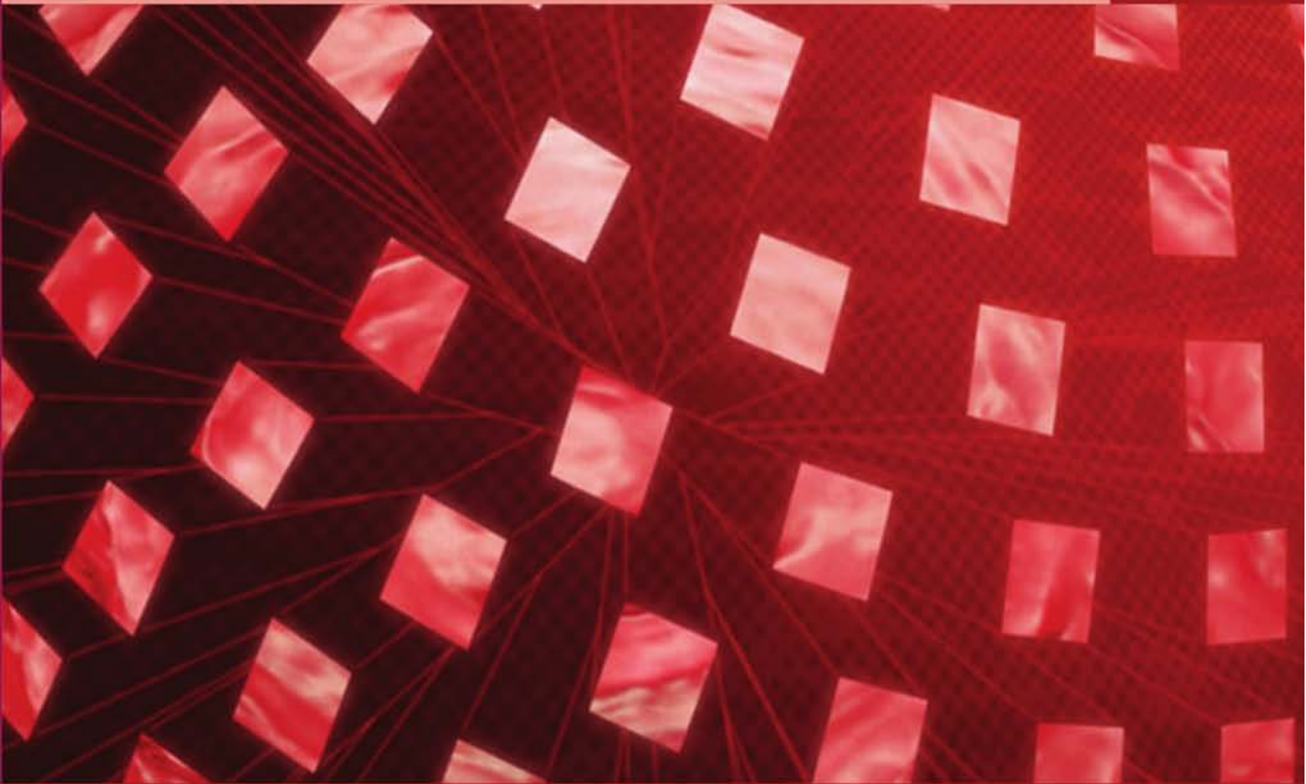
UNIVERSITY MBA SERIES

International Business Management

FOR VTU



Vyuptakesh Sharan

ALWAYS LEARNING

PEARSON

INTERNATIONAL BUSINESS MANAGEMENT

Vyuptakesh Sharan

PEARSON

Chennai • Delhi • Chandigarh

ISBN 9788131770184
eISBN 9788131798744

Head Office: A-8(A), Sector 62, Knowledge Boulevard, 7th Floor, NOIDA 201 309, India
Registered Office: 11 Local Shopping Centre, Panchsheel Park, New Delhi 110 017, India

To my parents,
Smt Kalyani Devi and Sri Hrishikesh Sharan

Contents

Preface

The growing acceptance of the policy of economic liberalisation and globalisation has led to fast expansion in international business. International trade and investment as also international transfer of technology have grown at a galloping gait in recent times. All these require trained manpower on a sizeable scale. Perhaps this is the main reason why the subject of international business has gained so much importance among the institutions imparting professional courses all over the world.

I have been writing in this area for over three decades and have been teaching this subject for quite some time. But it is my students who insisted and motivated me to write a textbook on this subject. The credit for this textbook, therefore, should go to them.

At present, there are a number of books on this subject, and I agree that a few of them are really good. But I feel the perspectives of the developing countries have not been stressed upon to the extent it is desired in view of the growing participation of these countries in the international business. I have tried to fill this gap so as to make the book more useful. Again, on an average, the students of business management get less than a month for covering one course. The size of the book has been intentionally kept limited to suit this time framework. Yet again, it is my experience that the students admitted to the professional courses come from various disciplines and they do not have sufficient idea about commerce and economics. Keeping this in mind, all efforts have been made to make the text lucid and intelligible. For readers who would like to go deep into any issue, there is a list of select further readings provided at the end of the respective chapters.

I have greatly benefited from the discussions with my colleagues and professionals working in this field of study. I am thankful to all of them.

I wish to express my sincere thanks to my wife, Roopa Sharan, for the inspiration and encouragement she has provided for preparing this book.

I am sure the readers will find the book useful. Their suggestions, which are most welcome, will surely make the next edition still more useful.

Vyuptakesh Sharan

About the Author

Vyuptakesh Sharan, Former Professor and Dean, Faculty of Commerce, Magadh University, is currently a Professor Emeritus at Chandragupt Institute of Management Patna (CIMP) which is an autonomous institution of Government of Bihar. Previously he was Emeritus Fellow at School of International Studies, Jawaharlal Nehru University, New Delhi, UGC Visiting Professor at the MIB Programme, Department of Commerce, Delhi School of Economics, University of Delhi and AICTE Visiting Professor at Global Business Operations Post-Graduate Programme, Sri Ram College of Commerce, University of Delhi.

Professor Sharan teaches international business and international finance. He has delivered special lectures in a number of Indian universities and abroad. He has to his credit six reference books and three text books mostly published by international publishers. He has also contributed a large number of articles to national and international journals, and has chaired more than half a dozen national seminars.

PART 1

Concept of International Business

This page is intentionally left blank.

An exhibition in Pragati Maidan, Delhi, India*

1

Overview of International Business

CHAPTER OBJECTIVES

The chapter acquaints the readers with the nature of international business and how it evolved and developed over time. In particular, it attempts to:

- ✦ Define the meaning and significance of globalisation and international business.
- ✦ Explain how international business is different from domestic business.
- ✦ Delineate the characteristics of an MNC.
- ✦ Discuss the process of evolution of international business and its development.
- ✦ Explain the factors leading to phenomenal growth in international business during the past fifty years.

1.1 THE CONCEPT AND PROCESS OF GLOBALISATION

1.1.1 Meaning

Globalisation is a process through which different economies get inter-woven by way of international trade and investment. They become an integral part of the world economy.

Globalisation is a move towards open economic policies lifting up the restriction imposed on the international economic flows that in turn leads to a sharp increase in the quantum of such flows. The different economies, driven by international trade and investment and aided by information technology, turn this way closely inter-woven and become an indispensable part of the world economy. However, the literature on the subject interprets globalisation in three different ways (Held *et al*, 1999). First of all, the hyper-globalist school feels that globalisation leads to a single global economy transcending and integrating the different economic regions. Supported by technological sophistications and market integration, globalisation leads to denationalisation of strategic economic activities. In the sequel, the flow of global finance exercises a decisive influence on the location and distribution of economic power and wealth. The economy turns borderless. A particular economy has no option rather than to accommodate global market forces.

Secondly, the sceptical view, on the contrary, does not interpret globalisation in terms of emerging and unified international economic activity. It believes in inter-nationalisation where the increasing flow of economic resources takes place among well-defined national economies. In this case, national economic policies remain effective to influence the flow of economic resources.

Thirdly, there are transformationalists who interpret globalisation in terms of a process or a set of processes rather than an end-state. The process embodies a shift in the spatial organisation of social relations from national to transcontinental pattern of human organisation. The economic activities stretch out across frontiers, regions and continents. There is growing interconnectedness among different regions through flow of trade and investment. The flow of trade and investment is so intensive and extensive that the impact of local developments spills over to remotest corners of the globe. In other words, the boundary between the domestic and global affairs turns blurred. The international organisations support and regulate such activities. The transformationalists go on arguing that the very scale of human social organisation extends the reach of power nations across the world's major regions.

Whatever might be the interpretation, the process of globalisation has many dimensions. It has multiple causes and multiple results. There are benefits of globalisation. But it is also true that this process leads sometimes to lack of homogenisation across countries because global economic transactions are influenced by disparity in the economic and political conditions in different countries. However, the divergence is corrected through the process of globalisation depending on the nature of this process.

1.1.2 Evidence

If globalisation fosters close linkages among countries through the flow of goods, labour and capital, it is worth discussing whether it does exist in the real world. In fact, the move towards globalisation was afoot a couple of centuries ago when the European countries, following Industrial Revolution, began exporting their manufactured products and in turn importing necessary raw material. Subsequently, they made foreign investment to ensure continued supply of raw material. As back as in 1870, the merchandise export/GDP ratio in the UK (at 1990 prices) was 12.2 per cent (Maddison, 2000). However, the growing trend towards globalisation was marked only after the Second World War, with the growth in the internationalisation of the US firms. The pace picked up subsequently with the growth of multinational firms in Europe, Japan, the newly industrialising countries and, of late, in the transition economies during 1990s. The foreign direct investment that was barely over $12 billion during 1950s rose to over $200 billion in 1990s and further to around $1.5 trillion during 2007. Similarly, the world trade recorded a jump from $60 billion to over $13.6 trillion during the same period. If one looks at these figures in relation to the gross world product (GWP), the international trade as percentage of GWP rose two-and-half times between 1960 and 2000. Similarly, the foreign direct investment (FDI) rose three-and-half times between 1980 and mid-2000s (Bourdeaux, 2008).

> The evidence of globalisation was found a couple of centuries ago. But it is only since 1950s, and especially in the recent decades that globalisation is distinctly visible.

The process got stimulus from the international institutions. The General Agreement on Tariff and Trade (GATT), established in 1947, created a consensus on axing the tariff and non-tariff barriers over the past five decades which in turn boosted up the world trade. The World Trade Organisation (WTO) substituting GATT implemented the Uruguay Round resolutions and covered many trade-related measures that had remained neglected earlier. Again, the role of the World Bank and the International Monetary Fund was no less significant. During early 1980s, they encouraged different governments to adopt structural adjustment and macro-economic reforms and provided financial assistance for this purpose. Such reforms provided a fillip, among other things, to foreign direct investment. Under the financial sector reforms, the capital market of different countries came to be closely knit, which in turn led to a large-scale flow of financial resources. The foreign portfolio investment, especially in the secondary capital market, which was meagre four or five decades earlier, has turned huge at present. However, the study of Sutcliffe and Glyn (2003) discounts the evidence at least to some extent. In their view, the figures stand exaggerated on account of inappropriate statistical measures and unreliable observations and due to exclusion of counter-globalisation tendencies.

1.1.3 The Impact

The impact of globalisation has been positive as far as rate of economic growth is concerned.

With the process of globalisation picking up the pace and with phenomenal growth in external trade and foreign direct and portfolio investment, there is a marked profound, positive impact on economic growth, labour markets and incomes and the macro and micro-economic policies which the different governments are pursuing. There is a clear indication that this process has weakened the independence of the national economic policies of various governments (Perraton, 2003). Dollar and Kraay (2002) believe that it has reduced poverty. Again, when the markets are highly integrated, the resources are allocated optimally among different markets. The gains accruing in one market are shared by other markets.

Mosley (2000), on the other hand, finds a weak linkage between globalisation and economic growth. Environmental degradation persists. The national governments still holds the key power. The economic chaos and upheavals arising in a country spill easily over to other markets. The US sub-prime crisis is a case in point that engulfed gradually a number of countries. The failure of market forces and inequalities require some kind of governance of the global market so that evils are controlled and the gains from globalisation can be maximised (Stglitz, 2002).

Whatever might be the argument for and against globalisation, some of the figures and analyses suggest the positive impact of globalisation. Gwartney and Lawson (2001) find that in the countries with closed trade policy, the per capita annual income was 13 per cent lower than in the countries opting for an open trade policy. Again, Sachs and Warner (1995) covered in their study 117 countries with both open and closed trade policies and found that in open industrialised countries, the rate of GDP growth was 2.29 per cent compared to 0.74 per cent in closed industrialised world. Similarly, in open developing countries, it was 4.49 per cent compared to 0.69 per cent in closed developing countries. The higher growth rate following globalisation did have a positive impact on other economic and socio-economic variables, such as living standard, life expectancy, low child mortality rate, improved working hours and many other comforts of life (Bourdeaux, 2008).

At the micro level, globalisation has been a boon for the companies. There are thousands of firms that operate, in the first phase, for a small locality or region. They move in due course of time to the national map. If their operations prove successful, they move to one or more countries and finally, they reign over the entire globe. Let us explain here a single example. Proctor and Gamble (P&G) started its operations in 1837 and supplied its products only within a narrow area, known as Cincinnati. By the close of the 19th century, when the rail and road network developed throughout the USA, it produced goods for the entire country. After the Great War of 1914–1918, it consolidated its position through a number of acquisitions and by 1930, it began catering to the overseas demand. After the Second World War and more especially, after 1960, P&G has been operating throughout the world along with its rivals, viz. Colgate-Palmolive, Henkel, Unilever and others. This is not the only case. Such cases are in thousands.

1.2 MEANING AND IMPORTANCE OF INTERNATIONAL BUSINESS

International business means carrying on business activities beyond national boundaries. These activities normally include the transaction of economic resources such as goods, capital, services (comprising technology, skilled labour, and transportation, etc.), and international production. Production may either involve production of physical goods or provision of services like banking, finance, insurance, construction, trading, and so on. Thus, international business includes not only international trade of goods and services but also foreign investment, especially foreign direct investment.

International business means carrying business activities beyond national boundaries. It normally includes the transactions of economic resources such as goods, capital, services (comprising technology, skilled labour, transportation etc.) and international production. Production may either involve production of physical goods or provision of services like banking, finance, insurance, construction, trading and so on.

International business has been playing a crucial role for centuries. In the present-day world, it has become indispensable. Its role has increased significantly, both at the macroeconomic and microeconomic levels. No country—developed, or developing—produces all commodities to meet its requirements. It needs to import items that are not produced domestically. At the same time, it tries to export all items that are produced over and above its domestic requirements, so that its balance of payments may not worsen in the wake of imports. In a developing economy, the range of production is often limited, with the result that import requirements are bigger. On the other hand, such an economy tries to expand its exports in order to earn foreign exchange that could, in turn, meet its import requirements.

Foreign Direct Investment (FDI), which has gained importance in the recent past, is made for a variety of purposes. Acquiring of natural resources, recovery of large expenditure made on research and development, capturing a larger segment of the international market, and earning large profits are some of its important motives. In the case of a developing country with weak balance of payments position, foreign direct investment is very crucial. It helps obtain large foreign exchange resources and latest technology, and also develops managerial capabilities required for economic development programmes. In other words, foreign direct investment is essential as it bridges the resource gap. Thus, whether it is international trade or investment, it is an integral part of a country's economic behaviour.

Corporate wealth is the value of productive assets plus the present value of wealth created by those assets. Alternatively, it is the sum of the value of debt and equity in a firm.

At the microeconomic level, from the viewpoint of maximising corporate wealth, it is in the interest of a firm to export its product to foreign markets and to capture a large share of the markets abroad, especially when the domestic market is saturated. On the other hand, in order to minimise the cost and thereby, maintain a competitive edge, a firm likes to import inputs from least-cost locations. In offshore assembly operations, components involving capital-intensive mode of production are manufactured in a capital abundant economy and exported to a labour abundant economy for their assembly so that the firm can make use of cheap labour. The assembled product is again shipped to the home country and to other markets.

When the demand for a firm's product matures in foreign markets, it is in the interest of the firm to start production in those markets so that the transportation cost and tariffs can be avoided. Manufacturing in a foreign location involves not only investment of capital but also the transfer of technology. The transfer of technology helps improve the firm's competitiveness in markets abroad and at the same time is able to recover the huge cost incurred on research and development. Firms receiving capital and technology are also able to improve their competitiveness.

1.3 DOMESTIC BUSINESS VERSUS INTERNATIONAL BUSINESS

International business differs from domestic business in that the former involves across-the-country transactions or across-the-country production or provision of services, whereas, in the case of domestic business such activities are limited to the length and breadth of the country.

Again, there are many complexities in international business that are not found in case of domestic business. First of all, transactions in international business are mostly intra-firm. Final goods, intermediate goods, and raw material flow between the parent company and the subsidiary, or among different subsidiaries of the same firm. What is unique in such cases is that transactions often involve transfer pricing. This is meant primarily to reduce the overall tax and tariff burden and thereby, maximise the global profit of the firm. But sometimes its purpose is to make necessary adjustments in the cash requirements of different units. This means that the price of the intra-firm export and import is often different from the arm's length prices. The designing of prices is a complex task.

> Transfer pricing is arbitrary pricing of intra-firm transactions at more/less than the arm's-length prices.

International business is different from domestic business. In international business:

- Intra-firm transactions using transfer pricing are common.
- Varying environment—political, legal, economic, socio-cultural and ethical—in host countries, is often not known to the firm.
- Presence of political risk and also of exchange rate risk, sometimes leading to financial risk is marked.
- Varying strategies of business are adopted in different host countries.

Secondly, international business transactions are carried out in unfamiliar conditions prevailing in the host countries. The political and legal environment in the host country may be different, manifesting in different sets of policies, rules, and regulations. The economic environment may be different, manifesting in different levels of income, lifestyle and consumption patterns. For example, a host country having foreign exchange constraints may be adopting exchange control regulations, the financial market in the host country may not be developed, and the social and cultural set-up may be dissimilar, and the social behaviour, language, and the very attitude towards consumption and production may be different in the host countries. Firms involved in international business have to take care of all these factors and chalk out the strategy accordingly. This is not an easy task. It is highly complex when the home country environment differs significantly from the host country environment. The degree of complexity increases if the firm operates simultaneously in many host countries, that is, in multi-environment conditions. Even if the strategy suits the environment of one host country, it may not necessarily suit the other.

If the strategy of the company is not in conformity with the political, social, or economic environment of a particular host country, conflicts arise between the company and the host government. In practice, it is found that the company tries to impose its own business ethics on the host country environment. In some cases it succeeds but in many cases this practice creates problems. For example, firms in USA do not employ child labour. If they operate in India or in some other developing countries, where the social environment is different and where child labour is commonly used, this policy leads to adjustment problems. McDonalds sells beef hamburger in many countries. However, in India beef burgers are not socially acceptable. Again, in many developing countries where tight exchange control measures exist, foreign companies adopt different ways to effect transfer of funds. The host government does not appreciate this and comes into conflict with the company. Thus, there are many occasions on which conflict arises, and conflict management is not an easy task.

Thirdly, international business is prone to various kinds of risks. Political risk is one of them. Nationalisation of foreign firms without providing adequate compensation is common in international business. If the host country government prefers state-run enterprises, the chances for nationalisation are more.

Besides the political risk, international transactions—export and import, borrowing and lending, and other forms of receipts and payments—are subject to exchange rate risk. In a floating rate regime, where market forces determine the exchange rate, changes in the exchange rate are common. Such changes cause losses or gains that in turn lead to fluctuations in profit and give rise to financial risk. Firms involved in international business need to be alert to these risks.

Fourthly, the management function in international business regarding finance and accounting, personnel, marketing, and production differs from that in domestic business. An international firm takes various financial decisions in terms of both domestic currency and host country currency and is more concerned with the hedging of exchange rate risk.

It implements an international accounting system and emphasises on the consolidation of accounts of the various units. The marketing strategy in international firms aims at raising the firm's share in the international market. To this end, the branding strategy, the advertising strategy, the strategy of market segmentation, and so on are quite different. As regards personnel management, it takes into account the utilisation of expatriates. It selects, motivates and rewards the personnel for foreign assignments. Again, as regards product planning, the international firm is more adaptive to differences in technical requirements, consumer preferences, available production skills, sourcing of raw material, and so on. These different decisions make international business really complex.

1.4 MULTINATIONAL CORPORATION

An MNC is an enterprise with a substantial part of its operations in a number of foreign countries.

It is a fact that there are millions of exporting and importing firms that are engaged in international trade. Again, there are numerous firms that make foreign direct investment. But it is the multinational corporations (MNCs) that are responsible for a very large segment of international trade—intra-firm as well as inter-firm—and the largest part of foreign direct investment. Foreign direct investment and MNCs have become synonymous. In view of the significant contribution of the MNCs in international business, it is essential to acquaint the readers with some of their important features.

An MNC is sometimes known as transnational corporation or as supranational corporation. There is no single definition that is widely acceptable. Nevertheless, an MNC is an enterprise that owns or controls production or service facilities outside the country in which it is based (United Nations, 1973). Since there are several small firms that possess these features, it is often said that for qualifying as an MNC, the number of countries where the firm operates must be at least six (Vernon, 1971; United Nations, 1978). At the same time, the firm must generate a sizeable proportion of its revenue from the foreign operation, although no exact percentage is agreed upon. All this means that the firm should be big enough to have its stronghold in many countries through branches and subsidiaries. Looking at the 100 largest multinationals of the world, it is evident that 57.5 per cent of total sales, 48.1 per cent of total assets, and 49.1 per cent of total employment of these companies during 2002 was foreign (United Nations, 2004).

- Deutsche Post AG of Germany is operating in as many as 111 countries.
- The total assets of General Electric of the United States in 2006 amounted to US $697 billion that was greater than the gross domestic product of as many as 164 countries in the world.

Source: Based on: 1. UNCTAD, *World Investment Report*: 2008
2. World Bank, *World Development Indicators*: 2008.

According to Vernon and Wells Jr. (1986), MNCs represent a cluster of affiliated firms located in different countries that:

1. are linked through common ownership
2. draw upon a common pool of resources
3. respond to a common strategy.

All this shows a high degree of integration among different units of the firm.

Based on the strategic features, MNCs are grouped as ethnocentric, polycentric, and geocentric (Perlmutter, 1969; Perlmutter and Heenan, 1974). Ethnocentric firms are those that adopt home market oriented policy and seldom distinguish between domestic operation and global operation policies. On the other extreme, polycentric firms operate in foreign countries just to cater to the demand in those countries. This means that they follow a host market oriented policy. Between the two extremes, geocentric firms maintain a balance between the home market and host market oriented policies. They are in fact closer to real situations. It is this behavioural distinction that influences Punnett and Ricks (1997) to differentiate between a multi-domestic company and a global company. The former is concerned more with the market of the host country where it operates. The latter is concerned with the global market. It finds the world as a single market and plans to cater it through integrated operations.

Again, basing on the behavioural features of MNCs, Bartlett and Ghoshal (1989) differentiate between a multinational company and a transnational company. In the former, decision making is normally decentralised and the activities of the firm in foreign countries are not tightly co-ordinated. In the latter, on the contrary, global business activities of the firm are perfectly configured, coordinated and controlled to achieve global competitiveness. However, in the present text, these different terms are used interchangeably.

> Ethnocentric firms are those that adopt home market oriented policy and seldom distinguish between domestic operation and global operation policies.
> Polycentric firms follow a host market oriented policy.
> Between the two extremes, geocentric firms maintain a balance between the home market and host market oriented policies.

> A **multi-domestic** company is more concerned with the market of the host country where it operates. While a **global company** is concerned with the global market. It considers the world as a single market.

> In a **multinational** company, decision making is normally decentralised.
> While business activities of a **transnational** firm are perfectly configured, coordinated and controlled.

1.5 EVOLUTION AND DEVELOPMENT OF INTERNATIONAL BUSINESS

1.5.1 Process of Evolution

MNCs do not emerge overnight. Domestic firms, after expanding their operation and going through various stages of the evolution process, qualify for being called an MNC. The process of evolution takes place in three successive stages. They are:

1. Trade
2. Assembly or production
3. Integration

> The process of evolution of a domestic firm into an MNC involves three successive stages:
> 1. Trade
> 2. Assembly or production
> 3. Integration

Some firms are able to innovate products for which demand gradually develops in foreign markets, leading to export orders. Here begins the first stage of evolution. Initially, the exporting firm takes the help of some middlemen. But after export becomes a regular phenomenon, an export department is created to substitute middlemen. With growing trade, the firm sets up a branch in importing countries, which gradually evolves into a subsidiary. The subsidiary operates as a marketing aide that helps penetrate the foreign market and collect information regarding the changing tastes of consumers. The two-way traffic gradually becomes easier.

The firm is not satisfied with export alone. It intends to reach the consumers at the lowest possible cost, probably to compete with other suppliers. It may be noted here that the technology involved in the product does not remain the monopoly of the firm in due course of time. Reaching consumers at the least cost is marred by the imposition of tariff and transportation cost. So, the firm decides to assemble the final product in the importing country itself so as to avoid tariff and the transportation cost. In some cases, the firm starts manufacturing of the product in the importing country if necessary facilities are available there. The second phase of the evolutionary process starts here.

Lastly, the firm tries to integrate the activities of its different units. Intra-firm transfer of funds or material takes place in order to maintain an optimal trade-off between liquidity and profitability in the various units located in different countries. It is also undertaken for maximising the global profit. Sometimes, depending upon the cost and the facilities available, various stages of production and assembly of the same product are carried out in different countries. Integration is required in this case too for strengthening and optimising the vertical linkages. The implementation of financial, marketing, production, and personnel strategies too requires foolproof integration among different units. In this way, the third stage of the evolution process is completed and a perfect MNC appears to exist, although internationalisation of business sets in with the beginning of export business.

> In the wake of Industrial Revolution in Europe, the character of international business changed. International enterprises came to be engaged in extracting, processing, and transporting raw material for industrial plants located in the home country and also in exporting their manufactured goods back to the raw material producing countries.

1.5.2 Early Developments

International trade is many centuries old. In the 16th and the 17th centuries, international trade was carried out by individuals seeking fortunes for themselves. The reward was often great, but the risk of the voyage was also very high. Exotic goods that were traded normally were those that were sold at home at soaring prices. It was the fabulous profits that motivated some firms to operate abroad. The East India Company was among the foreign trading companies that moved to India in the early decades of the 17th century.

However, in the wake of Industrial Revolution in Europe, the character of international business changed. International enterprises came to be engaged in extracting, processing, and transporting raw materials for industrial plants located in the home country and also in exporting their manufactured goods back to the raw material producing countries.

In short, their activities were guided by the requirements of the home country industries. During the last quarter of the 19th century through the outbreak of the First World War, the British and other European and American companies operating abroad reached the peak of their trading activities.

After the Great War of 1914–18, the functions of international companies widened. They also came to be engaged in various services that the government of host countries was not able to render efficiently. This was the reason why host governments provided western companies many concessions.

1.5.3 Post-War Developments

By the mid-1940s, the economy of the US turned out to be the strongest. American industries were well developed and needed to acquire new sources of raw material. Moreover, they wanted to capture the largest share of the world market. All this led to rapid internationalisation of US firms since 1950s. During the two decades beginning from 1950, US foreign direct investment grew from $12 billion to $80 billion (Wilkins, 1970).

Since 1960s, many European firms too turned into multinationals, and since 1970s, there was substantial growth in Japanese MNCs. In 1970 only one Japanese MNC was listed among the world's largest 50 companies. By the end of the decade, the number rose to six. By 1980s, the Japanese became the largest producers of automobiles—a position that was enjoyed by the USA until then.

Since 1970s, the firms of developing countries too began operating internationally. There were two sets of developing countries. One was represented by oil exporting countries that had acquired huge foreign exchange reserves in the wake of the oil crisis of the 1970s. The other group was represented by newly industrialising countries that had imported technology from the developed countries and built up their own industrial base. Firms from both types of the developing countries established their affiliates abroad in a big way.

> The US multinationals made a head-way in 1950s, the European ones in 1960s and the Japanese ones in 1970s. The MNCs of developing world appeared in 1970s and those from transition economies made a start in 1990s.

And, of late, multinational firms have come to emerge also among the East European Countries. Although their size is not big, they are expected to grow fast in view of their resource base and also in view of growing opportunities in the 25-member European Union.

If one is to name some of the most prominent MNCs of the Eastern Europe, they are as follows.

1. Primorsk Shipping Corporation of Russian Federation engaged in transportation
2. Zalakeramia Rt. of Hungary engaged in manufacturing of clay product
3. Pliva d.d. of Croatia engaged in pharmaceuticals
4. Novoship Co. of Russian Federation engaged in transportation
5. Policolor S.A. of Romania producing chemicals

On probing the growth of international business during the past five decades or so, its evident that prior to the 1960s, the dominant organisational pattern of international companies was distinctive in the sense that the affiliates were self-contained as far as possible and they were barely small clones of the mother company scattered around the world. It is only since the 1960s that the organisational structure came to be more centralised in the hands of the parent company and this ushered a fast growth in the activities of international companies. But the growing control of the parent company was not relished by the host country governments as it often clashed with their interests. Host country governments began playing a decisive role in the decision making of international firms. They framed various rules and regulations for the conduct of international companies. With the lapse of time, the interest of the various groups became more complex and international business came to be fraught with growing complexities (Robinson, 1981).

1.5.4 Recent Trends

The past couple of decades have witnessed significant growth in international business. It is a fact that international business was greatly constrained by the oil shock and the restrictive policies pursued by many developing countries during the 1970s, but it was resumed by the mid-1980s and it grew in the subsequent period. Statistics show that between 1983 and 1990, FDI outflow grew at an average annual rate of 27 per cent, which was almost four-fold greater than the growth of world output and around three-fold greater than the growth of world exports. During 1990, the amount of FDI outflow stood at US $245 billion, over two-thirds of which were accounted for by only five countries, namely, the United States of America, the United Kingdom, Japan, Germany, and France. There were 170,000 foreign affiliates of over 37,000 parent companies. The worldwide sales of these affiliates were approximately US $5.5 trillion, which was greater than the world export of goods and non-factor services (United Nations, 1993). The fast growth in FDI outflows during the 1980s could be attributed to a host of factors. (1) The growing internationalisation of the Japanese economy resulted in the large explosion of FDI from this country; (2) The phenomenal growth in the demand for services in the wake of growth in per capita real income. Since many services were not tradable, FDI was the only way to participate in foreign markets. (3) This period witnessed more effective moves towards regional integration, as a result of which both intra-bloc and inter-bloc FDI increased.

Table 1.1 shows more recent trends. FDI outflow grew from US $245 billion in 1990 to US $1,150 billion in 2000. However, during 2000, there were ups and downs in the size of the flow. In 2005, it was US $779 billion which increased to US $1,858 billion during 2008. The annual growth rate ascended from 15.7% during 1991–1995 to 35.7% during 1996–2000 but was negative by 5.1% during 2001–2005. In 2006–2007, the outflow increased by around 50% but again in 2008, due to

Table 1.1 Growth in FDI: 1990–2008

	Value at Current Prices (US $ billion)						*Annual Growth Rate (%)*					
Item	*1990*	*2000*	*2005*	*2006*	*2007*	*2008*	*1991–1695*	*1996–2000*	*2001–2005*	*2006*	*2007*	*2008*
FDI inflows	209	1271	916	1411	1833	1697	20.0	40.2	−4.0	47.2	29.9	−14.2
FDI outflows	245	1150	779	1323	1997	1858	15.7			50.2	50.9	−13.5
FDI outward stock	1716	5976	10672	12756	15602	16206	10.7	16.8	10.1	20.4	22.3	−0.1
Cross-border M&As	151	1144	716	1118	1637	673	23.3	51.5	2.2	20.3	46.4	−34.7
Sale of foreign affiliates	5503	15680	22171	25844	31197	30311	10.4	10.9	13.6	22.2	20.7	−4.6
Assets of foreign affiliates	5706	21102	45564	55818	68716	69771	13.7	19.2	15.8	18.6	23.1	−5.0
Employment in foreign affiliates (million)	23.6	45.6	62.0	70	82	77	5.0	14.2	6.5	21.6	16.6	−3.7

Source: Compiled on the basis of figures available from various issues of *World Investment Report*.

international financial crisis, the growth rate in FDI outflow was negative by 13.5%. The FDI outward stock rose from US $1,716 billion in 1990 to US $5,976 billion at the end of 2000 and to US $10,672 billion by 2005 and US $16,206 billion by 2008. The amount of world FDI inflows grew from US $209 billion in 1990 to US $1,271 billion in 2000. During 2000s, the size moved up and down. In 2005, it was US $916 billion which increased to US $1,697 billion during 2008. The total assets of foreign affiliates rose from US $5,706 billion in 1990 to US $21,202 billion by 2000 and to US $45,680 billion by 2005 finally settling to US $69,771 billion at the end of 2008. The sales surged up from US $5,503 billion to US $15,680 billion increasing to US $22,171 billion and US $30,311 billion during the same period. The employment in foreign affiliates increased from 23.6 million to 45.6 million and to US $62 million and US $77 million respectively during this period.

Merger and Acquisition is the combination of two running firms.

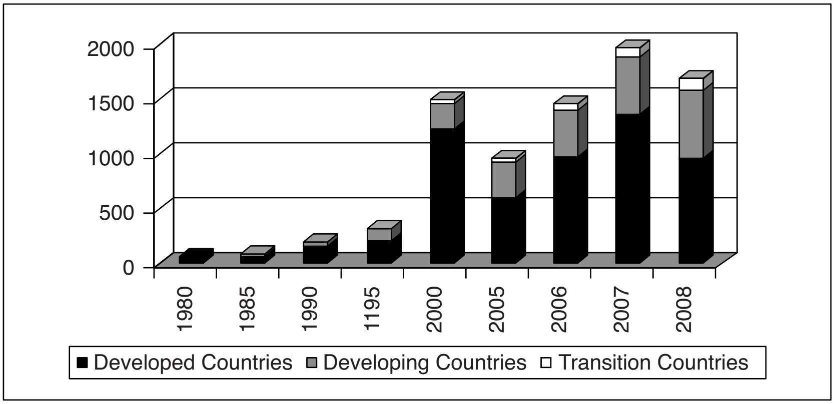
What is remarkable is that the mergers and acquisitions (M&As) formed a large part of the FDI outflow. In 1990s, the FDI through cross-border M&As had amounted to US $151 billion which rose to US $1,144 billion.in 2000 but fell to US $716 billion in 2005. During 2008, it was of the order of US $1,205 billion. If one looks at the annual growth rate, it rose from 23.3 per cent in 1991–1995 to 51.5 per cent in 1996–2000 but fell to 2.2 per cent during 2001–2005. In 2006 and 2007, the cross border M&As grew by 20 per cent and 46 per cent, respectively, but in 2008, it was negative at 35 per cent. A deeper probe reveals that the acquisitions were more common.

The other remarkable feature is that owing to the growth of FDI flow in general and the emergence of MNCs in developing as well as in transition countries in a big way, the share of these countries in FDI flow has increased. The figures in Table 1.2/Figure 1.1 show that the share of the developing countries in global FDI inflow moved up and down but remained lower than those for developed countries. The transition economies however, increased their share in global FDI inflow from around 2 per cent in 2000 to around 6 per cent in 2008.

Along with rapid internationalisation of firms, world trade, both intra-firm and inter-firm, grew manifold. The reduction of tariff and non-tariff barriers under the aegis of GATT and now under the WTO umbrella too gave a fillip to international trade. During two and a half decades

Table 1.2 FDI Inflows in Different Groups of Countries US $ Bill.

	1980	*1985*	*1990*	*1995*	*2000*	*2005*	*2006*	*2007*	*2008*
Developed Countries	58	57	162	208	1228	611	973	1359	962
Developing Countries		19	40	106	238	317	434	529	621
Transition Countries				14	26	31	55	91	114



Source: Based on the figures obtained from UNCTAD Database

FIGURE 1.1 FDI Inflows in Different Groups of Countries (US $ Bill.)

beginning from 1980, the value of world trade increased almost five-fold—from US $2,031 billion in 1980 to US $3,486 billion in 1990, to US $6,327 billion in 2000 and to US $10.2 trillion in 2005. The world trade in 2008 was as high as $15.8 trillion. MNCs have a big role in the increasing volume of trade (WTO, 2009). However, in recent decades, the small and medium-sized multinatinals or the so-called mini-multinationals that have come to possess globalising efficiency almost at par with the big organisation, do account for sizeable world trade (UNCTAD, 1993). Again, there has not been any noticeable change in the share of the developed market economies in the world trade. Their share continued to remain at 64 per cent (UNCTAD, 2005). Thus, international business has witnessed a phenomenal growth in the recent past.

Mini-MNCs have large-scale overseas linkages despite their smaller size.

1.6 FACTORS LEADING TO GROWTH IN INTERNATIONAL BUSINESS IN RECENT DECADES

It is a fact that the desire to expand sales and revenue, to acquire inputs at the least cost, and to minimise business and financial risk through geographic diversification has led to the growth of MNCs; yet there are some other factors too that provided them a congenial atmosphere to expand their activities at a very fast rate. These factors are:

1. Rapid technological advancement
2. Emergence of supportive institutions
3. Openness of economic policies among large number of countries
4. Break-up of the former USSR
5. Increase in competition

The past few decades have witnessed rapid advancement in product and process technology and in information technology. Many firms have emerged up with innovated products or with improved process technology. With the demand for such products and technology being price-inelastic, these firms have moved abroad in order to reap large profits. Sometimes the developed technology is meant for a larger market than the domestic one and in such cases it is imperative for the firm to go international in order to achieve economies of scale. The development of information technology has brought different countries closer and has encouraged firms to move abroad with the minimum of difficulties.

Technological advances have coincided with growth in financial and other infra-structural facilities. Besides the efforts of different developing countries for strengthening their infrastructural sector, it is mainly the bilateral and multilateral aid flows that have been directed towards this end. The International Bank for Reconstruction and Development has been responsible for the creation of Industrial Credit and the Investment Corporation of India and similar financial institutions in many other developing countries. Similarly, one of the primary objectives of the American aid programme has been to build up necessary infrastructure in developing countries so that American business could flourish in these countries. Whatever might be the reasons, developing countries have witnessed fast growth in their infrastructure, which has paved the way for international business.

Structural adjustment refers to macroeconomic policy reforms with an emphasis on liberalisation and globalisation.

The other factor responsible for the growth of international business, especially since 1980s, has been the structural adjustment and macroeconomic reforms in many developing countries. Many countries were facing huge trade deficit and severe external debt problems. In such cases, they have gone for economic adjustments or reforms, in turn improving their export sector and substituting external loans with foreign investment. The natural consequence is the growing volume of international business.

After the break-up of the former Soviet Union, there emerged a number of independent economies. They pursued a market-oriented economic policy substituting their closed economic and centrally planned economic policy. It was an outward-looking trade and investment policy. As a result, they added to the growing volume of international business.

Last but not least, it is the growing competition that has led to the growth of international business in the past few decades. With increasing competition, firms have preferred not only to source raw material and intermediate goods from the least-cost country but also to set up their units in different countries, which minimises the cost of operation and reduces financial risk. The growing concept of cost minimisation and risk reduction, with a view to surviving in a competitive environment, has thus led to rapid growth of the internationalisation process.

1.7 STRUCTURE OF BOOK

In view of the growing size and complexity of international business, the subject has now become an independent branch of study. This book deals with the various aspects of the subject and analyses the complex issues related to this branch of study.

The discussion is divided into three parts. The first part deals with the basic conceptual framework that forms a background for the discussions in the remaining two parts. To be precise, it delineates the process of globalisation and in this context the broad features of international business and its development, especially over past few decades; discusses different modes of international business and their comparative merits and demerits; presents the theoretical framework of international trade and foreign direct investment; and analyses the different aspects of balance of payments, which serves as a mirror showing the ultimate impact of international business on the economy as a whole.

