PERIYAR UNIVERSITY

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SALEM - 636 011, Tamil Nadu, India.

CENTRE FOR DISTANCE AND ONLINE EDUCATION

(CDOE)

BACHELOR OF COMMERCE

II SEMESTER

ELECTIVE PAPER – II: INTERNATIONAL TRADE

(Candidates admitted from 2024 onwards)

PREPARED BY

Centre for Distance and Online Education - CDOE

Periyar University, Salem-11

SYLLABUS

INTERNATIONAL TRADE

UNIT-I

Introduction to International Trade–Meaning–Definition-Difference between Internal and International Trade – Importance of International Trade in the Global context.

UNIT-II

Theories of International trade: Classical theories - Adam smith‘s theory of Absolute Advantage–Ricardo‘s Comparative cost theory- Modern theories of International Trade -Haberler‘s Opportunity Cost theory – Heckscher –Ohlin‘s Modern theory–International trade and Factor Mobility Theory– Leontiff‘s Paradox-International trade and economic growth theory-Immiserating growth theory.

UNIT-III

Balance of Payments– Components of Balance of Payments-Current account, Capital account & Official settlement accounts -Disequilibrium in BOP -Methods of correcting Disequilibrium –Balance of Payment adjustment Theories-Marshall Lerner mechanism. Balance of Trade – Terms of Trade – Meaning – Definition –Difference between BOP and BOT.

UNIT-IV

International Economic Institutions-International Monetary System - Bretton Woods Conference – IMF -Objectives, Organizational structure–Membership–Quotas–Borrowing and Lending Programme of IMF – SDRs – India and IMF -World Bank and UNCTAD.

UNIT-V

World Trade Organization (WTO)–Functions and Objectives–Agricultural Agreements–GATS -TRIPS – TRIMS.

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INTERNATIONAL TRADE

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Meaning and Introduction of International trade

UNIT OBJECTIVES

The Learn the making of trade policy and institutions, domestic trade politics and its impact on the global economy, development, and international relations. Understand and apply economic principles and models in an international trade context. Develop proficiency in international trade law and dispute settlement.

SECTION 1.1. Meaning and Introduction to International Trade

1.1.1. Introduction to International Trade

- International trade is the purchase and sale of goods and services by companies in different countries. Consumer goods, raw materials, food, and machinery all are bought and sold in the international marketplace.
- International trade allows countries to expand their markets and access goods and services that otherwise may not have been available domestically. As a result of international trade, the market is more competitive. This can ultimately result in more competitive pricing and cheaper products. Some

countries engage in national treatment of imported goods, treating them as equivalent to those same products produced domestically.

1.1.2 Meaning of International Trade

- International trade is the relationship between different countries for the purpose of trade and commerce. It comprises Imports (buying from another country) and Exports (selling to another country. The trade taking place may be of goods like garments, agricultural products, gems, petroleum etc., or of services such as inviting and/or sending people who possess technical knowledge and expertise like a doctor, diplomat, engineer etc.

1.1.3 Historical overview

- The barter of goods or services among different peoples is an age-old practice, probably as old as human history. International trade, however, refers specifically to an exchange between members of different nations, and accounts and explanations of such trade begin (despite fragmentary earlier discussion) only with the rise of the modern nation-state at the close of the European Middle Ages. As political thinkers and philosophers began to examine the nature and function of the nation, trade with other countries became a particular topic of their inquiry. It is, accordingly, no surprise to find one of the earliest attempts to describe the function of international trade within that highly nationalistic body of thought now known as mercantilism.

Mercantilism

- Mercantilist analysis, which reached the peak of its influence upon European thought in the 16th and 17th centuries, focused directly upon the welfare of the nation. It insisted that the acquisition of wealth, particularly wealth in the form of gold, was of paramount importance for national policy. Mercantilists took the virtues of gold almost as an article of faith; consequently, they never sought to explain adequately why the pursuit of gold deserved such a high priority in their economic plans.
- Mercantilism was based on the conviction that national interests are inevitably in conflict — that one nation can increase its trade only at the expense of other nations. Thus, governments were led to impose price and wage controls, foster national industries, promote exports of finished goods and imports of raw materials, while at the same time limiting the exports of raw materials and the imports of finished goods. The state endeavored to provide its citizens with a monopoly of the resources and trade outlets of its colonies.
- The trade policy dictated by mercantilist philosophy was accordingly simple encourage exports, discourage imports, and take the proceeds of the resulting export surplus in gold. Mercantilists' ideas often were intellectually shallow, and indeed their trade policy may have been little more than a rationalization of the interests of a rising merchant class that wanted wider markets—hence the emphasis on expanding exports—coupled with protection against competition in the form of imported goods.
- A typical illustration of the mercantilist spirit is the English Navigation Act of 1651, which reserved for the home country the right to trade with its colonies and prohibited the import of goods of non-European origin unless transported in ships flying the English flag. This law lingered until 1849. A similar policy was followed in France.

Liberalism

- A strong reaction against mercantilist attitudes began to take shape toward the middle of the 18th century. In France, the economists known as Physiocrats demanded liberty of production and trade. In England, economist Adam Smith demonstrated in his book The Wealth of

Nations (1776) the advantages of removing trade restrictions. Economists and businessmen voiced their opposition to excessively high and often prohibitive customs duties and urged the negotiation of trade agreements with foreign powers. This change in attitudes led to the signing of a number of agreements embodying the new liberal ideas about trade, among them the Anglo-French Treaty of 1786, which ended what had been an economic war between the two countries.

- After Adam Smith, the basic tenets of mercantilism were no longer considered defensible. This did not, however, mean that nations abandoned all mercantilist policies. Restrictive economic policies were now justified by the claim that, up to a certain point, the government should keep foreign merchandise off the domestic market in order to shelter national production from outside competition. To this end, customs levies were introduced in increasing number, replacing outright bans on imports, which became less and less frequent.
- In the middle of the 19th century, a protective customs policy effectively sheltered many national economies from outside competition. The French tariff of 1860, for example, charged extremely high rates on British products: 60 percent on pig iron; 40 to 50 percent on machinery; and 600 to 800 percent on woolen blankets. Transport costs between the two countries provided further protection.
- A triumph for liberal ideas was the Anglo-French trade agreement of 1860, which provided that French protective duties were to be reduced to a maximum of 25 percent within five years, with free entry of all French products

except wines into Britain. This agreement was followed by other European trade pacts.

Resurgence of protectionism

- A reaction in favour of protection spread throughout the Western world in the latter part of the 19th century. Germany adopted a systematically protectionist policy and was soon followed by most other nations. Shortly after 1860, during the Civil War, the United States raised its duties sharply; the McKinley Tariff Act of 1890 was ultra-protectionist. The United Kingdom was the only country to remain faithful to the principles of free trade.
- But the protectionism of the last quarter of the 19th century was mild by comparison with the mercantilist policies that had been common in the 17th century and were to be revived between the two world wars. Extensive economic liberty prevailed by 1913. Quantitative restrictions were unheard of, and customs duties were low and stable. Currencies were freely convertible into gold, which in effect was a common international money. Balance-of-payments problems were few. People who wished to settle and work in a country could go where they wished with few restrictions; they could open businesses, enter trade, or export capital freely. Equal opportunity to compete was the general rule, the sole exception being the existence of limited customs preferences between certain countries, most usually between a home country and its colonies. Trade was freer throughout the Western world in 1913 than it was in Europe in 1970.

The "new" mercantilism

- World War I wrought havoc on these orderly trading conditions. By the end of the hostilities, world trade had been disrupted to a degree that made recovery very difficult. The first five years of the postwar period were marked by the dismantling of wartime controls. An economic downturn in 1920, followed by the commercial advantages that accrued to countries whose currencies had depreciated (as had Germany's), prompted many countries to impose new trade restrictions. The resulting protectionist tide engulfed the world economy, not because policy makers consciously adhered to any specific theory but because of nationalist ideologies and the pressure of economic conditions. In an attempt to end the continual raising of customs barriers, the League of Nations organized the first World Economic Conference in May 1927. Twenty-nine states, including the main industrial countries, subscribed to an international convention that was the most minutely detailed and balanced multilateral trade agreement approved to date. It was a precursor of the arrangements made under the General Agreement on Tariffs and Trade (GATT) of 1947.

- However, the 1927 agreement remained practically without effect. During the Great Depression of the 1930s, unemployment in major countries reached unprecedented levels and engendered an epidemic of protectionist measures. Countries attempted to shore up their balance of payments by raising their customs duties and introducing a range of import quotas or even import prohibitions, accompanied by exchange controls.
- From 1933 onward, the recommendations of all the postwar economic conferences based on the fundamental postulates of economic liberalism were ignored. The planning of foreign trade came to be considered a normal function of the state. Mercantilist policies dominated the world scene until after World War II, when trade agreements and supranational organizations became the chief means of managing and promoting international trade.

1.1.4 Purpose of foreign/ international trade

- The answer is pretty simple. Since not everything that the residents need is available or available in adequate quantities in a country, there is a need to purchase (import) from the countries that have more or surplus of that product. So, while countries need diamonds and gold more than they have, they inevitably import them from Africa. Similarly when a country has a shortage of professional engineers and doctors, it looks for professionals who are ready to immigrate. Secondly, there are times when a country has excess or surplus of a product or service which will be wasted if not sold to other countries. We can think of China exporting huge volumes of steel to its Asian neighbours because it has more than it needs. Thirdly, if a country/ a tradesman feel that a particular product or service earns more abroad than in the home country, they are tempted to engage in exporting off such cash cows.

1.1.5 Understanding International Trade

- If you can walk into a supermarket and find Costa Rican bananas, Brazilian coffee, and a bottle of South African wine, you're experiencing the impacts of international trade.
- International trade was key to the rise of the global economy. In the global economy, supply and demand—and thus prices—both impact and are impacted by global events.
- Political change in Asia, for example, could result in an increase in the cost of labor. This could increase the manufacturing costs for an American sneaker company that is based in Malaysia, which would then result in an increase in the price charged for a pair of sneakers that an American consumer might purchase at their local mall.

Imports and Exports

- A product that is sold to the global market is called an export, and a product that is bought from the global market is an import. Imports and exports are accounted for in the current account section of a country's balance of payments.

Free Trade vs. Protectionism

- As with all theories, there are opposing views. International trade has two contrasting views regarding the level of control placed on trade between countries.

Free Trade

- Free trade is the simpler of the two theories. This approach is also sometimes referred to as laissez-faire economics. With a laissez-faire approach, there are no restrictions on trade. The main idea is that supply and demand factors, operating on a global scale, will ensure that production happens efficiently. Therefore, nothing must be done to protect or promote trade and growth because market forces will do this automatically.

Protectionism

- Protectionism holds that regulation of international trade is important to ensure that markets function properly. Advocates of this theory believe that market inefficiencies may hamper the benefits of international trade, and they aim to guide the market accordingly.
- Protectionism exists in many different forms, but the most common are tariffs, subsidies, and quotas. These strategies attempt to correct any inefficiency in the international market.
- As international trade opens up the opportunity for specialization, and thus more efficient use of resources, it has the potential to maximize a country's capacity to produce and acquire goods. Opponents of global free trade have argued, however, that international trade still allows for inefficiencies that leave developing nations compromised. What is certain is that the global economy is in a state of continual change. Thus, as it develops, so too must its participants.

1.1.6 Role of International Trade

- The buying and selling of goods and services across national borders is known as international trade. International trade is the backbone of our modem, commercial world, as producers in various nations try to profit from an expanded market, rather than be limited to selling within their own borders. There are many reasons that trade across national borders occurs, including lower production costs in one region versus another, specialized industries, lack or surplus of natural resources and consumer tastes.
- However, international trade among different countries is not a new a concept. History suggests that in the past there were several instances of international trade. There is plenty of evidence of continuous trade and exchange of ideas between India and China, through the centuries without either political cooperation or conflict.
- Traders used to transport silk, and spices through the Silk Route in the 14th and 15th century. In the 1700s fast sailing ships called Clippers, with special crew, used to transport tea from China, and spices from Dutch East Indies to

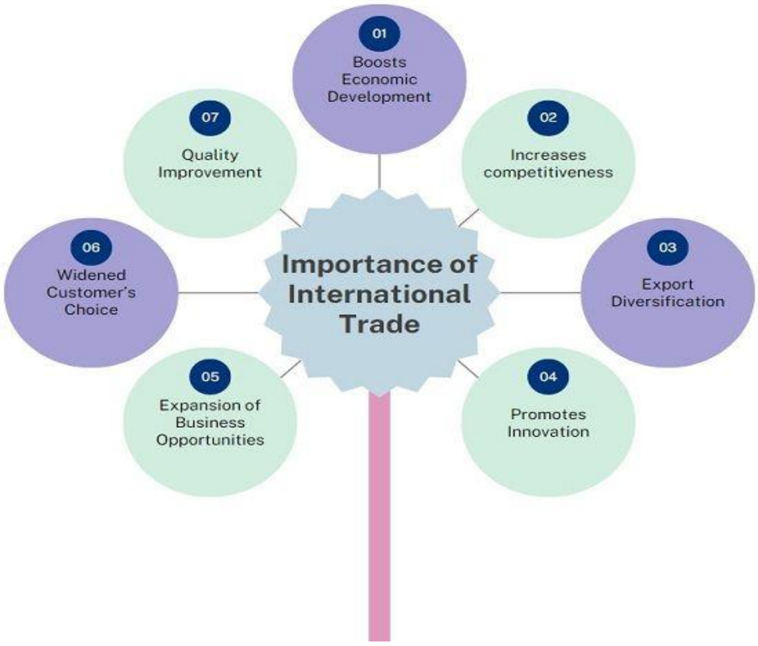
different European countries. The economic, political, and social significance of international trade has been theorized in the Industrial Age.

- The rise in the international trade is essential for the growth of globalization. The restrictions to international trade would limit the nations to the services and goods produced within its territories, and they would lose out on the valuable revenue from the global trade. International trading provides countries and consumers the chance to be exposed to those services and goods that are not available in their own country. International trading lets the developed countries use their resources effectively like technology, capital and labor. As many of the countries are gifted with natural resources and different assets (labor, technology, land and capital), they can produce many products more efficiently and sell at cheaper prices than other countries.
- A country can obtain an item from another country if it cannot effectively produce it within the national boundaries. International trade has flourished over the years due to many benefits it has offered to different countries across the globe. With the help of modem production techniques, highly advanced transportation systems, transnational corporations, outsourcing of manufacturing and services, and rapid industrialization, the international trade system is grown and spreading very fast.

1.1.7 Importance of International Trade

- **Boost Economic Development**: It boosts economic development and decreases poverty, as it accelerates growth through the rise in business opportunities and investment.
- **Increases competitiveness**: There will be an increase in competitiveness by facilitating the countries to reduce the cost of factors, raise finance through investments, and move up the global value chain.
- **Export Diversification**: Trade assist in the diversification of exports by enabling countries to tap new markets and materials, which paves the way for new production possibilities.

- **Promotes Innovation**: International Trade leads to innovation because it facilitates the exchange of technology, know-how, as well as investment in R & D.
- **Widened Customer's Choice**: Trade widens the choice of the customers as it lowers the price by increasing the supply sources and competition as well.



- **Expansion of Business Opportunities**: With the introduction of international trade, the world has become a small village, which has unlocked many opportunities for companies to open up new markets, lifting barriers and bans and easing exports.
- **Quality Improvement**: With the emergence of foreign companies in the domestic markets, there will be an enhancement in the quality, labour and environmental standards. This happens due to the rise in competition and exchange of trade practices amidst trade partners.

1.1.8 Types of international trade

A. Based on agreement

- **Bilateral trade-** if there is an agreement between two countries to buy and sell certain kinds of goods and services in exchange of money, it is called bilateral trade agreement. A country can have bilateral trade agreement with any number of countries.
- **Multilateral trade-** if there is a trade agreement between more than two countries to buy and sell certain kinds of goods and services among themselves in exchange of money, it is called multilateral trade agreement. Any number of multilateral trade agreements can be signed by a country.

Components of International Trade

B. Based on activity

- **Import trade-** If a country purchases goods and services from another it is called an import trade for the purchasing country.
- **Export trade-** If a country sells goods and services to another it is called an export trade for the selling country.
- **Entrepot trade-** if goods and services are sent or received from a country for the purpose of sending to another country, it is called entrepot trade.

1.1.9 Advantages of International Trade

1. Increased revenues

One of the top advantages of international trade is increasing your number of potential clients. Each country you add to your list can open up a new pathway to business growth and increased revenues.

2. Decreased competition

Your products and services may have to compete in a crowded market in the UK, but you may find less competition in other countries, where consumers may be more unfamiliar with your products where they live.

3. Longer product lifespan

Sales can dip for certain products domestically as consumers stop buying them or move to upgraded versions. Selling a product to an overseas market can extend the life of an existing product as emerging markets seek UK products.

4. Easier cash flow management

Getting paid upfront may be one of the hidden advantages of international trade. When trading internationally, negotiating payment terms with vendors may look different. It could be a general practice to ask for payment upfront, whereas at home, you may generally wait longer to be paid. Expanding your business overseas could potentially help you manage cash flow better.

Managing your small business' cash flow alongside vendor and supplier payments can be a tough balancing act - especially when the end of the month draws near and bills are due. With an American Express® Business Platinum Card you get up to 54 days to clear your Card balance, giving you more flexibility in your cash flow[1].

What's more, the Platinum Card also comes with a complimentary annual digital subscription to The Times, worth £312 per year, allowing you to keep up-to-date with the latest economic outlook, UK supply chain trends and international trade on the whole.

5. Better risk management

A significant advantage of international trade is market diversification. Focusing only on the domestic market may expose you to increased risk from economic downturns, political factors, environmental events, and other factors.

Becoming less dependent on a single market may help mitigate potential risks in your core market.

6. Benefiting from currency exchange

Companies that conduct international trade may benefit from currency fluctuations. For example, when the British pound is down, you may be able to export more as foreign customers benefit from the favorable currency exchange rate.

You can also benefit from currency conversion. Let's say you do business in the EU and the euro is strong against the pound. When you convert the payments in euros against a weak pound that means more pounds for your UK head office. This alone could be one of the most valuable advantages of international trade.

7. Access to export financing

Another advantage of international trade is you may be able to leverage export financing. This is where a business might finance the purchase of capital goods through a sovereign loan agreement, which is then granted to the importer. If you're a business looking into trade financing, the UK Export Finance page is a good place to start.

8. Disposal of surplus goods

One of the advantages of international trade is you may have additional outlets to dispose of surplus goods you can't sell in your home market.

9. Enhanced reputation

Success in one country can influence success in other countries, which can raise your company's credibility abroad and at home. This is one of the advantages of international trade that may be difficult to quantify and, therefore, easy to ignore.

10. Opportunity to specialize

International markets can open up avenues for new services or products to serve that market.

Being exposed to the realities of the world outside your home base may spark innovations, upgrades, and efficiencies for your existing products and services.

1.1.10 Disadvantages of International Trade

- International shipping companies make it easy to ship packages almost anywhere in the world.
- However, one of the disadvantages of international trade is that most of these destination countries' customs agencies charge extra fees on items shipped to them.
- While each government determines the duties and taxes differently, it is typically calculated on the value of the products sent (item, insurance plus shipping). The item description may also affect these fees based on what it is made of or used for.
- In addition to the cost of their product, a company needs to understand what the end consumer will be charged by the international shipping company. This is sometimes referred to as the “landed cost."

Larger shipments sent through these carriers may not be cost effective. Companies can seek freight-forwarding companies to help make it more economical or to handle the complicated documentation that is required.

1. Language Barriers

- Despite the availability of online translators, language is still one of the major disadvantages of international trade. While translation tools can be used to formulate instructions and communications in another language, they are far from foolproof.
- The marketplace is filled with examples of poorly translated products with names that got misconstrued in another language. To solve this, consider using a marketing agency in the targeted country or region to review all the company's materials before rolling out the product or service.

2. Cultural Differences

- One of the major disadvantages of international trade is that, many times, cultural differences are never documented. There are unwritten rules of commerce in the country that are hard to uncover and can be even more difficult to solve.

- For example, the word "yes," in Western cultures typically means agreement. In some Eastern cultures however, it can mean that the person understands what you are saying, but does not necessarily agree.
- When I traveled to India, I found that people would turn their head side to side to mean "yes" and up and down to mean "no" – the opposite of what those gestures mean in Western cultures.

3. Servicing Customers

- After international customers make a purchase, how will they be serviced when they are so far away? Again, language and cultural differences need to be considered to overcome one of the major disadvantages of international trade.
- Your company needs to be prepared up front to communicate with these customers in different time zones, preferably in their language. If you're not able to staff 24/7, expectations for when a reply will be received need to be set up front.

4. Returning Products

- Since not all international customers will be satisfied with a company's products, a process must be in place to return them and process a refund.
- The money side of the equation has become easier through credit cards and yet the physical return shipment can be just as complicated and costly as it was originally.
- A company needs to think about how a product will be returned and who will pay the cost of shipping it back. In some cases, companies will give a customer a refund and won't require the item to be returned since that cost is too high. I recommend every company thinks their return policy out far in advance.

5. Intellectual Property Theft

- The wider a product is distributed, the more likely that it may be illegally copied by a competitor. This can be in the form of proprietary information or market branding.
- With cross-country borders, it becomes very difficult for a company to prosecute. However, in the U.S. can help protect a company as long as the country where the product is sold has signed an international intellectual protection treaty. Some countries also have their own separate copyright and trademark protections that can be filed to protect companies selling products in their countries.
- Finally, there is always a political risk of international trade. Governments and their policies change over time, and sometimes companies can get stuck in the middle with different regulations that may target their sales and customers. This is why it may be good to market products to a geographic region, rather than a single country, to help balance the company's risk.

Let's Sum Up

- **Comparative advantage**

This is when a country has a lower opportunity cost to produce a good or service than other countries. This is a key principle in international trade and explains why free trade is beneficial to countries.

- **Absolute advantage**

This is when a country can produce more of a good than other countries, even when using the same amount of resources.

- **Tariffs and quotas**

Tariffs are taxes on imports, while quotas are limits on the quantity of imports.

- **Economic development**

International trade can be a key issue in economic development, helping to create jobs and improve living standards.

- **Digital trade**

As more goods and services are exchanged online, digital trade is becoming an increasingly important part of global trade.

- **Intellectual property rights**

Protection of intellectual property rights is an important factor in international trade.

- **Supply chains**

Supply chains have evolved over time to minimize costs, but this can sometimes come at the expense of transparency and resilience.

- **Foreign relations**

Open trade can lead to better foreign relations, as long-term relationships and strategic alliances can create a friendly environment.

Check Your Progress – Quiz – 1

Q1. Trade between two countries can be useful if cost ratios of goods are:

A. Undetermined

B. Decreasing

C. Equal

D. Different

Q2. The term Euro Currency market refers to

A. The international foreign exchange market

B. The market where the borrowing and lending of currencies take place outside the country of issue

C. The countries which have adopted Euro as their currency

D. The market in which Euro is exchanged for other currencies

Q3. Which of the following theories suggests that firms seek to penetrate new markets over time?

A. Imperfect Market Theory

B. Product cycle theory

C. Theory of Comparative Advantage

D. None of the above

Q4. Dumping refers to:

A. Reducing tariffs

B. Sale of goods abroad at a lower price, below their cost and price in their home market

C. Buying goods at low prices abroad and selling at higher prices locally

D. Expensive goods selling for low prices

Q5. International trade and domestic trade differ because of:

A. Different government policies

B. Immobility of factors

C. Trade restrictions

D. All of the above

Q6. The margin for a currency future should be maintained with the clearing house by

A. The seller

B. The buyer

C. Either the buyer or the seller as per the agreement between them

D. Both the buyer and the seller

Q7.The following statement with respect to currency option is wrong

A. Foreign currency- Rupee option is available in India

B. An American option can be executed on any day during its currency

C. Put option gives the buyer the right to sell the foreign currency

D. Call option will be used by exporters

Q8. Govt. policy about exports and imports is called:

A. Commercial policy

B. Fiscal policy

C. Monetary policy

D. Finance policy

Q9.Which of the following is international trade?

A. Trade between countries

B. Trade between regions

C. Trade between provinces

D. Both (b) and (c)

Q10. Market in which currencies buy and sell and their prices settle on is called the

A. International bond market

B. International capital market

C. Foreign exchange market

D. Eurocurrency market

Answer Key:	**Q1. D**	**Q2. B**	**Q3. D**	**Q4. B**	**Q5. D**	**Q6. D**	**Q7. B**	**Q8. A**	**Q9. A**	**Q10. C**

SECTION – 1.2 INTERNAL TRADE

1.2.1 Internal Trade - Meaning

- When the trade is carried out within the geographical borders of the country, then this is called internal trade. It takes place between the individuals residing in the same country.
- The trade takes place between buyers and sellers in the same locality, village, town or city. Also, it may occur between different states, but certainly within the same country. The alternative term for internal trade is domestic, home, international, or interregional trade.
- No customs duty or import duty is applicable on such trade. This is because they are a part of domestic production and are meant for domestic consumption.

Example

- A trade between Ahmedabad and Raipur is an internal trade.
- Buying a product from a local shop or mall comes under internal trade.

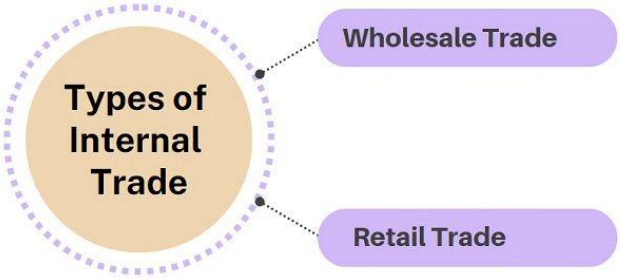
Characteristics of Internal Trade

- Purchasing and selling goods and services are carried out within the country's political boundaries.
- Payment for transactions is made in the domestic currency of the country.
- It involves transactions between the producers, consumers and the intermediaries.
- It comprises a supply chain network of middlemen, distributors and agencies involved in exchanging goods and services

1.2.2 Types of Internal Trade

Internal Trade can be divided into two types:

1. **Wholesale Trade**: Buying and selling goods in large quantities for reselling or intermediate use is wholesale trade. The traders who trade in wholesale goods are wholesalers.



2. **Retail Trade**: Buying and selling goods in small quantities to the ultimate consumers is retail trade. The traders who deal in retail trade are retailers.

International Trade

❖ International Trade refers to trade between two or more nations. It is governed by the laws, rules and regulations of the countries where trade is executed. Further, it is a branch of economics that deals with exchanging goods and services between people of different nations. Also, it not just involves the movement of goods and services. Instead, it also involves the movement of human resources, technology, capital and IP, i.e. Intellectual Property.

❖ Every country aims at exporting manufactured goods and importing raw materials whenever necessary. While the countries sell manufactured goods at higher prices, they buy raw materials at a cheaper rate. The company that exports manufactured goods can use the surplus for developmental purposes.

- It allows every country to enjoy such goods which it cannot produce even when it puts all the effort and money into it. However, one demerit of international trade is that it leads to across-the-border dependence.

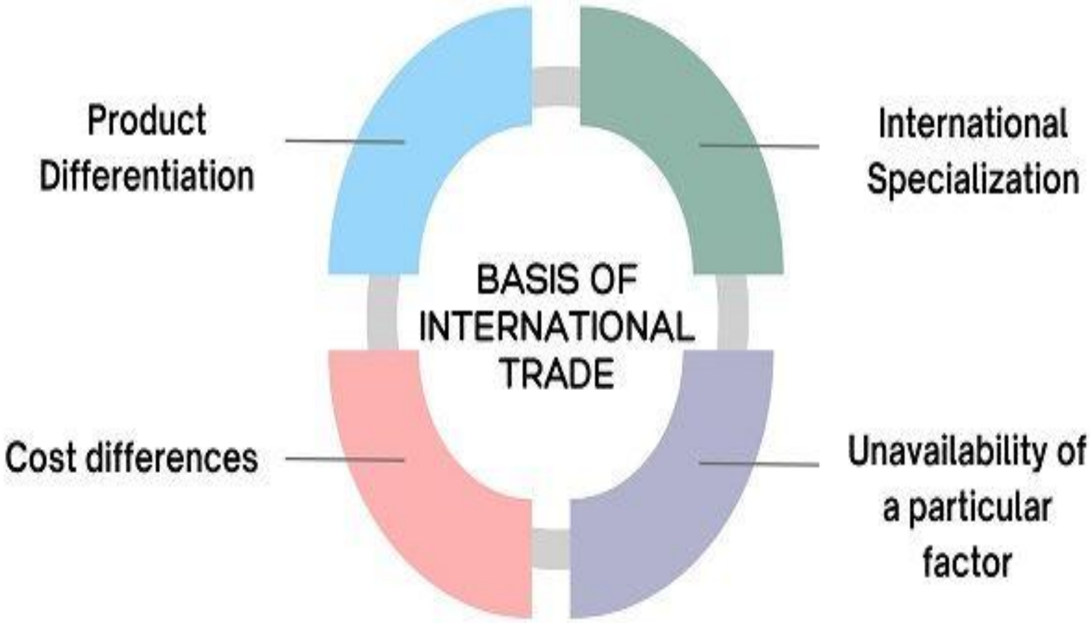
Example: Trade Between Australia and America is an international trade.

1.2.3 Internal and International Trade - Meaning

- Trade implies the process of buying and selling goods and services to earn profit. It covers all the activities resulting from which goods produced are distributed for consumption. This trade can take place either at the national or international level. While trade occurring within the boundaries of the nation is internal trade.
- Conversely, International Trade refers to the exchange of capital, goods and services across international boundaries or territories between the residents. When there is trade between two or more countries, factors such as government policies, currency, judicial system, laws, economy, markets, etc, have a significant impact on trade.

- In this post, we will talk about the differences between internal and international trade.

1.2.4 Basis of International Trade



1. **International Specialization**: Different countries of the world specialize in the production of such goods whose production requires special resources.
2. **Unavailability of a particular factor**: Not all the resources are present in all the countries of the world. Meaning that some factors are available in specific countries only, so the countries need to import those resources.
3. **Cost differences**: The cost of goods is different in different countries.
4. **Product Differentiation**: There are instances when a country imports goods which it can produce well. It does so to consume large varieties of goods

1.2.5 Difference between Internal Trade and International Trade

Basis	Internal Trade	International Trade
1. Meaning	Domestic business refers to business transaction transacted with geographical	International business refers to the business transaction beyond the boundaries of a

	boundaries of a country.	country
2. Participants of business	People/ organization within the country participate in business activities	People/ organizations outside the country participate in the business activities
3. Mobility of factors of production	The factors of production i.e., labour, capital, technology, material, etc., move freely within the boundaries of the country	The factors of production i.e., labour, capital, technology, material, etc., move across the boundaries of the country
4. Nature of consumers	Consumers are relatively homogeneous in nature in terms of culture, behavior, taste, preference, legal system, customs and practice, etc.,	Consumers are relatively heterogeneous in nature in terms of culture, behavior, taste, preference, legal system, customs and practice, etc., prevailing across the countries.
5. Business system	Domestic business is covered by the rules, laws, policies taxation system of single country	International business is governed by rules loss, policies, tariff and quotas, etc., of multiple countries
6. Currency used	Domestic business transactions are settled by local currency of a country	International business transaction are settled by foreign currencies
7. Mode of Transport	The goods involved in the domestic business are mainly transported by roadways and railways	The goods involved in international business is mainly transported by water and Airways
8. Risk Exposure	The risk involved in the domestic business are relatively less	The risk involved in the international business are more due to the distance difference in socio economic and political conditions

		change in foreign exchange values etc
9. Scope of market	The scope of market is limited to National boundaries of a country	The scope of international business is very wide and extends beyond the frontiers of a country
10. Payment of excise duty	Payment of excise duties involves in simple procedures and it is relatively low in domestic trade	The process of payment of excise is complicated in international business and the rate of excise duty is relatively high

1.2.6 Key Differences between Internal and International Trade

1. Internal trade is an exchange between two businesses or parties belonging to the same country. In contrast, International trade is trade between two sovereign nations which are politically independent.
2. In internal trade, stakeholders such as suppliers, producers, employees, distributors, etc., are of the same nation. In contrast, in international trade, stakeholders are of different nations.
3. In international trade, different countries use different currencies to participate in the exchange. For example, Indian Rupee, American US Dollar, Japanese Yen, etc. In contrast, internal trade takes place through a single currency, which is the local currency of the country in which trade is executed.
4. **Policy Differences**: In international trade, different countries participate. These countries have independent economic and other policies. Hence, these policies greatly impact the pattern of international trade like composition, volume and direction. Conversely, trade policies are the same throughout the nation, so there is an uninterrupted exchange of goods and services in internal trade.
5. **Endowment Differences**: In International Trade, endowment differences are always there. Factor endowments of different countries are different. Some

countries have a huge treasury of natural resources, while other countries have a pool of human resources. However, endowment differences do not exist in the case of domestic trade.

6. **Trade Restrictions**: Countries follow certain rules and policies which often restrict or broaden international transactions. This may include heavy import duties, tariffs, quotas, customs, etc. They restrict imports and exports. On the other hand, bilateral agreements, subsidies, tax concessions, etc., boost imports and exports. However, these rules and policies do not exist in the case of internal trade.
7. International Trade also encounters a number of specific issues like international liquidity, cooperation and understanding. Such issues have no concern with internal trade.
8. **Language**: Not all countries have the same language, which is a barrier to international trade. That is why companies that are engaged in international trade often employ translators for this purpose. This problem does not arise in the case of domestic trade.

1.2.7 Reasons for International Trade

In the world of economics, one key idea introduced by Ricardo is that countries trade based on comparative costs rather than absolute costs. Imagine one country is super good at making everything efficient. Even in that case, it's still better for them to trade based on what they are comparatively best at. Here are some of the important reasons for International Trade:

- **Production**

  Not every country can produce everything at a low cost. This is why international trade comes into play.

- **Factors of Production**

  Countries have different rates for factors like labour, capital, and raw materials. International trade allows them to use these factors efficiently.

- **Cost of Production**

It's smarter for each country to focus on making things they're good at making efficiently. For other things, they can rely on countries where it's cheaper.

- **Resource Distribution**

  Sometimes, countries face challenges because they don't have all the natural resources they need. International trade helps balance this by letting countries specialize in what they're best at.

Examples: Different countries specialize in specific sectors. For instance, Maharashtra in India is known for textiles, West Bengal for jute products, Haryana and Punjab for food, and Kerala for spices. Moreover, similar specializations exist in other countries.

1.2.8 Importance of International Trade in Global Context

International trade among nations isn't just about exchanging goods – it's a key player in improving our lives and economies. Here's how:

1. **Higher Living Standards and Jobs:** It lifts the standard of living by creating jobs and giving people more opportunities to enjoy a variety of goods.
2. **Raw Material Riches:** Some countries, like Qatar for oil or Iceland for metals and fish, are lucky to have many raw materials. Without international trade, they wouldn't fully benefit from these blessings.
3. **More Choices for You:** The more countries trade with each other, the more products you get to choose from.
4. **Specialization and Efficiency:** Countries can focus on what they're good at. Whether making cars or growing crops, specialization helps companies make more money efficiently.
5. **Global Growth and Less Poverty:** When countries trade globally, they grow economically. This growth isn't just for rich countries; it helps reduce poverty levels too.

Moreover, international trade isn't just about goods – it's about making life better, giving you more choices, and helping countries grow together.

1.2.9 Scope of International Trade in Global Context

- **Exports and Imports**

Exports and **Imports trade** is like a global shopping spree where countries trade tangible goods. Exporting is sending stuff to other nations, and importing is getting things from them. Don't forget, services are in the mix too.

- **Service Trade (Invisible Trade)**

Think of it as the secret agent of trade – it involves services with no physical presence. Tourism, hotels, transportation, training, and research are all part of this invisible trade.

- **Licensing and Franchising**

Imagine giving permission to other countries to use a company's brand or sell its product. Licensing involves selling a company's product under its trademark for a fee, like Pepsi and Coca-Cola. Franchising is similar but with services, like Domino's or Burger King, setting up shop abroad.

- **Foreign Investment**

This is like investing your money globally to make more money. Therefore, direct investment is putting money into foreign companies for production and marketing. Sometimes, it's a team effort called a joint venture. Moreover, Portfolio investment is when one company invests in another, earning income through interest and dividends.

1.2.10 Advantages of International Trade in Global Context

Here are some of the advantages of International Trade in Global Context:

- **Income Boost**

Organizations make money in foreign currencies, known as foreign exchange. This foreign cash helps pay for imported stuff like machinery, technologies, and fertilizers.

- **Resource Efficiency**

  Countries focus on what they do best and efficiently. If one nation is great at making cars, they focus on that, while another nation excels in something else. It's like a teamwork strategy where everyone plays to their strengths.

- **Growth and Jobs**

  International trade speeds up the growth of businesses and entire countries. Big players like China, Japan, and South Korea viewed the whole world as a marketplace. This global approach created jobs worldwide.

- **Better Living Standards**

  People in one country get to enjoy products and services from other nations. This sharing of goods and services improves everyone's quality of life. Moreover, international business isn't just about making money; it's about making the world work together efficiently, creating opportunities, and enhancing our lives.

1.2.11 Difference between Domestic and International Trade

Difference Between Domestic and International Trade		
Parameters	**Domestic Trade**	**International Trade**
Nationality of Buyers/Sellers	People work within their home nation.	People from different nations engage.
Nationality of Stakeholders	Suppliers, producers, etc., are from the same nation.	Stakeholders can be from various nations.

Mobility of Factors of Production	Capital and labor move within one nation.	Capital and labor move across different nations.
Heterogeneous Customers	Customers are generally similar in religion, caste, etc.	Customers can vary widely in terms of religion, caste, language, etc.
Risks	Nation deals with political risks within its borders.	Different nations bring different political risks.
Policies	Governed by the policies, regulations, and laws of one nation.	Governed by the diverse policies and laws of multiple nations.
Currency	Single currency is used.	Involves more than one currency.

1.2.12 Global Trade Liberalization and the Developing Countries

I. International Trade and the World Economy

II. The Benefits of Trade Liberalization

III. The Need for Further Liberalization of International Trade

IV. Reaping the Benefits

- Recent decades have seen rapid growth of the world economy. This growth has been driven in part by the even faster rise in international trade. The growth in trade is in turn the result of both technological developments and concerted efforts to reduce trade barriers. Some developing countries have opened their own economies to take full advantage of the opportunities for economic development through trade, but many have not. Remaining trade barriers in industrial countries are concentrated in the agricultural products and labor-intensive manufactures in which developing countries have a comparative advantage. Further trade liberalization in these areas particularly, by both industrial and developing countries, would help the poorest escape from extreme poverty while also benefiting the industrial countries themselves.

I. International Trade and the World Economy

- Integration into the world economy has proven a powerful means for countries to promote economic growth, development, and poverty reduction. Over the past 20 years, the growth of world trade has averaged 6 percent per year, twice as fast as world output. But trade has been an engine of growth for much longer. Since 1947, when the General Agreement on Tariffs and Trade (GATT) was created, the world trading system has benefited from eight rounds of multilateral trade liberalization, as well as from unilateral and regional liberalization. Indeed, the last of these eight rounds (the so-called "Uruguay Round" completed in 1994) led to the establishment of the World Trade Organization to help administer the growing body of multilateral trade agreements.
- The resulting integration of the world economy has raised living standards around the world. Most developing countries have shared in this prosperity; in some, incomes have risen dramatically. As a group, developing countries have become much more important in world trade—they now account for one-third of world trade, up from about a quarter in the early 1970s. Many developing countries have substantially increased their exports of manufactures and services relative to traditional commodity exports: manufactures have risen to 80 percent of developing country exports. Moreover, trade between developing countries has grown rapidly, with 40 percent of their exports now going to other developing countries.

- However, the progress of integration has been uneven in recent decades. Progress has been very impressive for a number of developing countries in Asia and, to a lesser extent, in Latin America. These countries have become successful because they chose to participate in global trade, helping them to attract the bulk of foreign direct investment in developing countries. This is true of China and India since they embraced trade liberalization and other market-oriented reforms, and also of higher-income countries in Asia—like Korea and Singapore—that were themselves poor up to the 1970s.
- But progress has been less rapid for many other countries, particularly in Africa and the Middle East. The poorest countries have seen their share of world trade decline substantially, and without lowering their own barriers to trade, they risk further marginalization. About 75 developing and transition economies, including virtually all of the least developed countries, fit this description. In contrast to the successful integrators, they depend disproportionately on production and exports of traditional commodities. The reasons for their marginalization are complex, including deep-seated structural problems, weak policy frameworks and institutions, and protection at home and abroad.

II. The Benefits of Trade Liberalization

- Policies that make an economy open to trade and investment with the rest of the world are needed for sustained economic growth. The evidence on this is clear. No country in recent decades has achieved economic success, in terms of substantial increases in living standards for its people, without being open to the rest of the world. In contrast, trade opening (along with opening to foreign direct investment) has been an important element in the economic success of East Asia, where the average import tariff has fallen from 30 percent to 10 percent over the past 20 years.
- Opening up their economies to the global economy has been essential in enabling many developing countries to develop competitive advantages in the manufacture of certain products. In these countries, defined by the World Bank as the "new globalizers," the number of people in absolute poverty declined by over 120 million (14 percent) between 1993 and 1998.[1]

- There is considerable evidence that more outward-oriented countries tend consistently to grow faster than ones that are inward-looking. Indeed, one finding is that the benefits of trade liberalization can exceed the costs by more than a factor of 10. Countries that have opened their economies in recent years, including India, Vietnam, and Uganda, have experienced faster growth and more poverty reduction. On average, those developing countries that lowered tariffs sharply in the 1980s grew more quickly in the 1990s than those that did not.
- Freeing trade frequently benefits the poor especially. Developing countries can ill-afford the large implicit subsidies, often channeled to narrow privileged interests that trade protection provides. Moreover, the increased growth that results from freer trade itself tends to increase the incomes of the poor in roughly the same proportion as those of the population as a whole. New jobs are created for unskilled workers, raising them into the middle class. Overall, inequality among countries has been on the decline since 1990, reflecting more rapid economic growth in developing countries, in part the result of trade liberalization.
- The potential gains from eliminating remaining trade barriers are considerable. Estimates of the gains from eliminating all barriers to merchandise trade range from US$250 billion to US$680 billion per year. About two-thirds of these gains would accrue to industrial countries. But the amount accruing to developing countries would still be more than twice the level of aid they currently receive. Moreover, developing countries would gain more from global trade liberalization as a percentage of their GDP than industrial countries, because their economies are more highly protected and because they face higher barriers.
- Although there are benefits from improved access to other countries' markets, countries benefit most from liberalizing their own markets. The main benefits for industrial countries would come from the liberalization of their agricultural markets. Developing countries would gain about equally from liberalization of manufacturing and agriculture. The group of low-income countries, however, would gain most from agricultural liberalization in industrial countries because of the greater relative importance of agriculture in their economies.

