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Chapter

INTERNATIONAL TRADE

- Unit 1: Theories of International Trade
- Unit 2: The Instruments of Trade Policy
- Unit 3: Trade Negotiations
- Unit 4: Exchange Rate and Its Economic Effects
- Unit 5: International Capital Movements

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Unit

THEORIES OF INTERNATIONAL TRADE

1. Introduction

- International trade = exchange of goods and services & resources between countries.

1.1 Benefits of International Trade

- Stimulates economic efficiency, growth, and raises incomes
- Efficient Deployment of resources, decrease domestic monopolies,
- Access to new markets and materials, enables sourcing inputs & components
- Increased use of automation, technology, innovation, and investment
- Innovative services like banking, insurance, logistics, and consultancy services
- Improvement in the quality of output
- Opening new markets creates new production possibilities and export diversification
- Trade: Trade contributes to human resources development
- Strengthens bonds between nations, **promotes harmony** & **cooperation in nations.**

1.2 Disadvantages of International Trade

- **Inequality:** Unequal benefits among nations
- **Vulnerability:** Underprivileged countries may be exploited by powerful global corporations

❖ **Environment:** Environmental damage & resource loss
❖ **Global economic instability:** Economic crises & trade cycles spread globally
❖ Dependency on foreign nations causes loss of cultural identity, economic autonomy & political sovereignty
❖ **Priorities:** Overreliance on exports diverts investment priorities
❖ Lack of transparency and predictability, the risks associated with changes in governments' policies

2. Important Theories of International Trade

Topic: Theories of International Trade
1. The Mercantilists' View of International Trade
2. The Theory of Absolute Advantage
3. The Theory of Comparative Advantage
4. The Heckscher-Ohlin Theory of Trade
5. New Trade Theory-an Introduction

2.1 The Mercantilists' View of International Trade

❖ Mercantilism, originating from "mercantile," refers to the economic policy in Europe during the 16th-18th century.
❖ According to Microsoft Encarta Dictionary (2009), Mercantilism means government's power to control industry and trade
❖ **Higher exports than imports** is the motive

- Zero-sum game
- Unequal global distribution of **labor, raw materials, and capital** led to cross-border trade.
- A **favorable balance of trade** through aggressive exports and minimal imports is Still significant in modern economy.

2.2 The Theory of Absolute Advantage (Given by Adam Smith)

- International trade is mutually beneficial when countries specialize in producing commodities where they have an absolute advantage, allowing for efficient production and trade.
- **Assumption:**
  - **Labor is the only input, 2 countries, two commodities**
  - No transportation cost
  - **Mobility:** Labour mobile within countries, immobile between countries

2.3 The Theory of Comparitive Advantage (Given by by David Ricardo)

- Trade is based on **comparative** rather than **absolute** cost advantages.
- Countries **export** goods when they have a greater advantage and **import** goods when they have a lesser absolute advantage.
- Even if a country is more productive in all goods, **specialization benefits both**.
- **Douglas Irwin (2009) calls comparative advantage “good news” for economic development**

2.4 Heckscher Ohlin Theory of Trade (Given by Eli Heckscher & Bertil Ohlin)

- **Proposition:** Countries export goods based on factor endowments/availability
  - Capital rich countries → export capital-intensive products
  - labour rich countries → export labour-intensive products
- **Limitation**: Ignored **technology & product variety** in early models.

2.5 Comparison of Theory of Comparative Costs and Modern Theory

	Theory of Comparative Costs	Modern Theory
Basis	Differences in comparative costs	Differences in factor endowments
Theory	Labour theory of value	Based on money cost
Factors	Labour as the sole factor	Includes labour and capital; 2-factor model
Trade	International trade distinct from domestic trade	International trade is a special case of interregional trade
Focus	Studies comparative costs of goods	Considers relative prices of factors
Advantage	Differences in productive efficiency of workers	Differences in factor endowments
Prices	Ignores factor price differences	Considers factor price differences
Cause	Explain differences in comparative advantage	Explains differences based on factor endowments
Approach	Normative; shows gains from international trade	Positive; focuses on the basis of trade

2.6 Globalization and New International Trade Theory

❖ Developed in the **1980s**, introducing **imperfect competition** and **increasing returns**.
❖ **Positive-Sum Game** → Trade benefit countries mutually.
❖ **Key Gains** → Expands **markets**, increases **competition**, and enables **economies of scale**.
❖ **Paul A Samuelson:** The factor price equalization theorem
❖ **Paul Krugman's noticed** →Trade occurs between **countries having similar capital to labor ratio**.
❖ **Two key concept of new trade theory**
1. Economies of Scale → **Lower costs** with higher production gives higher profit.
2. Network Effect (bandwagon effect) → **More users (like what'sApp)** → **higher value** & better consumer choice.

