reval.

DEVALUATION (REVALUATION) VS DEPRECIATION (APPRECIATION)

- 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 (RBI) 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 an 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.

₹ 1$ = 80

- Appreciation
  1$ = 75
  - Export ↓
  - Import ↑
- Depreciation
  1$ = 90
  - Export ↑
  - Import ↓

IMPACTS OF EXCHANGE RATE FLUCTUATIONS ON DOMESTIC 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.

(ii) Fluctuations in the exchange rate affect the economy by changing the relative prices of domestically-produced and foreign-produced goods and services.

👉 An appreciation of a country's currency raises the relative price of its exports and lowers the relative price of its imports.

👉 Depreciation lowers the relative price of a country's exports and raises the relative price of its imports.

(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.

(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.

(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. Payment > Receipt

👉If export earnings rise faster than the imports spending then current account balance will improve.

(viii) Companies that have borrowed in foreign exchange 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.

(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) 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.

(xi) Foreign investors are likely to be indecisive or highly cautious before investing in a country that has high exchange rate volatility.

AD = C + I + G + (X - M)

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) 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.

(iv) 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.

Exp > Rec

👉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.

UNIT - 5: INTERNATIONAL CAPITAL MOVEMENTS

TYPES OF FOREIGN CAPITAL

The term 'foreign capital' is a comprehensive one and includes any inflow of capital into the home country from abroad. Foreign capital may flow into an economy in different ways. Some of the important components of foreign capital flows are:

1. Foreign aid or assistance which may be:
(a) Bilateral or direct inter government grants.
(b) Multilateral aid from many governments who pool funds with international organizations like the World Bank.
(c) Tied aid with strict mandates regarding the use of money or untied aid where there are no such stipulations
(d) Foreign grants which are voluntary transfer of resources by governments, institutions, agencies or organizations.

2. Borrowings which may take different forms such as:
(a) Direct inter government loans
(b) Loans from international institutions (e.g. world bank, IMF, ADB)
(c) Soft loans for e.g. from affiliates of World Bank such as IDA
(d) External commercial borrowing, and
(e) Trade credit facilities

3. Deposits from non-resident Indians (NRI)

4. Investments in the form of :
(i) Foreign portfolio investment (FPI) in bonds, stocks and securities, and
(ii) Foreign direct investment (FDI) in industrial, commercial and similar other enterprises

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 . 1

- FDI has three components, viz., 2

👉 equity capital,

👉 reinvested earnings and

👉 other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises

- The main forms of direct investments are:

👉 the opening of overseas companies, including the establishment of subsidiaries or branches, 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.

- Based on the nature of foreign investments, FDI may be categorized as horizontal, vertical or conglomerate. 3

CA Hardik Manchanda

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).

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FOREIGN INVESTMENT PORTFOLIO (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.

- 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 investments are, to a large extent, expected to be speculative

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	$\boxed{\text{Relatively easy to withdraw}}$
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

REASONS FOR FOREIGN DIRECT INVESTMENT

- **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.**

Investments move across borders on account of:

- **The increasing interdependence of national economies** - MNC
- **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**

- Desire to procure a promising foreign firm to avoid future competition
- Risk diversification so that recessions or downturns may be experienced with reduced severity
- Desire to capture large and rapidly growing high potential emerging markets with substantially high and growing population
- Stable political environment and overall favourable investment climate in the host country
- 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
- 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.

Factors in the host country discouraging inflow of foreign investments are

- infrastructure lags,
- high rates of inflation,
- poor literacy and low labour skills,
- rigidity in the labour market,
- bureaucracy and corruption,
- unfavourable tax regime,
- cumbersome legal formalities and delays,
- land acquisition issues,
- small size of market and lack of potential for its growth,
- political instability, absence of well-defined property rights, exchange rate volatility, poor track-record of investments, prevalence of non-tariff barriers, stringent regulations, lack of openness, language barriers, high rates of industrial disputes, lack of security to life and property, double taxation and lack of a general spirit of friendliness towards foreign investors.

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.

FOREIGN DIRECT INVESTMENT IN INDIA

- 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.