III. The Need for Further Liberalization of International Trade

- These considerations point to the need to liberalize trade further. Although protection has declined substantially over the past three decades, it remains significant in both industrial and developing countries, particularly in areas such as agriculture products or labor-intensive manufactures and services (e.g., construction) where developing countries have comparative advantage.
- Industrial countries maintain high protection in agriculture through an array of very high tariffs, including tariff peaks (tariffs above 15 percent), tariff escalation (tariffs that increase with the level of processing), and restrictive tariff quotas (limits on the amount that can be imported at a lower tariff rate). Average tariff protection in agriculture is about nine times higher than in manufacturing. In addition, agricultural subsidies in industrial countries, which are equivalent to 2/3 of Africa's total GDP, undermine developing countries' agricultural sectors and exports by depressing world prices and pre-empting markets. For example, the European Commission is spending 2.7 billion euro per year making sugar profitable for European farmers at the same time that it is shutting out low-cost imports of tropical sugar.
- In industrial countries, protection of manufacturing is generally low, but it remains high on many labor-intensive products produced by developing countries. For example, the United States, which has an average import tariff of only 5 percent, has tariff peaks on almost 300 individual products. These are largely on textiles and clothing, which account for 90 percent of the $1 billion annually in U.S. imports from the poorest countries—a figure that is held down by import quotas as well as tariffs. Other labor-intensive manufactures are also disproportionately subject to tariff peaks and tariff escalation, which inhibit the diversification of exports toward higher value-added products.
- Many developing countries themselves have high tariffs. On average, their tariffs on the industrial products they import are three to four times as high as those of industrial countries, and they exhibit the same characteristics of tariff peaks and escalation. Tariffs on agriculture are even higher (18 percent) than those on industrial products.[8]

- Non-traditional measures to impede trade are harder to quantify and assess, but they are becoming more significant as traditional tariff protection and such barriers as import quotas decline. Antidumping measures are on the rise in both industrial and developing countries, but are faced disproportionately by developing countries. Regulations requiring imports to conform to technical and sanitary standards comprise another important hurdle. They impose costs on exporters that can exceed the benefits to consumers. European Union regulations on aflatoxins, for example, are costing Africa $1.3 billion in exports of cereals, dried fruits, and nuts per European life saved. Is this an appropriate balance of costs and benefits?
- For a variety of reasons, preferential access schemes for poorer countries have not proven very effective at increasing market access for these countries. Such schemes often exclude, or provide less generous benefits for, the highly protected products of most interest to exporters in the poorest countries. They are often complex, nontransparent, and subject to various exemptions and conditions (including noneconomic ones) that limit benefits or terminate them once significant market access is achieved.
- Further liberalization—by both industrial and developing countries—will be needed to realize trade's potential as a driving force for economic growth and development. Greater efforts by industrial countries, and the international community more broadly, are called for to remove the trade barriers facing developing countries, particularly the poorest countries. Although quotas under the so-called Multi-fiber Agreement are due to be phased out by 2005, speedier liberalization of textiles and clothing and of agriculture is particularly important. Similarly, the elimination of tariff peaks and escalation in agriculture and manufacturing also needs to be pursued. In turn, developing countries would strengthen their own economies (and their trading partners') if they made a sustained effort to reduce their own trade barriers further.
- Enhanced market access for the poorest developing countries would provide them with the means to harness trade for development and poverty reduction. Offering the poorest countries duty- and quota-free access to world markets would greatly benefit these countries at little cost to the rest of the world. The recent market-opening initiatives of the EU and some other countries are

important steps in this regard. To be completely effective, such access should be made permanent, extended to all goods, and accompanied by simple, transparent rules of origin. This would give the poorest countries the confidence to persist with difficult domestic reforms and ensure effective use of debt relief and aid flows.

IV. Reaping the Benefits

- The failure to start a new round of multilateral trade negotiations at the WTO conference in Seattle in 1999 was a setback for the international trading system. Such broad-based multilateral negotiations are particularly important because they provide an opportunity for countries to gain visible benefits for their exporters from market opening by others. This prospect provides an added incentive for countries to open their own markets, and to overcome opposition from the entrenched interests benefiting from protection. In this way, the packages of trade liberalization measures that result for these negotiations are assured of benefiting all of the participating countries.
- A new round of negotiations would raise global growth prospects and strengthen the international trading system. The IMF considers a successful trade round to be an important step toward meeting the goal of making globalization work for the benefit of all.

Let's Sum Up

International trade, including bilateral, multilateral, export, import, and entrepot trade:

- **Bilateral trade:** A barter system between two countries that involves trading a specific commodity for another.
- **Multilateral trade:** A trade agreement between a single country and multiple other countries.
- **Export trade:** When a country's manufactured goods or services are purchased by residents of another country.
- **Import trade:** When a country or business buys goods from another country or business.

- **Entrepot trade:** A combination of import and export trade, where a country imports goods to export at a higher price.

Foreign trade is another term that refers to the import and export of goods and services between countries. Foreign investment is the inflow of capital and technologies into a country from abroad.

Check Your Progress – Quiz – 2

Q1. Trade among 2 nations can be helpful if the price ratios of products are:

A. Equal
B. Decreasing
C. Undetermined
D. Different

Q2. The margin for a currency long term must be retained with the repository by

A. The buyer
B. The seller
C. Both the buyer and the seller
D. None

Q3. Government strategy regarding exporters and importers is called

A. Commercial policy
B. Monetary policy
C. Fiscal policy
D. Finance policy

Q4. Trade around two or more different countries is called ________.

A. International Trade
B. External Trade
C. Internal Business
D. Unilateral Trade

Q5 Global commerce and domestic trade differ because of:

A. Different government policies

B. Trade restrictions

C. Immobility of factors

D. All of the above

Q16. Which of the following is not a basis of international trade?

A. Difference in National Resources

B. Population Factor

C. Economic Development

D. None of the above

Q7. Which of the following are the types of international trade?

A. Bilateral trade

B. Multilateral trade

C. Slave trade

D. Both a and b

Q8. World Trade Organization was formed on

A. January 1, 1996

B. January 1, 1995

C. January 1, 1999

D. January 1, 1994

Q9. World Trade Organization earlier known as the

A. General Agreement for Tariffs and Trade (GATT)

B. General Arrangement for Tariffs and Trade (GATT)

C. General Allowance for Tariffs and Trade (GATT)

D. General Authority for Trade and Tariffs (GATT)

Q10. Which one of the following continents has the maximum flow of global trade?

A. Asia

B. Europe

C. North America

D. Africa

Q11. Choose the right answer from the four alternatives given below. (i) Most of the world's great ports are classified as:

A. Naval Ports

B. Comprehensive Ports

C. Oil Ports

D. Industrial Ports

Q12. The initial form of trade in primitive societies was called

A. Primitive system

B. Exchange system

C. Barter system

D. None of the above

Q13. Which of the following places still follow the barter system?

A. Jagiroad, Guwahati

B. Panikhaiti, Guwahati

C. Both a and b

D. None of the above

Q14. Which factor is not considered in the calculation of the Balance of Trade?

A. Exports of goods

B. Imports of goods

C. Services trade

D. Government expenditures

Answer Key:	**Q1. D**	**Q2. C**	**Q3. A**	**Q4. A**	**Q5. D**	**Q6. D**	**Q7. D**	**Q8. B**	**Q9. A**	**Q10. A**
	Q11. B	**Q12. C**	**Q13. A**	**Q14. D**						

1.3 Unit Summary

International trade is the exchange of goods and services between countries, and can involve imports and exports:

- **Imports**: Goods and services brought into a domestic country
- **Exports**: Goods and services sold to a foreign country

International trade can have many benefits, including:

- **Market expansion**: Countries can access goods and services that may be unavailable or more expensive domestically
- **Increased competition**: A more competitive market can lead to cheaper products
- **Specialization**: Countries can specialize in producing goods where they have a comparative advantage
- **Efficiency**: Trade can lead to more efficient investment spending and innovation

However, international trade can also be contentious, with some challenges including:

- **Dislocation**: Trade can disrupt firms and industries that are unable to adapt
- **Protectionism**: Restrictive and discriminatory trade policies are common

Some countries treat imported goods as equivalent to those produced domestically.

Internal trade is the exchange of goods and services within a country's borders. It is also known as domestic trade or home trade.

Internal trade is important to a nation's economic prosperity and includes a wide range of economic activities, from small-scale retail transactions to large-scale wholesale exchanges. It is characterized by the following features:

- **No import or export taxes**

  Internal trade does not involve import or export taxes or customs duties. The only taxes that apply are those levied by the local government.

- **Buying and selling**

  Internal trade includes buying and selling goods and services between individuals, business houses, corporations, and all other entities operating within a nation.

- **Examples**

  Examples of internal trade include buying and selling goods from a local shop, mall, or exhibition, or from a door-to-door salesperson.

Internal trade is divided into two sub-categories:

- **Wholesale trade**

  Involves purchasing goods in large numbers from producers and reselling them to other intermediate users.

- **Retail trade**

  Involves selling goods and services to the ultimate customers. Retailers buy large quantities from wholesalers and sell them in smaller lots to customers.

1.4 Glossary

- **Export:** Selling goods or services from one country to another
- **Import:** Buying goods or services from one country to another
- **Trade:** The exchange of goods and services between two or more countries
- **Tariff:** A tax on imports or exports
- **Protectionism**: A policy that taxes imports to protect domestic industries
- **Pro forma invoice:** A document prepared by the exporter before shipping goods that informs the buyer of the goods, their value, and other specifications
- **Incoterms**: A set of terms that can be divided into three groups: Ex Works (EXW), free carrier (FCA), FAS and FOB; Group C (CFR, CIF, CPT and CIP); and Group D (DAP, DPU and DDP)
- **Factors of production**: Labor, capital, and raw materials used to produce goods and services

1.5 Self-Assessment Questions

5 Marks

1. State the key difference between internal trade and international trade.
2. Enumerate the distinction between domestic trade and international trade.
3. State the role of International Trade.
4. What is the purpose of foreign/international trade?
5. Explain the scope of international trade.

10 Marks

1. Explain the types of International Trade.
2. Describe the advantages and disadvantages of international trade.

3. Sort out the advantages of International Trade in Global Context.
4. State the importance of international trade.
5. Describe the Global Trade Liberalization in Developing Countries

1.6 Case Studies

Case Study

China Limits Exports of Rare Earth Materials

Rare earth metals are a set of 17 chemical elements in the periodic table and include scandium, yttrium, cerium, and lanthanum. Small concentrations of these metals are a crucial ingredient in the manufacture of a wide range of high-technology products, including wind turbines, iPhones, industrial magnets, and the batteries used in hybrid cars. Extracting rare earth metals can be a dirty process due to the toxic acids that are used during the refining process. As a consequence, strict environmental regulations have made it extremely expensive to extract and refine rare earth metals in many countries.

Environmental restrictions in countries such as Australia, Canada, and the United States have opened the way for China to become the world's leading producer and exporter of rare earth metals. In 1990, China accounted for 27 percent of global rare earth production. By 2010, this figure had surged to 97 percent. In 2010, China sent shock waves through the high-tech manufacturing community when it imposed tight quotas on the exports of rare earths. In 2009, it exported around 50,000 tons of rare earths. The 2010 quota limited exports to 30,000 tons. The quota remained in effect for 2011 and was increased marginally to around 31,000 tons in 2012 and 2013.

The reason offered by China for imposing the export quota is that several of its own mining companies didn't meet environmental standards and had to be shut down. The effect, however, was to dramatically increase prices for rare earth metals outside of China, putting foreign manufacturers at a cost disadvantage. Many observers quickly concluded that the imposition of export quotas was an attempt by China to give its domestic manufacturers a cost advantage and to encourage foreign manufacturers to move more production to China so that they could get access to lower-cost supplies of rare earths. As news magazine The Economist concluded, "Slashing their exports of rare earth metals has little to do with dwindling supplies or environmental concerns. It's all about moving Chinese manufacturers up the supply chain, so they can sell valuable finished goods to the world rather than lowly raw materials." In other words, China may have been using trade policy to support its industrial policy.

Developed countries cried foul, claiming that the export quotas violate China's obligations under World Trade Organization rules. In July 2012, the WTO responded by launching its own investigation. Commenting on the investigation, a U.S. administration official said that the export quotas were part of a "deeply rooted industrial policy aimed at providing substantial competitive advantages for Chinese manufacturers at the expense of non-Chinese manufacturers."

In the meantime, the world is not sitting still. In response to the high prices for rare earth metals, many companies have been redesigning their products to use substitute materials. Toyota, Renault, and Tesla, for example all major automotive consumers of rare earth product shave stated that they plan to stop using parts that have rare earth elements in their cars. Governments have also tried to encourage private mining companies to expand their production of rare earth metals. By 2012, there were some 350 rare earth mine projects under development outside of China and India. An example, Molycorp, a U.S. mining company, is quickly boosting its rare earth production at a California mine. As a consequence of such actions, by early 2014, China's share of rare earth output had slipped to 80 percent. This did not stop China from announcing quota limits in 2014 that seemed to be in line with those of 2013.

1.7 Reference and Suggested Readings

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2. The Handbook of International Trade- chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/http://www.sze.hu/~gjudit/Exportszerzodesek/Handbook%20of%20international%20trade.pdf

3. chrome extension://efaidnbmnnnibpcajpcglclefindmkaj/https://ncert.nic.in/textbook/pdf/legy109.pdf

4. An International Trade: What Everyone Need To Known, Authors: Anne Osborn Krueger

UNIT-II THEORIES OF INTERNATIONAL TRADE

Theories of International trade: Classical theories - Adam smith‘s theory of Absolute Advantage–Ricardo‘s Comparative cost theory- Modern theories of International Trade - Haberler‘s Opportunity Cost theory – Heckscher –Ohlin‘s Modern theory–International trade and Factor Mobility Theory– Leontiff‘s Paradox-International trade and economic growth theory-Immiserating growth theory.

THEORIES OF INTERNATIONAL TRADE

UNIT OBJECTIVES

International trade theory, a branch of economics that studies the patterns of international commerce, their origins, and their consequences for human wellbeing. As a tool of evaluating the consequences of trade policy, international trade theory and economics have evolved.

SECTION 2.1. Introduction to International Trade Theories

2.1.1 INTRODUCTION

- International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. International trade is then the concept of this exchange between people or entities in two different countries. People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this many sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade. In this section, you'll learn about the different trade theories that have evolved over the past century and which are most relevant today. Additionally, you'll explore the factors that impact international trade and how businesses and governments use these factors to their respective benefits to promote their interests.

2.1.2 Importance of International Trade Theories

- To better understand how modern global trade has evolved, it's important to understand how countries traded with one another historically. Over time, economists have developed theories to explain the mechanisms of global trade. The main historical theories are called classical and are from the perspective of a country, or country based. By the mid-twentieth century, the theories began to shift to explain trade from a firm, rather than a country, perspective. These theories are referred to as modern and are firm-based or company-based. Both of these categories, classical and modern, consist of several international theories.

2.1.3 Classical or Country-Based Trade Theories

Mercantilism

- Developed in the sixteenth century, mercantilism was one of the earliest efforts to develop an economic theory. This theory stated that a country's wealth was determined by the amount of its gold and silver holdings. In it's simplest sense, mercantilists of exports. Believed that a country should increase its holdings of gold and silver by promoting exports and discouraging imports. In other words, if people in other countries buy more from you (exports) than they sell to you (imports), then they have to pay you the difference in gold and silver. The objective of each country was to have a trade surplus, or a situation where the value of exports are greater than the value of imports, and to avoid a trade deficit, or a situation where the value of imports is greater than the value.
- A closer look at world history from the 1500s to the late 1800s helps explain why mercantilism flourished. The 1500s marked the rise of new nation-states, whose rulers wanted to strengthen their nations by building larger armies and national institutions. By increasing exports and trade, these rulers were able to amass more gold and wealth for their countries. One way that many of these new nations promoted exports was to impose restrictions on imports. This strategy is called protectionism and is still used today.
- Nations expanded their wealth by using their colonies around the world in an effort to control more trade and amass more riches. The British colonial empire was one of the more successful examples; it sought to increase its wealth by using raw materials from places ranging from what are now the Americas and India. France, the Netherlands, Portugal, and Spain were also

successful in building large colonial empires that generated extensive wealth for their governing nations.

- Although mercantilism is one of the oldest trade theories, it remains part of modern thinking. Countries such as Japan, China, Singapore, Taiwan, and even Germany still favor exports and discourage imports through a form of neo-mercantilism in which the countries promote a combination of protectionist policies and restrictions and domestic-industry subsidies. Nearly every country, at one point or another, has implemented some form of protectionist policy to guard key industries in its economy. While export-oriented companies usually support protectionist policies that favor their industries or firms, other companies and consumers are hurt by protectionism. Taxpayers pay for government subsidies of select exports in the form of higher taxes. Within and outside of the industry. Absolute Advantage Import restrictions lead to higher prices for consumers, who pay more for foreign made goods or services. Free-trade advocates highlight how free trade benefits all members of the global community, while mercantilism's protectionist policies only benefit select industries, at the expense of both consumers and other companies, within and outside of the industry.

2.1.4 Classical Trade Theories

Adam Smith and David Ricardo gave the classical theories of international trade.

According to the theories given by them, when a country enters in foreign trade, it benefits from specialization and efficient resource allocation.

The foreign trade also helps in bringing new technologies and skills that lead to higher productivity.

The assumptions taken under this theory' are as follows:

a. There are two countries producing two goods.

b. The size of economies of these countries is equal

c. There is perfect mobility of factors of production within countries

d. Transportation cost is ignored

e. Before specialization, country's resources are equally divided to produce each good.

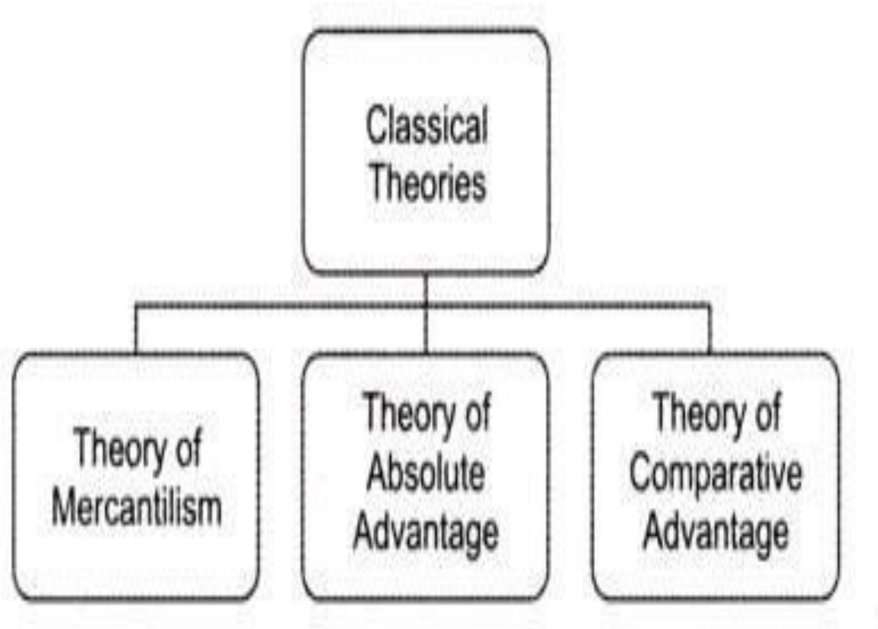


Figure-3: Classical Trade Theories

Theory of Mercantilism

- Mercantilism is the term that was popularized by Adam Smith, Father of Economics, in his book, The Wealth of Nations. Western European economic policies were greatly dominated by this theory. The theory of mercantilism holds that countries should encourage export and discourage import.
- It states that a country's wealth depends on the balance of export minus import. According to this theory, government should play an important role in the economy for encouraging export and discouraging import by using subsidies and taxes, respectively. In those days, gold was used for trading goods between countries.
- Thus, export was treated as good as it helped in earning gold, whereas, import was treated as bad as it led to the outflow of gold. If a nation has abundant gold, then it is considered to be a wealthy nation. If all the countries follow this policy, there may be conflicts, as no one would promote import. The theory of mercantilism believed in selfish trade that is a one-way transaction and ignored enhancing the world trade.

Mercantilism was called as a zero-sum game as only one country benefitted from it.

Theory of Absolute Advantage:

- Given by Adam Smith in 1776, the theory of absolute advantage stated that a country should specialize in those products, which it can produce efficiently. This theory assumes that there is only one factor of production that is labor.
- Adam Smith stated that under mercantilism, it was impossible for nations to become rich simultaneously. He also stated that wealth of the countries does not depend upon the gold reserves, but upon the goods and services available to their citizens.
- Adam Smith wrote in The Wealth of Nations, "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage".
- He stated that trade would be beneficial for both the countries if country A exports the goods, which it can produce with lower cost than country B and import the goods, which country B can produce with lower cost than it.
- An example can be used to prove this theory. Suppose there are two countries A and B, which produce tea and coffee with equal amount of resources that is 200 laborers. Country A uses 10 laborers to produce 1 ton of tea and 20 laborers to produce 1 ton of coffee. Country B uses 25 units of laborers to produce tea and 5 units of laborers to produce 1 ton of coffee.

Table- 1: This is shown in the resources used to produce a ton of Tea and Coffee without Trading

Table-1: Resources used to produce a ton of Tea and Coffee without Trading

	Country A	Country B
Tea	10	25
Coffee	20	5

- It can be seen from Table-2 that country A has absolute advantage in producing tea as it can produce 1 ton of tea by using less laborers as compared to country B. On the other hand, country B has absolute advantage in producing coffee as it can produce 1 ton of coffee by employing less laborers in comparison to country A.
- Now, if there is no trade between these countries and resources (in this case there are total 200 laborers) are being used equally to produce tea and coffee, country A would produce 10 tons of tea and 5 tons of coffee and country B would produce 4 tons of tea and 20 tons of coffee. Thus, total production without trade is 39 tons (14 tons of tea and 25 tons of coffee)

Table-2 shows the production without the trade between country A and country B:

Table-2: Production without Trade

	Country A (in tons)	Country B (in tons)
Tea	10	4
Coffee	5	20

- If both the countries trade with each other and specialize in goods in which they have absolute advantage, the total production would be higher. Country A would produce 20 tons of tea with 200 units of laborers; whereas, country B would produce 40 tons of coffee with 200 units of laborers. Thus, total production would be 60 units (20 tons of tea and 40 tons of coffee).

The production of tea and coffee after trade is shown in Table-3:

Table-3: Production with Trade

	Country A (in tons)	Country B (in tons)
Tea	20	0
Coffee	0	40

- Without specialization, total production of countries was 39 tons, which becomes 60 tons after specialization. Therefore, the theory of absolute advantages shows that trade would be beneficial for both the countries.

2.1.5 Absolute Advantage

- In 1776, Adam Smith questioned the leading mercantile theory of the time in The Wealth of Nations .Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (London: W. Strahan and T. Cadell, 1776). Recent versions have been edited by scholars and economists. Smith offered a new trade theory called absolute advantage, which focused on the ability of a country to produce a good more efficiently than another nation. Smith reasoned that trade between countries shouldn't be regulated or restricted by government policy or intervention. He stated that trade should flow naturally according to market forces. In a hypothetical two-country world, if Country A could produce a good cheaper or faster (or both) than Country B, then Country A had the advantage and could focus on specializing on producing that good. Similarly, if Country B was better at producing another good, it could focus on specialization as well. By specialization, countries would generate efficiencies, because their labor force would become more skilled by doing the same tasks. Production would also become more efficient, because there would be an incentive to create faster and better production methods to increase the specialization.
- Smith's theory reasoned that with increased efficiencies, people in both countries would benefit and trade should be encouraged. His theory stated that a nation's wealth shouldn't be judged by how much gold and silver it had but rather by the living standards of its people.

2.1.6 Comparative Advantage Theory

- This theory was propounded in the 19th Century by David Ricardo. As per this theory, a country must export that kind of goods in which there is a beneficial and relative cost advantage as compared to the absolute cost advantage. Even though a country has the resources to produce a certain product, it can still import the same from other countries if it feels that there is a relative advantage in bringing in such products.

- The modern Theory is also referred to as the Heckscher-Ohlin theory or the factor endowment theory. It was developed by two Swedish economists, Eli Heckscher and his student Bertil Ohlin at the Stockholm School of Economics. This theory states that a country's exports depend on its resource endowments. A country can either have a capital-abundant economy or a labor-intensive economy. In case it is a capital-abundant economy, it will produce and export capital goods with relative ease, whereas, in case of about intensive economy, it will produce and export labor-intensive goods.

- Modern theory is based on the concept of resource or factor endowments. Simply put, factor endowment means the number of resources that a country has for manufacturing and trading. These resources could include land, labour, and money, among others. The number of factor endowments is directly proportional to the number of exports of a country.
- Illustration: Consider the factor endowment as 'iron ores'. Country A is abundant with these, while country B does not have any iron ores. Hence, country A will specialize in and export iron due to its endowment of iron ore land.
- It further states that comparative advantage is the reason why a country chooses to produce and export goods. Comparative advantage essentially means taking advantage of the factors present in abundance in your country. Since these factors are present in abundance, they will be available at a lower cost due to less demand, while products with more demand but fewer factors in the country would lead to high prices. The latter is when the country chooses to import the goods.
- Under this theory, the absolute amount of capital or labour is not important, but the amount available per person is what counts. For example, India might have a bigger capital factor than, say, a small country like Austria. But if counted in capital per person terms, Austria might be higher than India, and this is what is taken into consideration under this theory.
- The challenge to the absolute advantage theory was that some countries may be better two countries. At producing both goods and, therefore, have an advantage in many areas. In contrast, another country may not have any

useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country A had the absolute advantage in the production of both products, specialization and trade could still occur between two countries.

- Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it can produce that product better and more efficiently than it does other goods. The difference between these two theories is subtle. Comparative advantage focuses on the relative productivity differences, whereas absolute advantage looks at the absolute productivity.
- Let’s look at a simplified hypothetical example to illustrate the subtle difference between these principles. Miranda is a Wall Street lawyer who charges $500 per hour for her legal services. It turns out that Miranda can also type faster than the administrative assistants in her office, who are paid $40 per hour. Even though Miranda clearly has the absolute advantage in both skill sets, should she do both jobs? No. For every hour Miranda decides to type instead of do legal work, she would be giving up $460 in income. Her productivity and income will be highest if she specializes in the higher-paid legal services and hires the most qualified administrative assistant, who can type fast, although a little slower than Miranda. By having both Miranda and her assistant concentrate on their respective tasks, their overall productivity as a team is higher. This is comparative advantage. A person or a country will specialize in doing what they do relatively better. In reality, the world economy is more complex and consists of more than two countries and products. Barriers to trade may exist, and goods must be transported, stored, and distributed. However, this simplistic example demonstrates the basis of the comparative advantage theory.

Theory of Comparative Advantage:

- Many questions may come in mind after reading the absolute advantage theory that what would happen if a country has absolute advantage in all the products or no absolute advantage in any of the product. How such a country would benefit from trade? The answers of these questions was given by David Ricardo in his theory of comparative advantage, which states that trade can be beneficial for two countries if one country has absolute advantage in all the products and the other country has no absolute advantage in any of the products.

- According to Ricardo, "…a nation, like a person, gains from the trade by exporting the goods or services in which it has its greatest comparative advantage in productivity and importing those in which it has the least comparative advantage. "
- This theory assumes that labor as the only factor of production in two countries, zero transport cost, and no trade barriers within the countries. Let us understand this theory with the help of an example.
- Suppose there are two countries A and B, producing two commodities wheat and wine with labor as the only factor of production. Now assume that both the countries have 200 laborers and they use 100 laborers to produce wheat and 100 laborers to produce wine.

Table-4 shows the production of wheat and wine in Country X and Country Y before trade:

Table-4: Situation of Country X and Country Y before Trade

	Country X	Country Y
Wheat	20	15
Wine	40	10

- Table-4 depicts that country X can produce 20 units; whereas, country Y can produce 15 units of wheat by using 100 laborers. In addition, country X can produce 40 units; whereas, country' Y can produce 10 units of wine by employing 100 laborers.
- Thus, country X has absolute advantage in producing both the products. As already discussed, country X employs same number of laborers (100 laborers in production of each good) in producing both wine and wheat; however, the production of wine is more than the production of wheat.
- It shows that country' X has comparative advantage in producing wine. Similarly, country Y also employs same number of laborers (100 laborers

in production of each good) in manufacturing wheat and wine; however, its production of wheat is more than the wine. It indicates that country Y has comparative advantage in manufacturing wheat.

- For example, country X has decided to produce 60 units of wine by employing 150 laborers. It uses 50 laborers to produce 10 units of wheat. On the other hand, country Y has decided to use all the 200 laborers to produce 30 units of wheat. It would not produce any unit of wine.

This data is represented in Table-5:

Table-5: Production of Country X and Country Y after Specialization

	Country X	Country Y
Wheat	10	30
Wine	60	0

- Now, country X exchanges 14 units of wine with 14 units of wheat produced by country Y.

The situation of both the countries after trade is shown in Table-6:

Table-6: Situation of Country X and Country Y after Trade

	Country X	Country Y
Wheat	24	16
Wine	46	14

- It can be observed from Table-6 that both the countries have gained from trade. Before trade, country X has 20 units of wheat and 40 units of wine; however, after trade, country Y has 24 units of wheat and 46 units of wine.
- On the other hand, country Y has 15 units of wheat and 10 units of wine before trade; however, it has 16 units of wheat and 14 units of wine after trade. Therefore, comparative advantage explains that trade can create benefit for both the countries even if one country has absolute advantage in the production of both the goods.

2.1.7 Haberler's Theory of Opportunity Cost

- Ricardo's theory of comparative cost advantage was criticized because it was based on the labour theory of value. According to the labour theory of value, the value of a good is equal to the amount of labour time involved in its production. Ricardo discovered that labour was the only factor of production, that it was homogeneous, and that it was used in fixed proportions in the production of all commodities. Although all of these assumptions were found to be unrealistic because there are other factors of production besides labour, labour cannot be used in uniform proportions, and labour can be substituted with capital in countries where capital is cheaply available. Because of these flaws, Haberler developed his theory of Opportunity Cost. According to the theory, if a country produces either A or B commodity, the opportunity cost of commodity A is the amount of commodity B sacrificed in order to obtain an additional unit of commodity A. Nonetheless, the exchange ratio of the two goods is expressed in terms of opportunity cost. Along with the production possibility curve, the concept has been used in international trade theory. Haberler's theory is based on the following assumptions:
  - There are only two trading countries, each of which has two factors of production, namely labour and capital;
  - Each country produces two goods;
  - There is perfect competition in the factor and goods markets;
  - There is full employment in both countries, factors are immobile
  - The two countries but completely mobile within the country; Trade between the countries was assumed to be free; and
  - The supply of goods was (PPC) depicts various alternative combinations of the two commodities that a country can produce more efficiently by utilizing both factors of production and the technology at hand. The slope of PPC assumed to be unlimited.
- According to the theory, a production possibility cucalculates the amount of one good that a country must give up in order to obtain an additional unit of another good. The slope of PPC, on the other hand, explains the marginal rate of transformation (MRT). Haberler's theory was thought to

be superior to the comparative costs theory of international trade. Its superiority stems from an examination of pre-trade and post-trade conditions under constant, increasing, and decreasing opportunity costs, whereas comparative cost theory was founded on constant production costs within a country and comparative advantage and disadvantage between the two countries. Despite its contributions to international trade, Jacob Viner has criticized the theory of opportunity cost on the following grounds:

- ❖ The opportunity costs approach was found to be inferior as a tool of welfare evaluation to the classical real cost approach, as the theory fails to measure real costs in the form of sacrifices made in providing productive services.
- ❖ Viner also criticized the PPC for failing to take into account changes in factor supply, and the assumptions of two countries, two commodities, two factors, and perfect competition were also found to be unrealistic.

Assumptions of the opportunity cost theory of international trade

- Existence of full employment equilibrium within the economy.
- Perfect competition.
- The price of each commodity is equivalent to the marginal cost of producing the same.
- The price of each factor is equivalent to its marginal productivity.
- A fixed supply of factors.
- State of technology is already given.
- Two trading nations or countries.
- Every country carries out the production of two commodities, For eg, X and Y.
- Countries have two productive factors- capital and labour.
- Existence of perfect factor mobility within each country.

- Immobile factors of production between two countries.
- No trade restrictions by either of the countries.

Derivation

- ❖ After carefully considering the above restrictions the production possibility curve of any country can be drawn. The opportunity cost curve, also known as the production possibility curve can be a straight line, concave to the origin, or convex to the origin based on the increasing, decreasing, or constant returns to scale of a particular country. Haberler further asserted that the theory of comparative cost would be accurate provided the theory of labour is not considered. The opportunity cost curve reflects the different combinations of two products a country can produce as per its characteristics and availability of technology. The slope of the opportunity cost curve is derived by the ratio or quotient of units sacrificed of one particular commodity to have one extra unit of the other commodity, this ratio is termed the marginal rate of transformation, or MRT.
- ❖ If a particular country A produces two products X and Y, and a compromise is made with regard to a certain quantity of labour, capital, or any other particular input of product Y for the increased production of product X. I.e., for the additional production of X, a certain quantity of Y is sacrificed and certain units of Y are given up and have been converted into a marginal unit of X. This very rate at which marginal unit of product X is being substituted for units of product Y is the marginal rate of transformation. Alternatively, the MRTxy can be calculated as a ratio of the marginal cost of producing X to the marginal cost of producing Y.

The derivation of the same is as shown:

$$\delta C = \frac{\delta C}{\delta X} \cdot \delta X + \frac{\delta C}{\delta Y} \cdot \delta Y$$

Here δC is the change in total cost, whereas δC /δX and Δc /δY are marginal costs of commodities X and Y, respectively. Taking note of the assumption that minute changes in X and Y, δC is zero.

$$\delta C = 0$$

$$\therefore \frac{\delta C}{\delta X} \cdot \delta X + \frac{\delta C}{\delta Y} \cdot \delta Y = 0$$

$$\text{or} \quad \frac{\delta C}{\delta Y} \cdot \delta Y = -\frac{\delta C}{\delta Y} \cdot \delta X$$

$$\text{or} \quad -\frac{\delta Y}{\delta X} = \frac{\delta C/\delta X}{\delta C/\delta Y}$$

$$\text{or} \quad MRT_{xy} = -\frac{\delta Y}{\delta X} = \frac{\delta C/\delta X}{\delta C/\delta Y}$$

As MRT xy is negative, the production possibility curve slopes down from left to right.

- As per figure 6.1(a) the MRT xy remains equivalent, that is MRT xy = – δY / δX = PP1/OQ1 = P1P2/Q1Q2. This also specifies that the marginal costs of both these commodities are untouched or unchanged. This establishes that all factors of production are efficient in equal terms with regard to all lines of production, as this view would differ in real life the Production Possibility Curve may not fall in a straight line. (in detail below)

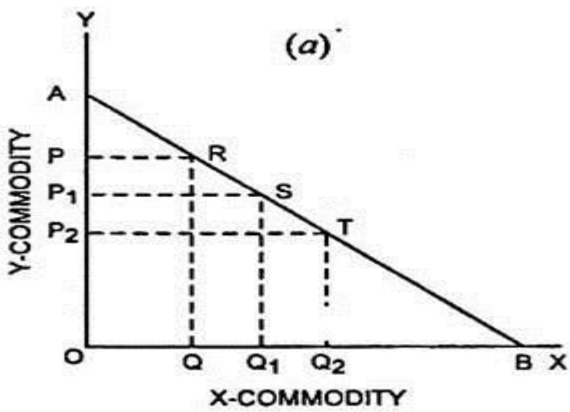


Fig. 6.1(a)

As per Fig. 6.1(b) the opportunity cost curve that is AB falls convex in the direction of its origin causing MRTxy to decrease.

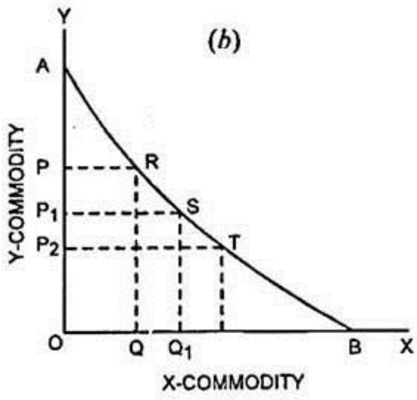


Fig. 6.1(b)

(PP1/QQ1 > P1P2/Q1Q2)

This occurs when the production of commodities is based on increasing returns to scale. In simpler words, this happens when the cost of commodity X in terms of commodity Y goes on diminishing and lesser units of Y are sacrificed in order to produce more units of X.

- As per Fig.6.1(c) the production possibility curve AB falls in a concave manner towards its very origin. In this instant scenario, MRTxy goes on increasing.

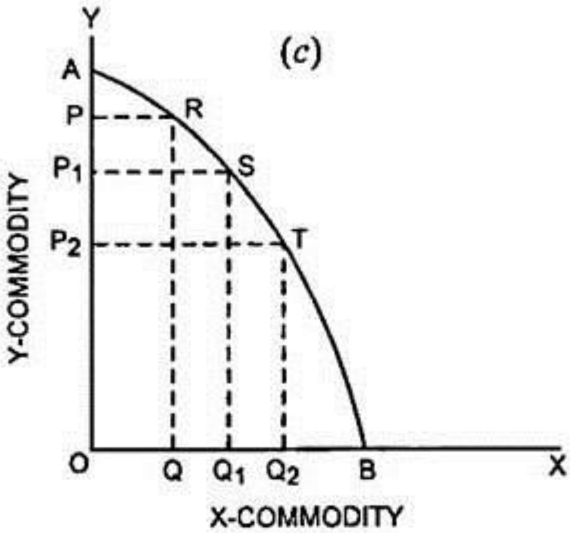


Fig. 6.1(c)

The production possibility curve takes this shift when production is based on diminishing returns to scale. Due to the increase in the production of X, the MC of the same increases while the MC of Y falls. In simpler terms, a greater availability of X commodity shows deterioration in the significance of Y.

Key terminologies

Production possibility Curve

The production possibility curve or the PPC depicted various combinations of producing two products by an optimum and complete utilization of all factors of production. In simpler words, the production possibility curve represents the ceiling limit which the production process cannot be carried out with the available level of technology and other key resources. Figure 1.3 represents the production possibility of a particular country A. With the available quotient of productive resources, it can carry out the production of either 10 units of cloth (provided all resources of the cloth production are employed) or 20 units of wine (provided all resources are specifically used in wine production). On the contrary, it can have a combination of both cloth and wine if resources are allocated optimally for both. Let's take an example, it may possess eight units of cloth and four units of wine, or six units of cloth and eight units of wine. If the output of cloth falls by one unit, the output of wine can be increased by two units as using the resources needed to carry out the production of one unit of cloth, the production of two units of wine can be completed.

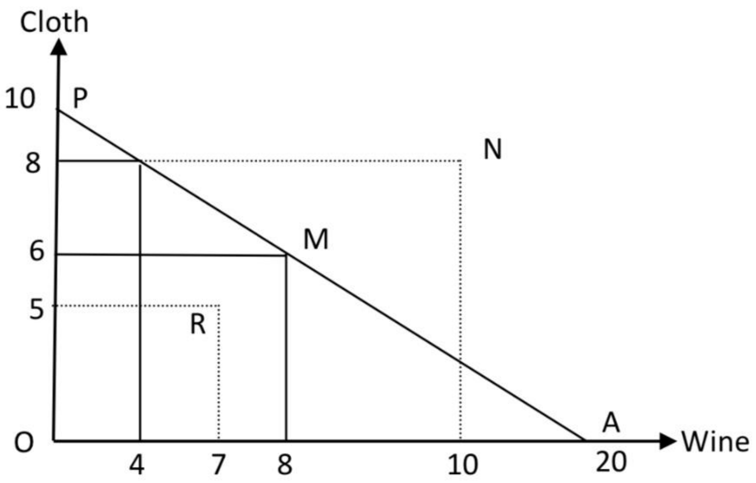


Fig. 1.3: PPC under Constant Costs

Credits-

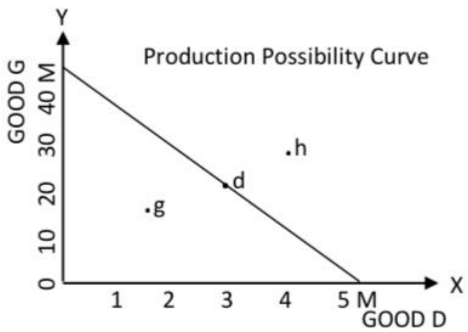
To be precise any point on the production possibility curve represents the output of producing combinations of the two commodities which are cloth and wine when the resources are fully allocated between the two commodities.

Increasing, Decreasing and Constant Cost Conditions

The production possibility curve is also known as the transformation curve. The slope of the curve at each point of the graph depicts the ratio of the marginal opportunity costs of both commodities. In simpler words, what can be understood is that the marginal opportunity cost of extra units of one commodity causes deterioration in the output of the other commodity or product. The shape of the curve is according to the assumptions laid down pertaining to the opportunity cost. It is to be noted that the opportunity cost curve shifts as per constant, increasing, and diminishing costs.

Constant costs

Trade under constant costs means that the MRT remains constant. It is the outcome of each factor of production being effective equally with respect to producing both goods. MRT as discussed above, is the amount of a particular good that must be sacrificed to ensure the availability of more resources to produce more units of the second commodity or good. Let's take an example here, let G denote the good or commodity that has to be given up and let D denote the good or commodity that is to be produced additionally, it's important to note that in this scenario the MRT remains the same. The table below represents alternative outputs of G and D when all resources are utilised and the figure depicts the production possibility curve



Combination	G	D	MRT
a	40	0	8/1
b	32	1	8/1
c	24	2	8/1
d	16	3	8/1
e	8	4	8/1
f	0	5	8/1

- As per the table above, each extra unit of D has the same cost when compared with its cost in terms of G, so resources which have the potential to produce 8 units of G must be sacrificed to maximize the output of D by a unit, irrespective of the level of production of both these commodities. Constant cost signifies that the MRT remains constant or unchanged. It is the outcome of each factor of production being effective in an equal manner with regard to the production of both goods.

