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International Trade

- **Unit 1:** Theories of International Trade including theories of intra-industry trade Krugman.
- **Unit 2:** Trade Policy – The Instruments of Trade Policy.
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UNIT

1

Theories of International Trade

INTRODUCTION

- International trade involves the exchange of goods, services, and resources between different countries. It involves transactions between residents of different countries.
- Economists widely agree that international trade benefits the world as a whole. It means trade among nations makes the world better-off.
- International trade reduces production costs and raises living standards for people.
- Foreign producers also benefit from increased sales and the acquisition of foreign exchange.
- It plays a crucial role in international relations and contributes to economic growth in both developed and developing countries.

BENEFITS OF INTERNATIONAL TRADE

- International trade boosts economic efficiency, leading to economic growth and higher incomes. Trade opens up broader markets, encouraging companies to benefit from both quantitative and qualitative advantages of division of labor.
- Foreign trade results in the efficient use of productive resources, which is economically advantageous. Efficiency in utilizing natural, human, industrial, and financial resources leads to increased productivity. International trade reduces the chances of domestic monopolies, benefiting the overall community.
- Trade provides access to new markets and materials, leading to innovative products, competitive prices, and a wider range of choices for consumers. It also helps nations acquire foreign exchange reserves crucial for sustaining their economies.
- International trade drives automation, technological change, innovation, research and development, and productivity improvements in the economy.
- Trade stimulates the growth of innovative services in sectors such as banking, insurance, logistics, and consultancy.
- Emerging economies benefit from improved product quality, labor and environmental standards, enabling them to move up the global value chain.
- Opening up new markets broadens the productive base and facilitates export diversification, creating new production possibilities.
- Trade supports human resource development by facilitating research, know-how exchange, and best practice sharing between trade partners.
- Trade fosters international cooperation and harmony by bringing citizens of different countries together in mutually beneficial exchanges, strengthening bonds between nations.

DISADVANTAGES OF INTERNATIONAL TRADE

(i) International trade may not equally benefit all nations due to unequal market access and a lack of fair trading principles, which can exacerbate disparities, especially among wealth-diverse countries.

(ii) Underprivileged countries are vulnerable to economic exploitation by powerful global corporations, which can outperform domestic entities.

(iii) Extensive environmental damage and rapid resource depletion can have severe negative consequences for society.

(iv) Economic crises and trade cycles in one country can quickly spread to others, leading to global economic instability.

(v) Underdeveloped countries' dependence on foreign nations can impair economic autonomy and political sovereignty, risking exploitation and loss of cultural identity.

(vi) Overreliance on exports can lead to a distortion of a country's actual investment priorities.

(vii) Lack of transparency and predictability in trade policies of trading partners, as well as the risks associated with changes in governments' policies, can pose challenges in international trade.

IMPORTANT THEORIES OF INTERNATIONAL TRADE

THE MERCANTILISTS' VIEW OF INTERNATIONAL TRADE

- Mercantilism, derived from "mercantile" meaning trade and commercial affairs. Mercantilism according to Microsoft Encarta Dictionary is the economic policy in Europe from the 16th to the 18th centuries.
- It involved government control of industry and trade with the belief that a nation's power is sustained by maintaining a consistent surplus of exports over imports.
- Mercantilism arose due to variations in the distribution and development of human and material resources among nations, enabling the flow of labor, raw materials, capital, and finished products across borders.
- This economic system emphasized aggressive export policies to accumulate wealth, achieve a favorable balance of payments, and remains relevant in today's economy.

THE THEORY OF ABSOLUTE ADVANTAGE

- Adam Smith, considered the father of economics, introduced the concept of absolute advantage in international trade.
- According to his theory, international trade is mutually beneficial when one country can produce one commodity with a clear absolute advantage, while the other country excels in producing a different commodity with its absolute advantage.
- Absolute advantage is the ability to produce more of a good using the same resources compared to competitors.
- Adam Smith initially applied this principle to international trade, focusing on labor as the sole input.

- If a nation has no absolute advantage in any product, according to this theory, no trade will occur with other nations.
- This concept can be distinguished from comparative advantage, which relates to the ability to produce specific goods at a lower opportunity cost.

ASSUMPTIONS OF THE ABSOLUTE ADVANTAGE THEORY

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

THE THEORY OF COMPARATIVE ADVANTAGE

- David Ricardo introduced the concept of comparative advantage, a fundamental idea in economics.
- He argued that trade is determined by comparative costs of producing goods, not absolute costs.
- A country might be more productive in all goods, meaning it can produce anything with fewer inputs than other nations.
- Ricardo's key insight was that even in such a scenario, a country benefits from trade by focusing on its comparative advantage.
- This means exporting products in which its absolute advantage is the greatest and importing products in which its absolute advantage is relatively less, even if it's still positive.
- Even a country highly efficient in everything it produces would still benefit from engaging in international trade. Consider following Example

  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. 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.

THE HECKSCHER-OHLIN THEORY OF TRADE

- 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 highlights the role of factor endowments, such as labor and capital, in determining trade advantage.
- Countries tend to export goods that heavily use the factor of production that is relatively abundant in their own country.
- However, modern economists believe that while factor endowments are essential, there are other critical influences on trade patterns.
- Increased foreign competition drives efficiency, leading less efficient firms to contract while allowing more efficient ones to expand.
- Trade fosters the introduction of better technologies, new product varieties, and a wider selection of goods, which isn't fully explained by the factor endowment approach.
- Trade brings efficiency benefits by providing greater product variety, access to higher-quality inputs, and enhancing overall investment and innovation.
- Trade's impact on technology transfer and pro-competitive forces, while challenging to model, is recognized as contributing to substantial benefits, especially when tariffs and trade barriers are reduced.

Comparison of Theory of Comparative Costs and Modern Theory

Theory of Comparative Costs	Modern Theory
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.
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

GLOBALIZATION AND NEW INTERNATIONAL TRADE THEORY

The "new trade theory" that emerged in the 1980s built upon traditional trade theory and reaffirmed that international trade remains mutually beneficial. This new theory introduced concepts like imperfect competition and increasing returns, which further enhance the gains from trade. Essentially, international trade enlarges markets, fosters competition, and allows for greater economies of scale, adding to the positive-sum nature of trade beyond the scope of comparative advantage.

The new trade theory proposes that many traded goods come from industries with oligopolistic characteristics and external economies due to factors like economies of scale in non-traded intermediates. This theory contrasts with the idea of an international economy at a Pareto optimum, instead suggesting that markets often result in suboptimal outcomes.

In the late 1970s, economist and journalist Paul Krugman observed a mismatch between the accepted model of international trade and actual trade patterns. The traditional Heckscher-Ohlin model predicted that trade would be driven by factors like the capital-to-labor ratio, with capital-rich countries exporting capital-intensive goods and labor-rich countries exporting labor-intensive goods. However, Krugman noticed that most international trade occurred between countries with similar capital-to-labor ratios. For instance, capital-intensive Sweden exported cars to capital-intensive America, while Swedish consumers imported cars from the United States. This phenomenon also applied to key economic sectors in India, including electronics, IT, food, and automotive, where cars were made in India, but many cars were imported from other countries. Krugman's observations challenged the traditional model of international trade.

Paul Krugman was an advocate of free trade and expressed deep concern for global well-being. He defended this perspective in an article titled "In Praise of Cheap Labor," published in 1997. In the article, Krugman highlighted the example of Smokey Mountain, a large garbage dump in Manila where people, including men, women, and children, earned a living by scavenging for valuable items. He argued that low-wage jobs in multinational companies' factories in countries like the Philippines and Bangladesh were much better alternatives for these workers. Krugman believed that these jobs, provided by multinational corporations, had lifted hundreds of millions of people out of abject poverty and significantly improved their living conditions, even though challenges remained.

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

a. **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.

b. **Network effects, also known as the "bandwagon effect,"** It occur when the value of a good or service to one person is influenced by its value to others. The product or service becomes more valuable as more people use it. This effect enhances utility, making products like mobile apps (e.g., WhatsApp) and software (e.g., Microsoft Windows) more appealing due to increased user participation, offering more choices and higher utility.

TRY YOUR UNDERSTANDING

1. Which of the following does not represent a difference between internal trade and international trade?
   (a) transactions in multiple currencies
   (b) homegenoity of customers and currencies
   (c) differences in legal systems
   (d) none of the abeve
2. The theory of absolute advantage states that
   (a) national walth and power are best sorved by increasing exports and docreasing imports
   (b) nations can increase their economic well-being, by specializing in the production of goods they produce more efficiently than anyone else.
   (c) that the value of price of a commodity depends exclusively on the amount of labour going into its production and therefore factor prices will be the same
   (d) differences in absolute advantage explains differences in factor endowments in different countries
3. Which of the following theories advocates that countries should produce those goods for which it has the greatest relative advantage?

(a) Modern theory of international trade

(b) The factor endownsent theory

(c) The Heckscher-Ohlin Theory

(d) None of the above

4. Which of the following holds that a country can increase its wealth by encouraging exports and discouraging imports

(a) Capitalism (b) Socialism

(c) Mercantilism (d) Laissez faire

5. According to the theory of comparative advantage

(a) trade is a zero-sum game so that the net change in wealth or benefits among the participants is zero.

(b) trade is not a zero-sum game so that the net change in wealth or benefits among the participants is positive

(c) nothing dofinite can be said about the gains from trade

(d) gains from trade depends upon factor endowment and utilization

6. According to Paul Krugman's New Trade Theory, trade between countries can be driven by:

(a) Comparative advantage in specific industries.

(b) Differences in factor endowments.

(c) Economies of scale, creating monopolistic competition in certain industries.

(d) Strict government regulations promoting domestic industries.

7. The New Trade Theory focuses on:

(a) Traditional theories of international trade, emphasizing absolute and comparative advantages.

(b) Increasing returns to scale and network effects in shaping trade patterns.

(c) The role of government intervention in trade policies.

(d) Cultural factors influencing international trade decisions.

Answer Key

1. (b) 2. (b) **3.** (d) 4. (c) **5.** (b) 6. (c) **7.** (b)

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UNIT 2

TradePolicy – The Instruments of Trade Policy

Unit overview

- International Trade
  - The Instruments of Trade Policy
    - Tariffs
    - Non-Tariff Measures (NTMs)
    - Export-Related Measures

INTRODUCTION

- **A few recent developments in India's international trade strategy.**
  - India has shifted its stance on free trade agreements (FTAs) after a decade of avoiding them.
  - India is now actively engaging in a series of FTAs, making it one of the most FTA-engaged countries globally.
  - The FTA rush began with an agreement with Mauritius in April 2021.
  - Fast-track negotiations have taken place with the United Arab Emirates (UAE), Australia, the United Kingdom (UK), Canada, and the European Union (EU).
  - A comprehensive economic partnership agreement (CEPA) with the UAE was concluded within 90 days and has been in force since May 1, 2022.
  - An Economic Cooperation and Trade Agreement (ECTA) with Australia was concluded in April 2022.
  - The UK is the next highly-anticipated FTA, expected to conclude by October 2022.
  - India is also expediting FTA discussions with Canada, the EU, the Gulf Cooperation Council (GCC), and Israel.

- Unit 1 highlights the efficiency benefits of trade, including economic growth, job creation, and improved welfare.
- These arguments for open trade assume fair competition between domestic and foreign producers. Fair competition is not always present, leading to challenges for domestic firms and industries.
- Unrestricted international trade can cause severe disruptions and difficult adjustment problems. As a result, individuals and organizations often advocate for policies that restrict imports or artificially boost exports.
- This unit focuses on describing commonly used forms of interference with trade.
- The goal is to help understand the uses and implications of common trade policy instruments.
- The understanding of these instruments enables the formulation of appropriate policy responses.
- It also promotes more balanced discussions and dialogues on trade policy issues and international trade agreements.