2 Unit THE INSTRUMENTS OF TRADE POLICY

1. Introduction

1.1 Basic Definitions

- **Trade Policy** are made by govt. to either promote or restrict trade, export or import
- **Free Trade:** Buyers and sellers from separate economies voluntarily **trade with minimum of state interference.**
- **Protectionism:** It is a state policy aimed to **protect domestic producers** against **foreign competition** through the **use of tariffs, quotas** and **non-tariff trade policy instruments.**
- **Trade liberalization:** It refers to opening up of domestic markets to rest of world by lowering trade barriers.

The Instruments of Trade Policy

- Tariffs
- Non-Tariff Measures (NTMs)
- Export-Related Measures

1.2. Tariff = Custom Duties

❖ Taxes on **imported/exported goods & services**
❖ **In this unit, tariff would refer to imported duties**
❖ **Tariff** raises **domestic price**, not world price

1.3 Types of Import Tariffs

❖ **Specific Tariff:** A fixed charge applied to each unit or weight of a product, such as 100 per kg.
❖ **Ad Valorem Tariff:** A tariff calculated as a percentage of the product's total value. i.e.A 30% ad valorem tariff on any American cycle.
❖ **Mixed Tariff:** A tariff imposed either Specific or Ad Valorem tariffs, whichever is higher
❖ **Compound Tariff:** calculated by adding up a specific duty to an ad valorem duty. compound tariff collects a revenue = $t_s q + t_a pq$.
❖ **Technical/Other Tariff:** This type of tariff is based on the specific content of the goods being imported, such as ₹2000 per solar panel or ₹100 per battery.
❖ **Preferential Tariff:** Lower tariffs applied under trade agreements, such as the reduced rates available within the EU or NAFTA agreements.
❖ **Generalized System of Preference (GSP):** A system that grants preferential tariff treatment to certain developing countries, offering trade benefits.

- **Tariff Rate Quotas (TRQ):** A combination of quotas and tariffs where:
  - Imports within the set quota are charged lower or no tariff.
  - Imports exceeding the quota face higher tariffs.
- **Most Favored Nation (MFN) Tariff:** The default tariff applied by WTO members to imports, unless there is a preferential agreement, like a Free Trade Agreement (FTA).
- **Variable Tariff:** A dynamic tariff system that adjusts import duties to align with domestic market support prices.
- **Applied Tariff:** The actual tariff imposed on imports under MFN, which may vary from the committed tariff but stays within agreed limits.
- **Escalated Tariff:** A higher tariff is imposed on processed or manufactured goods compared to raw materials, intended to protect domestic industries.
- **Prohibitive Tariff:** It is set so high that no imports can enter
- **Import Tariff:** The duty imposed on imports per unit or value, which may sometimes be escalated negatively.
- **Tariff Trade Distortions:** These arise from unfair trade practices, triggering actions like the “trigger-price” mechanism to counteract practices such as dumping and subsidies.
- **Bound Tariff:** The tariff rate that a WTO member has legally committed to not exceeding, providing transparency and predictability in trade relations.

❖ Anti-Dumping Duty
1. Tariff → Imposed on **imports sold below fair market value**.
2. Purpose → Prevent **unfair competition** & avoid **predatory pricing**.
❖ **Countervailing Duty (CVD)**
1. Tariff → Offsets **export subsidies given by exporting country** that lower prices artificially.
2. Purpose → Ensure **fair pricing**, support **domestic industries**.

1.4 Effects of Tariffs

❖ Acts as a trade barrier.
❖ Increases import costs, encouraging domestic consumption & production.
❖ Supports domestic industries by reducing foreign competition
❖ **Barrier** → Increases **import costs**, restricting trade.
❖ **Promotion** → Encourages **domestic consumption & production**.
❖ **Benefits** → Higher **prices & surplus gains** benefit domestic industries.
❖ **Employment** → Boosts **production & job creation**.
❖ **Distortion** → Hinders **comparative advantage & trade efficiency**.
❖ **Inefficiency** → Leads to **market inefficiencies**.
❖ **Revenue** → **Increases government income** through tariffs.

2. Non-Tariff Measures (NTMs) Divided into Technical and Non-technical Measures

2.1 Technical Measures

- **Focus** → Product-specific properties (quality, safety, environment, plant/animal health).

(a) Sanitary & Phytosanitary Measures (SPS)

- Protect **humans, animals, plants** from risks (additives, pests, toxins).
- **Actions** → Import bans, hygiene regulations, safety standards.

(b) Technical Barriers to Trade (TBT)

- Applies to **food & non-food products** (excluding SPS).
- Covers **size, shape, labeling, design, performance** standards.
- **Example** → Food laws, quality standards etc..