- The production possibilities curve represents all possible combinations of two commodities that a particular country in this instance W might produce. The choice of the combination is made as per the curve. Points within the curve like point (g) show outputs of less than full employment and are not taken into consideration. The point above the curve, such as point (h), requires more resources than that particular country has and is hence also outside the ambit of consideration. The full employment output must be taken on the curve. The slope of the production possibilities curve depicts the MRT.

- The slope represents the sacrifice required of one commodity to ensure an increase in the output of the other commodity. Since the MRT is constant in this scenario, the slope must also be constant and therefore, the production possibilities curve has to be in a straight line. It can be inferred here that the MRT of G for D is 8 to 1; then a fall in the output of D by a single unit will ensure the availability of resources to increase the output of G by 8 units. Country Z here has a comparative advantage in the production of product D. On the contrary, country W has a comparative advantage when it comes to the production of G. During constant returns to scale, trade can only occur if each nation has a distinct MRT.

- The benefits accrued from carrying out the trade by a particular nation are based on how much the international exchange rates differ from that given nation's MRT. The higher this difference, the greater the benefits or profits a nation will get from trade. The profits that arise from trade depend further on the amount of trade or the volume of trade that takes place. In the constant costs scenario, the exchange ratio is ascertained exclusively based on costs, the demand influences only the allocation of available factors of production between the two branches of production, and therefore the quantities of both commodities which are produced and in this particular situation demand has no correlation with price.

Increasing and diminishing costs

- It would be unrealistic to assume that all nations would only face the constant cost scenario. When the figures above are considered for each extra or additional unit of one particular product produced, ever-increasing quantities of the other product must be compromised. That is to produce an additional unit of one product the amount produced of the other product must be sacrificed. On the other hand, diminishing costs refer to the reduction in average costs as the output expands.

- As per Graham's thesis pertaining to diminishing costs, there is a contrary or contradictory view to the classical stigma that the specialisation based on comparative cost specifically leads to an increase in the quotient of output among trading countries. His notion was that in a scenario wherein there are free trade conditions when a country is subject to specialisation on the basis of comparative cost industries and tends to forgo decreasing-cost industries, its aggregate real income will fall in a manner that it's less than before trade.

Innovation

- It refers to the creation, development or establishment of any new product, service or procedure in order to improve efficiency, effectiveness, competitiveness or productivity. Innovation is mainly carried out with the objective to improve the quality of life or standard of living as a whole.

Neutral innovation

- Neutral innovation is an innovation that is capable of increasing productivity of all the factors that are present in the very same proportion.

Labour saving innovation

- Labour-saving innovation is a form of innovation that is capable of increasing the productivity of labour.

Capital saving innovation

- Capital saving innovation is the kind of innovation that is capable of increasing the capability of capital making it more productive and causing a shift in the product possibility curve.

Benefits of Haberler's opportunity cost theory of international trade

- Haberler's theory is a more exact and precise representation of international trade when compared with Ricardian theory.
- It has wider applicability than the Ricardian approach.
- Haberler's theory explains the international trade scenarios in constant, increasing and decreasing returns to scale.
- Haberler's theory also attempted to elaborate on the theory of international trade at various costs that is constant, decreasing and constant.

- Factor substitution was taken into consideration while profits were generated out of international trade.

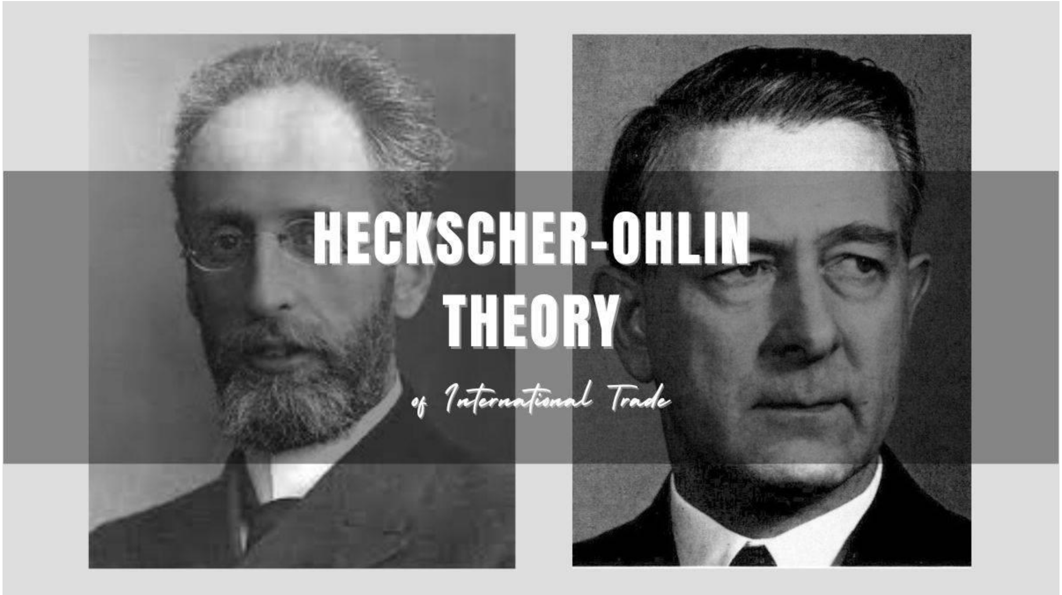
Criticism of the opportunity cost theory of international trade

The following are a few drawbacks of Haberler's theory:

- As per many economists like Jacob Viner, the opportunity cost theory is to be deemed comparatively more inaccurate than the real cost approach as it failed to take into account certain real aspects or factors like strain, pain, sacrifice, lack of utility etc.
- This theory was also criticized on account of its disregard for change in factor supplies.
- It was contended by various economists that the opportunity cost theory was unrealistic and invalid in many manners like the non-existence or absence of economies to scale, diseconomies and perfect competition. (This is applicable to both product markets and factor markets).
- Another criticism laid down by Jacob Viner is that the opportunity cost theory does not take into consideration the preference for leisure.
- It has also been criticized after being called notional costs as the earnings sacrificed by one can be earned by another and not investments.
- The employment market at every position may not be in a steady position to absorb skilled labour.

2.1.8 Heckscher-Ohlin Theory (Factor Proportions Theory)

- The Heckscher-Ohlin theory was developed by Swiss Eli Heckscher and Bertil Ohlin in 1977 at the Stockholm School of Economics. The Heckscher-Ohlin model demonstrates that comparative advantage is determined by the interaction between a country's resources, the relative abundance of factors of production, and technology.



- Heckscher-Ohlin's theory is based on the idea that countries have different resources. These resources can be things like land, labour, and capital (which includes things like machines and factories).
- The theory suggests that countries tend to export (sell to other countries) the goods that use their abundant resources and import (buy from other countries) the goods that use their scarce resources.

The Heckscher-Ohlin's theory is based on the following assumptions:

- Countries are endowed with different factors of production, such as labour, land, and capital.
- Factors of production are mobile within a country but not between countries.
- Goods are produced using different combinations of factors of production.
- Countries that use their abundant factors of production intensively tend to specialize in producing goods.

The theory emphasizes the interrelation between the proportion in which the factors of production are available in different countries and the proportion in which they are used in the production of different goods (Theory of the endowment of factors of production).

The Heckscher-Ohlin Theory - Example

Here's a simplified example to illustrate the concept:

- Imagine two countries, Country A and Country B.

- Country A has a lot of fertile land, so it has abundant agricultural resources like soil and sunshine.
- Country B, on the other hand, has a well-educated and skilled workforce, so it has an abundance of labour.
- The Heckscher-Ohlin theory is a useful tool for understanding global trade in the 21st century. The theory provides a framework for analyzing the factors that influence trade patterns and the potential benefits of trade.
- According to the Heckscher-Ohlin theory, Country A is likely to specialize in producing agricultural products because it has lots of land, and it can produce these goods more efficiently.
- Meanwhile, Country B might produce things that require skilled labour, like technology or machinery.
- As a result, Country A will export agricultural products to Country B, and Country B will export technology or machinery to Country A. This trade benefits both countries because they can get the goods they don't have in abundance, than by trying to produce everything themselves.

Heckscher-Ohlin Theory Applications in Real-World

Here are some examples of how the Heckscher-Ohlin theory applies in the real world:

- Countries with large populations and relatively lower wages, such as China and India, specialize in labor-intensive manufacturing, including textiles, toys, cosmetics, clothing, and consumer electronics. They export these goods to countries with higher labour costs.
- The USA is a capital-abundant country, so it exports capital-intensive goods, such as machinery and electronics.
- Brazil is a land-abundant country, so it exports agricultural products, such as soybeans and coffee.
- Nations like Saudi Arabia and Russia, with abundant natural resources like oil, specialize in the production and export of petroleum products.
- Developed countries like Germany and Switzerland specialize in capital-intensive manufacturing, such as precision machinery and automobiles.

H-O Theory and Other Trade Theories and Economic Factors

1. **Comparative Advantage:** The H-O Theory complements the concept of comparative advantage from Ricardo's theory. It provides a more detailed understanding of why countries have comparative advantages by considering factor endowments.
2. **New Trade Theory:** The H-O Theory can be integrated with the New Trade Theory, which focuses on economies of scale and product differentiation. Combining these theories can better explain why countries produce similar goods and engage in intra-industry trade.
3. **Technology and Innovation:** As discussed above, the H-O Theory does not explicitly address technological change. However, it can be incorporated with theories like the Product Life Cycle model or the Theory of Comparative Advantage in Technology to explain how technological advancements influence international trade patterns.
4. **Trade Agreements:** The H-O theory can help explain the rationale behind trade agreements. Countries with varying factor endowments may negotiate agreements to access each other's resources and markets more efficiently.
5. **Services Trade:** Although the H-O Theory primarily focuses on goods, its core principles can be applied to understand services trade. Countries with abundant skilled labour may specialize in exporting services like IT and software development.

Heckscher-Ohlin Trade Theorem

1. The traditional comparative cost theory was unable to adequately explain why the comparative costs of producing different goods varied between nations. The novel hypothesis put out by Heckscher and Ohlin probed the fundamental factors that influence variations in comparative costs. They clarified that the disparities in comparative costs are due to variances in the factor endowments of various countries and the various factor ratios required to produce various commodities. Therefore, the Heckscher-Ohlin theory of international trade is the name given to this novel theory.

2. Heckscher and Ohlin's explanation of international commerce is widely accepted among contemporary economists, hence the theory is also known as the modern theory of international trade. Additionally, this theory is often referred to as the General Equilibrium Theory of International Trade because it is based on a general equilibrium analysis of price setting. It is important to note that Ohlin claims there is no fundamental distinction between domestic (inter-regional) and international trade, in contrast to the perspective of classical economics. He is correct in saying that inter-regional trade is only a specific case of international trade.

3. Ohlin argues that while transportation costs are included in domestic inter-regional trade, they do not serve as a defining factor in separating domestic trade from international trade. Trade is possible because the value or purchasing power of different currencies is determined by their relationship to one another through foreign exchange rates.

Factor Price Equalisation Theorem

1. The factor-price equalisation theorem is the fourth significant theorem that results from the Heckscher-Ohlin model. The theorem simply states that as countries transition to free trade and the prices of the output goods are equalised between them, the prices of the factors (labour and capital) will also be equalised.

2. The implication is that free trade will globally equalise both worker salaries and capital rents. The model's most crucial premise that the two nations have the same manufacturing technology and that markets are perfectly competitive is where the theorem stems from.

3. The value of a factor of production's marginal productivity determines the return on investment in a market with perfect competition. The amount of labour being employed and the amount of capital both affect a factor's marginal productivity, such as labour. The marginal productivity of labour decreases as the amount of labour in a certain industry increases. The marginal productivity of labour increases as capital increases.

4. Finally, the output price that the good in the market commands determines the value of productivity. In autarky, the pricing for the output goods is different in the two nations. Because it influences marginal productivity, a difference in pricing alone can lead to variations in wages and rents between nations. The variance in wages and rents, however, also has an impact on the capital-labour ratios in each industry, which in turn has an impact on the marginal products, in a variable proportions model.
5. All of this indicates that the wage and rental rates will vary between nations in autarky for a variety of reasons.
6. The two nations' production prices will be equal once unrestricted trade in goods is permitted. Since the marginal productivity relationships between the two countries are the same, only one set of wage and rental rates can fulfil these relationships for a certain set of output prices. As a result, free trade will equalise the cost of commodities as well as wage and rent rates.
7. Both nations will use the same capital-labour ratio to create each good because they have the same salary and rental costs. However, the countries will generate different amounts of the two things since they continue to have differing amounts of factor endowments.
8. In contrast to the Ricardian model, this outcome states that the two nations' production technologies are thought to differ. Real wages continue to differ between nations even after they adopt free trade as a result; the nation with the highest productivity will have higher real wages.
9. It might be challenging to determine whether production technologies are unique, comparable, or distinct in the actual world. One could contend that cutting-edge capital can be sent anywhere in the world if equivalent industrial technology is used. On the other hand, one may argue that just because two pieces of equipment are comparable, it doesn't necessarily follow that the workforce will use it in the same way. Differences in organisational skills, work habits, and incentives will probably always exist.

10. One way to translate these model results into reality is to claim that, to the degree that nations have comparable production capacities, factor prices will tend to converge as freer trade is achieved.

Purposes of the Heckscher Ohlin theory of international trade

- ✓ The approach emphasizes how when each nation makes the greatest effort to export commodities that are domestically naturally abundant, everyone benefits globally and through international trade. When nations import the resources they lack natively, everyone wins. A country can benefit from elastic demand since it need not rely entirely on domestic markets. As additional nations and new markets grow, labour costs rise and marginal productivity falls. Trading globally enables nations to adapt to capital-intensive manufacturing, which would be impossible if each nation exclusively sold goods domestically.

- ✓ Additionally, it highlights the importation of items that a country cannot produce as effectively. It advocates for nations to export commodities and resources they have an excess of while proportionately importing those resources they require. Some nations have a relatively high level of capital, which means that the average worker has access to a wide range of tools and machines to help with the job. These nations typically have high pay rates, which makes it more expensive to produce labor-intensive commodities like textiles, sporting goods, and basic consumer electronics than it would be in nations where there is a surplus of labour and low wage rates.

- ✓ Conversely, in nations with cheap and abundant capital, items like automobiles and chemicals that require a lot of capital but little labour tend to be relatively inexpensive. Therefore, nations with a lot of capital should be able to create capital-intensive commodities fairly cheaply and export them to cover the cost of importing goods that require a lot of labour.

Assumptions made by the Heckscher Ohlin theory of International Trade about the World Economy

The seven assumptions that were put forth by the Heckscher Ohlin theory of international trade about world economy have been listed hereunder:

1. Consumers deal with the same preferences and consumption functions;
2. All nations use the same production technology;
3. While the marginal returns to any one factor are declining, the output yields constant returns to scale;
4. The technical costs of capital and labour per unit differ between the items;
5. Perfect competition is the foundation of the markets;
6. There are no restrictions on foreign trade; and
7. The availability of resources is fixed to a certain degree and is the same across all nations.

Heckscher Ohlin's theory of international trade in India

- Indian emergent markets have grown recently. Trade between major industrialized nations like the United States and other European nations is largely to blame for this. Traditional village farming, modern agriculture, a wide range of contemporary businesses, and a significant quantity of services are all part of India's varied economy. America and India currently have close cultural, strategic, military, and economic ties. The Heckscher-Ohlin theorem is one hypothesis that analyses the trade between two nations.

- The 1990s saw the country start to grow very quickly as markets opened up to foreign competition and investment. India is growing economically and has abundant natural and human resources. India's economic growth rate was accelerated in the 2000s by economic reforms and stronger economic policy. India's economy is primarily a domestic market, with 20% of its GDP coming from exports. China, the United States, the United Arab Emirates, the United

Kingdom, Japan, and the European Union are India's top trading partners. India's economy is primarily a domestic market, with 20% of its GDP coming from exports. China, the United States, the United Arab Emirates, the United Kingdom, Japan, and the European Union are India's top trading partners.

- The capital/labour ratio is the portion of capital to labour employed in a production that is described in the Heckscher-Ohlin model. Thus, the capital/labour ratios of various industries producing various items will vary. Each nation produces two items in the model, hence it must be assumed which industry has a higher capital-to-labour ratio. For instance, if a nation can produce both steel and clothing, and the production of steel requires more capital per worker than the manufacturing of clothing does, then we would say that the production of steel is more capital-intensive than the production of clothing.

Comparison between India and the United States with regards to the application of the Heckscher Ohlin theory

- As India and the United States are two different economies, with the former being developing and the latter exceeding the developed one, a comparison between the two can help the reader distinguish between the theory's applications in economies belonging to different spectrums.

- When compared to its workforce, the US possesses a large amount of physical capital. Developing nations have a sizable labour force despite having little physical wealth. Then, to determine the relative factor abundance between nations, we would use the capital-to-labour ratio. For instance, the United States has a higher ratio of total capital to labour than India. Accordingly, we may claim that the United States has more capital than India. India would be more labour-abundant than the United States because of its higher ratio of total labour to capital. The model presupposes that the only distinctions between the two nations are their varying relative endowments of production components.

- Based on the characteristics of the countries, the Heckscher-Ohlin theorem predicts the pattern of commerce between them. A country with an abundance of capital is said to export goods that require a lot of capital, whereas a country with an abundance of labour will export goods that require a lot of work. The reason for this is that a country with an abundance of capital generates goods that require significantly more capital during manufacture. As a result, if the two countries stopped trading, the cost of goods in the country with ample capital would decrease due to the increased availability of goods.

- This will be contrasted with the cost of identical goods in the other nation. The cost of labor-intensive goods will be the same everywhere there is an abundance of workers. Businesses will relocate their products to markets with higher prices once commerce between the two nations is open. Because the capital-intensive goods will temporarily cost more in the other country, the capital-abundant nation will export them. The labor-intensive goods will be exported from the country with an abundance of workers since the price will temporarily be higher in the other country.

Challenges surrounding the Heckscher Ohlin theory of international trade

- The Heckscher-Ohlin theory is frequently at odds with the actual patterns of international trade, despite its plausibility. Wassily Leontief, a Russian-born American economist, carried out one of the earliest studies on the Heckscher-Ohlin hypothesis. Leontief noted that the United States had a respectable amount of capital. Therefore, the reasoning goes, the United States should export commodities that need a lot of capital and import goods that require a lot of labour. He discovered that the contrary was true: American exports typically require more labour than the kinds of goods that the country imports. The Leontief Paradox refers to his results since they were the exact reverse of what the theory predicted.

- The Heckscher-Ohlin theory has undoubtedly been shown to be more accurate, precise, scientific, and analytically superior than the prior approaches to the theory of international trade, but it still has several flaws that have led to criticism from numerous writers.

1. Although Ohlin's theory was acknowledged by Haberler to be less abstract, a general equilibrium idea was never developed. It still mostly falls under the partial equilibrium analysis. This theory ignores a number of additional effects, including transport costs, economies of scale, external economies, etc., which also have an impact on the cost of production, in favour of attempting to explain the pattern of trade simply in terms of factor proportions and factor intensities. When multiple factors are simultaneously affecting costs, according to Ellsworth, "it becomes a matter of adding up the influence of all cost-reducing and rising forces to arrive at a net outcome."
2. This theory is built on a set of very oversimplified premises, including perfect competition, resource utilization at 100%, a production function that is identical, constant returns to scale, the absence of transit costs, and the lack of product differentiation. This collection of presumptions renders the entire model wildly unrealistic.
3. Given production functions, incomes, and expenses, the Heckscher-Ohlin model makes the assumption that fixed amounts of production elements exist. This indicates that the theory examines the course of global trade in a fixed environment. Simply put, the results reached from such a study do not apply to a dynamic economic system.
4. According to this idea, factors are identical on a qualitative level and may be precisely measured in order to determine factor endowment ratios. However, there are variations in qualitative factors in the real world. Furthermore, each element comes in more than one variation. This poses significant challenges for both determining the trade pattern and measuring and comparing expenses.
5. The hypothesis ignores the part that product differentiation plays in global trade. Due to product differentiation, international trade may still occur even though the manufacturing agents are the same in two nations. For

instance, American machines are sold out in Japan, whereas Japanese machines are sold out in the United States. According to Wijanholds, factor prices do not impact costs in this situation. Instead, factor prices are determined by commodity prices. According to the HO hypothesis, the export specialisation of various nations is determined by the relative factor proportions (or factor endowments). Labour- and capital-intensive items are exported by countries with ample capital, but the former also export capital-intensive goods. It suggests that trade between nations or regions with comparable relative factor proportions will not occur. However, this is untrue.

6. Prices of variables like raw materials, labour, etc., are ultimately dependent on the demand and prices of finished items because the desire for them is the derived demand. Prices of goods are decided by their utility to the buyers (the force of demand). Thus, according to Wijanholds, "prices are the only facts we can accept. Everything else should follow from that. He believes that the Heckscher-Ohlin theory and the Ricardian theory are both flawed because they overlooked the impact of product differentiation on global commerce and linked cost to factor prices".

2.1.9 Modern or firm-based theory

- ✓ The emergence of modern or firm-based theories is marked after period of World War II. The founders of these theories were mainly professors of business schools and not economists. These theories majorly came up after the rising popularity of multinational companies. The Country based classical theories were mainly focused on the country, however, the modern or firm-based theories address the needs of companies. The following are the modern or firm-based theories propounded by various business school professors:

2.1.10 Country similarity theory

- ✓ Steffan Linder, a Swedish economist, was the founder of this theory. The theory marked its emergence in the year 1961 and **explained the concept of in-train industry trade.** Linder suggested that countries that are in a similar phase of development will probably have similar preferences. The suggestion proposed by Linder was that companies first produce goods for their domestic consumption and later expand production, thereby exporting those products to other countries where customers have similar preferences. Linder suggested that most of the trade in manufactured goods, in most circumstances, will be between countries with similar per capita incomes, and that the in-train industry trade will thus be common among them. This theory is generally more applicable in understanding trade where buyers mainly decide on the basis of brand names and product reputations.

Check Your Progress – Quiz – 1

Q1. Zero sum game theory applies

a. Mercantilism
b. Absolute cost advantage theory
c. Factor equalization theorem
d. New Trade theory

Answer: A

Q2. The concept of opportunity cost is employed under

a. Modern theory of trade
b. Factor equalization theorem
c. Comparative cost advantage theory
d. Absolute cost advantage theory

Answer: C

Q3. Countries with abundant of capital should focus on

a. Labour intensive goods
b. Capital intensive goods
c. Distribute between labour and capital intensive goods
d. Importing more machinery

Answer: B

Q4. Economies of scale and network effects resulting in exports of goods is related to a. New Trade theory

b. Factor equalization theorem

c. Comparative cost advantage theory

d. The Heckscher-Ohlin theory

Answer: A

Q5. First mover advantage theory is related to

a. Absolute advantage theory

b. Comparative cost advantage theory.

c. New trade theory

d. Modern theory of trade

Answer: C

Q6. Which theory considers bullion as a part of the international trade

a. Modern theory of trade

b. Factor equalization theorem

c. Comparative cost advantage theory

d. Mercantilism

Answer: D

Q7. Prices of output of goods and prices of factors are equalized under

a. Modern theory of international trade

b. Factor Equalization theorem

c. New trade theory

d. Absolute cost advantage theory

Answer: b

Q8. Factor abundance is considered to be part of international trade

a. Heckscher Ohlin theory of international trade

b. Comparative cost advantage theory

c. New Trade theory

d. Factor Equalization theorem

Q9. If goods are exchanged with the in the country then it is called

a. Internal trade

b. Modern theory of trade

c. New trade theory

d. International trade

Q10. Money cost is considered by

a. Modern theory of trade

b. Comparative cost advantage

c. New Trade theory

d. Factor equalization theorem

Q11. The Comparative Cost Advantage Theory was given by

a. David Ricardo

b. Adam Smith

c. Raymond Vernon

d. Michael E. Porter

Q12. Assertion (A): Comparative cost theory is static in character.

Reason (R): Comparative cost theory is based on fixed supplies of factors of production.

Codes:

a. (A) is correct, but (R) is incorrect.

b. (R) is correct, but (A) is incorrect.

c. (A) and (R) both are correct, but (R) is not the correct explanation of (A).

d. (A) and (R) both are correct and (R) is the correct explanation of (A)

Answer Key:	**Q1. A**	**Q2. C**	**Q3. B**	**Q4. A**	**Q5. C**	**Q6. D**	**Q7. B**	**Q8. A**	**Q9. A**	**Q10. A**
	Q11. A	**Q12. D**								

SECTION- 2.2 MODERN THEORIES

2.2.1 Product life cycle theory

- ✓ This theory was propounded by **Raymond Vernon**, a business professor at Harvard Business School, in the 1960s. The theory that originated in the field of marketing proposed that a product life cycle has three stages, **namely, new product, maturing product, and standardized product.** The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II.

- ✓ It has also been used to describe how the personal computer (PC) went through its product cycle. The PC was a new product in the 1970s and developed into a mature product during the 1980s and 1990s. Today, the PC is in the standardized product stage, and the majority of manufacturing and production process is done in low-cost countries in Asia and Mexico.
- ✓ The product life cycle theory has been less able to explain current trade patterns where innovation and manufacturing occur around the world. For example, global companies even conduct research and development in developing markets where highly skilled labor and facilities are usually cheaper. Even though research and development is typically associated with the first or new product stage and therefore completed in the home country, these developing or emerging-market countries, such as India and China, offer both highly skilled labor and new research facilities at a substantial cost advantage for global firms. The theory has a presumption that the production of a new product will completely arise in the country where it was invented.
- ✓ This theory, up to a good extent, helps in explaining the sudden rise and dominance of the United States in manufacturing. This theory also explained the stages of computers, from being in the new product stage in the 1970s and thereby entering into their maturing stage in the 1980s and 1990s. In today's scenario, computers are in a standardized stage and are mostly manufactured in low-cost countries in Asia. However, this theory has not been able to explain the current trading pattern where products are being invented and manufactured in almost all parts of the world.

2.2.2 Global strategic rivalry theory

- ✓ Paul Krugman and Kelvin Lancaster were the founders of this theory. This theory emerged around the 1980s. The theory **majorly focused on multinational companies and their strategies and efforts to gain a comparative advantage** over other similar global firms in their industry. This theory acknowledges the fact that firms will face global competition and prove their superiority. They must surely develop a competitive advantage over each other. The ways through which the firms can gain competitive advantage were termed as barriers to entry for that particular industry. These barriers are basically the obstacles that a firm will face globally when they enter the market. The barriers that companies and firms may try to optimize are

- Mainly research and development,
- The ownership of intellectual property rights,
- Economies of scale,
- Unique business processes or methods,
- Extensive experience in the industry, and
- The control of resources or favorable access to raw materials.
- Porter's national competitive advantage theory
  - The theory **emerged in the 1990s** with the aim of explaining the concept of national competitive advantage. The theory proposes that a nation's competitiveness majorly depends upon the capability and capacity of the industry to come up with innovations and upgrades. This theory attempted to explain the reason behind the excessive competitiveness of some nations as compared to others. The main determinants proposed in this theory were local market resources and capabilities, local market demand conditions, local suppliers and complementary industries, and local firm characteristics. The theory also mentioned the crucial role of government in forming the competitive advantage of the industry.

2.2.3 Porter's National Competitive Advantage Theory

- In the continuing evolution of international trade theories, Michael Porter of Harvard Business School developed a new model to explain national competitive advantage in 1990. Porter's theory stated that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified four determinants that he linked together.

The four determinants are

(1) Local market resources and capabilities,

(2) Local market demand conditions,

(3) Local suppliers and complementary industries, and

(4) Local firm characteristics.

1. **Local market resources and capabilities (factor conditions).** Porter recognized the value of the factor proportions theory, which considers a nation's resources (e.g., natural resources and available labor) as key factors in determining what products a country will import or export. Porter added to these basic factors a new list of advanced factors, which he defined as skilled labor, investments in education, technology, and infrastructure. He perceived these advanced factors as providing a country with a sustainable competitive advantage.
2. **Local market demand conditions.** Porter believed that a sophisticated home market is critical to ensuring ongoing innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies. Many sources credit the demanding US consumer with forcing US software companies to continuously innovate, thus creating a sustainable competitive advantage in software products and services.

3. **Local suppliers and complementary industries.** To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry. Certain industries cluster geographically, which provides efficiencies and productivity.
4. **Local firm characteristics.** Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm's competitiveness. A healthy level of rivalry between local firms will spur innovation and competitiveness.

- In addition to the four determinants of the diamond, Porter also noted that government and chance play a part in the national competitiveness of industries. Governments can, by their actions and policies, increase the competitiveness of firms and occasionally entire industries.
- Porter's theory, along with other modern, firm-based theories, offers an interesting interpretation of international trade trends. Nevertheless, they remain relatively new and minimally tested theories.

2.2.4 International Trade and Factor Mobility Theory

- Introduction Simple trade theory is based on the assumption on traded goods and non-traded factors. Not consistent with the real world. in the real world both movements of goods and factors are possible — but entail costs, such as transport costs, non-tariff barriers costs, tariffs and other transaction costs. In a world of FPE, trade in goods substitutes for trade in factors, and there is no incentive for factors to move across borders. But the existence of trade costs implies that good trade alone will not equalize factor prices, and there is thus an incentive for factors move.

What will determine which commodities? — Goods and factors — which will actually be traded in a trade equilibrium?

- The model: a small open economy 2X2 HO framework Good 1: labour intensive, trade incurs trade cost t1 Good 2: capital intensive, free trade (the numeraire) Factor n, immobile Factor k, internationally mobile at cost tk

- The home economy is relatively abundantly endowed with labour; so in the absence of factor movements it would have a CA in the production of good 1. Price of good 1: pf 1 =world price of
- good 1 The foreign wage rate is given by r1(pf 1,wf)=r2(1,wf)2.
- 1 A model without capital mobility From Figure 1 we can see: ³ • ´ k n ³k1 ´h <] n1 : Specialized equilibrium in the home country.
- Good 1 is exported, good 2 is imported (point a, Figure 1) •] ³ k1 n1 ´ ³ < k n ´h < ³k n ´C : Diversified equilibrium, and since the home economy consumption is more capital intensive than the home endowment,
- good 1 will be exported and good 2 will be imported (point b, Figure 1) ³ • k n ´C < ³k n ´h : At prices ph 1 = pf 1 − t1 the home country will produce less of good 1 than is demanded, so there cannot be any export of good 1. Instead this will lead to ph 1 >pf 1 − t1, which shifts the rate of return curve for good 1 up (ex point c, Figure 1). Since the gap between ph 1 and pf 1 is less than t1,no trade occurs. for an overview of equilibria. 2.2 A model with capital mobility The resulting equilibrium depends on trade costs related to goods, trade costs related to capital and initial endowment ratio
- From Figure 3 follows that: • Area I: The difference in rates of return at home and abroad is less than the cost of moving capital. ⇒ No capital movement. Trade in goods if ³ k n ´h < ³k n ´C .• AreaII and III: In these regions tk <rh−rf, capital will be imported until tk = rh − rf.
- If the initial configuration is in II, the new equilibrium will still be one of complete specialization; the home country will import capital, export good 1, and import good 2 (since the domestic production of good 2iszero).
- If the initial configuration is in III, the home country will import capital and good 1, and export good
- International equilibria Key reference: article by Norman and Venables in Economic Journal in 19953.1 A simple model 2X2 HO framework
- Good 1: labour intensive, price pi 1,i= h,f, trade incurs trade cost t1 Good 2: capital intensive, price pi 2, i= h,f, free trade (the numeraire) Factor n, immobile, price wi Factor k, internationally mobile at cost tk, price ri Fixed coefficient technology The home economy is relatively abundantly endowed

with labour; so in the absence of factor movements it would have a CA in the production of

- Good 1. This implies that we restrict the analysis to the area under the diagonal in Figure 4. Diversified equilibria in both countries Assumes that transaction costs has a negative impact on consumers' utility in the exporting country (simplifying assumption) u = Y e(p1) −T e(p1)=index of cost of living T =utility that is "wasted" on international transactions T =t1· tradeingood1+ tk· trade in capital In terms of the numeraire, the cost of transaction services is e(p1)T, so the unit cost of transactions will be e(p1)t1 for good 1 and e(p1)tk for capital.3.1.1 Trade in goods but not in capital For what endowments will there beno trade in goods, given that there is no trade in capital?

  • Along the diagonal, relative factor endowments are the same in both countries, so relative factor and product prices are also the same. Hence there will ³ be no trade and c1 c2 ´h = ³x1 x2 ´h .

  • For some endowments near the diagonal, relative prices will be sufficiently close to make the price differences smaller than the transaction costs—in which case there will be no trade and ph 1 > pr 1 − e(ph 1)t1.

  • The boundaries for the no-goods-trade area (see Figure 4) are accordingly given by Ã c1 !h c2 Ã = x1 x2 !h . (1)ph 1 = pf 1 − e(ph 1)t1 3.1.2 Trade in capital but not in goods (2) Under what circumstances — for what endowments — will there be trade in capital, given that there is no trade in goods?

  Answer: there will be capital trade if the autarky differences in rates of return exceed transaction costs for capital. The boundary of the no-capital trade endowment area must therefore be given by differences in autarky rates of returns equal to the unit of transaction cost for capital, i.e. (since the home country is a potential capital importer): rh = rf +e(ph 1)tk (3)To allow the two cases of no-trade in goods versus no trade in capital to be compared, we use that the equilibrium rate of returns is given by r =p1 x1 k1 −wn1 and rearranging we may write w =p1 x1 n1 −rk1 k1 = x2 k2 −wn2 n1 = x2 k2 n2 −rk2 (4) (5) n2 and solving the latter of the two equalities for r, weget x2 r = n2 −p1x1 n1 k2 n2 − k1 n1 . (6) Since coefficients are fixed, the difference in autarky rates can be written as rh −rr =−B(ph 1−pf 1) with B ≡ x1/n1 k2 n2 −

k1 n1 Using (3), (7) and (8), we have that ph 1 = pf 1 −e(ph 1)tk/B (7) (8)The boundaries for the no-capital trade area(see Figure 4) are accordingly given by Ã c1 c2 !h Ã = x1 x2 !h . ph 1 = pf 1 −e(ph 1)tk/B (9) (10) The no-capital-trade boundary will look just like the no goods-trade boundary, but will be closer to the diagonal if tk/B < t1,andfurther from the diagonal for tk/B > t1.3.1.3 Trade in capital or goods? Different outcomes are possible depending on transaction cost of capital relative to transaction cost of goods. If tk/B < t1, two possible outcomes:

• If countries are fairly similar (endowments within area A), there will be no trade at all.

• If countries are sufficiently different in terms of endowments to be outside the capital-trade boundary (area B or C), there will be trade in capital but no trade in goods. ⇒the home country will import capital, have no trade in good 1, and therefore (since there is balanced trade overall) export good 2. The factor content of consumption must lie on the capital-trade boundary, because this gives the relative prices of good 1 in each country, and hence the consumption ratios. If tk/B > t1, the capital-trade boundary is irrelevant, since the product price differences can never exceed t1.

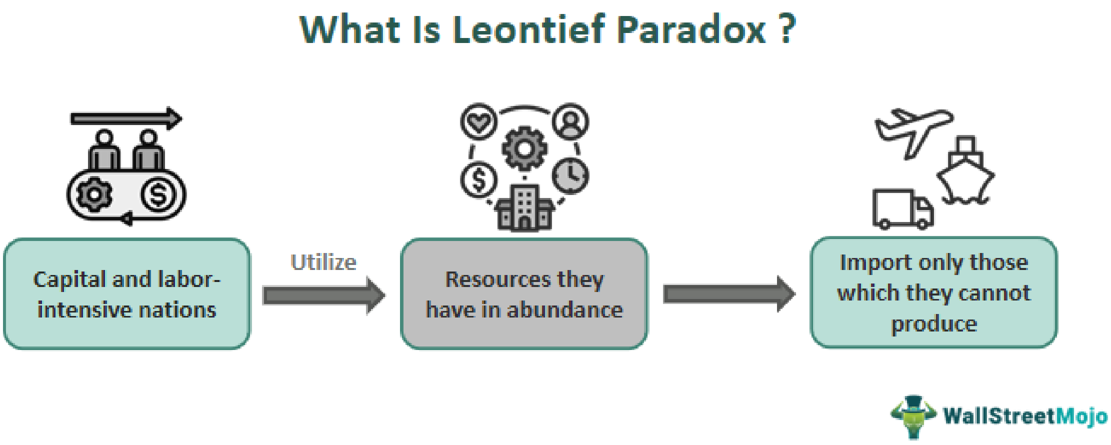
So trade in goods will ensure that the rate of return differences are smaller than the unit transaction cost for capital. Two possible outcomes:

• If countries are fairly similar, there will be no trade at all.

• If countries are sufficiently different in terms of endowments to be outside the no—goods-trade boundary, there will be trade in goods only. The home country will export good 1, and import good 2. The existence of transaction costs implies that trade patterns may turn out rather surprising.

2.2.5 Leontief Paradox

- The Leontief Paradox refers to the economic concept of international trade detecting a problem in nations, stating that any country’s trade reflects its economy. Therefore, the countries must utilize the resources that they are rich in and only import goods that they cannot produce domestically.



- The utility of the Leontief Paradox theory is mainly observed in US trade. The US, despite having a large amount of capital and producing capital-intensive products, imports these products and exports labor-intensive commodities despite a lack of a sufficient labor force. It changed how economists saw trade operations and declined the earlier models used for the study.

Leontief Paradox Theory Explained

- The Leontief paradox is a test conducted on the prior Heckscher Ohlin model of international trade that resulted in opposite or contradictory results to this generalized HO theory. This paradox reached a critical point when economists who had earlier believed in the prior model started questioning its outcome.

- In simple words, the Leontief paradox definition explains that capital- and labor-intensive nations are not using their resources and importing against their rich resources when observed closely. A capital-intensive nation is more indulged in importing such commodities, whereas a labor-intensive nation imports labor-intensive goods. According to this, despite being capital-abundant, America specializes in labor-intensive commodities.

- The results were both shocking and astonishing for world academicians and economists. To test the Leontief paradox further in international trade, Tatemato and Ichinmura researched the Japanese markets and confirmed the theory. Japan, a labor-abundant nation, was importing labor-intensive goods like raw materials, televisions, watches, automobiles, etc.

- Thus, this paradox states the critical issue of inconsistent patterns observed in the H-O theory. Therefore, it internally causes significant problems, which eventually affect the nation's economy in the world market. When a country can produce a good domestically yet chooses to import it from different countries, it is not helping itself or taking advantage of its resources simultaneously. Thus, when a nation is more focused on manufacturing goods with a lack of human resources, workers, and labor, they face the problems of inflated workforce prices, a lack of skilled labor, and delays in business operations.

- The Leontief paradox's meaning lies in pointing out such errors and rectifying the structure of trade businesses. Since its introduction, many economists have started studying nations in a more profound sense, as it is also beneficial for small nations with problems of capital and labor availability.

Examples

Take a look at some examples to understand the concept better:

Example #1

- Suppose two countries: one is a capital-intensive country (Country A), and the other is a labor-intensive nation (Country B). Technically, Country A should indulge in producing goods that require higher capital investment and labor-intensive imports from Country B. Likewise, Country B must focus on labor-intensive manufacturing goods and depend on the capital-intensive country for goods that demand high capital investment.

- If Country A being capital-intensive imports such goods from another nation and focuses on manufacturing labor-intensive goods in which it is not rich. In that case, this particular problem leads to a Leontief paradox example. Since a capital-intensive nation is importing capital goods from another country, it must utilize its capital and resources. At the same time, they have a labor crisis. The production of labor-intensive products involves them more, resulting in a lack of human capital, inflated prices, limited options, delayed operations, and disrupted pay scales for workers at large. These factors have a significant impact on the entire economy.

Example #2

- Before the Industrial Revolution, the French Physiocrats advocated the utilization of fossil fuels for extracting stored solar energy. Smith, who the Physiocrats influenced, believed that the division of labor was the reason for increased productivity and that labor was the source of wealth and consequently neglected energy in his works.

- With the loss of the Physiocrats emphasis on energy in economics, the Labour theory of value and Neoclassical and Post Keynesian production functions emerged. It provides a prime illustration of Leontief's Paradox, in which the researchers prioritized capital and labor over energy in their economic model.

2.2.6 Immiserising Growth Theory

Definition

- Immiserising growth arises when an increase in economic activity is associated with a fall in real living standards. The increased economic activity may be reflected in greater inputs of labour (people; labour hours), capital, land or any other resources which have an opportunity cost.

Preview: Immiserising growth may apply at the level of the individual, the household, the farm, the firm, groups of firms, sub-regions, provinces, countries, intercountry regions, and so on. The unit of aggregation depends on the purpose of the analysis.

- Theoretical antecedents Bhagwati (Bhagwati, 1958), who is responsible for the modern-day discussion of immiserising growth, drew on work by Edgeworth (1894) on “indemnifying growth”. Bhagwati and Johnson (1955) began by examining circumstances in which declining [barter] terms of trade outweigh the benefits of growth.

- This is a sharp focus which resonates with some of the points below in this note. However, in later work during the 1960s and early 1970s, this sharpness is lost. Bhagwati and others began by arguing that in a world of trade distortions (a sub-optimal policy environment), growth of production could induce a net loss of output. For example, he argued, tariffs could induce FDI targeting the domestic market, but with such inefficiencies that the result would be less favourable than a world free of tariffs (and of tariff-hopping FDI).

- For Bhagwati, at least, this provided an intellectual underpinning for the neoclassical critique of market interventions underlying industrial policies. These were said to lead to directly unproductive rent seeking behaviour, a suboptimal form of economic organisation. Thus, new investments in this regime which departure from perfect markets yield sub-optimal growth outcomes compared to the counterfactual of perfectly functioning markets, and hence probably constitutes immiserising growth. In my view, the concept of immiserising growth in this more recent literature is thus shorn of meaning.

- **Immiserising growth in a closed economy**

✓ Immiserising growth can occur in a closed economy. For example, in a world of diminishing, and then negative marginal rates of return, net additions to economic activity lead to a loss of output. (I remember illegally compiling political pamphlets in the 1960s, with fellow students round a table gathering cyclostyled paper and stapling the piles. There came a stage when by adding one more student we began to get in each other’s way, and our total output declined). This accords with a Malthusian view of the world.

Immiserising growth in an open economy.