TRADE POLICY

- Trade policy includes all tools and measures that governments employ to either promote or restrict imports and exports.
- It also encompasses a country's approach to trade negotiations, both multilateral and bilateral.
- Nations entering into trade agreements assume obligations that influence their national trade policies.
- Trade policy instruments can be categorized into two broad groups:

  (a) price-related measures like tariffs, and

  (b) non-price measures known as non-tariff measures (NTMs).

TARIFFS

- Tariffs, also known as customs duties, are taxes imposed on imported or exported goods and services.
- Different commodities are subject to varying tariff rates.
- Tariffs are financial charges collected at the border when goods cross from one customs territory to another.
- They are a fundamental trade measure used to regulate market access for goods.
- Each country has a tariff schedule specifying the tariff rate for specific goods and services.
- Tariffs typically refer to import duties, as import duties are more prevalent.
- Tariffs are primarily used to alter the relative prices of imported goods, reducing domestic demand and regulating imports.
- They don't affect the world market price but raise prices in the domestic market.
- The main objectives of tariffs are to generate government revenue and protect domestic industries that compete with imports.

FORMS OF IMPORT TARIFFS

(a) Specific Tariff:

- Specific tariff is a fixed monetary charge per physical unit, weight, or measurement of imported or exported commodities.
- The specific tariff rate can differ based on the specific type of goods being traded.
- Example: A specific tariff may be Rs.100 per 1000 kg of Sugar Imported.

(b) Ad valorem tariff:

- When the duty is levied as a fixed percentage of the value of the traded commodity, it is called as valorem tariff.
- An ad valorem tariff is levied as a constant percentage of the monetary value of one unit of the imported good.
- Example: 20% import duty on Imported Shoes. If the value of imported shoes is 5,000 then import duty shall be 20% of 5,000 i.e. 1,000.

OTHER VARIATIONS OF THE ABOVE TARIFFS.

(a) Mixed Tariffs:

- Mixed tariffs combine elements of both ad valorem and specific duty tariffs.
- The choice between ad valorem and specific duty is based on which generates more or less income for the nation.
- Mixed tariffs are flexible and depend on the type of goods being imported.
- For instance, the duty on a product like rice can be expressed as either 5% ad valorem or a fixed amount, such as ₹3000 per tonne, whichever is higher.

(b) Compound Tariffs

- A compound tariff, also known as a compound duty, combines elements of both ad valorem and specific tariffs.
- It is calculated based on both the value of imported goods (ad valorem duty) and a unit of measurement of those goods (specific duty).
- Compound tariffs are computed by adding a specific duty to an ad valorem duty.
- For example, a compound tariff on cheese might consist of a 5% ad valorem duty plus an additional 100 per kilogram specific duty.

(c) 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: ₹ 3000/ on each solar panel plus ₹ 50/ per kg on the battery

(d) Tariff Rate Quotas: Tariff rate quotas (TRQs) involve the combination of two trade policy instruments: quotas and tariffs.

- Imports falling within the predefined quota limit often encounter a lower, and sometimes zero, tariff rate.
- Imports exceeding the set quantity threshold of the quota are subjected to significantly higher tariff rates.

- TRQs are used to manage and regulate imports, typically favoring lower tariffs for goods within the quota and higher tariffs for those beyond it.

(e) Most-Favoured Nation Tariffs:

- Most-Favoured Nation (MFN) tariffs are import tariffs that countries commit to applying on imports from other members of the World Trade Organization (WTO).
- These tariffs are the default rates unless a country is part of a preferential trade agreement like a free trade area or customs union.
- In practice, MFN rates are typically the highest and most restrictive tariffs that WTO members impose on each other.
- Some countries may apply even higher tariffs to nations that are not part of the WTO, leading to further trade restrictions.

(f) 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.

(g) Preferential Tariff:

- Preferential tariffs are agreements in which countries commit to offering lower tariffs than their Most-Favoured Nation (MFN) rates to products from specific trading partners.
- These agreements are typically reciprocal, meaning both countries involved grant each other preferential treatment by charging lower tariffs.
- An example is the European Union (EU), where goods traded among EU member countries are often charged zero tariff rates.
- The North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the USA is another example, with a preferential tariff rate of zero on most products.
- Affluent countries may also unilaterally offer preferential treatment to specific products from selected developing countries. This is exemplified by the Generalized System of Preferences (GSP) system.

(h) Bound Tariffs:

- Bound tariffs in the context of the World Trade Organization (WTO) involve a legal commitment by a member nation not to raise its tariff rates above a certain specified level.
- This commitment, often established during negotiations, restricts a member's ability to set tariff rates beyond a predetermined threshold.
- These bound rates apply to individual products and represent the maximum allowable import duty that can be imposed on those products by the member country.
- Members are free to set tariffs lower than the bound level, but they cannot exceed it without negotiation and compensating trading partners for potential trade losses.
- Bound tariffs serve to enhance transparency and predictability in international trade by ensuring that tariff levels remain within agreed-upon limits.

(i) 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.

(j) Escalated Tariff

- Escalated tariff structure means that nominal tariff rates on imports of manufactured goods are higher than those on intermediate inputs and raw materials.
- This system leads to an increase in the tariff rate as a product progresses along the value-added chain.
- For instance, there may be a 4% tariff on iron ore or iron ingots and a 12% tariff on steel pipes.
- This type of tariff structure is considered discriminatory as it primarily shields manufacturing industries in importing countries and discourages the development of manufacturing industries in exporting countries.
- This situation is especially relevant in trade between developed and developing countries.
- Developing countries often find themselves compelled to remain suppliers of raw materials with limited value addition due to such tariff structures.

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

(l) 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).

(m) Tariffs as Response to Trade Distortions:

- Tariffs can be used by countries as a response to address "unfair" foreign trade practices that distort trade and harm domestic firms.
- In cases where foreign trade practices are confirmed to be distorting and detrimental to domestic interests, affected importing countries may swiftly implement tariff responses to counteract these distortions.
- These responsive policies are often known as "trigger-price" mechanisms.
- These tariffs are used as a countermeasure against trade practices like foreign dumping and export subsidies.

(n) Anti-dumping Duties:

- An anti-dumping duty is a protectionist tariff imposed by a domestic government on foreign imports it believes are priced below fair market value.
- Dumping occurs when foreign manufacturers sell goods in another country at prices below those in their domestic market or below their average production costs.
- Dumping can take various forms, including persistent, seasonal, or cyclical, and may be used as predatory pricing to eliminate domestic competition and establish a monopoly.
- Dumping is essentially a form of international price discrimination that benefits foreign buyers but harms domestic producers, as exporters intentionally lower prices to undercut domestic competitors.
- Anti-dumping measures are initiated to counteract the unfair price advantage of foreign firms when dumping is found. This involves imposing additional import duties or tariffs.
- These measures are justified only if the domestic industry is significantly harmed by import competition, and the protection aligns with national interests (i.e., the benefits to producers outweigh the costs to consumers).

- An example is India imposing anti-dumping duties on color-coated steel products from China and European nations, as well as on jute and jute products from Bangladesh and Nepal in January 2017.

(o) Countervailing Duty:

- Countervailing duties are tariffs designed to counteract artificially low prices set by exporters who benefit from export subsidies and tax incentives from their home governments.
- These duties are applied when a foreign country, lacking a comparative advantage in a specific product, uses government subsidies to promote exports, distorting the natural allocation of resources in free trade.
- Countervailing duties are imposed by importing countries to neutralize the advantage enjoyed by subsidized exporters, ensuring fair and market-oriented pricing of imported goods while safeguarding domestic industries and businesses.
- For instance, in 2016, India imposed a 12.5% countervailing duty on gold jewelry imports from ASEAN to protect its domestic industry.

EFFECTS OF TARIFFS

The impact of tariffs on both exporting and importing countries can be summarized as follows:

(i) Tariffs act as trade barriers, reducing the volume of international trade and hindering market access for exporting countries.

(ii) Tariffs increase the cost of imported goods, discouraging domestic consumers from buying foreign products. This results in a loss of consumer surplus as they pay higher prices and consume less.

(iii) Tariffs promote the consumption and production of domestic substitutes for imported goods, protecting domestic industries.

(iv) Producers in the importing country benefit from tariffs through increased well-being. They can charge higher prices and experience higher producer surplus due to reduced foreign competition.

(v) Tariffs lead to increased production by existing firms and the possible entry of new firms, resulting in more employment opportunities.

(vi) Tariffs create trade distortions by ignoring comparative advantage, discouraging efficient production in the rest of the world while encouraging inefficient production in the home country.

(vii) Tariffs increase government revenues in the importing country by the total value of the tariffs collected.

NON-TARIFF MEASURES (NTMs)

- The non-tariff measures constitute the hidden or 'invisible' measures that interfere with free trade.
- Non-tariff measures (NTMs) are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both

- Non-tariff measures (NTMs) differ from non-tariff barriers (NTBs).
- NTMs encompass a wide range of trade-related regulations and standards.
- NTBs are a subset of NTMs, characterized by a discriminatory or protectionist intent.
- NTBs are used by governments to favor domestic industries over foreign competition.
- NTMs, while related to NTBs, include a broader set of measures that may not necessarily have a protectionist purpose.
- NTMs are sometimes used as a means to circumvent free-trade rules and favour domestic industries at the expense of foreign competition. In this case they are called nontariff barriers (NTBs).

TYPES OF NTMS

A. **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.

B. **Non-technical Measures:**

- It relates 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.

TECHNICAL MEASURES

I. **Sanitary and Phytosanitary (SPS) Measures:**

- SPS measures are implemented to protect human, animal, and plant life from risks like additives, pests, contaminants, toxins, and disease-causing organisms, and to preserve biodiversity.
- These measures encompass import bans on certain goods, quality and hygiene requirements, production processes, and compliance assessments.
- Examples include prohibiting poultry imports from regions affected by avian flu, setting standards for meat and poultry processing to reduce pathogens, and establishing limits on pesticide residues in food.

II. **Technical Barriers To Trade (TBT):**

- Technical Barriers to Trade (TBT) apply to both food and non-food products and involve mandatory standards and technical regulations.
- These standards define specific product characteristics such as size, shape, design, labeling, packaging, functionality, performance, and production methods, excluding SPS-related measures.

- TBT also covers conformity assessment procedures like testing, inspection, and certification to ensure products meet these requirements.
- TBT measures can be used to protect consumers and natural resources but can also function as trade obstacles or discriminatory measures against imports to favor domestic products.
- Adapting products and production processes to meet the varying requirements in export markets can be challenging and costly, affecting the competitiveness of exporting countries.
- Examples of TBT include food laws, quality standards, industrial standards, organic certification, eco-labeling, and marketing and label requirements.

NON-TECHNICAL MEASURES

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

(a) Import Quotas.

- An import quota restricts the quantity of a specific good allowed into a country during a set time period, often one year, and is typically set below the level of free trade.
- Import quotas are enforced through licensing. Binding quotas are below the free trade level, while non-binding quotas have little trade impact as they are at or above free trade levels.
- There are two main types of import quotas: absolute quotas, which limit imports to a specific volume within a given time frame, with no condition on the country of origin, and country-specific quotas, where a fixed volume or value must originate from certain countries.
- Example: A quota of 1000 tonnes of fish that can be imported any time during the year, but where 750 tonnes must originate in country A and 250 tonnes in country B.
- Import quotas can also be seasonal or temporary.
- Import quotas do not generate government revenue; instead, profits from import licenses are known as "quota rents."
- Quotas indirectly affect market prices by raising the domestic price of the imported product, allowing license holders to purchase imports at a lower price and resell them at a higher price in the domestic market.
- The welfare effects of quotas are similar to tariffs; if a quota is set below the free trade level, it reduces imports, raises domestic prices, and benefits domestic producers but harms consumers. This leads to increased producer surplus, potentially more output, increased employment, and higher profits.