> The discussion is divided into three parts. The first part deals with the basic conceptual framework that forms a background for the discussions in the remaining two parts.

It has already been mentioned that international business is different from domestic business insofar as it is normally carried on in an unfamiliar environment. It is thus rather imperative to acquaint the readers with the various types of environment in which international business is carried on. They are the regulatory environment dealing with the trade and FDI regulations at the national level as well as at the international level and the economic integration schemes in different parts of the globe. There are also the political, legal, economic, socio-cultural and ethical environment that differ from one country to the other, in turn, influencing the international business. Besides, the international financial environment is also important, as trade and investment involve different currencies and also funds that are borrowed and lent in different currencies and in different segments of the international financial market. Thus, the second part of the book deals essentially with the various types of environment influencing international business.

> The second part of the book deals essentially with the various types of environment influencing International Business

A study of international business is not limited to the study of the heterogeneous environment influencing it. Framing and implementing of strategies in order to fulfil the basic objective of maximising corporate wealth is also very significant. Although this aspect is significant for both domestic and international firms, it is more crucial for international business, in view of the far greater complexity in the case of the latter. The third part of the book, therefore, embraces the various strategies that an international firm adopts or should adopt. The discussion of strategies begins with the very distinctive organisational structure, planning, and control, and moves ahead covering the vital issues of technology and production, marketing, and human resource management. The financial strategy is no less important in this area of business. So the discussion regarding strategy also embraces financial strategy. In the end, the discussion is devoted to doing business in different sets of countries as the politico-economic and other conditions differ among them. The situations are different between an industrialised country and a less developed country. They are different in the European Union from those in industrialised countries in general. Again, the situations are different in transition economies. International business strategy needs at least some modifications for these different sets of the host countries. The study will be concluded with a discussion of international business strategy for heterogeneous groups of countries.

> The third part of the book embraces the various strategies that an international firm adopts or should adopt.

SUMMARY

- Globalisation is a process through which different economies comes closer to one another by way of trade and investment. There is clear-cut evidence of globalisation in so far as there is a phenomenal growth in international trade and investment in recent decades. This process has led ultimately to a higher economic growth rate.
- International business includes international transaction of economic resources, international production of goods, and provision of services. The broad forms of internationalisation of business are, therefore, trade, technical collaboration, and investment.
- International business is different from domestic business. Domestic business is limited to national frontiers, while international business spreads beyond them. International business involves many complexities that are related to intra-firm transactions and to unfamiliar host-country environment—regulatory, economic, and financial, political and legal, socio-cultural, ethical, and many others. Moreover, the very management function in international business differs from those in domestic business. These differences are visible mainly in the area of accounting and finance, personnel, marketing, and production.
- The most significant participant in international business is the MNC. It operates simultaneously in many countries. Its different units are linked through common ownership and they respond to a common strategy, although the degree of integration varies from case to case.
- International business did not emerge overnight, and has in fact, developed over several centuries. The earliest phase was manifested in trade. Then followed international production. The element of integration is the latest addition. Centuries ago, international business manifested itself in the trade of exotic goods. In the wake of the Industrial Revolution in England and other European countries, international production made a beginning but it was limited mainly to exploration of minerals and production of primary commodities. The purpose was to provide the Empire with necessary inputs and to find market abroad for the goods produced at home. However, it is only during the past three to four decades that MNCs have registered phenomenal growth. International trade too has expanded fast. The reasons for this are mainly rapid growth in technology, supportive institutions, openness of the different economies, and increased competition.

REVIEW QUESTIONS

1. What do you mean by international business? Is it true that international business has to face greater complexities than domestic business?
2. Discuss the process of evolution of international business.
3. Distinguish between ethnocentric, polycentric, and geocentric multinational firms.
4. Elaborate on the factors contributing to rapid growth in international business during the past four decades.
5. What do you mean by globalisation? Is this process working now?

REFERENCES

Books

Bartlett, C. A. and S. Ghoshal (1989), *Managing Across Borders: The Transnational Solution* (Boston: Harvard Business School Press).

Boudreaux, D. J. (2008), *Globalisation*, Westport (Greenwood Press).

Caselli, F. and J. Feyrer (2008), "The Marginal Product of Capital", *Quarterly Journal of Economics*, 122 (May), 535–68.

Dollar, D. and A. Kraay (2002), "Spreading the Wealth", *Foreign Affairs*, 81 (1), 120–33.

Gwartney, J. and R. Lawson (2001), *Economic Freedom of the World Annual Report 2001* (Vancouver: Fraser Institute).

Held, D.A. et al (1999), *Global Transformations: Politics, Economics and Culture* (Cambridge: Polity Press).

Maddison, A. (2000), *The World Economy: A Millennial Perspective* (Paris: OECD).

Mosley, P. (2000), "Globalisation, Economic Policy and Convergence", *World Economy*, 23, 613–34.

Perraton, J. (2003), "The Scope and Implications of Globalisation" in J. Michie (ed.), *The Handbook of Globalisation* (Northampton: Edward Elgar).

Punnett, B. J. and D. A. Ricks (1997), *International Business* (Oxford: Blackwell Business), Chap.1.

Sachs, J. and A. Warner (1995), "Economic Reform and the Process of Global Integration, *Brookings Papers on Economic Activity*, Vol. 1.

Stiglitz, J. (2002), *Globalisation and Its Discontents* (London: Penguin Press).

Sutcliffe, B. and A. Glyn (2003), "Measures of Globalisation and Their Misinterpretation" in J. Michie (ed.), *The Handbook of Globalisation* (Northampton: Edward Elgar).

UNCTAD (1993), *Small and Medium-sized Transnational Corporation: Executive Summary and Report of the Osaka Conference*, Geneva.

Vernon, R. (1971), *Sovereignty at Bay: The Multinational Spread of United States Enterprises* (New York: Basic Books).

_______ and L. T. Wells Jr, (1986), *Manager in the International Economy* (Englewood Cliffs: Prentice-Hall).

Wilkins, M. (1970), *The Emergence of Multinational Enterprise: American Business Abroad from the Colonial Era to 1914* (Cambridge Mass.: Harvard University Press).

Journals and Reports

Perlmutter, H. V. (1969), "The Tortuous Evolution of the Multinational Corporation", *Columbia Journal of World Business*, IV (Jan.–Feb.), 9–18.

_______ and D. A. Heenan (1974), "How Multinational Should Your Top Manager Be", *Harvard Business Review*, LII (Nov.–Dec.), 121–32.

Robinson, R. D. (1981), "Background Concepts and Philosophy of International Business from World War II to the Present", *Journal of International Business Studies*, XII (Spring-Summer), 13–21.

United Nations (1973), *Multinational Corporation in World Development*, New York, p. 23.
_______ (1978), *Transnational Corporations in World Development: A Re-examination*, New York, pp. 154–63.
UNCTAD (2001), *Handbook of Statistics*: 2001, New York and Geneva.
_______ (1998), *World Economic and Social Survey*, New York.
_______ (1999), *World Investment Report: Foreign Direct Investment and the Challenges of Development*, New York.
_______ (2001), *World Investment Report: Promoting Linkages*, New York.
_______ (2004), *World Investment Report*, New York.
_______ (2006), *Trade and Development Report: 2006*, New York.
WTO (2009), *Annual Report: 2008*, Geneva.

SELECT FURTHER READINGS

Ball, D. A. and W. H. McCulloch, Jr. (1982), *International Business* (Plano, Tex.: Business Publications).
McCarthy, D. M. P. (1994), *International Business History* (Westport, Conn.: Praeger).

* India Trade Promotion Organisation (ITPO), located at Pragati Maidan, is the nodal agency of the Government of India for promoting the country's external trade. ITPO, during its existence of nearly three decades, in the form of Trade Fair Authority of India and Trade Development Authority, has played a proactive role in catalysing trade, investment and technology transfer processes. Its promotional tools include organising of fairs and exhibitions in India (depicted in the picture is one such exhibition) and abroad, Buyer-Seller Meets, Contact Promotion Programmes, Product Promotion Programmes, Promotion through Overseas Department Stores and Market Surveys and Information Dissemination.
Photo by Ivan Lam

New York Stock Exchange, New York, USA*

2

Modes of International Business

CHAPTER OBJECTIVES

The present chapter discusses the various modes through which international business is operated. In particular, the chapter attempts to:

- ✦ Explain the factors influencing the choice of a particular mode of international business.
- ✦ Describe the features, merits, and demerits of direct and indirect trade as well as counter-trade.
- ✦ Evaluate various forms of contractual entry mode.
- ✦ Distinguish between foreign direct investment and foreign portfolio investment.
- ✦ Explain the nature and forms of mergers and acquisitions and the motivations behind such moves.
- ✦ Present a comparative picture of trade vis-à-vis FDI.
- ✦ Compare between FDI and contractual entry mode.
- ✦ Present a comparative analysis of green-field investment, and mergers and acquisitions.

The preceding chapter has already explained the nature of international business. Yet it could be better explained if one discusses, at some length, the different modes through which international business is carried on. Moreover, since huge amount of funds are involved in international business, the choice of a particular mode or modes is very significant for carrying on business across national borders. The present chapter acquaints the readers with these modes, such as international trade, contractual entry mode, and investment mode, and also with their relative suitability.

The choice of entry mode is also significant in view of the fact that different firms prefer different levels of involvement in international business. If a firm is in favour of least involvement, only trade may suffice the purpose. On the contrary, if a firm is in favour of maximum involvement in international business, the investment mode will be most suitable. But the question is whether the firm is capable of making investment. Even if it is capable of making investment, the host country environment may not be congenial for making investment. So a firm may go for different entry modes in different countries. The choice of entry mode takes a number of factors into account. Some of the more important factors need some explanation before beginning any discussion of the different modes.

2.1 DETERMINANTS OF ENTRY MODE

A firm adopts various modes for its entry into business transaction across borders. Which particular mode a firm should adopt depends, at least, upon four factors. They are:

1. Subservience of the corporate objective
2. Corporate capability
3. Host country environment
4. Perceived risk

When the objective of a firm spreading internationally is simply to earn profits and not necessarily to maintain control over the entire operation, only trading activities will serve its purpose. But if control is the primary objective, the investment mode, and especially investment in a wholly owned foreign subsidiary, will be the best course of action. Thus, a particular mode is selected in tune with the very objective of the firm behind international business.

The corporate objective shaping the entry mode must be supported by the company's capability to select the particular entry mode. For example, if the company' financial position is not strong enough to make large investment abroad, it will be difficult for the company to make such investment even if it is desirable on the grounds of fulfilling corporate objectives. Thus, the choice of the entry mode depends, to a considerable extent, on the capability of the company going international.

A firm adopts various modes for its entry into business transaction across borders. Which particular mode a firm should adopt depends, at least, upon four factors. They are:

1. Subservience of the corporate objective
2. Corporate capability
3. Host country environment
4. Perceived risk

In a *wholly owned subsidiary* the entire equity capital is owned by the parent company.

The host country environment too influences the entry mode. It includes many aspects, such as the regulatory environment; cultural environment; political and legal environment; economic environment, especially the size of the market and the production; the shipping cost, and so on (Root, 1987). When the managers of a firm are not well acquainted with the values, beliefs, customs, language, religion, and other aspects of the target market, the firm does not prefer to invest there. Rather, it limits its business only to trading activities in such cases. The company starts operation in the host country only when the managers are acquainted with the cultural environment in the host countries. Again, if the political conditions are not congenial in the target market or if the legal formalities are lengthy, large investment is often avoided. Sometimes, when the host government bans certain types of investment, foreign investors cannot make such investments even if they wish to make them. In India, in 1973, the government had fixed a ceiling on foreign equity participation. Foreign companies that did not favour the ceiling dismantled their operations in India (Sharan, 1992). Yet again, it is the size of the market in the host country that influences the entry mode of foreign firms. When the market is large and ever expanding, foreign firms prefer to enlarge their involvement through investment. But if the size of the market remains small, trade is the only suitable option. Last but not least, if the cost of production in the host economy is lower than in the home country, the host country attracts foreign investment. In fact, this is one of the important reasons that companies from the developed world have moved to developing countries. If the shipping cost is also low, it is possible that the firm may shift the entire production process to the low cost host country and may ship the output back to the home country for meeting the domestic demand. If, on the other hand, the host country does not represent cost effectiveness, trading remains the only way out.

Besides these factors, it is risk involved in the different modes of entry that influences the decision of a firm in this respect. Different modes involve varying degrees of risk. The lesser the amount of control in a particular mode, the lower the risk. If trading activities are ranked on the lowest rung of the ladder from the viewpoint of control, it carries the least risk. On the contrary, if investment in a wholly owned subsidiary possesses the largest element of control, it is supposed to be highly risky. Thus, the choice of the entry mode depends, among other things, upon the control-risk consideration of the firm.

> In *direct export*, a company takes full responsibility for making its goods available in the target market by selling directly to the end-users.

2.2 TRADE MODE

2.2.1 Direct and Indirect Export

> *Indirect export* takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end users in the target market.

The trade mode presents the first step in international business. It includes export and import. Export may be either direct or indirect. In case of direct export, a company takes full responsibility for making its goods available in the target market by selling directly to the end users, normally through its own agents. Direct export is feasible when the exporter desires to involve itself greatly in international business; and at the same time possesses the capacity to do so. There are also some commodities where direct export is more convenient. They are, for example, air crafts and similar industrial products.

When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Trading companies provide services to exporters, in addition to exporting activities.

When the exporting company does not possess the necessary infrastructure to involve itself in direct exporting, indirect export takes place. It takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end-users in the target market.

It is a fact that the nature of intermediary differs in direct export or import from that in an indirect export and import. However, when one talks about intermediaries, export management companies (EMCs) and trading companies cannot be ignored. When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Sometimes it acts as an agent for one client and as a distributor for the other. Trading companies, on the other hand, provide services to exporters, in addition to exporting activities, such as storage facilities, financing services, and so on. These companies originated in Europe but are now common in Japan and South Korea.

Apart from the intermediaries, there are trade facilitators. They are independent entities supplying information and knowledge to the exporter but definitely not participating in the transactions. They exist both in the public and private sectors. Various commodity boards and export promotion councils can be grouped as trade facilitators. There are also government organisations working under the Ministry of Commerce, such as trade development authority, that act as trade facilitator.

2.2.2 Counter-trade

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods.

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods. In this type of external trade, a seller provides a buyer with deliveries and contractually agrees to purchase goods from the buyer equal to the agreed percentage of the original sale contract value (US Department of Commerce, 1978). Counter-trade is classified broadly as:

1. Commercial counter-trade such as classical barter, counter-purchase and pre-compensation.
2. Industrial counter-trade such as buy-back agreements, develop for import arrangements, and framework agreements.

Commercial Counter-trade: Classical barter is one of the oldest modes of commercial counter-trade. It involves a once-only exchange of goods on the terms agreed upon between the buyer and the seller. The quantum, quality, and value of goods to be exchanged are well defined. Naturally, the trade flows in one direction are fully compensated by those in the reverse direction. There is no need for bridging finance. Negotiating parties are often governments. The exchange of Iranian oil for New Zealand's lamb or the exchange of Argentine wheat for Peruvian iron pillets are examples of classical barter (Banks, 1983).

In case of counter-purchase, which is also known as parallel barter, the contracts are often separate for import and export. The type and price of goods traded are generally not specified at the time of signing of the contract. The exporter of goods agrees to accept, in return, a wide range of goods from the importer. Balancing of the value of export and import is done every three to five years. If the two sides are not equal, the balance is paid in cash.

In case of pre-compensation, the value of exports is entered into an evidence account and imports are made on that basis. This means that payments for imports are not made immediately.

Industrial Counter-trade: Being a form of industrial counter-trade, buy-back agreements normally involve a larger amount corresponding to the sale of industrial equipment or turnkey plants in exchange for the products manufactured by these industrial plants. Naturally, the contract period is longer, varying from 10 to 20 years. The United Nations Economic Commission for Europe (1979) mentions the case of Austria selling pipeline equipment and related material to the then Soviet Union so that the latter could develop certain gas fields and could pipe a part of the output back to Austria. In case of developing countries, such agreements are common as they suffer from the technology gap on a large scale.

Develop-for-import arrangements are also a variant of the buy-back agreement where the exporter of the plant and machinery participates in the capital of the importing firm and, thereby, takes a share in the profits thereof. This means the involvement of the exporting firm is deeper than in a general buy-back arrangement. Japanese investment in an Australian firm developing gunpowder copper mine is an apposite example (Nameth, 1984).

Framework agreements are the long term protocol or bilateral clearing agreement normally concluded between governments. Trade is balanced after a long period as mentioned in the agreement. If the trade is not equal in value, the debtor sells the agreed upon commodity in the international market and the creditor is paid off. For example, Mexico sold cocoa to the United States of America to pay for its excess import from Malaysia (Far Eastern Economic Review, 1983).

Growth of Counter-trade: Barter trade was the mode of international trade in the eighteenth century when there was no sufficient monetisation. During the twentieth century, especially during the inter-War years, the West german government had resorted to bartering for strategic raw material (Banks, 1983). In the post-War period, counter-trade was initiated on a large scale by East European countries while trading with western countries and developing countries because they did not relish multilateral trade. In the wake of the oil crisis of 1970s, oil was exchanged for Soviet arms. The share of counter-trade in the world trade rose from around two per cent in 1964 to 20–30 per cent by the late 1980s (Debroy, 1987), although accurate estimates cannot be made on account of unavailability of figures. There is also region-wise difference as far as the volume of counter-trade is concerned.

Merits of Counter-trade: It is true that the multilateral trading system is beneficial, but the gains from it are limited in view of imposition of trade barriers. In such cases bilateral trade plays a vital role. First of all, it is a good option for meeting import requirements, especially in case of developing countries whose export faces high barriers.

Secondly, counter-trade helps stabilise export earnings because it predetermines the size of export and import. It also helps stabilise the terms of trade as the ratio between export and import prices is predetermined. Through stabilising export earnings and terms of trade, it transfuses stability in the development process.

Thirdly, it helps in trade diversification and, thereby, reduces the risk of geo-political chaos. Diversification of exports allows greater outlets for exportable goods, which in turn creates a more competitive market, increases export earnings, and reduces import costs.

Fourthly, counter-trade augments the flow of technology to developing countries, especially when they suffer from a serious technology gap. Buy-back agreements are particularly helpful in such cases.

Fifthly, when the counter-trade agreement is long term, the importing country gets the same advantage as it gets from loans. This means that counter-trade serves the purpose of loans and at the same time does not impose the burden of interest payment.

Sixthly, despite the fact that balancing of trade sometimes poses a problem, it reduces the net currency outflow and, thus, helps avoid foreign exchange problems.

Seventhly, developing countries often face distortions caused by unsuitable exchange rate policies. For example, overvaluation of currency tends to make export uncompetitive despite its impact in form of reduced import cost. Counter-trade helps correct such distortions. Goods can be exported at less than the quoted price and this can act as an export subsidy.

All this shows that counter-trade helps avert the problem of foreign exchange, which is endemic to developing countries. In fact, this has been a major factor for resorting to counter-trade. To quote a few examples, Brazil and Mexico opted for counter-trade in 1979 when their external balance was disturbed. So was the case with Indonesia in 1981. India was ready to exchange various raw materials for wheat and other agricultural commodities from the USA only after its foreign exchange crisis in the late 1950s.

Counter-trade

Merits
- Absence of tariff barriers
- Stabilisation of export earnings
- Scope for benefits from trade diversification
- Possibility for flow of technology, especially in buy-back agreements
- Some advantages similar to those of loans
- No need for foreign exchange for making imports
- Avoiding distortions caused by unsuitable exchange rate policy

Demerits
- Non-conforming with the norms of the multilateral trading system
- Absence of multilateral surveillance leading to distortions in markets and price
- Lack of encouragement for quality improvement
- Lack of double coincidence of goods to be traded
- Balancing of trade sometimes turns difficult

Demerits of Counter-trade: It is maintained that counter-trade goes against the norms of multilateral trade and so countries opting for it, abstain from reaping gains, from the multilateral trading system. There is always the possibility of market distortions because of the lack of multilateral surveillance. Distortions can take place in many ways. The price of the import may be very low and hence may harm domestic industries. If it is abnormally high, terms of trade will deteriorate. Once caught in counter-trade, the weak trading partner is coerced by the strong counterpart.

Again, difficult to sell products are sometimes traded. This means the country exporting such goods never tries to improve its efficiency. This negatively influences the export performance in the long run.

Yet again, there is always a difficulty of double coincidence of traded goods with the result that the trade earnings become unstable.

Last but not least, the balancing of trade poses a serious problem both at the micro level and at the macro level. Experience shows that micro level balancing is often more cumbersome. The problem also occurs at the macro level when exports face supply constraints. This happened in Indonesia during 1982 and 1983, when the country faced serious problems in balancing trade (Miramon, 1985).

2.3 CONTRACTUAL ENTRY MODES

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm. But in this

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm.

case, the secrecy of technology is not maintained and the firm's ownership advantage is always at stake. Thus, in order to maintain the ownership advantage, a firm passes on the technology only to its own subsidiary located abroad. But if the host government does not permit any foreign investment, the subsidiary of the firm in that host country cannot exist. Transfer of technology through contractual deals is the only way out. The contractual entry mode, often known as technical collaboration or technical joint-venture, is very common. It is preferred in many cases where:

1. The licensor does not possess enough capital for investment, nor does it possess the requisite knowledge of the foreign market for the purpose of export.
2. The licensor wishes to exploit its technology in the foreign market.
3. The licensor finds the host country market too small to make any investment for reaping economies of scale.
4. Nationalisation is feared in the host country.
5. Foreign investment in the host country is restricted.

Technical collaboration normally takes four forms. They are:

1. Licensing
2. Franchising
3. Management Contracts
4. Turnkey Projects

These different forms of the contractual mode are explained here (Figure 2.1).

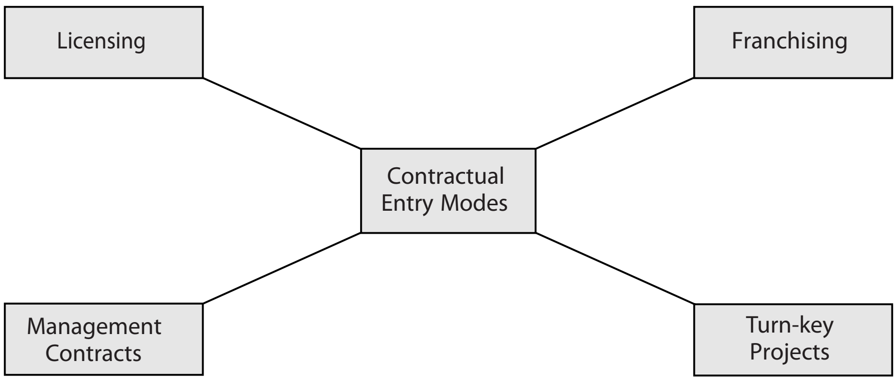


FIGURE 2.1 Different Forms of Contractual Entry Mode

2.3.1 Licensing

Nature and Forms: Licensing is an arrangement by which a firm transfers its intangible property such as expertise, know-how, blueprints, technology, and manufacturing design to its own unit, or to a firm, located abroad. It is also known as technical collaboration. The firm transferring technology, and so on is known as the licensor. The firm receiving technology, at the other end, and so on is known as the licensee. The arrangement is meant for a specific period. The licensor gets technical service fee from the licensee. The licensee, on the other end, does not have to make a huge investment on research and development. Thus both the parties reap the benefits of licensing.

A licence can be exclusive, non-exclusive, or cross. In an exclusive licence, the arrangement provides exclusive rights to produce and market an intangible property in a specific geographic region. On the contrary, a non-exclusive licence does not grant a firm sole access to the market. The licensor can grant even more companies the right to use the property in the same region. Cross licensing is reciprocal where intangible property is transferred between two firms, both of them being the licensor and the licensee at the same time. In the early 1990s there was cross licensing between Fujitsu of Japan and Texas Instruments of the USA. Both the companies used each other's technology for a given period.

Licensing is an arrangement by which a firm transfers its intangible property such as expertise, know-how, blueprints, technology, and manufacturing design to its own unit, or to a firm, located abroad. It is also known as technical collaboration.

A licence can be exclusive, non-exclusive, or cross.

Delhi-based Precision Pipes and Profiles, having already three tie-ups—a technical collaboration with Tokai Kogyo of Japan, a manufacturing and marketing agreement with Power Data Corporation of Australia and a licensing agreement with Nissen Chemitec of Japan, supplies automobile sealing system and auto-exterior products to Maruti Suzuki, General Motors (India), Toyota Kirloskar Motors and Honda SIEL and many others. It has already five manufacturing centres with a combined capacity of five million tonnes. However, in order to bring down the cost and to absorb minor cost fluctuations, it is setting up green-field unit at NOIDA to manufacture auto parts, major part of which will be exported to Australia and Japan under a buy-back plan.
Source: Based on the news published in *Business Standard,* 17.12.2007.

Advantages and Disadvantages: There are many advantages in a licensing arrangement. A licensor can expand its operation in different countries by exploiting its innovative technology, without making any investment. In other words, it can reap benefits from its technology without making any investment abroad. Secondly, it is less risky than the investment mode because it does not commit any investment. Even if there is an unfavourable political climate in the host country, the licensor is not going to lose anything except for some amount of technical fees. But in case of investment, the loss may be huge. Thirdly, licensing can be advantageous to the licensee too as it is able to upgrade its production technology and can develop its competitiveness in the international market.

However, there is the fear that licensing can reduce the global consistency of the quality and marketing of a licensor's product in different national markets, especially if different licensees operate in their own way. Again, the secrecy of technology is known to the licensee the moment the licensing agreement is made. In this way, a licensing arrangement hampers the very competitive advantage possessed by the licensor. During 1960s, RCA transferred technical know-how for the production of colour televisions to Sony and Matsushita for a handsome price. The licensees assimilated the technology and left RCA far behind in the competition in the world market.

2.3.2 Franchising

Franchising is a form of technical collaboration in which the franchisee makes use of intellectual property rights, like trademarks, copyrights, business know-how, managerial assistance, geographic exclusivity, or of a specific set of procedures of the franchiser for creating the product in question.

Meaning and Forms: In this form of technical collaboration, the franchiser is the entrant and the franchisee is the host country entity. The franchisee makes use of intellectual property rights, like trademarks, copyrights, business know-how, managerial assistance, geographic exclusivity, or of specific set of procedures of the franchiser for creating the product in question. In the literature available on this subject, a few experts have established similarities between licensing and franchising. Oman (1984) suggests that "franchising may be regarded as a particular type of licensing". Root (1987) too feels that franchising is a form of licensing in which the franchiser licenses a business system and other property rights to a franchisee. On the contrary, there are views to suggest that these two are different. Perkins (1987) is of the view that while franchising encompasses transfer of the total business function, licensing concerns just one part of business, including transfer of right to manufacture or distribute a single product or process. Again, franchising differs from licensing in that the former gives a company greater control over the sale of the product in the target market. When the franchisee fails to abide by the set of procedures, the franchiser takes back the franchise. Yet again, licensing is common in manufacturing industries, whereas franchising is more common in service industries where the brand name is more important.

Franchising may take different forms. In direct franchising, the franchiser frames policy and monitors and directs the activities in each host country from its home-country base. But in case of indirect franchising, there are sub-franchisers between the original franchiser and the host country units. The sub-franchiser possesses the exclusive right to exploit the original franchiser's business package within a defined geographic area.

Advantages and Disadvantages: The merit of franchising is that it allows the franchiser to maintain consistency of its standard products in different target markets. Moreover, it is a very low-risk mode of entry in different markets. However, there is often the problem of controlling a large number of franchisees in different markets. To avoid this problem, a master franchisee is established in a particular market to monitor the operation of individual franchisees in that market.

On the other hand, franchising is not cost-free. There are different types of costs involved in it. The costs are search costs, servicing costs, property right protection costs, and monitoring costs. The search cost is involved in evaluating, selecting and contacting a foreign party. The servicing cost includes the cost of codifying the franchise format appropriately, the cost of providing managerial and technical assistance, support, and ongoing training. The property right protection cost occurs in the process when the franchiser takes steps to safeguard its ownership advantage embodied in the franchise format. Last but not least, the franchiser needs to police and supervise the activities of the franchisee in order to maintain its brand image. The cost of policing and supervision is known as monitoring cost.

2.3.3 Management Contracts

Nature of Management Contracts: In a management contract, one company supplies the other with managerial expertise. Such agreements are normally signed in case of turnkey projects where the host country firm is not able to manage day to day affairs of the project, or in other cases where the desired managerial capabilities are not available in the host country. The transfer includes both technical expertise and managerial expertise.

In a *management contract*, one company supplies the other with managerial expertise. Such agreements are normally signed in case of turnkey projects where the host country firm is not able to manage day-to-day affairs of the project, or in other cases where the desired managerial capabilities are not available in the host country. The transfer includes both technical expertise and managerial expertise.

Merits and Demerits: It is through management contracts that many developing countries are able to utilise specialised expertise in different areas of their economy. But the moment local talent is developed, management contracts lose their significance.

Management contracts often supplement the licensing agreement insofar as they help the firm reap the advantages of licensing. Suppose a firm gets improved technology but lacks managerial inputs for better marketing, its products will remain unsold and the ultimate impact of the licensing agreement will be zero.

The transfer of managerial know-how is very easy as the licensor has to simply overstretch its management resources and make them available to the licensee. But the problem is that there is often misunderstanding between the foreign managers and the local managers, ultimately effecting productivity. Again, if foreign managers work only for a short period and do not train the local personnel, managerial efficiency will not be up to the mark. This will lead to problems when they go back to their home country.

2.3.4 Turnkey Projects

In a *turnkey project* agreement, a firm agrees to construct an entire plant in a foreign country and make it fully operational. It is known as turnkey because the licensor starts the operation and hands over the key of the operating plant to the licensee.

Meaning: In a turnkey project agreement, a firm agrees to construct an entire plant in a foreign country and make it fully operational. It is known as turnkey because the licensor starts the operation and hands over the key of the operating plant to the licensee. Agreements for turnkey projects normally take place where the initial construction part of the plant is more complex than the operational part. Such projects are either self-engineered or made to specifications. In case of the former, it is the licensor who decides the design of the project. In the latter, it is the licensee who takes such decision. In both cases, the contract involves either a fixed price or a cost-plus price. In a fixed-price contract, the risk of cost overruns lies with the licensor.

Advantages and Disadvantages: Turnkey projects allow firms to specialise in their core competencies, which they could not have done in the absence of such contracts. Moreover, such contracts allow the host government to obtain world class designs for its infrastructure projects.

Turnkey projects are also advantageous in cases where the host government restrict the inflow of capital. For example, many oil exporting countries did not permit foreign direct investment in the oil sector. Foreign firms entered these markets through turnkey projects. But the suppliers of turnkey projects often fall back on their own monopoly position in the international market.

2.4 FOREIGN INVESTMENT

2.4.1 Foreign Portfolio Investment and Foreign Direct Investment

Foreign portfolio investment is an investment in the shares and debt securities of companies abroad in the secondary market merely for sake of returns and not in the interests of the management of the company.

Foreign direct investment in form of green-field investment is an investment in the equity capital of a company abroad for the sake of the management of the company or investment abroad through opening of the branches.

M&As are either outright purchase of a running company abroad or an amalgamation with a running foreign company.

Foreign investment takes two forms. One is foreign portfolio investment, which does not involve the production and distribution of goods and services. It is not concerned with the control of the host country enterprise. It simply gives the investor, a non-controlling interest in the company. Investment in securities on the stock exchanges of a foreign country or under the global depository receipt mechanism is an example of foreign portfolio investment. On the other hand, foreign direct investment (FDI) is very much concerned with the operation and ownership of the host country firm. It is often said that even in case of FDI, if a company acquires around 10 per cent of the equity in a foreign firm, it should be treated as foreign portfolio investment as the investing or the acquiring firm does not have a say in the affairs of the target company (United Nations, 2000).

FDI is found in form of either green-field investment (GI) or mergers and acquisitions (M&As) or brown-field investment. Green-field investment takes place either through opening of branches in a foreign country or through foreign financial collaborations—meaning investment in the equity capital of a foreign company, in the majority of cases a newly established one. If the firm buys the entire equity shares in a foreign company, the latter is known as the wholly-owned subsidiary of the buying firm. In case of purchase of more than 50 per cent shares, the latter is known as a subsidiary of the buying firm. In case of less than 50 per cent purchase, it is known simply as an equity alliance. Sometimes an equity alliance is reciprocal, meaning that both companies invest in the equity capital of each other.

M&As are either outright purchase of a running company abroad or an amalgamation with a running foreign company. The term "brown-field" investment is used to denote a combination of green-field investment and M&As. It is found in cases when a firm acquires another firm; and after the acquisition, it completely replaces the plant and equipment, labour, and product line (Meyer and Estrin, 1998).

Again, FDI is either horizontal or vertical. Horizontal FDI is said to exist when a firm invests abroad in the same operation/industry. Suzuki's investment in India to manufacture cars is an example of horizontal FDI. On the contrary, vertical FDI is found when a firm invests abroad in other operations either with a view to have control over the supply of inputs or to have control over marketing of its product. British Petroleum and Royal Dutch Shell have invested abroad in the production of oil. Volkswagen has acquired a number of US dealers in order to sell its cars to consumers in the USA. These two are examples of vertical FDI. However, the first example is an example of a backward vertical FDI, where FDI assures the supply of inputs for its production at home. The second one is an example of forward vertical FDI in which it helps the sale of domestically produced goods in the host country. It may be noted that the forward vertical FDI is not as common as the backward vertical FDI.

Last but not least, based on the motives of the MNCs, FDI may be classified as: (1) market-seeking FDI, (2) resource-seeking FDI, (3) efficiency-seeking FDI and (4) strategic-asset-seeking FDI. Market-seeking FDI moves to a country where per capita income and the size of the market are large.

Suzuki Motor of Japan and many others like Hyundai Motor of the Republic of Korea, Toyota Motor and Honda Motor of Japan and General Motors and Ford Motor of the USA—all have invested and are going to expand their operations in India in view of large market. These investments can be categorised as market-seeking FDI.

The resource-seeking FDI flows to the host country where raw material and manpower are in abundance. The raw material may be related either to agriculture, forestry and fisheries or to non-renewable resources, such as energy minerals and metallic and non-metallic minerals. The share of extractive industries in global inward FDI stock was around 9.0 per cent at the end of 2005. In absolute terms, FDI in primary goods sector increased five times in 1970s, three-and-half times during 1980s and four times in 1990s.

Again the efficiency-seeking FDI moves to a country where the abundance of resources and presence of large market helps MNCs to improve their efficiency.

Last but not least, strategic-asset-seeking or created-asset-seeking FDI is meant to acquire next technologies in order to improve productivity.

Brown-field investment refers to mergers and acquisition followed by fresh doses of green-field investment. FDI is either horizontal or vertical. Horizontal FDI is said to exist when a firm invests abroad in the same operation/industry.

On the contrary, vertical FDI exists when a firm invests abroad in other operations either with a view to have control over the supply of inputs or to have control over marketing of its product.

2.4.2 Mergers and Acquisitions (M&As)

Forms of M&As: As mentioned above, FDI takes place also through mergers and acquisitions (M&As) that are not a start-from-scratch mode or a greenfield investment. Broadly speaking, M&As take two forms. One is the acquisition where one firm acquires or purchases another firm. The former is known as acquiring company and the latter is known as target company. No new firm comes into existence after the merger. The other form manifests in consolidation or amalgamation where two merging firms lose their identity into a new firm that comes to exist representing the interest of the two.

The M&As are either horizontal, or vertical, or conglomerate. Horizontal M&As are found where two or more firms engaged in similar lines of activities join hands. For example, if two firms manufacturing automobiles merge, it will be called a horizontal merger. Horizontal M&As help create economies of scale because the size of the firm becomes larger to reap such gains. On the other hand, vertical M&As occur among firms

Forms of M&As

- **Based on corporate structure:**
  1. Acquisition
  2. Amalgamation/consolidation
- **Based on financial relationship:**
  1. Horizontal
  2. Vertical
  3. Conglomerate
- **Based on technique:**
  1. Hostile
  2. Friendly

involved in different stages of the production of a single final product. If an oil exploration firm and a refinery unit merge, it will be called a vertical integration. It reduces cost of transportation, and of communicating and coordinating of production. Uncertainty over input supply is overcome as also the marketing of goods of a particular unit is assured through backward and forward linkages. Again, a conglomerate merger or consolidation involves two or more firms in unrelated activities. Three types of conglomerate M&As are often found. Product-extension combination broadens the product lines of the firm. Similarly, a geographic market extension merger involves two firms operating in different and non-overlapping geographic areas. The size of the market expands after the merger. Lastly, conglomerates representing neither of the two are known as pure conglomerate mergers. There are financial conglomerates where a financial company manages the financial functions of other companies in the group. Similarly, there are managerial conglomerates combining the management of several companies under one roof.

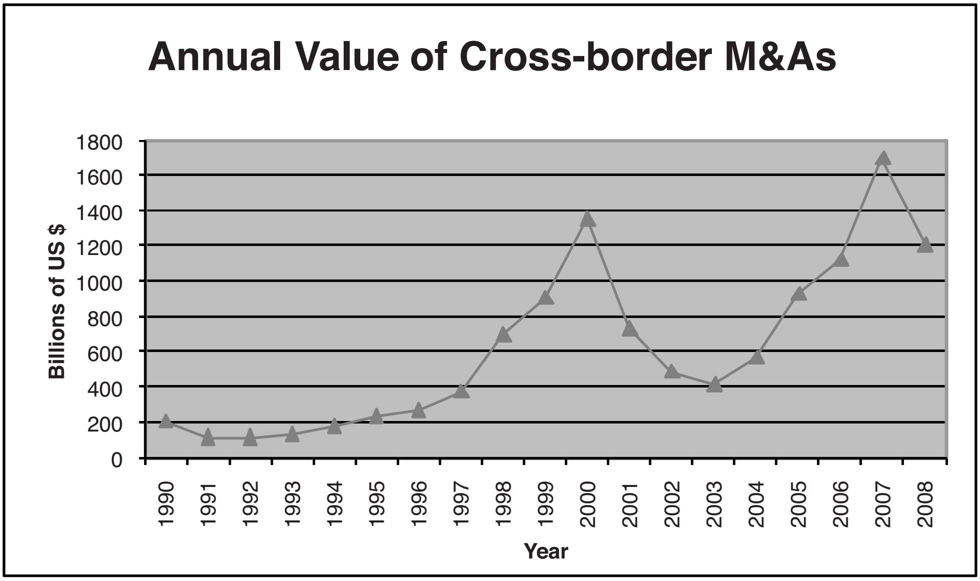
M&As are either hostile or friendly.

Again, from the viewpoint of technique, M&As are either hostile or friendly. In the hostile takeovers, the time devoted to negotiations is minimised as much as possible because it is just the discreet purchase of the shares of the target company. There are two ways to acquire shares. One is known as dawn raid, where the acquiring company makes a sudden purchase of shares of the target company. The other is by securing an irrevocable call option over someone else's shares. After the initial stake is finalised, the acquiring company makes a bid. In order to grab the shares it quotes a much higher price, which deters other parties from making bid. Such a bid is called as pre-emptive strike. On the other hand, if the company does not see a formidable competitor, it quotes a very low bid, often lower than the worth. This is done in order to gain more and this is called low-ball offer.

As far as friendly takeovers are concerned, there are a lot of negotiations. The take-over deal is not disclosed until it is finalised. To this end, the acquiring company signs confidentiality letter whereby it promises not to disclose the fact to any third party. When the negotiation is on and all the

Sun Pharmaceuticals bid for the assets of an Israeli company, Taro Pharmaceuticals was considered as the first ever hostile takeover by an Indian company for the control of a global company. Alkaloida, a subsidiary of Sun Pharma started a tender offer for all outstanding ordinary shares of Taro for $7.75 per share in cash on the June 30, 2008. This bid would bypass Taro's management and minority shareholders including Brandes Investment Partners and Franklin Templeton Asset Management.
Source: Based on the news published in *Hindustan Times Business*, 1.7.2008

relevant issues are sorted out, a letter of intent is signed. Finally, after the formal announcement is made to the press, a contract is signed.