- ✓ Once we move from a closed to an open economy, the valuation of output becomes an important component of immiserising growth. In a world of declining barter terms of trade, if the income terms of trade also fall (in other words the fall in prices of the products exported is greater than the increase in demand), we are unambiguously in a world of immiserising growth. But, even if income terms of trade rise, we may well be in a Bhagwati-type world where the opportunity cost of the resources required to obtain the enhanced income (which may be small if demand is not price elastic) is such that the counterfactual use of the additional resources used would be greater if production was destined for the home market. Finally, there is the additional problem of the numeraire which is used. That is, if the factor underlying the volume expansion of exports is currency devaluation, then the declining incomes arising from immiserising growth ("what is the global purchasing power of the resources arising from economic activity?") may not be reflected in domestic currency, but only in PPP currencies.

Difference between Classical theories and Modern theories

INTERNATIONAL TRADE THEORY

INTERNATIONAL TRADE THEORIES are the theories that explains international trade. It justifies, why a company does international trade.

CLASSICAL THEORIES	MODERN THEORIES
Mercantilism states that country should grow its reserves of gold and silver by encouraging exports and discouraging imports.	**Country Similarity Theory** states that people in countries that are in the same level of development have similar preferences.
Absolute Advantage focuses on the concept that country should produce an item that it can manufacture more proficiently than other countries.	**Product Life Cycle Theory** says there are three stages in every product life cycle - new product, maturing product, and standardized product.
Comparative Advantage says that business can take place even if one nation has an advantage in making both items.	**Global Strategic Rivalry Theory** focuses on how companies can get competitive advantage when competing against global firms in same industry.
Heckscher-Ohlin Theory maintain that company should focus on producing item that uses factors of production available in abundance in that country.	**Porter's National Competitive Advantage Theory** says that competitiveness business segment depends on innovative items, processes etc.
Leontief Paradox is based on the observation that US was importing more of capital-intensive goods, and was exporting more of labor-intensive items.	

Which Trade Theory Is Dominant Today?

- The theories covered in this chapter are simply that—theories. While they have helped economists, governments, and businesses better understand international trade and how to promote, regulate, and manage it, these theories are occasionally contradicted by real-world events. Countries don't have absolute advantages in many areas of production or services and, in fact, the factors of production aren't neatly distributed between countries. Some countries have a disproportionate benefit of some factors.
- The United States has ample arable land that can be used for a wide range of agricultural products. It also has extensive access to capital. While it's labor pool may not be the cheapest, it is among the best educated in the world. These advantages in the factors of production have helped the United States become the largest and richest economy in the world. Nevertheless, the United States also imports a vast amount of goods and services, as US consumers use their wealth to purchase what they need and want—much of which is now manufactured in other countries that have sought to create their own comparative advantages through cheap labor, land, or production costs.
- As a result, it's not clear that any one theory is dominant around the world. This section has sought to highlight the basics of international trade theory to enable you to understand the realities that face global businesses. In practice, governments and companies use a combination of these theories to both interpret trends and develop strategy. Just as these theories have evolved over the past five hundred years, they will continue to change and adapt as new factors impact international trade.

Check Your Progress – Quiz – 2

Q1. "Mature Industries tend to go out of own country and into low-cost assembly locations." Which of the following theory/model explain this?

a. Adam Smith's theory of absolute advantage

b. Porter's diamond model

c. Raymond Vermon's international product lifecycle theory

d. Heckscher-Ohlin theory of international trade

Q2. Consider the following statements with regard for the "Theory of Absolute Cost Advantage":

(i) Productive efficiency differed among different countries because of diversity in natural and acquired resources possessed by them.

(ii) The difference in natural advantage manifests in varying climate, quality of land,

availability of minerals, water and other resources.

(iii) The difference in acquired resources manifests in different levels of technology and skills available.

Identify the correct code from the following:

a. Statement (i) is correct, but (ii) and (iii) are incorrect.
b. Statements (i) and (ii) are correct, but (iii) is incorrect.
c. All the statements (i), (ii) and (iii) are correct.
d. None of the statements is correct

Q3. Labour is the only factor of production according to the _____ theory of international trade.

a. Classical theory
b. Modern theory
c. None of these
d. All of these

Q4. Heckscher – Ohlin theory of International trade assumes ______ (Countries* Commodities* factors of production)

a. 2*2*2
b. 2*2*1
c. 2*3*2
d. 3*2*2

Q5. In case of Heckscher – Ohlin theory of international trade, Factor abundance in physical terms refers to ______

a. TK1/TL1 >TK2/TL2
b. PK1/PL1< PK2/PL2

c. None of these

d. All of these

Q6. Strength and elasticity of one country's Demand for the other country's commodity in exchange for its commodity at different terms of trade is referred to as_____

a. Reciprocal demand

b. Market demand

c. Individual demand

d. Nene of these

Answer Key:	Q1. C	Q2. C	Q3. A	Q4. B	Q5. A	Q6. A

2.3 Unit Summary

- **Mercantilism**

  A classical country-based theory that originated in the 17th and 18th centuries. Mercantilists believed that countries should increase their gold and silver holdings by promoting exports and discouraging imports.

- **Absolute advantage**

  A theory developed by Adam Smith in The Wealth of Nations in 1776. Smith believed that economic growth depends on specialization and division of labor. However, some say that the theory is not always accurate because its assumptions are not always true in practice.

- **Comparative advantage**

  A theory based on David Ricardo's "Law of Comparative Advantage". This theory states that a country should trade with another country even if it is more efficient at producing all goods.

- **Product life cycle theory**

A theory developed by Raymond Vernon in the 1960s. It was useful in explaining the success of US manufacturing after World War II, but it has been less able to explain current trade patterns.

- **Porter's national competitive advantage theory**

A theory developed by Michael Porter in the 1990s that analyzes how a nation's characteristics create competitive advantages in certain industries.

2.4 Glossary

Tariff – It is a tax levied on goods traded internationally and is known as duty. Duties levied on imported goods are called Import duties, while duties levied on exported goods are called Export duties. The former are more extensively used than the latter.

Non-tariff - Non-tariff barriers include all rules, regulations, and bureaucratic delays that help keep foreign goods out of the domestic markets. Examples are Quotas, Embargos, Voluntary Export Restraints, and Subsidies to local goods, Technical barriers, Procurement policies, Exchange controls, etc.

Current Account: It measures a country's net exports (that is, the difference between exports and imports) of goods and services and net international income receipts.

Fixed Exchange Rate System: Under this fixed (or pegged) system, the governments or the central banks of the respective countries decide the rate of exchange of currency. The pegging is done to some common commodity or to some common currency.

Floating Exchange Rate System: Under this system, the exchange rates between currencies are variable and determined by the demand and supply of the currencies in the international market. This, in turn, depends on the flow of money between the countries, which may result either due to international trade or due to purely financial flows.

Free Float: The exchange rate is said to be freely floating, when its movements are totally determined by the market. There is no governmental or official intervention.

2.5 Self-Assessment Questions

5 Marks

1. State on Classical or Country-Based Trade Theories.
2. Brief on Product life cycle theory.
3. Give short note on Leontief Paradox.
4. What is Immiserising Growth Theory? Explain in brief.
5. What is Country similarity theory? Give short note.

10 Marks

1. Enumerate on Haberler's Theory of Opportunity Cost.
2. Explain Heckscher-Ohlin Theory (Factor Proportions Theory).
3. Describe on Porter's National Competitive Advantage Theory.
4. Explain the determinants of Porter's National Competitive Advantage Theory.
5. What will determine which commodities? — Goods and factors — which will actually be traded in a trade equilibrium?
6. Explain the difference between Classical theories and Modern theories.

2.6 Case Studies

International trade theories argue that nations should open their doors to trade Conventional free trade wisdom says that by trading
International trade theories argue that nations should open their doors to trade Conventional free trade wisdom says that by trading with others, a country can offer its citizens a greater volume and selection of goods at cheaper prices than it could in the absence of it. Nevertheless, truly free trade still does not exist because national governments intervene. Despite the efforts of WTO (World Trade Organization) and smaller groups of nations, government seems to be

crying foul in the trade game now more than ever before.

We see efforts at protectionism in the rising trends in governments charging foreign producers for "dumping" their goods on the world market. Worldwide, the number of anti-dumping cases that were initiated stood at about 150 in 2014, 225 in 2015, 230 in 2016, and 300 in 2017.

There is no shortage of similar examples. The US charges Brazil, Japan, and Russia with dumping their products in the US market as a way out of tough economic times. The US steel industry wants the government to slap a 200 percent tariff on certain types of steel. But car makers in US are not complaining, and General Motors even spoke out against the anti-dumping charges — as it is enjoying the benefits of low cost steel for the use in its auto production. Canadian steel makers followed the lead of the US and are pushing for anti-dumping actions against four nations.

Emerging markets too, are jumping into the fray. Mexico recently expanded coverage of its Automatic Import Advice System. The system requires importers (from a selected list of countries) to notify Mexican officials of the amount and price of the shipment 10 days prior to its expected arrivals in Mexico. The ten day notice gives domestic producers advance warning of incoming low priced products so they can complain of dumping before the product clear customs and enter the market place. India is also getting onboard by setting up a new government agency to handle anti-dumping cases.

Why dumping is on the rise for the first place? The WTO has made major inroads on the use of tariffs, slashing them across every product category in recent years. But the WTO does not have the authority to punish companies, but only governments. Thus the WTO cannot pass judgments against individual companies that are dumping their products in other markets. It can only pass the rulings against the governments of the country that imposes anti-dumping duty. But the WTO allows countries to retaliate against nations whose producers are suspected of dumping when it can be shown that:

i) The alleged offenders are significantly hurting the domestic producers.

ii) The export price is lower than the cost of production or lower than the home market price.

Supporters of anti-dumping tariff claim that they prevent dumpers from undercutting the price charged by the producers in a target market and driving them about of business. Another claim in support of anti-dumping is that it is an excellent way of retaining some protection against the potential dangers of totally free trade. Detractors of anti-dumping tariffs charge that once the tariffs are imposed they are rarely removed. They also claim that they cost companies and governments a great deal of time and money to file and argue their cases. It is argued that the fear of being charged with dumping causes international competitors to keep their price higher in the target market than would have otherwise be the case. This would allow domestic companies to charge higher prices and not loose market shares forcing consumers to pay more for their goods.

Required Question

Questions 01: Based on the above case study, evaluate the effects of dumping on domestic business and also on the consumers

Question 02: As we have seen WTO cannot currently get involved in punishing individual companies for dumping. Its action can be only directed towards governments of countries. Do you think this is a wise policy? Justify your answer.

2.7 Reference and Suggested Readings

1. https://testbook.com/ugc-net-commerce/theories-of-international-trade

2. https://blog.ipleaders.in/theories-of-international-trade-2/

3. Theories of International trade- A.X.Dixit and V.Norman.

UNIT-III BALANCE OF TRADE AND BALACE OF PAYMENT

Balance of Payments– Components of Balance of Payments-Current account, Capital account & Official settlement accounts -Disequilibrium in BOP -Methods of correcting Disequilibrium –Balance of Payment adjustment Theories-Marshall Lerner mechanism. Balance of Trade – Terms of Trade – Meaning – Definition –Difference between BOP and Balance Of Trade.

BALANCE OF TRADE AND BALACE OF PAYMENT

UNIT OBJECTIVES

It aims to track a country's surplus or deficit in its foreign transactions, revealing if it is a net lender or borrower to the rest of the world.

SECTION – 3.1 BALANCE OF PAYMENT

3.1.1 Introduction- Balance of Payment

- The balance of payment is the statement that files all the transactions between the entities, government anatomies, or individuals of one country to another for a given period of time. All the transaction details are mentioned in the statement, giving the authority a clear vision of the flow of funds.

- After all, if the items are included in the statement, then the inflow and the outflow of the fund should match. For a country, the balance of payment specifies whether the country has an excess or shortage of funds. It gives an indication of whether the country's export is more than its import or vice versa.

3.1. 2 Types of Balance of Payment

The balance of payment is divided into three types:

a. **Current account**: This account scans all the incoming and outgoing of goods and services between countries. All the payments made for raw materials and constructed goods are covered under this account. Few other deliveries that are included in this category are from tourism, engineering, stocks, business services, transportation, and royalties from licenses and copyrights. All these combine together to make a BOP of a country.

b. **Capital account**: Capital transactions like purchase and sale of assets (non-financial) like lands and properties are monitored under this account. This account also records the flow of taxes, acquisition, and sale of fixed assets by immigrants moving into the different country. The shortage or excess in the current account is governed by the finance from the capital account and vice versa.

c. **Finance account**: The funds that flow to and from the other countries through investments like real estate, foreign direct investments, business enterprises, etc., is recorded in this account. This account calculates the foreign proprietor of domestic assets and domestic proprietor of foreign assets, and analyses if it is acquiring or selling more assets like stocks, gold, equity, etc.

3.1. 3 Importance of Balance of Payment

A balance of payment is an essential document or transaction in the finance department as it gives the status of a country and its economy. The importance of the balance of payment can be calculated from the following points:

- It examines the transaction of all the exports and imports of goods and services for a given period.
- It helps the government to analyses the potential of a particular industry export growth and formulate policy to support that growth.
- It gives the government a broad perspective on a different range of import and export tariffs. The government then takes measures to increase and decrease the tax to discourage import and encourage export, respectively, and be self-sufficient.
- If the economy urges support in the mode of import, the government plans according to the BOP, and divert the cash flow and technology to the unfavourable sector of the economy, and seek future growth.

- The balance of payment also indicates the government to detect the state of the economy, and plan expansion. Monetary and fiscal policy are established on the basis of balance of payment status of the country.

3.1.4 How the BOP Is Balanced?

- The current account should be balanced against the combined capital and financial accounts; however, as mentioned above, this rarely happens. We should also note that with fluctuating exchange rates, the change in the value of money can add to BOP discrepancies.
- If a country has a fixed asset abroad, this borrowed amount is marked as a capital account outflow. However, the sale of that fixed asset would be considered a current account inflow (earnings from investments). The current account deficit would thus be funded.
- When a country has a current account deficit that is financed by the capital account, the country is actually foregoing capital assets for more goods and services. If a country is borrowing money to fund its current account deficit, this would appear as an inflow of foreign capital in the BOP.

3.1.5 Liberalizing the BOP

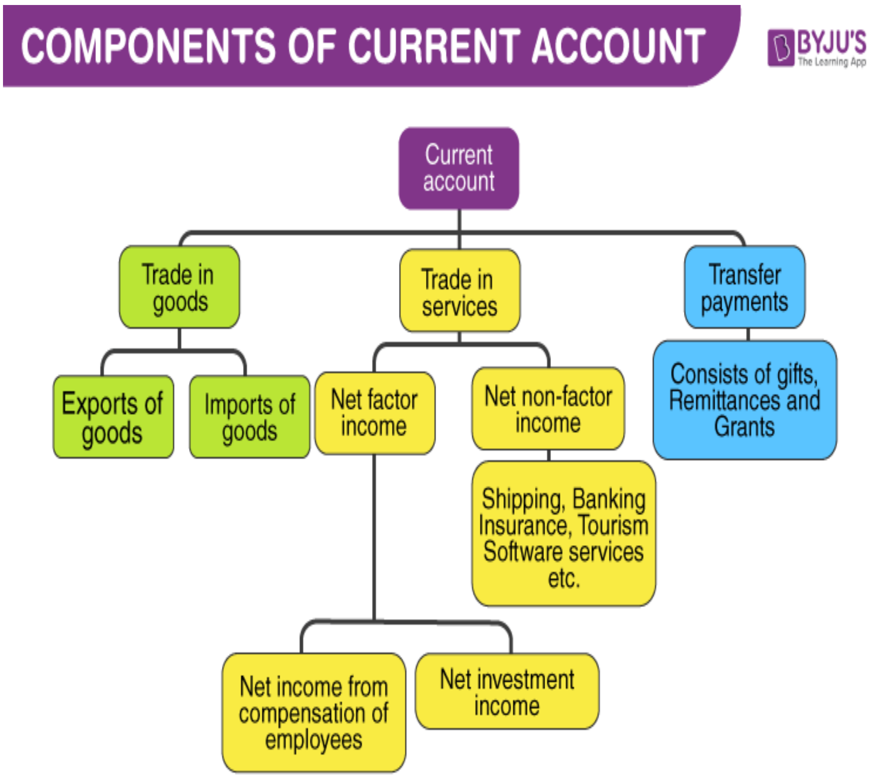
- The rise of global financial transactions and trade in the late 20th century spurred BOP and macro-economic liberalization in many developing nations. With the advent of the emerging market economic boom, developing countries were urged to lift restrictions on capital- and financial-account transactions to take advantage of these capital inflows.
- Many of these countries had restrictive macroeconomic policies, by which regulations prevented foreign ownership of financial and nonfinancial assets. The regulations also limited the transfer of funds abroad.
- With capital and financial account liberalization, capital markets began to grow, not only allowing a more transparent and sophisticated market for investors but also giving rise to foreign direct investment (FDI).
- For example, investments in the form of a new power station would bring a country greater exposure to new technologies and efficiency, eventually increasing the nation’s overall gross domestic product (GDP) by allowing for

greater volumes of production. Liberalization can also facilitate less risk by allowing greater diversification in various markets.

3.1.6 Components of Current Account

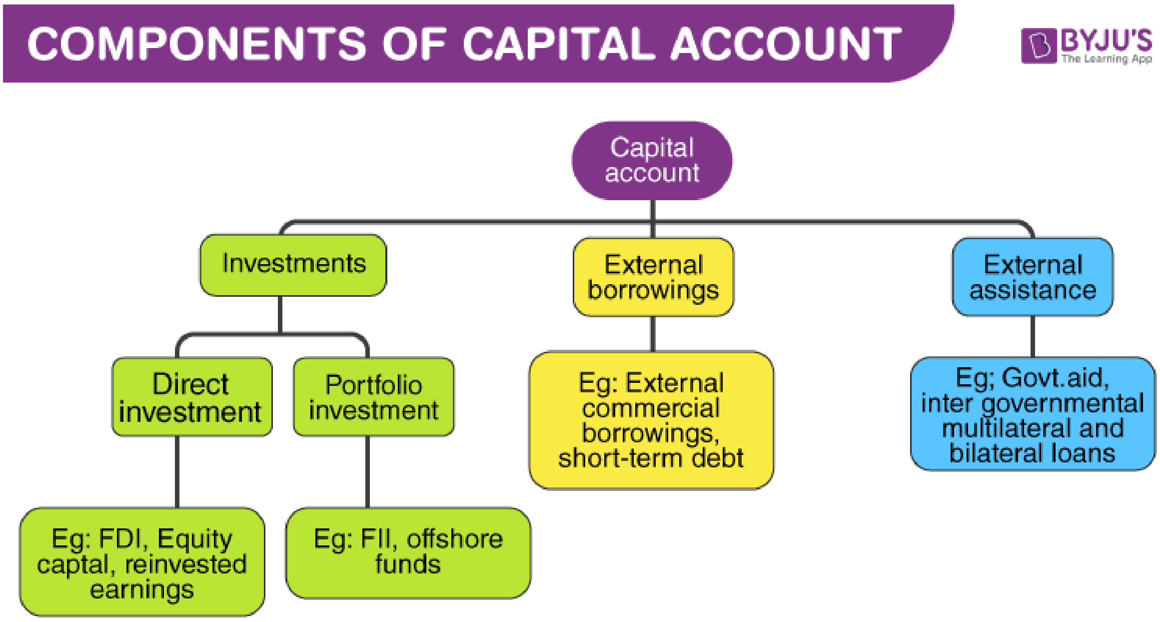
Current Account Definition

- The current account is a record of businesses in commodities, transfer payments, and services. Trade-in commodities comprise the exports and imports of commodities. Trade-in services comprise factor income and non-factor income transactions or undertakings.
- Transfer payments are the receipts that the citizens of a nation get for free', without having to provide any commodities or services in return. They consist of remittances, grants, and gifts. They could be provided by the government or by private residents living abroad.



3.1.7 Components of Capital Account

Capital Account Definition



- The capital account records all the international undertakings of assets. An asset is any one of the types in which wealth can be held. For instance, stocks, bonds, government debt, money, etc. The purchase of assets is a debit on the capital account. If an Indian purchases a UK car company, it enters the capital account undertakings as a debit (as foreign exchange is going out of India).

- On the other hand, the sale of assets, like the sale of the share of an Indian company to a Japanese customer, is a credit on the capital account. These items are foreign direct investments (FDIs), foreign institutional investments (FIIs), assistance, and external borrowings.

3.1.8 Standard Classification of the Balance of Payments

Main Components

- A coherent structure for classifying balance of payments transactions facilitates the process of adapting the data for various purposes, including analyzing recent trends and developing projections. The Manual's standard classification system has two key accounts: the current account and the capital and financial account. Their major components are presented in Box 4.3.

- In selecting the standard components, the following criteria have been given the greatest weight. Each item should:

- Exhibit distinctive behavior, that is, its economic influences should be unique;
- Be important in a number of countries;
- Be measurable, requiring regular collection of statistics; and
- Coordinate with other statistical systems (especially the SNA).

(i) Current account

- The current account comprises “real” transactions—goods, services, income, and current transfers. Transactions classified under “goods” relate to the movement of merchandise—exports and imports—and generally involve a change of ownership. “Services” can be of many different types. “Income” may be derived from labor (wages paid to employees living in neighboring countries) or from financial assets or liabilities (for example, interest payments on external debt).

- Most current account entries show gross debits or credits, but entries in the capital and financial account are typically net. Net entries are shown only as credits or debits, according to the conventions.

(ii) Capital and financial account

The two major categories of the capital and financial account. The main item in the capital account is capital transfers. The financial account has four functional categories.

- Direct investment, which is further divided into equity capital, reinvested earnings, and other capital. Direct investment is classified primarily on a directional basis (investment in the domestic economy by residents abroad and by nonresidents).

- Portfolio investment, which includes long-term debt and equity securities, money market debt instruments, and tradable financial derivatives, including currency and interest rate swaps.

- Other investment, such as trade credits and borrowing, including IMF credit and loans. Although transactions are classified primarily by instrument, they may also be classified according to their maturity structure, which is important in the analysis of indebtedness.

- Reserve assets that are available to meet immediate needs. Despite the name, reserve assets in the standard balance of payments accounts are not stocks but changes in gross external assets. These assets include foreign exchange (currency, deposits, and securities), monetary gold, SDRs, and the country's reserve position in the IMF.[4] Reserve assets are under the effective control of the monetary authorities and can be used either directly (to finance payment imbalances), or indirectly (to regulate imbalances by, for instance, intervening in foreign exchange markets to support the value of the currency). Transactions with the IMF affect balance of Trade reserve assets and reserve liabilities

3.1.9 Conceptual Framework of the Balance of Payments

Basic Conventions

A country's balance of payments tracks payments to and receipts from nonresidents. According to the Manual, the balance of payments is "a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world." Various conventions for recording items in the balance of payments are presented below.

The Double-Entry Accounting System

The basic convention applied in constructing a balance of payments is the double-entry accounting system. Every transaction recorded using this system is represented by two entries with equal values but opposite signs, a debit (−) and a credit (+). Thus, by convention, certain items are recorded as debits and others as credits, as follows:

With double-entry bookkeeping, the sum of all credits should be identical to the sum of all debits, and the overall total should equal zero. In this sense, the balance of payments is always in balance. The example in Box 4.1 illustrates how a shipment of cars exported from Russia to Poland and involving a payment by a Polish importer through the banking system is recorded under the above conventions.

Some key points in balance of payments accounting are:

- **Real and financial transactions**. "Real" flows involve transactions in goods and services (such as imports, exports, travel, and shipping). Such transactions contrast with financial transactions, or changes in levels of financial assets and liabilities (for example, the repayment of principal on an outstanding loan constitutes a reduction in a liability). Transactions in goods and services are recorded in the current account of the balance of payments. Financial transactions are recorded in the capital and financial account of the balance of payments.
- **Transfers.** Unrequited transfers across national borders are one-sided transactions. Suppose, for example, that the Japanese government donates to the Kyrgyz Republic buses for public transportation. To deal with such transactions, which involve no financial compensation, the balance of payments methodology includes a category called "transfers." This convention allows one-sided transactions to be converted to standard two-sided transactions. The donated buses are recorded as an import (debit) in the accounts of the Kyrgyz Republic, having been "paid for" by a transfer (credit). More generally, all transfers with an economic value, when no quid pro quo is involved, give rise to a counter entry, either a current or a capital transfer. Current transfers include cash transfers, gifts in kind (such as food and medicines), contributions to international organizations, and remittances sent by workers residing abroad to families back home. Capital transfers may be in cash (investment grants) or in kind (debt forgiveness).
- **Errors and omissions.** In practice, accounts tend not to balance, largely because data are derived from different sources or because some items are

under recorded or not recorded at all. All balance of payments accounts contain the item “net errors and omissions,” which reflects errors in estimation and omissions of transactions that should have been recorded. Entries are recorded net because of the possibility that credit errors will offset debit errors—that is, an underestimation of exports may be partly offset by an underestimation of imports. Since credit and debit errors may offset each other, the size of the net residual cannot be taken as an indicator of the relative accuracy of the balance of payments statement. Nonetheless, large and persisting net residuals impede the interpretation and analysis of the balance of payments for an individual country. Analogously, at the level of the world as a whole, recording discrepancies in one country are not offset by under- or overestimation in other countries.

- **Flows and stocks.** The balance of payments accounts record flows in two directions. These flows are distinguished from the stocks associated with a country’s international investment position—that is, the value of a country’s assets and liabilities vis-à-vis the rest of the world. The former are measured for a specific time period, whereas the latter are recorded at a point in time, often the end of the year. Two stocks discussed in this workshop are the level of international reserves (external assets of a country) and the level of external debt (a liability).

Residency

- The concept of residency in the balance of payments is based on the transactor’s center of economic interest, not on the transactor’s nationality. The main considerations relating to economic territory are as follows:
- Individuals living in a country are generally considered residents if they have resided there for at least 12 months. Nonresidents include visitors (tourists, crews of ships or aircraft, and seasonal workers); border workers (who are considered to be residents of the country in which they live); diplomats and consular representatives; and members of armed forces stationed in a foreign country, irrespective of the duration of their stay.

- Enterprises are considered residents of the economy where they are engaged in business, provided they have at least one productive establishment and plan to operate it over a long period of time. Therefore, subsidiaries of foreign-owned companies are considered to be resident in the country in which they are located.

- General government, including all agencies of the central, regional, and local governments, together with embassies, consulates, and military establishments located outside the country, are considered to be resident.

Time Periods and the Timing of Recording

- In principle, the time period for recording balance of payments flows may be of any length. However, it is usually dictated by practical considerations, especially the frequency of data collection. Many countries prepare balance of payments data annually because firm estimates for some balance of payments transactions are available only once each year. However, since other data (for example, for exports and imports) are often available quarterly and sometimes monthly, some countries prepare quarterly balance of payments data consistent with quarterly estimates of the national accounts.

- By convention, balance of Trade parties to an international transaction record it when there is a legal change of ownership. In principle, balance of Trade parties record the same transaction simultaneously, according to the principles of accrual accounting (when transactions such as interest payments are due to be settled, not when cash settlements are made). In practice, trade, service, and financial transactions may be recorded at different times by the two parties, so that adjustments need to be made to the original data derived from trade returns, exchange records, or enterprise surveys.

Valuation

- A balance of payments transaction should be valued at the market price, which reflects the terms of a specific exchange between a willing buyer and a willing seller. The market price is distinguished from a general price indicator (such as a world market price) for a specific commodity.

In practice, this definition creates difficulties in recording certain transactions, including:

- Barter transactions, which involve a direct exchange of goods for other goods rather than for money;
- Transactions between affiliated enterprises (for example, profit transfers between a subsidiary and the parent company); and
- Transfers, which often do not have a market price.
  - Proxy measures are used to record these kinds of transactions. For example, bartered goods are valued at market prices.
  - Exports and imports are shown f.o.b. (free on board), or excluding the cost of transportation beyond national borders. Imports are usually recorded by customs on a c.i.f. basis (including the cost of international insurance and freight). However, in the balance of payments accounts, the insurance and freight components are recorded under "services."

Unit of Account

- Since transactions may be settled in any currency, an appropriate unit of account is required for recording balance of payments transactions. Although the national currency can be used, its analytical value loses significance over time as the exchange rate fluctuates. For this reason, balance of payments accounts are often expressed in terms of a stable foreign currency (such as the U.S. dollar or the SDR), facilitating comparisons across countries. The appropriate exchange rate (the market rate prevailing on the transaction date) is used to convert data from the currency used in a transaction into the unit of account currency.

3.1.10 Changes in the Balance of Payments Manual

Changes in Coverage

- Between the publication of the Fourth Edition of the Manual (1977) and the Fifth Edition (1993), there were many developments in the field of international trade and finance, including increased trade in services, widespread abolition of capital controls, innovations in new financial instruments, and new approaches to restructuring external debt.

- As a result, the methodology for recording transactions in the Manual had to be adjusted to accommodate these changes. The Fifth Edition aims to improve the integration of external sector accounting with other macroeconomic accounts, particularly the SNA, and incorporate the changes that have taken place in international transactions. Unlike the previous edition, the 1993 Manual provides a conceptual framework for presenting the external transactions and international financial position of an economy through a comprehensive measure of external assets and liabilities. Among other important changes, the Fifth Edition:

- Records interest on an accrual rather than a cash basis;
- Redefines the current account to exclude capital transfers, including them instead in the capital and financial account (formerly the capital account), which has been revised to provide more detailed data on these flows;
- Changes the heading “nonfactor services” to “income transactions”;
- Expands the classification scheme for service transactions in recognition of their growing importance;
- Expands and restructures the coverage of portfolio investment to reflect the development of new financial instruments such as derivatives and financial futures;
- Extends coverage of emerging forms of exceptional financing transactions such as debt forgiveness and debt/equity swaps; and
- Develops a consistent classification scheme for income and financial assets and liabilities, which relates flows to the overall investment position (stocks).

Throughout, the nomenclature has been revised to describe the increasingly sophisticated composition of international transactions more accurately.

The Net International Investment Position

A country’s international investment position is its stock of external financial assets minus its stock of external liabilities. The position at the end of a specific period reflects financial transactions during that period (typically one year), valuation changes from movements in exchange rates and prices, and other adjustments that affect the level of assets and liabilities.

Data on balance of payments flows and the international investment position constitute the complete set of international accounts for an economy. Because data on stocks are often used to determine income receipts, consistent classifications of the income component of the current account, the financial account of the balance of payments, and the international investment position are essential for reconciling stocks and flows and for performing a meaningful analysis of yields and rates of return on external investments.

- According to the Fifth Edition of the manual, reserve asset flows exclude those that are not attributable to transactions. Thus, valuation changes resulting from fluctuations in the exchange rate, and the creation of new reserve assets (the monetization of gold or allocations of SDRs) are not included in the data on flows. These items are reflected in the international investment position (the data on stocks).
- Supplementary Information
- In the standard presentation of the balance of payments, the financial account does not distinguish between extraordinary and ordinary transactions. As a result, analytical presentations have been developed to highlight items, such as exceptional financing, that may be particularly important in analyses of the balance of payments. Additional data are often prepared for these presentations. The most important supplementary item—exceptional financing—has become increasingly important in recent years, especially in those countries that have experienced debt servicing problems. The main exceptional financing transactions are as follows:

- The rescheduling of existing debt, which involves replacing an existing contract with one that postpones debt service payments. The main balance of payments items affected by rescheduling are interest payments (shown in the current account) and amortization payments (shown in the financial account). Debt restructuring may cover arrears on interest or principal as well as scheduled interest and principal payments.

- Arrears on debt servicing, which can be either interest or amortization payments that are past due. Interest arrears are treated as if they have been paid for with a short-term loan—that is, as a scheduled interest payment is recorded as an income debit in the current account, it is offset by a credit in the financial account under short-term liabilities.

- Debt forgiveness, or the voluntary cancellation by an official creditor of all or part of a debt specified by a contractual arrangement. It is recorded as an official transfer under the capital account.[6]
- Equity investment, especially debt-equity swaps. This type of investment involves the exchange of bank claims on debtors, usually at a discount, for nonresident equity investment in a country.

3.1.11 Disequilibrium in Balance of Payments

- Several reasons such as differences in the value of exports and imports cause disequilibrium in the balance of payments. The disequilibrium may be either in minus, deficit, unfavorable side or plus, surplus, favorable side. Let us see the favorable and unfavourable balance of Payments concepts below:

Unfavourable/ Favourable BoP

- Balance of Payments is unfavorable when the Payments (debit) of the country is more than its receipts (credit). Meanwhile, when the receipts (credit) are more than the Payments (debit), the BoP is said to be favorable. Disequilibrium in Balance of Payments can be understood as:

  - Favourable BoP
  - Unfavourable BoP

Favorable BoP

- When the receipts are more than the Payments, then there is a favourable balance of Payments. Such a situation increases foreign exchange reserves. The export of goods, services, and capital receipts is more than that of the imports. It is also known as surplus BoP

Bf = R – P > 0

Bf = Balance of Payments

R – P > 0 = Receipts are greater than Payments or their difference is positive

Unfavorable BoP

- There is an unfavorable BoP when the Payments are more than the receipts. Such a situation reduces foreign exchange reserves. As well, the exports of goods, capital receipts, and services are less than that of the imports. It is also termed as a deficient balance of Payments.

Bu = R – P < 0

Bu = Unfavourable BoP

R – P < 0 = Receipts are less than the Payments or their difference is negative

Equilibrium in BoP

- When the capital receipts and exports (balance of Tradeh visible and invisible) of a country are equal to its capital imports and Payments (visible and invisible), then it is called equilibrium in the Balance of Payments.

B = R – P = 0

B = Balanced BoP

R = Receipts

P = Payments

3.1.12 Types of Disequilibrium in Balance of Payments (BOP)

The balance of payments (BOP) includes a value of non-commodity items that give rise to the International Monetary receipt and payments. Also, the balance of payments or BOP is more useful in economic calculation.

Broadly speaking, there are five different types of disequilibrium in the **BOP:**

1. Cyclical Disequilibrium.
2. Secular Disequilibrium.
3. Structural Disequilibrium.
4. Temporary Disequilibrium.
5. Fundamental Disequilibrium.

1. Cyclical Disequilibrium: In the **BOP** arises due to the influences of cyclical fluctuations. Cyclical Disequilibrium in the **BOP** in the occur, because:

1. The business cycle/Trade cycle follow different paths and patterns in different countries.
2. There are no identical timing and periodicity of occurrence of cycles in different nations.
3. No identical stabilization programs and measures are adopted by different states.
4. Income Elasticities of demand for imports in different nations are not identical.
5. Price Elasticities of demand for imports differ in different nations. Deficit and surplus alternatively take place during the depression and prosperity phase of a cycle. The balance of payments equilibrium is automatically set forth over the complete cycle.

2. Secular Disequilibrium: Secular disequilibrium in the balance of payments is a long-term, phenomenon, caused by persistent, deep-rooted dynamic changes that slowly take place in the economy over a long period of time. It may be caused by changes in several dynamic forces or factors such as capital formation, population growth, technological changes, the growth of markets, changes in resources, etc., a newly developing nation, For instance, needs huge Investments which far exceed exports. It’s domestic savings. Its imports also tend to exceed exports. If sufficient foreign capital is not forthcoming it may suffer from a secular deficit in its **Balance of**

payments. On the contrary, a mature economy may have surplus capital and a favorable balance of trade. If the outflow of capital is sufficient or restricted, a secular surplus in the balance of payments may accrue to the country.

3. Structural Disequilibrium: Structural disequilibrium arises from structural changes occurring in few sectors of the economy at home or abroad which may alter the demand for supply conditions for exports or imports or balance of Trade. A change in foreign demand for exports can arise from a change in technology, the invention of the cheaper substitute. **Similarly,** a change in supply can arise from the dislocation of production because of strikes or other political punches or natural calamities. Service income from abroad may also decline because of a change in the economic situation or the economic policy of other Nations. Structural changes are also produced by variation in the rate of international capital movement. **Structural disequilibrium** at the factor level takes place when a country's factor prices deviate disproportionately the factor endowment.

4. Temporary Disequilibrium: A country's Balance of payments is of a temporary nature lasting for a short period which may occur once in a while. Any factor which temporarily causes one-sided movement in the items constituting the Balance of payments is sufficient to cause a disequilibrium. This is subject to reversal within a limited period.

5. Fundamental or Long Run Disequilibrium: The **long-term disequilibrium** thus refers to a deep-rooted, persistent deficit or surplus in the **Balance of payments** of a country. It is a secular disequilibrium emerging on account of the chronologically accumulated short-term disequilibrium deficit or surpluses. It endangers the exchange stability of the country concerned. Especially, a **long-Run deficit in the Balance of payments** of a country tends to deplete its Foreign Exchange Reserves and the country may also be unable to raise any more loans from foreigners on account of such persistent deficits. A Fundamental equilibrium is said to exist when autonomous income and expenditure accord with each other over a given period without either necessitating import restrictions or causing excessive unemployment.

3.1.13 Methods to Correct Disequilibrium in Balance of Payments

- **Method 1# Trade Policy Measures: Expanding Exports and Restraining Imports:**

✓ Trade policy measures to improve the balance of payments refer to the measures adopted to promote exports and reduce imports.

✓ Exports may be encouraged by reducing or abolishing export duties and lowering the interest rate on credit used for financing exports. Exports are also encouraged by granting subsidies to manufacturers and exporters.

✓ Besides, on export earnings lower income tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competitive in the world markets.

✓ On the other hand, imports may be reduced by imposing or raising tariffs (i.e., import duties) on imports of goods. Imports may also be restricted through imposing import quotas, introducing licenses for imports. Imports of some inessential items may be totally prohibited.

✓ Before the economic reforms carried out since 1991. India had been following all the above policy measures to promote exports and restrict imports so as to improve its balance of payments position. But they had not achieved full success in their aim to correct balance of payments disequilibrium.

✓ Therefore, India had to face great difficulties with regard to balance of payments. At several occasions it approached IMF to bail it out of the foreign exchange crisis that emerged as a result of huge deficits in the balance of payments. At long last, economic crisis caused by persistent deficits in balance of payments forced India to introduce structural reforms to achieve a long-lasting solution of balance of payments problem.

- **Method 2# Expenditure-Reducing Policies:**

✓ The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that aim at reducing aggregate expenditure in the economy. The fall in aggregate expenditure or aggregate demand in the economy works to reduce imports and help in solving the balance of payments problem.

- **The two important tools of reducing aggregate expenditure are the use of:**

(1) Tight monetary policy and

(2) Concretionary fiscal policy.

We explain them below:

➢ **Tight Monetary Policy:**

❖ Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods.

❖ This therefore leads to the reduction in investment and consumption expenditure. Besides, availability of credit to lend for investment and consumption purposes is reduced by raising the cash reserve ratio (CRR) of the banks and also undertaking of open market operations (selling Government securities in the open market) by the Central Bank of the country.

❖ This also tends to lower aggregate expenditure or demand which will helps in reducing imports. But there are limitations of the successful use of monetary policy to check imports, especially in a developing country like India. This is because tight monetary policy adversely affects investment increase in which is necessary for accelerating economic growth.

- If a developing country is experiencing inflation, tight monetary policy is quite effective in curbing inflation by reducing aggregate demand. This will help in reducing aggregate expenditure and, depending on the income propensity to import, will curtail imports. Besides, tight monetary policy helps to reduce prices or lower the rate of inflation. Lower price level or lower inflation rate will curb the tendency to import, balance of Tradeh on the part of businessmen and consumers.
- But when a developing country like India is experiencing recession or slowdown in-economic growth along with deficits in balance of payments, use of tight monetary policy that reduces aggregate expenditure or demand will not help much as it will adversely affect economic growth and deepen economic recession. Therefore, in a developing country, monetary policy has to be used along with other policies such as a appropriate fiscal policy and trade policy to tackle the problem of disequilibrium in the balance of payments.

Contractionary Fiscal Policy:

- Appropriate fiscal policy is also an important means of reducing aggregate expenditure. An increase in direct taxes such as income tax will reduce aggregate expenditure. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in expenditure.
- The other fiscal policy measure is to reduce Government expenditure, especially unproductive or non-developmental expenditure. The cut in Government expenditure will not only reduce expenditure directly but also indirectly through the operation of multiplier.

- It may be noted that if tight monetary and contractionary fiscal policies succeed in lowing aggregate expenditure which causes reduction in prices or lowering the rate of inflation, they will work in two ways to improve the balance of payments. First, fall in domestic prices or lower rate of inflation will induce people to buy domestic products rather than imported goods. Second, lower domestic prices or lower rate of inflation will stimulate exports. Fall in imports and rise in exports will help in reducing deficit in balance of payments.

- ❖ However, it may be emphasized again that the method of reducing expenditure through contractionary monetary and fiscal policies is not without limitations. If reduction in aggregate demand lowers investment, this will adversely affect economic growth. Thus, correction in balance of payments may be achieved at the expense of economic growth.

- ❖ Further, it is not easy to reduce substantially government expenditure and impose heavy taxes as they are likely to affect incentives to work and invest and invite public protest and opposition. We thus see that correcting the balance of payments through contractionary fiscal policy is not an easy matter.

- **Method 3# Expenditure – Switching Policies: Devaluation:**

- ✓ A significant method which is quite often used to correct fundamental disequilibrium in balance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching policies help in correcting disequilibrium in balance of payments.

- ✓ The important form of expenditure switching policy is the reduction in foreign exchange rate of the national currency, namely, devaluation. By devaluation we mean reducing the value or exchange rate of a national currency with respect to other foreign currencies. It should be remembered that devaluation is made when a country is under fixed exchange rate system and occasionally decides to lower the exchange rate of its currency to improve its balance of payments.
- ✓ Under the Bretton Woods System adopted in 1946, fixed exchange rate system was adopted, but to correct fundamental disequilibrium in the balance of payments, the countries were allowed to make devaluation of their currencies with the permission of IMF. Now, Bretton Woods System has been abandoned and most of the countries of the world have floated

their currencies and have thus adopted the system of flexible exchange rates as determined by market forces of demand for and supply of them.