2.2 Non-Technical Measures

- **Relate to trade requirements** (e.g., shipping, investment).
- **Categories** →
  - **Hard Measures** → Price-based (e.g., tariffs).
  - **Threat Measures** → Anti-dumping duties.
  - **Other Measures** → Finance, investment restrictions.

(a) Import Quotas

- Definition → Limits quantity of imports within a given period (enforced via licenses).
- **Types:**
  - Binding Quota → Set below free trade level.
  - Non-Binding Quota → Above free trade level.
  - Absolute Quota → Fixed limit, imports allowed anytime.
  - Tariff Rate Quota → Price-based control affecting import prices.
  - Seasonal quotas
  - Temporary quotas

❖ **Effects:**

- Increases domestic prices. And no govt. revenue
- Creates "quota rents" (profits) for license holders.

(b) Price Control Measures

- **Purpose** → Regulate import prices to stabilize domestic markets.
- Known as → "Para-tariff" measures (fixed % or amount charges).
- Example → Minimum Import Price for surplus goods.

(c) Non-Automatic Licensing & Prohibition

- **Limits imports** regardless of origin.

- **Example**: India's **discretionary textile license** & prohibition on **primary animal products** under 60 EXIM codes.

(d) Financial Measures

- **Regulates import costs** by controlling access to foreign exchange.
- **Example**: Importers required to **prepay a % of goods' value** three months before arrival.

(e) Measures Affecting Competition

- **Provides special advantages** to select economic operators.
- **Example**:
  - Special import channels.
  - Mandatory use of national services.

(f) Government Procurement Policy

- **Favors domestic firms** in government purchases, even at higher prices.
- **Implemented via** mandates, tenders, and preferential treatment.

(g) Trade-Related Investment Measures (TRIMs)

- **Local content requirements**: Mandates a certain fraction of the final product be produced domestically.
- **Minimum local component use**: Restricts the use of imported components.
- **Limits on purchase/use of imported goods**.

(h) Distribution Restrictions
❍ **Limits distribution channels** for imported goods.
❍ **Requires licenses & certificates** for selling imported products.
(i) Restrictions on Post-Sale Services
❍ **Limits foreign producers** from providing after-sales services.
❍ **Services reserved for local firms** in the importing country.
(j) Administrative Procedures
❍ **Cumbersome import processes** that increase cost & time.
❍ **Discourages imports** through bureaucratic barriers.
(k) Safeguard Measures
❍ **Temporary import restrictions** to protect domestic industries.
❍ **Time-limited & non-discriminatory** as per WTO rules.
(l) Rule of Origin
❍ **Determines product origin** for tariff & trade policies.
❍ **Impacts duties, restrictions & trade agreements**.
❍ **Certification challenges** arise for goods with components from multiple countries.
(m) Embargoes
❍ **Total ban imposed by Government**
❍ **Imposed due to political reasons** (e.g., sanctions) or health and religious issues.

2.3 Export-Related Trade Measures

(a) Export Bans
❍ **Restrictions on exports** to manage domestic supply shortages.
(b) Export Taxes
❍ **Increases price of exported goods** to reduce exports & boost domestic consumption.
❍ **Lowers domestic prices** by increasing supply.
❍ **Can be specific (fixed) or ad valorem (percentage-based).**
(c) Export Subsidies and Incentives
❍ Export subsidies, duty drawbacks, duty-free imports to boost domestic exports like grants, loans, equity infusions, and income/price support.
(d) Voluntary Export Restraints (VERs):
❍ **Informal Export Quota:** Self-imposed by exporting countries.
❍ **Imposed due to Political reasons**
❍ **Impact:** Higher domestic prices & domestic surplus.

3 Unit TRADE NEGOTIATIONS

1. Introduction

- Intense bilateral and multilateral trade negotiations have increased recently.
- India is part of 19 concluded agreements and negotiating over two dozen more.
- Major 2020 events highlight the importance of trade negotiations:
  - Brexit
  - USMCA replacing NAFTA
  - US-China replacing NAFTA
  - Global Pandemic
- Various interest group, NGO influence trade negotiation:
- Negotiating parties have diverse agendas:
  - Market access through tariff reductions
  - Protection for domestic industries
- Understanding regional and free trade agreements is crucial before discussing multilateral trade negotiations and institutions.

2. Taxonomy of Regional Trade Agreements (RTAs)

2.1

❖ Regional trade agreements are agreements among countries, regardless of their geographical proximity formed to reduce trade barriers among member nations.
❖ It's a treaty among 2 or more governments defining rules for trade for all signatory.
❖ Enforced on 1 feb 2021, 339 RTAs
❖ **GATT:** General agreements on tariff and trade
❖ **WTO:** World trade organization Both serve as platforms of trade negotiations and provide rules for governing global trade.