Source: Based on the figures obtained from UNCTAD Database

Motivations behind M&A: M&A is preferable to other modes of investment or the start-from-scratch mode of investment. Firstly, the M&A provides a synergistic advantage. This means that the firms operating individually do not reap the benefits that they are able to reap when they are combined. This occurs because the combination allows firms to derive the economies of scale on different counts, especially on the count of production, technological research, management, finance, and marketing. For example, when the fixed cost in Firm A does not cross the relevant range even after it acquires Firm B, the combination will lead to saving of the fixed cost that Firm B was previously incurring. This would result in lower cost of production. Similar savings would occur in other relevant areas. These economies are most likely to occur in case of horizontal combinations where opportunities exist for avoiding duplicate facilities.

Secondly, M&A enables overnight growth of the firm. At the same time, the very risk of competition reduces after merger. However, emergence of monopolistic character has some amount of disadvantage for consumers when the price is unwarrantedly raised.

Thirdly, M&A reduces financial risk through greater amount of diversification. More particularly in case of conglomerates, assets of completely different risk classes are acquired and consequently there is the possibility of negative correlation between the rates of return from these different classes of assets. If so, the return from total portfolio of assets would be comparatively stable.

International M&A is preferred additionally where: 1. domestic market is saturated, 2. high tariff exists in host country, 3. firm possesses superior technology to take a lead in host country, and 4. host country is a regular source of raw material.

Fourthly, M&A leads to diversification, which raises the debt capacity of the firm. Because of greater stability in the rates of return or in the cash flow after merger, the firm goes ahead to employ leverage in the capital structure. This helps the cost of capital move downward and raises the value of corporate wealth.

Fifthly, tax savings sometimes leads firms to combine. Suppose Firm A is earning high profits. It combines with Firm B which is incurring loss. After combination, the total profit will be lower than Firm A's profit alone with the result that the amount of tax would be lower.

In international business, M&As are very common now a days because of the above mentioned reasons. However, international M&As sometimes become an essential step when the domestic market is saturated and the firm is desirous of further expansion for reaping gains from external economies. Again, international marketing often faces high tariffs, in which case M&A with the host country firms becomes a necessary step. It is found also when the firm having superior technology or managerial efficiency likes to reap advantages in the international market or when the firm likes to acquire improved foreign technology in order to make a lead in the domestic market. Besides all this, international M&A is also resorted to assure a regular source of raw material that is not available domestically.

2.5 STRATEGIC ALLIANCE

Strategic alliance is technical/financial collaboration with very specific objectives.

It has already been discussed that investment in the equity capital of a company registered abroad is known as equity alliance or foreign financial collaboration or financial joint venture. It is different from technical collaborations/joint ventures where only technology is transferred and not the capital. Strategic alliances too represent joint ventures. They take the form of either licensing, franchising, management contracts or equity alliance involving the flow of capital. But they are different from the general kind of financial and technical collaborations in so far as the purpose or the goal for which strategic alliances are made is very specific.

More commonly, the goal or purpose for which strategic alliances are made is as follows:

1. **Development of technology:** Apple Computers and IBM formed an alliance for the development of hardware and software technology for desktop computers.

2. **Increase in the size of market:** Ranbaxy formed a strategic alliance with a Japanese firm to grab the Japanese market for its generic drugs. Tata Tea's alliance with Tetley helped the former in the marketing of tea abroad.
3. Achieving economies of scale in production.
4. Reducing risk and promoting stability.
5. Multiple goal incorporating the above goals simultaneously.

Besides, involving a specific purpose, strategic alliance allows the partner firms to remain independent. But in such cases, there is uncertainty as to what one party is counting on the other party to do. Sometimes M&As are treated as a form of strategic alliance. But it is inconsistent with the very concept of alliance in so far as the acquired or merged firm does not depend on two or more existing organisations for its survival as does an alliance.

Inkpen (2001) mentions different types of strategic alliance. They are: (1) industry consortium, (2) technical training, (3) supply/buyback arrangement, (4) production/assembly arrangement, (5) patents licensing, (6) franchising, (7) know-how licensing, (8) management/marketing service agreement, (9) non-equity co-operative agreements and (10) equity joint-ventures.

Strategic alliances are assumed better than other modes in so far as they involve lower transaction costs. They are more economically feasible and involve a less irreversible commitment than an acquisition. Since there is no transfer of ownership rights, the partners may terminate alliance with a relatively low cost.

2.6 FDI COMPARED WITH TRADE

In the very beginning of the discussion on FDI, it is worth examining whether it is better than trade especially when the fulfilment of major international business objectives is concerned. Let us assume the objectives to be:

1. Expansion in sales and, thereby, in revenue
2. Acquisition of resources
3. Minimisation of risk through diversification
4. Political motive

Sales can be expanded also through greater magnitude of exports. But there are cases when export has only a limited scope. In such cases, FDI is made to generate sales. FDI overcomes the transportation cost involved in export. It is true that if the same product is exported to different markets, the firm produces more, exports more, and achieves economies of scale that largely compensates the transport cost. But when the product is differentiated, depending upon varying consumption pattern in different markets, economies of scale cannot be achieved. FDI is a better alternative in the sense that products with dissimilar features are produced in different countries in order to meet the specific demands of consumers there. It is the only way to generate sales.

FDI is better than trade because:

1. Different markets can better be served with differentiated products
2. FDI overcomes tariff and transport cost involved in trade
3. It is a better means to acquire resources from the host county
4. It reduces financial risk through greater diversification
5. It creates harmonious political relations.

Again, it is not only transport cost but also tariff and non-tariff barriers that are overcome by FDI. The generation of export is often handicapped by high tariff or non-tariff barriers imposed by importing countries. But if the exporting firm begins production in the importing country, trade barriers do not come in the way. The product becomes cheaper in the hands of the host country consumers. The firm finds itself in a competitive position and is able to raise its sales.

Apart from the generation of sales and revenue, the issue of the acquisition of resources is also important. Resources can be imported, but the import is possible only when the exporter agrees to export. On the other hand, FDI is a more reliable means to acquire resources. In the last quarter of the 19th century and the early decades of the 20th century, a good number of the British firms were engaged in mining activities. Even today, we find that Digital Equipment has made investments in India in order to access Indian software talent. Again, a large number of firms from industrialised countries have moved to developing countries to reap the benefit of cheap labour in the host countries. Suzuki produces cars with cheap Indian labour and exports them to the international market at competitive rates. Sometimes it is the cheap raw material that attracts FDI. Indian firms have moved to Sri Lanka for the manufacture of rubber products and to Nepal for the manufacture of herbal products. Thus FDI is more effective than other modes for the purpose of acquisition of resources. The resource acquisition process becomes easier, especially in a cross-border vertical set-up where the firm of an industrialised country uses cheap labour of a labour abundant economy through an off shore assembly operation.

Maximisation of return cannot be thought of in isolation of risk. With a given level of return, the risk has to be minimised. It can no doubt be minimised through the diversification of trade among larger number of countries. But the diversification process is easier in case of FDI. A firm can make investment in different countries; can source inputs from different countries, and can market its products in different countries. It is possible that the currency of a country from where the inputs are imported appreciates or it may be that the political relations with that country deteriorates. In such cases, risk can be reduced through diversifying the sources of inputs. Again, it is possible that the sales performance in a particular market is not good in a particular year; it may be diversified. Similarly, if returns from different ventures are negatively correlated, there will be stability in earnings and financial risk would be low. But all this is possible through diversification of the firm's operation.

FDI is a better instrument to develop harmonious political relationship with other countries. It is a fact that political motive is not the primary motive behind FDI, but it is definitely complementary to more important economic motives. The USA has made huge investments in some of Caribbean countries. One of the reasons is that these countries were opposed to the Cuban communist regime.

2.7 FDI COMPARED WITH CONTRACTUAL ENTRY MODE

It is true that, in almost all the cases, FDI also involves the transfer of technology with the result that the contractual entry mode can go side by side with FDI. But the two are different in nature. While FDI involves flow of funds or investment in the equity capital of a foreign company, contractual entry mode does not involve such investment. As a result, the contractual mode does not confer controlling power to the management of the company to which licenses/management know-how/trade mark, and so on are provided. Thus, from the viewpoint of control, FDI is superior to contractual entry mode.

Again, FDI is a broader form of joint venture compared to the contractual entry mode. It is because it involves capital investment and also, when required, the transfer of technical and managerial know-how. The investor can earn dividend and also charge royalty and technical service fees. Dividend is not payable to a licensor or a franchiser. This is why investors prefer FDI to the contractual entry mode.

It is true that FDI has an edge over the contractual entry mode, but even then there are cases when the contractual entry mode is preferred. It is preferred when the host government imposes restrictions on the inflow of FDI. Contractual mode is the only way out, apart from trade, to enter a foreign market. Again, it carries lesser risk of operating in a foreign land compared to FDI, especially when the investor is unaware of the political, legal, economic and socio-cultural environment prevailing in the host country. In such cases, firms enter a foreign market only gradually—first through trade, then through the contractual entry mode, and finally through making investment in the equity. In short, the two modes are to a large extent complementary rather than being competitive.

> *FDI* is a broader form of joint venture compared to the contractual entry mode. But contractual entry mode is preferred when the host government imposes restrictions on the inflow of FDI. It carries lesser risk of operating in a foreign land compared to FDI, especially when the investor is unaware of the political, legal, economic and socio-cultural environment prevailing in the host country.

2.8 GREENFIELD INVESTMENT (GI) VERSUS M&As

2.8.1 Substitutability between GI and M&As

The trends of international investment show that the share of M&As in total FDI outflow registered an increase from 60 per cent to 95 per cent and more during 1990–2000 (United Nations, 2001). This raises a very pertinent question whether M&As are an alternative to the greenfield investment (GI). It is often said that GI and M&As are the substitutes of each other. It may be correct if the level of economic development, institutional framework, and the FDI policy in the two countries—home country and the host country—are similar. Moreover, in the developed world, where financial markets are quite developed, M&As may serve as an alternative to GI. Again, as far as the impact of these two modes on the development in the host country is concerned, they are more or less the same and so they may be treated as an alternative to each

> Greenfield investment and M&As are not the substitutes of each other if the host country is a developing one. The two are found different from each other. On account of: 1. availability of financial resources, 2. technology considerations, 3. employment considerations, 4. building of export competitiveness, and 5. their impact on market structure and competitiveness.

other. But in a developing country, M&As should not be treated so. The reason is that:

1. The level of technology and management expertise is different from that in a developed country.
2. There are still governmental restrictions on the M&As, despite the liberalisation of economic policies.
3. Asset market is underdeveloped and accounting standard is poor, with the result that the assets of target companies are often undervalued, causing them to incur loss.

In short, the GI and the M&As are not the alternatives in the true sense of the term. Moreover, there are reasons to believe that the two differ in details. The difference is manifest in many ways.

2.8.2 Differing Impact of GI and M&As

The preceding section makes it clear that greenfield investment and M&As are not the substitutes of each other if the host country is a developing one. There are many viewpoints from which the two are found different from each other. Some of the more important viewpoints are discussed here.

Availability of Financial Resources: First of all, from the viewpoint of the inflow of the financial resources into the host economy it can be said that the financial resources provided under M&As do not necessarily add to the capital stock required for production. It is because they involve transfer of the ownership of the local assets to foreign hands normally in return for some amount of disposable shares. However, in case of distress sale when the target company is on the verge of bankruptcy and is not able to get financial resources from any of the sources, M&A adds to the foreign exchange resources of the host country. There are cases to show that during the Asian crisis, many firms could be saved in crisis-hit countries through cross-border M&As. Moreover, M&As often lead to currency appreciation of the host country insofar as the investment inflow is often lumpsum and immediate. GI does not lead to such effects because the investment inflow spreads over time and in most cases it is in kind. Similarly, outflow of resources in the form of dividend repatriation in case of M&As is sooner than in case of GI. Again, the GI essentially represents an investment in the plant; on the contrary, the M&As consideration value is fungible and can be used also for non-productive purposes.

The Technology Considerations: From the viewpoint of the transfer, upgrading, and diffusion and generation of technology, the two modes differ to some extent. Since M&As involve working with an existing facility and the GI is concerned with setting up a new one, the latter is more likely to involve newer equipment from the very beginning. However, this is not always the case. Caves (1998) finds that since the technology gap between a developed and a developing country is large, M&As too are found injecting new technology in the target firm and additionally, they help preserve the technology developed by the acquired firm.

As far as technological upgrading is concerned, it depends more upon the market orientation of the investment, local skills and capabilities in the host country, and the corporate strategy, and not much on the entry mode. However, empirical studies have shown that FDI through M&As has led to considerable technological upgrading (United Nations, 2000).

Apart from transfer and upgrading of technology, diffusion of technology is greater in case of M&As insofar as the acquired firms enjoy greater linkages with the local economy, whereas it takes time to develop such linkages in the case of GI. However, in the context of innovation or generation of technology, the views are different. It is true that if the R&D in the acquired firm is uneconomic, the acquiring firm's sword falls on it. But there is nothing wrong if uneconomic R&D is substituted by an economic one. If the existing R&D in the acquired firm is economic, there is no reason for its substitution. Rather, in case of efficiency seeking or created asset seeking foreign direct investment, the acquired company avails of the R&D capabilities within no time. In case of GI, it takes a long time to develop R&D activities.

Employment Considerations: From the viewpoint of quantity and quality of employment, the two modes—M&As and GI—differ substantially. GI generates new employment, while M&As transfers responsibility for existing employees who may be laid off by the new owner on the grounds of efficiency or over-staffing. In fact, the impact of M&A on employment generation depends on the motivation behind it as also on the characteristics of the acquired firm. First, if the M&A is a market seeking move, the impact on the employment generation is expected to be neutral or, to some extent, positive in the short run and medium term, as the existing employees are retained to work for the new market. Second, if the M&A is strategic asset seeking, employment in the acquired firm is expected to expand as the employees possess valuable skills and capabilities. Third, if the M&A is efficiency seeking, employment in the acquired firm may decrease if it has substantial excess capacity or has a duplication of functions. Cross-border M&As in automotive, financial, and service industries during the 1980s and 1990s led to cut in employment despite increase in output (United Nations, 2000). Fourth, if the motive is financial, employment may decrease owing to restructuring or asset-stripping. Fifth, if the motive is to privatise a public-sector unit, employment may decrease as a result of restructuring. Evidences from cross-border M&As in seven countries of Central and Eastern Europe support this phenomenon (United Nations, 1999). But if the acquired firm had been liquidated in the absence of an M&A, the M&A would have been employment conserving, even if there was a partial lay-off to some extent.

This is all about the impact of M&As on direct employment generation. There may be positive impact on indirect employment generation following forward and backward linkages of the acquired firm with other enterprises in the economy.

Turning to the qualitative aspects of employment, it is often found that both greenfield investment and M&As provide better-quality employment. But in specific circumstances, wages may be lowered and facilities may be cut on the grounds of cost reduction.

Building of Export Competitiveness: Greenfield investment is more useful for building export competitiveness when the host country firm does not possess large export potential. However, the experience varies from case to case. In Hungary, M&As were less export oriented than greenfield investment. In the Czech Republic, the export potential of M&As was the same as that of greenfield investment (United Nations, 2000). Again, when greenfield projects have weak linkages with local firms and depend more on imported inputs, imports tend to rise.

Impact on Market Structure and Competition: It is normally believed that greenfield Investment adds to the number of enterprises and reduces market concentration. But this is not always true. If the investing firms were present earlier in the market through other modes, new firms will not be created. Again, if the new foreign affiliate offsets the dominant market positions of incumbent firms or takes a dominant market position itself, the market will be more concentrated.

On the contrary, cross-border M&As may have a positive impact on the market structure if an ailing firm is acquired, which would have otherwise been forced out of the market. But if it is a monopolising or quasi-monopolising M&A, the market structure will turn more concentrated. In India, when Hindustan Lever Limited, the Indian subsidiary of Unilever, acquired its main rival, Tata Oil Mills Company, the market for toilet soaps and detergents became concentrated (Mehta, 1999). However, when market is open to imports and to foreign investment, the domestic concentration level may not necessarily make a difference to effective competition.

SUMMARY

- The choice of entry mode depends on the objective, extent, and capability of a firm's involvement in international business on the one hand, and the host country environment and the magnitude of risk involved on the other.
- The broad modes of international business are:

  1. Trade, including direct and indirect trade, and counter-trade;

2. Contractual mode, including licensing, franchising, management contracts, and turnkey jobs; and
3. Foreign direct investment, including greenfield investment and mergers and acquisitions.

- Direct trade means direct involvement of the firm in trade, while indirect trade is conducted through any other agency. In countertrade, one set of goods is exchanged for the other set of goods.
- Contractual modes are found in case of intangible products such as technology, patents, and so on.
- Foreign direct investment possesses essentially the element of control and this way it is different from foreign portfolio investment. Foreign direct investment that serves some of the international business objectives in a better way may be greenfield investment through foreign branches and subsidiaries. Alternatively, it can take the form of M&As.
- M&As may be horizontal, vertical, or conglomerate. They may be either hostile or friendly. There are a number of motives behind M&As, such as reaping of synergistic advantage, overnight growth of the firm, risk minimisation, tax savings, and so on. In cross-border M&As, exchange rate changes, tax rate differentials, financial leverage norms, and so forth too come in the picture.
- Strategic alliance is financial technical collaboration with specific objective.
- A comparative analysis of greenfield investment and M&As shows that in developed countries where the asset market is developed, they may substitute each other. But in the case of developing countries, substitution is not feasible. Moreover, the two methods are different in their impact with respect to the availability of financial resources, transfer, upgradation, diffusion and generation of technology, employment generation, building of export potential, and market structure and competition.

REVIEW QUESTIONS

1. "Choice of entry mode is crucial for international business". Discuss. Explain the determinants of entry mode.
2. What are the different forms of countertrade? Is it preferable to multilateral trade?
3. Present a comparative picture of the different forms of contractual entry mode of international business.
4. Explain different forms of M&As. In what ways are they different from green-field investment?
5. Write a note on strategic alliance.

REFERENCES

Books

Inkpen, A. C. (2001), "Strategic Alliance" in A. M. Rugman and T. L. Brewen, *The Oxford Handbook of International Business* (Oxford: Oxford University Press).

Root, F. R. (1987), *Entry Strategies for International Markets* (Lexington, M. A.: Lexington Books).

Journals and Reports

Banks, G. (1983), "The Economics and Politics of Countertrade", *The World Economy,* VI (2), 159–82.

Caves, R. E. (1998), "Industrial Organisation and New Findings on the Turnover and Mobility of Firms", *Journal of Economic Literature,* XXXVI (4), 1947–82.

Debroy, B. (1987), "Counter-trade", *The Economic Times*, 12th May and 13th May.

Far Eastern Economic Review (1983), 27th August.

Jacques de Miramon (1985), "Countertrade: An Illusory Solution", *The OECD Observer*, Paris, May, 24–25.

Mehta, P. S. (1999), "Foreign Direct Investment, Mega-mergers and Strategic Alliances: Is Global Competition Accelerating Development or Heading towards World Monopolies ?", *The Role of Competition Policy for Development in Globalising World Markets*, UNCTAD Series on Issues in Competition Law and Policy (Geneva: United Nations).

Meyer, K. and S. Estrin (1998), "Entry Mode Choice in Emerging Markets: Greenfield, Acquisition and Brownfield", *Centre for East European Studies*, Copenhagen Business School, Working Paper no. 18.

Nameth, L. (1984), "Offsets under Fire Down Under", *Multinational Monitor*, V (1), 3.

Oman, C. (1984), *New Forms of International Investment* (Paris: OECD).

Perkins, J. S. (1987), "How Licensing, Franchising Differ", *Les Nouvelles*, XXII (4), 15.

Sharan, V. (1992), "Foreign Investments in India: Trends, Problems and Prospect", *Foreign Trade Review,* XXVII (1), 74–84.

——— United Nations (1999), *World Investment Report*, 1999, (New York and Geneva: UNCTAD).

——— (2000), *World Investment Report*, (New York and Geneva: UNCTAD).

——— (2001), *World Investment Report*, (New York and Geneva: UNCTAD).

United Nations Economic Commission for Europe (1979), *Countertrade Practices in the ECE Region*, Geneva, Trade R. 385, p. 22.

United States Department of Commerce (1978), *East-West Countertrade Practices*, Washington, D.C.

SELECT FURTHER READINGS

Beamish, P. W. (1985), "The Characteristics of Joint Ventures in Developed and Developing Countries", *Columbia Journal of World Business*, XX (Fall), 13–19.

Contractor, F. J. (1990), "Contractual and Co-operative Forms of International Business: Towards a United Theory of Modal Choice", *Management International Review*, XXX (1), 31–54.

Hill, C. W. L. *et al* (1990), "An Eclectic Theory of the Choice of International Entry Mode", *Strategic Management Journal*, XI (2), 117–28.

Lecraw, D. J. (1989), "'The Management of Counter-trade: Factors Influencing Success", *Journal of International Business Studies*, XX (1), 41–59.

Oman, C. (1984), *New Forms of International Investment in Developing Countries* (Paris: OECD).

United Nations (2000), *World Investment Report: 2000* (New York and Geneva: UNCTAD).

Welch, L. S. and A. Pacifico (1990), "Management Contracts: A Role in Internationalisation", *International Marketing Review*, VII (Summer), 64–74.

---

* The **New York Stock Exchange (NYSE)** is located at 11 Wall Street in lower Manhattan, New York City, USA. It is the world's largest stock exchange by market capitalisation of its listed companies at US$28.5 trillion as of May 2008. Average daily trading value was approximately US$153 billion in 2008.

The NYSE is operated by NYSE Euronext, which was formed by the NYSE's 2007 merger with the fully electronic stock exchange Euronext. With more than 8,000 listed issues, NYSE Euronext is home to the world's leading companies providing access to the global liquidity they need to collaborate, compete and grow.

This page is intentionally left blank.


France*

3

Theories of International Trade

CHAPTER OBJECTIVES

The present chapter explains the theoretical basis of international trade. The focus, in particular, is to:

- ✦ Explain the various theories of international trade, ranging from the mercantilist version to classical theories of absolute and comparative cost advantage, the factor endowment theory, neo-factor proportions theory, country similarity theory, intra-industry trade, trade in intermediate products and services, and finally, Porter's theory of national competitive advantage.
- ✦ Discuss the static and dynamic gains from trade.
- ✦ Explain terms of trade and their various forms.

The preceding chapter makes it evident that trade is an important mode of international business. And so a very pertinent question arises in the very beginning as to what, how much and with whom a country should trade. The answer to the question lies in the explanation given by different economists during different periods. The explanation has taken the form of theories of international trade. The present chapter thus deals with the various trade theories. In the beginning, the conventional theories are discussed and then the post-Heckscher-Ohlin developments forming a part of modern theories will be analysed.

3.1 MERCANTILISTS' VERSION

Mercantilism was a school of economic thought prevalent in 17th and early 18th centuries that advocated for trade surplus.

Mercantilism stretched over about three centuries ending in the last quarter of the eighteenth century. It was the period when the nation-states were consolidating in Europe. For the purpose of consolidation, they required gold that could best be accumulated through trade surplus. In order to achieve trade surplus, the governments monopolised the trade activities, provided subsidies and other incentives for export. On the other hand, it restricted imports. Since the European governments were mainly the empire, they imported low-cost raw material from the colonies and exported high-cost manufactures to the colonies. They also prevented colonies from producing manufactures. All this was done in order to generate export surplus. Thus, in short, increasing gold holding through export augmentation and import restriction lay at the root of the Mercantilist theory of international trade.

Trade surplus can be defined as excess of export over import.

However, the later versions of the Mercantilist doctrine explained that trade surplus was not an everlasting phenomenon. A positive trade balance led to an increase in the commodity prices relative to other countries. The increase in commodity prices caused a drop in export and thereby an erosion in trade surplus.

Again, the Mercantilists had a static view of the world economy. They did not realise that the gains from trade of a particular country were possible only at the expense of the other country. In fact, trade should promote the welfare of the world economy and not simply of a particular nation.

Moreover, the exponents of this theory ignored the concept of production efficiency through specialisation. In fact, it is the production efficiency that brings in gains from trade (Heckscher, 1935).

3.2 ABSOLUTE AND COMPARATIVE ADVANTAGE

The classical economists refuted the Mercantilist notion of precious metals and specie being the source of wealth. They thought domestic production was the prime source of wealth. And so they took into account the productive efficiency as the motivating factor behind trade. Two such theories need to be mentioned here—one propounded by Adam Smith and the other propounded by Ricardo.

3.2.1 Theory of Absolute Advantage

Absolute cost advantage theory explains that a country having absolute cost advantage in the production of a product on account of greater efficiency should specialise in its production and export.

Adam Smith was one of the forerunners of the classical school of thought. He propounded a theory of international trade in 1776 that is known as the theory of absolute cost advantage. He is of the opinion that the productive efficiency among different countries differs because of diversity in the natural and acquired resources possessed by them. The difference in natural advantage manifests in varying climate, quality of land, availability of minerals, of water and other natural resources; while the difference in acquired resources manifests in different levels of technology and skills available. A particular country should specialise in producing only those goods that it is able to produce with greater efficiency, that is at lower cost; and exchange those goods with other goods of their requirements from a country that produces those other goods with greater efficiency or at lower cost. This will lead to optimal utilisation of resources in both the countries. Both the countries will gain from trade in so far as both of them will get the two sets of goods at the least cost.

Adam Smith explains the concept of absolute advantage in a two-commodity, two-country framework. Suppose Bangladesh produces 1 kg of rice with 10 units of labour or it produces 1 kg of wheat with 20 units of labour. On the other hand, Pakistan produces the same amount of rice with 20 units of labour and produces the same amount of wheat with 10 units of labour. Each of the countries has 100 units of labour. Equal amount of labour is used for the production of two goods in absence of trade in the two countries.

In absence of trade, Bangladesh will be able to produce 5 kg of rice and 2.5 kg of wheat. At the same time, Pakistan will produce 5 kg of wheat and 2.5 kg of rice. But when trade is possible between the two countries, Bangladesh will produce only rice and exchange a part of the rice output with wheat from Pakistan. Pakistan will produce only wheat and exchange a part of the wheat output with rice from Bangladesh. The total output in both the countries will rise because of trade. Bangladesh, which was producing 7.5 kg of food-grains in absence of trade, will now produce 10 kg of

Table 3.1 Theory of Absolute Cost Advantage

Amount of Production in Absence of Trade			*Amount of Production after Trade*		
	Rice	*Wheat*		*Rice*	*Wheat*
Bangladesh	5 kg	2.5 kg	Bangladesh	10 kg	Nil
Pakistan	2.5 kg	5 kg	Pakistan	Nil	10 kg
Total output in two countries: 15 kg			Total output in two countries: 20 kg		

food-grains. Similar will be the case with Pakistan where 10 kg of food-grains will be produced instead of 7.5 kg (Table 3.1).

The theory of absolute cost advantage explains how trade helps increase the total output in the two countries. But it fails to explain whether trade will exist if any of the two countries produces both the goods at lower cost. In fact, this was the deficiency of this theory that led David Ricardo to formulate the theory of comparative cost advantage (Haberler, 1950).

3.2.2 Ricardian View of Comparative Advantage

Comparative cost advantage theory explains that a country should specialise in the production and export of a commodity in which it possesses greatest relative advantage.

Ricardo focuses not on absolute efficiency but on the relative efficiency of the countries for producing goods. This is why his theory is known as the theory of comparative cost advantage. In a two-country, two-commodity model, he explains that a country will produce only that product which it is able to produce more efficiently. Suppose Bangladesh and India, each of the two has 100 units of labour. One half of the labour force is used for the production of rice and the other half is used for the production of wheat in absence of trade. In Bangladesh, 10 units of labour are required to produce either 1 kg of rice or 1 kg of wheat. On the contrary, in India, 5 units of labour are required to produce 1 kg of wheat and 8 units of labour are required for producing 1 kg of rice. If one looks at this situation from the viewpoint of absolute cost advantage, there will be no trade as India possesses absolute advantage in the production of both the commodities. But Ricardo is of the view that from the viewpoint of comparative advantage, there will be trade because India possesses comparative advantage in the production of wheat. This is because the ratio of cost between Bangladesh and India is 2:1 in case of wheat, while it is 1.25:1 in case of rice. Because of this comparative cost advantage, India will produce only 20 kg of wheat with 100 units of labour and export a part of wheat to Bangladesh. On the other hand, Bangladesh will produce only 10 kg of rice with 100 units of labour and export a part of rice to India. The total output of foodgrains in the two countries, which was equal to 26.25 kg prior to trade, rises to 30 kg after trade. Thus it is the comparative cost advantage that leads to trade and specialise in production and thereby to increase in the total output in the two countries (Table 3.2).

Table 3.2 Theory of Comparative Cost Advantage

Amount of Output in Absence of Trade			*Amount of Output after Trade*		
	Rice	*Wheat*		*Rice*	*Wheat*
Bangladesh	5 kg	5 kg	Bangladesh	10 kg	Nil
India	6.25 kg	10 kg	India	Nil	20 kg
Total output in two countries: 26.25 kg			Total output in two countries: 30 kg		

Despite being simple, the classical theory of international trade suffers from a few limitations. Firstly, it takes into consideration only one factor of production, that is labour. But in the real world, there are other factors of production too that play a decisive role in production. Similarly, the theory does not take into account the transportation cost involved in trade.

Secondly, the theory assumes the existence of full employment, but in practice, full employment is a utopian. Normally, the entire resources in a country are not fully employed. In such cases, the country puts restrictions on the import in order to employ its idle resources, even if these resources are not to be employed efficiently.

Thirdly, the theory stresses too much on specialisation that is expected to improve efficiency. But it is not always the case in real life. The countries may pursue some other objectives too that may not be necessarily the productive efficiency. It is because when the country specialises in the production of a particular good, changes in the technology make the economy highly vulnerable.

Fourthly, the classical economists feel that the resources are mobile domestically and immobile internationally. But neither of the two assumptions is correct. Within the country, it is difficult for the labour to move from one occupation to another, especially when the job is highly technical. On the contrary, labour and capital move easily across nations.

Nevertheless, the empirical tests carried on by MacDougall (1951), Stern (1962) and Balassa (1963) supported the Ricardian hypothesis. It would not be wrong to say that the classical theory holds good even today insofar as it suggests how a nation could achieve the consumption level beyond what it could do in absence of trade. This is in fact the reason why the countries stress upon expansion in the world trade (Haberler, 1950).

3.2.3 Comparative Advantage based on Opportunity Cost

Later writings did not remain confined to a single factor of production, labour. They explained comparative advantage based on opportunity cost. Opportunity cost is the amount of a commodity foregone to get the other commodity. Recalling the earlier example, if 6.25 kg of rice are foregone to get 10 kg of wheat in India, the marginal rate of transformation (MRT) in India will be −0.625 kg of rice for 1 kg of wheat. Similarly, in Bangladesh, 5 kg of rice are foregone to get 5 kg of wheat, the MRT in Bangladesh will be −1 kg of rice for 1 kg of wheat. In terms of equation,

> MRT is the amount of one product that a country must forego to produce each additional unit of the other product.

$$\text{MRT} = \Delta \text{ Product A}/\Delta \text{ Product B} \qquad \text{....(3.1)}$$

Comparing the MRT in both the countries, it is found that India has lower opportunity cost of wheat for rice and so India has comparative advantage in the production of wheat.

Now trade is possible only when demand exists in each country for the commodity produced in other country. If demand is intense, the country may pay a higher price for imports. Suppose that there is demand for wheat in Bangladesh as a result of which it likes to import wheat from India. But now the question is at what price India will be ready to export wheat. If MRT in India is −0.625 kg rice/1 kg wheat, it will not accept less than 0.625 kg of rice for 1 kg of wheat. Rather it will like to get a better price. On the other hand, Bangladesh will not be ready to forego more than 1 kg of rice for 1 kg of wheat. Rather it will prefer to forego less rice for 1 kg of wheat. Thus the price will lie between the MRT existing in the two countries. If Bangladesh is ready to forego more rice than MRT in India, the terms of trade will move in favour of India because the same amount of export will fetch more imports for India. Suppose, Bangladesh is ready to forego 0.80 kg of rice for 1 kg of wheat in view of strong demand for it. In that case, India will get 0.80 kg − 0.625 kg or 0.175 kg more rice that what it could get in case of no trade. Bangladesh has still to forego less rice for wheat that it could have foregone in absence of trade.

3.2.4 Production Possibilities Schedule

The gains from trade can be explained through production possibilities frontier (PPF). PPF represents various combinations of two goods produced in a country with fully employed factors of production. We assume for the moment constant opportunity cost with the result that PPF is a straight line. The PPF existing in the two countries is given here in Figure 3.1(a) and Figure 3.1(b).

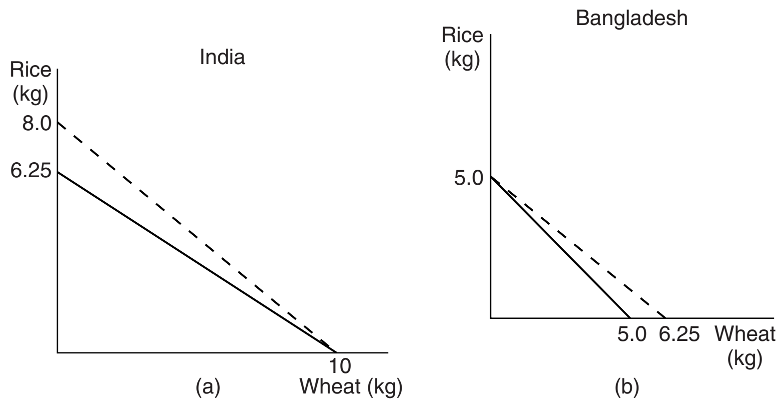


FIGURE 3.1 PPF and Gains from Trade (Constant opportunity cost)

Figure 3.1 (a) shows the MRT existing in India in absence of trade and also how, after trade with Bangladesh, 10 kg of wheat are traded for 8 kg of rice conferring gains on India. The difference between the MRT after trade and MRT in absence of trade represents the gain from trade. Similarly,

Figure 3.1 (b) shows the MRT existing before trade and after trade in Bangladesh and also how this country gains through trade.

3.2.5 Static and Dynamic Gains from Trade Re-examined

The above analysis has shown gains from trade. They are in fact production gains and consumption gains both of static nature. Trade leads to specialisation and thereby growth in output in both the countries. Similarly, with larger production and trade, there will be ample opportunity for increased consumption. How much one of the two countries will share the gains depends on the terms of trade which was not explained systematically by Ricardo. Ricardo set a limit within which the terms of trade lay. He did not explain the role of demand that influences the terms of trade. The larger the demand, the greater the price a country will be willing to pay. And this will influence the terms of trade. The country is able to share more gains in whose favour the terms of trade will move.

Static gains manifest in larger production and consumption.
The share of the trading country in total gains depends on the terms of trade.

Dynamic gains manifest in contribution of trade to economic growth.

However, there are dynamic gains too in form of contribution of trade to economic growth. The productivity theory of international trade explained by Hla Myint (1958, 1977) relates economic growth to the country's foreign trade. It is because trade encourages innovations, overcomes technical indivisibilities and raises labour productivity. These are nothing but dynamic gains. Leibenstein (1966) is of the view that free trade may lead to promote X-efficiency which means better use of inputs so as to reduce the real costs per unit of output. The cost reduction is definitely the dynamic gains from trade.

First of all, when resources are employed more efficiently based on comparative advantage, GDP is bound to rise. Income grows; saving grows and then investment grows.

Secondly, increasing production of specific commodities helps the producers to achieve economies of scale and thereby to reduce the cost per unit. The process makes the producers more competitive in the international market. Greater competition enhances efficiency.

Thirdly, import of lower cost goods compels the domestic producers to improve efficiency. All round efficiency will certainly be beneficial for the process of economic growth.

3.3 FACTOR PROPORTIONS THEORY

Almost after a century and a quarter of the classical version of the theory of international trade, the two Swedish economists, Eli Heckscher and Bertil Ohlin, propounded a theory that is known as the factor endowment theory or the factor proportions theory. In fact, it was Eli Heckscher (1919) who mooted the notion of a country's comparative advantage (disadvantage) based on relative abundance (scarcity) of factors of production.

Later on, his student, Bertil Ohlin (1933) developed this notion of relative factor abundance into a theory of the pattern of international trade.

3.3.1 Heckscher-Ohlin Theorem

Factor endowment theory explains that a country should produce and export a commodity that primarily involves a factor of production abundantly available within the country.

The theory explains in a two-country, two-factor and two-commodity framework: (1) What determines the comparative advantage? (2) How trade influence the income of the factors of production?

The theory believes that different countries are endowed with varying proportions of different factors of production. Some countries have large population and large labour resource. The others have abundance of capital but short of labour resource. Capital-abundant country presents a higher capital/labour ratio than what a labour-abundant country presents. Thus a country with large labour force will be able to produce those goods at lower cost that involve labour-intensive mode of production. Similarly, the countries with large supply of capital will specialise in those goods that involve capital-intensive mode of production. The former will export its labour-intensive goods to the latter and import capital-intensive goods therefrom. After the trade, both the countries will have both types of goods at the least cost (Ohlin, 1933).

All this means that the theory holds good if the capital-abundant country has a distinct preference for the labour-intensive goods and the labour-abundant country has a distinct preference for capital-intensive goods. If it is not, the theory may not hold good. Again, the theory does not hold good if the labour-abundant economy is technologically advanced in capital-intensive goods or if the capital-abundant economy is technologically advanced in the production of labour-intensive goods.

3.3.2 Factor Price Equalisation

The effect of free trade among nations would be to increase the overall welfare by equating not only the prices of goods exchanged but also the prices of factors of production involved in the production of those goods in different countries. For example, in absence of trade, the price of capital in a capital-abundant economy of the USA will be much lower than that in case of a labour-surplus economy of India. But after trade is established between the two countries, more capital-intensive commodities will be produced in the USA. As a result, the price of capital will increase in the USA and the existing differential in this respect between the two countries will be lower. Similarly, more labour-intensive commodities will be produced in India. Wage level will increase in India with the result that the wage differential between the two countries will be narrower (Samuelson, 1948, 1949).

Now the question is whether the factor prices will be the same in two countries. Heckscher-Ohlin theory is affirmative. But in the real world, the answer is in negative in view of imperfections in the factor market.

3.3.3 Leontief Paradox

Leontief paradox refers to the empirical evidence based on US export of labour intensive goods challenging the factor endowment theory.

Leontief (1954) put this theory to empirical testing and found in case of the US trade during 1947 that this country was exporting less capital-intensive goods even when it had abundance of capital compared to labour. Had the factor proportions theory been true, the USA would have exported more of capital-intensive goods. This is really a paradox and so it is known as *Leontief Paradox*. However, Leontief himself re-examined this issue and found that the paradox disappeared if the natural resource industries were excluded. Moreover, he found that the USA exported more of labour-intensive goods because the productivity of labour in this country was higher than in many labour-abundant countries. Even in case of labour-abundant economies, he viewed, different countries differ in the sense that some countries possess skilled labour pool, whereas in other countries, the labour resource may be unskilled. The country with skilled labour force will be able to manufacture the same labour-intensive product in a more capital-intensive fashion and will be able to export that product to those labour-abundant countries where improved skill is not employed in the manufacture of the same product. Thus it is not only that the factor endowments are not homogeneous, but also they differ along parameters other than the relative abundance. Leontiefs later views find support from a couple of studies. The studies of Hufbauer (1966) and of Gruber, Mehta and Vernon (1967) reveal that improved technology was involved in the US export of labour-intensive goods that characterised US exports as technology-intensive rather than labour-intensive.