- ✓ However, even in the present flexible exchange rate system, the value of a currency or its exchange rate as determined by demand for and supply of it can fall. Fall in the value of a currency with respect to foreign currencies as determined by demand and supply conditions is described as depreciation.
- ✓ If a country permits its currency to depreciate without taking effective steps to check it, it will have the same effects as devaluation. Thus, in our analysis we will discuss the effects of fall in value of a currency whether it is brought about through devaluation or depreciation. In July 1991, when India was under Bretton-Woods fixed exchange rate system, it devalued its rupee to the extent of about 20%. (From Rs. 20 per dollar to Rs. 25 per dollar) to correct disequilibrium in the balance of payments.
- ✓ Now, the question is how devaluation of a currency works to improve balance of payments. As a result of reduction in the exchange rate of a currency with respect to foreign currencies, the prices of goods to be exported fall, whereas prices of imports go up. This encourages exports and discourages imports. With exports so stimulated and imports discouraged, the deficit in the balance of payments will tend to be reduced.
- ✓ Thus policy of devaluation is also referred to as expenditure switching policy since as a result of reduction of imports, people of a country switches their expenditure on imports to the domestically produced goods. It may be noted that as a result of the lowering of prices of exports, export earnings will increase if the demand for a country's exports is price elastic (i.e., $e_r > 1$). And also with the rise in prices of imports the value of imports will fall if a country's demand for imports is elastic. If demand of a country for imports is inelastic, its expenditure on imports will rise instead of falling due to higher prices of imports.
- ✓ **Devaluation:** Marshall Lerner Condition. It is clear from above that whether devaluation or depreciation will lead to the rise in export earnings

and reduction in import expenditure depends on the price elasticity of foreign demand for exports and domestic demand for imports.

- ✓ Marshall and Lerner have developed a condition which states that devaluation will succeed in improving the balance of payments if sum of price elasticity of exports and price elasticity of imports is greater than one. Thus, according to Marshall-Lerner Condition, devaluation improves balance of payments if

$e_x + e_m > 1$

where

e_x stands for price elasticity of exports

e_m stands for price elasticity of imports

If in case of a country $e_x + e_m < 1$, the devaluation will adversely affect balance of payments position instead of improving it. If $e_x + e_m = 1$, devaluation will leave the disequilibrium in the balance of payments unchanged.

➢ Income-Absorption Approach to Devaluation:

- Further, for devaluation to be successful in correcting disequilibrium in the balance of payments a country should have sufficient exportable surplus. If a country does not have adequate amount of goods and services to be exported, fall in their prices due to devaluation or depreciation will be of no avail.
- This can be explained through income-absorption approach put forward by Sidney S Alexander. According to this approach, trade balance is the difference between the total output of goods and services produced in a country and its absorption by it.
- By absorption of output of goods and services we mean how much of them is used up for consumption and investment in that country. That is, absorption means the sum of consumption and investment expenditure on domestically produced goods and services.

Expressing algebraically we have;

B = Y – A

Where:

B = trade balance or exportable surplus

Y = national income or value of output of goods and services produced

A = Absorption or sum of consumption and investment expenditure

- It follows from above that if expenditure or absorption is less than national product, it will have positive trade balance or exportable surplus. To create this exportable surplus, expenditure on domestically produced consumer and investment goods should be reduced or national product must be raised sufficiently.

- To sum up, it follows from above that for devaluation or depreciation to be successful in correcting disequilibrium in the balance of payments, the sum of price elasticities of demand for a country s exports and imports should be high (that is, greater than one) and secondly it should have sufficient exportable surplus. The devaluation will also not be successful in the achievement of its aim if other countries retaliate and make similar devaluation in their currencies and thus competitive devaluation of the exchange rate may start.

- After Independence India devalued its currency three times, first in 1949, the second in June 1966 and third in July 1991 to correct the disequilibrium in the balance of payments. The devaluation of June 1966 was not successful for some time to reduce deficit in the balance of payments.

- This is because the demand for bulk of our traditional exports was not very elastic and also we could not reduce our imports despite their higher prices. However devaluation of July 1991 proved quite successful as after it our exports grew at a rapid rate for some years and growth of imports remained within safe limits.

- **Method 4# Exchange Control:**

✓ Finally, there is the method of exchange control. We know that deflation is dangerous; devaluation has a temporary effect and may provoke others also to devalue. Devaluation also hits the prestige of a country. These methods are, therefore, avoided and instead foreign exchange is controlled by the government.

✓ Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country and it is then rationed out among the licensed importers. None else is allowed to import goods without a licence. The balance of payments is thus rectified by keeping the imports within limits.

✓ After the Second War World a new international institution' International Monetary Fund (IMF)' was set up for maintaining equilibrium in the balance of payments of member countries for a short term. Member countries borrow from it for a short period to maintain equilibrium in the balance of payments. IMF also advises member countries how to correct fundamental disequilibrium in the balance of Payments when it does arise.

✓ It may, however, be mentioned here that no country now needs to be forced into deflation (and so depression) to root out the causes underlying disequilibrium as had to be done under the gold standard. On the contrary, the IMF provides a mechanism by which changes in the rates of foreign exchange can be made in an orderly fashion.

- **Conclusion:**

✓ **In short, correction of disequilibrium calls for a judicious combination of the following methods:**

(i) Monetary and fiscal changes affecting income and prices in the country;

(ii) Exchange rate adjustment, i.e., devaluation or appreciation of the home currency;

(iii) Trade restrictions, i.e., tariffs, quotas, etc.;

(iv) Capital movement, i. e., borrowing or lending aboard; and

(v) Exchange control.

No reliance can be placed on any single tool. There is room for more than one approach and for more than one device. But the application of the tools depends on the nature of the disequilibrium.

3.1.14 Balance of Payments Adjustment Theories

- The correction of BOP disequilibrium is a prime necessity for the country which experiences it. In the case of a deficit, a country can only sustain the deficit, without changing its exchange rate or resorting to controls on its imports as long as, its stock of international liquidity holds out.In the case of a surplus, the forces impelling correction in less strong.

- The surplus country will accumulate international liquidly and will continue to do so as long as the surplus persists. Such accumulation of international liquidity may have repercussions upon the price level of the surplus country.

- Clearly the size of a country’s reserve holdings determine, in great part, the urgency of the need for adjustment if a deficit develops in its BOP. A country with large reserves may be able to tolerate a deficit for a long time, using its reserves to maintain its exchange rate by equalizing the demand and supply of its currency in the foreign exchange market. But ultimately and however large the country’s reserve holdings may be, action to adjust the deficit will have to be taken. Thus, the function of international liquidity is to finance deficit that are in process of being corrected, not to remove the need for correction.

- We have seen that the greater the reserves held by a country the less is the pressure upon it to adjust a deficit in its BOP. Only when the reserves approach depletion, the country is compelled to take action for adjustment. The more efficient the adjustment mechanism is, the more quickly the BOP is brought back to equilibrium by it, the smaller the stock of international liquidity needs to be. The demand for international liquidity becomes greater the less efficient the adjustment mechanism.

3.1.15 The Classical Theory of BOP Adjustment

- Economic theory has furnished us with two different approaches to adjustment process-the classical approach which explains the adjustment as operating through changes in the price levels of countries as the force which restores equilibrium and the modern approach which explains the adjustment as operating through the changes in the levels of national income to restore the balance. These approaches are not alternative theories, mutually exclusive through the correctness and modernity of one and the obsolescence of the other. They are rather complementary ways of regarding the adjustment process.
- Each approach springs from the general body of economic theory current at the time of its inception. The classical approach reflecting the Ricardian system with its emphasis on price changes, the quantity theory of money and flexibility of costs and prices. The income approach reflecting the Keynesian theory of income determination with its emphasis on income changes through multiplier effects.
- Each approach dictates a different emphasis for policy—the classical approach implying price adjustment through monetary policy and income approach reflecting the use of fiscal policy for income adjustment. In the adjustment process price and income changes work in the same direction. The income approach has supplemented rather than supplanted the classical approach to BOP adjustment process.

- The price mechanism can operate in two ways to produce BOP adjustment. The first and most obvious way is for prices to act directly, through changes in the price levels of countries; the second is indirect and occurs where changes in relative prices are brought about by changes in exchange rate between two currencies. The classical economists explained the BOP adjustment under two currency standards—the gold standard and the inconvertible autonomous paper currency standard.

3.1.16 The BOP Adjustment under the Gold Standard:

- Under the gold standard, the classical economists pointed out, there was automaticity in BOP adjustment as it was developed from Mume to Marshall. The movement of goods in international trade is considered to be the result of differences in national price levels. The upward or downward movement of an individual country's price level changes the direction and volume in which the goods flow and therefore changes the BOP of the country concerned.
- With gold standard in operation differences between foreign receipts and payments would be offset by such gold flows as would, by enlarging or depleting the national monetary stock, produces appropriate price changes to alter the demand for the imports and exports of the country concerned and thus corrects the balance. In brief, the classical theory was one of the equalization of prices internationally, adjustment of prices as a result of gold movements being the means of establishing the normal relation of equality. At the heart of the classical approach lay the quantity theory of money which dominated ideas on general price level determination.

The classical theory of adjustment was based on a number of implicit assumptions:

(i) The validity of the quantity theory of money;

(ii) The efficiency of the banking arrangements whereby an increase in the money supply had an immediate impact on the domestic monetary situation;

(iii) Complete mobility of factors within the country concerned;

(iv) Completely flexible prices; and

(v) In the country and the world at large, a quick and considerable reaction of balance of Trade demand and supply to price changes.

- Some of these assumptions were, at least in the free economy of the 19th century, quite justifiable. In the early days, when the gold standard was a gold bullion standard, movements of gold in and out of an economy did directly augment or deplete the money supply; later when gold was held as a reserve to a domestic money supply which bore to it some specified ratio and when the whole paraphernalia of credit control and interest rates became involved, the connection between gold movements and the domestic money supply became more tenuous.
- The most sweeping assumption inherent in classical theory of adjustment was that, when prices fell in a deficit country (following its loss of gold), demand for Its exports would rise by such an amount as would not only off set the fall in export prices but would actually raise total export revenue. On the import side it was assumed that since goods from abroad would become relatively dearer as home prices fell, domestic goods would be substituted for imported goods.
- This assumption of high elasticity of demand for exports and imports in international trade was a vital one for the classical theory of price adjustment. Its non-fulfillment would abrogate the whole system. This is a theoretical and practical difficulty of some importance. To 19th century economists, who usually assumed that elasticities of demand were high, it did not appear so.

3.1.17 David Hume’s Price-Specie-Flow Mechanism

- Hume, an English classical economist, was the first economist to suggest a connection between exports and imports. He developed the price-specie-flow mechanism to show how an increase in exports would lead to an increase in imports, and the f50P disequilibrium would be automatically corrected through price mechanism. Thus, there is automaticity in BOP adjustment under the gold standard. Let us discuss how the BOP disequilibrium is automatically rectified.

- Suppose the world is composed of two countries country I and country II. Country I's exports exceeds its imports and therefore country II's imports exceeds its exports. Since exports exceed imports in country I, gold will flow into it and gold being the basis of currency and credit the supply of money will expand. Following the rules of gold standard, game, when gold is flowing into a country, the country is required to lower the rate of interest.
- Given the marginal efficiency of capital, when the rate of interest is lowered, it would lead to expansion of investment activities. Now, country I will be confronted with general inflationary situation. Now country I is a very good market to sell but a very bad market to purchase. Thus, its exports decrease and imports increase.
- Let us see what happens in country II. Country II's import exceeds its exports. Gold flows out of it and gold being the basis of currency and credit, the supply of money will contract and there will be a general deflationary situation, following the rules of gold standard game, country II will Increase the rate of interest. Given the marginal efficiency of capital, when the rate of interest is increased, the investment activities will contract and will aggravate the deflationary situation in the country, now the country is a very good market to buy but bad market to sell. Thus its exports expand and imports contract.
- The above analysis shows how the initial excess of exports over imports in country I and excess of imports over exports in country II are automatically corrected through the changes in the levels of price between the two countries. Under the gold standard, the short-term capital movement was also playing a vital role in the BOP adjustment. We have seen how the market rate of interest prevailing in country is lower than the rate in country II. This will encourage short-term capital movement from country I to country II.

- Classical economics assumed that a BOP disequilibrium could be adjusted by a change in relative price levels as between the deficit and surplus countries, however this price level change was brought about.

3.1.18 BOP Adjustment under Paper Currency Standard

- Under the gold standard, the exchange rate between currencies is fixed and the BOP adjustment is effected through the changing price levels between the countries. But under the paper currency standard, the adjustment of disequilibrium in BOP is bought about by the changes in exchange rates between currencies. The changes in exchange rates, ultimately bring about the changes in the relative price levels between countries.
- The exchange rate for a currency is the price in foreign currency terms of a unit of the home country's money. Thus, the price of the pound sterling in dollar terms is $2.4 and the exchange rate is said to be $ 2.4 = £ 1. Clearly an change in the exchange rate alters the price to the foreigners of all exports of the country concerned. In the example above, if the exchange rate were devalued to £1 = $ 1.2 then the prices of British goods would be halved to United States buyers. If the sterling dollar exchange rate were revalued to £ 1 $ 4.8, all British prices would be doubled for United Stated buyers.
- Thus, a condition in which the price level is constant and the exchange rate varies is the same conceptually as one in which the exchange rate is fixed and the price level alters. Let us assume that domestic prices are constant and that when the BOP moves into deficit the exchange rate depreciates on the foreign exchange market until the relation between home and foreign prices has altered sufficiently, exports cheapening and imports becoming clearer to the home country, to adjust the BOP deficit. Such a system of adjustment finds institutional expression in floating exchange rate system.
- Let us discuss how exports and imports are affected by changes in the exchange rate and in particular how far the BOP is improved by them. Any answer to this question involves us in considering the sensitivity of exports

and imports to price changes, not only with regard to the way in which demand for them varies with price but also how supply reacts to it.

- In short, we are concerned with the elasticities of demand and supply in foreign trade. These elasticities are relevant in deciding whether and how far depreciation improves the quantity, value of exports minus value of imports.
- Suppose the world consists of two countries I and II. The national currency of country I is pound sterling and that of country II is dollar. In country I, exports exceed imports; so that the demand for dollar in the foreign exchange markets exceeds the supply of dollar. The external value of pound sterling declines in terms of dollar; in other words pound depreciates in terms of dollar. This means dollar appreciates in terms of pound. The deficit in BOP of country I has resulted in the depreciation of the value of its currency; and the surplus in the BOP of country II has resulted in the appreciation of the value of its currency.
- The depreciation or devaluation of country I's currency promotes its exports and restricts imports whereas the appreciation of country II's currency promotes its imports and restricts its exports. This is how, the disequilibrium between the exports and imports is rectified through the variation in the exchange rate between the currencies. Thus the classicists held that the BOP disequilibrium is automatically rectified through the market mechanism.

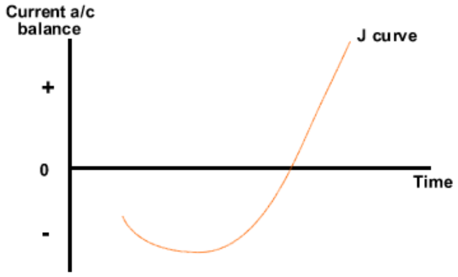
3.1.19 Marshall-Lerner condition

⇒ The Marshal-Lerner condition relates to the impact of a **change in the value of a currency** on a country's net exports, and the current account of the balance of payments.

⇒ An increase in the exchange rate will reduce import prices and increase export prices. However, the effect of this on import spending an export revenue is not certain. The impact of this depends upon the price **elasticity of demand for imports and exports**.

⇒ The Marshall-Lerner condition states that a change in the exchange rate of a currency will only impact the trade account the sum of **price elasticities of**

demand for imports and exports is greater than 1.0. We tend to assume that this condition is met, and hence a fall in the exchange rate will stimulate exports and constrain imports to the extent that net trade increases, and aggregate demand increases.



⇒ In the **short run**, domestic demand for imports and overseas demand for **exports tends to be inelastic** and slow to respond to price changes. In this case, the Marshall-Lerner condition may not be satisfied.

⇒ However, in the longer run, consumer demand tends to adjust more to price changes, and the Marshall-Lerner condition is more likely to be satisfied.

⇒ This explains the '**J-curve**' path following a devaluation, indicating the Marshall-Lerner condition is not met in the short-run, and devaluation (or depreciation) causes any trade deficit to worsen. In the graph, a devaluation during 2019 (at point 'a') leads to a worsening of the current account in 2020 (at point 'b'). However, by 2023 a current account balance is achieved (at point 'c'). The impact of this analysis on trade policy is to **raise concerns** about the **effectiveness** of devaluation on the current account, suggesting that it is not a policy that works in the short-run - indeed, it may be counter-productive.

⇒ Although not conclusive, a good deal of research has been undertaken, which supports the general conclusion that, at least in the long-run, the Marshall-Learner conditions is satisfied (see research on exchange rates in India).

Other criticisms of devaluation

1. Other countries may see a devaluation as an artificial attempt to gain a competitive advantage and devalue their own currency as a form of **retaliation**.
2. While devaluation could stimulate export-led growth there is a danger of **inflation -** firstly because import prices will rise, and secondly as a result of economic growth.
3. Devaluation could result in **speculation** against the currency that devalues if speculators feel that the new rate is not sufficiently low enough to have the desired policy effect.

Worked example of the Marshall-Lerner hypothesis

⇒ In this simple example we consider one country, country A, which trades with country B. Country A produces one good, which it exports to B, and imports one good from country B. Balance of Tradeh countries use different currencies, which initially have a par value (of 1 - 1).

⇒ In scenario 1, country A has a trade balance with B. In scenario 2, country A devalues its currency by 10%, but consumers in balance of Tradeh A and B do not react to the price changes that follow devaluation. In scenario 3, the same 10% devaluation results in changes in demand for imports in country A, and changes in country B for A's exports.

Scenario 1 - Where country A's trade is in balance

We will assume the following about country A:

A's imports from B

The **volume of imports** from B are **100** units;

The **price of these imports** in country A is **20** units of A's currency;

The **expenditure on imports** (**M**) by A is the price of imports times the quantity imported, which is = **2000**.

A's exports to B

The **volume of exports** to country B is **100** units of output;

The **price of exports** is **20** units of A's currency;

The **value of exports** (**X**) is the price of exports times the quantity, which is = **2000**.

Therefore:

Trade is in BALANCE between A and B, at M=2000 and X=2000, where the exchange rate is 1 for 1.

Scenario 2 - Where country A devalues, but there is no consumer response (PED is perfectly inelastic)

⇒ Country A now **devalues** its currency by **10%**, but in this scenario we assume there is no change in volumes of imports and exports given we assume price elasticity of demand for imports and exports in balance of Tradeh countries is zero, therefore:

A's imports from B

The **volume of imports** remains at **100** units of output;

⇒ However, the **price of imports increases by 10%**, to **22** units of currency (which are needed to purchase 20 units of B's currency) following the devaluation;

⇒ This means that the **value of imports** (**M**) (which is the price of imports times the quantity imported) now increases to (100 x 22) = **2200**.

A's exports to B

⇒ On the export side, there is **no change in volume**, and **no change in the price received by the exporters** - they still charge 20 units of their own currency. Consumers in country B now face reduced prices of 10% (with the relatively higher exchange rate of B's currency) but, given the **assumption of perfect inelasticity,** there is no response by B's consumers. Hence:

The **volume of exports** is still **100** units of output;

However, the **price of exports** is still **20** units of 'A's currency;

Hence, the **value of exports** (**X**) remains at = **2000**.

The result is that:

Country A has a trade DEFICIT of 200 (M=2200, X=2000).

⇒ **Conclusion -** when PED's of imports and exports are perfectly inelastic, any devaluation simply raises import prices with no effect on export revenue - hence, **worsening the trade balance.**

Check Your Progress – Quiz – 1

Q1. Balance of Payments is an accounting statement that records monetary transactions between ________.

a. Residents of a nation and the rest of the world

b. Non-residents and the rest of the world

c. Residents of a nation and non-residents

d. None of the above

Q2. Balance of Payments uses the _________ system of accounting.

a. Single-entry

b. Double-entry

c. Cash basis

d. Accrual basis

Q3. The 'resident', whose monetary transactions get recorded under the Balance of Payments system, includes _______.

a. Government agencies

b. Individuals

c. Firms

d. All of the above

Q4. The components of a Balance of Payment account are ____________.

a. Capital Account

b. Current Account

c. Balance of Trade a and b

d. None of the above

Q5. The Balance of Payment account records the inflow of foreign exchange on the _______.

a. Debit side

b. Credit side

c. Balance of Trade a and b

d. None of the above

Q6. The measures taken to improve the negative Balance of Payments include ___________.

a. Exchange control

b. Currency devaluation

c. Import substitution

d. All of the above

Q7. An increase in the foreign exchange reserve gets recorded on the _________ of the Balance of Payments account.

a. Debit side

b. Credit side

c. Not added to any side

d. It can be added to any side

Q8. Which of the following is not a component of the Balance of Payments?

a. Real account

b. Current account

c. Capital account

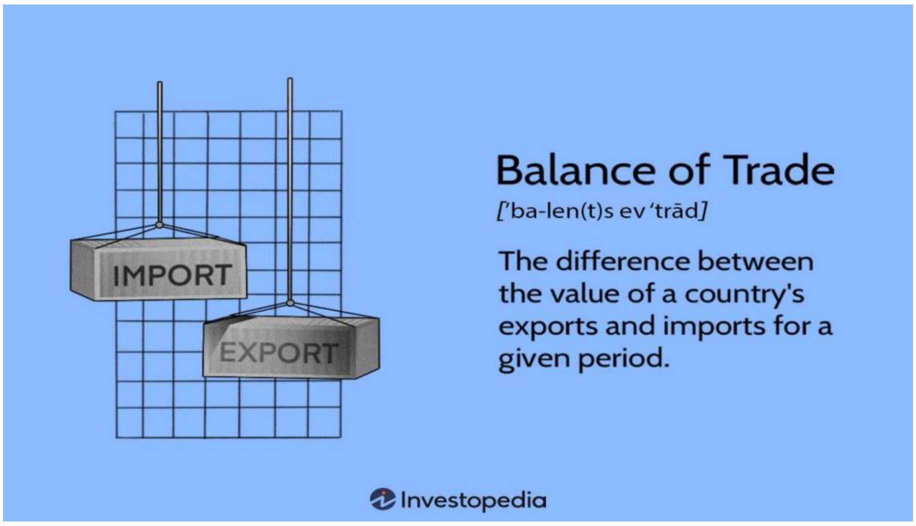
d. None of the above

Answer Key:	Q1. A	Q2. B	Q3. D	Q4. C	Q5. B	Q6. D	Q7. B	Q8. A

SECTION – 3.2 BALANCE OF TRADE

3.2.1 Balance of Trade (BOP)

- Balance of trade (BOP) is the difference between the value of a country's exports and the value of a country's imports for a given period. Balance of trade is the largest component of a country's balance of payments (BOP). Sometimes the balance of trade between a country's goods and the balance of trade between its services are distinguished as two separate figures.
- The balance of trade is also referred to as the trade balance, the international trade balance, the commercial balance, or the net exports.



KEY TAKEAWAYS

- Balance of trade (BALANCE OF TRADE) is the difference between the value of a country's imports and exports for a given period and is the largest component of a country's balance of payments (BOP).
- A country that imports more goods and services than it exports in terms of value has a trade deficit while a country that exports more goods and services than it imports has a trade surplus.
- Viewed alone, the balance of trade is not sufficient to gauge the health of an economy. It is important to consider the balance of trade with respect to other economic indicators, business cycles, and other indicators.

- The United States regularly runs a trade deficit, while China usually runs a large trade surplus.

3.2.2 Understanding the Balance of Trade (BALANCE OF TRADE)

- The formula for calculating the BALANCE OF TRADE can be simplified as the total value of exports minus the total value of its imports. The BALANCE OF TRADE on its own is not an indicator of economic health, and a negative trade balance is not necessarily bad. In order to use the trade balance as part of an economic health assessment, context is needed. One must look at why the balance is positive or negative.
- A country that imports more goods and services than it exports in terms of value has a trade deficit or a negative trade balance. Conversely, a country that exports more goods and services than it imports has a trade surplus or a positive trade balance.
- A positive balance of trade indicates that a country's producers have an active foreign market. After producing enough goods to satisfy local demand, there is enough demand from customers abroad to keep local producers busy. A negative balance of trade means that currency flows outwards to pay for exports, indicating that the country may be overly reliant on foreign goods. However, that is not always the case. It could also mean the country is wealthy and has a high level of demand that needs to be satisfied.

3.2.3 Balance of Trade Significance

- BALANCE OF TRADE illustrates the fluctuation in the imports/exports of a country and exports over time.
- When a nation achieves the same status regarding exports and imports, it is known as Trade Equilibrium.
- A country can produce a trade deficit if the former is greater than the latter, which is not the best situation for any country.
- If exports' value is greater than that of the import value, a trade surplus is created, putting the economy in a better position.

- The current account is the Balance of Trade of a country.

3.2.4 Types of Balance of Trade

- Favourable Balance of Trade: A Favourable or surplus balance of trade occurs when a country's exports surpass its imports.

Favourable Balance of Trade = Export of Goods > Imports of Goods

- Unfavorable/Deficit Balance of Trade: An unfavourable or adverse balance of trade is one in which the entire value of goods imported exceeds the total value of products exported.

Unfavourable Balance of Trade = Export of Goods < Imports of Goods

- Equilibrium in Balance of Commerce: Equilibrium in balance of trade refers to the total value of products exported and total value of goods imported being equal.

Equilibrium in Balance of Commerce **= Export of Goods = Imports of Goods**

Calculating the Balance of Trade

A country's balance of trade is calculated by the following formula:

BALANCE OF TRADE=Exports−Imports

Where exports represents the currency value of all goods and services exported to foreign countries, and imports represents the currency value of all goods and services imported from foreign countries.

Example of How to Calculate the BALANCE OF TRADE

- Here's an example of how to calculate the balance of trade:
- Let's say that a country's export in a given year are worth $100 million, and its imports are worth $80 million. To calculate the balance of trade, you would subtract the value of the imports from the value of the exports:

Balance of trade = Exports – Imports = $100 million - $ 80 million = $20 million

- In this example, the balance of trade is +$20 million, which means that the country has a trade surplus of $20 million.

- It's important to note that the balance of trade is typically measured in the currency of the country whose trade balance is being calculated. For example, if the country in the above example is the United States, the balance of trade would be measured in US dollars. If the country is Japan, it would be measured in Japanese yen, and so on.

Examples of Balance of Trade

- The United States imported $324.6 billion in goods and services in January 2024, and exported $257.2 billion in goods and services to other countries. In January 2024, the United States had a trade balance of -$67.4 billion, or a $67.4 billion trade deficit.1
- A trade deficit is not a recent occurrence in the United States. In fact, the country has had a persistent trade deficit since the 1970s. Throughout most of the 19th century, the country also had a trade deficit (between 1800 and 1870, the United States ran a trade deficit for all but three years).2
- For its January-February 2024 period, China reported a trade surplus of $125.16 billion. This was significantly higher than forecasted amounts, and much greater than the December 2023 trade surplus of $75.3 billion.3.

3.2.5 Balance of Trade: Surplus vs. Deficit

- A numerically positive balance of trade, also known as a trade surplus, occurs when a country's exports are worth more than its imports. This is measured in their total value using the country's currency. A trade surplus can be a result of a country having a competitive advantage in the production and export of certain goods, or it can be the result of a country's currency being relatively undervalued, making its exports cheaper for foreign buyers.
- On the other hand, a numerically negative balance of trade, also known as a trade deficit, occurs when a country imports more goods and services than it exports in terms of their total value in the country's currency. This means that the country is spending more on imports than it is earning from exports. While it may be a cause for concern in some instances, often it's not a problem. It is also not an indication of economic crisis, or weakness. A trade deficit can be the result of a country having a comparative disadvantage in the production of certain goods, or it can be the result of a country's currency

being relatively overvalued, making its imports cheaper and its exports more expensive.

- In general, a trade surplus is seen as a positive sign for a country's economy, while a trade deficit is often seen as a negative sign. However, this is not always the case. A trade surplus or trade deficit is not inherently good nor bad. The balance of trade alone is not an indicator of economic health. The context of the balance of trade is very important. It's necessary to look at why a trade deficit or surplus is occurring. For example, if imports fall faster than exports due to a recession killing demand that would be a situation in which a surplus can occur during a time of economic difficulty. On the other hand exports could boom due to an increase in demand from a key trading partner, an example of a trade surplus in positive times. To access an economy's overall strength or weakness, it's also necessary to look beyond the balance of trade at things such as inflation, unemployment, growth, production, and more.

Special Considerations

- A country with a large trade deficit borrows money to pay for its goods and services, while a country with a large trade surplus lends money to deficit countries. A country may only be able to borrow a lot to run that deficit if it is deemed dependable and creditworthy. The United States would be a great example of such a country. On the other hand, the less creditworthy a country, the higher its borrowing costs will be, and therefore its deficit will be more damaging.

A trade surplus or deficit is not always a viable indicator of an economy's health, and it must be considered in the context of the business cycle and other economic indicators. For example, in a recession, countries prefer to export more to create jobs and in turn more demand in the economy from those benefiting from the new jobs. In times of economic expansion, countries have a great appetite for imports and may use them to increase price competition, which limits inflation.

3.2.6 Trade Surplus

- A surplus in trade indicates economic activity that shows a positive trade balance where the country's exports are greater than its imports.

- Trade Balance = the total value of exports minus the full value of imports.
- If the calculation results above are positive, we have an increase in our trade surplus.
- The net flow of currency domestically from foreign markets is an exchange surplus.

3.2.7 Importance of Trade Surplus

- A trade surplus could lead to employment and growth in the economy. However, it could increase prices and higher interest rates in an economy.
- The Balance of Trade between a countries could also affect its currencies' value on the world market, as it allows a nation to control the majority of its currency via trade.
- In many instances, the trade surplus can help boost a country's currency compared to the other currencies and impact the currency's exchange rate. However, it depends on the number of services and goods produced by an individual country compared to other nations and other market variables.
- Suppose you focus solely on the impact of trade. In that case, the trade surplus can indicate a significant global demand for goods and services from a particular country, which increases the price of these items and causes the local currency to appreciate.

3.2.8 Trade Deficit

- A trade deficit is when a nation imports more items and services than what it sells value.
- Trade Balance = the total value of exports minus the value of imports.
- If the above calculation results are negative, then we have the result of a trade deficit.
- Net outflows of domestic currency out of markets outside the country are known as the trade deficit.
- India was the country with the highest export deficit for November in 2021. It was ₹2290 crores.

There are two causes to have a trade deficit.

Domestic production isn't sufficient to meet the demands.

For instance, we have imports of crude oils, pulses and edible oils as there isn't enough domestic supply to meet the demands.

- Consumers' preference for imported goods results in an increase in domestic production that is high cost.
- For steel production, India has enough manufacturing capacity. However, our costs for production are higher than those of China and, therefore, Indian customers, like auto companies, are buying Chinese steel for less cost, but of the identical quality.

3.2.9 Advantages of Trade Deficits

- A trade deficit is an obvious advantage of allowing a nation to consume more than it produces.
- Trade imbalances could help countries avoid shortages of goods and other economic issues in the short run.
- In the floating exchange rate system, the trade deficit places the country under pressure to lower its currency.
- Imports are more expensive in countries with an imbalance in trade when the country's currency is more affordable. This causes consumers to lessen their consumption of imports and move to locally produced alternatives.
- Exports are less costly and more competitive on overseas markets as the currency of the country declines.

3.2.10 Disadvantages of Trade Deficits

- In the long term, trade deficits could be a source of concern for the government.
- The most pressing and prominent problem is that trade imbalances can lead to economic encroachment. If a country's trade deficits stay, citizens from other countries can access money to invest in the country. Also, if this pattern continues, foreign investors could control most of the nation's wealth.
- If exchange rates are fixed, trade deficits can be more damaging. A currency's devaluation is not possible in the fixed exchange rate system as trade imbalances tend to last longer, and the rate of unemployment could increase dramatically.

- There is a link between deficits in trade and budget deficits, as per the twin deficits theory. Trade deficits serve as a precedent for budget surpluses.

3.2.11 Methods to Reduce the Trade Deficit

a) Reduce Consumption and Boost Savings

Imports will drop as borrowing overseas will be needed for consumption if governments or households cut their consumption (companies can save more money than they pay).

b) Consumption Taxes

Taxes on consumption similar to those found in nearly every other nation can help reduce the deficit by reducing consumption, encouraging savings and helping to reduce the government's deficit.

c) Depreciating the Currency Rate

A real huge rate of depreciation in the exchange rate is typically the cause of the reversal of trade deficits. A lower rupee increases the cost of imports but decreases the cost of exports, which improves the Balance of Trade.

d) Taxing Capital Flows

Taxon (non-foreign direct investment) capital inflows that rise proportional to the size of the inflow can aid in reducing the deficit of the government by reducing the excessive borrowing for consumption.

3.2.12 Pros of Calculating Balance of Trade

To achieve balanced trade, a country may use tariffs or other trade barriers to try to balance the total amount of imports and/or exports, which may be on a country-by-country basis (zero balance on a bilateral basis) or for the overall trade balance (where a surplus with one country may be offset by a deficit with another). In addition to tariffs, there have been other ideas. Some of the benefits offered by Balance of trade are.

1. Economic Stability

⇒ Maintaining balanced trade can help to maintain economic stability by avoiding trade imbalances and the risk of unsustainable deficits or surpluses. Balanced trade aids in the prevention of rapid and disruptive changes in exchange rates and trade flows. Consider how variable currency rates and reliance on foreign countries for goods can put undue strain on a country's economy.

2. Payments Balance

⇒ The balance of trade is crucial in calculating a country's balance of payments. The term "Balance of Payments" refers to an economy's ledger. What it owes other countries and what it is due.

⇒ Loans and financial aid are not the only elements considered in modern countries when calculating the Balance of Payments. The trade deficit or surplus, in addition to loans and debts through treasury bonds, can be included in the Balance of Payments.

3. Government Policies

⇒ If the balance of payments is favorable, the government will view imports liberally; otherwise, various sorts of limitations (tariff and non-tariff measures) will be enforced as corrective measures. It will undoubtedly have an impact on international trade. Thus, the examination of a country's Balance of Payments status is particularly useful for international companies because it helps to decide on his domestic or foreign trade policies, programmes, procedures, and strategies. It is a fundamental document that guides government policies and programmes.

4. Jobs and Domestic Industries

⇒ Trade that is balanced may assist balance of Tradeh jobs and domestic industries. It helps to protect domestic industry from unfair competition and potential job losses by maintaining a fair balance of imports and exports. It encourages the retention of jobs in a variety of industries and allows local businesses to compete on an equal playing field.

5. Long-term Sustainability

⇒ It is commonly assumed that balanced commerce is more long-term sustainable. Trade imbalances and distortions can develop from recurrent trade deficits or surpluses. By pursuing balanced trade, countries can promote long-term economic growth, avoid excessive reliance on debt to finance trade imbalances, and foster a more stable and resilient economy.

6. Global Equity

⇒ Proponents of balanced trade argue Fairness and reciprocity are promoted by balanced trade. Balanced trade between trading partners reduces the potential of one country unfairly benefiting or economically abusing the other. This could contribute to a more equitable international trading system.

7. Impact on GDP

⇒ The balance of trade is an important aspect in calculating a country's Gross Domestic Product. Exports are added to GDP estimates, and imports are removed from the total. As a result, the higher a country's trade surplus, the greater its GDP. The explanation behind this is that GDP is a measure of a country's total value produced. While imports require money to leave the country, exports bring money back in.

8. Foreign Currency

⇒ The Balance of Trade is another essential factor in determining a country's foreign exchange reserves. The Central Bank can levy export tariffs through government taxation, increasing a country's foreign exchange reserves.

These Reserves are critical in times of crisis and when seeking international loans. To enable governments to acquire loans from international institutions. During the balance-of-payments crisis of 1991.

3.2.13 Impact of Balance of Trade

- A growing country may choose to import more goods and services from other countries, hence increasing competition in their individual marketplaces. As a result, they keep prices and inflation low. That country will have a trade deficit during these times. To an outsider, the country appears to be consuming more than it is creating. As the country's economy slows, this situation may be incorrectly expected. But in reality, what if the country is experiencing a trade deficit for the first six months and
- Developed nations such as the United States and the United Kingdom have had long trade deficits against developing and emerging economies such as China and Japan, which have run long trade surpluses. As a result, the time range, business cycles, and relative condition with other countries all have a role in providing an accurate assessment of the BALANCE OF TRADE.
- However, in general, an increase in the Balance of Trade number is beneficial to currency. It is a proportional indicator, which means. Lower or negative Balance of Trade figures in comparison to earlier periods indicate currency depreciation, and vice versa.
- In conclusion, when a country's exports and imports are roughly equal, it is considered to have balanced trade. Its goals include maintaining trade flow equilibrium, reducing trade imbalances, and promoting economic stability. Balanced trade, proponents argue, may promote home sectors, protect jobs, and improve national security by reducing reliance on imports. Those who oppose balanced trade argue that countries must give up advantages and perhaps impede economic progress in order to achieve equilibrium.

3.2.14 Terms of Trade (TOT)

- Terms of trade (TOT) represent the ratio between a country's export prices and its import prices. TOT indexes are defined as the value of a country's total exports minus total imports. The ratio is calculated by dividing the price of the exports by the price of the imports and multiplying the result by 100.
- When more capital is leaving the country than is entering the country, then the TOT will be less than 100%. When the TOT is greater than 100%, the country is accumulating more capital from exports than it is spending on imports. In the United States, the ebb and flow of value of trade activity is tracked by the Import/Export Price Index (MXP)

KEY TAKEAWAYS

- Terms of trade (TOT) is a key economic metric of a country's health measured through what it imports and exports.
- TOT is expressed as a ratio that reflects the number of units of exports that are needed to buy a single unit of imports.
- TOT is determined by dividing the price of the exports by the price of the imports and multiplying the number by 100.
- A TOT over 100% or that shows improvement over time can be a positive economic indicator as it can mean that export prices have risen as import prices have held steady or declined.

3.2.15 Understanding Terms of Trade (TOT)

- The TOT is used as an indicator of a country’s economic health, but it can lead analysts to draw the wrong conclusions. Changes in import prices and export prices impact the TOT, and it's important to understand the specific causes underlying price increases or decreases. TOT measurements are often recorded in an index for economic monitoring purposes.2
- An improvement or increase in a country's TOT generally indicates that export prices have gone up as import prices have either maintained or dropped. Conversely, export prices might have dropped but not as significantly as import prices. Export prices might remain steady while import

prices have decreased or they might have simply increased at a faster pace than import prices. All these scenarios can result in an improved TOT.

3.2.16 Factors Affecting Terms of Trade

- TOT is dependent to some extent on exchange and inflation rates and prices. A variety of other factors influence TOT as well, and some are unique to specific sectors and industries.
- Scarcity—the number of goods available for trade—is one such factor. The more goods a vendor has available for sale, the more goods it will likely sell, and the more goods that vendor can buy using capital obtained from sales.

3.2.17 Fluctuating Terms of Trade

- A country can purchase more imported goods for every unit of export that it sells when its TOT improves. An increase in the TOT can thus be beneficial because the country needs fewer exports to buy a given number of imports.
- It might also have a positive impact on domestic cost-push inflation when the TOT increases because the increase is indicative of falling import prices to export prices. The country's export volumes could fall to the detriment of the balance of payments (BOP), however.
- The country must export a greater number of units to purchase the same number of imports when its TOT deteriorates. The Prebisch-Singer hypothesis states that some emerging markets and developing countries have experienced declining TOTs because of a generalized decline in the price of commodities relative to the price of manufactured goods.

TOT Example

- Developing countries experienced increases in their terms of trade during the commodity price boom in the early 2000s. They could buy more consumer goods from other countries when selling a certain quantity of commodities, such as oil and copper.
- A rise in globalization, however, has reduced the price of manufactured goods. Industrialized countries' advantage over developing countries is becoming less significant.

3.2.18 Concepts of Terms of Trade

The following are the various concepts of Terms of Trade:

1. Net Barter Terms of Trade
2. Gross Barter Terms of Trade
3. Income Terms of Trade
4. Single factor Terms of Trade
5. Double Factorial Terms of Trade
6. Real Cost Terms of Trade
7. Utility Terms of Trade

1. Net Barter Terms of Trade:

Net Barter Terms of Trade also called commodity Terms of Trade is defined as a ratio of export prices to import prices.

In symbolic terms:

Tn = Px/Pm

Where; Tn stands for net barter terms of trade.

Px stands for price of exports (x),

Pm stands for price of imports (m).

2. Gross Barter Terms of Trade:

Gross Barter Terms of Trade is the ratio of physical quantity of import to physical quantity of export.

In symbolic terms:

Tg = Qm/Q

Where; Tg = gross barter terms of trade

Qm = quantity of imports

Qx = quantity of exports

3. Income Terms of Trade:

Income Terms of Trade is defined as- commodity TOT multiplied by quantity of export.

Symbolically, income terms of trade can be written as:

Ty = (Px/Pm) Qx.

Where; Ty = Income terms of trade

Px = Price of exports

Qx = Volume of exports

Pm= Price of import

4. Single factor Terms of Trade:

Single factor Terms of Trade is calculated by multiplying Net Barter Terms of Trade with productivity index of domestic export sector.

Symbolically, Single factor Terms of Trade can be written as:

$$Ts = (Px/Pm)\ Zx$$

Where; Ts = Income terms of trade

Px = Price of exports

Pm= Price of imports

Zx = productivity index of domestic export sector

5. Double Factorial Terms of Trade:

Double Factorial Terms of Trade is calculated by multiplying Net Barter Terms of Trade with the ratio of factor productivity of domestic industry and foreign export industry.

Symbolically, Double Factorial Terms of Trade can be written as:

$$TD = TC\ (ZX/ZM)$$

Where; TD = Double Factorial Terms of Trade

TC= Net Barter Terms of Trade

ZX = Productivity index in the domestic export sector,

ZM= Import productivity index.

6. Real Cost Terms of Trade:

Real Cost Terms of Trade is measured by multiplying the single factor Term of Trade by the index of the amount of disutility (pain, sacrifice,).

Symbolically, Real Cost Terms of Trade can be written as:

$$Tr = Ts.Rx$$

Where; Tr = Real Cost Terms of Trade

Ts = Single factor Terms of Trade

Rx= disutility, real cost in producing export goods.

7. Utility Terms of Trade:

The utility terms of trade is calculated by multiplying the real cost terms of trade index with an index of the relative average utility of imports and of domestic commodities foregone.

Symbolically, Utility Terms of Trade can be written as:

$$Tu = Tr.\ U$$

Where; Tu = Utility Terms of Trade

Tr = Real cost terms of trade index

U = Index of relative utility of imports and domestically for one commodities.