(b) Price Control Measures:

- Price control measures are employed to influence or control the prices of imported goods, primarily to bolster (support) the domestic prices of specific products when the import prices are lower.

- These measures, often termed "para-tariff" measures, go beyond traditional tariffs and include methods that raise the cost of imports by fixed percentages or fixed amounts.
- An example is a minimum import price is established for a product like sulfur.

(c) Non-automatic licensing and prohibitions

- Non-automatic licensing and prohibitions are measures designed to restrict the quantity of imported goods, irrespective of their source or supplier.
- These measures can manifest as non-automatic licensing requirements or outright prohibitions.
- For example, certain countries may require discretionary licenses for the import of textiles, granting them the authority to approve or deny imports.
- There may also be complete prohibitions on specific items, such as India prohibiting the import/export of arms and related material to/from Iraq.
- India also enforces prohibitions on numerous items, primarily of animal origin, classified under specific EXIM codes.

(d) Financial measures

- It aims to raise the cost of imports by regulating access to and the cost of foreign exchange for import transactions and payment terms.
- These measures include requirements for advance payments and foreign exchange controls that restrict the use of foreign currency for specific types of imports or goods from particular countries.
- For instance, an importer may need to pay a percentage of the import value three months before the goods arrive, or foreign exchange may not be allowed for the import of certain products like newsprint.

(e) Measures affecting competition

- These measures are designed to provide exclusive or special advantages to a limited group of economic operators.
- These measures may involve government-imposed exclusive import channels or enterprises and the mandatory use of national services.
- For instance, a statutory marketing board might be granted exclusive import rights for a specific product like wheat, or a monopoly import agency (e.g., State Trading Corporation) could be given a monopoly to distribute palm oil.
- When a state or monopoly agency sells products in the domestic market at prices higher than those in the world market, it has a similar effect to an import tariff, protecting domestic producers.

(f) Government Procurement Policies:

- Government procurement policies can disrupt trade when they require a certain percentage of government purchases to be made from domestic firms, even if their prices are higher than those offered by foreign suppliers.
- Government tenders may prioritize local bids over foreign ones when accepting public contracts.

(g) Trade-Related Investment Measures:

- These measures involve rules on local content requirements that specify a portion of a final product must be manufactured domestically.

- They can include requirements to use a minimum amount of locally made components, restrict the level of imported components, or limit the purchase or use of imported products based on the quantity or value of locally produced goods.
- For example, a rule may mandate that at least 25 percent of automobile components must be sourced domestically, or a firm might be allowed to import only up to 75 percent of its previous year's export earnings.

(h) Distribution Restrictions:

- Distribution restrictions are constraints placed on the distribution of goods in the importing country, often requiring additional licenses or certifications.
- These restrictions can pertain to geographical limitations or specify the types of agents allowed to resell the products.
- For instance, there might be a requirement that imported fruits can only be sold through outlets equipped with refrigeration facilities.

(i) Restriction on Post-sales Services:

- Producers may be restricted from providing aftersales services for exported goods in the importing country.
- Such services may be reserved to local service companies of the importing country.

(j) Administrative procedures

- Administrative procedures can serve as barriers to free trade by imposing expensive and time-consuming requirements on the import of foreign goods, which raise transaction costs and discourage imports.
- These measures can benefit domestic industries competing with imports. Examples include mandating specific procedures, licenses, administrative delays, bureaucratic hurdles, and customs-related issues that frustrate potential importers and create obstacles linked to proving compliance.
- Example: Importers of electronic equipment are often required to obtain licenses, submit extensive documentation, and undergo lengthy inspection procedures at customs, which can significantly slow down the import process and increase costs. This administrative burden can discourage foreign manufacturers from exporting their products to the importing country.

(k) Rules of origin:

- Country of origin refers to where a product was made or the home country of a service provider.
- Rules of origin are criteria used by importing countries to determine the national source of a product, impacting duties and restrictions on imports.
- Challenges arise in obtaining certifications of origin when a product has components from different countries. Example: A car may be assembled in Country A, but its engine is made in Country B, and some of its electronic components come from Country C. Determining the origin of such a car can be complicated, as it may not qualify as a product of any one specific country, affecting the applicable tariffs and regulations when it's imported into another country.

(l) Safeguard Measures:

- Safeguard measures are implemented by countries to temporarily limit imports of a product when their domestic industry is harmed or at risk of significant harm due to a surge in imports.
- These restrictions are temporary in nature and must be applied in a non-discriminatory manner, meaning they should not favor specific countries or trading partners.

(m) Embargos:

- An embargo is a comprehensive government-imposed ban on the import or export of some or all goods to specific countries or regions.
- This can be initiated for various reasons, including political, health, or religious factors, and they represent the most extreme form of trade barrier.

EXPORT-RELATED MEASURES

(a) Ban on exports:

- Export-related measures encompass all actions taken by the government of an exporting country, including both technical and non-technical measures.
- For instance, during shortages, a country may prohibit the export of agricultural products like onions and wheat to ensure sufficient domestic supply.
- Export restrictions can significantly impact international markets by reducing global supply, which has been known to increase international prices.

(b) Export Taxes:

- An export tax is a tax imposed on goods that are exported, and it can be specific or ad valorem (based on the value of the goods).
- The primary impact of an export tax is to increase the price of the exported product, which, in turn, lowers the volume of exports.
- Additionally, an export tax can lead to reduced domestic prices and increased domestic consumption since it reduces exports and boosts domestic supply.

(c) Export Subsidies and Incentives:

- These measures are developed to compensate exporters when tariffs on imports negatively affect their exports.
- These measures can include export subsidies, duty drawback, duty-free access to imported intermediates, and financial support from governments to domestic producers.
- Such policies are aimed at encouraging domestic industries to sell specific products or services abroad and can be considered trade policy tools.

(d) Voluntary Export Restraints:

- Voluntary Export Restraints (VERs) are informal quotas voluntarily imposed by exporting countries to limit the quantity of goods they export.

- VERs are often initiated due to political considerations and negotiations between the importing and exporting countries.
- Exporters may agree to VERs to appease the importing country and avoid potential retaliatory trade restraints.
- VERs, like tariffs and quotas, result in higher domestic prices and a reduction in domestic consumer surplus.

TRY YOUR UNDERSTANDING

1. The FTA rush began with an agreement with Mauritius in ___
   (a) April 2021 (b) June 2021
   (c) April 2011 (d) June 2011
2. Mixed tariffs combine elements____.
   (a) specific duty tariffs
   (b) ad valorem tax
   (c) both specific duty tariffs and ad valorem
   (d) none of the above
3. Country of origin refers to where a product was made or the _____of a service provider
   (a) home country (b) foreign country
   (c) both home and foreign country (d) whole world
4. Bound tariffs in the context of the World Trade Organization (WTO) involve a ____ commitment by a member nation not to raise its tariff rates above a certain specified level.
   (a) Legal (b) Social
   (c) Economic (d) Political
5. A specific tariff is
   (a) a tax on a set of specified imported good
   (b) an import tax that is common to all goods imported during a given period
   (c) a specified fraction of the economic value of an imported good
   (d) a tax on imports defined as an amount of currency per unit of the good
6. A tariff on imports is beneficial to domestic producers of the imported good because
   (a) they get a part of the tariff revenue
   (b) it raises the price for which they can sell their product in the domestic market
   (c) it determines the quantity that can be imported to the country
   (d) it reduces their producer surplus, making them more efficient
7. A tax applied as a percentage of the value of an imported good is known as
   (a) preferential tariff (b) ad valorem tafiff
   (c) specific tariff (d) mixed or compound tariff

8. Escalated tariff refers to

   (a) nominal tariff rates on raw materials which are greater than tariffs on manufactured products

   (b) nominal tariff rates on manufactured products which are greater than tariffs on raw materials

   (c) a tarilf which is escalated to prohibit imports of a particular good to protect domestic industries

   (d) none of the above

9. Voluntary export restraints involve:

   (a) An importing country voluntarily restraining the quantity of goods that can be exported into the country during a specified period of time

   (b) domestic firms agreeing to limit the quantity foreign products sold in their domestic markets

   (c) an exporting country voluntarily restraining the quantity of goods that can be exported out of a country during a specified period of time

   (d) quantitative restrictions imposed by the importing country's government.

10. Anti-dumping duties are

   (a) additional import duties so as to offset the effects of exporting firm's unfair charging of prices in the foreign market which are lower than production costs.

   (b) additional import duties so as to offset the effects of exporting firm's increased competitiveness due to subsidies by government.

   (c) additional import duties so as to offset the effects of exporting firm's unfair charging of lower prices in the foreign market

   (d) Both (a) and (c) above

11. An import subsidy is simply a payment per unit or as a percent of value for the ___of a good

   (a) importation (b) exportation

   (c) production (d) consumption

12. Specific tariff is a ____ monetary charge per physical unit, weight, or measurement of imported or exported commodities.

   (a) Fixed (b) Flexible

   (c) Adjustable (d) Temporary

Answer Key

1. (a) **2.** (c) **3.** (a) **4.** (a) **5.** (d) **6.** (b) **7.** (b) **8.** (b) **9.** (c) **10.** (d)
11. (a) **12.** (a)

❑❑❑

UNIT

3

Trade Negotiations

INTRODUCTION

- There has been a significant increase in bilateral and multilateral trade negotiations among various countries in recent years, with India being involved in 19 concluded agreements and actively negotiating more than two dozen proposals.
- Major trade events in 2020 included Britain's exit from the European Union (Brexit) and the United States–Mexico–Canada Agreement (USMCA) as a successor to the North American Free Trade Agreement (NAFTA), as well as other unpredictable developments resulting from the U.S.-China trade war and the global pandemic.
- Trade negotiations have become a highly relevant area of study due to these significant global trade developments.
- In trade negotiations, national governments are not the only stakeholders; various interest groups, lobbying groups, pressure groups, and Non-Governmental Organizations (NGOs) also exert influence on the process.
- The positions taken by each negotiating party reflect their underlying interests and agendas. For example, one party may seek market access through tariff reduction, while others may focus on protecting domestic industries.
- It's important to understand the nature of regional and free trade agreements that evolve through negotiations before discussing multilateral trade negotiations and related institutions.

TAXONOMY OF REGIONAL TRADE AGREEMENTS (RTAS)

REGIONAL TRADE AGREEMENTS

- Regional Trade Agreements (RTAs) are agreements among countries, regardless of their geographical proximity, formed to reduce trade barriers among member nations.
- RTAs are treaties that establish trade rules for all signatory countries.
- As of February 1, 2021, there were 339 RTAs in force around the world.
- RTAs aim to promote economic cooperation and facilitate trade by reducing barriers such as tariffs and non-tariff trade barriers among member countries.

TYPES OF RTA

(a) Unilateral trade agreements

- Unilateral trade agreements are arrangements in which an importing country offers trade incentives to encourage an exporting country to engage in international economic activities that will benefit the exporting country's economy.
- An example of a unilateral trade agreement is the Generalized System of Preferences (GSP).

(b) Bilateral Agreements

- Bilateral Agreements are trade agreements that establish trade rules between two countries, two regional blocs, or a regional bloc and a country.
- These agreements can cover specific goods and services or address particular market entry barriers.
- Examples of bilateral agreements include the EU-South Africa Free Trade Agreement and the ASEAN–India Free Trade Area.

(c) Regional Preferential Trade

- 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.
- Example Global System of Trade Preferences among Developing Countries (GSTP).

(d) Trading Bloc

- 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).