Soon after Leontiefs study, Tatemoto and Ichimura (1959) found that in case of US-Japan trade, Japan exported labour-intensive goods to the USA and imported capital-intensive goods therefrom. Similarly, Bharadwaj (1962) found in case of Indo-US trade that India imported mainly capital-intensive goods from the USA and exported labour-intensive goods to this country in 1951. These two empirical tests support the Heckscher-Ohlin theory of international trade.

3.3.4 Distribution of Income

Since labour and capital are fully employed before and after the trade, it is natural for the real income of both the factors to move up along with the rise in their prices. It means that the share of capital in national income will tend to rise in a capital-abundant economy compared to the share of labour in national income. In a labour-surplus economy, the share of labour in the national income will rise compared to that of capital. In all, this means that trade will lead to inequality of income within a country. This view is confirmed by Stopler-Samuelson theorem which states that trade does not necessarily leads to equal distribution of income in the country.

3.4 NEO-FACTOR PROPORTIONS THEORIES

Neo-factor proportion theories also consider the third factor, such as human skill, skill intensity, economies of scale and R&D.

Extending Leontief's view, some of the economists emphasise on the point that it is not only the abundance (scarcity) of a particular factor but also the quality of that factor of production that influences the pattern of international trade. The quality is so important in their view that they analyse the trade theory in a three-factor framework instead of two-factor framework taken into account by Heckscher and Ohlin. The third factor manifests in the form of:

1. Human capital
2. Skill-intensity
3. Economies of scale
4. Research and development (R&D) including technological innovation

As Kravis (1956) suggests, human capital which is the result of better education and training, should be treated as factor input like physical labour and capital. A country with improved human capital maintains an edge over other countries in regard to the export of commodities produced with the help of improved human capital.

The skill-intensity hypothesis is similar as the human capital hypothesis as both of them explain the capital embodied in human beings. It is only the empirical specifications of these two hypotheses that differ. Keesing (1965, 1971) computed the direct skill requirements for production of 1957 manufactured exports and imports for nine countries and 15 manufacturing sectors. The study revealed that labour is a non-homogeneous factor and it is the differing quality of labour in terms of skills that determines the pattern of international trade.

The scale-economies hypothesis explains that with rising output, unit cost decreases. The producer achieves internal economies of scale. A country with large production possesses an edge over other countries as regards to export. However, even a small country can reap such advantages if it produces exportables in large quantity.

Last but not least, R&D activity is positively associated with the competitive ability of the manufacturing industries. It is a proxy for trade advantage meaning that a country with large expenditure on R&D possesses a comparative trade advantage. Krugman and Obstfeld (1994) deal with both the process innovation and the product innovation. The process innovation hypothesis examines how different countries are ranked on the basis of technological level and how goods are ranked by technological intensity. The higher-ranked countries do always maintain an absolute advantage over the low-ranked countries. Again, their model with product innovation demonstrates that the process of innovation goes on continuously. A technologically advanced country exports newly innovated goods where its innovation continues to remain as its monopoly. It imports "old" goods where the technology has already been imitated by the producers in other countries.

3.5 COUNTRY SIMILARITY THEORY

Different from the classical argument or the factor proportions theory, Linder (1961) did not emphasise on the supply side or the cost of production. He rather stressed on the demand side meaning that trade is dependent upon the preference of the consumers. The pattern of consumption depends upon the level of income. And so, the consumers in the developed countries demand for sophisticated goods in contrast with the consumers in the less developed countries that demand for less sophisticated goods. Whenever an entrepreneur manufactures a particular commodity, it designs the product keeping in view the taste of the domestic consumers. It is because that the meeting of demand of the domestic consumers is the primary concern. The manufacturer expands the production in order to achieve the economies of scale and then only it is able to export the product. The export is made to similar countries or the countries with the same level of income because it will not be accepted in the countries with different levels of income. In other words, international trade in manufactured goods is influenced by the similarity of demand. For example, if the level of income between the US and the UK is similar, the US-manufactured goods will be exported to the UK or the latter's goods will be exported to the US. The goods of the US may not be in demand in Bangladesh because the living standard and the consumption pattern there is quite different from that in the US. In the words of Linder, "the more similar the demand structures of two countries, more intensive, potentially is the trade between these two countries" (p. 98). If the two countries have the same pattern of demand, their items of export and import will be the same, although they will vary on the basis of product-differentiation that in turn depends upon the degree of specialisation.

Linder has tested his theory empirically through the use of a matrix of trade intensities for a sample of 32 countries. He finds that most of high trade intensities lie closer to the diagonal meaning that the countries with similar per capita income record most of the greater trade intensities. Using Linder's data, Sailors et al (1973) have tested the theory with the help of rank correlation between absolute differences in per capita income and trade intensities for 31 countries. Their findings are generally in support of Linder's hypothesis.

3.6 INTRA-INDUSTRY TRADE

3.6.1 Nature of Intra-industry Trade

Ricardo's comparative advantage theory and Heckscher-Ohlin theorem both had conceived of inter-industry trade. But during the past few decades, intra-industry trade has attained huge proportions. Let us first explain intra-industry trade. The goods produced in the same industry, irrespective of the fact whether they are identical from every angle or differentiated on account of brand, etc. come under the purview of intra-industry trade. Now the question is how one defines a particular industry. Pen, pencil and sharpener may constitute a single industry under the banner of "stationery". Alternatively, they may be looked at as three different industries. In case of the latter, the size of intra-industry trade will be the minimal.

Grubel and Llyod (1975) classify the goods based on similarity of input and substitutability in use. The first group includes those goods with similar input requirements but low substitutability in use. The second one includes goods with low similarity in input requirements but high substitutability in use. The third group contains goods with similarity in input requirements and high substitutability in use. The trade in commodities of the first two groups can be explained to some extent by the conventional theories. But the third one needs a new theory dealing with intra-industry trade.

Intra-industry trade is found both in homogeneous products and the differentiated products.

The commodities belonging to the third group can further be compartmentalised as homogeneous products and differentiated products. A country may export and import homogeneous products. Suppose a company supplies its products to different countries in a region. The demand is such that it involves frequent orders. In such cases, the company sets up its warehouse in one of the countries of that region, from where the products are shipped to different countries on demand. Thus, the country, where warehouse is located, imports and exports the same commodity. This type of trade is known as entrepot trade. The entrepot trade is shown in Figure 3.2.

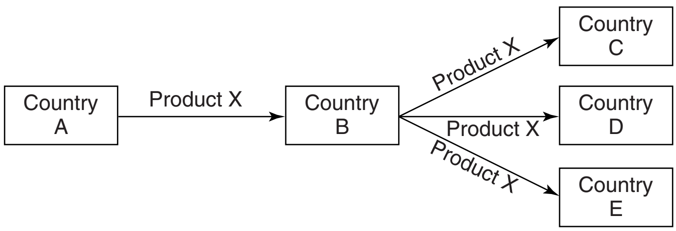


FIGURE 3.2 Entrepot Trade (Homogeneous Product)

Sometimes, trade in homogeneous products takes place because of heavy weight of that product. Suppose cement factories are located in northern part of India. They cater to the domestic as well as international market. But if a factory located in the extreme southern part of the country needs cement, it is easier and economical to import cement from Sri Lanka. In such cases, India will be exporting and importing the same product. Such cases are, however, not usual.

Intra-industry trade occurs mostly in differentiated products. The products are either vertically differentiated or horizontally differentiated. Vertically differentiated goods have different physical features and different prices. On the contrary, horizontally differentiated goods have similar prices. In fact, the trade of such goods takes place under imperfect market conditions. The market conditions may take varying form, such as monopoly, duopoly, oligopoly, monopolistic competition, etc. The prices tend to vary in different forms of markets. A country can export and import the same product with varying brands depending on the varying preferences of the consumers for different brands of the same product. The US is a manufacturer and exporter of automobiles but at the same time it imports car from Japan. It is because a good number of the American consumers have preference for Japanese make. Intra-industry trade in differentiated products is shown in Figure 3.3.

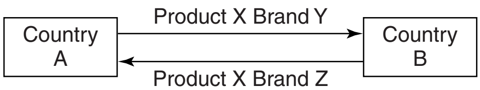


FIGURE 3.3 Intra-industry Trade in Differentiated Products

3.6.2 Measures of Intra-industry Trade

The size of intra-industry trade can be measured based on Grubel-Lloyd index. Grubel-Lloyd Index,

$$GLI = 1 - \{(Xi - Mi)/Xi + Mi\} \qquad ....(3.2)$$

The index for any industry is calculated by taking the absolute value of trade balance and dividing it by the sum of export and import of the same industry and then subtracting the ratio from 1. If the export and import of an industry are equal to each other, the index will be one which means that the entire trade of the industry is intra-industry. On the other extreme, if index is zero, the industry does not have intra-industry trade. The evidences suggest that the index is normally high in (1) high-technology industries where frequent creation of new products leads to product differentiation; (2) industries with few trade barriers and (3) high-income countries.

3.6.3 Gains from Intra-industry Trade

When the manufacturers of the same product compete among themselves, they try to cut the cost through different means. The benefit of the cost reduction reaches the consumers in form of lower price. In case of inter-industry trade, it is not guaranteed that if the import price falls, export price too will fall. But if it is intra-industry trade, the export and the import prices fall simultaneously normally in the sequel of internal economies benefiting in turn the consumers in both the countries.

The gains from intra-industry trade may appear in form of variety of a single product available to consumers at lower price. The gains may lead to employment and income generation.

The consumers get an added advantage. It is that their choice is not limited to a specific variety of a product. They use many varieties/brands of a single product. It is because the different brands have some unique product features.

Any fall in export and import prices leads to emergence of new firms in that particular industry. The income and employment get a boost up. Trade in the two countries moves upward in the sequel of less restrictive measures. The reason is that intra-industry trade occurs normally among the countries of similar income level and of similar factor endowment.

3.7 TRADE IN INTERMEDIATE PRODUCTS AND SERVICES: OUTSOURCING

The conventional theories discussed the trade in final products. But in view of large volume of trade in intermediate products emerging on account of growth of multinational firms and development of transport and communication in recent decades, the very concept behind such trade needs to be discussed. Today, with a view to acquire larger share in the domestic as well as international market, firms are trying to slice their value chain and to get the different parts of their production process performed in different countries so that the cost of production be the minimum. For example, if labour is cheap in labour-surplus developing country, the firms of the industrialised countries locate their assembly units in these countries. In other words, the firms are "outsourcing" their assembly operation to a developing country. Here it may be mentioned that it is not only manufacturing activities where outsourcing is found. It is now common in services too. Thus the concept of outsourcing and its potential gains need to be discussed.

3.7.1 Outsourcing and Off-shoring

Outsourcing occurs when a firm locates a part of production process in some other countries Intra-firm outsourcing is off-shoring.

Outsourcing may be a domestic one. Domestic outsourcing occurs when a firm uses in its manufactured product some components manufactured by some other domestic firms. But here we are concerned with international outsourcing. In this case, a firm locates its specific parts of production process in some other countries depending on the availability of labour force and on the cost-cutting possibilities.

In this context, two terms are used—one is outsourcing and the other is off-shoring. When a firm outsources some of the functions to its own affiliates in some other countries, it is off-shoring. In other words, intra-firm outsourcing is known as off-shoring. Inter-firm outsourcing is known simply as outsourcing. For example, many automobile firms import components from India. Maruti Udyog buys components from local producers. In the initial years, Maruti-Suzuki was importing automobile engines from its parent company in Japan. These three examples are respectively of international outsourcing, domestic outsourcing and off-shoring.

3.7.2 Bases of Outsourcing

In order to have a full view of outsourcing, we may divide the manufacturing of a product into different phases. The consecutive phases are as follows:

1. Research and development
2. Production of components
3. Assembly
4. Marketing and sales

Now the question is which of these four functions will be performed in the domestic unit and which of them shall be outsourced to a foreign location. In fact, this decision depends upon the availability of the skilled labour force and the level of wages. Since the skilled worker asks for higher wage than unskilled or semi-skilled labour, only those functions need to be assigned to the skilled labour force that cannot be performed by the unskilled or semi-skilled labour force. The other functions should naturally be assigned to the semi-skilled or unskilled labour force. This way, the cost of production can be minimised.

Again, it is found that the developing world has a large reservoir of unskilled and semi-skilled labour force who is satisfied with lower wages. On the other hand, developed countries possess large number of skilled labourers. Thus it is natural for the firms located in the industrialised world to outsource those functions to the developing world that can be performed by the semi-skilled and unskilled workers at low cost. In the four functions mentioned above, production of components and their assembly should be outsourced, and the R&D and marketing and sales should be performed at the domestic unit located in the industrialised world. Similarly, the firms headquartered in the developing countries import R&D from the developed world. The newly industrialising countries of the developing world have a long history of technology import. They import technology and subsequently modify it in order to make it suitable for their own economy. In some cases, they export the modified technology to the developed world. Nevertheless, as far as the latest and sophisticated technology is concerned the firms of the developing world outsource R&D to the developed world. They also outsource the sophisticated components when they lack skilled workers to produce them. The computer industry in India is found outsourcing many such components.

3.7.3 Gains from Outsourcing

The gains from outsourcing can better be explained through PPF. We base our analysis on two factors—R&D involving skilled workers and component production involving unskilled and semi-skilled workers. Suppose a firm located in an industrialised country produces a final product without outsourcing, the quantity of final product, F_1 will be produced with components, Q_C and R&D, Q_R, as shown in Figure 3.4, at Point *A*. This is the point where the relative price line, *P* or Q_C/Q_R meets the PPF and Isoquant F_1 is tangent to PPF. Point *A* indicates the maximum output using a combination Q_C and Q_R.

But if the company outsources components to a labour-surplus developing country, the relative price line, P_1 meets the PPF at Point *B* on account of cheaper component. At Point *C*, a new isoquant, F_2 is tangent to PPF which shows the final product with outsourcing. The difference between F_2 and F_1 shows the additional output or the gain from outsourcing.

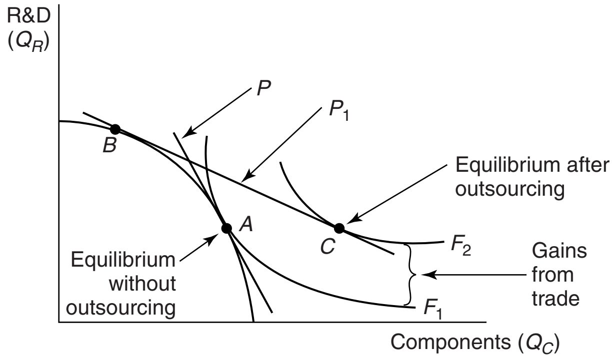


FIGURE 3.4 Outsourcing and Gains from Trade

Diamond of national advantage refers to the factors responsible for maintaining a nation' s competitive advantage, as explained by Porter. The factors are:

1. Factor conditions
2. Demand conditions
3. Related and supporting industries
4. Firm strategy, structure, and rivalry

However, there are two additional factors, such as governmental policy and chance of events that do influence the "Diamond".

3.7.4 Outsourcing of Services

The outsourcing of services is comparatively a new phenomenon but the size of services outsourced is huge and variety of outsourced services is wide (WIR, 2004). Although the same objective of cost reduction works behind it, yet it is not simply the availability of skilled manpower that is important but also it is the strong communication infrastructure which has been an important factor. Why is India a good host for outsourcing? It is because the communication system here is highly developed; Indians have English-speaking skill; and above all, software industry is highly developed.

3.8 THE NATIONAL COMPETITIVE ADVANTAGE

It is a fact that Porter (1990) never focussed primarily on the factors determining the pattern of trade, yet his theory of national competitive advantage does explain why a particular country is more competitive in a particular industry. If, for example, Italy maintains competitive advantage in the production of ceramic tiles and Switzerland possesses the competitive advantage in watches, it can be interpreted that the former will export ceramic tiles and the latter will export watches and both of them will import those goods in which their own industry is not competitive.

Why is this difference? Porter explains that there are four factors responsible for such diversity. He calls those factors as the"diamond of national advantage". The diamond includes the following (Figure 3.5):

1. Factor conditions
2. Demand conditions
3. Related and supporting industries
4. Firm strategy, structure and rivalry

These factors have been more or less taken into account by the earlier economists. What is crucial in Porter's thesis is that it is the interaction among these factors that shapes the competitive advantage.

Factor conditions show how far the factors of production in a country can be utilised successfully in a particular industry. This concept goes beyond the factor proportions theory and explains that availability of the factors of production per se is not important, rather their contribution to the creation and upgradation of product is crucial for the competitive advantage. This is possible if labour force is well-skilled and better-trained. Skill and training in Porter's view is an advanced factor which is essential for maintaining competitive advantage. If one says that Japan possesses competitive advantage in the production of automobiles, it is not simply because Japan has easy access to iron ore but this country has skilled labour force for making this industry competitive.

Secondly, the demand for the product must be present in the domestic market from the very beginning of production. Porter is of the view that it is not merely the size of the market that is important, but it is the intensity and sophistication of the demand that is significant for the competitive advantage. If consumers are sophisticated, they will make demand for sophisticated products and that in turn will help the production of sophisticated products. Gradually, the country will achieve competitive advantage in such production.

Thirdly, the firm operating along with its competitors as well as its complementary firms gathers benefit through close working relationship in form of competition or backward and forward linkages. If competition is acute, every firm will like to produce better-quality goods at lower cost in order to survive in the market. Again, if there is agglomeration of complementary units in a particular region, there may be strong backward and forward linkages. All this will help attain national competitive advantage.

Fourthly, the firm's own strategy helps in augmenting export. There is no fixed rule regarding the adoption of a particular form of strategy. It depends upon a number of factors present in the home country or the importing country and it differs from one point of time to the other. Nevertheless, the strategic decisions of the firm have lasting effects on their future competitiveness. Again, equally important is the industry structure and rivalry among the different companies. The greater the rivalry, the greater will be the competitive strength of the industry.

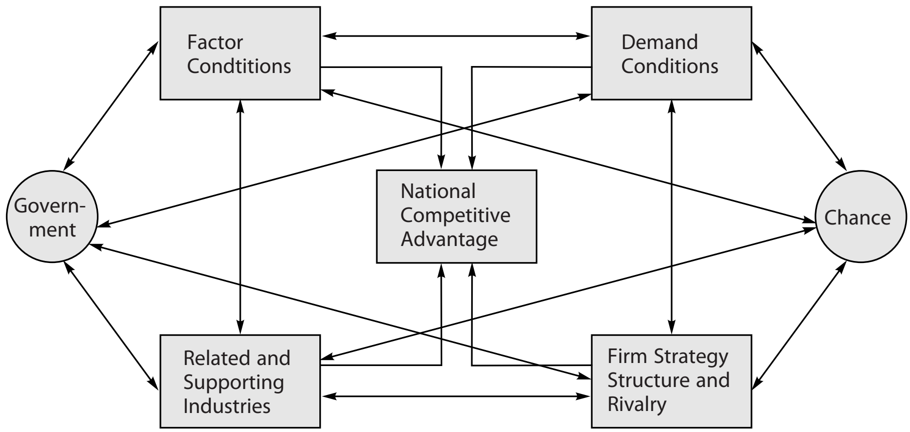


FIGURE 3.5 Porter's Diamond of National Advantage

Besides the four factors, Porter gives weightage to a couple of factors such as, governmental policy and the role of chance of events. The governmental policy influences all the four factors through various regulatory/deregulatory measures. It can control the availability of various resources or change the pattern of demand through taxes, etc. It can encourage/discourage the supportive industries through various incentives/disincentives. Similarly, chance of events such as, war or some unforeseen events like inventions/innovations, discontinuities in the supply of inputs, etc. can eliminate the advantages possessed by the competitors.

However, there are various criticisms put forth against Porter's theory. First, there are cases when the absence of any of the factors does not influence much the competitive advantage. For example, when a firm is exporting its entire output, the intensity of demand does not matter. Secondly, if the domestic suppliers of inputs are not available, the backward linkage will be meaningless. Thirdly, Porter's theory is based on empirical findings covering 10 countries and four industries. Majority of the countries in the world have different economic background and do not necessarily support the finding. Fourthly, availability of natural resources, according to Porter, is not the only condition for attaining competitive advantage and there must be other factors too for it. But the study of Rugman and McIlveen (1985) shows that some of the Canadian industries emerged on the global map only on the basis of natural resource availability. Fifthly, Porter feels that sizeable domestic demand must be present for attaining competitive advantage. But there are industries that have flourished because of demand from foreign consumers. For example, a lion's share of Nestle's earnings comes from foreign sales. Nevertheless, these limitations do not undermine the significance of Porter's theory.

3.9 TERMS OF TRADE

Net barter terms of trade index is defined as Export price index divided by import price index.

Gross barter terms of trade index refers to export quantity index divided by import quantity index.

Income terms of trade index is defined as net barter terms of trade index multiplied by the index of the size of export.

The concept of terms of trade is important in view of ascertaining the gains from trade. It is based on"what you get for what you give". If you get more than what you give, the terms of trade move in your favour and the trade brings in gain to you. For example, the raising of oil prices in 1973 by the OPEC nations improved their terms of trade and worsened the terms of trade of the oil-importing countries. In order to explain this phenomenon, if the import price rises relatively to the export prices, it means that one physical unit of the export will buy fewer physical units of import than before. It will be nothing but deterioration in the terms of trade. For a comparative analysis of the trend in the export and the import prices, one constructs the price index for exports and imports in the same fashion that the consumer price index is constructed.

There are different measures of terms of trade, such as net barter terms of trade, gross barter terms of trade, income terms of trade, factoral terms of trade, utility terms of trade and the real cost terms of trade (Meier, 1965). However, the first three measures are more commonly used for empirical analysis. Net barter terms of trade represent the ratio between the export price index and the import price index. In form of an equation,

$$\text{Net barter terms of trade} = P_x/P_m \quad \text{.... (3.3)}$$

Where P_x is the export price index, and
P_m is the import price index.

For example, if in India in 2001, the export price index is 183 and the import price index is 224 (1980 = 100), the net barter terms of trade in 2001 will be unfavourable at 0.817 showing a decline by 18 per cent over the base year.

In case of gross barter terms of trade, the index of import quantity and the index of export quantity are computed and then the ratio between the two is found out. Since the quantity of different commodities cannot be easily added up, it is the value of export and import that is taken into account for this purpose. Gross barter terms of trade are favourable if a given quantity (value) of export is able to import a larger quantity (value) of import. In other words, gross barter terms of trade are reciprocal of the net barter terms of trade. In form of an equation,

$$\text{Gross barter terms of trade} = Q_x/Q_m \quad \text{.... (3.4)}$$

Where Q_x is export quantity index, and
Q_m is the import quantity index.

If in India in 2001, the quantity of export index and quantity of import index are respectively 110 and 105 with base year as 1980, the gross barter terms of trade in 2001 will be unfavourable at 1.048 showing a decline of 4.8 per cent over the base year.

The computation of the income terms of trade is also important. With a fall in the export prices over a period, the net barter terms of trade will tend to deteriorate, but if the demand is highly price-elastic, the export earnings will rise at a greater rate that is beneficial from the viewpoint of country's foreign exchange earnings. If this is the situation, the income terms of trade will tend to improve despite deterioration in the net barter terms of trade. The computation of income terms of trade is very simple. The net barter terms of trade index is multiplied by the index of the size of export.

$$\text{Income terms of trade} = (P_x/P_m) \times V_x \qquad ....(3.5)$$

Here V_x *is the index of the value of total export.*

Example

A country exports three items and imports three items, the volume and value during the base year (2000–2001) and the current year (2006–2007) being indicated below. The weight of a particular commodity in a particular year depends on the value of export/import. Find out the net barter, gross barter and income terms of trade.

Export					*Import*				
Item	*2000–2001*		*2006–2007*		*Item*	*2000– 2001*		*2006– 2007*	
	Volume (tonnes)	*Value $*	*Volume (tonnes)*	*Value $*		*Volume (tonnes)*	*Value $*	*Volume (tonnes)*	*Value $*
A	600	30000	800	36000	D	400	8000	400	12800
B	800	24000	500	20000	E	400	16000	400	18000
C	100	6000	200	16000	F	800	16000	1000	15000

1. **Net barter terms of trade in 2006–2007 (Base Year = 100):**
   Weighted average unit price of export:
   2000–2001:
   $50 \times 0.5 + 30 \times 0.4 + 60 \times 0.10 = \$43$
   2006–2007:
   $45 \times 0.5 + 40 \times 0.28 + 80 \times 0.22 = \$\ 51.30$
   Price index for export in 2006–2007
   $51.30/43.00 \times 100 = 119.30$
   Weighted average price for import:
   2000–2001:
   $20 \times 0.2 + 40 \times 0.4 + 20 \times 0.4 = \$\ 28$
   2006–2007:
   $32 \times 0.28 + 45 \times 0.39 + 15 \times 0.33 = \$\ 31.46$
   Price index for import in 2006–2007:
   $31.46/28 \times 100 = 112.36$
   Export price index/import price index = 119.30/112.36 = ***106.18***
   Net barter terms of trade have improved by 6.18%.
2. **Gross barter terms of trade in 2006–2007 (Base Year = 100):**
   Export value index in 2006–2007:
   $\$\ (36000 + 20000 + 16000)/(30000 + 24000 + 6000) \times 100 = 120$

Import value index in 2006–2007:
$ (12800 + 18000 + 15000)/(8000 + 16000 + 16000) × 100 = 114.50
Export value index/import value index = 120/114.50 = ***104.80***
Gross barter terms of trade have turned unfavourable by 4.80%.

3. **Income terms of trade in 2006–2007 (Base Year = 100):**
Net barter terms of trade index × Export value index = 106.18 × 120/100 = 127.42
Income terms of trade have improved by 27.42%.

SUMMARY

- The theories of trade explain that goods produced competitively and more efficiently in a given country are exported. As a corollary, it means that those products that cannot be produced efficiently at home should be imported. The advocates of mercantilism argued for trade surplus that would in turn add to the country's stock of gold and the country's wealth, while the classical economists based their theories on the principle of cost advantage. Adam Smith talked about absolute advantage in a two-commodity, two-country framework. But his theory failed to explain the possibilities for trade when a single country possessed absolute advantage in both the commodities. Ricardo explained that trade could occur even in such cases if one country possessed comparative advantage in one of the two products. The classical theory was simple, but suffered from many limitations. So the comparative advantage explained through the opportunity cost is free from those limitations.
- After about a century and a quarter of the classical approach, Heckscher and Ohlin propounded the factor proportions theory of international trade. It is the factor endowment in a particular country that confers on it the competitive advantage. A labour-surplus country will produce and export labour-intensive goods, while a capital-abundant economy should produce and export capital-intensive products. This way the prices of factors of production tend to equalise among the trading countries. Leontief found in his empirical study that the USA being a capital-abundant economy exported labour-intensive goods. But he was of the view that such possibilities could not be ruled out because the US was able to produce labour-intensive goods in a bit capital-intensive fashion. The proponents of neo-factor proportions theories extend Leontief's idea and are of the view that it is not simply the abundance of labour or capital in a country that helps determine the pattern of trade, but importantly, it is the quality of the factors of production. The quality of factors of production manifests in human capital, skill intensity, economies of scale and R&D including product and process innovation.
- Linder's view is, however, different. He opines that large amount of trade today takes place among the industrialised countries because they share similar market segments. His theory also explains intra-industry trade that did not find a place in the conventional analysis. Besides, it is the outsourcing of intermediate products that brings in gains from trade.
- Last but not least, Porter's theory of national competitive advantage believes that countries seek to improve their national competitiveness through developing successful industries.

The success of targeted industries depends upon a host of factors that is termed as diamond of national advantage.

- Again, favourable terms of trade lead to gains from trade. There are different forms of terms of trade, yet more commonly used forms are net barter terms of trade, gross barter terms of trade and the income terms of trade.

REVIEW QUESTIONS

1. Explain the comparative cost advantage theory of international trade. Is it an improvementover the theory of absolute cost advantage?
2. Examine the factor proportions theory of international trade.
3. What do you mean by national competitive advantage as explained by Porter?
4. Distinguish between static and dynamic gains from trade.
5. Explain:
   (i) net barter terms of trade
   (ii) gross barter terms of trade
   (iii) income terms of trade
   (iv) outsourcing and off-shoring
6. Explain the comparative advantage theory based on opportunity cost.
7. What do you mean by intra-industry trade? Describe the possible gains from such trade.

STUDY TOPIC

Recent Trends in India's Terms of Trade

The following table shows variation in the unit value of India's exports and imports that has influenced in turn the net barter terms of trade. The net barter terms of trade figure has moved up and down depending upon the changes in the ratio of import and export unit prices. The gross barter terms of trade have also shown variations among

(1978–79 = 100)

FY	*Unit Value Index*		*Volume Index*		*Terms of Trade Index*		
	Exports	*Imports*	*Exports*	*Imports*	*Gross*	*Net*	*Income*
1991–92	369.5	309.1	208.6	228.0	109.3	119.5	249.3
1992–93	421.5	331.0	222.9	282.0	126.5	127.3	283.8
1993–94	474.1	327.2	257.5	329.1	127.8	144.9	373.1

FY	*Unit Value Index*		*Volume Index*		*Terms of Trade Index*		
	Exports	*Imports*	*Exports*	*Imports*	*Gross*	*Net*	*Income*
1994–95	494.6	324.6	292.7	408.3	139.5	152.4	446.0
1995–96	484.2	351.0	384.3	514.8	134.0	137.9	530.0
1996–97	504.7	399.8	411.8	511.8	124.3	126.2	519.7
1997–98	589.4	404.2	386.0	562.1	145.8	145.8	562.8
1998–99	611.7	407.8	399.2	644.2	161.4	150.0	598.8
1999–00	604.5	450.5	461.0	704.8	152.9	134.2	618.7
2000–01	624.3	487.5	571.4	697.7	122.1	128.1	732.0
2001–02	618.0	492.9	592.7	732.8	123.6	125.4	743.2
2002–03	619.6	545.6	721.6	802.4	111.2	113.6	819.7
2003–04	672.4	545.1	764.8	970.4	126.9	123.4	943.5
2004–05	732.0	663.0	899.0	1113.0	110.0	124.0	991.0
2005–06	881.0	988.0	1307.0	1095.0	67.0	90.0	662.0
2006–07	863.0	608.0	1,164.0	2,047.0	176.0	142.0	1,653.0
2007–08	939.0	575.0	1,227.0	2,603.0	212.0	163.0	2,000.0

Source: Government of India, *Economic Survey: 2006–2007*, (New Delhi: Ministry of Finance).

different years. The reason is that the size of trade has moved up and down depending upon the varying requirements for imports and also the demand and supply constants influencing the size of exports. However the income terms of trade have normally increased over the years at a greater rate which shows that the decline in export prices has led to an increase in demand for India's export.

REFERENCES

Books

Bharadwaj, R. (1962), *Structural Basis of India's Foreign Trade*, Bombay: Bombay University Press.

Grubel, H. G and P. J. Lloyd (1975), *Intra-industry Trade: The Theory and Measurement of International Trade in Differentiated Products*, London: Macmillan.

Haberler, G. (1950), *The Theory of International Trade*, London: William Hodge.

Heckscher, E. (1919), "Foreign Trade and Income Distribution, *Economisk Tidskrift*, translated in Ellis, H. S. and L. A. Metzler, *eds*. (1950), *Readings in the Theory of International Trade*, London: Allen & Unwin.

———— (1935), *Mercantilism*, London: George Allen & Unwin.

Hufbauer, G. (1966), *Synthetic Materials and the Theory of International Trade*, Cambridge MA: Harvard University Press.

Krugman, P. and Maurice Obstfeld (1994), *International Economics: Theory and Policy*, New York: Harper Collins.

Linder, S. B. (1961), *An Essay on Trade Transformation*, New York: Wiley.

Meier, G. M. (1965), *International Trade and Development*, New York: Harper & Row.

Ohlin, B. (1933), *Interregional and International Trade*, Cambridge Mass.: Harvard.

Porter, M. E. (1990), *The Competitive Advantage of Nation*s (New York: Free Press).

Rugman, A. M. and J. McIlveen (1985), *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen/Nelson).

Journals

Balassa, B. (1963),"An Empirical Demonstration of Classical Comparative Cost Theory", *Review of Economics and Statistics*, XLV (3), 231–38.

Gruber, W. H., D. Mehta and R. Vernon (1967),"The R&D Factor in International Trade and International Investment of the United States Industries", *Journal of Political Economy*, LXXV (1), 20–37.

———— (1971), "Different Countries' Labour Skill Coefficients and the Skill Intensity of International Trade Flows", *Journal of International Economics*, I (4), 443–52.

Keesing, D. B. (1965),"Labour Skills and International Trade: Evaluating Many Trade Flows with a Single Measuring Device", *Review of Economics and Statistics*, XLVII (3), 287–94.

Kravis, I (1956), "Availability and Other Influences on Commodity Compositions of Trade", *Journal of Political Economy*, LXIV (2), 143–55.

Leibenstein, H. (1966), "Allocative Efficiency versus X-Efficiency", *American Economic Review*, LVI (3), 392–415.

Leontief, W. W. (1954)," Domestic Production and Foreign Trade: The American Capital Position Re-examined", *Economia Internazionale*, VII (1), 9–45.

MacDougall, G. D. A. (1951),"British and American Export: A Study Suggested by the Theory of Comparative Costs", *Economic Journal*, LXI (244), 697–724.

Myint, H. (1958), "The Classical Theory of International Trade and the Underdeveloped Countries", *Economic Journal*, LXVIII (270), 317–37.

Meier (1977),"Adam Smith's Theory of International Trade in the Perspective of Economic Development", *Economica*, VIL (175), 231–48.

Sailors, J. W. et al (1973),"Empirical Verification of Linder's Trade Thesis", Southern Economic Journal, XL (2), 262–68.

Samuelson, R. A. (1948), "International Trade and the Equalisation of Factor Prices", *Economic Journal*, LVIII (230), 163–84.

———— (1949), "International Factor Price Equalisation: Once Again", *Economic Journal*, LIX (233), 181–97.

Stern, R. M. (1962), "British and American Productivity and Comparative Costs in International Trade", *Oxford Economic Papers*, XIV (3), 275–96.

Tatemoto, M. and S. Ichimura (1959), "Factor Proportions and Foreign Trade: The Case of Japan", *Review of Economics and Statistics*, XLI (4), 442–46.

* **France** is the world's sixth-largest agricultural producer and the second-largest agricultural exporter, after the United States. However, the destination of 70% of its exports is other EU member states. Wheat, beef, pork, poultry and dairy products are the principal exports. A member of the G8 group, its economy is the fifth largest in the world in nominal terms, behind the United States, Japan, China and Germany and the eighth largest by purchasing power parity.

Gold Souk in Diera, Dubai, UAE*

4

Balance of Payments

CHAPTER OBJECTIVES

The chapter acquaints the readers with the structure of the balance of payments, balance of payments disequilibrium and with how disequilibrium is adjusted. In particular, it attempts to:

- ✦ Discuss the structure of balance of payment (BOP) focussing on the current and capital account transactions.
- ✦ Show how official reserves account is related to BOP disequilibrium.
- ✦ Explain BOP equilibrium and disequilibrium.
- ✦ Discuss various approaches to BOP adjustment – beginning from the classical approach to the elasticity approach, Keynesian approach and monetary approach.

Whatever the mode of international business, it involves cross-border movement of funds. The movement of funds is reflected in a country's balance of payments. In other words, balance of payments shows the financial impact of international business. It is from this point of view that it is essential to acquaint the readers with the basic concept of balance of payments.

4.1 STRUCTURE OF BALANCE OF PAYMENTS

Balance of payments is a macrolevel statement showing inflow and outflow of foreign exchange.

Balance of payments is a statement listing receipts and payments in the international transactions of a country. In other words, it records the inflow and the outflow of foreign exchange. The system of recording is based on the concept of double entry book keeping, where the credit side shows the receipts of foreign exchange from abroad and the debit side shows payments in foreign exchange to foreign residents. Disequilibrium does occur, but not from accounting point of view because debit and credit balances equal each other if the various entries are properly made. The concept of accounting equilibrium is discussed later in this chapter.

Again, receipts and payments are compartmentalised into two heads: one being the current account and the other being the capital account. The basic distinction between the two is that the former represents transfer of real income, while the latter accounts only for transfer of funds, without effecting a shift in real income.

4.1.1 Current Account Transactions

Current account is part of BOP statement showing flow of real income or foreign exchange transactions on account of trade of goods and invisibles.

The current account records the receipts and payments of foreign exchange in the following ways. They are:

Current account receipts:

1. Export of goods
2. Invisibles:
   (a) Services
   (b) Unilateral transfers
   (c) Investment income
3. Non-monetary movement of gold

Current account payments:

1. Import of goods
2. Invisibles:
   (a) Services
   (b) Unilateral transfers
   (c) Investment income
3. Non-monetary movement of gold

Export of goods effects the inflow of foreign exchange into the country, while import of goods causes outflow of foreign exchange from the country.

The difference between the two is known as the balance of trade. If export exceeds import, balance of trade is in surplus. Excess of import over export means deficit balance of trade. Table 4.1 shows the balance of payments figures released by the Reserve Bank of India. During 2007–08, the statement shows a deficit balance of trade for US $119.403 billion.

There is another item in the current account, known as non-monetary movement of gold. It may be noted that there are two types of sale and purchase of gold. One is termed as monetary sale and purchase that influences the international monetary reserves. The other is non-monetary sale and purchase of gold. This is for industrial purposes, and is shown in the current account, either separately from, or along with, the trade in merchandise. In some of the years, the balance of payments statement prepared by the Reserve Bank of India has shown the non-monetary movement of gold, separately from the trade in the merchandise account. But now this item stands included in the trade in merchandise.

Besides, trade in services embraces receipts and payments on account of travel and tourism, financial charges concerning banking, insurance, transportation, and so on. Investment income includes interest, dividend and other such receipts and payments.

Similarly, unilateral transfers include pension, remittances, gifts, and other transfers for which no specific services are rendered. They are called unilateral transfers because they represent the flow of funds in only one direction. They are unlike export or import, where goods flow in one direction and the payment flows in the other.

Trade in services, investment income and the unilateral transfers form the "invisibles", which is a significant item in the current account, shown separately from the trade in the merchandise account. There may be an inflow or outflow of foreign exchange on account of invisibles, and accordingly credit and debit entries are made.

Invisibles refer to trade in services, investment income, and unilateral transfers.

The debit and the credit sides of two accounts—trade in merchandise and the invisibles—are balanced. If the credit side is greater than the debit side, the difference shows the current account surplus. On the contrary, the excess of debit side over the credit side indicates current account deficit. Table 4.1 shows current account surplus for US $29.817 billion during 2007–08.

4.1.2 Capital Account Transactions

Similarly, capital account transactions take place in the following ways:

Capital account is a part of BOP statement showing flow of foreign loans/investment and banking funds.

Capital account receipts:

1. Long term inflow of funds
2. Short term inflow of funds

Capital account payments:

1. Long term outflow of funds
2. Short term outflow of funds

The flow on capital account is long-term as well as short-term. The difference between the two is that the former involves maturity over one year, while the short-term flows are effected for one year or less. The credit side records the official and private borrowing from abroad net of repayments, direct and portfolio investment and short-term investments into the country. It records also the bank balances of the non-residents held in the country. The debit side includes disinvestment of capital, country's investment abroad, loans given to foreign government or a foreign party and the bank balances held abroad. When credit side of the current account along with the credit side of the long-term capital account transactions is compared with the transactions on the debit side of the current account and the long-term capital account, the difference is known as the *basic balance* which may be negative or positive. As per the practice adopted by Reserve Bank of India, basic balance is not shown in the balance of payments statement.