3.2.19 Difference between Balance of Payments and Balance of Trade

Points of difference between balance of trade and balance of payments are briefly explained in the following Table.

Difference Between Balance of Payments and Balance of Trade

Nature	Balance of Payment	Balance of Trade
1. Meaning	It is a systematic record of all economic transactions happened between the resident of one country and resident of foreign countries during a particular period.	Balance of trade is statement showing the net effect of export and import of a country
2. Nature of Transactions recorded	It records both the transactions relating to goods and services	It records only transactions relating to merchandise , i.e. goods transactions
3. Capital Transactions	It records capital transactions	It does not record capital transactions
4. Structure	It includes balance of trade. balance of services, balance of unilateral transfer and balance of capital transactions	It is part of current account of BOP
5. Net Position	It always remains balanced in the sense that receipt side is made equal to payment side	It may be at favorable or unfavourable or in equilibrium state.
6. Indicator Economic Status	It is true indicator of economic performance of an economy	It is not true indicator of economic prosperity or economic relations of country.
7. Correcting Unfavourableness	Unfavourable balance of payment leads to deficit in balance of payment situation.	Unfavourable balance of trade can be converted into favorable balance of payment

3.2.20 Structure of Balance of Payments

The balance of payments consists of four components namely, current account. Capital account, they are highlighted briefly.

Current Account

The current account balance includes two items

- visible trade - Import and export of goods
- Invisible trade - Invisible service items like, banking, shipping, insurance, travel and transportation.

Current Account

Credit Items	Debit Items
1. Goods Export(visible)	1. Goods Import
2. Invisible Exports	2. Invisible Imports
1. Transport service sold abroad 2. Banking service sold abroad 3. Insurance service sold abroad 4. Income received on loan and investment made in foreign countries 5. Expenses incurred by foreign tourists in India	1. Transport services purchased from foreign countries 2. Banking services purchased from foreign countries 3. Insurance services purchased from foreign countries 4. Visit of our tourists to foreign countries 5. Other services purchased from foreign countries 6. Interest paid on loan in home country

CAPITAL ACCOUNT

Capital account consists of three components

1. Private Capital
2. Banking Capital
3. Official Capital

1. Private Capital

Private capital consists of foreign investments, long term loan and foreign currency deposits

2. Banking Capital

Banking capital includes movement into external financial asset and liabilities commercial and co-operative banks authorized to dealing in foreign exchange

3. Official Capital

It includes RBI's holdings of foreign currency and special drawing rights (SDR) held by the Government.

Check Your Progress – Quiz – 2

Q1. Balance of trade is the ___________.

a. Difference between export and import of services

b. Total of export and import of services

c. Difference between export and import of goods

d. Total of export and import of goods

Q2. Import and export of goods are known as _____.

a. Nominal trade

b. Invisible trade

c. Visible trade

d. None of the above

Q3. Import and export of services are known as ________.

a. Nominal trade

b. Invisible trade

c. Visible trade

d. None of the above

Q4. Import of machinery and equipment is recorded under __________ of the ______ account.

a. Credit side, capital

b. Debit side, capital

c. Debit side, current

d. Credit side, current

Q5. Gifts or grants received from outside the country get recorded under __________ of the ______ account.

a. Credit side, capital

b. Debit side, capital

c. Debit side, current

d. Credit side, current

Q6. The Current account of the Balance of Payments includes transactions like ___________.

a. Imports and exports of goods and services

b. Transfers to and from abroad

c. Income to and from abroad

d. All of the above

Q7. The Capital account of the Balance of Payments includes transactions like ___________.

a. Changes in foreign exchange reserves

b. Investments to and from abroad

c. Borrowings and lendings to and from abroad

d. All of the above

Q8. Balance of payments is a ___________ concept as compared to balance of trade.

a. Broader

b. Similar

c. Narrower

d. None of the above

Q9. Trade Deficit occurs when ______________.

a. Export of goods is less than imports of goods

b. Export of goods is more than imports of goods

c. Export of services is less than imports of services

d. Export of services is more than imports of services

Q10. A business organization located within India gets a loan from a foreign-based company. This transaction is recorded in the ____________ of ____________ account within the Balance of Payment account of India.

a. Debit side, current

b. Credit side, current

c. Debit side, capital

d. Credit side, capital

Q11. A business organization located within India invests in a foreign-based company. This transaction is recorded in the ____________ of ____________ account within the Balance of Payment account of India.

a. Debit side, current

b. Credit side, current

c. Debit side, capital

d. Credit side, capital

Q12. Foreign exchange transactions that are independent of other activities in the Balance of Payments account are ________ transactions.

a. Capital account

b. Current account

c. Accommodating

d. Autonomous

Q13. Foreign exchange transactions that are dependent on other activities in the Balance of Payments account are __________ transactions.

a. Capital account

b. Current account

c. Accommodating

d. Autonomous

Q14. When payments of foreign exchange are more than receipts, then the Balance of Payments is __________.

a. Surplus

b. Deficit

c. Balanced

d. None of the above

Q15. The transactions undertaken to cover the deficit or surplus of autonomous transactions are called __________.

a. Accommodating transactions

b. Capital account transactions

c. Current account transactions

d. None of the above

Q16. Which of the following are a part of the Capital account of the Balance of Payments?

a. Foreign loans

b. Monetary movements

c. Foreign investments

d. All of the above

Q17. Balance of Payments is an accounting statement for _________.

a. Business year

b. New year

c. Accounting year

d. All of the above

Q18. The current account deficit is unfavourable for a country because it signifies ______.

a. Demerits for the nation

b. That the nation is a borrower from the rest of the world

c. The government does not have sufficient foreign exchange to finance its international payment

d. Balance of Trade b and c

Q19. The interest amount on deposits from a foreign bank is recorded in the current account because it is ______.

a. A transfer receipt

b. An income from abroad

c. An invisible service

d. A visible good

Q20. If the value of visible exports is more than the value of invisible imports, the balance relates to ____________.

a. Trade deficit

b. Capital account

c. Current account

d. It cannot be determined

Q21. If the value of visible imports is more than the value of invisible exports, the balance relates to ____________.

a. Trade deficit

b. Capital account

c. Current account

d. It cannot be determined

Q22. If the trade deficit is Rs. 1000 crores and the import of goods is Rs. 2000 crores, then the export of goods will be Rs. _________.

a. 2000 crores

b. 1000 crores

c. 1500 crores

d. 500 crores

Answer Key:	**Q1. C**	**Q2. C**	**Q3. D**	**Q4. C**	**Q5. D**	**Q6. D**	**Q7. D**	**Q8. A**	**Q9. A**	**Q10. D**
	Q11. C	**Q12. D**	**Q13. C**	**Q14. B**	**Q15. A**	**Q16. D**	**Q17. C**	**Q18. D**	**Q19. B**	**Q20. D**
	Q21.D	**Q22. B**								

3.3 Unit Summary

The balance of trade and the balance of payments (BoP) are balance of Trade important indicators of a country's economic health and global standing. The Balance of Trade is the difference between a country's exports and imports, while the BoP is the difference between a country's inflow and outflow of foreign exchange. The Balance of Trade is the largest component of the BoP.

Here are some more details about the Balance of Trade and BoP:

- **Balance of trade**

The Balance of Trade is the difference between the value of a country's exports and imports. A country with a favorable surplus has more exports than imports, while a country with an unfavorable deficit has more imports than exports.

- **Balance of payments**

  The BoP records a country's payments and receipts from transactions with other countries. It includes transactions related to goods, services, transfers, international investments, and loans. The BoP is made up of three main components: the current account, the capital account, and the financial account.

- **Importance**

  The Balance of Trade and BoP are important for understanding a country's economic dynamics and planning for the future. They can also help policymakers, economists, investors, and businesses make better decisions.

3.4 Glossary

- **Balance of trade**

  The difference between a country's exports and imports, also known as the trade balance, net exports, commercial balance, or international trade balance. A favorable balance of trade means a country's exports are greater than its imports, while an unfavorable balance of trade means a country's imports are greater than its exports.

- **Balance of payments**

  The sum of all economic transactions between a country and its trading partners. This includes transactions related to goods, services, and transfers. The formula for calculating the balance of payments is current account + capital account + financial account + balancing item = 0.

- **Debit items**

  Imports, foreign aid, domestic spending abroad, and domestic investments abroad.

- **Credit items**

  Exports, foreign spending in the domestic economy, and foreign investments in the domestic economy

- **Disequilibrium**

A BOP is considered to be in disequilibrium when it shows a surplus or a deficit.

- **Deficit and surplus**

A BOP is considered to be in surplus when a country's exports exceed its imports. A BOP deficit occurs when a country's imports exceed its exports.

- **Favourable balance of payments**

A favorable BOP occurs when a country sends out more products and enterprises, and moves more capital abroad, than it imports and receives in capital exchanges.

- **Balance of payment surplus**

A BOP surplus occurs when a country's exports to other nations surpass its imports. This surplus can provide capital for domestic production and allow the country to invest funds abroad.

- **Capital account**

A part of a country's BOP account that reflects the net change in asset ownership nationally.

3.5 Self-Assessment Questions

5 Marks

1. State on the types of balance of payment.
2. How the BOP is Balance?
3. Brief on methods to correct disequilibrium in balance of payments
4. Explain in short about the Structure of Balance of Payments.
5. What is TOT? Explain Factors Affecting Terms of Trade.
6. Give short note on Balance of Trade: Surplus vs. Deficit.

10 Marks

1. Explain the types of Disequilibrium in Balance of Payments (BOP).
2. Describe the advantages and disadvantages of trade deficit.
3. Distinguish between Balance of Payments and Balance of Trade.
4. Summarize on David Hume’s Price-Specie-Flow Mechanism.

5. Explain the Classical Theory of BOP Adjustment and BOP Adjustment under the Gold Standard.

6. What are the Methods to Correct Disequilibrium in Balance of Payments?

3.6 Reference and Suggested Readings

1. https://testbook.com/banking-awareness/balance-of-payment

2. https://www.slideshare.net/ProfMKGhadoliya/balance-of-trade-and-balance-of-payments

3. https://ebooks.inflibnet.ac.in/mgmtp08/chapter/balance-of-trade-and-balance-of-payment/

4. Trade and Balance Of Payments: Global Changes and Instability - Punam Kumari.

Unit – IV INTERNATIONAL ECONOMIC INSTITUTIONS
International Economic Institutions-International Monetary System - Bretton Woods Conference – IMF -Objectives, Organizational structure–Membership–Quotas–Borrowing and Lending Programme of IMF – SDRs – India and IMF -World Bank and UNCTAD.

INTERNATIONAL ECONOMIC INSTITUTIONS

UNIT OBJECTIVES

Studying international economic institutions can help you understand how they promote global economic stability, cooperation, and development.

SECTION-4.1 WORLD TRADE ORGANIZATION AND INTERNATIONAL MONETARY FUND

4.1.1 Introduction- International Economic Institution

- In this ever more globalized situation, companies require to be globally competitive and aggressive in order to survive and sustain. It has become important for every student to assimilate knowledge and understanding of different countries' economies as well as the factors which are affecting these nations while trading globally. Businesses have gone beyond their national boundaries and that is why the relevance of international business and the organizations or institutions governing trade globally is constantly increasing.

- It's quite necessary to understand the meaning of international economic institutions and the international organizations which are dominating the world trade. WTO, popularly known as World Trade Organization (WTO) and its contribution towards the international business is very pertinent topic towards learning about International Business.

- WTO is one of the three biggest international organizations that formulate and co-ordinate world economic policies. WTO places among the most significant role in promoting free international trade .It is, in fact, an umbrella institutions that cover the agreements made during the Uruguay Round, which was the preparatory platform before the launching of WTO. The said round was also based on the General Agreement on Tariffs and Trade (GATT), which we will discuss too in this module. In this module we will try to understand various International Economic Intuitions and role of WTO in the global scenario.

4.1.2 International Economic Institutions

- There are certain principal international economic institutions which act as foundation and provide structural support of the world economy. There are various international institutions which not only provide funds to the developing nations but also assist them to achieve a level of development. Major important one's are IMF (The Fund), World Bank and Development Banks like Asian Development Bank. The countries who have accepted to be the members of such international institutions are largely affected by their membership norms. Their economic policies and financial decisions are largely influenced by these economic international institutions. These international institutions provide funds to the member countries for several reasons and assist them timely e.g IMF provides not only financial support but it also provides them technical assistance to the member countries. There are universally three principal international institutions which have assumed a greater and a larger role to play in the world economy. All three originated in wartime planning for a better economic future these are:

1. The International Monetary Fund
2. The International Bank for Reconstruction and Development (World Bank) and
3. GATT the General Agreement on Tariffs and Trade now WTO World Trade Organization

- The WTO emerged out of the General Agreement on Tariffs and Trade (GATT) in 1995; the key role of WTO is to act as a forum or a platform which negotiates on trading rules at international level. Moreover it serves as a mechanism for dispute settlement on various trade issues.

- On the other hand the World Bank and IMF help the developing countries during times of economic crisis or they deal with those countries which seek additional foreign exchange resources. The membership of IMF is presently 188. The fund works in order to ensure stability of international monetary as well as financial system. The mandate of IMF states its objective as promoting exchange rate stability, growth of international trade as well as helping and assisting the member countries to solve and resolve balance of payment position. Since its establishment IMF is working as central institution of International monetary system. With 29 countries as its members initially it started its financial operations in 1947. Which was the result of Bretton Woods conference of nations held in 1944.

- The highest body of IMF is its Board of Governors. Each member country has to appoint a governor and an alternate governor. Day today decision making is done by an executive board. This has 24 Executive Directors and a Managing Director as a chairman. The basic purpose of IMF is to promote, foster and encourage international cooperation by consultation as well as collaboration on the international monetary issues. Its fundamental objective is to promote and expand international trade in the world economy. By contributing to boost international trade it helps to encourage high levels of employment opportunities in the member countries. It takes steps to maintain orderly exchange arrangements among the member countries for promoting exchange rate stability.

- IMF also helps to eliminate all those foreign exchange restrictions in the international markets which hamper the international trade. The prime function of IMF is to lend to its member countries at the time of crises. If the member countries suffer balance of payment problems then IMF provides them loans so that they can restore to the equilibrium position and come out of the crises for a balanced structural growth of their economy. The financial assistance of IMF is provided to the economies to rebuild their depleting international reserves at the time of their downfall. It also helps them to sustain out of the situations arising out of devalued currencies and contributes towards payments of their necessary imports. The loans are generally provided out of some arrangements which are the necessary stipulations or the conditions which a country must fulfill in order to get an access to the loan. The arrangement if is approved by the executive body the loan is disbursed in a phased manner. The financial assistance by IMF is tailored according to the need of the member countries. All those economies which are Low Income Economies can borrow at concessional rate of interests under the Poverty Reduction and Growth Facility. Other type of lending is done through various other schemes like Stand By arrangements, the Extended Fund Facility, the Supplement Reserve Facility and Compensatory Financing Facility etc.

- World Bank also originated through Bretton Woods Conference. It is the world’s biggest development funding institution.
- It originated in 1944 as a single institution. But now it has expanded to a group of five development institutions including –

1. International Development Association
2. The International Finance Corporation (IFC)
3. The Multilateral Guarantee Agency (MIGA)
4. And the International Centre for the Settlement of Investment Disputes (ICSID).

- Originally World Bank was created as a post war facilitator for reconstruction, the role now has extended to eradicate poverty. Reconstruction still is an important activity performed by World Bank. “Poverty reduction through an inclusive and sustainable globalization” is the extend goal of World Bank and its affiliates. Recently the World Bank has set “two ambitious goals to push extreme poverty to no more 3 percent by 2030 and to promote shared prosperity and greater equity in the developing world”. The World Bank plays a pivotal role in providing financial as well as technical assistance to the developing nations throughout the world. It is a unique institution supporting development worldwide along with aiming for reducing poverty in nations. The headquarters of World Bank is in Washington DC. It has around 120 offices worldwide. World Bank through its financial assistance programmes provides support in the areas of education, health, public administration, infrastructure, sectoral development, agriculture, environmental and natural resource management. It helps the developing nations by providing low-interest loans, zero to low-interest credits, and grants to such nations. Timely it also support the developing nations by giving policy advices and technical assistance as well as know how facilitation. It also contributes by providing capacity development in those nations where they serve.

- The World Bank works like a cooperative. Presently there are 188 countries who have taken its membership. The Board of Governors is the ultimate policymaking body and plays a critical role in putting its mission into practice. The governors are mostly the ministers of finance or ministers of development from the member nations. They meet once a year at the Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund.

- There is a group of 25 Executive Directors, who work on-site at the Bank and the powers of the governors are delegated to this group. The five largest shareholders appoint an executive director, while other member countries are represented by elected executive directors.

4.1.3 GATT to WTO

- There was a strong desire in the economies to liberalize trade in the world economies as a result The General Agreement on Tariffs and Trade (GATT) was born in 1948. In the Bretton Woods conference the establishment of ITO, IMF and World Bank was recommended. ITO was never ratified by the members, in place of ITO; GATT was drawn as an interim agreement to fill the gap of ITO, until the character of ITO was ratified. Thus General Agreement on Tariffs and Trade (GATT) was a multilateral agreement between various nations to regulate international trade. According to its preamble, its purpose was the “substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis.” GATT was signed by 23 nations in Geneva on October 30, 1947. It came into force on January 1, 1948. This agreement lasted until the signature by 123 nations in Marrakesh on April 14, 1994 of the Uruguay Round Agreements, which established the World Trade Organization (WTO) on January 1, 1995. The prime object of GATT was to enlarge and expand international trade by introducing liberalized trade measure so as to encourage and facilitate all round economic prosperity worldwide. Various conventions were implemented in the GATT regime which governed international trade for decades.

- The General Agreement on Tariffs and Trade established a forum for negotiations on cutting tariffs that consequently took place during decades through multilateral trade rounds. Moreover the initial negotiations resulted in an agreement which helped to establish a set of basic rules and disciplines that member countries were required to follow. It also devised a forum for dispute resolution if countries deviated from the established rules.

- The most important and enduring of these basic rules embodied in the GATT 1947 are the fundamental principle of reciprocity and two nondiscrimination principles—most-favored- nation treatment and national treatment.

- GATT held a total of nine rounds. In these rounds issues like reducing tariffs, anti-dumping measures, non-tariff barriers, pluri-lateral agreements were the major issues which were deliberated upon in all these rounds. The most ambitious of these rounds was **Uruguay Round.** In this round its members agreed on the fact that there is a strong need to adopt global changing patterns regulating foreign trade in the world economy. In relation to this various problems which were identified in 1982 Ministerial Declarations, the 8th GATT round which is famously known as the Uruguay Round – was launched in September 1986, in Punta del Este, Uruguay. It is stated that it was the biggest negotiating mandate on trade ever agreed. The Final Act which concluded concluding the Uruguay Round and officially establishing the WTO regime was signed 15 April 1994, during the ministerial meeting at Marrakesh, Morocco, and hence is known as the Marrakesh Agreement.

4.1.4 World Trade Organization (WTO)

- In world economy there was a strong need for a full proof and sound international body to support and promote international trade. WTO has contributed immensely towards the end of achieving these goals. If there is free international trade it can help the economies in enabling them to achieve high growth rate, improving living standards, reducing poverty, removing trade barriers.

- With 161 members since 26 April 2015, The World Trade Organization (WTO) is an international organization which primarily deals with the rules of trade between nations. Russia became its member in August 2012 and since then almost all major trading economies are now part of WTO. The WTO came into existence in 1995, succeeding the General Agreement on Tariffs and Trade (GATT).
- "The WTO works to help international trade flow smoothly, predictably, and freely, and provides countries with a constructive and fair outlet for dealing with disputes over trade issues".

4.1.5 Functions of WTO

The main functions of WTO are following:

- Its main function is Administering WTO trade agreements.
- It is a Forum for trade negotiations in world economy.
- Handling trade disputes between member countries is one of its main activities.
- It helps in Monitoring national trade policies.
- It provides Technical assistance and training for developing countries.
- It provides Cooperation to other international organizations for promoting world trade.

All the WTO agreements are based upon achieving three main objectives-

1. To promote, health and encourage trade flow at international level as freely as possible
2. To attain high level of liberalization on global fore front in international trade through negotiations between major economies.
3. To device a system or a dispute settlements body which works on transparent and impartial means promoting international trade.

The agreements under WTO are based upon some fundamental principles which are-

1. Nondiscrimination i.e. most favoured nation treatment.

2. Encouraging healthy competition among economies leading to free trade as well as sound and full proof predictable policies.
3. Special and favoured treatment by providing more provisions for less developed countries.

4.1.6 Organization of WTO

All the decisions under WTO are taken by consensus by the member countries. The agreements are ratified in member's parliaments. Ministerial Conference is the highest level decision making body of WTO. This body meets once in two years. Under this ministerial conference there is a General Council which generally meets at Geneva many times in a year. The general council constitutes normally ambassadors and heads of delegation. This Council also acts as a Trade Policy Review Body as well as a Dispute Settlement Body. At the next level there are some others Councils which report to the General Council. These include-

- Goods Council
- Services Council
- Intellectual Property Council.

4.1.7 International Monetary System

- The international monetary system is a set of conventions and rules that support cross-border investments, trades, and the reallocation of capital between different countries. These rules define how exchange rates, macroeconomic management, and balance of payments are addressed between nations. The international monetary system structure was reformed after the North Atlantic financial crisis of 2008-2009.
- The International Monetary System comprises central and commercial banks, international financial institutions, and various money market funds, including open market funds from the currency and bond markets. In their eyes, money is a medium of exchange that facilitates the exchange of capital flows, goods, and services across countries.
- The international monetary system is the operating system of the global financial environment. This body comprises investors, multinational companies, and financial institutions. The International Monetary System

formulates the framework that facilitates the exchange rates, international payments, and movement of capital between two countries with different currencies.

Key Takeaways

- International Monetary System refers to the framework in the world of foreign exchange through which capital movements and trade of goods and services are facilitated.
- It has evolved from using gold as a means of exchange in the 1880s to implementing the floating exchange rates since the convention in Jamaica in 1971.
- Its systems ensure sufficient liquidity to aid the temporary Balance of Payments (BOP) deficits.
- It also allows member countries to practice independent fiscal and monetary

- The prerogative of the International Monetary System is to facilitate the exchange of capital, goods, and services between countries. The International Monetary Fund (IMF) oversees articles of the agreement signed in this regard between countries. The responsibility of member countries is to formulate economic and financial policies that facilitate the economic and financial conditions to ultimately result in economic growth by maintaining price stability.

- Moreover, member countries take active action toward creating systems that help avoid manipulation or tampering of exchange rates and keep improving rate change policies that foster growth and safety to benefit the global economy. To broaden the approach from just focusing on exchange rates, the IMF sought to create external stability through a balance of payments system that eliminates uncontrollable exchange rate movements.
- Since IMF is a multilateral institution, its policies and regulations help the functioning of the International Monetary System. More so, as IMF plans to extend its reach and address issues such as inequalities, financial supervision, poverty, and climate change. However, it is essential to note that The International Monetary Fund (IMF) has no power or control over the International Monetary System. Beyond domestic policies and other primary policies relating to the financial sector.
- Since the formulation of the Financial Sector Assessment Program (FSAP) and its mandatory application to 25 countries in 2009, IMF has been the central source of surveillance, supervision, and policy-generating body that stands to erode its stability.

4.1.8 Evolution of IMF

- Since the 19th Century, the International Monetary System has undergone four stages of evolution at different points in time to form the structure as we know it today. Let us understand the occurrences that led to the changes and their current implications through the points below:

#1 – The Gold Standard

Between 1880 and 1914, the gold standard was referred to as the monetary system through which each country could fix the value of their currency in terms of gold. The exchange rate was based on the determined value. For example, if the U.S. fixed 1 ounce of gold = $20. The United Kingdom had set the value of one ounce of gold equal to 10 pounds. Then, the pound-dollar exchange rate would be $20 = 10 Pounds.

The gold standard system had a fixed exchange rate system that facilitated the free convertibility of gold into national currencies and vice versa. The most significant advantage of this system was its ability to correct imbalances. As gold payments make balancing off easier, settling the balance of payment (BOP) deficits or surpluses could be easy. Moreover, the fixed exchange rates made international trade easier under the gold standard.

#2 – The War Period

Between 1925-1933 the world wars, the gold standard started losing its way. The war had created a dent in the world economy, and every country wanted to export more to revamp and rebuild their economies.

Therefore, they significantly depreciated their currencies' value to export extensively and benefit from economies of scale. This period of chaos and rebuilding saw exchange rates fluctuate and competitive devaluation unlike ever before.

#3 – The Bretton Woods System

Only a few nations had the resources to survive after two world wars, while others struggled to feed their citizens. In times like these, the United States of America and the United Kingdom started discussing the possibilities and ways to rebuild the world economy after two disastrous wars in the mid-1940s.

The United Nations formulated the new international monetary system at the Bretton Woods Conference in Bretton Woods, New Hampshire. The Bretton-woods conference led to the creation of a dollar-based fixed exchange rate system. Under this system, the U.S. dollar was backed by reserve gold. All other currencies did not have to maintain a gold reserve for conversion. Therefore, the conversion rates were minimal.

#4 – The Jamaica System

Around 1971, high inflation rates and a trade deficit led to a gold process hike. Therefore, the U.S. had to stop the convertibility of gold. Owing to factors like these, the Bretton woods system collapsed.

Hence the global economy moved towards a flexible exchange rate system in 1973 and by 1976. They formalized the system through the convention in Jamaica. Under the Jamaica or floating rate system, demand and supply would affect the currency exchange rates.

4.1.9 Features of International Monetary System

Let us discuss the key features of the Floating rate system through the points below:

#1 – Independence

The push and pull of the market enforce the exchange rate. Hence, there is no need for government intervention, which makes it far more transparent than its alternatives.

#2 – Constant Fluctuation

A feature of the reiteration of the 'floating' exchange system is the constant fluctuation of rates due to the movements in the market.

#3 – Adjustments

The balance of payments (BOP) is adjusted with exchange rates. The surplus or deficit of funds between countries is settled through the real-time rates displayed on the exchange.

#4 – Transparency

Interventions do not bind the smooth conduct of exchange between countries from the full reigns of governments or central banks. Thereby, the fluctuation of exchange rates is backed by market factors beyond the control of any individual or centralized organization.

4.1.10 Functions of International Monetary System

Let us discuss the functions of the International Monetary System through the points below:

- Facilitates the free flow of different currencies in the open market.
- Restrict intervention from government or central banks only in cases of currency stabilization.
- Third, facilitate global trade of goods, services, and money.
- Fourth, maintain a system that regulates the exchange rates through the forces of the market and not by any particular institution or organization.

Examples

Let us understand the concept better through the examples below:

Example #1

Country A borrows $100 million from Country B to finance its infrastructural development for a repayment schedule of 10% each year with interest. Due to the exchange rate fluctuations, country A benefits from the dip in USD in the first year but pays extra the following year. However, member countries can maintain repayment schedules irrespective of the movement through BOP calculations.

Example #2

For close to a century, the world's economies have been using U.S. dollars as their reserve currency as it is globally viable and is the strongest currency in the market. However, since 2022, Russia and China have been using the Chinese Yuan as a means of payment for Russian oil. Other countries, such as Saudi Arabia, have also considered doing the same.

China has been on a gold purchasing spree to shift the global reserve currency towards the Chinese Yuan. However, due to the open nature of commodity and currency markets, only the market's push and pull shall have a say on the future reserve currency.

4.1.11 Advantages & Disadvantages of International Monetary System

Let us discuss the advantages and disadvantages of the International Monetary System through the points below:

Advantages

#1 – Liquidity

Member countries are not limited to using one anchor currency. Therefore, countries can hold surplus or reserve cash in different currencies, resulting in a more significant liquidity factor than other systems.

#2 – Larger Gains

Easing trade restrictions allows for the free exchange of currencies, benefiting governments and central banks and allowing retail investors to experience greater gains through their trades.

#3 – Confidence

International systems in the past have come under the scanner for being manipulative and deceiving. However, the International Monetary System is independent in terms of policymaking. The policies leave the exchange rates to the market's forces, leaving almost no room for manipulation.

Disadvantages

#1 – Instability

Constant fluctuations make these exchange rates unstable and sometimes unreliable in making investments or committing to trade goods and services.

#2 – Curbs International Trade

The very nature of uncertainty in the exchange rate is sometimes a hindrance. Due to the uncertainty in movement, the parties involved are inhibited from trading or investing internationally.

#3 – Elasticity

The constant rate changes cause instability, and the smaller trades get adversely affected as the price shift results in the parties taking a step back and awaiting some stability in the market.

4.1.12 Bretton Woods Conference & the Birth of the IMF and World Bank

- The Bretton Woods Conference, officially known as the United Nations Monetary and Financial Conference, a meeting of delegates from 44 nations that met from July 1 to 22, 1944 in Bretton Woods, New Hampshire. The purpose of the conference was to agree upon a series of new rules for the monetary system after World War II.

- The genesis of the 1944 conference dates back to the Atlantic Conference in 1941, but by early 1942 more detailed plans were being developed with the ideas from Harry Dexter White a Special Assistant to the U.S. Secretary of the Treasury and John Maynard Keynes an advisor to the British Treasury being the two major competing schools of thought. In mid-June 1944 a preliminary conference was held in Atlantic City and on July 1, 1944 the Bretton Woods Conference convened.

- The conference resulted in the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction & Development (IBRD) though that quickly became become the World Bank. It was intended that the IMF was to maintain a system of fixed exchange rates centered on the U.S. dollar and gold, while the IBRD was responsible for providing financial assistance for the reconstruction of war-ravaged nations and the economic development of less developed countries. The IMF and IBRD formally came into existence on 27 December 1945. The World Bank opened it doors on June 25, 1946 and made its first loan in 1947.
- While the Bretton Woods system was in place until President Richard Nixon ended the dollars convertibility to gold in 1971, both the IMF and World Bank are still operating today.
- Today, the IMF is an organization of 190 member countries with proximately 2,700 staff from 150 countries. The World Bank includes 189 member countries with staff from more than 170 countries and offices in over 130 locations and is a family of five organizations including the International Bank for Reconstruction and Development (IBRD) International Development Association (IDA), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), and International Centre for Settlement of Investment Disputes (ICSID).

4.1.13 Formation of IMF

- The breakdown of international monetary cooperation during the Great Depression led to the development of the IMF, which aimed at improving economic growth and reducing poverty around the world. The International Monetary Fund (IMF) was initially formed at the Bretton Woods Conference in 1944. 45 government representatives were present at the Conference to discuss a framework for postwar international economic cooperation.
- The IMF became operational on 27th December 1945 with 29 member countries that agreed to bound to this treaty. It began its financial operations on 1st March 1947. Currently, the IMF consists of 189 member countries.

- The IMF is regarded as a key organization in the international economic system which focuses on rebuilding the international capital along with maximizing the national economic sovereignty and human welfare.

4.1.14 Organizational Structure of International Monetary Fund (IMF)

- The United Nations is the parent organization that handles the proper functioning and administration of the IMF. The IMF is headed by a Managing Director who is elected by the Executive Board for a 5-year term of office. The International Monetary Fund (IMF) consists of the Board of Governors, Ministerial Committees, and the Executive Board.

4.1.15 Governance Setup of IMF

- **Board of Governors:** It consists of one governor and one alternate governor for each member country. Each member country appoints its two governors.
  - It is responsible for electing or appointing executive directors to the Executive Board.
  - Approving quota increases, Special Drawing Right allocations,
  - Admittance of new members, compulsory withdrawal of member,
  - Amendments to the Articles of Agreement and By-Laws.
  - Board of Governors is advised by **two ministerial committees, the International Monetary and Financial Committee (IMFC) and the Development Committee.**
  - Boards of Governors of the IMF and the World Bank Group normally meet once a year, during the IMF–World Bank Annual Meetings, to discuss the work of their respective institutions.
- **Ministerial Committees:** The Board of Governors is advised by two ministerial committees,
  - **International Monetary and Financial Committee (IMFC):** IMFC has 24 members, drawn from the pool of 190 governors, and represents all member countries.

- It discusses the management of the international monetary and financial system.
- It also discusses proposals by the Executive Board to **amend the Articles of Agreement**.
- And any other matters of **common concern affecting the global economy**.

  - **Development Committee:** is a joint committee (25 members from Board of Governors of **IMF & World Bank**), tasked with advising the Boards of Governors of the IMF and the World Bank on issues related to economic development in emerging market and developing countries.
    - It serves as a forum for building intergovernmental consensus on critical development issues.

- **Executive Board:** It is 24-member Executive Board elected by the Board of Governors.
  - **It conducts the daily business of the IMF** and exercises the powers delegated to it by the Board of Governors & powers conferred on it by the Articles of Agreement.
  - It discusses all aspects of the Fund's work, from the IMF staff's annual health checks of member countries' economies to policy issues relevant to the global economy.
  - The Board normally makes decisions based on consensus, but sometimes formal votes are taken.
  - **Votes** of each member equal the sum of its basic votes (equally distributed among all members) and **quota-based votes**. A member's quota determines its voting power.
- **IMF Management:** IMF's **Managing Director** is both chairman of the IMF's Executive Board and head of IMF staff. The Managing Director is appointed by the Executive Board by voting or consensus.
- **IMF Members:** Any other state, **whether or not a member of the UN,** may become a member of the IMF in accordance with IMF Articles of Agreement and terms prescribed by the Board of Governors.
  - Membership in the IMF is a **prerequisite to membership in the IBRD**.

- **Pay a quota subscription:** On joining the IMF, each member country contributes a certain sum of money, called a **quota subscription**, which is based on the country's wealth and economic performance **(Quota Formula)**.
    - It is a weighted average of GDP (weight of 50 %)
    - Openness (30 %),
    - Economic variability (15 %),
    - International reserves (5 %).
    - GDP of member country is measured through a blend of GDP—based on market exchange rates (weight of 60 %) and on PPP exchange rates (40 %).
    - **Special Drawing Rights (SDRs)** is the IMF's unit of account and not a currency.
        - The currency value of the SDR is determined by summing the values in U.S. dollars, based on market exchange rates, of a SDR basket of currencies
        - SDR basket of currencies includes the U.S. dollar, Euro, Japanese yen, pound sterling and the Chinese renminbi (included in 2016).
        - The SDR currency value is calculated daily (except on IMF holidays or whenever the IMF is closed for business) and the valuation basket is reviewed and adjusted every five years.
    - **Quotas are denominated (expressed) in SDRs.**
    - SDRs represent **a claim to currency held by IMF member countries** for which they may be exchanged.
- **Members' voting power** is related directly to their **quotas** (the amount of money they contribute to the institution).
- IMF allows each member country to choose its own method of determining the exchange value of its money. The only requirements are that the member no longer base the value of its currency on gold (which has proved to be too inflexible) and inform other members about precisely how it is determining the currency's value.

4.1.16 IMF and India: What is the Scenario?

- India is a **founder member** of the IMF.
- International regulation by IMF in the field of money has certainly contributed towards expansion of international trade. India has, to that extent, benefitted from these fruitful results.
- **Post-partition period,** India had serious balance of payments deficits, particularly with the dollar and other hard currency countries. It was the IMF that came to her rescue.
- The Fund granted India loans to meet the financial difficulties arising out of the Indo–Pak conflict of 1965 and 1971.
- From the inception of IMF up to March 31, 1971, India purchased foreign currencies of the value of Rs. 817.5 crores from the IMF, and the same have been fully repaid.
- Since 1970, the assistance that India, as other member countries of the IMF, can obtain from it has been increased through the setting up of the **Special Drawing Rights** (SDRs created in 1969).
- India had to borrow from the Fund in the wake of the steep rise in the prices of its imports, food, fuel and fertilizers.
- In 1981, India was given a massive loan of about Rs. 5,000 crores to overcome foreign exchange crisis resulting from persistent deficit in balance of payments on current account.
- India wanted large foreign capital for her various river projects, land reclamation schemes and for the development of communications. Since private foreign capital was not forthcoming, the only practicable method of obtaining the necessary capital was to borrow from the International Bank for Reconstruction and Development (i.e. World Bank).
- India has availed of the **services of specialists of the IMF** for the purpose of assessing the state of the Indian economy. In this way India has had the benefit of independent scrutiny and advice.
- The balance of payments position of India having gone utterly out of gear on account of the oil price escalation since October 1973, the IMF has started making available oil facility by setting up a special fund for the purpose.

- **Early 1990s** when **foreign exchange reserves – for two weeks' imports** as against the generally accepted **'safe minimum reserves'** of **three month equivalent** — position were terribly unsatisfactory.
  - Government of India's immediate response was to secure an emergency loan of $2.2 billion from the International Monetary Fund by pledging 67 tons of India's gold reserves as collateral security.
  - India promised IMF to launch several structural reforms (like devaluation of Indian currency, reduction in budgetary and fiscal deficit, cut in government expenditure and subsidy, import liberalization, industrial policy reforms, trade policy reforms, banking reforms, financial sector reforms, privatization of public sector enterprises, etc.) in the coming years.
- The foreign reserves started picking up with the onset of the liberalization policies.
- India has occupied a special place in the **Board of Directors** of the Fund. Thus, India had played a **creditable role in determining the policies of the Fund**. This has **increased the India's prestige** in the international circles.
- India has **not taken any financial assistance from the IMF since 1993**.
- Repayments of all the loans taken from the International Monetary Fund were completed on 31 May 2000.
- **The Finance Minister** of India is the **ex-officio Governor on the Board of Governors** of the IMF.
  - **RBI Governor is the Alternate Governor at the IMF.**
- India's current quota in the IMF is SDR (Special Drawing Rights) 5,821.5 million, making it the **13th largest** quota holding country at IMF and giving it **shareholdings of 2.44%**.
- However, based on **voting share, India (together with its constituency countries Viz. Bangladesh, Bhutan, and Sri Lanka) is ranked 17th in the list of 24 constituencies at the Executive Board**.

What is India's Contribution to Lending Resources to IMF?

- In the **London Summit** of the **Group of Twenty (G-20)**, a decision was taken to **triple the IMF's lending capacity up to US$ 500 billion**.
- In pursuance of this decision, **India decided to invest its reserves, initially up to US$ 10 billion through the Notes Purchase Agreement (NPA), and**

subsequently up to US$ 14 billion through New Arrangement to Borrow (NAB).

- As of **7 April 2011, India has invested SDR 750 million (approx. 5,340.36 crores) through nine note purchase agreements with the IMF**.

4.1.17 Status of IMF Reforms

- **Quota Reforms:** As part of the **Fourteenth General Review of Quotas** (2010, India's total quota has been increased to SDR 13,114.4 million from SDR 5821.5 million.
  - With this increase, **India's share would increase to 2.75 % (from 2.44%), making it the 8th largest quota-holding country in the IMF**.
  - Significantly, the reforms will lead to a realignment of quota shares of member countries, with the shifts to dynamic **Emerging Market and Dynamic Countries (EMDCs)** and from over- to under-represented countries both exceeding 6%, while protecting the voting share of the poorest member.
- **Due to discontent with IMF,** BRICS countries established a new organization called **BRICS bank to** reduce the dominance of IMF or World Bank and to consolidate their position in the world as BRICS countries accounts for 1/5th of WORLD GDP and 2/5th of world population.
- It is almost impossible to make any reform in the current quota system as more than 85% of total votes are required to make it happen. The 85% votes does not cover 85% countries but countries which have 85% of voting power and only USA has voting share of around 17% which makes it impossible to reform quota without consent of developed countries.
- **2010 Quota Reforms** approved by Board of Governors were implemented in 2016 with delay because of reluctance from US Congress as it was affecting its share.
- Combined quotas (or the capital that the countries contribute) of the IMF increased to a combined SDR 477 billion (about $659 billion) from about SDR 238.5 billion (about $329 billion). It **increased 6% quota share for developing countries** and reduced same share of developed or over represented countries.

- **More representative Executive Board: 2010 reforms** also included an amendment to the **Articles of Agreement** established an **all-elected Executive Board,** which facilitates a move to a more representative Executive Board.
- **The 15th General Quota Review (in process)** provides an opportunity to assess the appropriate size and composition of the Fund's resources and to continue the process of governance reforms

4.1.18 Objectives of the IMF

IMF was developed as an initiative to promote international monetary cooperation, enable international trade, achieve financial stability, stimulate high employment, diminish poverty in the world, and sustain economic growth. Initially, there were 29 countries with a goal of redoing the global payment system. Today, the organization has 189 members. The main objectives of the International Monetary Fund (IMF) are mentioned below:

1. To improve and promote global monetary cooperation of the world.
2. To secure financial stability by eliminating or minimizing the exchange rate stability.
3. To facilitate a balanced international trade.
4. To promote high employment through economic assistance and sustainable economic growth.
5. To reduce poverty around the world.

4.1.19 Criticism of IMF

- IMF's governance is an area of contention. For decades, Europe and the United States have guaranteed the helm of the **IMF to a European** and that of the **World Bank to an American**.
  - The situation leaves little hope for ascendant emerging economies that, despite modest changes in 2015, do not have as large an IMF voting share as the United States and Europe.

- **Conditions placed on loans are too intrusive** and compromise the economic and political sovereignty of the receiving countries. 'Conditionality' refers to more forceful conditions, ones that often turn the loan into a policy tool.
  - These include fiscal and monetary policies, including such issues as banking regulations, government deficits, and pension policy.
    - Many of these changes are simply politically impossible to achieve because they would cause too much domestic opposition.
- IMF imposed the policies on countries without understanding the distinct characteristics of the countries that made those policies difficult to carry out, unnecessary, or even counter-productive.
- **Policies were imposed all at once, rather than in an appropriate sequence.** IMF demands that countries it lends to privatize government services rapidly. It results in a blind faith in the free market that ignores the fact that the ground must be prepared for privatization.