(e) Free-trade area

- A Free-trade area is a group of countries that eliminate all tariff and quota barriers on trade with each other to promote the exchange of goods among member states.
- Trade among member countries is conducted without tariffs, but each member maintains its own distinct external tariff for imports from countries outside the free-trade area.
- Member countries retain the freedom to set their own tariffs for non-members, allowing them to maintain sovereignty in trade policies.
- An example of a free trade area is the ASEAN–India Free Trade Area (AIFTA), which includes the ten member states of the Association of Southeast Asian Nations (ASEAN) and India. It came into force on August 1, 2005.

(f) Customs union

- A customs union is a group of countries that eliminate all tariffs on trade among themselves while maintaining a common external tariff on trade with countries outside the union, which may technically violate the Most-Favored-Nation (MFN) principle.
- In a customs union, the member countries share a common external tariff, meaning they charge the same tariff on imports from outside the union, regardless of which member country receives the goods.
- The European Union (EU) is a notable example of a customs union, where its 27 member countries are considered a single territory for customs purposes.

- Other examples of customs unions include the Gulf Cooperation Council (GCC) and the Southern Common Market (MERCOSUR).
- The common external tariff is a distinguishing feature of customs unions and can lead to greater economic integration among member countries.

(g) Common Market:

- A Common Market goes beyond a customs union by allowing for the free movement of not only goods but also factors of production, including labor, capital, and other productive resources.
- It achieves this by reducing or eliminating internal tariffs on goods among member countries and establishing a common external tariff for trade with countries outside the Common Market.
- Member countries aim to harmonize institutional arrangements, commercial laws, and financial regulations among themselves to facilitate economic integration.
- Common Markets often create barriers against non-member countries to promote economic cooperation and protect the interests of member states.
- Examples of Common Markets include the European Union (EU) and the Association of Southeast Asian Nations (ASEAN), both of which aim to promote deeper economic integration among member countries.

(h) Economic and Monetary Union:

- An Economic and Monetary Union represents a further stage of economic integration beyond the Common Market.
- In an Economic and Monetary Union, member countries share a common currency, eliminating the need for foreign exchange operations within the union.
- The adoption of a common currency necessitates a high degree of convergence in macroeconomic policies among member states.
- An example is the European Union, where Eurozone countries share the euro as a common currency, and they coordinate their monetary and fiscal policies to maintain stability and convergence.

FOR YOUR KNOWLEDGE

- International trade has experienced significant growth since the end of World War II, primarily driven by the multilateral trade system.
- The multilateral trade system is a political process involving negotiations and bargaining among sovereign governments to establish rules governing trade.
- Key political institutions supporting international trade cooperation have been the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO).
- GATT and WTO serve as platforms for trade negotiations and provide the rules governing global trade, contributing to the growth and regulation of international commerce.

THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

- The General Agreement on Tariffs and Trade (GATT) primarily addresses international trade in goods.

- The GATT agreement is overseen by the Council for Trade in Goods (Goods Council), composed of representatives from all member countries of the World Trade Organization (WTO).
- The Goods Council comprises 10 committees, each focusing on specific subjects such as agriculture, market access, subsidies, and anti-dumping measures.
- All member countries participate in these committees, which serve to discuss and manage various aspects of international trade in goods, ensuring a coordinated and inclusive approach.
- Also reporting to the Goods Council are a working party on state trading enterprises, and the Information Technology Agreement (ITA) Committee.
- The GATT lost its relevance by the 1980s because
  (a) GATT became obsolete in the fast-evolving world trade landscape due to emerging globalization, increased international investments, and the absence of coverage for intellectual property rights and trade in services.
  (b) GATT couldn't keep up with the substantial growth in world merchandise trade, leading to its limitations.
  (c) Ambiguities in the multilateral system allowed for exploitation, and efforts to liberalize agricultural trade were unsuccessful.
  (d) Inadequacies in its institutional structure and dispute settlement system hampered GATT's effectiveness.
  (e) GATT was not a treaty, and its terms were binding only to the extent that they did not conflict with a nation's domestic rules, highlighting its limited legal enforceability.

THE URUGUAY ROUND AND THE ESTABLISHMENT OF WTO

- By the late 1980s, many countries recognized the need for a more powerful and comprehensive international organization for trade.
- The Uruguay Round, initiated in 1986, was a landmark in world trade negotiations, addressing a wide range of trade policy issues and leading to significant reforms in the global trading system.
- The Round involved 15 groups focusing on areas such as tariffs, non-tariff barriers, agriculture, subsidies, intellectual property, services, and other GATT-related matters.
- Originally scheduled to be completed by December 1990, the Uruguay Round faced delays and controversies, particularly regarding agriculture.
- After seven years of negotiations, it concluded in December 1993. Most countries signed the agreement on April 15, 1994, and it came into effect on July 1, 1995.
- The Uruguay Round marked the establishment of the World Trade Organization (WTO), which became the single institutional framework encompassing the General Agreement on Tariffs and Trade (GATT) as modified by the Uruguay Round.

THE WORLD TRADE ORGANIZATION (WTO)

- The World Trade Organization (WTO) is the sole global international organization responsible for regulating trade rules among nations.

- The foundation of the WTO is its agreements, which have been negotiated and ratified by the majority of the world's trading nations.
- The primary aim of the WTO is to promote the smooth, predictable, and free flow of international trade.
- The WTO seeks to facilitate international trade by ensuring fairness and predictability in global trade relations, benefiting economies and businesses around the world.
- The WTO has six main objectives:
  (a) Establishing and enforcing international trade rules.
  (b) Creating a platform for negotiations and oversight to promote additional trade liberalization.
  (c) Resolving trade disputes among member countries.
  (d) Enhancing transparency in the decision-making processes of the organization.
  (e) Collaborating with other major international economic institutions involved in global economic management.
  (f) Assisting developing countries in realizing the full benefits of the global trading system.
- The objectives of the WTO Agreements, stated in the preamble of the Agreement establishing the World Trade Organization, include:
  (1) Raising standards of living.
  (2) Ensuring full employment and sustained growth in real income and effective demand.
  (3) Expanding the production and trade of goods and services.
- The WTO achieves these objectives by:
  (1) Serving as a platform for trade negotiations among member governments.
  (2) Administering trade agreements.
  (3) Reviewing national trade policies.
  (4) Assisting developing countries in trade policy matters through technical assistance and training programs.
  (5) Collaborating with other international organizations.
- In essence, the WTO's primary purpose is to promote open trade for the benefit of all and foster global economic growth and development.

THE STRUCTURE OF THE WTO

- The WTO operates with a Secretariat in Geneva, led by a Director General.
- Its decision-making system includes three tiers: the Ministerial Conference, the General Council, and specialized councils like the Goods Council, Services Council, and Intellectual Property (TRIPS) Council.
- The Ministerial Conference, held at least once every two years, is the highest decision-making body, capable of making decisions on all multilateral trade agreements.

- The General Council meets regularly and also serves as the Trade Policy Review Body and the Dispute Settlement Body.
- Specialized councils oversee the implementation of WTO agreements in their respective areas.
- The WTO Secretariat collaborates with nearly 200 international organizations on activities like statistics, research, standard-setting, technical assistance, and training.
- Various specialized committees, working groups, and working parties handle individual agreements and other areas such as the environment, development, membership applications, and regional trade agreements.
- The WTO has 164 members, with 117 being developing countries or separate customs territories, and approximately 24 others are in negotiations for membership.
- The agreements of the WTO have been ratified in the parliaments of all member countries. The WTO plays a significant role in governing about 95% of world trade.

THE GUIDING PRINCIPLES OF WORLD TRADE ORGANIZATION (WTO)

A. Trade without discrimination

1. Most-favoured-nation (MFN):
    - Under WTO agreements, countries are generally prohibited from discriminating between their trading partners. Any special favor granted to one country, such as lower customs duties, must be extended to all WTO members.
    - This principle is known as Most-Favored-Nation (MFN) treatment and is a fundamental part of the General Agreement on Tariffs and Trade (GATT), General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).
    - Some exceptions are allowed, like setting up free trade agreements within a group of countries, providing special access to markets for developing countries, or raising barriers against unfairly traded products from specific nations.
    - These exceptions are subject to strict conditions. In general, MFN means that when a country reduces trade barriers or opens its market, it must do so for the same goods or services from all trading partners, regardless of their economic strength.
2. National treatment:
    - The principle of "national treatment" in WTO agreements stipulates that imported and locally produced goods, as well as foreign and domestic services and intellectual property (trademarks, copyrights, and patents), should be treated equally once they have entered the market.
    - National treatment is a common feature in all three major WTO agreements (GATT, GATS, and TRIPS), although each agreement may handle the principle slightly differently.
    - National treatment applies only after a product, service, or intellectual property item has entered the market. Therefore, imposing customs duties on imports is not considered a violation of national treatment, even if locally-produced products are not subject to an equivalent tax.

B. Freer trade: Gradually, through negotiation

- Lowering trade barriers, such as customs duties (tariffs) and selective measures like import bans or quotas, is a clear way to promote international trade.
- The WTO agreements enable countries to implement changes gradually through a process known as "progressive liberalization."
- Developing countries often receive more extended timelines to meet their trade liberalization commitments, recognizing their unique circumstances and needs.

C. Predictability: through binding and transparency

- Promising not to raise trade barriers can be just as significant as lowering them, as it provides businesses with a stable and predictable environment for investment, job creation, and consumer benefits.
- In the WTO, countries "bind" their commitments when they agree to open their markets for goods or services. These commitments act as ceilings on customs tariff rates, ensuring predictability for traders and investors.
- While some countries tax imports at rates lower than the bound rates, in developed countries, the actual rates and the bound rates are typically the same.
- Changing these bindings requires negotiations with trading partners and may involve compensating them for potential trade losses.
- The Uruguay Round of multilateral trade talks increased the amount of trade under binding commitments, enhancing market security for traders and investors.
- The WTO strives to improve predictability and stability by discouraging the use of quotas and promoting transparency in trade rules. Many WTO agreements require governments to disclose their policies and practices, contributing to transparency both domestically and at the multilateral level.

D. Promoting fair competition

- The WTO is not just a "free trade" institution but a system of rules focused on promoting open, fair, and undistorted competition.
- Rules like Most-Favored-Nation (MFN) and national treatment are designed to ensure fair trade conditions.
- The WTO's rules cover issues like dumping (exporting at below cost to gain market share) and subsidies, aiming to establish what is considered fair or unfair trade practices and how governments can respond, often through additional import duties to compensate for damage.
- Various other WTO agreements, including those in agriculture, intellectual property, and services, also aim to support fair competition.
- The agreement on government procurement, a "plurilateral" agreement signed by only a few WTO members, extends competition rules to government purchases by numerous entities in many countries, promoting fairness in this area as well.

E. Encouraging development and economic reform

- The WTO system supports development, with a focus on flexibility for developing countries in implementing agreements.
- Over 75% of WTO members are developing countries or transitioning to market economies.

- During the Uruguay Round, many developing countries autonomously implemented trade liberalization programs, and they played a more active and influential role in negotiations than in previous rounds.
- Developing countries were willing to take on obligations similar to developed countries at the end of the Uruguay Round, but they were provided transition periods to adapt to complex WTO provisions, especially the least-developed nations.
- A ministerial decision from the Uruguay Round urged developed countries to accelerate market access commitments for least-developed countries and provide increased technical assistance.
- Recently, developed countries have begun allowing duty-free and quota-free imports for most products from least-developed nations, but challenges remain.
- The current Doha Development Agenda continues to address developing countries' concerns regarding the implementation of Uruguay Round agreements.