Balance of Payments

- Balance of trade = Export of goods – Import of goods
- Balance of current account = Balance of trade + Net earnings on invisibles
- Balance of capital account = Foreign exchange inflow – Foreign exchange outflow, on account of foreign investment, foreign loans, banking transactions, and other capital flows
- Overall balance of payments = Balance of current account + Balance of capital account + Statistical discrepancy

The capital account balancing is not complete with the basic balance. The debit and the credit sides of the short-term capital account transactions are added to their respective sides. Then the two sides are compared. The difference is known as the capital account balance. Table 4.1 shows a surplus balance in the capital account for US $9.146 billion.

Statistical discrepancy refers to estimate of foreign exchange flow on account of either variations in the collection of related figures or unrecorded illegal transaction of foreign exchange.

Errors and omissions, which is also termed as "statistical discrepancy", is an important item on the balance of payments statement, and is taken into account for arriving at the overall balance. As per Table 4.1, it stands at US $591 million during 2007–08. It may be noted that the statistical discrepancy arises on different accounts. Firstly, it arises because of difficulties involved in collecting balance of payments data. There are different sources of data, which sometimes differ in their approach. In India, trade figures compiled by the Reserve Bank of India and those compiled by the Director-General of Commercial Intelligence and Statistics differ. Secondly, the movement of funds may lead or lag the transactions that they (funds) are supposed to finance. For example, goods are shipped in March, but the payments are received in April. In this case, figure compiled on 31st March, the financial year end, will record the shipment that has been sent, but its payment would be recorded in the following year. Such differences lead to the emergence of statistical discrepancy. Thirdly, certain figures are derived on the basis of estimates. For example, figures for earning on travel and tourism account are estimated on the basis of sample cases. If the sample is defective, there is every possibility of error and omission. Fourthly, errors and omissions are explained by unrecorded illegal transactions that may be either on the debit side, or on the credit side, or on both the sides. Only the net amount is written on the balance of payments. When the country is politically or economically stable, credit balance is normally found because unrecorded inflows of funds occur. But in the reverse case, there is capital flight and the amount is normally negative. The experiences reveal that when Iraq invaded Kuwait, the US balance of payments witnessed such flows, in large measure, on the credit side. This was so because there was substantial capital flight from the Middle East to the USA.

After the statistical discrepancy is located, the overall balance is arrived at. The overall balance represents the balancing between the credit items and the debit items appearing on the current account, capital account, and the statistical discrepancy. Table 4.1 shows an overall balance that is surplus by US $20.080 billion during 2007–08.

If the overall balance of payments is in surplus, the surplus amount is used for repaying the borrowings from the IMF and then the rest is transferred to the official reserves account. On the contrary, when the overall balance is found in deficit, the monetary authorities arrange for capital flows to cover up the deficit. Such inflows may take the form of drawing down of foreign exchange reserves or official borrowings or purchases (drawings) from the IMF. From this point of view, capital inflows are bifurcated into autonomous and accommodating ones. If the inflow of funds on the capital account is for meeting the overall balance of payments deficit, it is termed as accommodating or compensatory capital flow. In other words, accommodating capital inflows aim at putting the balance of payments in equilibrium. On the other hand, autonomous capital flows take place regardless of such considerations. A foreigner paying back the loan or the inflow of foreign direct investment is an apposite example of autonomous capital inflow. This is why autonomous capital inflow goes "above-the-line", while accommodating capital inflow goes "below-the-line".

Accommodating capital flow is the inflow of foreign exchange to meet the balance of payments deficit, normally from the IMF.

Autonomous capital flow refers to flow of loans/ investment in normal course of a business.

4.1.3 Official Reserves Account

Official reserves are held by the monetary authorities of a country. They comprise of monetary gold, SDR allocations by the IMF, and foreign currency assets. Foreign currency assets are normally held in form of balances with foreign central banks and investment in foreign government securities. If the overall balance of payments is in surplus, the surplus amount, as it is mentioned above, adds to the official reserves account. But if the overall balance of payments is in deficit, and if accommodating

SDRs allocation is the creation of international reserve assets by the IMF, and their allocation among member countries in order to improve international liquidity.

Table 4.1 India's Overall Balance of Payments

Item	*US $ million* 2008–09
A. Current Account	
1. Exports, f.o.b.	1,75,184
2. Imports, c.i.f.	2,94,587
3. Trade Balance	–1,19,403
4. Invisibles, Net	89,586
(a) 'Non-factor' services *of which*:	49,818
software services Exports	47,000
(b) Income	–4,511
(c) Private Transfers	44,047
(d) Official Transfers	232
5. Current account balance	–29,817
B. Capital Account	
1. Foreign Investment, Net (a + b)	3,462
(a) Direct investment *of which*:	17,496
i. In India	34,982
Equity	27,809
Re-invested earnings	6,426
Other capital	747
ii. Abroad	–17,486
Equity	–13,558
Re-invested earnings	–1,084
Other capital	–2,844
(b) Portfolio investment	–14,034
In India	–13,855
Abroad	–179
2. External Assistance, Net	2,638
Disbursements	5,042
Amortisation	–2,404
3. Commercial Borrowings	8,158
Disbursements	15,382
Amortisation	–7,224
4. Short term credit, net	–5,795
5. Banking capital *of which*:	–3,397
NRI deposits, Net	*4,290*
6. Rupee Debt Service	–101
7. Other Capital, Net	4,181
8. Total Capital Account	9,146
C. Errors & omissions	**591**
D. Overall balance [A(5) + B(8) + D]	**–20,080**
E. Monetary movements (F + G)	**20,080**
F. IMF, Net	**0**
G. Reserves and monetary gold [Increase (–), Decrease (+)]	**20,080**

Source: *RBI Annual Report: 2008–09*

capital is not available, the official reserves account is debited by the amount of deficit.

Table 4.1 shows that US $20.080 billion was drawn from the official reserves account.

4.2 EQUILIBRIUM, DISEQUILIBRIUM AND ADJUSTMENT

4.2.1 Accounting Equilibrium

Since the balance of payments is constructed on the basis of double entry book keeping, credit is always equal to debit. If debit on the current account is greater than the credit side, funds flow into the country, which are recorded on the credit side of the capital account. The excess of debit is wiped out. Thus, the concept of balance of payments is based on the concept of accounting equilibrium, that is,

$$\text{Current account} + \text{Capital account} = 0 \tag{4.1}$$

The accounting balance is an *ex post* concept. It describes what has actually happened over a specific past period. There may be accounting disequilibrium when the two sides of the autonomous flows differ in size. But in such cases, accommodating flows bring the balance of payments back to equilibrium.

4.2.2 Disequilibrium and the Focus of Adjustment

In economic terms, balance of payments equilibrium occurs when surplus or deficit is eliminated from the balance of payments. However, normally, in real life, such equilibrium is not found. Rather it is the disequilibrium in the balance of payments that is a normal phenomenon.

There are external economic variables influencing the balance of payments and giving rise to disequilibrium. But domestic economic variables are more important for causing disequilibrium. Some important variables are:

1. National output and national spending
2. Money supply
3. Exchange rate
4. Interest rate

If national income exceeds national spending, the excess amount (saving) will be invested abroad, resulting in capital account deficit. Conversely, excess of national spending over national income causes borrowings from abroad, pushing the capital account into a surplus zone.

Disparity in national income and national spending influences the capital account via the current account as well. If national output exceeds national spending, the difference manifests in export, causing current account surplus. The surplus is invested abroad, which means capital account deficit. The excess of national spending over national output leads to import. Deficit appears on the current account. The country borrows to meet the current account deficit. The borrowing results in capital account surplus.

Similarly, increase in money supply raises the price level and exports turn uncompetitive. Fall in export earnings leads to deficit in the current account. The higher prices of domestic goods make the price of imported commodities competitive and imports rise, leading to enlargement of deficit in the current account.

If the currency of a country depreciates, exports become competitive. Export earning improves. On the other hand, imports become costlier. If, as a result, imports are restricted, the trade account balance will improve. But if imports are not restrained, deficit will appear in the trade account. Infact, the net effect depends upon how far the demand for export and import is price-elastic.

Last but not least, the increase in domestic interest rate causes capital inflow in lure of higher returns. Capital account runs surplus. The reverse is the case when the interest rate falls.

However, diseqilibrium becomes a cause for concern when it is associated with the current account. This is because current account represents a shift in real income; and at the same time, any adjustment in this account is not very easy. Even in the current account, it is the balance of trade account that is largely responsible for disequilibrium. If the balance of trade is in surplus, its correction is not difficult. The surplus amount is used either for meeting the deficit on invisible trade account, or it may be invested abroad. But if the balance of trade is in deficit zone and if the deficit is large, so as not to be covered by invisible trade surplus, current account deficit will occur. Correcting it is not easy, insofar as the autonomous and accommodating capital flows are not so smooth. Again, if the deficit on the current account continues to persist, official reserves will be eroded. If a country borrows large amounts to meet the deficit, it may fall into a vicious debt trap. This is why adjustment measures are primarily aimed at correcting disequilibrium in the trade account.

4.3 DIFFERENT APPROACHES TO ADJUSTMENT

4.3.1 The Classical View

Price-specie-flow mechanism deals with relationship between flow of specie, money supply, prices, and foreign trade.

The issue of linkage between domestic economic variables and the balance of payments responsible for disequilibrium in the latter, as well as its adjustment, has been investigated by a number of experts. Classical economists were aware of the balance of payments disequilibrium, but they were of the view that it was self adjusting. Their view, which was based on the price-specie-flow mechanism—stated that an increase in money supply raises domestic prices, where by exports become uncompetitive and export earnings drop. Foreign goods become cheaper, and imports rise, causing the current account balance to go into deficit in the sequel. Precious metal leaves the country in order to finance imports. As a result, the quantity of money lessens, that lowers the price level. Lower prices in the economy lead to greater export and trade balance reaches equilibrium once again. In this manner, the classical version of the balance of payments adjustment was a refutation of the mercantilist belief that a country could achieve a persistent balance of trade surplus through trade protection and export promotion.

4.3.2 Elasticity Approach

After the collapse of the gold standard, the classical view could not remain tenable. The adjustment in the balance of payments disequilibrium was thought of in terms of changes in the fixed exchange rate, that is through devaluation or upward revaluation. But its success was dependent upon the elasticity of demand for export and import. Marshall and Lerner explained this phenomenon through the "elasticity" approach (Marshall, 1924; Lerner, 1944).

The elasticity approach is based on partial equilibrium analysis where everything is held constant, except for the effects of exchange rate changes on export or import. It is also assumed that elasticity of supply of output is infinite so that the price of export in home currency does not rise as demand increases, nor does the price of import fall with a squeeze in demand for imports. Again, the approach ignores the monetary effects of variation in exchange rates. Based on these assumptions, devaluation helps improve the current account balance only if:

$$E_m + E_x > 1 \tag{4.2}$$

Where E_m is the price elasticity of demand for import and
E_x is the price elasticity of demand for export.

If the elasticity of demand is greater than unity, the import bill will contract and export earnings will increase as a sequel to devaluation. Trade deficit will be removed. However, the problem is that the trade partner may also devalue its own currency as a retaliatory measure. Moreover, there may be a long lapse of time before the quantities adjust sufficiently to changes in price. Till then, trade balance will be even worse than that before devaluation. This is nothing but the J-curve effect of devaluation. In Figure 4.1, trade balance moves deeper into the deficit zone immediately after devaluation. But then it gradually improves and crosses into surplus zone. The curve resembles the alphabet, J and so, it is known as the J-curve Effect.

> When the devaluation of currency leads to a fall in export earnings in the initial stage and then a rise in export earnings, making the earning curve look like the alphabet, J it is called J-curve effect

The weakness of the elasticity approach is that it is a partial equilibrium analysis and does not consider the supply and cost changes as a result of devaluation as well as the income and the expenditure effects of exchange rate changes. In this context, it may be mentioned that it was Stern (1973) who incorporated the concept of supply elasticity in the elasticity approach. According to him, devaluation could improve balance of payments only when:

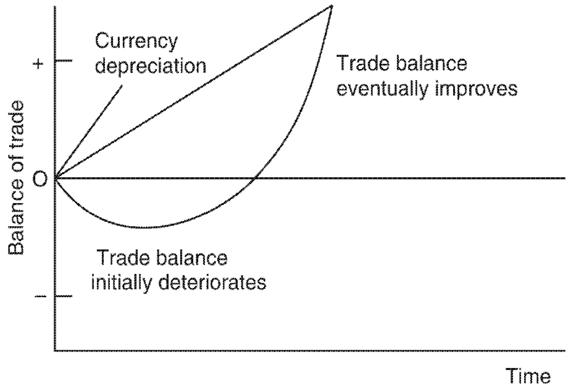


FIGURE 4.1 J-curve Effect

$$X\left[\frac{(ED_X - 1)}{\left(1+\frac{ED_X}{ES_X}\right)}\right] + M\left\{\frac{\left[ED_m \times \left(1+\frac{1}{ES_m}\right)\right]}{\left(\frac{ED_m}{ES_m}+1\right)}\right\} > 0 \qquad (4.3)$$

Where X and M are exports and imports,
ED_x is elasticity of demand for exports,
ES_x is elasticity of supply for exports,
ED_m is elasticity of demand for imports, and
ES_m is elasticity of supply for imports.

It is not only elasticity of demand but also the elasiticity of supply for export and import that influences balance of trade.

Based on the figures of British exports and imports, Stern came to the conclusion that the balance of trade would improve if:

1. the elasticity of demand for exports and imports is high and is equal to one coupled with elasticity of supply both for imports and exports, which could be either high or low.
2. the elasticity of demand for imports and exports is low but the elasticity of supply for imports and exports is lower.

On the contrary, if low elasticity of demand is matched with high elasticity of supply, the balance of trade should worsen.

Absorption approach deals with how changes in total income and absorption, meaning consumption, investment and governmental spending influence the trade balance.

4.3.3 Keynesian Approach

The Keynesian view takes into consideration primarily the income effect that was ignored under the elasticity approach. Here the readers are being acquainted with three different views that are based on the Keynesian approach.

Absorption Approach: The absorption approach explains the relationship between domestic output and trade balance and conceives of adjustment in a different way. Sidney A. Alexander (1959) treats balance of trade as a residual given by the difference between what the economy produces and what it takes for domestic use or what it absorbs. He begins with the contention that the total output, Y is equal to the sum of consumption, C, investment, I, government spending, G, and net export, $(X - M)$. In form of an equation,

$$Y = C + I + G + (X - M)$$

Substituting $C + I + G$ by absorption, A, it can be rewritten as:

$$Y = A + X - M$$

or $$Y - A = X - M \tag{4.4}$$

This means that the amount by which total output exceeds total spending or absorption is represented by export over import or the net export, which means a surplus balance of trade. This also means that if $A > Y$, deficit balance of trade will occur. This is because excess absorption in the absence of desired output will cause imports. Thus, in order to bring equilibrium to the balance of trade, the government has to increase output or income. Increase in income without corresponding and equal increase in absorption will lead to improvement in balance of trade. This is called the expenditure switching policy.

In case of full employment, where resources are fully employed, output cannot be expanded. Balance of trade deficit can be remedied through decreasing absorption without equal fall in output. This is known as the expenditure-reducing policy. On the contrary, where full employment is yet to be achieved, output can be increased or/and absorption can be reduced in order to bring about equilibrium in the trade balance. It may be noted that the validity of the absorption approach depends upon the operation of the multiplier effect, which is essential for accelerating output generation. It also depends on the marginal propensity to absorb, which determines the rate of absorption.

> J. Black ignores governmental expenditure, G, and equates $X - M$ with $S - I$.

J. Black (1959) explains absorption in a slightly different manner. He ignores governmental expenditure, G, and equates $X - M$ with $S - I$ (where S is saving and I is investment). He is of the opinion that when balance of trade is negative, the country has to increase savings on the one hand and to reduce investment on the other. In case of full employment, he suggests redistribution of national income in favour of profit earners who possess greater propensity to save.

Let us now look at the effects of devaluation/depreciation in the framework of absorption approach. The effects fall upon both the income and absorption. There are three types of effect on income—idle resource effect, terms of trade effect, and resource allocation effect. As a sequel to devaluation, imports turn costlier and demand for home produced goods increases, which helps use of idle resources and, thereby, in output expansion. This is idle-resource effect. Terms-of-trade effect is subject to the elasticity of supply for export and import. If terms of trade improve, income improves and then so does the balance of payments. Again, if productivity is lower in the non-traded goods sector and if devaluation takes place, resources will shift from the lower to higher productivity sector. Income will naturally improve. This is the resource allocation effect.

The effect of devaluation on absorption manifests in rising import cost and the consequent upsurge in the cost and price of home produced goods. High price goods lower consumption.

Mundell-Fleming Approach: Mundell-Fleming (1962) approach, developed in the Keynesian framework, focuses through IS–LM curve on how the internal and external balance is influenced by fiscal and monetary policies. The IS curve for an open economy shows various combinations of output and interest rate. It shows that:

$$S + M = I + G + X \tag{4.5}$$

The left side of the equation is known as the leakages and the right side is known as the injections. Savings include autonomous savings plus savings on account of risen income based on marginal propensity to save. Imports include autonomous imports plus imports on account of risen income based on marginal propensity to import. Investment is assumed to be an inverse function of rate of interest. Exports and governmental expenditure are autonomous with respect to interest rate and the level of national income. The relationship between leakages and income can be shown with an upward sloping line, whereas the injection schedule is downward sloping—from left to right.

The L–M schedule shows various combinations of level of income and rate of interest under the assumption that the supply of money is equal to demand for money meaning that the money market is in equilibrium. Money is demanded either for transaction purposes or for speculative purposes. The larger is the income, the bigger is the money held for transaction purposes meaning that transaction demand for money is a positive function of income. The demand for money for speculative purposes has an inverse relationship with the rate of interest. Taking together these two forms of demand, L–M schedule is upward sloping from left to right because the income levels require comparatively bigger transaction balances than the speculative balances.

The balance of payments (BP) schedule shows various combinations of rate of interest and income accruing in the balance of payments. As far as current account is concerned, export is assumed to be independent of the level of national income and then rate of interest. But import is assumed to be positively related to income which means higher income, higher the imports and deficit is the current account. Current account deficit, if any, is offset by surplus in the capital account. Net capital account flow is positively related to the rate of interest, which means higher interest rate in the country attracts inflow of capital. Thus, the current account and capital account schedules slope downward from left to right.

The balance of payments is in equilibrium because IS and LM schedules intersect at a point on the BP schedule corresponding to a given interest rate and the level of income, as shown in Figure 4.2 a.

If the income and imports increase and interest rates decrease following an expansionary monetary policy, the balance of payments

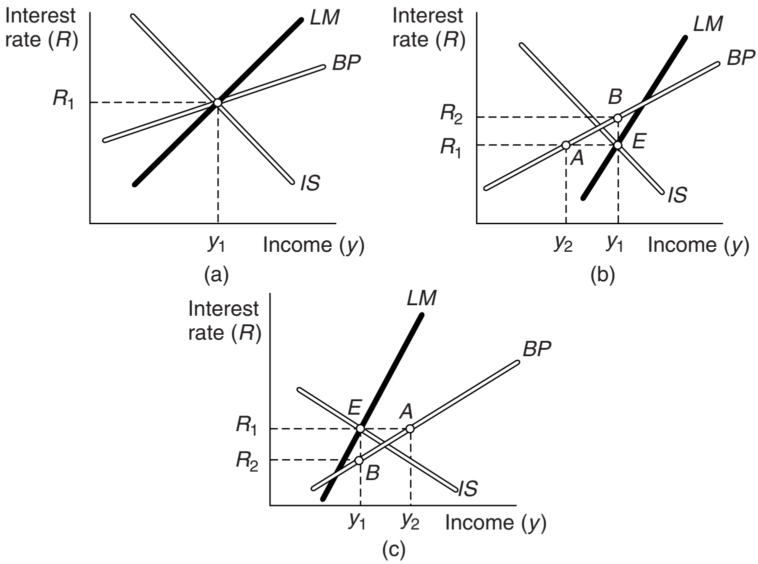


FIGURE 4.2

will turn deficit and BP schedule will shift leftward (Figure 4.2 b). On the contrary, during contractionary monetary policy regime, the balance of payments will turn surplus and the BP schedule will shift rightward (Figure 4.2 c).

New Cambridge School Approach: This is a special case of absorption approach. It takes into account savings (*S*), investment (*I*), taxes (*T*), and government spending (*G*), and their impact on the trade account. In form of an equation, it can be written as:

$$S + T + M = G + X + I$$

Or $$(S - I) + (T - G) + (M - X) = 0$$

Or $$(X - M) = (S - I) + (T - G) \qquad (4.6)$$

The theory assumes that $(S - I)$ and $(T - G)$ are determined independently of each other and of the trade gap. $(S - I)$ is normally fixed as the private sector has a fixed net level of saving. And so the balance of payments deficit or surplus is dependent upon $(T - G)$ and the constant $(S - I)$. In other words, with constant $(S - I)$, it is only the manipulation of $(T - G)$ that is necessary and a sufficient tool for balance of payments adjustment.

4.3.4 Monetary Approach

Monetarists believe that the balance of payments disequilibrium is a monetary and not a structural phenomenon (Connolly, 1978). The adjustment is automatic unless the government is intentionally following an inflationary policy for quite a long period. Adjustment is brought about by making changes in monetary variables. To explain the phenomenon, it is assumed that:

1. Demand for money, L, depends upon the domestic price level, P, and real income, Y. The relationship among these three variables does not change significantly over time. In form of an equation, it can be written as
$$L = kPY \tag{4.7}$$
2. Money supply, M, depends upon domestic credit, D, and international reserves held, R, and money multiplier, m. It can be written as
$$M = (R + D)m$$
Assuming m being equal to 1, it can be rewritten as
$$M = R + D \tag{4.8}$$
3. Domestic price level depends on the foreign price level, P^*, and the domestic currency price of foreign currency, E, we can write it as
$$P = EP^* \tag{4.9}$$
4. Demand for money equals the supply of money because there is held an equilibrium in the money market, which is
$$L = M \tag{4.10}$$

In **fixed exchange rate regime**, monetary authorities set the external value of the currency vis-a-vis another currency/SDRs/a basket of currencies.

The process of adjustment varies among the types of exchange rate regime the country has opted for. In a fixed exchange rate regime or in gold standard, if the demand for money, that is the amount of money people wish to hold, is greater than the supply of money, the excess demand would be met through the inflow of money from abroad. On the contrary, with the supply of money being in excess of the demand for it, the excess supply is eliminated through the outflow of money to other countries. The inflow and the outflow influence the balance of payments. To explain it further, with constant prices and income and, thus, constant demand for money, any increase in domestic credit will lead to outflow of foreign exchange as the people will import more to lower excessive cash balances. Consequently, the balance of payments will turn deficit. Conversely, a decrease in domestic credit would lead to an excess demand for money. International reserves will flow in to meet the excess demand and balance of payments will improve.

Floating rate regime refers to the exchange rate which is not fixed but varies, depending upon the forces of demand and supply.

However, in a floating rate regime, the demand for money is adjusted to the supply of money via changes in the exchange rate. Especially in a situation when the central bank makes no market intervention, the international reserves component of the monetary base remains unchanged. The balance of payments remains in equilibrium with neither surplus nor deficit. The spot exchange rate is determined by the quantity of money supplied and the quantity of money demanded.

When the central bank increases domestic credit through open market operations, the supply of money is greater than the demand for it. Households increase their imports and with increased demand for imports, the domestic currency will depreciate and it will continue depreciating until the supply of money equals the demand for money. Conversely, with decrease in domestic credit, the households reduce their import.

Domestic currency will appreciate and it will continue appreciating until supply of money equals demand for money.

In case of managed floating, the central bank often intervenes to peg the rates at a desired level. Therefore, this case is a mix of fixed and floating rate regimes. It means that changes in the monetary supply and demand not only influence the exchange rate, but also the quantum of international reserves.

Different Approaches to BOP Adjustment

- Classical view: Self-adjusting process. Trade deficit → outflow of gold → decreased money supply → lower prices → higher exports → elimination of trade deficit.
- Elasticity Approach (Marshall/Lerner's view): Trade deficit → devaluation → (demand for export and import being price-elastic) exports cheaper abroad and higher export earnings + costlier imports and squeezed import bill → elimination of trade deficit. Stern added the concept of supply elasticity, meaning that supply elasticity for import and export must be favourable.
- Absorption Approach (Alexander's view): Trade deficit → decrease in absorption (consumption + investment + government expenditure) so that total output > absorption → elimination of trade deficit. Black suggests increasing saving and reducing investment in order to eliminate trade deficit.
- Mundell-Flemming view through adjustment in interest rate and income: Rise in interest rate → lower income → lower import → elimination of trade deficit. Again, rise in interest rate → inflow of foreign investment → improvement in capital account to absorb trade deficit.
- New Cambridge School Approach: Greater taxes + lower governmental expenditure → lower income → lower import → elimination of trade deficit.
- Monetary Approach:
  - Fixed exchange rate: Reduction in credit creation → decreased supply of money → lower import → falling trade deficit.
  - Floating exchange rate: Size of credit → size of money supply → exchange rate → balance of trade.

SUMMARY

- The balance of payments is a statement showing a country's commercial transaction with the rest of the world. It shows inflow and outflow of foreign exchange. It is divided into current and capital accounts. The former records the transaction in goods and services. The latter incorporates the flow of financial assets.
- The major economic variables influencing the balance of current and capital accounts are national output, national spending, money supply, exchange rate, and interest rate. The concept of disequilibrium is normally associated with the current account, and that too with the trade account.

- There are various approaches to adjustments in the balance of payments disequilibria. Classical economists believed in automatic adjustment through the flow of precious metals. Neo-classical economists emphasised on devaluation for improvement in the balance of trade. The focal point of the Keynesian approach is the income effect. Different views have been expressed in the Keynesian framework. One view, known as the absorption approach, suggests a proper alignment between output and absorption. Mundell-Fleming approach incorporates interest rate also and analyses the impact of interest rate changes, both on the current account and the capital account. The views of the New Cambridge school highlight taxes minus government spending as a tool for balance of payments adjustment. The monetarists, on the other hand, argue for changes in the monetary variables for adjustment in the balance of payments.

REVIEW QUESTIONS

1. What are the items listed in the current and the capital accounts?
2. Distinguish between:
   (a) monetary movement of gold and non-monetary movement of gold
   (b) autonomous capital flow and accommodating capital flow
   (c) capital account and current account
3. Explain statistical discrepancy.
4. Mention the macroeconomic variables that influence balance of payments.
5. "The adjustment in the balance of payments is automatic". Discuss this statement from the viewpoint of classical economists.
6. Explain elasticity approach to the adjustment in balance of payments.
7. Explain the Keynesian approach to the balance of payments adjustment.
8. Explain the monetary approach to balance of payments adjustment.

REFERENCES

Books

Connolly, M. (1978), "The Monetary Approach to an Open Economy: The Fundamental Theory" in Putnam, R. *et al.* (eds.), *The Monetary Approach to International Adjustment* (New York: Praeger), pp. 46–59.

Lerner, A. P. (1944), *The Economics of Control* (New York: Macmillan), Chaps. 28–29.

Marshall, A. (1924), *Money, Credit and Commerce* (London: Macmillan), Book, III.

Mundell, R. A. (1968), *International Economics* (New York: Macmillan).

Stern, R. M. (1973), *The Balance of Payments* (London: Macmillan).

Journals

Alexander, Sidney A. (1959),"Effects of a Devaluation: A Simplified Synthesis of Elasticity and Absorption Approaches", *American Economic Review*, I L (1), 22–42.

Black, J. (1959),"Saving and Investment Approach to Devaluation", *Economic Journal*, LXIX (273), 267–74.

SELECT FURTHER READINGS

Daniels, J. and D.Vanhoose (1999), *International Monetary and Financial Economics* (New York: International Thomson Publishing Company).

Melvin, M. (1985), *International Money and Finance* (New York: Harper Row), Chap.6.

* **Dubai Gold Souk** is a traditional market located in the heart of eastern Dubai's commercial business district in Deira. By some estimates, approximately 10 tons of gold is present at any given time in the souk. In 2003, the value of trade in gold in Dubai was approximately Dh. 21 billion (US$ 5.8 billion), while trade in diamonds was approximately Dh. 25 billion (US$ 7 billion) in 2005. India is Dubai's largest buyer of gold, accounting for approximately 23% (2005) of the emirate's total gold trade in 2005.

PART 2

International Business Environment

This page is intentionally left blank.

Freight Station, Hamburg, Germany*

5

National Regulation of International Business

CHAPTER OBJECTIVES

International business is normally subject to various kinds of regulatory environment. The present chapter discusses the regulation of international business at the national level. In particular, the objective is to:

- Examine the merits of free trade versus trade protection.
- Explain the forms of trade regulation—trade restrictions and trade liberalisation.
- Examine the rationale behind regulation of FDI from the viewpoints of both the home country and the host country.
- Discuss the modalities of FDI regulation in both, the home country and the host country.

It has already been mentioned that international business is carried on in a multiplicity of environments insofar as the environment differs from one country to the other. This part of the book, therefore, acquaints the readers with the various kinds of environments. A beginning is made with the regulatory environment at the national level.

Regulation does not simply mean restrictions on foreign trade and investment, but also encouragement to them. The two divergent processes—restrictions vis-a-vis encouragement, determine essentially the quantum and pattern of international trade and investment in two different directions. The present chapter presents the relative merits of these two divergent processes and then discusses the different forms of regulation.

5.1 FREE TRADE VERSUS PROTECTION

5.1.1 Case for Free Trade

Free trade refers to absence of restrictions on export and import.

Protection is restricting import in order to protect domestic industries.

If regulation aims at *liberalisation of trade*, it is definitely a move towards *free trade*. If, on the contrary, it is meant for restriction of trade, it is nothing but protection. It is better to mention the arguments sometimes given in favour of free trade before any discussion of regulation of trade.

First of all, the argument for free trade rests primarily on the belief that it leads to specialisation, which helps increase output and the gains from the increased output is shared by the trading partners. It may be noted that output can also be increased through acquiring greater resources or through improving the quality of the factors of production. But, international trade is the least painful of the three measures for increasing output. Moreover, trade facilitates the other two types of the measures.

Secondly, free trade generates competition, which in turn promotes efficiency in production. Increased productive efficiency leads to improvement in quality and in lowering of prices. All this benefits both the producers and the consumers.

Thirdly, free trade leads to the generation of economies of scale. There are some industries that can achieve minimum average cost only through a bigger amount of sale, which is possible only when goods are exported to a global market. For example, the aeroplane-manufacturing industry cannot achieve economies of scale when its has only domestic customers.

Fourthly, free trade helps check inflation through the application of the one-price principle. It maximises the welfare of trading countries, and consequently, global welfare.

5.1.2 Arguments for Protection

It is a fact that free trade has a sound theoretical base, but it has only limited empirical support. Moreover, in real life, free trade is a utopian ideal. There are economic as well as non-economic arguments for regulating

Table 5.1 Arguments for Trade Protection

Economic Factors	*Non-economic Factors*
1. Protection of infant industry	1. Maintenance of essential industries
2. Promotion of industrialisation	2. Relations with unfriendly countries
3. Retaliatory action	3. Preservation of culture and national identity
4. Balance of payments adjustment	4. Preservation of community health
5. Price control and terms of trade	5. Preservation of national security
6. Employment generation	

trade (Table 5.1). The economic arguments are normally concerned with strengthening industrialisation in the country or with protecting balance of payments from any deterioration. The non-economic arguments are mainly political in nature. Whenever any government regulates foreign trade, there is normally a combination of factors behind it. Here it is relevant to discuss some of the major arguments behind protection of international trade.

Economic Factors:

1. The **infant industry** argument presents the most important justification behind the regulation of international trade. Newly born firms are generally not strong enough to compete with well established firms. Global firms enjoy economies of scale and are able to sell goods at a lower price. On the other hand, newly born domestic firms have high costs and cannot sell their products at low prices, at least in the short run. If the import of such products is not restricted, consumers will demand the imported product and not the domestically produced high cost goods. The result will be that in absence of demand, domestic firms producing such goods will have to close down their operations. Thus, if such firms have to be developed at home, import restriction becomes a necessity.

   This concept is not new. As far back as in 1930s, several industries in India were given protection against imports from the UK and other countries. It is often said that the sugar industry in India is a child of protection. However, there are a few problems that arise in such cases. First, it is very difficult to decide which industry has to be protected. Second, protection, once given, cannot easily be lifted because the producers, workers, and consumers tend to oppose it. Third, there is every possibility that the infant industry becomes dependent on the protection. If this is the case, it can never stand on its own feet and become competitive. Fourth, protection often causes greater economic harm than good insofar as the consumers have to pay higher prices for the product. Thus, whenever imports are restricted to help develop the infant industry, it should be a short-run phenomenon.

2. The **industrialisation promotion** argument is also important. In many countries, import substituting industries are developed to achieve self-reliance and to give a boost to other industries. This means that import restrictions lie at the very root of industrialisation. Sometimes, it is also said that when the government restricts imports, foreign investors boost up their investment in that country. This is because they get a sheltered market where they can make huge profits. Daniels and Radebaugh (2000) cite an example where Japanese automobile manufacturers began investing in the United States of America following restrictions on automobile import by the US Government. If this is the case, it means that import restrictions lead to foreign investment inflow and, thereby, strengthens the process of industrialisation.

   Again, sometimes the government restricts imports in order to help revive an already existing industry that is not in its infancy but is quite old. This is because such industries get a breathing space for revival in the absence of competition from imported products. This argument holds good in Canada where footwear imports are restricted because this is a traditional industry in Canada.

3. Sometimes, **retaliatory actions** need import restrictions. Such measures are taken when exporters adopt unfair trade practices. In order to capture the market, exporters sell goods in foreign countries, even at a lower price than their cost structure justifies. Such practices disrupt the very industrial structure in the importing countries. In order to counteract this move of exporters, the government in the importing country imposes restrictions on imports. However, it is very difficult to prove unfair trade practices in some cases. Moreover, retaliatory measures often turn to be unending and they prove harmful for trading countries.

4. **Balance of payments adjustment** is another justification, either for imposing restrictions on import or for export encouragement or both. In developing countries, axing the trade deficit lies at the root of import restrictions. In India, when the balance of trade was in a very bad shape during the early 1990s, import restriction measures were adopted quite intensively. Again, the import restriction measures are often accompanied by export encouragement measures. But sometimes it is found that import restrictions considerably hamper the export potential since the exporting industries do not get the desired amount of raw material or they get it only at a higher cost. So, import restrictions are only a short-term measure. They cannot be long-term, especially when they affect the exporting industries.

5. **Price control** is another objective behind the regulation of international trade. It is often found in cases where the exporting country is in a monopolistic or oligopolistic position with respect to a particular commodity. The exporting government shapes the price of the export in such a way that it provides for maximum profit. When the demand for the product is price inelastic, the exporting government raises the price of the product far beyond the cost of production. But if, on the contrary, the demand for export is price-elastic and the importing government imposes duty on the import, the price of the product will be unusually high in the hands of the consumers. As a result, the supplier will be forced to cut the price in order to maintain demand for the product. With a cut in the price, the ratio between the import price and the export price will be lower for the importing countries, improving in turn the terms of trade. An improvement in the terms of trade means accruing of gains from trade.
6. Protection of trade helps **generate employment** in the importing country. In macroeconomic terms, protection helps generate balance of payments surplus, which in turn increases income and employment. But if the additional income is used for imports, surplus in the balance of payments is eroded. On the contrary, the microeconomic employment case for protection starts with the fact that imposition of tariff may raise the demand for labour in a particular industry where import substituting goods are produced. But if labour is not mobile among industries, this effect may not be felt.

Non-economic Factors:

1. Among the non-economic factors, **maintenance of essential industries** is a guiding factor behind the regulation of trade. Each and every country tries to develop some essential industries so that in case of an extra-ordinary situation, the supply of essential products is not completely hampered. In order to protect these industries, the government regulates the export and import of these products. Again, in some other cases where the producers need the assurance of an uninterrupted supply of raw material, the government regulates the export and import of raw material. For example, the US Government subsidises the domestic production of silicon, which is made easily available to the computer industry.
2. **Trade with unfriendly countries** needs to be regulated. If the political relations are not friendly between two governments, trade is not encouraged between them. In cases where minimum trade is conducted, there is often the possibility of non-payment. So in such cases, trade is highly regulated in terms of commodities and price.

3. **Preservation of national culture and identity** is one of the factors behind regulating trade. For example, France imposes partial curb on the import of foreign films. This is out of fear that those films may affect badly the French culture and identity. In Canada too, there are restrictions on the import of entertainment products from the United States.
4. **Preservation of community health** is of utmost importance. The essence of health and sanitary regulations is to import only those products that do not adversely affect consumers' health. This is why food products are checked by health authorities the moment they enter ports
5. Trade regulation is necessary in order to preserve **national security.** Industries considered important for national security are often subjected to export or import regulations. The export and import of defence related products are cases in point.

5.1.3 Move from Inward-looking to Outward-looking Trade Policy Regimes

Neither of the two extremes–completely free trade on the one hand and complete trade restriction on the other–is found in the real life. The real scenario over past couple of decades shows that majority of the developing countries have moved from an inward-looking trade policy regime to an outward-looking one. Here the readers should be acquainted with the nature of these two policy regimes.

> ILP regime discriminates against imported products through imposing trade barriers
>
> OLP regime liberalises imports and provides incentives for encouraging exports

Inward-looking Policy: The inward-looking policy (ILP) regime represents a situation when a country tries to establish its domestic market for its own products through discriminating against the imported products by way of imposing trade barriers. Normally, this policy is known as import-substitution policy (ISP).

ISP was widely in use after the Second World War untill 1980s. The argument behind the use of this policy during the initial years was that the industrialisation in the developing world could not be financed through the export of primary commodities because the prices of these commodities tended to languish over the period that led to shrinkage in foreign exchange earnings (United Nations, 1949; Prebisch, 1950). Moreover, this policy helped the infant industries to grow (Hirschman, 1968). A number of tools were employed to serve the policy objective, such as tariff and quantitative restrictions, multiple exchange rates and different kinds of subsidies. However, it was never an easy sail. High tariff on intermediate goods harmed the final goods producers using those inputs. Balassa (1980) has cited some cases of Argentina and Hungary where the export industries using imported inputs had suffered a lot and the effective rate of protection is quite higher than the nominal rate of protection if the domestic value addition is not sizeable. The empirical study of Little et al (1970) shows that the effective rate of protection in India and

Pakistan was 200 per cent higher than the nominal rate of protection and it was 100 per cent higher in Argentina and Brazil. Moreover, the protected industries gain at the cost of unprotected ones. It leads to malallocation of resources and also to price distortions over time. Taylor (1998) finds quite substantial price distortions in terms of black market premium on foreign exchange among the inward-looking countries during 1950–1980. Again, the growth rate in the ISP countries lagged behind the growth rate in non-ISP countries. Maddison (1995) finds that in India, an ISP country, the growth rate in per capita GDP was lower than in six non-ISP countries of Latin America during the same period. The ISP scenario was thus subject to multiple maladies which led the different governments to make a good-bye to this policy by 1980s.

Outward-looking Policy: The outward-looking policy (OLP) regime is based on the export-oriented strategy where imports are liberalised and other incentives are provided to boost up exports. This strategy came into light when some East Asian countries shifted from ISP to outward-looking policy encouraging manufactured exports and recorded faster growth since 1960s. The policy requires a supportive macroeconomic environment and suitable macroeconomic incentives. The incentive may take the form of investment incentives, softer form of export credit, fiscal incentives for research and development and setting up of export-processing zones.

The outward-looking policy is found successful in so far as foreign demand is often larger in size and especially more stable than the domestic demand. The exports tend to reduce in many cases the foreign exchange constraints on growth (Krueger, 1990); and also, they encourage larger size of production and thereby the economies of scale. The economies of scale influence productivity in a positive way (Girma et al, 2004).