4.1.20 IMF lending instruments

The IMF has several lending instruments to meet the different needs and specific circumstances of its members. They are:

i) The Stand-by Arrangement (SBA) provides short-term financial assistance to countries facing balance of payments problems. Historically, it has been the IMF lending instrument most used by advanced and emerging market countries. Through the years, the SBA has been upgraded to be more flexible and responsive to countries' needs.

ii) The Stand-by Credit Facility (SCF) provides financial assistance to low-income countries with short-term balance of payments needs. The SCF is one of the facilities under the Poverty Reduction and Growth Trust (PRGT).

iii) The Extended Fund Facility (EFF) provides financial assistance to countries facing serious medium-term balance of payments problems because of structural weaknesses that require time to address. To help countries implement medium-term structural reforms, the EFF offers longer program engagement and a longer repayment period.

iv)The Extended Credit Facility (ECF) provides medium-term financial assistance to low-income countries with protracted balance of payments problems. The ECF is one of the facilities under the Poverty Reduction and Growth Trust (PRGT).

v) The Rapid Financing Instrument (RFI) provides prompt financial assistance to any IMF member country facing an urgent balance of payments need. The RFI is one of the facilities under the General Resources Account (GRA) that provide financial support to countries, including in times of crisis.

vi) The Rapid Credit Facility (RCF) provides fast concessional financial assistance to low-income countries facing an urgent balance of payments need. The RCF is one of the facilities under the Poverty Reduction and Growth Trust (PRGT) that provide flexible financial support tailored to the diverse needs of low-income countries, including in times of crisis.

vii) The Flexible Credit Line (FCL) is designed to meet the demand for crisis-prevention and crisis-mitigation lending for countries with very strong policy frameworks and track records in economic performance.

viii) The Short-term Liquidity Line (SLL) is a liquidity backstop for members with very strong policy frameworks and fundamentals, who face potential, moderate, short-term liquidity needs because of external shocks that generate balance of payment difficulties. It aims to minimize the risk of shocks evolving into deeper crises and spilling over to other countries.

ix) The Precautionary and Liquidity Line (PLL) is designed to meet the liquidity needs of member countries with sound economic fundamentals but with some remaining vulnerabilities that preclude them from using the Flexible Credit Line (FCL).

x) The Resilience and Sustainability Facility (RSF) provides affordable long-term financing to countries undertaking reforms to reduce risks to prospective balance of payments stability, including those related to climate change and pandemic preparedness.

Let's Sum Up

The World Trade Organization (WTO) and the International Monetary Fund (IMF) are both multilateral institutions that play key roles in global economic policy:

- **The WTO**

The WTO is responsible for determining international trade rules. It was founded in 1995 to expand on the General Agreement on Tariffs and Trade (GATT).

- **The IMF**

The IMF supports economic policies that promote monetary collaboration and economic stability. It also issues Special Drawing Rights (SDRs), an international reserve asset that member countries can voluntarily exchange for currencies.

The WTO and IMF cooperate in several ways, including:

- **Mutual participation**

The WTO and IMF participate in each other's governance, which allows for the exchange of information on macroeconomic trade-related issues.

- **Regular consultations**

The WTO and IMF regularly hold informal consultations and workshops to discuss trade policy and global economic development.

- **Policy advice**

The IMF provides policy advice to countries on trade and trade policy.

- **Cooperation with other organizations**

The IMF prioritizes cooperation with other international organizations, especially the WTO.

The WTO and IMF are part of a group of multilateral institutions that also includes the World Bank. These institutions have agreements that mandate cooperation and regular consultation to promote coherence in global economic policy-making.

Objectives of WTO and IMF

The Fund's primary goal is to create worldwide monetary collaboration among its diverse members by creating a permanent institution that offers the tools for collaboration and consultation on various global monetary topics and difficulties.

Check Your Progress – Quiz – 1

Q1. Which of the following is not the objective of the IMF?

(a) To promote international monetary cooperation

(b) To ensure balanced international trade

(c) To ensure exchange rate stability

(d) To provide loan to private sectors

Q2. Which of the following statement is NOT correct about the quota at the IMF?

(a) Voting power in the IMF is based on a quota system

(b) USA has highest quota in the IMF

(c) Germany has third highest quota in the IMF

(d) Indian quota in the IMF stands at 2.79% of the total quotal quota

Q3. If the Balance of Payment of a country is adverse, then which institution will help that country?

(a) World Bank

(b) World Trade Organization

(c) International Monetary Fund

(d) Asian Development Bank

Q4. Which of the following currency is not included in the calculation of SDR value?

(a) Yen

(b) Yuan

(c) Rupee

(d) Pound sterling

Q5. Which of the following is known as the Paper Gold?

(a) US Dollar

(b) Pound

(c) Demand draft

(d) Special Drawing Right

Q6. The price of one country's currency in terms of another country's currency is known as what?

(a) The exchange rate

(b) The adjustment index

(c) Capital rate

(d) Interest rate

Q7. The Bretton Woods Agreement spawned two new institutions - what were they?

(a) The United Nations and the North Atlantic Treaty Organization

(b) The International Monetary Fund and the International Bank for Reconstruction and Development

(c) The United Nations and the World Financial League

(d) The World Trade Organization and the Trans-Pacific Partnership

Answer Key:	Q1. D	Q2. C	Q3. C	Q4. C	Q5. D	Q6. A	Q7. B

SECTION-4.2 SDR, WORLD BANK AND UNCTAD

4.2.1 Special Drawing Right (SDR)

- The Special Drawing Right (SDR) is an interest-bearing international reserve asset introduced by the International Monetary Fund (IMF) in 1969 to augment member nations' other reserve assets. The SDR is based on a basket of foreign currencies that includes the US dollar, Japanese yen, euro, British pound, and Chinese renminbi. It is neither a currency nor a claim on the IMF, although it may constitute a claim on IMF members' freely usable currencies.

4.2.2 Background of SDR

- The IMF first introduced special drawing powers in 1969. In the context of the Bretton Woods fixed exchange rate regime, the SDR was formed as a supplemental international reserve asset.
- The Bretton Woods system's demise in 1973, as well as the transition of major currencies to variable exchange rate regimes, reduced reliance on the SDR as a worldwide reserve asset.
- Nonetheless, as was the case during the global financial crisis, SDR allocations can play a role in providing liquidity and boosting member nations' official reserves.

4.2.3 India's Current Quota in the IMF

- India's current quota in the IMF stands at SDR 13,114.4 million. This makes it the 13th largest quota holder among the 190 member countries.
- This translates to a 2.75% voting share. This grants India a slightly stronger voice in IMF decisions compared to many developing nations.

4.2.4 Significance of Quota

- A larger quota signifies a country's economic weight and contribution to the IMF's resources.
- It determines the maximum financial help a country can borrow from the IMF in times of crisis. This directly impacts its access to emergency funds.
- Higher quotas also translate to greater voting power on IMF decisions, influencing matters like quota allocations, lending policies, and global economic governance.

4.2.5 Weightage of Basket Currencies in Special Drawing Rights (SDR)

- The International Monetary Fund (IMF) determines SDR value using a basket of currencies, and the weightage given to various baskets of currencies fluctuates depending on their significance in international commerce and the individual nation's foreign exchange reserves.
- The currency weightages are listed below.
  - British Pound – 8.09%
  - Japanese Yen – 8.33%

  - Chinese Yuan – Around 11%
  - Euro – Around 31%
  - US Dollar – Around 41.73%
  - International Treaties – Special Dr
- The IMF and other international organisations use the SDR as their accounting unit.
- SDR is a prospective claim on IMF members' freely usable currencies, which is neither a currency nor an IMF claim and can be converted into SDRs.

4.2.6 Purpose of Special Drawing Rights

- The primary goal of introducing SDRs at the time was to utilize them as a supplemental foreign currency reserve.
- This was owing to a scarcity of US dollars and gold, which were the primary assets kept in foreign currency reserves at the time.
- The SDR was created to be used under the Bretton Woods fixed exchange rate regime and was worth one US dollar or 0.888671 grams of gold at the time.
- Following the collapse of this system in 1973, the SDR was replaced by a basket of major currencies.
- SDRs continue to serve their initial role as a complement to foreign currency reserves, albeit to a lesser extent since 1973. When the US dollar becomes weak or unappealing, countries may choose special drawing privileges.
- One of the primary functions of SDRs is to serve as a unit of account for the IMF's internal accounting.
- The IMF can regulate the exchange rate volatility of any particular currency by holding this basket of key currencies.
- Countries have also linked their currencies to the SDR in order to improve transparency.

4.2.7 How does the SDR market work?

- The SDR market has been totally voluntary for more than three decades.
- Several Fund members, as well as one prescribed SDR holder, have consented to buy and sell SDRs on a voluntary basis.
- The Fund facilitates transactions between members who wish to sell or buy SDRs and the counterparties to the voluntary agreements that, in effect, constitute an SDR market.
- Participants in the SDR department may also engage in bilateral transactions among themselves or with designated holders under the supervision of the Fund.
- If there aren't enough willing purchasers of SDRs, the IMF can designate members with strong balance-of-payments positions to supply freely usable currency in return for SDRs.
- This "designation method" assures that a member can utilize its SDRs to easily receive an equal quantity of currency if it has a need for such a currency due to its balance of payments, reserve position, or reserve developments.
- Since 1987, the designation mechanism has been deactivated.

4.2.8 SDRs for COVID-19 relief

- As the pandemic caused havoc on both developed and developing nations' budgets, the IMF rushed to address the global economic system's liquidity deficiencies and to provide financing for several countries.
- The IMF eventually distributed Special Drawing Rights (SDRs) worth US$ 650 billion to its member nations in order to channel additional cash to countries in need.
- Countries that receive SDRs can either keep them as currency reserves or swap them for real currency, which they can then use for a variety of fiscal objectives, including subsidizing vaccine imports.
- The IMF's own facilities, such as the Poverty Reduction and Growth Trust (PRGT) or a yet-to-be-established Resilience and Sustainability Trust (RST),

and Multilateral Development Banks are logical conduits for repurposing SDRs because they are subscribed' holders and may receive payments in SDRs.

4.2.9 Challenge of Reallocating Special Drawing Rights

- SDRs are a technique for sharing reserves. They aren't money in the usual sense because they can't be used to buy anything genuine.
- They are, however, a financial asset that may be used as a means of exchange between sovereign states.
- There has been widespread and outspoken opposition to the strategy proposed by the IMF and high-income economies for SDR channeling.
- A further issue that has developed is that numerous high-income nations aim to treat their on-lending of SDRs to the IMF and MDBs as assistance obligations, which will likely lead to a reduction in other areas of aid expenditure.
- More global reserves denominated in SDRs would minimise exchange rate volatility among the major reserve currencies principally by reducing possible government demand movements among those currencies.

4.2.10 World Bank

THE WORLD BANK

- **World Bank**, international organization affiliated with the United Nations (UN) and designed to finance projects that enhance the economic development of member states. Headquartered in Washington, D.C., the bank is the largest source of financial assistance to developing countries. It also provides technical assistance and policy advice and supervises—on behalf of international creditors—the implementation of free-market reforms. Together with the International Monetary Fund (IMF) and the World Trade Organization, it plays a central role in overseeing economic policy and reforming public institutions in developing countries and defining the global macroeconomic agenda.

4.2.11 Origins of World Bank

- Founded in 1944 at the UN Monetary and Financial Conference (commonly known as the Bretton Woods Conference), which was convened to establish a new, post-World War II international economic system, the World Bank officially began operations in June 1946. Its first loans were geared toward the postwar reconstruction of Western Europe. Beginning in the mid-1950s, it played a major role in financing investments in infrastructural projects in developing countries, including roads, hydroelectric dams, water and sewage facilities, maritime ports, and airports.
- The World Bank Group comprises five constituent institutions: the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID). The IBRD provides loans at market rates of interest to middle-income developing countries and creditworthy lower-income countries. The IDA, founded in 1960, provides interest-free long-term loans, technical assistance, and policy advice to low-income developing countries in areas such as health, education, and rural development. Whereas the IBRD raises most of its funds on the world's capital markets, the IDA's lending operations are financed through contributions from developed countries.
- The IFC, operating in partnership with private investors, provides loans and loan guarantees and equity financing to business undertakings in developing countries. Loan guarantees and insurance to foreign investors against loss caused by noncommercial risks in developing countries are provided by the

MIGA. Finally, the ICSID, which operates independently of the IBRD, is responsible for the settlement by conciliation or arbitration of investment disputes between foreign investors and their host developing countries.

- From 1968 to 1981 the president of the World Bank was former U.S. secretary of defense Robert S. McNamara. Under his leadership the bank formulated the concept of “sustainable development,” which attempted to reconcile economic growth and environmental protection in developing countries. Another feature of the concept was its use of capital flows (in the form of development assistance and foreign investment) to developing countries as a means of narrowing the income gap between rich and poor countries. The bank has expanded its lending activities and, with its numerous research and policy divisions, has developed into a powerful and authoritative intergovernmental body.

4.2.12 Organization of World Bank

- The World Bank is related to the UN, though it is not accountable either to the General Assembly or to the Security Council. Each of the bank’s more than 180 member states are represented on the board of governors, which meets once a year. The governors are usually their countries’ finance ministers or central bank governors. Although the board of governors has some influence on IBRD policies, actual decision-making power is wielded largely by the bank’s 25 executive directors.
- Five major countries — the united States, Japan, Germany, the United Kingdom, and France — appoint their own executive directors. The other countries are grouped into regions, each of which elects one executive director. Throughout the World Bank’s history, the bank president, who serves as chairman of the Executive Board, has been an American citizen.
- Voting power is based on a country’s capital subscription, which is based in turn on its economic resources. The wealthier and more developed countries constitute the bank’s major shareholders and thus exercise greater power and influence. For example, in the early 21st century the United States exercised nearly one-sixth of the votes in the IBRD, more than double that of Japan, the second largest contributor. Because developing countries hold

only a small number of votes, the system does not provide a significant voice for these countries, which are the primary recipients of World Bank loans and policy advice.

- The bank obtains its funds from the capital subscriptions of member countries, bond flotations on the world's capital markets, and net earnings accrued from interest payments on IBRD and IFC loans. Approximately one-tenth of the subscribed capital is paid directly to the bank, with the remainder subject to call if required to meet obligations.
- The World Bank is staffed by more than 10,000 people, roughly one-fourth of whom are posted in developing countries. The bank has more than 100 offices in member countries, and in many countries staff members serve directly as policy advisers to the ministry of finance and other ministries. The bank has consultative as well as informal ties with the world's financial markets and institutions and maintains links with nongovernmental organizations in both developed and developing countries.

4.2.13 Debt and policy reform

- The debt crisis of the early 1980s—during which many developing countries were unable to service their external debt to multilateral lending institutions, because of a slowdown in the world economy, high interest rates, a decline in commodity prices, and wide fluctuations in oil prices, among other factors—played a crucial role in the evolution of World Bank operations.
- The bank had become increasingly involved in shaping economic and social policies in indebted developing countries. As a condition of receiving loans, borrowing countries were required to implement stringent "structural adjustment programs," which typically included severe cuts in spending for health and education, the elimination of price controls, the liberalization of trade, the deregulation of the financial sector, and the privatization of state-run enterprises.
- Although intended to restore economic stability, these programs, which were applied in a large number of countries throughout the developing world, frequently resulted in increased levels of poverty, mounting unemployment, and a spiraling external debt.

- In the wake of the debt crisis, the World Bank focused its efforts on providing financial assistance in the form of balance-of-payments support and loans for infrastructural projects such as roads, port facilities, schools, and hospitals. Although emphasizing poverty alleviation and debt relief for the world's least developed countries, the bank has retained its commitment to economic stabilization policies that require the implementation of austerity measures by recipient countries.
- The World Bank and the IMF played central roles in overseeing free-market reforms in eastern and central Europe after the fall of communism there in the 1980s and '90s. The reforms, which included the creation of bankruptcy and privatization programs, were controversial because they frequently led to the closure of state-run industrial enterprises. "Exit mechanisms" to allow for the liquidation of so-called "problem enterprises" were put into place, and labour laws were modified to enable enterprises to lay off unneeded workers. The larger state enterprises often were sold to foreign investors or divided into smaller, privately owned companies.
- In Hungary, for example, some 17,000 businesses were liquidated and 5,000 reorganized in 1992–93, leading to a substantial increase in unemployment. The World Bank also provided reconstruction loans to countries that suffered internal conflicts or other crises (e.g., the successor republics of former Yugoslavia in the late 1990s). This financial assistance did not succeed in rehabilitating productive infrastructure, however. In several countries the macroeconomic reforms resulted in increased inflation and a marked decline in the standard of living.
- The World Bank is the world's largest multilateral creditor institution, and as such many of the world's poorest countries owe it large sums of money. Indeed, for dozens of the most heavily indebted poor countries, the largest part of their external debt—in some cases constituting more than 50 percent—is owed to the World Bank and the multilateral regional development banks. According to some analysts, the burden of these debts—which according to the bank's statutes cannot be canceled or rescheduled—has perpetuated economic stagnation throughout the developing world.

4.2.14 Organization associated with the World Bank

The World Bank Group consists of five international organizations that provide financing to developing countries. They are:

1. The International Bank for Reconstruction and Development (IBRD)
2. The International Development Association (IDA)
3. The International Finance Corporation (IFC)
4. The Multilateral Investment Guarantee Agency (MIGA)
5. The International Centre for Settlement of Investment Disputes (ICSID).

IBRD and IDA are sometimes collectively referred to as the World Bank. The IBRD has 189 member countries and the IDA has 173 member countries.

4.2.15 Objectives of World Bank

- Providing member countries with long-term capital for economic reconstruction and development
- Inducing long-term capital investment to ensure a balanced development of BOP balance and international trade.
- Promote capital investment in member countries in the following ways.

1. To provide a guarantee on capital investment or private loans.
2. If capital is not available even after the guarantee has been provided, IBRD will provide credit for production activities on favourable terms.

- Ensuring the implementation of development projects to bring about a smooth transition from wartime to a peaceful economy.

4.2.16 Function of the World Bank

- The World Bank supports countries devastated by the war by providing loans for reconstruction.
- They provide a wealth of experience and the World Bank's financial resources help poor countries promote economic growth, reduce poverty and achieve better living standards.
- They also support developing countries by providing development loans.
- The World Bank also lends to various governments for irrigation, agriculture, water supply, health and education.
- Encourage foreign investment in other organizations by guaranteeing loans.

- The World Bank also provides member countries with financial, financial and technical advice on all projects.
- In this way, by introducing various economic reforms, we are promoting the development of industries in developing countries.

4.2.18 World Bank CEO

- David R. Malpass was elected by the Board of Directors on April 5, 2019 as the 13th President of the World Bank Group. His five-year term began on April 9.
- Previously, Mr. Malpass was Deputy Secretary of the US Treasury. Mr. Malpas is the G7 and G20 Deputy Finance Ministers, the World Bank-IMF Spring and Annual Meetings, the Financial Stability Board, the Organization for Economic Co-operation and Development, and the Foreign Private Investment Group.
- Mr. Malpass pushed for a capital boost for the IBRD and IFC in 2018 as part of a reform programme that included sustainable lending methods, more effective capital management, and a focus on improving living standards in disadvantaged nations. He was also a driving force behind the Bank Group and IMF's Debt Transparency Initiative, which aims to boost public financial disclosure and hence lessen the frequency and severity of debt crises.

4.2.19 United Nations Conference on Trade and Development (UNCTAD)

- The United Nations Conference on Trade and Development (UNCTAD) is the United Nations' key point for trade and development and for interlinked issues in the areas of finance, technology, investment and sustainable development.
- Its goal is to support the developing countries, particularly the least developed countries and countries with their economies in transition, to integrate profitably into the global economy.
- It also seeks to assist the global community to stimulate a global partnership for development, boost coherence or consistency in the global economic policy creation and guarantee development gains for all from trade.

- UNCTAD carries out ahead-of-the-curve study and analysis on both long-standing and rising development issues.
- It structures the consensus around efforts to foster national and international policies and approaches favorable to development and assists countries in enforcing their development strategies.
- The specific work stream of UNCTAD comprises:
    - contributing to the global debate on globalization and the handling of its after-effects for developing countries;
    - seeking to make consensus, enhance capacity and encourage partnerships for trade policy, trade dealings, trade in goods and services, competition law and protection of consumers and managing issues occurring at the intersection of trade, environment and climate change
    - providing international expertise in research and policy scrutiny, inter-governmental consensus-structuring, providing technical assistance with regards to investment and enterprise and
    - Improving economic growth and competitiveness in developing countries in the areas of science, technology and innovation, trade logistics and development of human resources.

4.2.20 Formation of United Nations Conference on Trade and Development (UNCTAD)

- The United Nations Conference on Trade and Development (UNCTAD) was constituted in 1964 as a permanent intergovernmental body.
- UNCTAD is a part of the United Nations Secretariat that deals with issues pertaining to trade, investment and development.
- UNCTAD reports to the UN General Assembly and United Nations Economic and Social Council (ECOSOC).
- At present, UNCTAD has 195 member states and is headquartered in Geneva, Switzerland.

4.2.21 Functions of the United Nations Conference on Trade and Development (UNCTAD)

The major functions of the UNCTAD have been listed below:

1. To foster global trade between the developed and under-developed countries that have varied socio-economic organizations with special importance to the rapid growth of the under-developed countries.
2. To devise the principles and policies related to international trade and problems linked to economic development.
3. To make proposals for putting the said principles and policies into practice and to adopt measures that may be appropriate in this regard.
4. To normally evaluate and enable the coordination of activities of other establishments within the fold of the United Nations in relation to international trade and economic development.
5. To be accessible as a center for harmonized trade-related policies of governments and the regional economic groupings in execution of Article 7 of the Charter of the United Nations.

4.2.22 UNCTAD Objectives

Framing policies in various domains such as trade, technology, finance, aid, and transport is the most important priority of UNCTAD. Geneva is the permanent secretariat of UNCTAD and the conference ordinarily meets once in four years.

UNCTAD collects data and conducts research and analyses policies.

UNCTAD, with its work in the national and global levels, aims to help countries to:

1. Understand options to address macro-level development challenges.
2. Acquire beneficial integration into the international trading system.
3. Reduce the dependency on commodities by diversifying the economies.
4. Decrease their exposure to debt and financial volatility.
5. Increase development-friendliness by attracting more investments.
6. Increase technologies related to the digital domain.
7. Give more thrust to innovation and entrepreneurship.
8. Aid local firms to move up value chains.
9. Facilitate the flow of goods across borders.

10. Prevent consumer abuse.
11. Competition should not be stifled, hence any concerned regulations would be cross-checked.
12. Effectively utilize natural resources that would help in adapting to climate change.

4.2.23 Difference between IMF and World Bank

IMF	World Bank
Has a single institution structure.	Consists of two institutions: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).
190 member countries (as of 2021).	189 member countries (as of 2021).
Founded to avoid repetitive economic crises.	Founded to finance reconstruction after World War II.
Provides financial support during balance of payments crises.	Provides financial and technical assistance to developing nations.
Focused on global economic monitoring.	Focused on capacity building and knowledge sharing.
Member countries have quota-based voting power.	Voting power is based on financial contribution.
Aims to maintain financial stability.	Aims to promote sustainable development.
Assistance usually tied to policy reform.	Funding typically tied to specific projects.
Provides short-term loans.	Provides long-term loans and grants.
Primarily focused on macroeconomic issues.	Primarily focused on poverty reduction.

4.2.24 How Do IMF and World Bank Achieve Their Objectives?

- The IMF and World Bank, while distinct, work together in many ways to achieve their objectives. The IMF focuses on providing policy advice and financial assistance to countries in economic turmoil, thereby fostering global economic stability. It supports its member nations by offering resources and expertise to promote economic growth and sustainability.

- On the other hand, the World Bank goes directly into the heart of developing nations, offering financial support for projects that directly enhance socio-economic conditions. By funding projects in sectors like education, healthcare, and infrastructure, it aims to help developing nations transition into developed ones.

4.2.24 The Governance Structure of IMF and World Bank

- Each of these global financial institutions operates under its distinct governance structure, embodying the ethos and goals of their founding charters.

International Monetary Fund (IMF)

- The IMF operates under a quota system. Member countries are assigned quotas reflecting their relative position in the global economy. This quota system affects their financial contributions, voting power, and borrowing capability. The main components of the IMF's governance include:
- **Board of Governors**: Each member country appoints a governor, usually the finance minister or central bank head. The Board usually meets once a year.
- **Executive Board**: The Executive Board is responsible for conducting the day-to-day business of the IMF. It is composed of 24 directors, who are appointed or elected by member countries or by groups of countries.
- **Managing Director**: The managing director is the head of the IMF staff and chair of the Executive Board and is appointed by the Executive Board.

World Bank

- The World Bank is made up of two institutions: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Its governance structure includes:
- **Board of Governors**: These are typically the finance ministers or central bank governors of the member countries. The Board meets once a year.

- **Board of Executive Directors**: The 25 Executive Directors make up the Board, which discusses new policies, decides on the loan, and approves the World Bank's budget.
- **President**: The President of the World Bank is elected by the Board of Executive Directors and is responsible for chairing the meetings of the Board and the overall management of the World Bank.

4.2.26 The Roles of IMF and World Bank in Developing Countries

- The IMF and World Bank play pivotal roles in developing countries. Although their methodologies and focal points differ, they collectively aim to uplift economies and better the lives of citizens in these countries.

IMF's Role in Developing Countries:

- Financial assistance during balance of payments crises.
- Technical assistance and training to enhance the economic management capabilities of these countries.
- Policy advice to maintain macroeconomic stability.

World Bank's Role in Developing Countries:

- Financial and technical assistance for development projects, such as infrastructure, education, healthcare, and agriculture.
- Knowledge sharing and capacity building initiatives to help countries improve governance and economic management.
- Strategic advice and financial products to help manage diverse types of risk.

4.1.46 Impacts of IMF and World Bank Policies on Member Countries

- While both organizations have noble mandates, their policies can have different impacts on member countries:

Effects of IMF Policies

Check out the positive and negative impact of IMF Policies:

Positive Impacts:

- The IMF's policy advice and financial assistance can help countries overcome economic crises, stabilize their economies, and restore growth.
- The IMF's capacity development efforts can help countries improve their economic management.

Critiques:

- Critics argue that the conditionality of IMF loans can lead to austerity measures, affecting social spending in areas such as education and health.
- Some argue that the IMF's policy recommendations may not always suit the specific circumstances of individual countries.

Effects of World Bank Policies

Here are the positive and negative impacts of World Bank policies.

Positive Impacts:

- World Bank projects have helped many countries make significant strides in areas such as health, education, and infrastructure.
- Its technical assistance and knowledge sharing can help countries improve their development strategies.

Critiques:

- Some critics argue that the World Bank's project-based approach may not sufficiently consider the broader economic and social context of a country.
- There are concerns about the environmental and social impacts of some World Bank-funded projects.

Check Your Progress – Quiz – 1

Q1. How many member countries are there in World Bank now?

a. 200

b. 250

c. 189

d.180

Q2. Which of the following is the basic objective of World Bank?

a. To provide social service

b. To eradicate poverty

c. To provide financial institution

Q3. World Bank Headquarters located at:

a. Paris

b. Washington DC

c. New York

d. India

Q4. Which among the following is considered as an important power of World Bank?

a. World Bank has right to insist on pegged parities

b. World Bank has right to float Bonds and use the proceeds for loans

c. World Bank has right to buy gold below current Gold prices

d. All are correct

Q5. Which among the following helps to solve the balance of payments problem of member countries?

a. World Bank

b. International Development Fund

c. Asian Development Bank

d. World Economic Forum

Answer Key:	**Q1. C**	**Q2. B**	**Q3. B**	**Q4. B**	**Q5. B**

4.3 Unit Summary

SDR is short for Special Drawing Rights, which is a unique form of currency used by the International Monetary Fund.

The World Bank is an international organization that provides financial assistance, technical advice, and policy guidance to developing countries. Its main goals are to reduce poverty, promote sustainable development, and increase shared prosperity.

- **Lending**

The World Bank lends money to governments of poorer member countries to improve their economies and the standard of living for their people.

- **Technical assistance**

The World Bank provides technical assistance to help countries apply innovative knowledge and solutions to their challenges.

- **Policy advice**

The World Bank provides policy advice to help countries reform public institutions and oversee economic policy.

- **Free-market reforms**

The World Bank supervises the implementation of free-market reforms on behalf of international creditors.

- **Private sector**

The World Bank works to create new opportunities for the private sector and build partnerships.

The World Bank is headquartered in Washington, D.C. and is affiliated with the United Nations. It works with the International Monetary Fund (IMF) and the World Trade Organization to define the global macroeconomic agenda.

4.4 Glossary

Adjusted Rate of Remuneration Rate used to pay interest (remuneration) to members on their remunerated reserve tranche position with the IMF.

Adjusted Rate of Charge Rate applied to charge members on their outstanding credit to the IMF.

Agreed Amount: Agreed Amount represents the maximum amount available for drawing under an arrangement approved by the IMF's Executive Board.

Average SDR Interest Rate: Average of the weekly rates calculated at the end of each financial quarter for that quarter.

Deferred Charges Adjustments (Charges): Refundable resources collected on a quarterly basis from members with credit outstanding by adding an upward adjustment to the rate of charge. The purpose of these resources is to cover unpaid charges of members in arrears. Once members in arrears settle their charges, these resources are refunded to contributors.

Deferred Charges: Adjustments (Remuneration) Refundable resources collected on a quarterly basis from members receiving remuneration by adding a downward adjustment to the rate of remuneration. The purpose of these resources is to cover unpaid charges of members in arrears. Once members in arrears settle their charges, these resources are refunded to contributors. See Burden Sharing.

Drawn Amount: The Drawn Amount represents the cumulative amounts disbursed under an arrangement.

Net SDR Charges: The SDR Department pays interest on holdings of SDRs and levies charges on the cumulative allocation of SDRs to participants (all IMF members are participants) at the same interest rate. Participants whose holdings are below their cumulative holdings incur net charges, i.e., the charges net of the interest. Both SDR interest and charges accrue daily and are settled quarterly.

New Arrangements to Borrow (NAB): The New Arrangements to Borrow (NAB) is a standing set of credit arrangements under which the participants (member countries and institutions) commit to provide supplementary resources to the IMF when these are needed to forestall or cope with an impairment of the international monetary system. The NAB is the facility of first and principal recourse in circumstances in which the IMF needs to supplement its quota resources.

Notes Purchase Agreements (NPA): To supplement its capacity to provide finance assistance to its members, the IMF issues promissory notes to the official sector under the Notes Purchase Agreements (NPA). The NPA includes a limit on the total amount that can be purchased during the term of the NPA. Notes are issued at the time of a loan disbursement to a borrowing member.

4.5 Self-Assessment Questions

5 Marks

1. What is IMF? State the **evolution of IMF**.
2. Brief on **Special Drawing Right.**
3. How does the SDR market work and explain SDRs during COVID-19 relief?
4. Explain the objectives and functions of World Bank.
5. Brief on Formation of UNCTAD and its functions.
6. State on Bretton Woods Conference & the Birth of the IMF and World Bank

10 Marks

1. Explain difference between IMF and World Bank.
2. How do IMF and World Bank Achieve their objectives?
3. IMF and India: What is the Scenario?
4. What is the impacts of IMF and World Bank policies on member countries?
5. Enumerate the advantages & disadvantages of International Monetary System.

4.6 Case Studies

Case Study: 1

A Holistic Approach to Strengthen Macroeconomic Capacity in Myanmar after Decades of Isolation

THE CHALLENGE

To support its reform and opening-up efforts, Myanmar needed to significantly boost its capacity in macroeconomic management, essential for maintaining macroeconomic stability and achieving sustainable, inclusive growth.

THE APPROACH

After careful reviews of Myanmar's needs and constraints, the IMF developed holistic capacity development programs, including training, largely funded by Japan, the European Union, and other development partners, targeting the most critical areas of reform.

IMPACT

Myanmar has reformed its central bank and foreign exchange market, developed monetary policy tools, set up a large taxpayer office, began modernizing tax collection and expenditure management, strengthened the anti-money laundering regime, established a macroeconomic monitoring group, and built a statistics program, including a redesigned consumer price index. With these and many other reforms, Myanmar has managed to lower inflation, boost financial access, increase government revenue, and achieve strong economic growth since 2011.

Case Study: 2

Reining in Risk with Georgia's Central Bank to Enhance Financial Stability

Since 2014, Georgia has been forced to deal with large and persistent external challenges to its economic stability, including pressure on its currency as well as lower global oil and commodity prices, which have undercut Georgia's export receipts.

Under these circumstance, the National Bank of Georgia (NBG) has undertaken a number of reforms, making real progress in improving its operations and governance in recent years, drawing upon advice from the IMF and other central banks. In April 2015, Georgia collaborated with a technical assistance team from the IMF's monetary and capital markets, legal, and finance departments, with the specific aim of helping Georgia's authorities strengthen its central bank's financial reporting and risk management work.

The technical assistance project focused on several areas in which Georgia's central bank could contribute to greater financial stability. The IMF team's recommendations grew out of interviews with management and staff and then were conveyed to the NBG via presentations on theory and in-depth interactive workshops with operational staff.

First, the team helped the NBG initiate a stronger, more-clearly defined set of risk management policies in line with international standards and best practices. This entailed guiding the NBG to improve its risk culture by raising risk awareness throughout the organization. The team also identified the need to develop further risk appetite analyses and finalize ongoing work on tools, such as its risk taxonomy and registry as well as a centralized incident register.

These policies and procedures rely on accurate and timely financial reporting. To this end, the IMF team helped develop an improved management information system, and suggested ways to better integrate strategic considerations into the yearly budget process.

Some other outcomes from this successful collaboration included the NBG joining the International Operational Risk Working Group, which consists of more than 60 central banks around the world that share best practices on risk management. The mission also helped establish an ongoing dialogue between Georgia's and the Netherlands' central banks, with the Netherlands providing follow-up technical assistance to Georgia. The fruits of the collaboration have enhanced the NBG's reputation as a governance role model for other central banks in and outside of the region. In the end, strengthening the NBG's internal organization set the tone for governance of the financial sector as a whole, and strengthened its stewardship of Georgian financial stability.

4.7 Reference and Suggested Readings

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UNIT-V WORLD TRADE ORGANIZATION AND GENERAL AGREEMENT ON TRADE IN SERVICES

World Trade Organization (WTO)–Functions and Objectives–Agricultural Agreements–GATS -TRIPS – TRIMS.

WORLD TRADE ORGANIZATION AND GENERAL AGREEMENT ON TRADE IN SERVICES

UNIT OBJECTIVES

The overall objective of the WTO is to help its members use trade as a means to raise living standards, create jobs and improve people's lives. The WTO operates the global system of trade rules and helps developing countries build their trade capacity.

5.1.1 World Trade Organization (WTO)

- Created in 1995, the World Trade Organization (WTO) is an international institution that oversees the rules for global trade among nations. It superseded the 1947 General Agreement on Tariffs and Trade (GATT) created in the wake of World War II.
- The WTO is based on agreements signed by a majority of the world's trading nations. The main function of the organization is to help producers of goods and services, as well as exporters and importers, protect and manage their businesses.
- As of 2021, the WTO has 164 member countries, with Liberia and Afghanistan the most recent members, having joined in July 2016, and 25 "observer" countries and governments.

KEY TAKEAWAYS

- The World Trade Organization (WTO) oversees global trade rules among nations and mediates disputes.

- The WTO has been a force for globalization, with both positive and negative effects.
- Big businesses tend to support the WTO for its positive impact on international economic growth.
- Skeptics see it as increasing the wealth gap and hurting local workers and communities.

5.1.2 Understanding the World Trade Organization (WTO)

- The WTO is essentially an alternative dispute or mediation entity that upholds the international rules of trade among nations. The organization provides a platform that allows member governments to negotiate and resolve trade issues with other members. The WTO's main focus is to provide open lines of communication concerning trade among its members.
- The WTO has lowered trade barriers and increased trade among member countries. It also has also maintained trade barriers when it makes sense to do so in the global context. The WTO attempts to mediate between nations in order to benefit the global economy.
- Once negotiations are complete and an agreement is in place, the WTO offers to interpret the agreement in case of a future dispute. All WTO agreements include a settlement process that allows it to conduct neutral conflict resolution.

5.1.3 History of WTO

- With the end of World War II, plans were laid to create a third institution, '**The International Trade Organization (ITO)**', to handle the trade side of international economic cooperation, joining the two "Bretton Woods" institutions, the World Bank and the International Monetary Fund.
- The aim was to create the ITO at a UN Conference on Trade and Employment in Havana, Cuba in 1947.
- Meanwhile, 23 countries began talks to reduce and bind customs tariffs. This first round of negotiations resulted in a package of trade rules and several tariff concessions. These came into effect by 30 June 1948 through a "**Protocol of Provisional Application**". And so the new General Agreement on Tariffs and Trade was born, with 23 founding member.

- From 1948 to 1994, the **General Agreement on Tariffs and Trade (GATT)** provided the rules for much of world trade. However, it was a provisional agreement and organization.
- The Havana conference began soon after GATT was signed. The ITO Charter was finally agreed, but was never ratified due to opposition from US Congress.
- As the GATT was provisional with a limited field of action, member countries were convinced that a new effort to reinforce and extend the multilateral system should be attempted. That effort resulted in the **Uruguay Round, the Marrakesh Declaration**, and the creation of the WTO.
- **Uruguay Rounds (1986-1994):**
    - The seeds of the Uruguay Round were sown in 1982 at a ministerial meeting of GATT members in Geneva.
    - It is the biggest negotiating mandate on trade ever agreed. It extended into several new areas, such as services and intellectual property, and reformed trade in the sensitive sectors of agriculture and textiles.
    - The Final Act concluding the Uruguay Round and officially establishing the WTO regime was signed 15 April 1994, during the ministerial meeting at Marrakesh, Morocco, and hence is known as the Marrakesh Agreement.
- The WTO replaced GATT as an international organization, but the General Agreement still exists as the WTO's umbrella treaty for trade in goods.

5.1.4 WTO Leadership

- On Feb. 15, 2021, the WTO's General Council selected two-time Nigerian finance minister Ngozi Okonjo-Iweala as its director-general. She is the first woman and the first African to be selected for the position. She took office on March 1, 2021, for a four-year term.
- No negotiation, mediation, or resolution would be possible without the foundational WTO agreements. These agreements set the legal ground-rules for international commerce that the WTO oversees. They bind a country's government to a set of constraints that must be observed when setting future trade policies.

- The agreements protect producers, importers, and exporters while encouraging world governments to meet specific social and environmental standards.

5.1.5 Functions of WTO

The overriding objective of the WTO is to help international trade flow as freely as possible while also making it predictable. To achieve this objective, it carries out several functions which serve to reach the ultimate objective of providing common institutional framework for the conduct of trade relations among its member countries.

Function 1

- WTO is a system based on rules. Its trade rules consist of approximately 60 agreements covering different areas of trade in goods, customs, agriculture, quality infrastructure, services, intellectual property rights etc. Having rules without implementation would not help. Thus, implementation of these multilaterally agreed rules is vital to assure the proper functioning of the system.

These functions of the WTO can be summed up as follows:

1. Administering WTO agreements
2. Providing a forum for trade negotiations
3. Handling trade disputes
4. Monitoring national trade policies
5. Providing technical assistance for developing countries
6. Cooperating with other international organizations

- With this in mind, WTO facilitates the implementation, administration, and operation of the multilateral trade agreements while furthering the objectives of such agreements. The WTO also provides the framework for the implementation, administration and operation of the plurilateral agreements to which only a handful of WTO members are parties.

Function 2

- WTO was established as a result of negotiations and everything it does is the result of negotiations.
- As a member driven organization, it is the members who decide for the WTO on different questions through negotiations. WTO provides for a forum where Members go and try to solve the trade problems they encounter with one another. These problems can be related to issues covered by already existing agreements or issues not addressed yet in the WTO.
- Although it covers a great deal of trade-related matters, there are issues that agreement could not be achieved at the time of WTO's establishment or new issues that came up since the establishment. Thus, it is logical that WTO also provides for further negotiations with a view to expanding the multilateral trading system and adapting it to the new realities.

Function 3

- Imagine a system based on rules without an appropriate enforcement mechanism. Would such a system be effective and respected by the members? The answer is most probably, not. Therefore, the dispute settlement mechanism is an essential part of the WTO as it ensures that the trade rules are respected and it guarantees the security and predictability to the multilateral trading system.
- The achievements of the WTO dispute settlement mechanism have been celebrated for years by the members making it the "crown jewel" of the organization. Needless to say, that it is one of the most active and highly effective state-to-state dispute settlement mechanisms in the world.

Function 4

- Taking commitments in the multilateral level is not the end of story, of course. Members have to follow their multilateral commitments at home.

- The WTO monitors the domestic policies and regulations of the members to make sure that they are in compliance with WTO requirements. The Trade Policy Review Mechanism ("TPRM") exists for this purpose. The function of the TPRM is to examine the impact of a country's trade policies and practices on the multilateral system. The review tries to increase the transparency of Members' trade policies and practices and to improve the quality of public and interstate debate on the trade-related issues. Around 24 countries are reviewed each year.

Function 5

- Not all WTO members are in the same level of development. The organization has highly developed, developing and least-developed country members. Apart from special and differential provisions offering more convenient rules for developing countries and LDCs, WTO also developed several tools, both on its own and in cooperation with other organizations, to support developing and least-developed country members in participating more fully in the global trading system.
- These include different technical assistance and training programs offering human, institutional and infrastructural capacity building to members which are in need of this. The assistance helps developing and least-developed country members to benefit from trade more and achieve economic growth and poverty reduction through trade.

Function 6

- The WTO does not exist in isolation from the international community. It cooperates with international organizations and non-governmental organizations when conducting its activities. To assure coherent and mutually supportive policies in global economic sphere, WTO cooperates with the International Monetary Fund and World Bank.
- In the quality infrastructure, food safety, sanitary and phytosanitary area, the WTO cooperates with several standard-setting international organizations. It is also worth mentioning WTO's cooperation with the United Nations on the achievement of Millennium Development Goals through trade

5.1.6 Foundational Principles

1. **Non-discrimination**: A country should not discriminate between its trading partners and it should not discriminate between its own and foreign products, services or nationals. It has two major components:
   a. **Most Favoured Nation (MFN):** Under the WTO agreements, countries cannot normally discriminate between their trading partners. If they grant some country a special favor (such as a lower customs duty rate for one of their products), then they'll have to do the same for all other WTO members.
   b. **National Treatment policy:** Domestic and foreign goods, services and IP rights must be treated equally once they've entered the market.
2. **Openness**: Lowering trade barriers is one of the most obvious ways of encouraging trade. This barrier includes customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively.
3. **Predictability and transparency**: Foreign companies, investors and governments should be confident that trade barriers should not be raised arbitrarily. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices.
4. **More competitive**: Discouraging 'unfair' practices, such as export subsidies and dumping products at below cost to gain market share; the issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.
5. **More beneficial for less developed countries**: Giving them more time to adjust, greater flexibility and special privileges; over three-quarters of WTO members are developing countries and countries in transition to market economies. The WTO agreements give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions.
6. **Protect the environment**: The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health. However, these measures must be applied in

the same way to both national and foreign businesses. In other words, members must not use environmental protection measures as a means of disguising protectionist policies.