2.2 Types of RTA

Unilateral	❖ Importing country offers trade incentives to boost the exporting country's economy (e.g., Generalized System of Preferences)
Bilateral	❖ Agreements setting trade rules between two countries or blocs, possibly limiting certain goods or market entry barriers
Regional	❖ Preferential trade agreements reducing barriers reciprocally among group member
Trading bloc	❖ Group of countries with free trade agreements and common external tariffs
FTA	❖ Group eliminating tariffs and quotas among members while maintaining individual external tariffs

Customs Union	❖ Countries eliminating internal tariffs and imposing common external tariffs, possibly violating Most-Favored-Nation principle (e.g., Gulf Cooperation Council)
Common Market	❖ Deepens customs union with free flow of goods and production factors, and common external tariffs (e.g., EU, ASEAN)
Economic Union	❖ Member countries share a common currency & align macroeconomic policies, reduce need for forex operation

3. The General Agreement on Tariffs and Trade (GATT)

❖ GATT's working is responsible for 'goods council' which includes representatives from all WTO member countries.
❖ The council has 10 committees dealing with specific subjects like agriculture etc.
❖ Councils reporting to goods council-working party on state trading enterprise and information technology agreement (ITA) committee.

3.1 Reasons for GATT's Decline

Reason	Explanation
Globalization	❖ Fast evolving contemporary complex world trade by emerging globalization
Investment	❖ Growth of international investment.
IPR and Services	❖ Intellectual property rights and trade in services not covered.
Merchandise Trade	❖ Increased world merchandise trade became beyond its scope.

System Ambiguities	❖ Ambiguities in the multilateral system could be heavily exploited.
Agricultural Trade	❖ Unsuccessful effort to liberalize agricultural trade.

4. The Uruguay Round and Establishment of WTO

Need	❖ Late 1980s saw need for more powerful and comprehensive international organization
Uruguay Round	❖ Started in September 1986, aimed at addressing various trade policy issues including tariffs and non-tariff barriers
Delays	❖ Faced delays & controversies, especially in agriculture
Duration	❖ Involved 123 countries, lasted seven years, concluding in December 1993
Agreem ents	❖ Agreements signed by most countries on April 15, 1994
WTO	❖ Establishment of World Trade Organization (WTO), incorporating the GATT

5. World Trade Organization (WTO)

❖ Sole global institutional organization regulating trade rules among nations, foundation if which have been negotiated & ratified by majority world trading countries.
Objectives of WTO
❖ Set and enforce rules for international trade
❖ Forum for monitoring & debate of trade liberalization
❖ Resolve trade disputes

❖ Increase transparency of decision making process
❖ Corporate with international economic institutions involved in global economic management
❖ Help developing countries benefit from global trading system
Preamble of WTO agreement includes
❖ Raising standards of living
❖ Full employment
❖ Sustainable growth of real income and effective demand
❖ Expansion of production of trade in goods + services
Measures
❖ Acts as forum for trade negotiation
❖ Reviewing national trade policies
❖ Administering trade agreements
❖ Technical assistance & training to developing nations
❖ Collaborations with other international orgs.

5.1 Structure of WTO

❖ Secretariat in Geneva, headed by a Director General.
❖ WTO Secretariats collaborate with 200 international orgs.
❖ **WTO members:**

- Out of 164, 117 being developing countries or separate customs territories
- 24 under negotiations

❖ WTO governs almost 95% of world trade

❖ 3 tier decision making system -
  - **Ministerial conference:** convenes at least once every two years
  - **General Council:** meets several times a year, also serves ad trade policy review body and dispute settlement body.
  - **Councils for Goods, Services, and Intellectual Property:** Specialize councils oversee implementation of WTO agreements in specific areas.

5.2 The Guiding Principles of WTO Most Favoured Nation (MFN)

❖ WTO members must treat all the members equally without discrimination, i.e. any special treatment to a nation shall apply top all WTO members.

❖ First article of GATT, 2nd for GATS & 4th for TRIPS

❖ Exceptions being free trade agreements among specific groups, special access to developing countries and barriers against unfair trade practices.

❖ Limited disclination is allowed under strict conditions

5.3 National Treatment

- After entering the market, imported and locally-produced goods, foreign and domestic services, and intellectual property rights must be treated equally.
- Article 3 of GATT, 17TH for GATS and 3rd for TRIPS
- Custom duty on imports is not a violation.