WTO AGREEMENTS

The WTO agreements encompass trade rules that cover goods, services, and intellectual property, along with permitted exceptions. This makes the WTO a "rules-based" system, built on agreements negotiated by governments. The following are some of the important agreements under the WTO, with a focus on major provisions:

1. **Agreement on Agriculture**: Aims to enhance GATT regulations and improve agricultural trade. It includes binding commitments in market access, domestic support, and export subsidies.
2. **Agreement on the Application of Sanitary and Phytosanitary Measures (SPS):** Establishes frameworks for planning and implementing measures to safeguard against arbitrary or unjustifiable trade restrictions due to sanitary and phytosanitary measures.
3. **Agreement on Textiles and Clothing (ATC)**: Replaced the Multi-Fibre Arrangement (MFA) and aimed to deregulate textile trade over a 10-year transition period by integrating it into GATT disciplines.
4. **Agreement on Technical Barriers to Trade (TBT)**: Seeks to prevent standards and conformity assessment systems from becoming unwarranted trade barriers by ensuring transparency and harmonization with international standards.
5. **Agreement on Trade-Related Investment Measures (TRIMs):** Expands disciplines on investment measures for cross-border investments, prohibiting countries from imposing measures inconsistent with national treatment principles and the elimination of quantitative restrictions.
6. **Anti-Dumping Agreement:** Aims to establish clear rules for calculating dumping margins and conducting investigations, preventing misuse of anti-dumping measures for the protection of domestic industries.
7. **Customs Valuation Agreement:** Specifies rules for consistent and reliable customs valuation, striving to harmonize customs valuation systems internationally and eliminate arbitrary practices.
8. **Agreement on Pre-shipment Inspection (PSI):** Aims to ensure transparency in pre-shipment inspections conducted by a designated company in the exporting country on

behalf of the importing country's customs office, covering quality, volume, pricing, tariff classification, customs valuation, and dispute resolution.

9. **Agreement on Rules of Origin:** Harmonizes rules of origin for non-preferential commercial policies, provides dispute settlement procedures, and establishes a rules of origin committee.
10. **Agreement on Import Licensing Procedures:** Simplifies administrative procedures to prevent import licensing processes from becoming trade barriers.
11. **Agreement on Subsidies and Countervailing Measures:** Clarifies subsidy definitions, strengthens discipline by subsidy type, and enhances procedures for imposing 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):** Sets out obligations for trade in services, including most-favored-nation treatment and transparency, while specifying service sectors and commitments regarding market access and non-discrimination.
14. **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS):** Covers intellectual property protection, including copyright, trademarks, patents, and enforcement procedures, with provisions for dispute settlement.
15. **Trade Policy Review Mechanism (TPRM):** Establishes procedures for periodical reviews of members' trade policies and practices, conducted by the Trade Policy Review Body (TPRB).
16. **Plurilateral Trade Agreements:** These agreements involve multiple countries with shared interests but not all WTO members, and they may not be 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 known as the Doha Development Agenda, is the ninth round of global trade negotiations since World War II.
- It was officially launched at the Fourth Ministerial Conference of the WTO in Doha, Qatar, in November 2001.
- The primary goal of the Doha Round is to make significant changes to the international trading system by reducing trade barriers and updating trade rules.
- The negotiations cover 20 areas of trade, including agriculture, services trade, non-agricultural product market access (NAMA), trade facilitation, environment, geographical indications, and certain intellectual property issues.
- Agriculture trade was one of the most contentious issues in the Doha Agenda.

G 20 ECONOMIES: FACILITATING TRADE

- Some trade-restrictive measures have been removed by G20 countries, but the overall trend has been moving in the wrong direction.
- Export restrictions have contributed to shortages, price volatility, and uncertainty in global markets.
- G20 economies are urged to build on their previous commitments and demonstrate leadership in maintaining open and predictable markets, especially for essential goods like food and fertilizer.
- The report highlights the resilience of global supply chains despite challenges like the Ukraine conflict, the ongoing COVID-19 pandemic, high inflation rates, and central bank tightening.
- While some export restrictions were lifted, many remain in place, affecting specific industries and regions.
- As of mid-October 2022, WTO members had 52 export restrictions on food, feed, and fertilizers, along with 27 export restrictions on COVID-19 essential products.
- G20 economies maintained 44% of export restrictions on food, feed, and fertilizers and 63% of pandemic-related export restrictions.
- G20 countries introduced 66 trade-facilitating measures worth USD 451.8 billion and 47 trade-restrictive measures worth USD 160.1 billion unrelated to the pandemic.
- Accumulated stockpiles of G20 import restrictions continued to grow, affecting 11.6% of G20 imports by mid-October, implemented since 2009 and still in effect.
- Initiations of trade remedy investigations by G20 economies decreased, with 17 initiations during the review period, mainly involving anti-dumping measures.
- Implementation of new COVID-19-related trade measures and support measures by G20 economies slowed in the past five months.
- Since the beginning of the pandemic, G20 economies implemented 201 COVID-19 trade measures in goods, with 61% being trade-facilitating and 39% trade-restrictive.
- G20 economies phased out pandemic-related import and export measures, with 77% of export restrictions repealed, but trade coverage remaining significant at USD 122.0 billion.
- WTO trade monitoring reports have been prepared by the WTO Secretariat since 2009.
- G20 members include 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.

EXERCISE

1. Unilateral trade agreements are arrangements in which an importing country offers trade incentives to encourage an ___to engage in international economic activities that will benefit the exporting country's economy.

   (a) Exporting country (b) Importing country

   (c) Developed country (d) Under-developed country

2. Bilateral Agreements are trade agreements that establish trade rules between __ countries,

(a) 2 (b) 3 (c) 4 (d) 5

3. The GATT lost its relevance by the___

(a) 1980s (b) 1970s (c) 1960s (d) 1990s

4. Which of the following culminated in the establishment of the World Trade Organization?

(a) The Doha Round (b) The Tokyo Round

(c) The Uruguay Round (d) The Kennedy Round

5. Choose the correct statement

(a) The GATT was meant to prevent exploitation of poor countries by richer countries

(b) The GATT dealt with trade in goods only, while, the WTO covers services as well as intellectual property.

(c) All members of the World Trade Organization are required to avoid tariffs of all types

(d) All the above

6. The 'National treatment' principle stands for

(a) The procedures within the WTO for resolving disagreements about trade policy among countries

(b) The principle that imported products are to be treated no worse in the domestic market than the local ones

(c) Exported products arc to be treated no worse in the domestic market than the local ones

(d) Imported products should have the same tariff, no matter where they arc imported from

7. 'Bound tariff' refers to

(a) clubbing of tariffs of different commodities into one common measure

(b) the lower limit of the tariff below which a nation cannot be taxing its imports

(c) the upper limit on the tariff that a country can levy on a particular good, according to its commitments under the GATT and WTO.

(d) the limit within which the country's export duty should fall so that there arc cheaper exports

8. The essence of 'MFN principle' is

(a) Equality of treatment of all member countries of WTO in respect of matters related to trade

(b) Favour one. country, you need to favour all in the same manner

(c) Every WTO member will treat all its trading partners equally without any prejudice and discrimination

(d) All the above

9. The World Trade Organization (WTO)
   (a) Has now been replaced by the GATT
   (b) Has an inbuilt mechanism to settle disputes among members
   (c) Was established to ensure free and fair trade internationally.
   (d) (b) and c) above

10. Over 75% of WTO members are _____ or transitioning to market economies.
   (a) Developing countries (b) Developed countries
   (c) Under-developed countries (d) None of the above

11. An example of a _________ agreement is the Generalized System of Preferences (GSP).
   (a) Unilateral trade (b) Bilateral trade
   (c) Multi-lateral trade (d) None of the above

Answer Key

1. (a) 2. (a) **3.** (a) 4. (c) **5.** (b) 6. (b) 7. (c) 8. **9.** (d) 10. (a) **11.** (a)

UNIT

4

Exchange Rate and Its Economic Effects

INTRODUCTION

- International transactions involve the exchange of one currency for another.
- India engages in various international activities, including trade, investment, lending, borrowing, and more.
- These transactions create an international dimension of money, where different currencies are used for various purposes.
- The exchange rates between currencies are determined through market transactions, reflecting the price of one currency in terms of another.
- International trade refers refers to the buying and selling goods and services between 2 or more countries.

THE EXCHANGE RATE

A foreign currency transaction is a transaction that involves the use of a foreign currency and can occur when:

(a) Buying or selling goods or services with prices specified in a foreign currency.

(b) Borrowing or lending funds with amounts payable or receivable specified in a foreign currency.

(c) Entering into an unperformed forward exchange contract.

(d) Acquiring or disposing of assets or settling liabilities denominated in a foreign currency.

TRY YOUR UNDERSTANDING 9.4.1

1. The price of one currency in terms of other currency is called :
   (a) Foreign exchange Rate
   (b) Flexible rate of exchange
   (c) Current rate of exchange
   (d) None of the above

Answer Key

1. (a)

THE EXCHANGE RATE REGIMES

Exchange rates are influenced by supply and demand, and governments can impact them using various methods. Different exchange rate systems exist, and they fall into three main categories:

1. A system where exchange rates are solely determined by private market forces, and governments have no involvement. Rates fluctuate constantly based on currency demand and supply.
2. A system where currency values are allowed to change, but governments intervene in currency markets to influence those values.
3. A system where governments aim to fix the values of their currencies, either through market participation or regulatory policies.

An exchange rate regime refers to how a country manages its currency concerning foreign currencies and determines the value of its domestic currency in terms of foreign currencies.

There are two major types of exchange rate regimes at the extreme ends; namely: .

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

(ii) fixed exchange rate regime

FREE-FLOATING EXCHANGE RATE SYSTEM

In a free-floating exchange rate system, governments and central banks do not interfere in the foreign exchange market. It operates similarly to how governments and institutions interact with stock markets, with minimal regulation to prevent fraud.

Advantages of a free-floating system include self-regulation and the ability to act as a buffer against external shocks. For example, increased demand for Canadian goods can raise the Canadian dollar's value, making their products more expensive for foreigners.

However, the main drawback is the unpredictability of exchange rates. Businesses must account for potential rate changes in their contracts, making international transactions riskier and increasing the cost of doing business with other countries.

MANAGED FLOAT SYSTEMS

- In a managed float exchange rate system, governments and central banks intervene in the foreign exchange market by buying or selling their own currencies to influence exchange rates while allowing them to float freely. This practice is known as a managed float.
- In a floating exchange rate system, countries may occasionally intervene in the currency market to influence the value of their own currency.
- Intervention is often aimed at preventing sudden and significant fluctuations in the currency's value.
- The impact of such intervention on exchange rates is generally limited and may not have a substantial effect.
- Governments or central banks can try to influence their exchange rates by selling their own currency when its value is rising rapidly.

- The goal of this intervention may be to prevent a major decrease in net exports by stabilizing the currency's value.
- Announcements indicating that further increases in the exchange rate are unacceptable may be made, followed by currency sales by the central bank to lower the exchange rate.
- Such actions can change market expectations, reducing demand for the currency and increasing its supply, which may help in stabilizing the exchange rate.

FIXED EXCHANGE RATES

- In a fixed exchange rate system, the exchange rate between two currencies is set by government policy.
- In an open economy, the main advantages of a fixed rate regime are:
  (i) Stability: Fixed exchange rates provide stability and eliminate currency fluctuations and associated risks and transaction costs in international trade and investments.
  (ii) Promotion of Trade and Investment: Reduced risks and stable exchange rates can significantly enhance international trade and investment.
  (iii) Reduced Speculation: A fixed exchange rate system can lead to reduced speculation on exchange rate movements when everyone expects rates to remain constant.
  (iv) Discipline and Lower Inflation: Fixed exchange rates impose discipline on a country's monetary authority, promoting lower levels of inflation.
  (v) Encouragement of Trade and Investment: Government stability encourages investment and can foster greater trade and investment.
  (vi) Enhanced Credibility: A fixed exchange rate peg can enhance the credibility of a country's monetary policy.