It is the success of the outward-looking policy in many parts of the world that has made this policy an integral component of the development policy throughout the world.

The Global Enabling Trade Report 2008 evaluates the trade policy of 118 countries and presents a cross-country analysis of measures stimulating trade. The higher the score is, the greater is the outward-orientation or the liberalisation in the trade policy. Hong Kong and Singapore have the highest score of, respectively, 6.04 and 5.71 because they have the most hassle-free customs procedures alongwith an equally open business environment. Among the other eight top-scorer countries are Sweden, Norway, Canada, Denmark, Finland, Germany, Switzerland and New Zealand. China is positioned on the 48th rank as this country has a near-closed import market characterised by tariff and non-tariff barriers. India ranks 52nd in the sample in view of cumbrous customs procedures and corrupt border administration resulting in hampered market access.
Source: Based on reports published in *Outlook Business*, 29/6–12/7, 2008.

Soren Kjeldsen-Kragh (2001) distinguishes between inward-looking policy and the outward-looking policy on the basis of effective exchange rate (EER) for the export and the import sectors. The EER for the export sector,

$$EER_X = ER(1 - t_x + s_x)$$

where t_x is export tariff that needs to be deducted from the world market price before the export proceeds are received by the producers; and s_x is the subsidy that the export sector gets.

Similarly, ERR for import sector,

$$EER_M = ER\ (1 + t_m)$$

where t_m is the trade barriers supporting domestic producers to compete with imports.

Now outward-looking policy is found where $EER_X = EER_M$ because there is no discrimination either against the importer or against the exporter. But if $EER_M > EER_X$, it is an indicator of the inward-looking policy because the government discriminates to the advantage of the import-competing industries.

5.2 FORMS OF TRADE REGULATION AT THE NATIONAL LEVEL

It may be emphasised at the very beginning that regulation of trade at the national level is not simply confined to the restriction of trade—export and import. It also includes different measures that act as stimuli to trade—import liberalisation and export encouragement. In all, trade regulation embraces:

1. Restriction of imports
   (a) Imposition of tariff and non-tariff barriers
   (b) Currency controls, such as restrictions on the convertibility of the currency into convertible currencies
   (c) Administrative delays in respect of licences and customs valuation
2. Restriction of exports
   (a) Putting export product on negative/restricted list
   (b) Imposing tariff on export
   (c) Imposing quota on export
3. Import liberalisation
   (a) Tariff cut
   (b) Reduction/abolition of quota and other non-tariff barriers
   (c) Shifting of import items from prohibited/restricted list to open list
4. Export augmentation
   (a) Passing on information or advising the exporters
   (b) Financial support, such as production subsidy and guarantees
   (c) Marketing support, especially provision of export subsidy

(d) Establishment of export-processing zones/special economic zones Since the EPZ units import inputs duty-free, they are able to sell the products in international market at competing prices.

5.3 INSTRUMENTS OF TRADE REGULATION

There are a number of tools that are applied by a government for regulating trade. More importantly, they are tariff. They are non-tariff barriers, such as quota, customs valuation, embargo and the technical barriers, such as classification, labelling requirements, testing standards, voluntary export restraints and buy-local legislation. Subsidy is another tool to augment export. In this section, they need discussion at some length.

5.3.1 Tariff

Tariff means duty levied by the government on imports. When assessed on a per unit basis, tariff is known as specific duty. But when assessed as a percentage of the value of the imported commodity, tariff is called *ad valorem* duty. When both types of tariff are charged on the same product, it is known as compound duty. Sometimes tariff is imposed to counter unfair trade practices, such as subsidy of the trading partner. In such cases, tariff is known as countervailing duty. Whatever may be the form of tariff, it reduces the quantum of import as the imported product turns costlier after the imposition of tariff. How much deeper the effect of tariff will be on the import restriction depends not only on the nominal rate of tariff but, more importantly, on the effective rate of protection.

Specific duty refers to duty based on units of goods.

Ad valorem duty is duty based on the value of goods.

Compound duty is duty based on both the unit and the value.

Countervailing duty refers to duty to negate the impact of unfair business practices, such as subsidy.

Effective rate of protection may be much lower/much higher than the nominal rate of tariff. This is because many goods are produced with imported raw material or intermediate products. Suppose a ball-point pen produced in India costs Rs. 25, of which Rs. 10 represents imported ink and the rest, Rs. 15, represents the value addition in the country. If tariff on an imported ball-point pen is 30 per cent and the tariff on the import of ink is 5 per cent, the effective rate of protection comes to 46.6 per cent compared to a nominal tariff rate of 30 − 5 or 25 per cent. This difference is because the entire production process is not protected, but only the value addition is protected. So, the effective rate of protection can be unusually high if any, or all, of the following conditions prevails.

The conditions are:

1. tariff on imported input is very low or zero
2. tariff on the final product to be imported is very high
3. value addition to the imported input is only insignificant

The effective rate of protection is

$$erp = \frac{(T - a_m T_m)}{(1 - a_m)} \qquad \text{...(5.1)}$$

Where T is the nominal tariff rate,
a_m is the percentage of the final product that is imported,
$1 - a_m$ is percentage value added in the country, and
T_m is tariff on the imported component of production.

Based on the above example, the effective rate of protection will be:

$$\frac{0.3 - 0.05 \times 0.4}{0.6} = 0.466 \text{ or } 46.6\%$$

Impact of Tariff Under Partial Equilibrium Analysis: The effect of tariff, especially in a country that is not in a position to dictate the terms at which it trades, is presented in Figure 5.1. Assume in the beginning that there is no trade. The country produces 50 motorcycles and sells them at Rs. 28,500 each. Later on, it opens its domestic market to foreign suppliers. Motorcycles are available at an international price equivalent to Rs. 24,000 each. Lower price raises the demand for 80 motorcycles out of which 20 are domestically supplied and 60 are imported. Openness of the market raises the gains accruing to the consumers. But when the government imposes a tariff of Rs. 3,000 per motorcycle, price of motorcycle is higher at the consumers' end leading to a cut in demand to 60 out of which 40 are supplied by the domestic producers and 20 are imported. A part of the gains enjoyed by the consumers in absence of tariff shifts away from them after the imposition of tariff.

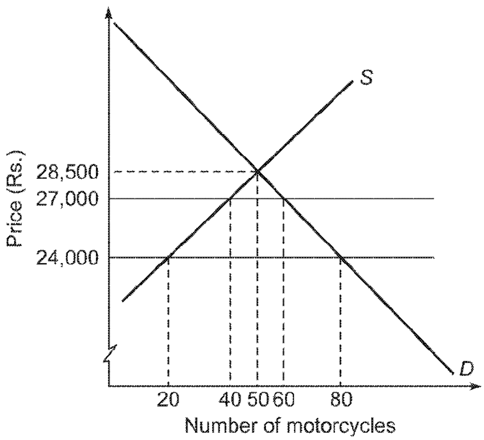


FIGURE 5.1 Tariff Trade and Welfare Effects: Small-Nation Model

When the domestic market is open for the foreign supplier, gains to consumers rise by Rs. (50 × 4,500) + (30 × 4,500/2) = 2,92,500 (as per simple geometry, the area of triangle is equal to height × base/2). When tariff is applied, gains shifting away from the consumers partly to the government, partly to the domestic producers and partly as deadweight loss are as follows:

1. Government's income effect = Rs. 3,000 × (60 – 40) = 60,000.
2. Consumption effect as deadweight loss = Rs. 3000 × [(80 – 60)/2] = 30,000.

3. Protective effect encouraging inefficient producers as deadweight loss = Rs. 3,000 × {(40 – 20)/2} = 30,000
4. Redistributive effect shifting net gains to producers = Rs. (3,000 × 40) – 30,000 as protective effect = 90,000.

A large country is different from a small country in so far as the former is in a position to change the world price of the commodity. Through the imposition of tariff, it influences the foreign suppliers to cut prices. The reduced price of import turns the terms of trade in favour of the importing country. The favourable terms of trade confers gain on the importing country, as a result of which the welfare increases. Here, it may be noted that a small importing country is not in a position to influence the world price and so it does not reap terms of trade gains through tariff imposition.

The impact of tariff on a large importing country can be explained through Figure 5.2. In case of autarky, 50 thousand motorcycles are supplied and demanded in the country at the rate of Rs. 28,500 each. But when the country begins to trade with no restrictions, the supply schedule changes to S_{D+F}. The schedule is upward-sloping in view of the fact that the price of imports can be changed. The price of the imported motorcycles is Rs. 24,000 each. As a result of the lower price of import, the demand moves up to 75 thousand motorcycles. The domestic producers supply 15 thousand of them and rest 60 thousand of them are imported.

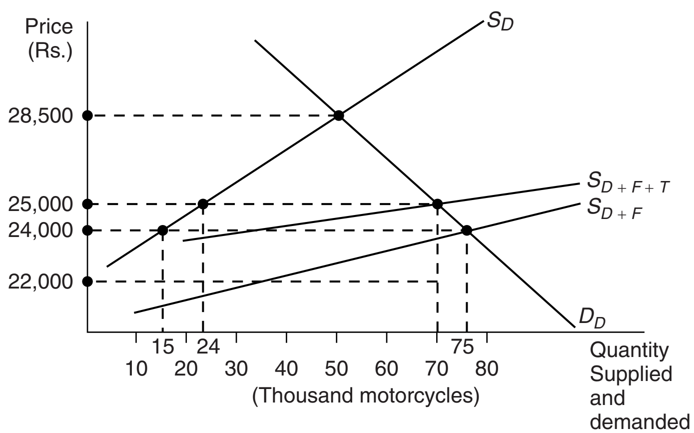


FIGURE 5.2 Welfare Impact of Tariff: The Case of a Large Nation

At a later stage, the country imposes tariff at a rate of Rs. 3,000 per motorcycle. Since the importing country is a very large buyer and it can influence the world price, the price of the imports in the hand of the domestic consumers rises not by the amount of tariff but only by Rs. 1,000. The rest Rs. 2,000 are shared by the foreign supplier which is manifested in the reduced price of import. To be specific, the imported price per motorcycle is Rs. 22,000 and the domestic consumers get the import for Rs. 25,000 each. Again, in the sequel of rising price in the hands of consumers, the supply schedule changes as S_{D+W+T} and the demand slips to 70 thousand motorcycles, out of which 24 thousand are supplied by domestic producers and the rest 46 thousand of them are imported.

On the basis of the above facts, the various effects of tariff will be as follows:

1. Redistributive effect shifting from consumers to domestic producers = Rs. (1,000 × 15) + Rs. 1,000 × {(24 – 15)/2} = Rs. 19,500
2. Dead-weight loss
   (a) Consumption effect = Rs. 1,000 × {(75 – 70)/2} = Rs. 2,500
   (b) Protective effect = Rs. 1,000 × {(24 – 15)/2} = Rs. 4,500
3. Income effect reaped by government = Rs. 3,000 × (70 – 24) = Rs. 1,38,000

The income effect in case of a large importer is divided into domestic revenue effect and terms of trade effect

The income effect can be grouped into two compartments. One is the domestic revenue effect which is equal to Rs. 1,000 × 46 = Rs. 46,000. The other is the terms of trade effect which is equal to Rs. 2,000 × 46 = Rs. 92,000.

1. The nation's welfare increases if terms of trade gains > dead-weight loss
2. The nation's welfare decreases when terms of trade gains < dead-weight loss
3. The nation's welfare remains constant if terms of trade gains = dead-weight loss

In this case, the tariff is justified because terms of trade effect is greater than the dead-weight loss.

Social Cost of Tariff: In the preceding sub-sections, we have seen that the loss of consumers' surplus is not completely offset by an increase in producers' surplus and government's revenue. The net loss is known as dead-weight loss either in form of protective effect or consumption effect.

The dead-weight loss represents a social cost of tariff. The consumption effect shows that the domestic consumers have to lower their demand on account of higher prices and use the imported commodities at higher price in the wake of tariff. It goes against the concept that free trade is better than tariff-fraught trade. Again, the protective effect shows that the inefficient producers begin producing after tariff is imposed. This is nothing but the misallocation of resources because, in absence of tariff, these resources would have been used for exportable goods in which the country possessed comparative advantage. However, if there is less than full employment, the imposition of tariff may help create employment when the inefficient producers begin production. If this is true, the protective effect will be lower. Nevertheless, if exporters of the commodity take retaliatory measures, it would be difficult to measure the employment-generating effect and the imposition of tariff involves administrative cost that must be deducted from the government revenue from tariff.

Concept of Optimal Import Tariff: The imposition of tariff by a large country has two effects. The first one is a dead-weight loss manifesting in the decline in the volume of trade which reduces in turn the nation's welfare. The second one is apparent in improving terms of trade that in turn improves the nation's welfare. If the country imposes small tariff, it helps to increase nation's welfare because the terms of trade gain exceed the dead-weight loss. With the raising of tariff, the excess of terms of trade gains over the dead-weight loss goes on increasing, enhancing the nation's welfare. But this upward move is only to a certain point. Beyond this, if the tariff is raised, the excess of terms of trade gain goes on shrinking and a time will come when the net gain will come down to a no-trade position or a position where no import is made on account of very high tariff. Thus, a large country should impose tariff only to that extent where the excess of terms of trade gains over the dead-weight loss is the highest or, in other words, the net increase in welfare is the maximum. In fact, this rate of tariff is the optimal tariff rate (de Graff, 1949).

However, the imposition of optimal tariff may not be suggested. It is because the other trading partner will face a twin problem of loss of the volume of trade and at the same time a deteriorating terms of trade. In the sequel, it may retaliate and the gains from trade reaped may be lower.

Now, the question is whether an optimal tariff exists in a small country. A small country does not reap the terms of trade gain. Any tariff leads to a dead-weight loss with the result that optimal tariff rate does not exist.

Impact of Tariff under General Equilibrium Analysis: Since the effect of tariff spills over to other sectors of the economy, a general equilibrium analysis is required to assess the impact of tariff. The impact falls in a variety of ways. They are as follows:

First, tariff causes an increase in domestic production. Even those domestic producers start meeting the domestic demand that were not capable of producing goods at the international price of the product. It is because tariff makes the domestic market a sheltered market for the producers. It is not only an increase in production but also a shift in the production structure in the economy that is marked in the sequel of tariff imposition. The resources shift from other industries to the industry where tariff is imposed to reap the advantage of a sheltered market.

Secondly, with the rising production, the income of the factors of production rises, especially of those factors that are used intensively in the production of the product. A rise in income generates demand and thereby output and employment in the country.

Thirdly, tariff helps to reduce consumption because the imported goods turn costlier. Lower income or lower consumption means lower welfare. However, if the government uses the tariff income for providing various services to the community, the loss of consumption would be offset partly or wholly. Again, as the Metzler's paradox explains, since the marginal propensity to import in the tariff-imposing country is often very low, the price of the imported commodity may drop in the world market more than the amount of tariff. This means that the imported commodity in the tariff-imposing country may be cheaper. Cheaper imports may not have an adverse impact on consumption.

Fourthly, tariff helps to lower the volume of trade. The reason is that tariff leads to a rise in the domestic production of that commodity. The imports turn costlier on account of tariff. The domestic availability of gods at a lower price helps to cut the volume of imports. If the tariff is very high, it is possible that the import of the commodity in question comes down to a zero level. Such tariff is known as a prohibitive tariff.

Fifthly, when the tariff imposing country is large enough to influence the world demand and prices, the imposition of tariff compels the foreign suppliers to reduce the price of the product. The lower price of the import helps to improve the terms of trade. The terms of trade gains leads to a further boost for the economy.

5.3.2 Quota

> Quota is a quantitative restriction on import. It may be global or country-specific. Additionally, it may be tariff-rate quota.

Quota is an instrument to put quantitative restrictions on import. It may take different forms. One is the outright limitation on the quantity of import. Limitation may be either a global one or specific to a country. For example, if the government permits the import of only 2,000 bicycles without mentioning a particular country, it will be global quota. But if the government limits the import of 500 bicycles from the USA, it will be country-specific quota or selective quota. Since the global quota is based on first-come-first-served, the importing country has to accept those supplies that are made earlier irrespective of their quality and source.

Sometimes, the government fixes quota for the import and at the same time imposes tariff. Up to the quota limit, the rate of tariff is lower, but if the imports are made beyond the quota, a higher rate of tariff is applicable for the additional import. The tariff-rate quota is a subtler form of quota that permits the import beyond the quota limit, although at a higher rate of tariff.

> Import licensing requirement and voluntary export restraints may be treated as quota.

The other form of quota is import licensing requirement. If obtaining licence from the government to import a particular commodity is mandatory, the commodity can be imported only to the extent it is specified in the licence. The government issues licence for import based on the required size of import. It is true that the import licensing requirement is a less transparent form of quota than the outright limitation on the size of import, but it is a common instrument. By 1980s, it was used as a major tool for protecting industries in Mexico. In India too, it was used more frequently till 1980s.

Still the other form of quota is known as voluntary export restraint (VER). In this case, the exporting country is asked by the importing country to limit the supply of a particular commodity. The restriction is imposed by the exporting country and not by the importing country. There are many examples of VER negotiated by the USA to restrict the

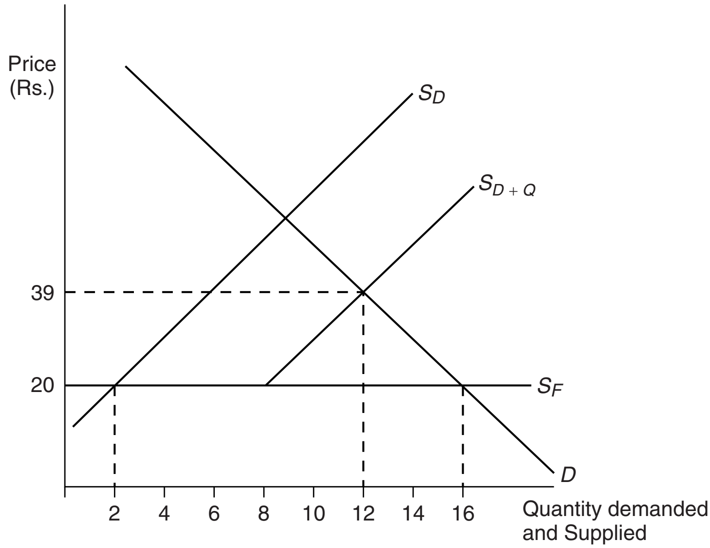


FIGURE 5.3 Welfare Impact of Import Quota

import of textiles, automobiles and other products from Japan, Korea and other countries.

Welfare Impact: Import quota leaves a definite impact on the welfare of the country. The impact is explained in Figure 5.3. Suppose, India's total demand for edible oil is 16 million tonnes, out of which it produces only 2 million tonnes. The rest is imported from Italy under a free trade scenario. There are two supply schedules—one for home, S_D showing availability of 2 million tonnes of the commodity and the other for Italy, S_F where the supply is perfectly elastic. The price of the commodity is equal in both the countries, which is equivalent to Rs. 20 per tonne of oil.

Now, the Indian Government restricts import up to 6 million tonnes under the provisions of quota. The supply schedule will now change showing limited availability of this product. The new supply line, S_{D+Q} intersects the demand line at a higher point meaning that the price of edible oil gets higher at Rs. 39 on account of the imposition of quota. The consumers' surplus and thereby the nation's welfare decreases. The decrease is equal to:

1. Redistributive effect = {(Rs. 39 – Rs. 20) × 2 mn tonnes} + {(Rs. 39 – Rs. 20) × 4 mn tonnes)/2 = Rs. 76 mn
2. Protective effect = {(Rs. 39 – Rs. 20) × 4 mn tonnes}/2 = Rs. 38 mn
3. Consumption effect = {(Rs. 39 – Rs. 20) × 4 mn tonnes}/2 = Rs. 38 mn
4. Revenue effect = {(Rs. 39 – Rs. 20) × 6 mn tonnes} = Rs. 114 mn

Difference between Quota and Tariff: Quota and tariff both restrict imports. But the impact of the two is different. In short, the axe of quota on the volume of import is harsher than in case of tariff. In case of the former, the government limits the volume of import arbitrarily. On the contrary, in case of tariff, the price of the product rises by the amount of tariff. The consumers can buy any quantity of the product at risen price.

Moreover, tariff yields revenue for the government but quota offers gains to the quota holders, provided there is perfect competition among the foreign exporters and that the importing country is a small country. If there is no perfect competition among the foreign suppliers, they may reduce the price after the imposition of tariff by the home government in order to maintain the market share. Tariff may not then be harsh in effect.

Quota is a harsh measure in the sense that it gives rise to monopoly power at home. The domestic industry may raise the price without any fear of any drop in the sale. Tariff cannot help maintain a higher price because it will affect the volume of sales.

5.3.3 Subsidies

Subsidies are other form of non-tariff barriers. Subsidies take many forms, such as cash assistance given by the government, tax concessions, loans at lower than market rate of interest arranged by the government and such others. In this way, they allow the domestic producers to produce at prices lower than warranted by the actual cost or profit considerations.

> Subsidies may be either domestic subsidy given normally to producers of import-competing goods or they may be export subsidy given to exporters to make them internationally competitive.

Domestic Subsidy: With domestic subsidy, inefficient producers begin production at a price compatible with the international price. As a result, domestic production rises and import falls with a given demand for the product. As per Figure 5.4, in absence of trade, the domestic production and domestic demand, Q_1 meets each other at price, P_1. When the country opts for trade, the commodity is available at lower price, P_3. At the lower price, the demand rises to B, out of which OQ_2 is supplied domestically and Q_2Q_3 is imported. But when subsidy is given to domestic producers,

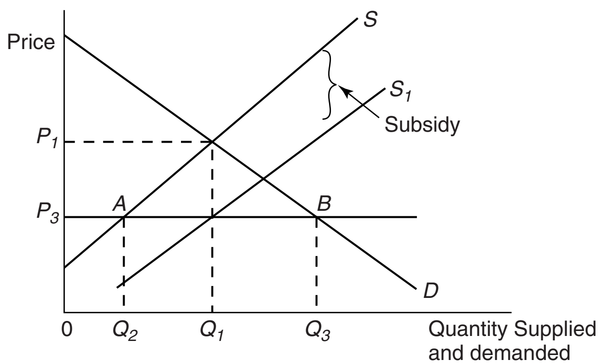


FIGURE 5.4 Welfare Impact of Domestic Subsidy

the supply schedule changes from S to S_1 and domestic output increases from Q_2 to Q_1 negating any import to that extent. The net price to the producers of the commodity equals the sum of international price and the amount of subsidy. The financial burden on government is equal to the amount of subsidy multiplied by OQ_1. This additional domestic production in the sequel of subsidies may be termed as protective effect of subsidies.

Domestic subsidies are better than tariff and quota. It is because the subsidies do not force consumers to lessen their demand and there is no dead-weight loss in the form of consumption effect. But, at the same time, subsidies fall on the state exchequer and enlarge the fiscal deficit.

Export Subsidy: Export subsidy is confined to those producers that produce for export. In this case, the domestic price of the commodity is higher than the foreign price. It is true that the volume of export rises thereby increasing the total export earnings, but the net barter terms of trade worsens as a result of the fall in price. Figure 5.5 shows that in free trade, Q_1 commodity is supplied at price, P_2. When subsidy is given to exporters, supply schedule tends to change from S to S_1 that leads in turn to greater volume of export at Q_2. But, at the same time, the price of the export falls to P_1 worsening in turn the terms of trade. How far a fall in price will augment export depends on the price elasticity of demand. But it is true that the domestic consumers have to pay a higher price at P_3, which is equal to the sum of foreign price and the amount of subsidy.

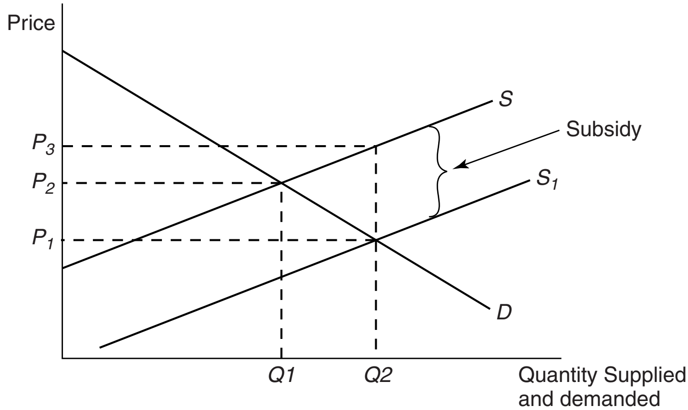


FIGURE 5.5 Welfare Impact of Export Subsidy

Huge Subsidisation of Chinese Exports

The share of Chinese exports in the world trade moved up from 4.7 per cent to 10.8 per cent between 2000 and 2006. The most important reason is that the Chinese goods are highly price-competitive in the international market on account of ample subsidies provided to producers and exporters in variety of ways. The subsidies are diversely spread and the government uses fancy names for the subsidies, such as market exploration fund, export

credit insurance, offshore processing trade project, etc. with the result that it is very difficult to quantify them. However, there are some more important forms of subsidies. First of all, cash grant is given to the manufacturers in the form of technology and research promotion. Secondly, there are equity infusions by the government. Thirdly, preferential loans are given. Fourthly, it is the tax exemptions. Fifthly, it is the supply of power at a subsidised rate. Last but not least, the government has put the value of Renminbi well below its market-determined value. According to some estimates, Renminbi is undervalued by 35–55 per cent.
Source: Based on the reports of *Outlook Business*, 18–31 May, 2008

5.3.4 Dumping

Dumping is a form of price discrimination in favour of foreign consumers. The same product is sold to foreign buyers at a lower price than what the domestic buyers have to pay. Dumping also occurs when goods are sold in the overseas market at a price below the average cost of production.

Dumping may take different forms depending upon the purpose for which it is done. The first is distress dumping or the sporadic dumping. In this case, a firm clears its unsold stock at a lower price in overseas market. It is true that it hurts the competing exporters in other countries or the producers in the importing countries, but it is only a short-term problem.

The second is the predatory dumping. The purpose is not the clearance of the unsold stock but to throw the competing exporter out of the market. It is expected that when the competitors are out of the market and when the dumping firm enjoys the monopoly position, it raises the price in order to recover the losses incurred during dumping. However, this form of dumping is normally not found in the real world.

The third one is known as persistent dumping. It is a long-term phenomenon. A firm charges higher price from the domestic market where competition is lacking and a lower price from a highly competitive international market. Thus, it is synonymous with international price discrimination (Prusa and Skeath, 2001). In Figure 5.6, it is assumed that the firm enjoys monopoly position at home meaning that any additional sale of the product is possible only at a reduced price. The result is that the marginal revenue curve will slope downwards. On the other hand, there are many suppliers in the foreign market with the result that the firm has to charge the prevailing market price for the product, irrespective of the amount of sale. In the sequel, the marginal revenue curve is a horizontal straight line. The slope of the average and marginal cost is based on the increasing return initially and then diminishing return to scale. The equilibrium is achieved where marginal revenue in the domestic market, marginal revenue in the foreign market and marginal cost are equal or,

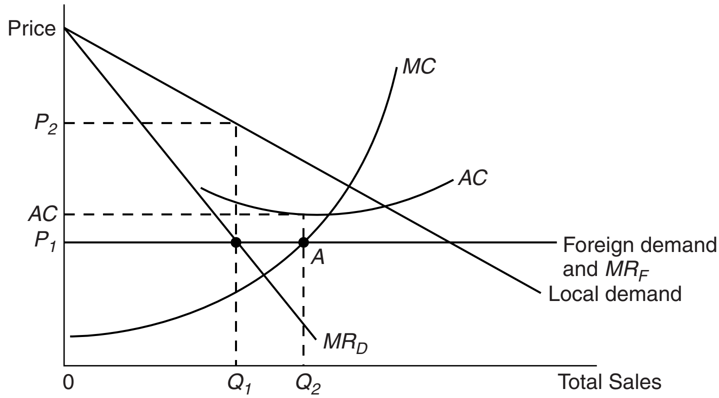


FIGURE 5.6 Persistent Dumping and International Price Discrimination

$$MR_D = MR_F = MC \qquad ....(5.1)$$

In Figure 5.6, MR_F and MC are equal at Point A which represents the total sale, Q_2 at a price P_1. But the entire sale is not directed to the foreign market. A part of it, Q_1 is sold in the domestic market at a higher price, P_2. Q_1 lies at Point B where MR_D is equal to MR_F. We find that even if the price in foreign market is lower than the average cost, the higher price at home not only compensates the loss in the foreign market but also, over and above, yields profit.

5.3.5 Some Other Forms of Non-tariff Barriers

Among other non-tariff barriers, we here discuss some of their important forms, such as buy-local legislation, social regulations, health and sanitary regulations, etc.

Buy-local legislation is enacted to force the domestic producers to buy the inputs first in the domestic market. It also forces the consumers to buy locally-made goods. Such legislation is treated as a trade barrier because it discriminates against low-cost foreign suppliers in favour of domestic suppliers. Costly inputs raises the cost of production and thereby the price of the product and lowers the consumers' surplus. It causes dead-weight welfare losses in the form of consumption effect and protective effect.

During the international financial crisis of 2008 and 2009, the US Government emphasised on the local purchase of iron and steel for the infrastructural projects. It entailed upon the export performance of the Indian economy during FY 2009–2010.

Social regulations apply to specific social problems, environmental issues and other related issues. The US Government has put restrictions on the import of carpet from India because the Indian carpet industry employs child labour. Similarly, restrictions are there in case of environment-polluting exports. India put restrictions on the import of Chinese toys which had harmful effects on the health of the Indian children. More recently, the European Union has put restrictions on the import of chemicals on the ground of protecting environment. The exporters were to get registered with the Registration, Evaluation and Authorisation of Chemical Substances (REACH) by November 2008. The REACH would permit the import only after proper scrutiny.

Other technical barriers to trade are related to a country's national standards of health and safety. They are also related to product designing and product packaging. When the US automobile firms sell cars in the UK and Japan, the steering system is changed from left to right. At the US ports, edible products are checked thoroughly. If any harmful live bacterium is found in any packet of the product, the ship is returned on the ground of preserving health in the country. Similarly, packaging is very important to protect the product from getting rancid. So goods with improper packaging are not accepted at the port of many countries.

The details of some of the major NTMs that are maintained against Indian exports are as under:

Country	*Item*	*Details of NTM*
United States	Marine products	Increased inspections under the Bio-Terrorism Act, Customs Bond requirement, Mandatory labeling discriminating "farm raised" and "wild" with punitive fines and non-recognition of EIC certification
United States	Paper products	Non scientific quarantine restrictions, customs surcharges, eco labeling stipulations and food safety/health standards exist on paper products exports
United States	Tobacco	A TRQ regime restricts imports
United States	Food products	Detailed labeling requirements are stipulated with extensive product and content description
Argentina	Processed Marine Products, Matches, Insecticides, Fungicides, Plastics, Rubber, Leather, Wood and Paper Products, Textiles and Clothing, Headgear, Footwear, Articles of Iron and Steel, Mechanical and Electrical Machinery, two wheelers, optical instruments, furniture, toys, miscellaneous manufactured articles	A new regulation (57 and 58/2007 dated 24.08.2007) wherein minimum import price has been established for specified product imports from India and some other countries. Under this the Argentine Customs authorities can ask for validation of Indian customs invoice with a full set of original documents if they suspect that the invoiced value is less than the minimum import price established
Argentina	Pharmaceuticals	There is delay in registration leading to non-viability of exports

Australia	Mangoes	Australia maintains ban on the pretext of the presence of fruit flies and stone weevils
Armenia	Agro chemicals and pharmaceuticals	Armenia stipulates registration requirements and mandates permission for imports and exports.
Bangladesh	Poultry products	Bangladesh continues to ban imports despite India gaining the avian influenza free status
Brazil	Pharmaceuticals	Procedural delays occur in the clearances, inspections and registration by the Brazilian Health Surveillance Agency (ANVISA)
Canada	Paper products	Non scientific quarantine restrictions, customs surcharges, eco labeling stipulations and food safety/health standards exist on paper product exports
Chile	Wheat, wheat flour and sugar	A complex price band system wherein a minimum import price (well above the international price and domestic prices) is stipulated. On account of a WTO dispute decision, this band would be lowered by 2% every year from 2008 to 2014 after which a Presidential review would be undertaken
China	Agricultural products	Opacity of sanitary and phytosanitary (SPS) measures and delays in giving clearances
Colombia	Pharmaceuticals	The registration by Colombian Drugs Control and Certification takes 11 to 12 months, inspections are undertaken for environmental compliance and a 10% price preference is granted for French pharmaceutical companies under a bilateral agreement
European Communities	Bovine meat	Standards are more stringent than OIE (World Organization for Animal Health) Terrestrial Animal Health Code, a ban is maintained on account of Foot and Mouth Disease (FMD) and prolonged delay in upgradation of India's status to GBR1 (No risk of BSE)
European Communities	Marine products	Rejection and subsequent destruction of consignments with chloramphenicol/nitrofuran residues, rejections in Italy and France due to the presence of vibrio parahaemolyticus without judging the virulence factors, rejection due to alleged presence of bacterial inhibitors/antibiotic residues without any confirmatory tests
European Communities	Chemicals	The Registration, Evaluation and Authorisation of Chemicals (REACH) legislation increases cost of compliance by € 85,000 to € 325,000 per chemical product

(*Continued*)

Country	*Item*	*Details of NTM*
European Communities	Engineering and Electronics	The stipulation of CE (originally known by the French term Conformité Européenne) marking to indicate conformity with the essential health and safety requirements increases cost for small and medium enterprises
Japan	Footwear	The tariff rate quota (TRQ) restricts imports to the quantum of the quota
Korea	Chemicals, pharmaceuticals, computer and medical equipment	Certification requirements (including prior approval) add on to the cost of exports
New Zealand	Paper products	Non scientific quarantine restrictions, customs surcharges, eco labeling stipulations and food safety/health standards exist on paper products exports
Norway	Marine products	The pathogen analysis is carried out by the NMKL method which is not accepted internationally
Russia	Meat products	Standards for bovine meat are more stringent than the OIE Terrestrial Animal Health Code, EIC Conformity certificates are not recognised and certification with respect to swine fever and FMD are insisted upon for poultry exports which are not relevant
Ukraine	Bovine meat, coffee, tea, spices, pharmaceuticals, cosmetics, plastics, leather products, textiles and clothing	A compulsory certification with the option of either (a) certificate of acceptance of foreign certification by Derzh Standard or (b) Conformance certificate by the Ukrainian agency. Though ISO 9000 standards are adopted by Derzh Standard, foreign certification recognition exists only to the extent of international treaty obligations of Ukraine
Uzbekistan	All products	Registration and certification, a custom processing fee @ 0.7% of value and lengthy procedure for conversion of hard currency as well as profit repatriation

Source: *GOI website vb*

5.4 REGULATION OF FDI

FDI is regulated both at the national and international levels. At the national level, the home country government as well as the host country government provides various kinds of incentives in order to encourage FDI flow. But it does not mean that governments let loose their rein of control. Various checks are maintained so as to reap maximum advantage from the FDI flow. Similarly, at the international level, it is the WTO that regulates FDI under the aegis of TRIMS.

5.4.1 Rationale behind Regulation

Host-country Perspective: It is clear from the earlier section of this chapter that there are certain benefits to be reaped by the host country from FDI inflow. They are, for example, availability of scarce foreign exchange, improvement in the balance of payments, accelerated rate of economic development through warranted rate of investment and through the creation of economic linkages, and so forth. In fact, these are the factors responsible for the adoption of a favourable FDI inflow policy by the host country government. But at the same time, FDI inflow is subject to checks because it often produces negative impact on the host economy, such as deterioration in its balance of payments on account of larger imports, payment of dividend and other fees, and continued dependence on the imported technology. These issues have already been discussed and so do not need repetition. Nevertheless, it may be mentioned that since the subsidiary sources its inputs either from the parent unit or from a third country unit of the firm, FDI inflow fails to help build what Porter calls a "cluster". In such cases, the developmental impact of FDI is very little. Moreover, in such cases of sourcing, transfer pricing is very common. This means over-invoicing of imports of the subsidiary, which in turn channels out scarce foreign exchange from the country and entails upon the balance of payments. The host government encourages local sourcing. If foreign sourcing is indispensable, the government scrutinises the invoicing procedure.

Again, it is true that a high tariff wall motivates tariff-jumping FDI. But in such cases, the foreign firms are able to raise the price of the product to the extent of tariff imposed on the import of similar products. It happens in cases where demand for the product is price-inelastic and local substitutes are not available. Consumers are then forced to bear the price rise. In order to avoid such a situation host country governments often encourage FDI inflow through lowering of tariff.

> Tariff-jumping FDI is an FDI made in a country just to evade its high tariffs.

It is not only the consumers in the host country that are affected through tariff-jumping FDI, domestic producers face tough competition from foreign manufacturers. They ask the government to put some sort of restriction on foreign investors so that the domestic market can be sheltered. It is perhaps from this viewpoint that the European Union limits the market share for Japanese car manufacturers (Safarian, 1993).

The host country government controls the operation of foreign investors not only on economic grounds, but it is also on the grounds of defence and national security. The US government justifies prohibition or restrictions on foreign investment in air transport, coastal shipping, commercial fisheries, communications, and energy resources. This is simply on the grounds of national security.

> Extra territoriality issue refers to the issue concerning a company implementing its home country rules and regulations for its foreign subsidiaries.

Apart from reasons of national security there is the issue of extraterritoriality. When foreign ownership results in extraterritorial application of laws and the regulatory mechanism of the firm's home country to its activities in the host country, the host country government does not relish it and imposes certain restrictions. The US anti-trust law is applicable not only to the US owned firms but also to foreign-country firms. Developing countries do not like the use of inappropriate technology or technologies that do not help develop local skills by foreign firms. If it is so, they impose various types of restrictions.

Home country Perspective: It is also the home country government that regulates FDI on, both, economic and political grounds. It encourages investment abroad when such investment is beneficial to the home country. But when foreign investment outflow is not conducive to the economy, the home country government imposes restrictions on it. Similarly, FDI is encouraged/restricted depending upon the political relationship with the host country. Readers are suggested to go through the positive and negative impact of FDI on the home country discussed earlier. Infact, these are also the reasons behind either encouraging or discouraging FDI outflow.

5.4.2 Modalities of Regulation in Host Country

There are different tools for regulating FDI. The first is concerning ownership. In India, when the government proposed to restrict FDI in 1973, the Foreign Exchange Regulation Act was amended to limit the equity owned by foreign investors to 40 per cent. But when it tried to encourage FDI in 1991, this ceiling was abolished. Now foreign investors can have 100 per cent equity in an Indian enterprise in special cases.

Secondly, the government opens different sectors of the domestic economy for FDI. This happened in India in 1991. But when the purpose is to restrict FDI, it is not allowed in many sectors of the domestic economy. In 1968 and again in 1973, the Indian government limited the scope for FDI inflow.

Thirdly, the government restricts the repatriation of dividend, royalty, and other fees to the home country. Alternatively, it introduces the balancing requirements where the foreign enterprise has to export a certain amount of its product, which could balance its payments for imports or other payments.

Fourthly, the host government provides financial incentives and infrastruc-tural facilities to foreign investors in order to attract such investment. The financial incentives normally include tax or tariff incentives. The infrastructural incentives include free or subsidised provision of land, electricity, transport, and so on. In India, foreign investors get such facilities if they operate in an export processing zone/special economic zone.

5.4.3 Modalities of Regulation in Home Country

When the home country government intends to encourage FDI outflow, it provides insurance cover to the investors against political risk in the host country. Sometimes it grants loans to the investors for investment abroad or guarantees loans provided by financial institutions. Again, it provides tax rebates on the inflow of dividend and other fees. Last but not least, it puts pressure on the host country government to relax restrictions, if any.

When the home country government intends to restrict FDI outflow, it withdraws the facilities given to the investors and increases the tax rates on profits earned. In extreme cases, it imposes outright sanctions that prohibit making any foreign investment.