5.4 Freer Trade (Through Negotiation)

- Lowering trade duties (tariff and non tariff) encourages trade.
- WTO discusses issues like red tape an exchange rates
- WTO allows to introduce changes gradually through progressive liberalization (developing countries given longer to fulfil obligations)

5.5 Predictability trough Binding & Transparency

- Promising not to raise trade barriers is crucial for providing businesses with stability and predictability, encouraging investment, job creation, and benefiting consumers with increased competition, choice, and lower prices.
- WTO binds countries entering open markets by setting celling on tariff rates (developed countries match ceiling and developing nations have rates)
- WTO promotes transparency at domestic and multinational level.

5.6 Encouraging Development & Economic Reforms

Support	❖ WTO supports developing nations with flexibility in implementing agreements
Participation	❖ Developing countries and transition economies played a more active role in Uruguay Round negotiations
Concession	❖ Developed countries allow duty-free and quota-free access for almost all product from least-developed country

5.7 WTO Agreements

❖ WTOs rule based system includes previsions about agreements on -
❖ **Agriculture:** It include binding & specific allegiance (by WTO members govt.) in 3 areas:
❍ Market access
❍ Domestic support
❍ Export subsidies
❖ **Application of Sanitary & Phytosanitary (SPS):** Establishes frameworks to prevent unjustifiable discrimination or disguised trade barriers in sanitary and phytosanitary measures.
❖ **Textile & Clothing:** Replaced the Multi-fibre Arrangement, gradually integrating textile trade into GATT disciplines over a 10-year period.
❖ **Technical Barriers to Trade (TBT):** Prevent standards from becoming trade barrier by ensuring transparency and harmonization with international standards.
❖ **Trade Related Investment Measures:** Expands disciplines on investment measures, prohibiting inconsistent requirements on foreign investments.

- **Anti-dumping:** Tightens rules for calculating dumping margins to prevent abuse of anti-dumping measures.
- **Custom Valuation:** Establishes rules for consistent and reliable customs valuation to harmonize customs systems internationally.
- **Pre-Shipment Inspection (PSI) Agreement:** Ensures transparency in pre-shipment inspection procedures and provides dispute resolution mechanisms.
- **Rules of Origin:** Harmonizes rules for non-preferential commercial policy instruments and provides for dispute settlement procedures.
- **Import Licensing Procedure:** Simplify administrative procedures to prevent import licensing from acting as trade barriers.
- **Subsidies & Countervailing Measures:** Clarifies definitions of subsidies and procedures for adopting countervailing tariffs.
- **Safeguards:** Clarifies requirements and procedures for imposing safeguards in response to sudden import surges.
- **General Agreement on Trade in Services (GATS):** Provides obligations for trade in services, including most-favoured-nation treatment and transparency.
- **Trade Related Intellectual Property Rights (TRIPS):** Ensures intellectual property protection and enforcement, with dispute settlement procedures.
- **Trade Policy Review Mechanism (TPRM):** Conducts periodic reviews of members' trade policies and practices.
- **Plurilateral Trade:** Involves multiple countries with common interests but not all WTO members, negotiated separately from multilateral agreements.

6. The Doha Round

❖ **Doha Round (Doha Development Agenda):** Ninth round of trade negotiations launched at the WTO's Fourth Ministerial Conference in November 2001.
❖ **Aims:** Seeks major modifications of the international trading system by reducing trade barriers and revising trade rules.
❖ **Negotiations:** Cover 20 areas of trade, including agriculture, services trade, market access for nonagricultural products (NAMA), trade facilitation, environment, geographical indications, and certain intellectual property issues.
❖ **Controversial Topic:** Agriculture trade emerged as the most contentious issue in the Doha Agenda.

7. G20 Economies: Facilitating Trade

Restrictions	❖ Rising trend in export restrictions causing shortages, price volatility, and uncertainty
Resilience	❖ Supply chains remain resilient amid challenges like the Ukraine war, COVID-19, inflation, and monetary tightening, with varying industry impacts
Current	❖ As of mid-October 2022, WTO members had 52 export restrictions on food, feed, and fertilizers, and 27 COVID-19 essential products, mainly by G20 economies
Measures	❖ G20 economies introduced 66 trade-facilitating and 47 trade-restrictive measures unrelated to the pandemic, with import restrictions affecting 11.6% of G20 imports

Investigation	❖ Decline in trade remedy investigations, with anti-dumping measures being the most frequent
COVID-19	❖ Slowed implementation of new COVID-19-related trade measures, mostly trade-facilitating, with many phased out by mid-October 2022
G20	❖ G20 members include major economies like Argentina, Australia, Brazil, Canada, China, the EU, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the UK, and the US

4 Unit THE EXCHANGE RATE AND ITS ECONOMIC EFFECTS

1. The Exchange Rate

❖ A foreign currency transaction requiring settlement in a foreign currency, including:
1. Buying/selling goods or services in a foreign currency.
2. Borrowing/lending in a foreign currency.
3. Entering a forward exchange contract.
4. Acquiring/disposing of assets or settling liabilities in a foreign currency.