NOMINAL VERSUS REAL EXCHANGE RATES

NOMINAL EXCHANGE RATE

It represents the rate at which one can trade the currency of one country for another. Each country has multiple nominal exchange rates because its currency can be exchanged for various foreign currencies. To analyze exchange rate changes, economists use indexes that average these multiple exchange rates, creating a single measure of a currency's international value.

REAL EXCHANGE RATE

It reflects the rate at which one can exchange the goods and services of one country for those of another. It quantifies the trade ratio between the two countries, indicating how much of a particular good or service from one country can be traded for one unit of the same good or service in a foreign country. A nation's real exchange rate significantly influences its net exports of goods and services.

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

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:

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

REAL EFFECTIVE EXCHANGE RATE (REER)

The Real Effective Exchange Rate (REER) is calculated by dividing the nominal effective exchange rate (which measures a domestic currency's value against a weighted average of foreign currencies) by a price deflator or cost index. An increase in REER signifies that exports become more costly and imports become cheaper. This indicates a decrease in trade competitiveness.

TRY YOUR UNDERSTANDING 9.4.2

1. Based on the supply and demand model of determination of exchange rate, which of the following ought to cause the domestic currency of Country X to appreciate against dollar?
   (a) The US decides not to import from Country X
   (b) An increase in remittances from the employees who are employed abroad to their families in the home country
   (c) Increased imports by consumers of Country X
   (d) Repayment of foreign debts by Country X
2. All else equal, which of the following is true if consumers of India develop taste for imported commodities and decide to buy more from the US?
   (a) The demand curve for dollars shifts to the right and Indian Rupee appreciates
   (b) The supply of US dollars shrinks and. therefore, import prices decrease
   (c) The demand curve for dollars shifts to the right and Indian Rupee depreciates
   (d) The demand curve for dollars shifts to the loft and leads to an increase in exchange rate
3. 'The nominal exchange rate is expressed in units of one currency per unit of the other currency. A real exchange rate adjusts this for changes in price levels'. The statements are
   (a) Wholly correct
   (b) Partially correct
   (c) Wholly incorrect
   (d) None of tho above
4. At any point of time, all markets tend to have the same exchange rate for a given currency due to
   (a) Hedging
   (b) Speculation
   (c) Arbitrage
   (d) Currency futures

Answer Key

1. (a)	**2.** (c)	**3.** (a)	**4.** (a)

THE FOREIGN EXCHANGE MARKET

The participants in the foreign exchange (Forex) market include commercial banks, brokerage houses, exporters, importers, investment institutions, insurance and retirement funds, hedgers, and private investors. Commercial banks often engage in speculative currency trading and play a major role in the market. Brokerage houses act as intermediaries between various market players. They, along with commercial banks, are referred to as market makers because they influence price formation. Passive market players do not set their own exchange rates but engage in Forex transactions for purposes like international trade, investment, tourism, speculation, and hedging against currency risks.

In the foreign exchange market, transactions fall into two main categories:

1. **Current transactions:** These occur in the spot market and involve immediate delivery of the currencies being exchanged.
2. **Future transactions:** These transactions are based on contracts to buy or sell currencies for future delivery. They take place in the forward and/or futures markets, allowing parties to agree on exchange rates for a future date.

In the foreign exchange market, there are various types of exchange rates:

1. **Spot Exchange Rates:** These rates are for immediate settlement, typically within two days, and are used for current transactions.
2. **Forward Exchange Rates:** These rates are used for future transactions and specify the exchange rate for a future date. Parties agree to buy or sell currencies at a predetermined rate in the future. A forward premium occurs when the forward exchange rate is higher than the spot exchange rate, while a forward discount is when the forward rate is lower than the spot rate.
3. **Currency Futures:** These are similar to forward contracts but are distinct in nature and details concerning settlement and delivery.

The U.S. dollar often plays a central role in foreign exchange transactions, even when it's not the national currency of the parties involved, earning it the nickname "vehicle currency."

DETERMINATION OF NOMINAL EXCHANGE RATE

The external value of a domestic currency, or its exchange rate, is primarily determined by the forces of supply and demand in the domestic foreign exchange market. In this market, the supply of and demand for foreign exchange play a crucial role in shaping the currency's value in relation to other currencies.

Participants in the foreign exchange market seek (demand) foreign currency for various reasons, including:

1. Buying goods and services from foreign countries.
2. Conducting unilateral transfers, such as gifts, awards, grants, donations, or endowments.
3. Making investment income payments to foreign entities.
4. Investing in foreign financial assets, such as stocks or bonds.

5. Opening foreign bank accounts.
6. Acquiring direct ownership of real capital in other countries.
7. Engaging in speculation and hedging activities to manage risk associated with currency fluctuations.

Supply of forex results form:

1. Exports of goods and services
2. Conducting unilateral transfers, such as gifts, awards, grants, donations, or endowments
3. Receiving investment income from foreign entities.
4. Investment made by foreign countries
5. Placement of bank deposits by foreigners
6. Loans paid bank by foreign Country
7. Speculation and hedging activities

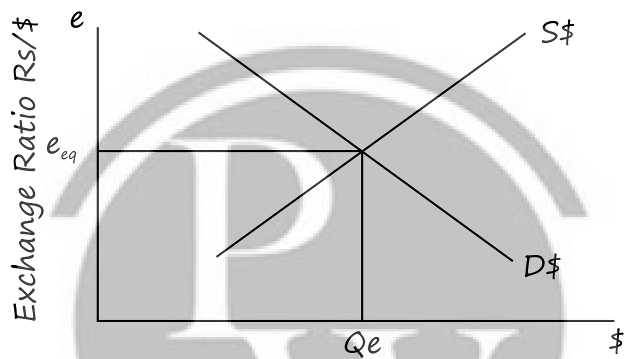

Fig. 4.4.1 Determination of Nominal Exchange Rate

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

CHANGES IN EXCHANGE RATES

Exchange rates can undergo changes that result in either currency appreciation or depreciation:

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.

HOME CURRENCY DEPRECIATION

Under a floating rate system, if for any reason, the demand curve for foreign currency shifts to the right representing increased demand for foreign currency, and supply curve remains unchanged, then the exchange value of foreign currency rises and the domestic currency depreciates in value.

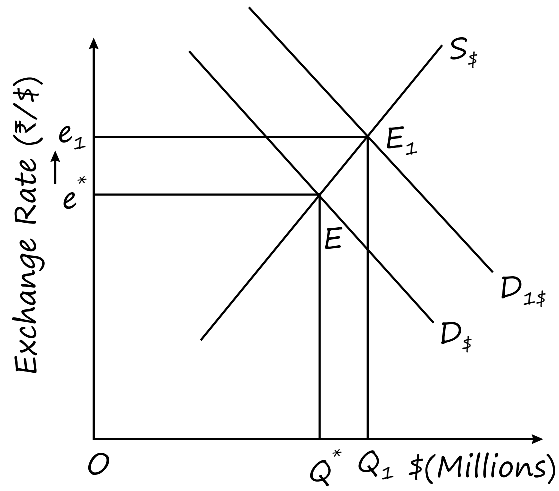

Fig. Depreciation of home Currency

The market initially is in equilibrium at point E with equilibrium exchange rate e eq. An increase in domestic demand for the foreign currency, with supply of dollars remaining constant, is represented by a rightward shift of the demand curve to D1$. The equilibrium exchange rate rises to e1 . This indicates that more units of domestic currency (here Indian Rupees) are required to buy one unit of foreign currency (here dollar) and that the domestic currency (the Rupee) has depreciated.

HOME CURRENCY APPRECIATION

An increase in the supply of foreign exchange shifts the supply curve to the right to S 1 $ and as a consequence, the exchange rate declines to e1 . It means, that lesser units of domestic currency (here Indian Rupees) are required to buy one unit of foreign currency(dollar), and that the domestic currency (the Rupee) has appreciated.

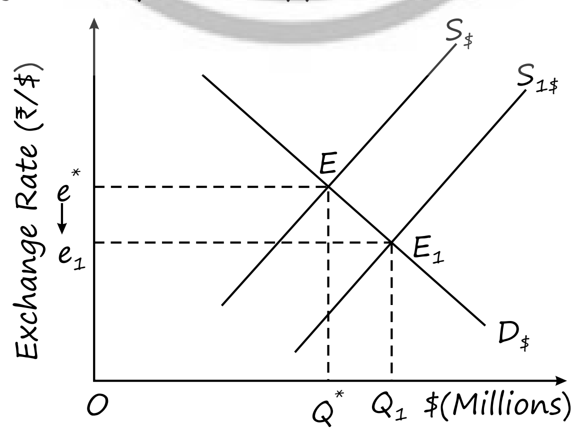

Fig. Appreciation of home Currency

Impact of exchange rate movements on international trade flows

1. Foreign prices can be expressed in terms of domestic currency.
2. Import and export prices can be expressed in single currency.

3. Prices of same goods/services in different countries can be compared.

TRY YOUR UNDERSTANDING 9.4.3

1. 'Vehicle Currency' refers to
   (a) a currency that is widely used to denominate international contracts made by parties because it is the national currency of cither of the parties
   (b) a currency that is traded internationally and. therefore, is in high demand
   (c) a type of currency used in euro area for synchronization of exchange rates
   (d) a currency that is widely used to denominate international contracts made by parties even when it is not the national currency of either of the parties

Answer Key

1. (c)

DEVALUATION (REVALUATION) VS DEPRECIATION (APPRECIATION)

Instruction: Shift Devaluation to right and Depreciation to Left

Basis of Difference	Devaluation (Revaluation)	Depreciation (Appreciation)
Meaning	It is deliberate downward (upward) adjustment in the value of currency.	It is decrease (Increase) in currency's value due to market forces.
Exchange Rate System	It is followed under fixed exchange rate regime.	It takes place under flexible exchange rate regime.
Reason	It involves govt/central bank intervention.	It does not involve govt/central bank intervention.
Impact on Economy	It affects the economy for a short term.	It affects the economy for a longer term.
Frequency	There is no fixed time for it but it doesn't occur in regularly.	It occurs on a daily basis.

IMPACTS OF EXCHANGE RATE FLUCTUATIONS ON DOMESTIC ECONOMY

(i) Exchange rates have a significant role in determining a country's trade dynamics, affecting import and export volumes, as well as import spending and export revenue.

(ii) Exchange rate fluctuations impact relative prices of domestically-produced and foreign-produced goods and services. Currency appreciation raises export prices and lowers import costs, while depreciation has the opposite effect.

(iii) Currency depreciation leads to an expansionary impact on the economy, driven by increased demand for domestic goods and services.

(iv) A depreciated currency benefits an economy with high export volumes, particularly labor-intensive industries that may see positive effects on employment and wages.

(v) Depreciation can lead to short-term consumer price inflation, affecting prices of imported goods and increasing demand for domestic products.

(vi) Currency depreciation affects a country's fiscal health, with rising export earnings and import payments impacting the current account balance.

(vii) Companies with foreign currency-denominated debts may face increased debt burdens and lower profits due to currency depreciation.

(viii) Countries with foreign currency-denominated government debts may experience higher interest burdens and fiscal strain when repaying and servicing foreign debt.

(ix) Exchange rate fluctuations make financial forecasting more challenging for firms, necessitating increased hedging against exchange rate risks.

(x) Exchange rates significantly affect the value of international investments, influencing business volumes, profit forecasts, and investment outcomes.

(xi) High exchange rate volatility can make foreign investors cautious and lead to shrinking foreign capital inflows, impacting a country's fiscal health.

To reduce the fiscal deficit at the end of 2022,

- Russia and India plan to increase trade volumes and switch to trade settlements in their national currencies to overcome currency fluctuations and enhance bilateral trade.
- India has allowed the use of Rupees in international trade settlements, aiming to boost trade with Russia.