SUMMARY

- Free trade, no doubt, has merits. But in real life, international trade is regulated. It is regulated at the national level as well as by international authorities. A number of arguments—economic as well non-economic—are given for regulation at the national level. The economic factors are mainly the protection of infant industries, promotion of industrialisation, retaliation, balance of payments adjustment, price control, and generation of employment. Among the non-economic factors are mainly the maintenance of essential industries, relations with the unfriendly countries, preservation of culture and national identity, community health, and national security.
- Over past few decades, countries have moved away from inward-looking policy regime to outward-looking policy regime.
- Regulation at the national level is found in the form of import restriction, import liberalisation, export restriction, and export liberalisation. Tariff and non-tariff measures have an important role to play in this process, although some other measures are also applied for this purpose.
- In view of the benefits and costs of FDI, it is regulated both by the home country and the host country governments. In order to encourage it, various incentives are provided by the government. But if the objective is to restrict FDI, incentives are withdrawn and restrictions are imposed. The home country government may impose sanctions. The host country government may put restrictions on the ownership pattern as well as it may limit the area of operation open to foreign investors.

REVIEW QUESTIONS

1. What is the rationale behind trade protection? What are the ways of restricting export and import?
2. Distinguish between inward-looking and outward-looking policy regimes.
3. Do you agree with the statement that import liberalisation is a prerequisite for export promotion? What are the ways of augmenting export?
4. Explain effective rate of protection. What are the factors responsible for the difference between the nominal rate of tariff and the effective rate of tariff?
5. Discuss the impact of tariff.
6. What do you mean by quota? Describe its impact.
7. What do you mean by subsidy? Discuss its impact.
8. Write a note on dumping.
9. Is regulation of the MNCs essential? What are the modalities to regulate them?

Study topic

Indian Special Economic Zones

In April 2000, the Indian Government announced the Special Economic Zones (SEZs) policy to make then existing export processing zones (EPZs) even more effective and to set up new SEZs in the context of the country's export promotion programme. The policy emphasised on the quality infrastructure alongwith an attractive fiscal package, both at the centre and the state level, and on the minimum possible regulations.

Special Economic Zones Act, 2005

In order to make the SEZs a reality, the government enacted Special Economic Zones Act, 2005 in June 2005, which came into effect on February 10, 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments. The main objectives of the SEZ Act are as follows:

1. Generation of additional economic activity
2. Promotion of exports of goods and services
3. Promotion of investment from domestic and foreign sources
4. Creation of employment opportunities
5. Development of infrastructure facilities

The Act envisages key role for the state governments in export promotion and the creation of related infrastructure. A Single Window SEZ approval mechanism has been provided through a 19-member inter-ministerial SEZ Board of Approval (BoA). The applications duly recommended by the respective state governments/UT administration are considered by this BoA periodically. All decisions of the BoA are with consensus.

The SEZ Rules, 2006

The SEZ rules created subsequently provide for minimum land requirement for different classes of SEZs. Every SEZ is divided into a processing area wherealone the SEZ units would come up and the non-processing area where the supporting infrastructure is to be created. To be precise, the SEZ rules provide for:

1. simplified procedures for development, operation and maintenance of the special economic zones and for setting up units and conducting business in SEZs,
2. single window clearance for setting up of a SEZ,
3. single window clearance for setting up a unit in a SEZ,
4. single window clearance on matters relating to central as well as state governments and

5. simplified compliance procedures and documentation with an emphasis on self certification.

The developer submits the proposal for establishment of SEZ to the concerned state government. The state government has to forward the proposal with its recommendation within 45 days from the date of receipt of such proposal to the Board of Approval constituted by the central government. The applicant has the option to submit the proposal directly to the Board of Approval.

The functioning of the SEZs is governed by a three-tier administrative set up. The Board of Approval is the apex body and is headed by the secretary, Department of Commerce. The Approval Committee at the zone level deals with approval of units in the SEZs and other related issues. Each zone is headed by a development commissioner, who is the ex-officio chairperson of the Approval Committee.

Once a SEZ has been approved by the Board of Approval and the central government has notified the area of the SEZ, units are allowed to be set up in the SEZ. All the proposals for setting up of units in the SEZ are approved at the zone level by the Approval Committee consisting of development commissioner, customs authorities and representatives of the state government. All post-approval clearances including grant of importer-exporter code number, change in the name of the company or implementing agency, broadbanding diversification, etc. are given at the zone level by the development commissioner. The performance of the SEZ units are periodically monitored by the Approval Committee and the units are liable for penal action under the provision of Foreign Trade (Development and Regulation) Act, in case of violation of the conditions of the approval.

Incentives Offered to SEZs Units

The units in the SEZs get:

1. duty free import/domestic procurement of goods for development, operation and maintenance purposes,
2. 100% income tax exemption on export income for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for the next 5 years,
3. exemption from minimum alternate tax,
4. external commercial borrowing up to US $500 million in a year without any maturity restriction through recogniged banking channels.
5. exemption from central sales tax,
6. exemption from service tax,
7. single window clearance for central and state level approvals and
8. exemption from state sales tax and other levies as extended by the respective state governments.

Number of SEZs

There were 15 EPZs operating before the enactment of the SEZs Act. All of them were converted into SEZs. Moreover, 260 new were added to the list till September 2008. Of the new 260 units, 56 were set up in Andhra Pradesh, 42 in Tamil Nadu, 38 in

Maharashtra, 24 each in Karnataka and Haryana, 23 in Gujrat and the rest were set up in other states and union territories.

SEZs and the growth of labour intensive manufacturing industry

Out of the 531 formal approvals given till September 2008, 174 approvals were for sector specific and multi product SEZs for manufacture of textiles and apparels, leather footwear, automobile components, engineering, etc. which would involve labour-intensive manufacturing. SEZs are going to lead to the creation of employment for large number of unemployed rural youth. Nokia and Flextronics electronics hardware SEZs in Sriperumbudur are already providing employment to 14,577 and 1,058 persons, respectively. Hyderabad Gems SEZ for jewellery manufacturing in Hyderabad has already employed 2,145 persons, majority of whom are from landless families, after providing training to them. They have a projected direct employment for about 2,267 persons. Apache SEZ being set up in Andhra Pradesh will employ 20,000 persons to manufacture 10,00,000 pairs of shoes every month. Current employment in Apache SEZ is 5,536 persons. Brandix Apparels, a Sri Lankan FDI project would provide employment to 60,000 workers over a period of 3 years. Even in the service sector, 12.5 million sq meters space is expected in the IT/ITES SEZs, which as per the NASSCOM standards translates into 12.5 lakh jobs. By the end of June 2008, SEZs helped create 3.49 lakh jobs, out of which 2.14 lakh jobs were created after February 2006. It is, therefore, expected that establishment of SEZs would lead to faster growth of labour intensive manufacturing and services in the country.

SEZs and Exports

Benefit derived from SEZs is evident also from the exports generated. During the past five financial years, the exports rose almost five-fold—from Rs. 139 billion in FY 2003–2004 to Rs. 666 billion in FY 2007–2008. The performance of the SEZs on this count was sizeable during FY 2007–2008 as there was 92 per cent increase in the quantum of the export earnings.

Financial Year	*Value (Rs. in billion)*	*Growth Rate (over previous year)*
2003–2004	138.54	39%
2004–2005	183.14	32%
2005–2006	228.40	25%
2006–2007	346.15	52%
2007–2008	666.38	92%

Government of India, *Ministry of Commerce and Industry Annual Report,* various issues.

QUESTIONS

1. How are the SEZs different from EPZs?
2. What are the broad provisions of the SEZ rules?
3. Do you feel that the SEZs have led to the growth of employment?
4. Comment on the issue that SEZs are export promoters.

REFERENCES

Books

Balassa, B. (1980), "The Process of Industrial Development and Alternative Development Strategies", *Essays in International Finance*, 141 (Princeton: Princeton University Press).

Daniels, J. D. and L. H. Radebaugh (2000), *International Business: Environments and Operations* (New Delhi: Addison Wesley Longman (Singapore) Private Limited).

Girma, S., D. Greenaway and and R. Kneller (2004), "Does Exporting Increase Productivity? A Micro-econometric Analysis of Matched Firms", *Review of International Economics*, 12(5), 855–66.

Hirschman, A.O. (1968), "The Political Economy of Import Substitution", *Quarterly Journal of Economics*, 82 (1), 1–32.

Kjeldsen-Kragh, S. (2001), *International Trade Policy* (Copenhagen: Copenhagen) (Business School Press).

Krueger, A. O. (1990), "Trends in Trade Policies of Developing Countries" in C. S. Pearson and James Riedel (*eds.*), *The Direction of Trade Policy* (Cambridge, MA.: Basil Blackwell).

Little, I. T. Scitovsky and M. Scott (1970), *Trade and Industry in Some Developing Countries* (Oxford: Oxford University Press).

Maddisson, A. (1995), *Monitoring the World Economy: 1870–1992* (Paris: OECD Development Centre).

Prebisch, R. (1950), *Economic Development of Latin America and Its Principal Problems*, UN Doc. E/CN 12/89.

Safarian, A.E. (1993), *Multinational Enterprise and Public Policy; A Study of the Industrial Countries* (Aldershot: Edward Elgar), pp. 467–70.

Taylor, A.M. (1995), "On the Costs of Inward-looking Development: Price Distortions, Growth and Divergence in Latin America", *The Journal of Economic History*, 58(1), 1–28.

The World Bank (1998), *India 1998: Macroeconomic Update,* Washington D. C.

United Nations (1949), *Post-War Price Relations in Trade between Under-developed and Industrialised Countries*, Doc. E/CN. 1/Sub 3/W. 5.

Journals

Sharan, V. (1981), "Non-tariff Barriers in International Trade and India's Exports", *Journal of Social and Economic Studies*, IX (2), 295–304.

SELECT FURTHER READINGS

Kotabe, M. and M. R. Czinkota (1992), "State Government Promotion of Manufacturing Exports: A Gap Analysis", *Journal of International Business Studies*, XXIII (Winter), 637–58.

Milner, H. V. (1989), "An Alternative to Free Trade or Protectionism: Why Corporations Seek Strategic Trade Policy", *California Management Review*, XXXI (4), 111–31.

* Located in the North of Germany at Elbe River, Hamburg is the trade and transport hub of Northern Europe. It offers an outstanding transport infrastructure and most advanced logistical support for passenger and freight transport. Everyday 170–180 goods trains ply the rails between the Port of Hamburg and inland areas. They convey 4,000 goods wagons which are delivered and collected daily from around 1,000 sidings and loading points around the port. In the domestic battle between carriers for long-distance traffic to and from Hamburg, the rail has a market share of over 70%.

City of London, UK*

6

Multilateral Regulation of Trade and Investment

CHAPTER OBJECTIVES

The purpose of the chapter is to discuss the regulation of trade and investment at the international level. The focus of discussion lies on GATT/WTO and UNCTAD. In particular, the objective is to:

- Discuss the basic principles of multilateral trade negotiations.
- Acquaint the readers with the GATT and its various rounds prior to the Uruguay Round.
- Delineate the broad features of, and major agreements concluded at, the Uruguay Round.
- Present the main features of the WTO, in comparison to GATT, and the organisational structure and the functions of the WTO.
- Show how the dispute settlement mechanism works at the WTO.
- Mention the major challenges before the WTO.
- Explain India's relationship with the WTO.
- Introduce the readers to UNCTAD, especially about its origin, its status compared to GATT/WTO, and the major areas of negotiations at UNCTAD.
- Evaluate some of the more recent trends in UNCTAD's role in the area of international trade and development.

Trade regulation at the national level was found as far back as during mercantilism. But the regulation of trade at the international level is of recent origin. The creation of the General Agreement on Tariffs and Trade (GATT) in 1947 was the beginning of multilateral regulation in international trade. The creation of GATT was an interim arrangement and so with the evolution of consensus at the international level, the World Trade Organisation (WTO) came into being in 1995. The WTO substituted GATT for providing more effective stimuli to the multilateral trading system. It also regulates foreign direct investment through TRIMS. The present chapter discusses the basic principles of multilateral trade negotiations under the GATT/WTO umbrella, the long journey from the creation of GATT to the creation of WTO and the present challenges that this new organisation is facing. It also includes a brief discussion of the functioning of the United Nations Conference on Trade and Development (UNCTAD), which looks after the interests of developing countries in particular.

6.1 BASIC PRINCIPLES OF MULTILATERAL TRADE NEGOTIATIONS

GATT was an international institution set up in 1947 to encourage multilateral trade.

The GATT will always be remembered for conferring upon the world trading system a multilateral character as also for making world trade more restriction-free. The WTO has stepped into the same shoes with more vibrant measures. It would thus be worthwhile to explain what actually formed the basis for multilateral trade negotiations during the past five decades. Hockman and Kostecki (1995) refer to four such principles (Figure 6.1). They are:

1. Non-discrimination
2. Reciprocity
3. Market Access
4. Fair Competition.

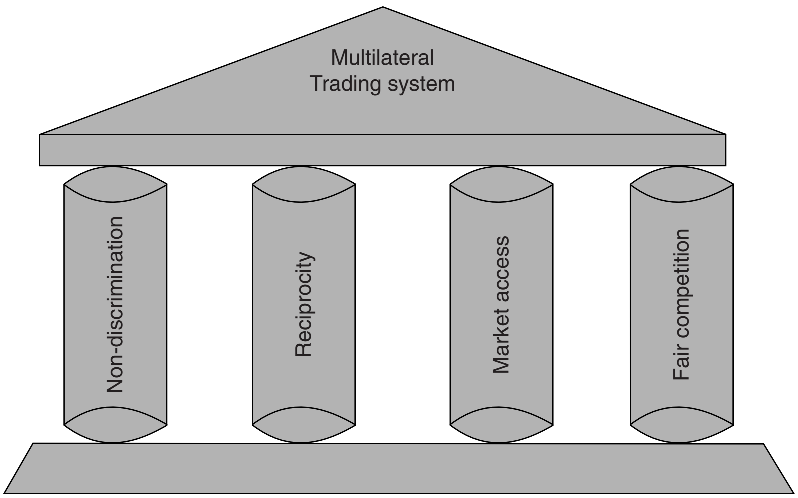


FIGURE 6.1 Principles of Multilateral Trading System

First of all, the principle of non-discrimination which is referred to in the very preamble of the GATT, is amplified in two key provisions, they are, Article I, adopting the principle of "Most-favoured Nation's Treatment (MFNT)" and Article III, adopting the principle of national treatment. MFNT requires that any tariff reduction negotiated between two member countries will be extended immediately and unconditionally to all member countries. This means that MFNT provides for equal, and not any special treatment irrespective of the economic status of a member country. However, there are a few bilateral features that have continued to exist. For example, trade concessions negotiated between the United States of America and Canada remained bilateral. A few safeguard clauses also continued to remain bilateral. For example, any country facing a balance of payments problem could impose restrictions on import from a specific country. Similarly, manufactured products of the less developed world continued to enjoy preferential status in the developed world under the Generalised Scheme of Preferences (GSP) initiated during the 1970s. Again, the trade concessions applicable to the members of a regional trade bloc are also examples of exceptions.

In the **most-favoured nation's treatment** any tariff reduction will be applicable equally to all member countries irrespective of economic status of the member country.

At the national level too, the government has to give equal treatment to a foreign product and an identical domestic product as far as taxes and regulations are concerned. Once foreign products are subjected to import duty, no additional burden can be imposed through internal taxes or internal regulations where domestic producers of the same product do not bear the same burden. In this way the principle of non-discrimination makes it very difficult for a member country to prevent foreign products from entering its domestic market. Both foreign suppliers and domestic buyers are assured of a transparent regulatory environment in which they operate.

Secondly, the principle of reciprocity implies *quid pro quo*. Any reduction in the level of protection of one member country has to be matched by an equivalent reduction in the level of protection given to the other country. The reciprocity criteria may be interpreted in two ways. One involves the exchange of similar concession, that is tariff concession against tariff concession. The other provides for the exchange of dissimilar concessions such as tariff concession as against removal of quota. Again, reciprocity criteria may be product specific or it may be an across-the-board trade barrier reduction, usually meaning reduction in average tariff rate. Here it may be mentioned that the initial GATT round discussions were confined to bilateral concessions, but since the Kennedy Round, the concessions became mainly multilateral in character.

Principle of reciprocity is based on *quid pro quo*, that is, any concession given by one country has to be matched by the other.

Thirdly, the concept of market access is based on an open trading system where competition prevails among suppliers located in different countries. A country cannot raise tariff beyond the bound level for limiting access to its market. If it does, it will have to compensate the affected parties.

Fourthly, competition should be fair and it should not harm the trading partner. The WTO maintains transparency in its own dealings and likes its members to maintain transparency in their trade policies and procedure. This is why the GATT rules have provided for imposing anti-dumping

Dumping refers to selling goods abroad at a price lower than the domestic price.

duty in order to counter any move for unwarranted dumping. The importing governments may intervene if the imports are injurious to domestic industries or to the balance of payments of the country.

6.2 GATT AND ITS EARLY ROUNDS

The process of the evolution of GATT was not very smooth. In fact, the pursuance of beggar-thy-neighbour policy, including competitive devaluation, tariff imposition, and discriminatory trade barriers resulting in shrinkage in world trade during 1930s and early 1940s led resolutions during the Bretton Woods Conference in 1944 to create the International Trade Organisation (ITO). The first discussion on then proposed ITO was held at the 1946 United Nations Conference on Trade and Employment. A preparatory committee was formed, which had various meetings and the final charter was agreed upon at Havana. But in the wake of the refusal of the United States Congress to ratify the Charter, the GATT, designed as a multilateral treaty to regulate the world trade, came into being as an interim arrangement (Table 6.1).

Table 6.1 GATT Rounds

Round	*Year*
• Geneva Round	1947
• Annecy Round	1949
• Torquay Round	1951
• Geneva Round	1951–56
• Dillon Round	1960–61
• Kennedy Round	1962–67
• Tokyo Round	1973–79
• Uruguay Round	1986–94

Beginning from 1947, GATT endeavoured its best to promote multilateral trading system for almost five decades. The number of member countries, which was 23 in 1947, rose to 124 by the 1990s and to 149 by 2005. It covered eight rounds of meeting of its members during which it negotiated primarily for the axing of trade barriers. The first round, at Geneva in 1947, led to the creation of the General Agreement and to some 45,000 tariff concessions covering around one half of world trade. The following two rounds—one at Annecy in France in 1949 and the other at Torquay in the UK in 1951—were largely concerned with accession negotiations and tariff reduction was only modest. By the Geneva Round of 1951–56, the number of members had reached 33. During this round too, the negotiations for tariff reductions were modest compared to those in the first round. The average cut in tariff for the United States of America, which was 21.1 per cent in 1947, ranged between 1.9 per cent and 3.5 per cent (Baldwin, 1986). During the Dillon Round of 1960–61, tariff adjustments were made following the creation of the European Common Market and some tariff reduction negotiations were held.

However, the tariff cut negotiated at the Kennedy Round (1962–67) was sizeable. An across-the-board formula was adopted for tariff reduction on industrial products, resulting in a tariff cut of 35 per cent on such products. Even some of the non-tariff barriers were negotiated for the first time. It witnessed the conclusion of an anti-dumping code and an agreement on the US customs valuation procedures for specific products.

In the Tokyo Round (1973–79), 99 countries participated, representing around 90 per cent of the world trade. The negotiations spared 33,000 tariff lines with the result that the average import weighted tariff on manufactured goods dropped to around 6 per cent. There were also a few specific agreements such as preferential treatment for exports of developing countries into the developed market, specific non-tariff measures, like subsidies and countervailing measures, customs valuation, product standards, import licensing procedures, and a revision of the Kennedy Round anti-dumping code.

6.3 URUGUAY ROUND

6.3.1 Main Features

The Uruguay Round (1986–94), or the eighth round, was of great significance, especially in view of its broad coverage.

1. The unfinished agenda of the Tokyo Round had to be completed. They were primarily: (a) **reforms** in the **safeguard measures** that were adopted by some of the member countries to restrict import on the pretext of protecting balance of payments or domestic industries and (b) **reforms in agriculture** that had remained outside the mainstream of the GATT rules.
2. Besides including the traditional tariff axing measures that brought down the average level of tariff to 3.9 per cent by the mid-1990s, compared to about 40 per cent during late 1940s (Jackson, 1989; Wall Street Journal, 1993), the Uruguay Round discussions aimed at doing away with, or smoothening of, some of the important **non-tariff barriers**.
3. The constitution of a **trade policy review mechanism (TPRM)** for examining the trade policy of member countries was stressed on so that reforms could be brought about in the trade policy and procedures of the individual member countries.
4. Some **new aspects related to international trade,** such as trade-related investment measures (TRIMS), trade-related intellectual property rights (TRIPS), and general agreement on trade in services (GATS) were also covered.

5. **Refurbishment of the dispute settlement system** so as to make it more effective and to provide relief to the affected member countries within a prescribed time framework was dealt with.
6. GATT was conferred with a legal status through the **creation of WTO**.

6.3.2 Agreements at the Uruguay Round

Plurilateral agreements are agreements binding only on signatories as opposed to multilateral agreements that are binding on all members.

The contracting parties at the Uruguay Round concluded 18 separate agreements: 14 were multilateral in character and the remaining four were plurilateral in character. It may be noted that multilateral agreements are binding on all members, while plurilateral agreements are binding only on their signatories.

Agriculture: The agreement on agriculture included three aspects: market access, domestic support, and export subsidies. The market access provision included imposing tariff for non-tariff barriers and gradual reduction of such tariffs by 36 per cent in case of developed countries over a period of six years and by 24 per cent in case of developing countries over a ten-year period. Domestic support to farmers was to be cut by 20 per cent by developed countries over a six year period and by developing countries over a 10 year period. Similarly, export subsidies were to be cut by 36 per cent by developed and developing countries, respectively, over six years and ten years. No such measures were proposed in case of the least developed countries. Finally, the agreement sought to set up a committee on agriculture.

Uruguay Round Agreements

Multilateral: agriculture, sanitary and phytosanitary measures, textiles and clothing, technical barriers to trade, TRIMS, anti-dumping practices, customs valuation, pre-shipment inspections, rules of origin, import licensing procedures, subsidies and countervailing measures, safeguards, GATS, TRIPS, dispute settlement, and trade policy review mechanism (TPRM).

Plurilateral: public procurement, trade in civil aircraft, international dairy products, and international bovine meat.

Sanitary and Phytosanitary Measures: Although sanitary and phytosanitary measures were covered under GATT, the Uruguay Round set out detailed guidelines in the sense that such measures should not be arbitrary and discriminating, but they should be more transparent and justified on scientific grounds. A committee in this area has been set up to monitor the agreement.

Textiles and Clothing: Textile and clothing, trade had been taken away from the GATT purview by the 1974 Multi-fibre Arrangement. The Uruguay Round brought it back to the GATT fold. The restrictions under this arrangement were to be reduced in four phases. The first phase started in January 1995 and required member states to integrate into GATT 16 per cent of the total volume of such imports effected in 1990. The second phase began in January 1998 and covered a further 17 per cent of such imports. The third phase started from January 2002, covering an additional 18 per cent of such imports and the remaining share of imports are to be phased out by January 1, 2005. Safeguard measures can be adopted by importers, but only in exceptional cases of injury to domestic industries and only for a maximum of three years. These measures are subject to monitoring by the Textiles Monitoring Body.

Technical Barriers to Trade: The agreement on technical barriers to trade was meant for the protection of the environment. It says that member countries have the right to introduce regulations and standards that ensure health and protect the environment. The agreement sought to establish a committee on technical barriers to trade.

TRIMS: Regarding TRIMS, it was stated that no member country should attach conditions to foreign direct investment, which could in turn restrict or distort the trade. The conditions were related to purchases from the domestic country, a specific import-export ratio in the enterprise, and restrictions on export. The developed countries, developing countries, and the least developed countries were to adhere to these norms within two years, five years, and seven years, respectively. The agreement sought to set up a committee for monitoring TRIMS.

Anti-dumping Practices: The GATT had permitted imposing of anti-dumping duties. The agreement at the Uruguay Round provided greater clarity to this issue. A "sunset" clause was introduced for the review of anti-dumping actions every five years. Moreover, it sought to establish a committee on anti-dumping practices.

Customs Valuation: Fraudulent practices normally involved in customs valuation were taken care of during the Tokyo Round. The agreement in the Uruguay Round re-emphasised that the basis for the valuation of goods for customs purposes should be at the maximum of the transaction value of the goods. It provided the customs authorities some additional power to obtain further information from the importer and to establish the customs value through recourse to alternative methods. It sought to establish a committee in this respect.

Pre-shipment Inspection: It involves the use of specialised private companies to check shipment details, such as the price, quality, and quantity of goods. The agreement sought to introduce greater transparency and so it was in favour of an independent review procedure that could resolve any dispute between the inspecting agencies and the exporter.

Rules of Origin: Origin means "nationality" of a product. It is important, particularly in case a product is manufactured in more than one country. This is because the origin of a product determines the amount of tariff to be imposed in the importing country. The agreement at the Uruguay Round sought to ensure transparency in this respect. It provided that the Committee on Rules of Origin, along with a technical committee, would supervise the harmonisation of different countries' procedures in this context.

Import Licensing Procedures: The agreement tried to bring in transparency to the import licensing procedure. It emphasised on the publication of the licensing rules in the importing countries and on avoidance of unnecessary delays in granting licence.

Subsidies and Countervailing Measures: The agreement went a few steps further than what was agreed upon at the Tokyo Round and it governed "specific subsidy" that was available to an enterprise or an industry. It prohibited subsidies that were related to export performance but the least developed countries and developing countries below $1000 per capita income continued to remain outside the scope of this provision. The ad valorem subsidisation of a product exceeding 5 per cent or a subsidy given in order to prop up a loss-making industry was subject to be taken to the dispute settlement body. But the subsidy assisting industrial research was not questionable. The agreement introduced new rules for the computation of the value of subsidies.

Safeguards: In case of safeguards involving protective measures to save the domestic industry from injury, the agreement limited the scope and duration of the safeguard measures. All the grey area measures, such as voluntary export restraint agreements and orderly market arrangements were to be phased out by the end of 1999. If at all safeguard measures were adopted, their life was set at four years with the possibility of one four year extension.

GATS: The agreement involved reduction and elimination of barriers in international trade in services and the establishment of the MFNT principle in this area. This means that WTO members are now obliged to offer MFN status and provide market access, ensuring transparency to all service providers from countries bound by the GATT in the form of transparent rules and regulations and administrative actions. The GATS framework is made up of 29 articles. A Council for Trade in Services was established to protect trade in services.

TRIPS: The Uruguay Round agreement covered TRIPS in view of the fact that practices like counterfeiting, copying, and piracy on a large scale had come in the way of fair trade. It was estimated that the loss incurred by EU on account of copyright piracy was around 10 per cent of the value of its export. The agreement aimed at regulating and standardising international intellectual property rights in order to prevent these abuses.

It provided greater protection to trademarks and industrial designs and introduced patent protection for pharmaceutical and chemical products. It also set up a Council for TRIPS to oversee the smooth running of the agreement.

Dispute Settlement: A dispute settlement procedure existed in the pre-Uruguay Round GATT but it was handicapped by the refusal of countries—mainly developed countries—to respect its final rulings. But the Uruguay Round agreement made the ruling binding on the parties to the dispute and made the procedure more effective.

TPRM: The purpose of TPRM is to monitor trade policies and practices of member countries and to achieve a greater degree of transparency in their trading policies. The Uruguay Round agreement authorised the WTO to make such reviews.

Plurilateral Trade Agreements: Besides the multilateral agreements that the member countries have to abide by, there were four plurilateral agreements concluded at the Uruguay Round. They are the agreements whose acceptance is not a prerequisite to WTO membership. The first is the agreement concerning public procurement. This means that the foreign suppliers must be given equal treatment in government procurement just as the domestic suppliers. A Committee on Government Procurement has been established under the supervision of the WTO General Council. The second agreement concerns trade in civil aircrafts, which aims at the elimination of import duties on all aircrafts. The third concerns international dairy products. This agreement tries to introduce greater stability in the market by seeking to limit surpluses, shortages, and fluctuations in price. The International Dairy Council has been established under the supervision of the WTO General Council. The fourth agreement concerns international bovine and meat products. Its purpose is to regulate such trade.

6.4 WORLD TRADE ORGANISATION

The WTO was officially launched on January 1, 1995 replacing the GATT, which take care of the agreements contained in the final act of the Uruguay Round.

The greatest success of the Uruguay Round discussions was evident in the creation of the World Trade Organisation (WTO). The WTO, which was officially launched on January 1, 1995, replaced the GATT. Naturally, the GATT members became the members of WTO. It administers the agreements contained in the Final Act of the Uruguay Round.

6.4.1 Basic Difference between GATT and WTO

Although the WTO replaced the GATT, there are a few similarity and disimilarity in agreements between the two.

It is a fact that the WTO replaced the GATT and so the purpose of these two institutions is the same. Nevertheless, there is some dissimilarity between the two. First of all, GATT allowed the continuance of some side agreements concluded between specific members during different GATT rounds. But WTO administers a unified package of agreements to which all members are committed.

Secondly, the coverage of the WTO is bigger as it includes TRIPS, GATS, etc. under its purview. Moreover, the environment has come up as a major issue on the agenda for the first time.

Thirdly, WTO contains an improved version of the original GATT rules in relation to the trade in goods. And so it is more effective than the GATT.

Fourthly, the grey area measures such as textiles and clothing and agriculture remained to exist outside the GATT purview. But they are now under WTO.

Fifthly, the membership of the GATT was not as large as that of WTO. WTO members had 153 members during July 2008 and so its jurisdiction is far wider.

Finally, the settlement of the disputes between the member countries was not easy during the GATT regime as the members used to block decisions arrived at under the dispute settlement mechanism. But it is not possible under WTO. Moreover, there is a fixed time framework during which the dispute has to be settled.

6.4.2 Organisational Structure

The Ministerial Conference is the apex body in the WTO's organisational structure meeting every two years. It is composed of the representatives of the member governments—one representative from each member. It is the chief policy-making body. Any major policy change requires its approval.

Below the Ministerial Conference lies the General Council. Its composition is similar to that of the Ministerial Conference. Its principal functions are: to act as a dispute settlement body; to administer the TPRM; and to supervise the functioning of trade in goods, GATS, TRIPS, as well as all the trade committees. There is no fixed timing for its meeting, but normally it meets every two months. For day-to-day functioning, it delegates its responsibility to three subordinate councils meant for trade in goods, trade in services, and intellectual property rights. The General Council can appoint a working group to deal with specific issues. The report of the working group is placed before the Heads of Delegation meeting. The findings and the suggestions are approved by the General Council.

The three councils just below the General Council have to look after the functioning of different committees constituted for specific areas. For example, the Council for Trade in Goods looks after the functioning of committees on market access, agriculture, specific non-tariff barriers, TRIMS, and the Textile Monitoring Body. The Council for Trade in Services looks after the committees established in the area of services. The Council for TRIPS manages the operation of the TRIPS agreement.

The Trade Committees looking after specific areas of the multilateral trade agreements are the lowest wing in the WTO structure. The committees are established in two ways. Those established under the terms of the

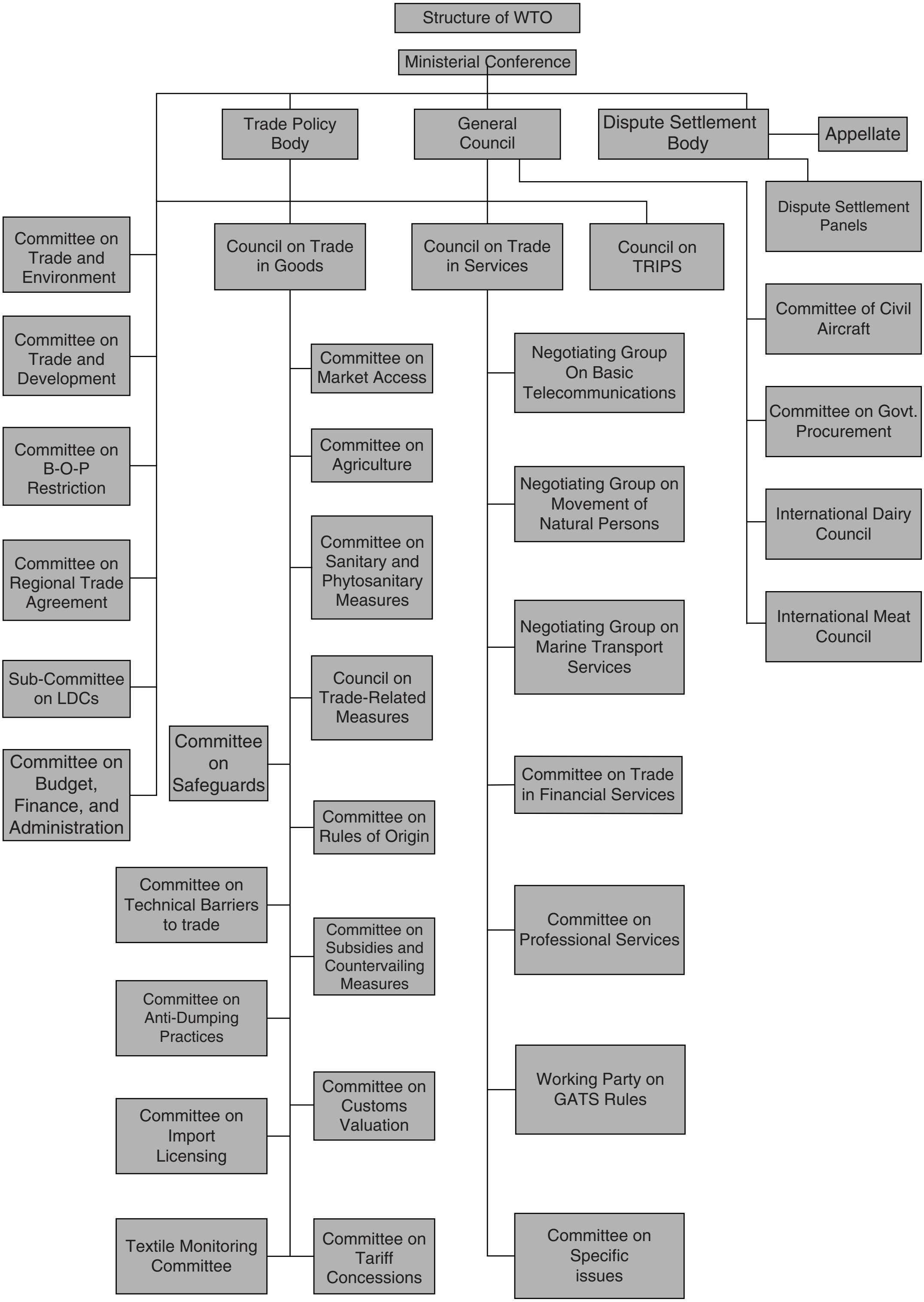


FIGURE 6.2 Structure of the World Trade Organisation

Multilateral Trade Agreements and by the Trade Councils report to their supervising Trade Council. Those appointed by the Ministerial Conference or under the terms of the plurilateral agreements report directly to the General Council. The Director-General is the Head of the Secretariat who looks after the collective interest of the member countries.

The decisions at WTO are normally taken by consensus. However, in some not-so-important cases, either three-fourths or two-thirds majority votes serve the purpose. It may be noted that there is no weighted voting, rather there is one-member, one-vote.

6.4.3 Functions of the WTO

Broadly speaking, the function of the WTO is to implement, administer, direct, and further the objectives of the multilateral and plurilateral trade agreements concluded during the Uruguay Round. To be specific, it:

1. Provides a forum for further negotiations for trade liberalisation in the framework of the various agreements concluded;
2. Administers the new dispute settlement procedure;
3. Establishes and directs a trade policy review mechanism so as to examine trade policies and practices of the member countries and to suggest measures of reform;
4. Cooperates on an equal footing with the World Bank and the International Monetary Fund for the purpose of economic policy making; and
5. Undertakes research and publishes information and studies for the international community.

6.4.4 Settlement of Disputes

It has already been mentioned that the procedure of settlement of trade disputes has come to be more effective during the WTO regime than under the GATT. The GATT in its original terms did not possess any provision for arbitration, nor did it make any reference to the possibility of appeal to an International Court of Justice. However, Article XXII required the contracting parties to consult with each other in the event of a dispute with respect to a matter affecting the operation of the GATT and to give it sympathetic consideration. Again, under Article XXIII, an aggrieved party could request the contracting parties to investigate the complaint. If the complaint was found justified, the contracting parties could authorise the aggrieved party to suspend concessions to the party against which the complaint was filed. But the dispute resolution mechanism remained practically ineffective. The reason was that the affected parties were to prove that the matter really involved a breach of the GATT agreement. Moreover, the consultation between the contracting parties was left largely to their discretion and there was no time limit for the settlement of the dispute. In case the aggrieved party was a developing country, it did not have the resources and expertise to negotiate effectively during consultations. On the contrary, the other party could block the negotiation indefinitely, with ultimately no settlement of the dispute. Even if disputes were settled, the decision was not binding on the parties.

DSB Cuts US Anti-dumping Duty and Cash Guarantee on Indian Shrimps

It was in August 2004 when the US authorities imposed 10.54 per cent anti-dumping duty on the import of Indian shrimps on the ground that the price was lower than that from any other country. The additional problem for the Indian exporters was that they had to deposit cash guarantee to cover any increase in anti-dumping duty usually at the same rate. The bonds got to be renewed every year for three years.

The entire matter was referred to the Disputes Settlement Body (DSB) which examined the entire issue. In January 2006, after the first review, the duty was cut to 7.22 per cent. Again, the second review was made in January 2007 and the duty was further cut to 1.69 per cent. The third review was made in March 2008 and the duty was expected to be slashed to 1.06 per cent.

The slash helped Devi Seafoods Ltd. to save the cash guarantee it had to pay. It is the largest Indian shrimp exporter accounting for over 15.0 per cent of the shrimp exports from the country. In its case, the burden of duty has fallen to 0.35 per cent. Since the exporter has not to deposit cash guarantee if duty is below 0.5 per cent, it is able to save that amount.

As many as 68 shrimp exporters, who had moved to the DSB for doing away with the cash guarantee scheme, welcomed DSB's decision in India's favour. Now, they will reap the benefit from the DSB judgement. But over 200 Indian shrimp exporters will not gain as they were not the party to the representation made to the DSB. They have still to pay 10.54 per cent duty along with the cash guarantee.

Source: Based on the reports published in *Mint*, 12.7.2008

But the settlement of disputes under WTO is effective and is possible within a prescribed time framework. This is the reason that during the first two years of the new dispute settlement regime, 74 dispute cases were reported compared to only 300 cases during the entire 48 year history of GATT (Anderson, 2000). In the WTO framework, there is Dispute Settlement Body (DSB) that has the authority to establish panels, adopt panel reports, scrutinise the implementation of recommendations, and to authorise retaliatory measures, if necessary. The coverage of the dispute settlement mechanism is broader, and includes not only the trade in goods, but also trade in services and intellectual property.

The dispute settlement mechanism is time-bound and phase-wise. In the first phase, stress is given on consultation and mediation. If the parties do not arrive at any conclusion within 60 days, the matter is referred to a panel to be established by the DSB. The panel members are normally the retired international civil servants well acquainted with the trade matters. The panel hears the arguments, prepares a report along with recommendations and submits it with the DSB. The panel report is adopted by the DSB within 60 days. If a party does not agree with the panel report, it may appeal to the Appellate Body. The appeal proceedings have to be complete within 60 days.

The parties have to abide by the decision of the Appellate Body within a reasonable period of time. They go for a negotiation to compensate the aggrieved party. If it is not done, DSB may ask for retaliatory action.