2. The Exchange Rate Regime

2.1

❖ 3 broad categories of exchange rate systems:
1. Floating Exchange Rate → Set by market forces without government intervention.
2. Managed Floating (Soft Peg) → Market-driven but influenced by government actions.
3. Fixed Exchange Rate (Hard Peg) → Government controls currency value via policy or intervention.

2.2 Exchange Rate Regime

❖ It is the system a country uses to manage its currency value against foreign currencies.
❖ **Major types:**
1. Floating Exchange Rate → Fully flexible.
2. Fixed Exchange Rate → Government-controlled.

2.3

❖ **Free Floating Exchange Rate:**
1. Self-regulating.
2. No government intervention is needed.
3. Unpredictable, leading to uncertainty in trade.
4. Buyers & sellers must account for exchange rate fluctuations.
❖ **Managed Floating Exchange Rate:**
❍ Governments/central banks influence rates by buying or selling currency.
❖ **Fixed Exchange Rate:**
❍ The government sets and maintains the exchange rate between currencies.

2.4 Advantages of Exchange Rate Regimes

❖ **Fixed Exchange Rate:**
1. Eliminates currency fluctuations, reducing exchange rate risk & transaction costs.
2. Boosts international trade & investment.
3. Reduces speculation on exchange rate movements.
4. Imposes monetary discipline, controlling inflation.
5. Enhances trade & investment through stability.
6. Strengthens monetary policy credibility.
7. Requires central bank intervention & foreign exchange reserves.
❖ **Floating Exchange Rate:**
1. Allows independent monetary policy.
2. Exchange rate can be adjusted for competitiveness.
3. No need for large foreign exchange reserves.

2.5 Disadvantage of Floating Exchange Rate

❖ Volatility creates uncertainty & increases risk premium in international transactions.

3. Nominal Versus Real Exchange Rates

3.1 Real Exchange Rate (RER)

- Measures the trade value of goods/services between countries.
- **Formula**: $\text{Real Exchange Rate} = \text{Nominal Exchange Rate} \times \dfrac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$

3.2 Real Effective Exchange Rate (REER)

- This is the Nominal Effective Exchange Rate or NER (a measure of the value of a domestic currency against a weighted average of various foreign currencies) divided by a price deflator or index of costs.
- **Formula:** $\text{Real Effective Exchange Rate (REER)} = \dfrac{\text{Nominal Effective Exchange Rate}}{\text{Price Deflator}}$

4. The Foreign Exchange Market

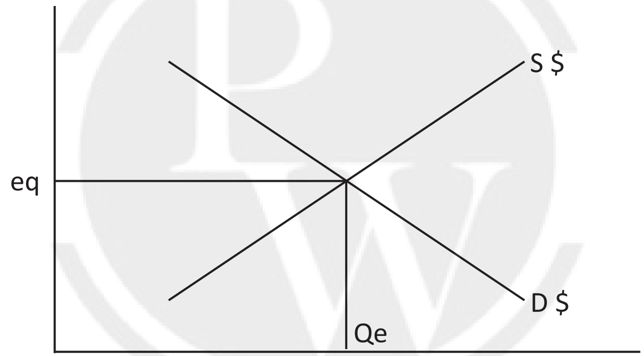
- Commercial banks & brokerage houses set their own prices, influencing market rates.
- So, they are called **MARKET MAKERS**.
- **Types of Transactions:**

1. **Current Transactions (Spot Market):** Immediate currency exchange.

2. Future Transactions (Forward/Futures Market): Contracts for future currency exchange.
❖ **Vehicle Currency:**
❖ The U.S. dollar plays a dominant role in forex markets.

5. Determination of Nominal Exchange Rate

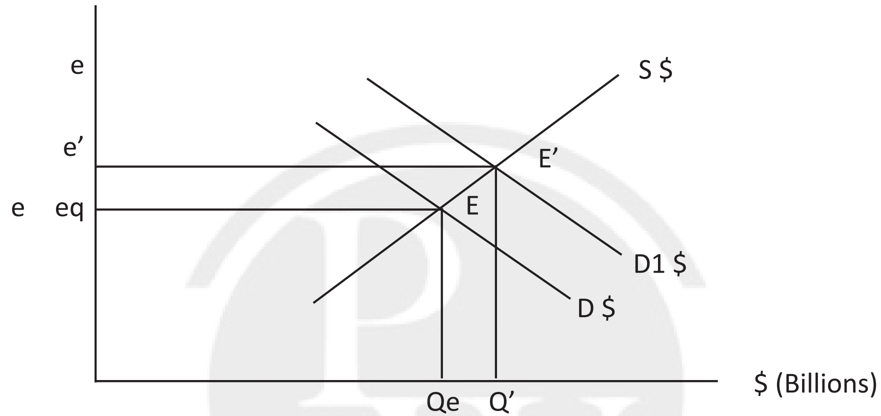
Determination of Nominal Exchange Rate



6. Changes In Exchange Rates

❖ **Appreciation:** Currency value **increases** relative to another currency or a currency basket.
❖ **Depreciation:** Currency value **decreases** relative to another currency or a currency basket.