TRY YOUR UNDERSTANDING 9.4.4

1. The decrease in the value of domestic currency in relation to foreign currency due to fluctuations in the foreign exchange rate is
   (a) Devaluation (b) Appreciation
   (c) Depreciation (d) None of the above

2. Due to depreciation of domestic currency,
   (a) Exports rise (b) Imports rise
   (c) Exports falls (d) None of the above

Answer Key

1. (c) 2. (a)

IMPACT OF CURRENCY APPRECIATION:

(i) Currency appreciation increases the value of the domestic currency, leading to higher export prices and reduced export quantities. Cheaper imports may result in increased import quantities, causing a decline in domestic aggregate demand and potentially negatively impacting economic growth.

(ii) The impact of appreciation varies depending on the business cycle. During a recession, currency appreciation may further reduce aggregate demand and increase unemployment. In a boom, it can help mitigate inflationary pressures and slow down economic growth.

(iii) Appreciation can lead to lower inflation levels due to cheaper imports, reduced production costs, and decreased demand-pull inflation. Lower consumer goods prices may improve living standards.

(iv) Increasing export prices can harm the competitiveness of domestic industries, motivating firms to innovate and adopt cost-cutting measures to remain competitive.

(v) A stronger domestic currency can lead to larger trade deficits, worsening the current account balance. The impact depends on the elasticity of demand for exports and imports. Relatively inelastic demand may improve the current account, while elastic demand can adversely affect it.

(vi) Loss of competitiveness is less significant when currency appreciation is driven by strong economic fundamentals.

PRACTICAL QUESTIONS (PART E)

1. The increase in the value of domestic currency in relation to foreign currency due to fluctuations in foreign exchange rate is called
   (a) Depreciation (b) Devaluation
   (c) Appreciation (d) Revaluation
2. Due to appreciation of domestic currency,
   (a) Exports rise (b) Imports rise
   (c) Imports falls (d) None on the above

Answer Key

1. (c) 2. (b)

EXERCISE

1. Based on the supply and demand model of determination of exchange rate, which of the following ought to cause the domestic currency of Country X to appreciate against dollar?
   (a) The US decides not to import from Country X
   (b) An increase in remittances from the employees who are employed abroad to their families in the home country
   (c) Increased imports by consumers of Country X
   (d) Repayment of foreign debts by Country X
2. All else equal, which of the following is true if consumers of India develop taste for imported commodities and decide to buy more from the US?
   (a) The demand curve for dollars shifts to the right and Indian Rupee appreciates
   (b) The supply of US dollars shrinks and, therefore, import prices decrease

(c) The demand curve for dollars shifts to the right and Indian Rupee depreciates

(d) The demand curve for dollars shifts to the left and leads to an increase in exchange rate

3. 'The nominal exchange rate is expressed in units of one currency per unit of the other currency. A real exchange rate adjusts this for changes in price levels'. The statements are

(a) Wholly correct (b) Partially correct

(c) Wholly incorrect (d) None of the above

4. Match the following by choosing the term which has the same meaning

(i)	floating exchange rate	a.	fixed exchange rate
(ii)	pegged exchange rate	b.	depreciation
(iii)	devaluation	c.	revaluation
vi	appreciation	d.	flexible exchange rate

(a) (i c); (ii d); (Ui b); (iv a)) (b) (i b); (ii a); (Ui d); (iv c)

(c) (i a); (ii d); (Ui b); (iv c) (d) (i d); (ii a); (Ui b); (iv c)

5. Choose the correct statement

(a) An indirect quote is the number of units of a local currency exchangeable for one unit of a foreign currency

(b) the fixed exchange rate regime is said to be efficient and highly transparent.

(c) A direct quote is the number of units of a local currency exchangeable for one unit of a foreign currency

(d) Exchange rates are generally fixed by the central bank of the country

6. Which of the following statements is true?

(a) Home-currency appreciation or foreign-currency depreciation takes place when there is a decrease in the home currency price of foreign currency

(b) Home-currency depreciation takes place when there is an increase in the home currency price of the foreign currency

(c) Home-currency depreciation is the same as foreign-currency appreciation and implies that the home currency has become relatively less valuable.

(d) All the above

7. An increase in the supply of foreign exchange

(a) shifts the supply curve to the right and as a consequence, the exchange rate declines

(b) shifts the supply curve to the right and as a consequence, the exchange rate increases

(c) more units of domestic currency are required to buy a unit of foreign exchange

(d) the domestic currency depreciates and the foreign currency appreciates

8. Currency devaluation

(a) may increase the price of imported commodities and, therefore, reduce the international competitiveness of domestic industries

(b) moy reduce export prices and increase the international competitiveness of domestic industries

(c) may cause a fall in the volume of exports and promote consumer welfare through increased availability of goods and services

(d) (a) and (c) above

9. At any point of time, all markets tend to have the same exchange rate for a given currency due to

(a) Hedging (b) Speculation

(c) Arbitrage (d) Currency futures

10. 'Vehicle Currency' refers to

(a) a currency that is widely used to denominate international contracts made by parties because it is the national currency of either of the parties

(b) a currency that is traded internationally and, therefore, is in high demand

(c) a type of currency used in euro area for synchronization of exchange rates

(d) a currency that is widely used to denominate international contracts made by parties even when it is not the national currency of either of the parties

Answer Key									
1. (b)	**2.** (c)	**3.** (c)	**4.** (d)	**5.** (c)	**6.** (d)	**7.** (a)	**8.** (b)	**9.** (c)	**10.** (d)

❑❑❑

UNIT
5

International Capital Movements

INTRODUCTION

- There has been a significant increase in international capital movements.
- This phenomenon has garnered attention from economists, policy-makers, workers' organizations, and civil society.
- The unit will explore the reasons for capital moving across national boundaries.
- It will also examine the consequences of these capital movements.
- Additionally, it will provide a brief overview of the foreign direct investment (FDI) situation in India.

TYPES OF FOREIGN CAPITAL

The term 'foreign capital' encompasses any capital inflow into a home country from abroad. It's important to distinguish between the movement of capital and foreign investment. Foreign capital can enter an economy through various means. Some of the important components of foreign capital flows are:

1. Foreign Aid or Assistance:
    - Bilateral grants from one government to another.
    - Multilateral aid from multiple governments or international organizations like the World Bank.
    - Tied aid with specific mandates on how the funds should be used or untied aid with no such stipulations.
    - Foreign grants involving voluntary resource transfers from governments, institutions, agencies, or organizations.
2. Borrowings:
    - Direct intergovernmental loans.
    - Loans from international institutions such as the World Bank, IMF, or ADB.
    - Soft loans, often from affiliates of organizations like the World Bank's IDA.
    - External commercial borrowing.
    - Trade credit facilities.
3. Deposits from non-resident Indians (NRI)

4. Investments:

    (i) **Foreign Portfolio Investment (FPI):** Involves investments in bonds, stocks, and securities.

    (ii) **Foreign Direct Investment (FDI):** Entails investments in industrial, commercial, and other enterprises, typically with a significant degree of ownership and control.

FOREIGN DIRECT INVESTMENT (FDI)

Foreign Direct Investment (FDI) involves long-term relationships and reflects a lasting interest and control of a resident entity in one economy in an enterprise resident in another economy. It typically occurs through the acquisition of more than 10 percent of the target asset's shares.

FEATURES OF FDI

- FDI includes all investments establishing a relationship between the investor and the enterprise, as well as subsequent transactions among them and affiliated enterprises.
- The acquisition of at least 10 percent of ordinary shares or voting power in an enterprise by non-resident investors qualifies as FDI.
- FDI components include equity capital, reinvested earnings, and other direct capital, such as intra-company loans between parent enterprises and affiliate enterprises.
- Foreign direct investors can be individuals, private or public enterprises, governments, groups, trusts, or other entities.
- Forms of direct investment include opening overseas companies, establishing subsidiaries or branches, creating joint ventures, joint development of natural resources, and acquiring companies in the host country.
- Direct investments are real investments in production facilities, assets, land, inventories, etc., with foreign ownership and control over the invested capital.
- The lasting interest signifies a long-term relationship and significant influence by the investor on the enterprise's management.

TYPES OF FDI

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

(i) Horizontal FDI: Occurs when an investor establishes the same type of business in a foreign country as it operates in its home country, e.g., a U.S.-based cell phone service provider expanding to provide the same service in India.

(ii) Vertical FDI: Involves establishing or acquiring a business activity in a foreign country that is different from the investor's main business activity but complements it, e.g., an automobile manufacturer investing in a foreign company supplying parts or raw materials.

(iii) Conglomerate FDI: Occurs when an investor makes foreign investments in a business unrelated to its existing home country business, often through joint ventures with foreign firms in the same industry.

(iv) Two-way direct foreign investment: It involves reciprocal investments between countries. This type of investment reflects industries being more advanced in one country and other industries being more efficient in other nations.

TRY YOUR UNDERSTANDING 9.5.1

1. Which of the following statements is incorrect?
   (a) Direct investments arc real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities.
   (b) Foreign portfolio investments involve flow of 'financial capital'
   (c) Foreign direct investment (FDI) is not concerned with either manufacture of goods or with provision of services.
   (d) Portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.
2. Which of the following is a component of foreign capital?
   (a) Direct inter government loans
   (b) Loans from international institutions (o.g. World Bank. IMF. ADB)
   (c) Soft loans for c.g. from affiliates of World Bank such as IDA
   (d) All the above

Answer Key

1. (c) 2. (d)

FOREIGN PORTFOLIO INVESTMENT (FPI)

Foreign portfolio investment (FPI) involves financial capital rather than ownership or control and typically includes investments in financial stocks, bonds, and other financial instruments. Examples include depositing funds in a foreign bank or purchasing bonds from a foreign entity. FPI is carried out by individuals and institutions through capital markets and mainly affects balance of payments and exchange rates rather than production or income generation.

KEY POINTS ABOUT FPI:

- FPI does not focus on manufacturing or service provision.
- Investors in FPI do not aim to control or manage the companies they invest in.
- The primary goal of FPI is to earn a return on investment and safeguard capital.
- FPI typically involves a lower stake in companies (usually below 10% ownership).
- It's characterized by short-term investments and doesn't contribute to long-term capital asset creation.
- FPI investments are often speculative, and capital can quickly shift between countries, potentially causing financial crises for the host nation.

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

Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets

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

REASONS FOR FOREIGN DIRECT INVESTMENT

- Export of capital is often driven by economic prosperity and the abundance of capital reserves, making it feasible for economic agents to invest in other countries where profit opportunities exist.
- Economic agents aim to maximize their economic interests, which may lead to investments in other countries with the potential for profits.
- Capital is moved to regions or industries with the expectation of higher returns compared to the home country.
- Foreign firms may find investment in a host country profitable due to specific knowledge or assets, like superior management skills or essential patents, enabling them to outperform local firms.

REASONS FOR FDI ARE:

1. Increasing interdependence of national economies and growing trade relations.
2. Internationalization of production and investment by transnational corporations.
3. Desire to benefit from economies of scale due to technological growth.
4. Infeasibility of licensing agreements with foreign producers due to rapid technological innovations.
5. Need to retain direct control of production knowledge or managerial skills in monopolistic or oligopolistic markets.
6. Desire to acquire promising foreign firms to prevent future competition and potential loss of export markets.
7. Risk diversification to mitigate the impact of economic recessions or downturns.
8. Shared common language or boundaries and cost savings due to geographical proximity.
9. Necessity to maintain control over trade patents and ensure consistent quality and services or establish global monopolies.