5.1.7 Objectives of WTO

Apart from reducing barriers and promoting trade, the **world trade organization economics** pans out for other facets of global trade too. The objectives of the World Trade Organization are below:

- WTO aims to improve the standard of living of every individual belonging to its member nations.
- WTO aims to ensure a hundred percent employment and a rise in demand for goods and services.
- It aims to enlarge the production and trading of products and services.
- WTO also aims to ensure the full utilization of national and international resources.
- WTO even aims to safeguard the environment from depletion due to human interference.
- It aims to ensure that all companies accept and abide by the concept of sustainable development.
- WTO also aims to implement a new foreign trade mechanism as provided in the Agreement.
- WTO aims to promote international trade that can certainly benefit all countries.
- To remove the existing obstacles present in an open global trading system.
- It even aims to take certain steps towards developing the poorest and underdeveloped countries.
- WTO even aims to enhance competitiveness between all the member countries to benefit the maximum number of customers.

5.1.8 Structure of WTO

- **Council for Trade in Goods:**
    - Forum for discussing issues and decisions which may ultimately require the attention of the General Council and for putting issues in a broader context of the rules and disciplines that apply to trade in goods.

  - There are 12 committees under the jurisdiction of the Goods Council each with a specific task. All members of the WTO participate in the committees.
  - The body has its own chairman and only 10 members.
- **Council for Trade in Services:**
  - Responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS)
- **Council for Trade-Related Aspects of Intellectual Property Rights**
  - Monitors implementation of the TRIPS Agreement, provides a forum in which WTO Members can consult on intellectual property matters, and carries out the specific responsibilities assigned to the Council in the TRIPS Agreement.
- **Trade Negotiations Committee:**
  - The Trade Negotiations Committee (TNC) is the committee that deals with the current trade talks round. The chair is WTO's director-general. Presently, the committee was tasked with the Doha Development Round.
- **The Secretariat** employs over 600 staff and its experts (lawyers, economists, statisticians and communications experts) assist WTO members on a daily basis to ensure that negotiations progress smoothly and that the rules of international trade are correctly applied and enforced.
- **Decisions are taken through consensus** but voting on matters is also possible.

5.1.9 Major Agreements

Over the past 60 years, the WTO and its predecessor organization the GATT have helped to create a strong and prosperous international trading system, thereby contributing to unprecedented global economic growth.

The WTO agreements cover goods, services and intellectual property. They spell out the principles of liberalization, and the permitted exceptions. The current body of trade agreements comprising the WTO consists of 16 different multilateral agreements (to which all WTO members are parties) and two different plurilateral agreements (to which only some WTO members are parties).

5.1.10 General Agreement on Trade in Services (GATS)

- The GATS covers a wide range of service industries such as financial services, transport and shipping, communications, construction, and distribution.
- The definition of services trade under the GATS is four-pronged, depending on the territorial presence of the supplier and the consumer at the time of the transaction:
  - **Mode 1** (Cross border supply): to cover services flows from the territory of one Member into that of another Member.
  - **Mode 2** (Consumption abroad): situations where a service consumer moves into another Member's territory to obtain a service. Eg: Tourism
  - **Mode 3** (Commercial presence): a service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a service. Eg: A Hotel chain
  - **Mode 4** (Presence of natural person)**:** Consists of persons (Eg: Helath professionals) of one Member entering the territory of another Member to supply a service.

5.1.11 Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)

- The most comprehensive multilateral agreement on intellectual property
- The Agreement sets out the minimum standards of protection to be provided by each Member and certain general principles applicable to all IPR enforcement procedures.
- The TRIPS Agreement is based on the main conventions of the World Intellectual Property Organization (WIPO). Most of the provisions of these conventions are incorporated into the TRIPS.
- The areas of intellectual property that it covers are:

- Copyright and related rights (i.e. the rights of performers, producers of sound recordings and broadcasting organizations)
- Trademarks including service marks
- Geographical indications including appellations of origin
- Industrial designs
- Patents including the protection of new varieties of plants
- Layout-designs of integrated circuits
- Undisclosed information including trade secrets and test data.

5.1.12 WTO's Agreement on Agriculture (AoA)

- AoA was negotiated during the **Uruguay Round of trade talks** (1986).
- It was **formally ratified** in **1994** at **Marrakesh**, **Morocco** and **came into effect in 1995**.
- The AoA aims to promote **fair competition**, **reduce trade-distorting subsidies**, and **ensure market access** for agricultural products.
- To achieve this, the AoA includes **explicit commitments** to **decrease support and protection in domestic support**, **export subsidies**, **and increased market access**.
  - The most controversial of all these is the **reduction in domestic food subsidies**.
  - This is also a great concern for India as it would directly affect the livelihoods of a large population.
- The agreement also considers **non-trade concerns** such as **food security** and environmental protection, offering **special treatment for developing countries**.

Three Pillars of the Agreement on Agriculture

Market Access

- Market access commitments, outlined in **Article 4** of the AoA, aim to eliminate and prevent future **non-tariff barriers**.
- The agreement emphasizes **tariffication**, converting non-tariff barriers like quotas into tariffs.
- Non-tariff barriers: Quotas, variable levies, minimum import prices, discretionary licensing, state trading measures, and voluntary restraint agreements.

- **For tariff reduction**, the following commitments must be implemented by the different countries.
- **Developed countries** must reduce total tariffs, **including tariffication**, by an average of 36 per cent over **six years** of implementation of the agreement.
- **Developing countries** need to reduce tariffs by an average of 24 percent over **ten years of implementation of the agreement**.
- **Least developed** countries have **no commitments**.
- **Special treatment**: Some developing countries, which are maintaining **quantitative restrictions** due to **payment balance** problems, were allowed to offer **ceilings** instead of tariffication.

Domestic support

- Domestic support commitment has been covered in **Article 6** of the Agriculture Agreement.
- Domestic support refers to **government subsidies** such as **Minimum Support Price** (MSP) or **Input subsidies**, which are **provided at the domestic level** either directly or product-specific, or both.
- The AoA categorizes domestic support measures into three boxes—**green**, **blue**, **and amber** based on their **trade-distorting nature**.

Green box

- **Subsidies that do not distort trade** or, at most, cause minimal distortion are in this box.
- Usually, these subsidies are not directed at specific products.
- There is **no limit** on governments for giving this kind of subsidies to their farmers.

Amber Box

- The **subsidies that distort international trade** by making products of a particular country cheaper as compared to similar products from another country are slotted under this box.
- **Example**–

Input subsidies such as subsidies on electricity, seeds, fertilizers, irrigation, etc. **Market support price (**MSP**)** subsidies also fall under this box.

- To measure ‘amber box’ support, WTO member countries are required to compute **the aggregate measure of support** (AMS).
- The AMS means the annual level of support (subsidies) expressed in monetary terms provided for an agricultural product. It includes both product-specific & non-product-specific support.
- The **fixed external reference price** is used to calculate the AMS to determine compliance with subsidy limits.
- The fixed external reference price shall be based on the years 1986 to 1988.
- WTO limits this subsidy by capping it at **5% for developed countries** & **10% for developing countries** of their total agriculture production.

5.1.13 India’s Concern Regarding the Fixed External Reference Price

- The fixed ERP at the WTO has not been updated for many years, leading to a significant gap between the Minimum Support Price (MSP) and the fixed ERP due to inflation.
- India’s ERP for rice in 1986-88 was $262.51/tonne, while the MSP was lower than this.
- In 2015-16, India’s applied administered price for rice was $323.06/tonne, surpassing the ERP from 1986-88.
- If India procures all 23 crops at MSP, it could exceed the de minimis limit, inviting potential legal challenges at the WTO.
- Even if the government involves private parties in procurement at government-determined prices, as with sugarcane, the 10% de minimis limit still applies.

Peace Clause

- The “peace clause” was the approach adopted at WTO’s Bali Ministerial Conference (2013).
- It protects developing countries from legal challenges regarding their breach of subsidy limits for agricultural products.
- However, the peace clause is not a long-term solution. There have been ongoing negotiations to find a permanent resolution for issues related to public stockholding for food security purposes.

Blue Box Subsidies

- According to the WTO, the Blue Box is the "**amber box subsidy with conditions**" attached.
- The Blue Box subsidies **aim towards limiting production** by imposing production quotas or requiring farmers to set aside part of their land.
- Blue Box subsidies are also **exempted** from the calculation of AMS.

Export subsidies

- Export subsidies commitment has been covered under **Article 8** of the agricultural agreement.
    - Member states are required to **decrease the monetary expenditure** on export subsidies
    - **Developing countries**: to reduce the value of export subsidies by 36% and the quantity of subsidized Exports by 21% within six years of the implementation of the agreement.
    - **Developed countries**: to reduce the value of export subsidies by 24% of and the quantity of subsidized Exports by 14% within ten years of the implementation of the agreement.
    - **Least developed countries** do **not have to comply** with this provision.
    - The agreement also mentions that the products that do not come under the subsidized export goods category **cannot be included in the list in the future**.

5.1.14 Special Safeguard Mechanism

- At the Doha Ministerial Conference, the developing countries were given a concession to adopt a Special Safeguard Mechanism (SSM) besides the existing safeguards (like the Special Agricultural Safeguard or the SSG).
- It allows developing countries to raise import duties on agricultural products in response to import surges.
- The SSG was available to all countries (both developing and developed), whereas the SSM is only allowable to developing countries.

5.1.15 Concern for India with Respect to WTO's AoA

- **Issue of domestic support and subsidies**.
- The AOA places limits on the support that a country can provide to its farmers.
- India's extensive **public procurement programs**, such as the minimum support price (MSP) for various crops, have faced scrutiny under these rules.
- **Concerns about the formula used for calculating the aggregate measurement of support (AMS)**.
- The outdated fixed external reference price, which has not been revised for several decades, creates challenges for India in maintaining its domestic support programs.
- **The special safeguard mechanism (SSM) has limitations** that may not fully address the concerns of vulnerable farmers.
- **The AOA prevents India from using export subsidies since it has not used** this instrument in the past. However, the agreement allows the advanced countries that were using export subsidies to continue using this instrument.

  India's Stand
- India rejects other proposed food security solutions beyond **public stockholding** (PSH) and **special safeguard mechanisms** (SSM).
- India has suggested the **necessity of recalculating external reference prices** to account for the influence of inflation and other economic factors on food stock prices.
- India, along with other countries (China, Lanka, South Africa, and Egypt), highlighted the importance of PSH being applied to all developing countries. Particularly least developed countries (LDCs) and **net-food importing developing countries** (NFIDCs), to help address the severe food security problem.
- India also wants **amendments in the formula to calculate the food subsidy cap** and inclusion of programmes implemented after 2013 under the ambit of the **'Peace Clause'**.

Let's Sum Up

The General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) are both related to international trade, but they have different purposes, structures, and functions:

- **Purpose**

  GATT's purpose was to reduce trade barriers, while the WTO's purpose is to help its members use trade to improve people's lives.

- **Structure**

  GATT was an international treaty with a temporary existence, while the WTO is a permanent body.

- **Functions**

  GATT's main function was to reduce trade barriers, while the WTO's functions include setting and enforcing trade rules, resolving trade disputes, and monitoring national trade policies.

- **Relationship**

  The WTO incorporates the principles of the GATT, and the Uruguay Round of negotiations that established the WTO was the biggest reform of international trade since World War II.

Here are some more details about GATT and the WTO:

- **GATT**

  GATT came into effect on January 1, 1948, after a sufficient number of nations ratified it. GATT's seven rounds of negotiations between 1947 and 1993 reduced average tariffs on industrial goods from 40% to 5%.

- **WTO**

  The WTO was established on January 1, 1995, as a result of the Uruguay Round of negotiations. The WTO also created new procedures for settling disputes, which are generally faster and more effective than GATT's dispute settlement. The WTO also covers trade in services and intellectual property, in addition to trade in goods.

Check Your Progress – Quiz – 2

Q1 When did the World Trade Organization come into effect?

(a) March 6, 1996

(b) April 8, 1994

(c) February 5, 1994

(d) January 1, 1995

Q2. Which of these institutions is not a part of the World Bank community?

(a) IFC

(b) IDA

(c) WTO

(d) IMF

Q3. Along with the World Bank and ___________________, WTO is the third economic pillar of worldwide dimensions.

(a) International Economic Association (IEA)

(b) International Monetary Fund's (IMF)

(c) International Development Bank (IDB)

(d) International Funding Organization (IFO)

Q4. Which of the following statements is false?

(a) India's vote share in the International Monetary Fund is 10%.

(b) Both the IMF and the IBRD have headquarters in Washington.

(c) The IBRD is also known as the World Bank.

(d) Both the IMF and the World Bank are known as the Bretton Woods twins.

Q5. Among the following options, which one is not the objective of the WTO?

(a) To protect environment

(b) To improve the balance of payment situation of the member countries

(c) To improve the standard of living of people of the member countries

(d) To enlarge production and trade of goods

Q6. Who is the current Director-General of WTO?

(a) Pascal Lamy

(b) Mahmoud Riad

(c) Chedli Klibi

(d) Roberto Azevêdo

Q7 TRIPS (Trade-Related Aspects of Intellectual Property Rights) agreement is administered by the _______ .

(a) World Bank (WB)

(b) United Nations Organization (UNO)

(c) World Trade Organization (WTO)

(d) United Nations Conference on Trade and Development (UNCTAD)

Q8 Who is most recently appointed as the Ambassador and Permanent Representative of India to WTO?

(a) JS Deepak

(b) TS Deepak

(c) Anwar Hussain Shaik

(d) Brajendra Navnit

Answer Key:	**Q1. D**	**Q2. C**	**Q3. B**	**Q4. A**	**Q5. B**	**Q6. D**	**Q7. C**	**Q8. D**

SECTION -5.2 GATT (General Agreement of Tariffs and Trade)

5.2.1 GATT (General Agreement of Tariffs and Trade)-Meaning

- The General Agreement on Trade in Services of the World Trade Organization (WTO), commonly known as the GATS, established a multilateral framework of rules and principles for trade in services, a large and fast-growing segment of world trade. It also set in motion a process for the progressive removal of restrictions on international services trade.

- The GATS was a major accomplishment of the Uruguay Round of Multilateral Trade Negotiations, and it is incorporated as an annex to the Marrakesh Agreement Establishing the World Trade Organization, which was signed at the Round's conclusion. That Agreement along with the GATS entered into force on January 1, 1995. It has no expiration date. All WTO member governments (offsite link) are subject to the GATS.

  The GATS is designed to ensure that the laws and regulations that WTO member governments apply to services trade are transparent and fair. Its key market-opening element is the Schedule of Specific Commitments that each signatory annexed to the GATS as an integral part of the Agreement. In these Schedules, which resulted from negotiations that took place during the Uruguay Round, signatories identified the extent to which they would accord full market access and national treatment in specific service sectors.

The Schedules, however, were only a first step in the complex process of liberalizing services trade, and many countries continue to impose limitations and conditions on both market access and national treatment. These restrictions are specified in each country's Schedule. Continuing services negotiations that are taking place under the GATS are aimed at removing these limitations and conditions.

Key Takeaways

- The General Agreement on Tariffs and Trade (GATT) was signed by 23 countries in October 1947, after World War II, and became law on Jan. 1, 1948.
- The purpose of GATT was to make international trade easier.
- Its goal was to eliminate undesirable trade aspects of the prewar period.
- GATT held eight rounds of trade negotiations in total, from April 1947 to December 1993, and each had significant achievements and outcomes.5
- In 1995, GATT was absorbed into the World Trade Organization (WTO), which extended it.

5.2.2 Understanding the General Agreement on Tariffs and Trade (GATT)

GATT was created to form rules to end or restrict the most costly and undesirable features of the prewar protectionist period, namely quantitative trade barriers such as trade controls and quotas.

The agreement also provided a system by which to arbitrate commercial disputes among nations. The framework enabled a number of multilateral negotiations for the reduction of tariff barriers. GATT was regarded as a significant success in the postwar years.

5.2.3 Equal Treatment of Nations in Trade

One of the key achievements of GATT was that of trade without discrimination. Every signatory member of GATT was to be treated as equal to any other. This is known as the most-favored-nation principle, and it was carried through into the WTO.

A practical outcome of this was that once a country had negotiated a tariff cut with some other countries (usually its most important trading partners), this same cut would automatically apply to all GATT signatories. Escape clauses did exist, whereby countries could negotiate exceptions if their domestic producers would be particularly harmed by tariff cuts.16

Most nations adopted the most-favored-nation principle in setting tariffs, which largely replaced quotas. Tariffs (preferable to quotas but still a trade barrier) were, in turn, cut steadily in successive rounds of negotiations.

5.2.4 Why GATT was replaced by WTO?

GATT (General Agreement of Tariffs and Trade) was replaced by the WTO (World Trade Organisation) because of the following reasons:

- GATT (General Agreement of Tariffs and Trade) was ad hoc and provisional in nature as well as never approved by the member countries Parliament.
- GATT used to deal with trade in goods but the WTO also used to deal with intellectual property and cover services at the same time.
- The dispute settlement of WTO is faster but their rulings can never be obstructed.

- WTO has a strong legal basis as its agreements are permanent and all the member countries have approved it in their Parliaments.
- WTO is far better than GATT in comparison. GATT lacked a proper institutional structure whereas WTO provides a more institutional framework for implementing its principles.
- MFN is the fundamental principle of the GATT and it appears in article one of the GATT 1947.
- This states that each contracting party to the GATT has to provide to other contracting parties the same condition of trade as the most favourable terms.

5.2.5 History of the GATT

GATT held eight rounds of meetings—the first beginning in April 1947, the last ending in December 1993. Each of the conferences had significant achievements and outcomes.

- The first meeting was in Geneva, Switzerland, and included 23 countries. The focus of this opening conference was on tariffs. The members established tax concessions affecting more than US$10 billion of trade around the globe.
- The second series of meetings began in April 1949 and was held in Annecy, France. Again, tariffs were the primary topic. Thirteen countries were at the second meeting, and they accomplished an additional 5,000 tax concessions reducing tariffs.
- Starting in September 1950, the third series of GATT meetings occurred in Torquay, England. This time, 38 countries were involved and almost 9,000 tariff concessions passed, reducing tax levels by as much as 25%.
- Japan became involved in GATT for the first time in 1956 at the fourth meeting along with 25 other countries. The meeting was in Geneva, and again the committee reduced worldwide tariffs, this time by US$2.5 billion.

This series of meetings and tariff reductions would continue, resulting in new GATT provisions in the process. In 1964, GATT began to work toward curbing predatory pricing policies (known as dumping). Then in the 1970s, an arrangement regarding international trade in textiles, known as the Multifibre Arrangement (MFA), came into force. The next big event was the Uruguay Round, which lasted from 1986 to 1993, with the agreements signed in 1994, and which created the WTO.

Overall Tariff Reduction

The average tariff rate fell from around 22% when the General Agreement was first signed in Geneva in 1947 to around 5% by the end of the Uruguay Round. As the years passed, the member countries continued to take on global issues, including addressing agriculture disputes and working to protect intellectual property.

5.2.6 Objectives and Purpose of GATT

The objectives and purpose of GATT are as follows:

- GATT (General Agreement of Tariffs and Trade) the ultimate objective was to reduce barriers to international trade.
- It was created to establish regulations to remove the costly and inefficient characteristics of the prewar protectionist period like trade quotas and controls.
- The member countries had to eliminate all trade discrimination. Its main purpose was to remove harmful trade protectionism.

5.2.7 Principles of GATT

The principles under which GATT functions are as under:

Non-Discrimination

The main objective of non-discrimination is to prevent protectionist measures.

- It guarantees the freedom of trade among all member states.
- It is created or made to secure trade fair conditions.

Most Favoured Nation Principle (MFN-principle), Article 1

- According to the MFN principle, a signatory state granting any trade or financial advantage to another state shall grant it to all the other signatory states.
- This happens unconditionally and immediately. In accordance with Article 1, custom tariffs or other fees charged by one country for the import or export of products have to be identical for all contracting parties. For all member states, equal conditions are established.

Principle of National Treatment, Art. 3

- This principle is supporting non-discrimination between the member states and guarantees national compliance with the non-discrimination rule in foreign trade.
- Therefore it restraints unequal treatment of foreign imported and locally-produced goods.
- The Agreement on Subsidies and Countervailing Measures (SCM) is narrowing down this basic principle as it restricts certain subsidies to companies contingent upon the performance of their export and upon the use of imported or domestic goods.

Liberalization through negotiation

- One of the most important aims of GATT is to reduce tariffs and trade barriers substantially, it does not restrict any kind of custom tariffs of individual countries.
- By way of multilateral negotiations between the member states (for instance the so-called "Uruguay Round", which was held in Uruguay from 1986 to 1994, from which the World Trade Organization (WTO) arose), custom tariffs shall be reduced and made transparent.

Quantitative Restrictions on Import and Export

- GATT placed Quantitative Restrictions on imports and Export to liberalize trade.
- Article XI, validates "duties, taxes, and charges", but proscribes "prohibitions or restrictions" on the importation or exportation of products or on sale for export.

5.2.8 Rounds of Global Trade Talks Under GATT

First Round

The first round of global trade talks took place in Geneva in April 1947 when 23 countries formed GATT and exchange tariff concessions on 45000 products which were worth rupees 10 billion US dollars of trade.

Second Round

The second round of the Global trade talks under GATT was held in 1949 in Annecy, France. Total of 13 countries took part in the second round.

Third Round

The third round of the trade talk took place in Torquay, England in 1959. A total of 38 countries took part in this round.

- **Fourth Round**

The fourth round of this trade talk took place in Geneva in 1955 and lasted till May 1956. A total of 26 countries participated in this round.

- **Fifth Round**

The fifth round took place in Geneva and lasted from 1960 to 1962. This round of talks was named after the US Treasury secretary and former Under Secretary of State, who was the first one to propose the talks.

- **Sixth Round**

The sixth round of trade talks took place in the year 1964 to 1967. The formation of the EEC has put the USA at a disadvantage. As a result or reaction to this, the Congress of USA passed the Trade Expansion Act in October 1962 which gave the power to the Kennedy administration to make 50% tariff reduction in all commodities.

- **Seventh Round**

The seventh round of the general trade talks took place in 1973 - 1979. Reduced tariffs and the new regulation establishment aim at controlling the proliferation of non-tariff barriers and voluntary export restrictions. A total of 102 countries took part in the Tokyo round.

- **Eighth Round**

The eighth round of the trade talks took place in 1986 to 1993. This round of GATT negotiation started at Punta Del Esta in Uruguay in September 1986 which was concluded by the end of 1990. The Director General of GATT Aurthur Dunkel drafted a draft final act of the Uruguay round which was also known as the Dunkle Draft Text.

5.2.9 Challenges Faced by GATT

The challenges faced by GATT are given as follows:

- The nature of world trade changed by 1980. This was not addressed by GATT as it did not address the trade in services between Nations.

- GATT reduced the rights of a sovereign to rule its people like other free trade agreements. The agreement on trade and tariffs required the countries to synchronize their domestic laws in accordance with the agreement to gain trade benefits. However, since countries did not agree to this provision it led to disputes between the Nations.
- The rapid proliferation of the bilateral and regional trade free trade agreements like RCEP, NAFTA, etc. across the globe also raised concern over trade diversion.

5.2.10 Difference between GATT and WTO

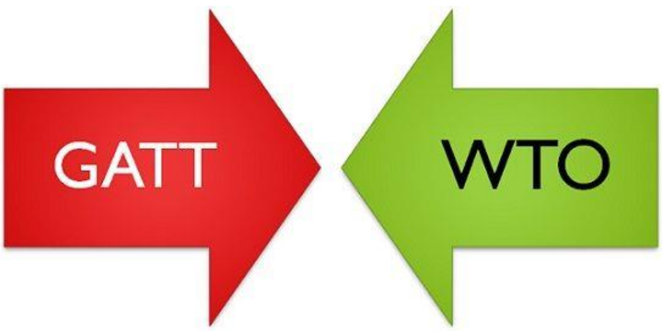
The differences between GATT and WTO are presented in a tabular format for better understanding.

GATT	WTO
GATT was a multilateral agreement that was formed to reduce tariffs. It was a series of rules without any institutional framework with just an ad Hawk secretariat, originated from the attempt to establish an GATT covered only trade in goods	WTO is a permanent institution with a proper institutional framework and its own secretariat. WTO not only covers goods but also services in trade which includes aspects of intellectual property.
GATT was a mere set of rules which had no institutional foundation. It was a multilateral agreement with a small functioning associate secretariat	WTO is a global body that has a permanent institution along with a secretariat.
GATT was an ad hoc provisional agreement	WTO has goals and existence that are full and permanent.
The nations that participated in GATT were called contracting parties	The members of WTO are called member states
GATT was less powerful and the participating countries did not pay much heed and attention to it. It also had a very slow and inefficient dispute resolution system which made the	The WTO holds a lot of power and accounts for nearly 96% of the global GDP. It has a much faster and efficient dispute settlement department.

countries not take it seriously	
GATT was initially very selective in nature and it was much later in the 1980s when the notion of plurilateral nature of agreements was added.	From the very get-go, the WTO involves memberships and commitments which are multilateral in nature.
Under GATT, domestic legislation could continue even if they violated any agreements of GATT.	The same was not permissible under WTO.
GATT was signed only by 23 nations	WTO has 164 member states who collectively work international trade.
GATT has a permanent appellate body to review findings and settle disputes.	Disputes under WTO are resolved faster as the settlement system has a select time frame

Key Differences between GATT and WTO

1. GATT was an agreement established in 1947, while the WTO is an international organization created in 1995.
2. GATT primarily focused on reducing tariffs on goods, whereas the WTO's scope extends to services, intellectual property, and agriculture.
3. GATT operated on a provisional basis without a permanent secretariat, while the WTO has a permanent secretariat for daily operations.
4. Decision-making in GATT relied on consensus among member countries, while the WTO adopts decisions through majority voting.



5. GATT had a limited number of initial members, while the WTO has a broader membership, including most countries worldwide.
6. GATT evolved through multiple rounds of negotiations, addressing specific trade issues, while the WTO provides a platform for ongoing negotiations, such as the Doha Development Agenda.
7. GATT had a narrow focus on trade in goods and tariffs, while the WTO addresses non-tariff barriers, trade facilitation, and intellectual property rights.
8. GATT did not have a formal dispute settlement mechanism, whereas the WTO establishes a robust dispute settlement system.
9. GATT served as a precursor to the establishment of the WTO, which represents an upgrade and institutionalization of the GATT framework.

5.2.11 Advantages of GATT

1. Promoted the reduction of tariffs, leading to increased trade flows.
2. Created a framework for negotiations and trade rules among member countries.
3. Contributed to economic growth and development by facilitating international trade.
4. Fostered cooperation and peaceful relations among member countries.
5. Provided a platform for addressing trade issues and resolving disputes.
6. Encouraged multilateral trade agreements and fair competition.
7. Helped developing countries gain access to global markets.
8. Supported the principle of non-discrimination in trade relations.
9. Fostered transparency and predictability in international trade.
10. Provided a forum for member countries to voice their concerns and interests.

5.2.12 Disadvantages of GATT

1. Had a limited focus on goods and tariffs, excluding other important areas such as services and intellectual property.
2. Lacked a formal dispute settlement mechanism, leading to challenges in resolving trade disputes effectively.

3. Depended on consensus-based decision-making, which could result in slow progress or deadlock in negotiations.
4. Did not have a permanent secretariat, which limited its capacity to oversee and enforce trade rules.
5. Had a limited membership initially, excluding several major trading nations.
6. Limited provisions for addressing non-tariff barriers and trade facilitation.
7. Did not adequately address the needs and concerns of developing countries.
8. Less efficient in adapting to the changing global trade landscape over time.
9. Limited enforcement mechanisms to ensure compliance with trade rules.
10. Less equipped to handle the complexities and challenges of modern global trade.

5.2.13 TRIPS (Trade Related Aspects of Intellectual Property Right)

Trade Related Aspects of Intellectual Property Right (TRIPS) is an agreement on international IP rights.

- TRIPS came into force in 1995, as part of the agreement that established the World Trade Organization (WTO).
- TRIPS establishes minimum standards for the availability, scope, and use of seven forms of intellectual property namely, trademarks, copyrights, geographical indications, patents, industrial designs, layout designs for integrated circuits, and undisclosed information or trade secrets.
- It applies basic international trade principles regarding intellectual property to member states.
- It is applicable to all WTO members.
- TRIPS Agreement lays down the permissible exceptions and limitations for balancing the interests of intellectual property with the interests of public health and economic development.
- TRIPS is the most comprehensive international agreement on IP and it has a major role in enabling trade in creativity and knowledge, in resolving trade disputes over intellectual property, and in assuring WTO members the latitude to achieve their domestic policy objectives.

- It frames the IP system in terms of innovation, technology transfer and public welfare.
- The TRIPS Council is responsible for administering and monitoring the operation of the TRIPS Agreement.
- TRIPS was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1986–1994.
- The TRIPS Agreement is also described as a "Berne and Paris-plus" Agreement.

5.2.14 TRIPS Significance

- The TRIPS Agreement makes protection of intellectual property rights an integral part of the multilateral trading system, as embodied in the WTO. The agreement is often termed one of the three "pillars" of the WTO, the other two being trade in goods (the traditional domain of the GATT) and trade in services.
- Before TRIPS, the extent of protection and enforcement of IP rights varied widely across nations and as intellectual property became more important in trade, these differences became a source of tension in international economic relations. Therefore, it was considered prudent to have new trade rules for IP rights in order to have more order and predictability, and also to settle disputes in an orderly manner.

5.2.15 TRIPS Agreement during COVID-19

- In view of the COVID-19 pandemic, India and South Africa had proposed to the WTO in October 2020 that the TRIPS Agreement (that included patent protection to pharmaceutical products including COVID vaccines) be waived off for COVID vaccines, medicines and diagnostics for the time period of the pandemic in order to make vaccines and drugs for COVID available to a maximum number of people worldwide.
- If the vaccines are patent protected, only a few pharmaceutical companies from developed western countries would be able to manufacture it, making such drugs unavailable or inaccessible due to the high costs to people of other countries, especially, developing and least developed countries.
- The US, which was opposed to any TRIPS waiver, has backed this proposal, along with the EU. This move has been welcomed by many since it might lead

to the manufacture of more volumes of COVID vaccines enabling the whole world to get rid of the coronavirus at the earliest. However, pharmaceutical companies have protested the move saying this would not necessarily ensure vaccine availability since developing countries did not have the capability to produce the vaccines.

5.2.16 Arguments in favour of relaxing TRIPS rules

- This would make the vaccines more available to people of developing countries and also LDCs.
- Life-saving drugs and vaccines should be made available to everyone and pharmaceutical companies should not be looking to make profits out of these. There is an ethical and moral issue here.
- With particular reference to the COVID-19 pandemic, it is said that no one is safe unless everyone is safe. In this respect, it is imperative that vaccines are made available to everyone in countries affected since it can easily spread to all countries as seen in the first wave.
- Rules granting monopolies that place the right to access basic healthcare in a position of constant peril must end.

5.2.17 Arguments made by opponents of TRIPS waiver

- Unless corporations are rewarded for their inventions, they would be unable to recoup amounts invested by them in research and development.
- Without the right to monopolies production there will be no incentive to innovate.
- They also claim that companies in the developing world do not have the capacity to manufacture vaccines or drugs on a large scale.

5.2.18 Intellectual Property

"Intellectual property" refers to creations of the mind. These creations can take many different forms, such as artistic expressions, signs, symbols and names used in commerce, designs and inventions.

5.2.19 Intellectual Property Rights

Intellectual property rights are the rights given to persons over the creations of their minds. Intellectual property rights (IPRs) are legal rights that protect these creations. In contrast to rights over tangible property, IP rights give their owners rights to exclude others from making use of their creations only for a limited period. IP rights entitle the owners to receive a royalty or any sort of financial compensation or payment when another person uses their creations.

IP rights are generally classified into two categories:

1. **Copyright and rights related to copyright:** This rights relates to rights protecting art works, literary works, computer programmes, films, musical compositions, sculptures, paintings, etc. Related rights also include rights of performers, broadcasting organisations, and producers of phonograms (sound recordings). The main purpose of protection of copyright and related rights is to encourage and reward creative work.
2. **Industrial property:** There are two main areas of rights under this head.
    1. The protection of distinctive signs, especially trademarks (which differentiate the goods or services of one organisation/establishment from those of other undertakings) and geographical indications. These rights are aimed at protecting and ensuring fair competition consumer protection.
    2. The second type of industrial property rights are protected primarily to stimulate innovation, design and the creation of technology. These rights protect innovations by patents, trade secrets and industrial designs.

5.2.20 Trade Related Investment Measures (TRIMs)

Trade-Related Investment Measures (TRIMs) are rules that apply to a country's domestic regulations regarding foreign investors. These rules were set up as part of an industrial policy. They aim to facilitate the operation of international firms in foreign markets. TRIMs were negotiated under the General Agreement on Tariffs and Trade (GATT). It came into force in 1995 as part of the World Trade Organization (WTO). They are one of the four key legal agreements of the WTO trade treaty.

5.2.21 History of TRIMs

- In the late 1980s, there was a significant increase in foreign direct investment worldwide.
- Some countries receiving foreign investment imposed restrictions to protect their domestic industries and prevent the outflow of foreign exchange reserves.
- These restrictions included requirements such as local content, manufacturing, trade balancing, domestic sales, technology transfer, export performance, local equity, foreign exchange, remittance, licensing, and employment.
- These measures violated GATT Articles III and XI. This led to the prohibition of these restrictive practices.
- Prior to the TRIMs Agreement, there were limited international agreements providing guidance on content and country coverage for measures restricting foreign investment.
- The TRIMs Agreement concluded during the Uruguay Round negotiations.

5.2.22 Objectives of TRIMs

The main aim of TRIMs is to ensure that investment policies and regulations do not create unnecessary barriers to trade and to promote and facilitate foreign direct investment (FDI) flows.

Some of the significant objectives of TRIMs have been mentioned below.

- To ensure that foreign investors are treated no less favorably than domestic investors in terms of laws, regulations, and other measures affecting investment.
- It seeks to prevent WTO members from using TRIMs to create unnecessary trade barriers or distort competition between domestic and foreign firms.
- To require WTO members to publish and provide information on their laws and regulations affecting investment and to provide timely notification of any changes to these laws and regulations.
- To prohibit Trade Related investment measures that are inconsistent or nullify the benefits accruing to WTO members under the GATT 1994.
- Encourage and facilitate investment by providing investors with a stable, predictable, and transparent environment.

- To allow WTO members to take measures to safeguard their balance of payments, subject to certain conditions and limitations.

Overall, the TRIMs Agreement seeks to promote non-discriminatory investment policies and to reduce unnecessary barriers to trade with regard to investment measures.

5.2.23 Important Features of Trade Related Investment Measures

Countries can employ Trade Related investment measures (TRIMs), which are laws and policies, to control foreign investment within their borders. Some of the important characteristics of TRIMs are as follows:

Local content requirements

- This includes compelling foreign investors to use local labor or equipment or to source a specific percentage of their supplies or inputs locally.
- Requirements for locally sourced products can support domestic sectors, generate employment, and strengthen local supply chains.

Restrictions on investment

- Some nations may limit foreign investment in particular segments or industries or demand that international investors collaborate with domestic businesses.
- Investment limitations can support local ownership and control while protecting domestic businesses.

Performance requirements

- These are the criteria that foreign investors must meet in order to be eligible for specific benefits, including tax reductions or access to particular markets.
- Examples include obligations to pass on technology to local partners or to export specific quantities of production.
- Performance requirements can encourage technology transfer and attract foreign investors to support regional economic growth.

Export Restrictions

- Some nations could demand that foreign investors export a specific proportion of their finished goods.
- Export restrictions can promote exports and maintain the trade balance.

Requirements for licensing

- This involves obligating foreign investors to obtain a license to operate in a specific industry or adhere to specific regulatory requirements.
- Requirements for licensing can aid in ensuring that foreign investment adheres to national priorities and legislation.

5.2.24 TRIMs Agreement

The TRIMs Agreement is a part of the World Trade Organization trade treaty. It sets rules to regulate the domestic regulations that countries impose on foreign investors. The agreement aims to restrict measures that prefer domestic firms over international firms, making it easier for foreign businesses to operate in foreign markets. The TRIMs Agreement was negotiated under the WTO's predecessor, GATT, and came into effect in 1995.

5.2.25 Restrictions According to the TRIMs Agreement

Certain measures that are judged to be discriminatory toward foreign investors and trade-distorting are prohibited by the TRIMs agreement. These consist of the following:

- Local content requirements: TRIMs forbid using measures that compel foreign investors to buy local inputs or incorporate a specific percentage of local content into their goods.
- Trade balancing requirements: Requirements for balancing the imports with the exports are not allowed under TRIMs, nor are requirements that foreign investments reach a specific level of domestic output or sales.
- Export performance requirements: TRIMs, prevents requiring foreign investors to export a specific percentage of their production or to earn a specific amount of foreign currency from their exports.
- Domestic sales Requirements: TRIMs restrict requirements that foreign investors sell a specific proportion of their goods in the domestic market.

However, the TRIMs agreement enables WTO members to put policies in place that encourage investment and do not discriminate against international investors. These measures consist of:

- Efforts to increase the effectiveness of manufacturing and distribution.
- Steps taken to protect the safety, health, and morality of the public.

- Efforts to support the growth of small and medium-sized businesses.

The TRIMs agreement's overall goal is to urge nations to implement open, non-discriminatory investment policies that support trade and economic growth.

5.2.26 Conclusion

The Agreement on Trade Related Investment Measures (TRIMs) is an important agreement under the World Trade Organization (WTO) that regulates investment measures that may impact trade in goods and services. Although the agreement has drawn criticism for its potential to have an impact on domestic rules and regulations, it cannot be denied that it has contributed to a more open and transparent global trading system. Overall, the TRIMs agreement is an essential tool for fostering an environment that is fair and competitive for worldwide trade and investment.

Check Your Progress – Quiz – 1

Q1. TRIMs stands for _______.

(a) Trade Related Investment Methods

(b) Trade Related Inventories Measures

(c) Trade Related Income Measures

(d) Trade Related Investment Measures

Q2. TRIP is one of the WTO agreements that deal with

(a) Trade in agriculture

(b) Trade in services

(c) Trade related investment measures

(d) None of these

Q3. How many countries originally signed GATT in 1947?

(a) 47

(b) 33

(c) 23

(d) 25

Q4. GATT was a provisional agreement that was meant to be replaced by what?

(a) North American Free Trade Agreement

(b) International Trade Organization

(c) World Health Organization

(d) United Nations

Answer Key:	Q1. C	Q2. D	Q3. D	Q4. A

5.3 Unit Summary

The General Agreement on Tariffs and Trade (GATT) was a multilateral agreement that aimed to promote international trade by reducing tariffs and quotas:

- **Purpose**

GATT was established in 1947 to help boost economic recovery after World War II. Its purpose was to reduce tariffs and other trade barriers, and to eliminate trade discrimination.

- **Signatories**

23 countries signed the agreement and agreed to open their markets equally to each other.

- **Rounds of negotiations**

Seven rounds of negotiations were held between 1947 and 1993. The most important rounds were the Kennedy Round (1964–67), the Tokyo Round (1973–79), and the Uruguay Round (1986–94).

- **Results**

The rounds of negotiations reduced average tariffs on industrial goods from 40% to 5%.

- **Replacement by the World Trade Organization (WTO)**

  GATT was replaced by the WTO in 1995. The WTO adopted GATT's principles and the trade agreements it reached.

5.4 Glossary

- **Tariffs**

  A way for nations to determine economic policy, and to support political goals or regulate industries.

- **Anti-dumping**

  An unfair trade practice that is regulated by national governments through anti-dumping duties.

- **Trade facilitation**

  The process of communicating and processing data and information for the movement of goods in international trade.

- **General Agreement on Trade in Services (GATS)**

  One of the three main pillars of the WTO, along with merchandise trade and trade-related intellectual property rights.

- **Agreement on Safeguards**

  A Multilateral Agreement on Trade in Goods that is an integral part of the WTO Agreement.

- **WTO dispute resolution**

  A faster process than GATT, with rulings that cannot be blocked.

5.5 Self-Assessment Questions

5 Marks

1. State on functions of WTO.
2. Brief on Intellectual Property Rights.
3. Explain the objectives of TRIMs.
4. Distinguish between GATT and WTO.

5. Narrate the objectives and purpose of GATT.

10 Marks

1. Enumerate on GATS.
2. Explain TRIPS.
3. Describe the concern for India with Respect to WTO's AoA
4. What are **important features of Trade Related Investment Measures?**
5. Explain the India's Concern Regarding the Fixed External Reference Price.
6. Enumerate the structure of WTO

5.6 Case Studies

Case Study

The big picture

The cases in this book cover a wide range of commercial and government activities.

A Bangladeshi rock band finds that a 'Bollywood' movie producer has pirated one of its songs; band members use the provisions of the WTO to regain their rights.

The tiny Pacific island economy of Vanuatu decides to suspend its application for WTO membership when its inexperienced government administrators fail to find a sympathetic hearing from existing WTO members.

An 'inside' account of how India struggled to develop a national consensus on the liberalization of its protected agriculture sector.

The Kenyan government fights for the right, under the WTO Agreements, to import AIDS drugs manufactured elsewhere under 'compulsory licences' for use in Kenya. It finds that the issue of patent protection under its own legislation is not straightforward and that the patent law changes are not the biggest barrier to reducing the impact of the disease.

The tuna industry of Thailand fights to retain access to the European Union (EU) market on comparable terms to its competitors, but manages to avoid a costly formal dispute adjudication.

Chilean poultry exporters and government officials act urgently to handle an animal health emergency that could have killed exports to the vital European market, making effective use of international standards and notification procedures established by the WTO.

An exporter of traditional herbal medicines from Nepal runs into regulatory barriers he cannot understand or do much about until Nepal joins the WTO and the Nepalese government creates a regulatory framework that helps him to meet his customers' expectations of good manufacturing practice.

The Mexican government is backed into a corner, domestically, by the powerful Peasants' Union's revolt against imports from the United States under the North American Free Trade Agreement (NAFTA); the facts show, however, that the agreement has opened up new horizons for Mexican industry that could be extended by multilateral negotiation.

Nigerian industry is penalized by a system of import prohibitions that have strong political support but are economically costly — why Nigeria's WTO obligations don't offer a solution.

5.7 Reference and Suggested Readings

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