Currency Depreciation under Floating Exchange Rates



7. Devaluation, Revaluation, Depreciation and Appreciation of domestic currency

Term	Definition	Cause	Exchange Rate System
Devaluation	Official reduction in currency value	Government policy	Fixed Exchange Rate
Depreciation	Market-driven fall in currency value	Demand & supply forces	Floating Exchange Rate
Revaluation	Official increase in currency value	Government policy	Fixed Exchange Rate
Appreciation	Market-driven rise in currency value	Demand & supply forces	Floating Exchange Rate

8. Impacts of Exchange Rate Fluctuations on Domestic Economy

Impact	Description
Trade Effects	Determines the extent and nature of trade by influencing export and import competitiveness.
Price Changes	Affects relative prices of domestic and foreign goods, shifting demand patterns.
Economic Activity	Depreciation makes foreign goods expensive, encouraging domestic consumption.
Export Gains	Economies with high exports benefit from currency depreciation.
Inflation	Depreciation raises import costs, increasing inflation.
Fiscal Health	Affects current account balance through export earnings and import costs.
Foreign Debt Burden	Depreciation increases repayment costs for companies and governments with foreign loans.
Financial Forecasting	Currency volatility makes planning and hedging more complex for businesses.
Investment Risks	Increases exchange rate risks for foreign investors and corporations.
Foreign Direct Investment (FDI)	High exchange rate volatility discourages foreign investors.

9. Consequences of Currency Appreciation on the Real Economy

1. **Reduced Exports:** Higher export prices lead to a decline in export quantity.
2. **Business Cycle Impact:** During a recession, appreciation worsens aggregate demand and unemployment.
3. **Lower Inflation:** Cheaper imports help reduce inflation.
4. **Reduced Competitiveness:** Domestic firms face challenges but may adopt cost-cutting innovations.
5. **Current Account Deficit:** Higher imports and lower exports worsen trade balance.
6. **Minimal Impact if Fundamentals Are Strong:** Appreciation due to a strong economy may not harm competitiveness.

5 Unit INTERNATIONAL CAPITAL MOVEMENTS

1. Types of Foreign Capital

❖ **Foreign capital:** any inflow of capital into home country from abroad
❖ Hence requiring distinction between movement of capital and foreign investment

1.1 Importance

Grants	Bilateral/direct inter government grants
Multilateral	Aid from pooled govt funds with inter. organization (e.g., World Bank)
Tied Aid	Aid with strict mandates on usage untied aid without stipulations
Grants	Voluntary transfer of resources by governments, institutions, agencies, or organizations

❖ **Forms of borrowings:**
❍ Direct inter government loans
❍ Loans from international institutions (e.g. world bank, IMF, ADB)

❍ Soft loans for e.g. from affiliates of World Bank such as IDA
❍ External commercial borrowing
❖ **Forms of investment:**
❍ Foreign Portfolio Investment (FPI) → eg bonds etc
❍ Foreign Direct Investment (FDI) → eg. Industrial enterprise

2. Foreign Direct Investment (FDI)

Long-term interest and control of a resident entity in one economy by an enterprise from another economy	
Components	❖ Equity capital, reinvested earnings, intra-company loans
Forms	❖ Opening overseas companies, establishing subsidiaries, joint ventures
Nature	❖ Investments where the investor retains control over use and decision-making

❖ **Types:**
❍ **Horizontal:** Establishing the same type of business operation in foreign country as in the home country.
❍ **Vertical:** Establishing or acquiring a business activity in a foreign country that supplements the investor's main business activity.
❍ **Conglomerate:** Making a foreign investment in a business unrelated to the investor's existing business in the home country.

3. Foreign Portfolio Investment (FPI)

3.1

❖ It involves flow of financial capital rather than real capital & does not entail ownership or control by the investor.

3.2 Characteristics

Execution	❖ Through capital markets by individuals and institutions
Involves	❖ Does not involve manufacturing goods or providing services
Control	❖ Investors do not intend to exercise control over companies they invest in
Aim	❖ Primary aim is to earn return on investment, focusing on capital safety, appreciation potential, & generated return

❖ **Investment stake:** Portfolio investments typically involve a lower stake in companies, usually below 10%
❖ **Nature:**
○ Short term
○ Evaluation separately for each unit
○ Often speculative (can lead to crises if inverts confidence shakes)
❖ **Example:** Investing in stocks of foreign companies, foreign country bonds etc.