10. Promotion of optimal resource utilization.
11. Desire to tap into large and rapidly growing high-potential emerging markets with substantial populations.
12. Easy market penetration in countries with import restrictions or high customs duties.
13. Cost savings due to lower environmental standards in the host country.
14. Stable political environment and a favorable investment climate in the host country.
15. Openness to foreign capital and preferential investment systems like special economic zones.
16 Strategy to control strategic raw materials or resources to ensure a continuous and cost-effective supply.
17. Desire to access minerals or raw material deposits and profit from processing them into finished products (e.g., FDI in petroleum).
18. Low relative wages in the host country due to labor abundance and high labor costs in the home country, especially for labor-intensive production.
19. Lower economic efficiency and development gaps in host countries.
20. Tax differentials and favorable tax policies in the host country supporting foreign direct investment.
21. Defensive investments to protect a firm's competitive position.
22. High GDP and per capita income with a high growth rate.
23. Philanthropic objectives, such as strengthening socio-economic infrastructure and reducing poverty in the host country.
24. Availability of high standards of social amenities and a good quality of life in the host country.

Host Country Determinants of Foreign Direct Investment

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

FACTORS DISCOURAGING FDI

Factors in the host country that discourage the inflow of foreign investments:

1. Infrastructure lags.
2. High rates of inflation.
3. Balance of payment deficits.
4. Poor literacy and low labor skills.
5. Rigidity in the labor market.
6. Bureaucracy and corruption.
7. Unfavorable tax regime.
8. Cumbersome legal formalities and delays.
9. Difficulties in contract enforcement.
10. Land acquisition issues.
11. Small size of the market and lack of growth potential.
12. Political instability.
13. Absence of well-defined property rights.
14. Exchange rate volatility.
15. Poor track record of investments.
16. Prevalence of non-tariff barriers.
17. Stringent regulations.
18. Lack of openness.
19. Language barriers.
20. High rates of industrial disputes.
21. Lack of security for life and property.
22. Lack of facilities for immigration and employment of foreign technical and administrative personnel.
23. Double taxation.
24. 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:

1. Opening of a subsidiary or associate company in a foreign country,
2. Equity injection into an overseas company,
3. Acquiring a controlling interest in an existing foreign company,
4. Mergers and acquisitions(M&A)

5. Joint venture with a foreign company.
6. Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).
7. 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.

BENEFITS OF FOREIGN DIRECT INVESTMENT

1. Fosters competition and creates a competitive market environment.
2. Allows countries to finance more investment than domestic savings can support.
3. Accelerates growth and economic development by providing capital, technology, and management skills.
4. Promotes political and structural reforms to attract foreign investors.
5. Generates direct employment opportunities and multiplier effects on employment and income.
6. Creates indirect employment opportunities, benefiting a surplus labor force.
7. Promotes higher wages for skilled jobs and employment in the lower-end services sector.
8. Provides better access to foreign markets and fosters international relations.
9. Promotes the establishment of ancillary units, leading to job creation and skill development.
10. Utilizes global marketing networks to promote exports of developing countries.
11. Can provide new tax revenue for the host country when effective tax measures are implemented.
12. Allows for economies of scale, potentially reducing consumer prices.
13. Increases competition, weakening domestic monopolies, leading to higher output and lower prices.
14. Has a favorable impact on the host country's balance of payment position compared to external borrowings.
15. Introduces better work culture, higher productivity standards, and contributes to overall human resources development.

POTENTIAL PROBLEMS ASSOCIATED WITH FOREIGN DIRECT INVESTMENT

Arguments against the entry of foreign capital:

1. FDI may focus on capital-intensive methods of production, offering few job opportunities, especially in labor-abundant countries.
2. FDI may accentuate regional disparities and income inequalities in host countries.
3. Inflows of foreign capital might discourage domestic savings efforts, especially with tax incentives like tax holidays.

4. Borrowing in the host country's capital market by foreign firms can raise interest rates and divert funds from essential domestic investments.
5. While FDI improves the balance of payments initially, the later repatriation of profits can strain the host country's balance of payments and lead to currency depreciation.
6. The most skilled and entrepreneurial jobs are often retained in the home country, leaving the host country with routine management jobs.
7. FDI may lead to the production of elite and non-essential items, rather than essential goods.
8. Foreign entities are accused of using aggressive advertising and anti-competitive practices that distort the market.
9. Large foreign firms may outcompete local industries due to technological advantages, driving domestic companies out of the market and causing labor displacement.
10. FDI often involves offshoring, moving jobs and operations abroad to reduce costs, which can lead to reduced employment in the home country.
11. The persistence of lower labor and environmental standards in host countries benefits foreign enterprises, but it's a concern for global standards.
12. National security considerations may arise when foreign firms operate in a host country, especially during conflicts.
13. FDI can impact the host country's commodity terms of trade, potentially driving down the prices of its exports relative to imports.
14. FDI can lead to the ruthless exploitation of natural resources and environmental damage.
15. Substantial FDI in developing countries can create a dual economy with a developed foreign sector and an underdeveloped domestic sector.
16. Foreign direct investment may pose risks to the sovereignty of host countries, as powerful multinational firms can influence policies, evade corporate social responsibility, and engage in corruption.

CONCLUSION (BENEFITS AND COST COMPARISON)

- Assessing the balance of benefits and costs of foreign direct investment (FDI) is specific to each country and investment, making general assessments difficult.
- Each FDI case should be evaluated based on its unique circumstances.
- Both developed and developing countries implement safeguards and performance requirements to maximize FDI benefits and minimize drawbacks.
- Examples of such measures include domestic content rules, reserving key sectors for local firms, setting minimum local employment quotas, limiting profit repatriation, requiring local material sourcing, and mandating full or partial export to earn foreign exchange.

FOREIGN DIRECT INVESTMENT IN INDIA

- FDI plays a crucial role in India's economic growth and development.
- India offers investment incentives, such as tax benefits and lower labor costs, which attract foreign corporations.

- Government policies and a favorable business environment have contributed to increased FDI in India.
- In 2020-21, India received a record-high FDI inflow of $81,973 million, representing a 10% increase from the previous year.
- India was ranked eighth among major global FDI recipients in 2020, according to the World Investment Report 2022.
- Key sectors receiving FDI in India include information technology, telecommunications, and the automobile industry.
- Strategic collaborations between MNCs and domestic business groups have led to an 83% increase in cross-border M&A, totaling $27 billion.

OVERSEAS DIRECT INVESTMENT BY INDIAN COMPANIES

- India's economy is primarily driven by domestic demand, with consumption and investments contributing to 70% of economic activity.
- Despite global economic challenges, India has shown resilience and recovery from the Covid-19 pandemic, thanks to strong policy measures.
- Indian businesses are well-positioned to make investments abroad and expand their operations.
- Overseas investments by Indian companies lead to knowledge spillover, bringing new innovations to India and contributing to the growth of other nations.
- These overseas investments result in mutual benefits for India and host countries.

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

1. Tata Steel to invest £7 million in its Hartlepool Tube Mill in the UK.
2. Tata Communications invested $690 million in its subsidiary in Singapore.
3. Jindal Steel and Power invested $366 million in its wholly-owned subsidiary in Mauritius.
4. Wipro invested $204.96 million in its wholly-owned subsidiary in Cyprus.
5. Jindal Saw invested $64.5 million in its wholly-owned subsidiary in the UAE.
6. Restaurant Brand Aisa invested $141.34 million in its joint venture in Indonesia, and Lupin Ltd invested $131.25 million in the US.
7. Reliance New Energy invested $87.73 million in its wholly-owned subsidiary in Norway.
8. Mohalla Internet Pvt. Ltd. invested $86 million in its fully owned unit in Mauritius.
9. ONGC Videsh invested $83.31 million in a joint venture in Russia.
10. ICICI Bank partnered with Santander in the UK to serve corporate banking needs.
11. ANI Technologies, the promoter of OLA, invested $675 million in its wholly-owned subsidiary in Singapore.
12. Dr. Reddy invested $149.99 million in a joint venture in the US.
13. Reliance New Energy invested $168.9 million in joint ventures and wholly-owned subsidiaries in Germany and Norway.
14. Gail India invested $70.17 million in a joint venture and wholly-owned unit in Myanmar and the US.

15. ONGC invested \$74.15 million in various countries through different ventures.
16. Reliance Brands signed a distribution agreement with Maison Valentino, planning to open boutiques in Delhi and Mumbai.
17. Reliance Retail entered a partnership with Gap Inc. to bring the Gap brand to India.
18. Tata Steel signed an MoU with BHP to explore low-carbon iron and steelmaking technology.
19. Ola Electric plans to establish Ola Futurefoundry, a global hub for advanced engineering and vehicle design in the UK, with a \$100 million investment over the next 5 years.
20. Essar Group partnered with Progressive Energy in the UK for a \$1.34 billion investment in a hydrogen manufacturing plant at the Essar Stanlow refinery complex.
21. Hindalco Ltd's subsidiary, Novelis, will invest \$365 million in a state-of-the-art vehicle recycling facility in North America.

These investments reflect Indian companies' global expansion and diverse business interests.

TRY YOUR UNDERSTANDING 9.5.2

1. Which of the following would be an example of foreign direct investment from Country X?
   (a) A firm in Country X buys bonds issued by a Chinese computer manufacturer.
   (b) A computer firm in Country X enters into a contract with a Malaysian firm for the latter to make and sell to it processors
   (c) Mr. Z a citizen of Country X buys a controlling share in an Italian electronics firm
   (d) None of the above
2. Which of the following types of FDI includes creation of fresh assets and production facilities in the host country?
   (a) Brownfield investment
   (b) Merger and acquisition
   (c) Greenfield investment
   (d) Strategic alliances
3. Which is the leading country in respect of inflow of FDI to India?
   (a) Mauritius (b) USA (c) Japan (d) USA

Answer Key

1. (c) **2.** (c) **3.** (a)

EXERCISE

1. Which of the following statements is incorrect?
   (a) Direct investments are real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities.
   (b) Foreign portfolio investments involve flow of 'financial capital'.

(c) Foreign direct investment (FDI) is not concerned with ei ther manufacture of goods or with provision of services.

(d) Portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

2. Which of the following is a component of foreign capital?

(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) All the above

3. Which of the following would be an example of foreign direct investment from Country X?

(a) A firm in Country X buys bonds issued by a Chinese computer manufacturer.

(b) A computer firm in Country X enters into a contract with a Malaysian firm for the latter to make and sell to it processors

(c) Mr. Z a citizen of Country X buys a controlling share in an Italian electronics firm

(d) None of the above

4 Which of the following types of FDI includes creation of fresh assets and production facilities in the host country?

(a) Brownfield investment (b) Merger and acquisition

(c) Greenfieldinvestment (d) Strategic alliances

5 . Which is the leading country in respect of inflow of FDI to India?

(a) Mauritius (b) USA

(c) Japan (d) USA

6. An argument in favour of direct foreign investment is that it tends to

(a) promote rural development

(b) increase access to modern technology

(c) protect domestic industries

(d) keep inflation under control

7. Which of the following is a reason for foreign direct investment?

(a) secure access to minerals or raw materials

(b) desire to capture of large and rapidly growing emerging markets

(c) desire to influence home country industries

(d) (a) and (b) above

8. A foreign direct investor

(a) May enter India only through automatic route

(b) May enter India only through government route

(c) May enter India only through equity in domestic enterprises

(d) Any of the above

9. Foreign investments are prohibited in
   (a) Power generation and distribution
   (b) Highways and waterways
   (c) Chit funds and Nidhi company
   (d) Airports and air transport

10. Which of the following statement is false in respect of FPI?
   (a) portfolio capital in general, moves to investment in financial stocks, bonds and other financial instruments
   (b) is effected largely by individuals and institutions through the mechanism of capital market
   (c) is difficult to recover as it involves purely long-term investments and the investors have controlling interest
   (d) investors also do not have any intention of exercising voting power or controlling or managing the affairs of the company.

Answer Key

1. (c)	**2.** (d)	**3.** (c)	**4.**	**5.** (a)	**6.** (b)	**7.** (d)	**8.** (d)	**9.** (c)	**10.** (c)

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