4. Reason for Foreign Direct Investment (FDI)

4.1

Profit	❖ Economic agents seek to maximize economic interests, exporting capital for profitable opportunities
Return	❖ Primary motive is achieving a higher rate of return compared to the home country
Assets	❖ Foreign firms invest due to firm-specific assets like superior management skills or important patents
❖ **Other Reasons:** Listing only a few below	
❍ Interdependence of Economies	
❍ Transnational Corporations	
❍ Economies of Scale	
❍ Licensing Feasibility	
❍ Direct Control	
❍ Avoiding Competition	
❍ Risk Diversification	

4.2 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:
❖ Raw materials
❖ Low -cost unskilled labour Availability of skilled labour
❖ Technological, innovation etc.
❖ Physical infrastructure
Efficiency Seeking:
❖ Cost of physical and human resources
❖ Other input costs
❖ Membership in regional integration agreements

Business facilitation:
❖ Investment promotion and incentives
❖ Hassel cost
❖ Social amenities
❖ After investment services

5. Modes of Foreign Direct Investment (FDI)

❖ Opening of a subsidiary or associate company in a foreign country
❖ Equity injection into an overseas company
❖ Acquiring a controlling interest in an existing foreign company
❖ Mergers and Acquisitions (M&A)
❖ Joint venture with a foreign company
❖ Greenfield investment (establishing a new overseas affiliate to start production afresh)
❖ Brownfield investments (using existing infrastructure through merging, acquiring, or leasing)

5.1 Benefits of FDI

❖ Fosters competition	❖ Tax revenue
❖ Access to market s	❖ Promotes reforms
❖ Accelerates growth	❖ Favourable BOP
❖ Indirect employment	

5.2 Problems Associated with FDI

❖ **Dual Economy:** FDIs can create a dual economy with a developed foreign sector and an underdeveloped domestic sector.
❖ **Crowding-Out Effect:** FDIs may borrow from local markets, raising interest rates and reducing domestic investments.

8. FDI of India

❖ **Offshoring:** FDIs may shift jobs abroad, reducing employment potential in the home country.
❖ **Capital-Intensive Methods:** FDIs often use capital-intensive methods, which create few jobs, unsuitable for labor-abundant developing countries.
❖ **National Security:** Foreign firms may pose national security risks in host countries with existing hostilities.

Role	❖ Crucial for India's economic growth by providing non-debt financial resources
Privileges	❖ Investment privileges like tax breaks and lower salaries attract foreign corporations
Support	❖ Supportive policy framework, vibrant business climate, and rising global competitiveness attract FDI
Record High	❖ FDI inflows reached US$ 81,973 million in 2020-21, 10% increase over previous year
Key Sectors	❖ Major recipients include information technology, telecommunications, and automobile sectors in FY22
Ranking	❖ Ranked eighth among the world's major FDI recipients in 2020, up from ninth in 2019

9. Overseas Direct Investments Made by Indian Companies

- **Overview of Indian Economy:** India's economy is primarily driven by domestic demand, contributing 70% to economic activity, with robust policy measures aiding its recovery from the Covid-19 pandemic.
- **Investment Abroad:** Indian businesses are leveraging India's strong economic position to make investments abroad, expanding their operational footprint and contributing to mutual growth.

9.1 Recent Overseas Investments

Investor	Amount	Subsidiary Invested in
Tata Steel	7 million pounds	Hartlepool Tube Mill, England
Tata Communication	US$ 690 million	Subsidiary in Singapore
Jindal Steel and Power	US$ 366 million	Subsidiary in Mauritius
Wipro	US$ 204.96 million	Subsidiary in Cyprus
Jindal Saw	US$ 64.5 million	Subsidiary in the UAE

9.2 Strategic Partnerships

Companies Partnering	Purpose of Partnership
ICICI Bank and Santander	Facilitate banking requirements for corporates in Britain
Reliance Brands and Maison Valentino	Open boutiques for Maison Valentino in India

Reliance Retail and Gap Inc.	Introduce the Gap brand to the Indian market
Tata Steel & BHP	Explore low-carbon iron and steelmaking technology through MoU

9.3 Innovative Ventures

Company	Venture
Ola Electric	❖ Ola Electric ❖ Ola Future Foundry, a global hub for engineering and vehicle design in the UK
Essar Group	❖ Partnered with Progressive Energy to invest in a hydrogen manufacturing plant in the UK
Hindalco's Subsidiary Novelis	❖ Partnered with Progressive Energy to invest in a hydrogen manufacturing plant in the UK