6.4.5 Challenges before WTO

It has already been discussed that after the inclusion of the Uruguay Round agreements, the WTO came to be the strongest authority regulating global trade. According to an estimate, the WTO discipline covers around 40–50 per cent of the world GDP compared to only 25–30 per cent under the GATT discipline in 1993 (Messerlin, 2000). But, at the same time, it is also true that there is still a long way for the WTO to go in view of the conflicting interest of the developed and the developing countries.

First of all, let us talk about the trade barriers. The tariff is not a problem as its level is quite low. As per a United Nations study, the effectively applied tariffs have come down by 33.7–50.6 per cent among the developing countries and by 51.5–53.2 per cent among the developed countries during 1994–2005 (United Nations, 2006). Moreover, some of the NTBs have been brought under control. If the trade barriers are fully brought

Simulating the Environmental Impact of Trade Liberalization

Mexico: Beghin, Roland-Holst, and van der Mensbrugghe calibrated the OECD GREEN model for Mexico and used it to model the environmental impact of three policy scenarios: trade liberalization, implementation of piecemeal environmental policies (i.e. abatement taxes to reduce emissions), and trade liberalization *cum* emission reduction. When trade liberalization is accompanied by pollution abatement measures, GDP growth is accompanied by a decline in pollution emissions.

Indonesia: Lee and Roland-Holst analyse the environmental impact of trade liberalization in Indonesia. Trade liberalization results in an expansion in Indonesia's trade of about 6 per cent and a corresponding increase in GDP of about 0.9 per cent. But liberalization also leads to pollution rising at a rate greater than the increase in output. This is because liberalization leads to Indonesia specializing more towards environmentally 'dirty' industries. The paper then simulates both trade liberalization and implementation of a uniform emission tax to reduce pollution. The simulation shows that Indonesia is able to achieve both an increase in output (0.3 per cent) and a reduction in emissions.

United Kingdom: The paper by Espinosa and Smith is notable for incorporating the negative externalities associated with air pollution into a CGE model. Reducing trade barriers in durable manufacturing in the UK still results in an overall increase in welfare despite the rise in morbidity and mortality from more emissions. The increase in morbidity and mortality rates from increased air pollution reduces welfare by only 0.09 per cent of GDP.

Source: World Trade Report 2004.

under control and the merchandise trade is fully liberalised, the welfare gains on this account may touch $ 280 billion a year by 2015, out of which $ 86 billion will accrue to the developing countries (Hertel and Winters, 2006). But the trade barriers are still quite high. The overall trade restrictiveness index (OTRI) in 2005 was 11 per cent in high-income countries, down from 12 per cent in 2002. It was higher at 20 per cent among the low-income and least developed countries (The World Bank, 2006). The important reasons are that the use of NTBs in form of technical barriers almost doubled from 31.9 per cent to 58.5 per cent during 1994–2004 and the anti-dumping measures were more frequently used by developing and developed countries (United Nations, 2006).

To be specific for agricultural products where NTBs have been substituted by a transparent tariff system in many cases, the level of tariff is very high. As per an estimate, the level of protection in case of these commodities is more than ten times the average on other merchandise (Anderson, 2000). The primary reason is that there is disagreement on domestic support regarding which the WTO draft recommends a modification of Blue Box subsidies (production limiting) that allows an extension of subsidies. The USA supports this view but the developing countries are arguing for elimination/capping of subsidies. The argument of the developing countries is that the agricultural sector in majority of them accounts for a very large share of GDP and employment. Moreover, subsidies elicit overproduction that causes world price to fall. Again, there is disagreement on the issue of cotton. The WTO considers cotton as a part of the agricultural group of products. But a large number of developing countries argue for treating cotton as a separate group. Moreover, the production and trade of cotton is highly distorted on account of government support programme in developed countries. The US Farm Bill, 2007, does not promise for removal of government support to cotton.

> The protection level in textiles and clothing and agricultural products is more than ten times the average on other merchandise.

Secondly, as far as the issue of the market access of non-agricultural products (NAMA) is concerned, the tariff level is low. But since the developing countries with cheap labour maintain an edge over the developed countries, especially in case of the products involving labour-intensive mode of production, the developed countries have employed different techniques to restrict the import of such goods. They talk about the "social issues" and the "environmental issue" in order to defend themselves. They know that the developing countries use cheap child labour that lowers the cost of production. They also know that the developing countries seldom use environment-protection measures and are thus able to arrest the cost of production. So if the developed countries are rigid on these two issues, they can restrict imports of manufactures and thereby can protect their own industry. It is because of their rigid attitude that the issue has remained unsolved so far.

> "Social issues" and "environmental issues" are yet to be solved.

Thirdly, as far as the Singapore issue is concerned, many governments still lack transparent policies on TRIMS. The private sector policies in many countries are non-competitive. The developing countries know that their domestic industry cannot compete with the large-size foreign enterprises. So they are insisting on dropping this issue from the WTO agenda. But the developed countries are very keen on TRIMS so that their MNCs should get a lasting ground in the developing countries.

The Singapore issues are still to be solved. GATS is not effective. TRIPS goes against free trade.

Fourthly, regarding GATS, the efforts of the WTO are not very pin-pointed, although they cover all modes of services and all forms of barriers (Snape, 1998). Moreover, in the sequel of the revolution in the digital technology, some of the services have become tradable, blurring the national demarcation in many cases. They account for 20–25 per cent of total cross-border trade. According to a study by the Coalition of Services industries in the USA, the liberalisation of services trade under the Doha Development Agenda (DDA) may result in global welfare gains equalling US $ 1.7 trillion. The WTO rules and modalities need to be very effective.

Fifthly, the case of TRIPS is not very different. Bhagwati (2000) feels that the WTO provisions concerning TRIPS are tilted against the interest of the consumers and go against the concept of free trade. There are many small countries where the government is not in a position to tune the intellectual property rights regulations in conformity with those of the WTO. The TRIPS agreement does not embrace the provisions for protecting traditional knowledge, genetic resources and folklore because they fall under the public domain meaning that they are not innovations and so they cannot be patented. It is this reason that has made developing countries to argue for amending the TRIPS provisions.

In India, the situation has improved. The Indian Patent Office granted 15,262 patents during FY 2007–2008 compared to 1911 in FY 2004–2005. India is willing to share with its digital knowledge library on 1,70,000 traditional medicines with the USPTO and its European counterpart on the condition that it should not be put in the public domain. It is to launch a campaign to rope in universities and the scientific community. The government likes more men to have been trained at the World Intellectual Property Organisation.
Source: Based on the news published in *Financial Express*, 22/23.04.2008.

Representation by transition countries and least developed countries is still meagre. The accession procedure at the WTO is very slow.

Sixthly, despite efforts of the WTO to confer the benefits of freer trade among large number of countries, there are a number of countries, especially the low-income and least developed ones that are still not its member. The reason is that the procedure of accession is lengthy. It is a fact that bureaucracy in many countries is not equipped to pursue the accession process. In others, the government does not enjoy political support on the accession issue. But the WTO is definitely held responsible for a slow process. A number of experts feel that the WTO is still a developed countries' club. Accession of large number of developing countries would mean a slap on their proportionate representation. Moreover, the political and economic interest of the developed countries is not served with a rapid accession process. For example, China, after its accession to the WTO, enjoys many privileges. The developed countries do not relish it (Anderson, 1997). However, in recent past, Cambodia, Nepal and Tonga became member to the WTO as a result of which the least developed countries have started representing at this institution. But at the end of 2005, there were as many as 29 such countries knocking at the door of WTO for accession.

It is not only that only a few of the least developed countries (LDCs) are the WTO member, the solution of their problems is not very easy for the WTO. They number around one-fourth of the total number of countries, but they share not even 1 per cent of the global merchandise trade. In view of this asymmetry, DDA pledged to integrate these countries with the multilateral trading system through providing them duty-and-quota-free market access and extending them economic aid to improve trade. The Hong Kong Ministerial declaration reiterated this objective. But, contrary to the assertion, the US move to exclude some of the products from this facility may jeopardise the whole initiative. For example, Bangladesh and Cambodia are doing well in textiles and clothing. But they do not have the desired response from many developed countries. Again, among the developing countries, it is only Brazil that has offered this facility to the LDCs, but in that country itself, there is a powerful lobby against this initiative.

> The creation of regional trading blocs is a major challenge before the WTO as such arrangements can result in trade and investment diversion.

Seventhly, the creation of the regional trading blocs and the conclusion of bilateral agreements at a fast growing speed has become a problem for the WTO. In January 2005, there were around 170 notified regional trade agreements, up from 24 in 1990 "that went up to 387 by July 2007". Many more are in the process of notification. As a result, they have come to account for approximately one-third of the world trade. In some cases, for example, on account of the scheme of generalised system of preferences, the exports of the developing countries have increased. In 2005, the European Union liberalised this scheme through covering more products and extending more liberal treatment for vulnerable economies as well as sub-Saharan countries. But these trade agreements being not non-discriminatory, block the way for growing multilateralism of trade. Such trade agreements, it is found, help divert trade rather than creating trade. The gainers are usually the rich countries and not the poor ones. It is true that Article XXIV of WTO permits such arrangements but it does not contain the diversion effects. Moreover, bilateral investment agreements lie outside the scope of this chapter.

Eighthly, it is true that the dispute settlement mechanism has improved under the WTO system. The developing countries can get redressed their grievances. It is this reason that, in 2005, they brought 64 per cent of the complaints to the DSB. But the problem is that the decision of the dispute settlement body is not fully implemented by the developed/economically stronger countries. Nothing substantial can be achieved if the developed countries do not change their attitude.

> DSB decision/the Appellate Body report is not fully implemented by the concerned countries.

Now the question is how far the WTO has taken care to meet these challenges. We know that the Ministerial Conference meets at least once during a two-year period. It met at Singapore in 1996, at Geneva in 1998, at Seattle in 1999, at Doha in 2001, at Cancun in 2003 and at Hong Kong in 2005. In the first three Ministerial Conferences, nothing substantial could be achieved insofar as both the developed and the developing countries harped on their own tune. However, at Doha, both groups agreed on a declaration. Important elements at Doha Round included the mandate to sharply reduce trade-distorting agricultural subsidies that had kept many developing countries out of international market, to reduce tariff peaks and tariff escalation particularly on the products of special interest of developing countries, to fine-tune WTO rules in areas like anti-dumping, to deal with services in conformity with Article XIX of GATS, to strengthen the relationship between trade and development and to promote trade facilitation programmes.

The successive meetings focussed on the Doha declarations. But nothing substantial could be achieved. Although at Hong Kong, the members showed their willingness to agree at least on some measures. They were concerning:

- Cutting subsidies on agriculture completely by 2013
- Reaching an agreement on cotton
- Restriction-free market access for the least developed countries
- A beefed-up framework for full modalities in agricultural and non-agricultural products
- A text on services for forward negotiation

The Hong Kong summit also set a foundation for a new "aid-for-trade" package. It was to address the supply constraints, to raise the training level and to improve the infrastructure. The purpose was to integrate the developing countries more fully in the global trading system. As per a World Bank study, the implementation of the Hong Kong measures may lead to a global gain of $ 95–120 billion. The General Council along with different committees is making efforts to transform these decisions into ground reality. The meeting at Davos in 2007 was held to review the progress. But even though, there nothing could be done to free the LDCs' export from quota and tariff and to eliminate subsidies on developed countries' agricultural export by 2013.

6.5 WTO AND INDIA

India was a founder member of the GATT and so is one of the original members of the WTO. The country was an active participant of the Uruguay Round discussions, and is bound to abide by the resolutions taken up there and incorporated in the Final Act. Over the years, India has been tuning its external sector policy in conformity with WTO principles. Some of the specific cases in this respect are listed below.

1. India has bound around two-thirds of its **tariff lines** compared to only 5 to 6 per cent of its tariff lines bound prior to the WTO. The ceiling has come to be 25 per cent for intermediate goods, 40 per cent for manufactured and 100 per cent in the case of agricultural goods. The period under which the tariff has to be phased out is 10 years, beginning March 1995. However, the Indian government has clarified its stand that if the agreements on

textiles and clothing do not materialise during this period, it may revert to pre-Uruguay Round duties. Moreover, it has not made any commitment on the issue of market access and on subsidies.

2. As far as **quantitative restrictions** are concerned, they are still maintained on the grounds of balance of payments inquiry. But, in May 1997 the Indian Government presented a detailed plan for the elimination of these restrictions in a phased manner over a period of 9 years. The length of the period was not acceptable to some of the importing countries. Therefore, it was reduced to six years, to which several countries, except the United States of America, have given their consent.
3. India has agreed to abide by the agreement on the **intellectual property rights**, ensuring non-discrimination and transparency in this regard. In March 2005, the Indian parliament passed the patent bill in order to tune its provisions with those of the WTO.

   However, on the issue of public health, India still maintains that the Doha mandate should not be diluted to restrict the scope of definition of disease to just infection disease, as desired by the United States of America.
4. Under the **trade related investment measures**, India has already notified its stand. It has also assured establishment and administration of national standards and technical regulations in conformity with the MFN principle.

   However, there are many areas of special interest for India where it has tabled its conditional offer for liberal moves on the part of developed countries.
5. India has agreed to offer **entry to foreign service providers** in 33 lines of activities, which is more than the average for individual developing countries.

   In view of this very argument, India has made a couple of submission to the Negotiating Group of Rules: first, there should be special and differential treatment for developing countries during anti-dumping and countervailing duty investigation; second, there should be greater transparency in the rules related to regional trade agreements and fisheries subsidies; third, there should be more discussion on substantive issues under GATT Article XXIV.

   The WTO made a third review of India's trade policy in June 2002. It was satisfied with the trade and FDI liberalisation policy of the country, although it was of the view that the tariff regime was still complex, containing numerous exemptions. It also raised concerns about large subsidies in the agricultural sector and about anti-dumping provisions.
6. The Indian government has amended the **customs valuation rules** to bring them in line with the provisions of WTO.

On the other hand, India expects from the other members of the WTO, especially the developed countries to strengthen the multilateral trading system in true spirit. It is of the view that the provisions of the agreement on textiles and clothing have not been implemented meaningfully as desired market access has not been granted to developing countries. It is also of the view that the safeguard clauses that permit any country to impose NTBs should be interpreted in a different way for developing countries insofar as the balance of payments scenario is quite different in developing countries, as compared to that in developed countries. Again, as regards subsidies, India is of the view that the stage of industrial development in developing countries is quite different. As a result, subsidies form an essential part of maintaining industrial development in these countries.

Taking a bold initiative, India hosted Ministerial Conference in September 2009. In the following Conference, it reiterated its commitment to uphold development dimension, especially the need of the poor. At the successive meetings, India sought to strengthen anti-dumping duties, rules concerning the sunset reviews and mandatory application of lesser duty.

6.6 UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD)

6.6.1 Origin of UNCTAD

UNCTAD is an international institution set up in 1964 to promote trade and development, especially of developing countries.

The UNCTAD, which came into being in 1964 is a significant international institution shaping international trade and development in the developing world. It was the absence of a desired remedy to the trade problems of the developing world in the hands of the GATT that led to the establishment of the UNCTAD. GATT had no doubt led to multilateral trade negotiations and, thereby, to large growth in international trade, but its principle of non-discrimination and reciprocity did not suit the interest of developing countries. This is because the developed countries and the developing countries stood on different footings. The latter were never in a position to reciprocate with the former. Moreover, the GATT negotiations were heavily tilted towards developed countries, as only products that suited their interest were covered under negotiations and not those that were significant from the viewpoint of developing countries. Again, GATT failed to limit the use of non-tariff barriers imposed by developed countries on their imports from the developing world under the guise of "safeguard" measures. The greatest victims were the manufactured exports of developing countries, which enjoyed comparative cost advantage on account of their labour-intensive mode of production. The aftermath was evident in lop-sided world trade. During 1950s and early 1960s, world trade rose over two-fold, but the export from the developing countries increased only by half, with the result that their share in world trade fell from nearly one-third in 1950 to around one-fifth by the early 1960s. Between 1950 and 1961, the terms of trade of the developing countries deteriorated by around 17 per cent. All this led to growing trade deficit, especially at a time when they needed a large amount of foreign exchange for their economic development programmes (Cutazar, 1985).

The weak bargaining position was highlighted by a number of economists. The Latin American economist, Raul Prebisch, explained the theory of trade and development that had pinpointed the shortcomings of the GATT and this was one of the factors for third world countries to consolidate, especially in the form of the Group of 77. Various meetings were held at regional and the global levels; and finally, the Economic and Social Council and the General Assembly took a decision to convene the first United Nations Conference on Trade and Development in 1964. Subsequently, the UNCTAD was set up as an organ of the General Assembly, for deliberations and negotiations in the field of trade and development. With the setting up of the UNCTAD, developing countries got a platform from where they could build pressure on developed countries for granting them relief in matters of trade and development finance (Table 6.2).

6.6.2 Major Areas of Negotiations

The negotiations and deliberations at different rounds covered a wide area of trade and development, which has been of special interest from the viewpoint of developing countries. These rounds have taken place at regular intervals and at different places.

Table 6.2 UNCTAD Rounds

Round	*Year*	*Place*
UNCTAD I	1964	Geneva, Switzerland
UNCTAD II	1968	New Delhi, India
UNCTAD III	1972	Santiago, Chile
UNCTAD IV	1976	Nairobi, Kenya
UNCTAD V	1979	Manila, Philippines
UNCTAD VI	1983	Belgrade, Yugoslavia
UNCTAD VII	1987	Geneva, Switzerland
UNCTAD VIII	1992	Cartagena, Colombia
UNCTAD IX	1996	Midrand, South Africa
UNCTAD X	2000	Bangkok, Thailand
UNCTAD XI	2004	Sao Paulo, Brazil
UNCTAD XII	2008	Accra, Ghana

Broadly speaking, the negotiations pinpointed at the following issues:

1. Stabilisation in export earnings, especially of the primary goods exporters,
2. Improvement in market access for the goods of developing countries,
3. Increase in development finance and initiation of debt relief measures,
4. Preferential treatment for least developed countries, and
5. Code of Conduct for international shipping.

Commodity Stabilisation Programmes: The commodity stabilisation programme primarily included international commodity agreements on ten core and eight additional commodities of special interest to developing countries. The ten core commodities were sugar, coffee, cocoa, tin, tea, cotton, hard fibres (sisal), jute and jute products, rubber, and copper. The eight additional commodities were bananas, bauxite and alumina, manganese, iron ore, beef, phosphate, tropical timber, and vegetable oils. The purpose of the commodity agreement was to regulate the supply of, and demand for, these commodities and fixing up the floor and ceiling prices so as to bring stability in the export proceeds.

In order to regulate the supply, stress was laid on the creation of an international buffer stock. However, funds are required to finance such stocks, and so, the second aspect of the commodity stabilisation programme was the creation of the Common Fund.

Despite conclusion of the international commodity agreements and the creation of the Common Fund, it was feared that the primary goods exporting countries might face oscillations in their export earnings. In case of a sudden drop in export earnings, there was IMF's Compensatory Financing Facility through which exporting countries could get balance of payments support. Nevertheless, the stress was on making the IMF's facility more meaningful by adding up a complementary financing facility.

This issue was raised at the UNCTAD II and the UNCTAD III but nothing significant could emerge. It was only at the UNCTAD IV that these issues were agreed upon. The developed countries were quite aware of the price rise of food-stuff and raw material, which was evident between mid-1972 and mid-1974, and they were afraid of the collective action of developing countries as in case of oil. The developing countries, on the other hand, had already formulated the Integrated Programme for Commodities (IPC), which had been approved by the Manila Declaration of 1976. However, the move towards integrated commodity agreements was very slow. Agreements were concluded only with respect to cocoa, sugar, natural rubber, jute and jute products, tropical timber, tin, olive oil, and wheat. The Common Fund could not take its originally envisaged shape for want of required financial support, although its establishment provided financial backing for the operation of international stocks and for R&D projects in the field of commodities. The IMF too did not set up any complementary mechanism to the existing compensatory financing facility.

GSP is the provision to allow duty free import of manufactured goods form developing countries into the market of developed countries.

The Market Access Issue: UNCTAD negotiations emphasised on increasing the market access for products from developing countries, especially those going into developed market economies. To this end, diversification of the export structure in favour of manufactured export was suggested. In order to help develop processing in the developing world, the negotiation favoured the creation of the second window of the Common Fund, which could provide financial assistance for this purpose. Again, to help manufactured exports enter the markets of the developed world, the UNCTAD suggested removal of duty by developed countries on their import of manufactured and semi-manufactured goods from the developing world. The issue was raised at UNCTAD I. But since the United States of America clung to the principle of non-discrimination and reciprocity, no headway could be made in this direction. It was only in April 1967 that the United States of America changed its stand, and then it was easy for UNCTAD II to reach an agreement. This scheme, known as the Generalised System of Preferences (GSP), was first introduced by the European Union in 1971, which was followed by many other countries. As a result, over US $70 billion of export from the developing world, per year, received preferential treatment under this scheme. However, the creation of the second window of the Common Fund for encouraging processing in developing countries could not take concrete shape for want of the required resources.

As far as the expansion of trade among developing countries is concerned, the UNCTAD helped reach an agreement on the Global System of Trade Preferences (GSTP) among developing countries in 1989. Under this agreement, a developing country provides preferences on its imports from another developing country.

GSTP refers to import liberalisation scheme among developing countries.

Development Finance and Debt Relief: The UNCTAD was of the view that reform in the trading system was essential for financing the foreign exchange component of the development outlays in developing countries. But this was not enough. The export earnings were to be supplemented by concessional finance flowing from both bilateral and multilateral sources. The UNCTAD was of the view that 0.7 per cent of the GNP of developed countries should come out in form of concessional assistance, either bilaterally or through multilateral sources, out of which 0.15 per cent should be earmarked exclusively for least developed countries. It is a fact that the ratio of concessional assistance in the total flow of development finance increased, but the 0.7 per cent target was never achieved.

Again, the UNCTAD's move led to the evolution of many debt relief measures such as writing-off of debt, debt refinancing, and rescheduling. It helped in the creation of guidelines for international action in the area of debt rescheduling in 1980. In 1978, the Trade and Development Board resolved to agree to retroactive adjustment of the terms of the ODA debt of low-income developing countries, under which more than 50 such countries benefited from debt relief for debts valued over US $6.5 billion.

Preferential Treatment for Least Developed Countries (LDCs): The UNCTAD has played a significant role in mobilising international support for LDCs. In 1981, the Special New Programme of Action (SNPA) was created to help generate faster growth in these countries. A similar programme was created for their development during the 1990s. In 1995, an agreement was signed for improving the transport system in the land-locked countries. In all, the purpose is to bridge the gap between the LDCs and other developing countries.

Code of Conduct for Liner Conferences: The UNCTAD helped in the adoption of the United Nations Convention on a Code of Conduct for Linear Conferences in 1974, which helped developing countries to get an equitable share in merchant fleets in the ocean carriage of their trade. This convention was followed by many other conventions that related to international multi-modal transportation of goods, conditions for registration of ships, and also to maritime liens and mortgages.

6.6.3 Some Recent Developments

The UNCTAD is making consistent efforts to attain its objectives. Through its Division on Investment, Technology, and Enterprise Development (DITE), it tries to encourage the flow of FDI, including technology, and plays a leading role in the area of enterprise internationalisation. Since UNCTAD X in Bangkok in 2000, DITE has undertaken research and policy analysis in the field of FDI. It is delivering policy advice on institution capacity building. It has organised seminars/symposia and undertaken fact-finding studies. As a result, 160 bilateral investment treaties have been concluded since then (UNCTAD, 2004).

UNCTAD XI at Sao Paulo, Brazil, in June 2004, proposed, among other things, to ensure coherence between the national development strategies and global economic development as a means to foster sustainable trade and development, especially in the developing world. Fortunately, there was a general consensus on this issue between the developed and the developing countries, although there were some contentious issues between them that need to be resolved. The developed countries interpreted good national governance in the framework of economic liberalisation and globalisation, but the developing countries stressed on the cooperation to be shown by the developed world with respect to trade, debt, transfer of technology, and making investments.

Here it may be pointed out that UNCTAD XI focussed on trade and development from a gender-and-women-in-development perspective. It identified 'trade and gender" as a major issue along with the issue of "trade and poverty" and "trade creating industries and development". Several of discussions were held and a consensus evolved on this issue, although it is still entirely not clear what actions will be taken in this respect in the coming years.

Last but not least, UNCTAD XII held at Accra, Ghana addressed the opportunities and challenges of globalisation for development. It called for coherence between economic development and poverty alleviation, enhancing the enabling environment to strengthen productive capacity, trade and investment and for enhancing the role of UNCTAD and its institutional effectiveness. Its role in respect of commodities, including agriculture was also felt especially in the face of the crisis provoked by surging prices for basic food items.

In other words, the Accra Accord highlighted the challenges facing many developing countries as they strive to integrate successfully into the international economic and financial system. It set out detailed agenda for economic and social development spanning over areas ranging from commodities, trade and debt to investment and new technologies. While welcoming the strong economic growth rates that global trade and investment flows have brought in many of the developing countries, UNCTAD XII autioned that these advances have not been shared by all and also have been accompanied by new difficulties, most notably the current crises in food prices and financial markets, as well as growing income inequalities.

SUMMARY

- Multilateral regulation of trade began with the GATT, which came into being in 1947 and was substituted by the WTO in 1995. The GATT/WTO believes in the multilateral trading system, which is based on the principle of non-discrimination, reciprocity, full market access, and fair competition.
- The GATT endeavoured to axe trade barriers, mainly the tariff barriers, during its first seven rounds. Its eighth round, known as the Uruguay Round, was much broader in coverage. Besides resolving to cut tariff and NTBs, it stressed on reforming safeguard measures and trade in agricultural products, constitution of TPRM, inclusion of some new aspects such as TRIMS, TRIPS, GATS, and so on, and on an effective trade dispute settlement system. As many as 18 agreements were concluded, of which 14 were multilateral in character and the other 4 were plurilateral. The WTO administers these agreements and maintains an effective dispute settlement mechanism. Still, there are several challenges before the WTO.
- India has been a member of the GATT/WTO. Its external trade policy is considerably well tuned with those of the WTO. This means it has bound a significant part of its tariff lines and has been phasing out quantitative restrictions. It has agreed also to abide by the provisions of TRIPS, TRIMS, and GATS. However, in case of subsidies, it has its own viewpoint.
- The UNCTAD is yet another international institution that was set up in 1964. It believes that the two unequal trade partners—developed and developing—cannot be treated equally and so developing countries should get preferential treatment. In this way it is different from the WTO, and yet it has been an important recommending body with respect to international trade benefiting the developing world.
- During its twelve rounds so far, the UNCTAD has made vital recommendations. Prominent among them are stabilisation of export earnings, especially of primary goods exporting countries; improvement in the market access for the goods of the developing countries; increase in the flow of development finance, investment and technology preferential treatment for least developed countries; and framing a code of conduct for international shipping.

REVIEW QUESTIONS

1. What are the principles on which the GATT/WTO's multilateral trade negotiations are based? Do the same principles guide the UNCTAD's recommendations?
2. Is the WTO different from the GATT? Explain the organisational structure of the WTO.
3. What are the major agreements concluded at the Uruguay Round, which the WTO now administers? Briefly mention the major challenges that the WTO is currently facing in this regard.
4. Do you agree that the dispute settlement mechanism is more efficient under the WTO than it was under the GATT? How is a dispute settled?
5. Comment on the broad achievements of the UNCTAD.

STUDY TOPIC

Anti-dumping Duties and the WTO

Article VI of GATT 1994 authorises WTO members to impose AD duties in addition to other tariffs, if they find that (1) the price of imports of a specific product is less than the normal value and (2) the imports cause injury to a domestic industry. The article lays guidelines for determining if dumping has occurred, for identifying the "normal value" of the targeted product and for assessing the dumping margin. It also provides for conducting injury investigations. The imposition of AD duties must expire after five years of the date of imposition, unless an investigation shows that ending the measure would continue to result in injury.

Since the number of AD initiations has turned large especially since 1995, there is pressure on WTO to find an amicable way to keep these measures well within limits. The issue was significant at Doha Declaration in November 2001 and at the Hong Kong Declaration during December 2005. According to statistics, the total number of AD initiations rose sharply after 1994 and peaked at 366 in 2001. There was marginal decline in the initiation in the following years perhaps because of the on-going DDA negotiations.

To be precise, India initiated 412 AD petitions during January 1995–June 2005, followed by the USA (358), the European Union (318), Australia (174), Canada (133) and New Zealand (46). Other developing countries leading initiators of AD actions included Argentina (193), South Africa (191), Brazil (119), China (110) and Turkey (97). The leading exporter targets of AD initiations during the above period were China (434), the European Union (363), Korea (212) and the USA (158). The most important victims were inputs used in the manufacturing process, including steel and chemical products.

WTO members are obliged to inform the WTO of their anti-dumping legislation. By the end of 2007, the EU members and the other 95 members had submitted notifications regarding anti-dumping legislation and/or regulations. The review of members' notifications of legislation takes place at the regular meetings of the Committee on Anti-Dumping Practices. The Committee has two subsidiary bodies—the Working Group on Implementation and the Informal Group on Anti-Circumvention. These bodies normally meet twice a year in regular session, in conjunction with the regular meetings of the committee. The Working Group on Implementation considers, principally, technical issues concerning the agreement. At its meetings in April and October 2007, the Working Group continued discussions on a series of topics referred to it by the committee based on papers submitted by WTO members, draft recommendations prepared by the WTO secretariat and information submitted by the members concerning their own practices. In the Informal Group on Anti-Circumvention, the members discuss the matters referred to the committee by the ministers in the 1994 Ministerial Decision on Anti-Circumvention. The Informal Group met in April and October 2007, continuing to discuss: "what constitutes circumvention", "what is being done by members confronted with what they consider to be circumvention" and "to what extent can circumvention be dealt with under the relevant WTO rules and what other options may be deemed necessary?"

The data available indicate that 159 new anti-dumping investigations were initiated by WTO members from July 1, 2006 to June 30, 2007. WTO members initiating 10 or more new investigations were India (29), the European Communities (18), Brazil (14) and China (11). The United States initiated nine new investigations and Argentina, Egypt, Korea and Malaysia each initiated eight new investigations. Australia, Canada, Chile, Colombia, Japan, Mexico, New Zealand, Pakistan, Peru, South Africa, Chinese Taipei, Thailand and Turkey each initiated seven or fewer new investigations. As of June 30, 2007, 28 members reported anti-dumping measures (including undertakings with exporters) in force. Of the 1,274 measures reported, 18 per cent were maintained by the United States, 13 per cent by India, 12 per cent by the European Communities, 8 per cent each by China and Turkey, and 5 per cent each by Argentina, Mexico and South Africa. The products exported from China were the subject of the most anti-dumping investigations (53) initiated from July 1, 2006 to June 30, 2007, followed by products exported from Korea (11), Chinese Taipei (10), the European Communities and Indonesia (9 each), Japan (8) and the United States (7). The remaining members exporting products subject to investigation were each subject to fewer than seven new investigations. The following figures show the countrywise details.

Reporting WTO member	*Initiations*	*Provisional measures*	*Definitive Duties*	*Price undertakings with exporters*	*Measures in force on 30 June 30, 2007*
Argentina	8	5	10	0	62

Australia	2	3	3	1	46
Brazil	14	3	1	0	50
Canada	3	6	3	0	40
Chile	2	1	1	0	1
China	11	10	14	0	103
Colombia	5	9	3	0	6
Costa Rica	0	1	1	0	1
Egypt	8	0	6	0	31
EU	18	11	13	2	149
India	29	20	18	0	162
Indonesia	0	0	1	0	15
Israel	0	0	3	1	6
Jamaica	0	0	0	0	Not Reported
Japan	4	0	0	0	2
Korea	8	3	7	2	29
Malaysia	8	8	0	0	16
Mexico	5	5	0	0	69
New Zealand	6	1	2	0	10
Pakistan	3	4	4	2	17
Paraguay	0	0	0	0	1
Peru	1	1	2	0	33
Philippines	0	0	0	0	1
South Africa	5	1	5	0	61
Taipei	4	1	2	2	7
Thailand	3	1	0	0	24
Trinidad & Tobago	0	0	0	0	4
Turkey	3	0	13	0	99
USA	9	8	6	0	229
Total	159	102	118	10	1274

Source: Based on WTO, Annual Report: 2008

Thus, it is clear that the WTO has taken due consideration of the anti-dumping duties. It is expected, they will be well within limits.

QUESTIONS

1. What do you mean by AD duties? When are they imposed?
2. Why has its management become more significant?
3. Describe the steps taken at the WTO in this respect.

REFERENCES

Books

Anderson, K. (2000),"The Future Agenda of the WTO", in WTO, *From GATT to the WTO: The Multilateral Trading System in the New Millenium* (The Hague: Kluwer Law International,) pp. 7–33.

Bhagwati, J. (2000),"Fifty Years: Looking Back, Looking Forward", in WTO, *op. cit.,* pp. 57–66.

Cutazar, M. Z. ed. (1985), *UNCTAD and the South-North Dialogue: The First Twenty Years* (Oxford: Pergamon Press).

Hertel, T. and L. A. Winters eds. (2006), *Poverty and the WTO: Impacts of the Doha Development Agenda* (Washington D.C.: The World Bank and Palgrave Macmillan).

Hockman, B. M. and M. M. Kostecki (1995), *The Political Economy of the World Trading System* (Oxford: Oxford University Press).

Jackson, J. H. (1989), *The World Trading System* (Cambridge MA: MIT Press).

Messerlin, P. A. (2000),"The WTO's New Horizons", in WTO, *op.cit*., pp. 83–96.

Puche, J. S. (2000),"Regionalism and the WTO", in WTO, *op. cit.,* pp. 123–35.

Snape, R. H. (1998),"Reading Effective Agreements Covering Services", in A. O. Krueger, ed., *WTO as an International Organisation* (New York: Oxford University Press) pp. 279–96.

The World Bank (2006), *The Global monitoring Report, 2006*, Washington D.C.

United Nations (2006), *Trade and Development Report: 2006*, Geneva: UNCTAD.

Journals

Anderson, K. (1997),"On the Complexities of China's WTO Accession", *World Economy*, XX (5), 749–72.

Baldwin, R. (1986), "Towards More Efficient Procedures for Multilateral Trade Negotiations", *Aussenwirtschaft*, XLI (3), 379–94.

Wall Street Journal (1993), *The Uruguay Round's Key Results*, December 15, p. A6.

SELECT FURTHER READINGS

Bhagwati, J. (1991), *Protectionism* (Cambridge MA: MIT Press).

Cutazar, M. Z. (1985), *UNCTAD and the South-North Dialogue: The First Twenty Years* (Oxford: Pergamon Press).

Krueger, A. O. (1998), *WTO as an International Organisation* (New York: Oxford University Press).

Qureshi, A. H. (1996), *The World Trade Organisation: Implementing International Trade Norms* (Manchester: Manchester University Press).

WTO (2000), *From GATT to the WTO: The Multilateral Trading System in the New Millenium* (The Hague: Kluwer Law International).

---

* The city of London is recognised as one of the key "world cities". Located in a small area within Greater London, England, it is often referred as the city or Square Mile. Today the city is a major business and financial centre, ranking on a par with New York City as the leading centre of global finance. It accounted for 4% of UK's GDP in 2008.

LNG plant at Bontang, East Kalimantan, Indonesia*

7

Regional Economic Integration

CHAPTER OBJECTIVES

The purpose of this chapter is to acquaint readers with the basics of regional economic integration and how integration influences international business. In particular, the objective is to:

- Describe the different levels of regional economic integration.
- Discuss the benefits and costs of regional economic integration from the viewpoint of international trade and FDI.
- Acquaint the readers with some regional economic integration schemes presently followed in different parts of the globe.

International trade is also regulated at the regional level through the creation of regional integration schemes. Regional economic integration scheme, opines Balassa (1973), is a process as well as a state of affairs. As a process, it means the removal of discrimination between different states. As a state of affairs, it means the absence of different forms of discrimination. While the former is a dynamic concept, the latter is a static concept. While intra-region trade is normally tariff-free, tariff is imposed on imports from outside the region. Again, there is often no restriction on the intra-region movement of capital and labour that also regulates other forms of international business. In view of trade and business regulation of this kind, the present chapter discusses the major specialities of the integrative arrangements that do influence the business decisions of international managers.

7.1 LEVELS OF ECONOMIC INTEGRATION

Economic integration or regional economic grouping represents some kind of preferential economic arrangement among member countries, where they cooperate with one another in many ways and eliminate restrictions on the intra-region flow of goods, services, capital, and labour. The member countries normally belong to a particular geographic region, with the result that they have common history and similar awareness to the regional problem. However, belonging to a specific geographic region is not an essential qualification for regional grouping. Cuba was a member of the Council for the Mutual Economic Assistance (COMECON) before the break-up of the former USSR, despite the fact that it was quite distantly located.

The different forms of regional economic integration schemes differ from each other. One of the reasons is that they represent different levels of economic integration. Based on the varying levels, the integration schemes are known as:

1. Free Trade Area
2. Customs Union
3. Common Market
4. Economic Union
5. Political Union

Free Trade Area refers to a situation where intra-region trade is duty-free but there is variation in tariff structure for import from a third country.

Free Trade Area: In a free trade area, which involves the least integration, member countries abolish tariff and non-tariff barriers on intra-region trade but they are free to impose tariff on their import from a third country at different rates. Thus tariff abolition is a preferential economic arrangement that aims at encouraging intra-region trade. European Free Trade Association (EFTA) and North American Free Trade Agreement (NAFTA) are apposite examples of this type of economic integration.

Customs Union refers to free trade within the union along with a uniform tariff structure for import from a third country.

Customs Union: The second form of economic integration is known as customs union where the member countries abolish tariff and non-tariff barriers on intra-region trade just as in case of a free trade area. But, the member countries maintain a common tariff wall on imports from a third country. Thus, it is different from the free trade area, which does not involve a common external tariff. The European Union in its initial stage was a customs union.

Common Market: The third form is known as common market where the degree of integration is further one step ahead. The common market involves common external tariff that is found in a customs union. Over and above, it also involves free movement of factors of production such as labour, capital, enterprise, and technology among the member states. As a result, there are chances for best allocation of resources in a common market leading to maximisation of benefits from resource utilisation among the member states.

Common Market is a customs union along with free intra-union movement of factors of production.

Economic Union: The fourth form is known as an economic union where all the features of a common market exist. But additionally, the member states try to harmonise monetary, fiscal, and other economic policies. Thus, the content of integration is the maximum in this case. This may mean that the member states surrender, at least to some extent, their national sovereignty for the harmonisation of economic policies. The European Union, after the Maastricht Treaty, has come to be an economic union.

Economic Union is a common market along with a common economic and monetary policy.

Political Union: Political union represents the highest level of integration. Although it is not a pure form of economic integration, it does indicate the logical outcome of increased economic integration among a group of nations. In this case, the member countries lose their national identity and come under a single state. East Germany joined West Germany to form a political union.

Political Union is a single political sovereignty.

These are the five stages through which the process of economic integration moves further. The time span for the movement from one stage to the other may vary widely depending upon the subservience of the economic goal amongthe member states. In Europe, it took around four decades to enter a complete economic union. In South Asia, the first stage is not complete even after oneand a-half decades of the formation of the South Asian Association of Regional Co-operation (SAARC).

Policy Action	*Type*				
	Free Trade Area	*Customs Union*	*Common Market*	*Economic Union*	*Political Union*
1. Removal of tariff and quota	Yes	Yes	Yes	Yes	Yes
2. Common external tariff	No	Yes	Yes	Yes	Yes
3. Factor mobility	No	No	Yes	Yes	Yes
4. Harmonisation of economic policies	No	No	No	Yes	Yes
5. Total economic and political unification	No	No	No	No	Yes

7.2 BENEFITS AND COST OF ECONOMIC INTEGRATION

7.2.1 Trade Creation and Trade Diversion

Locus of production shifting from high cost to low cost centre within the union, leading to productive efficiency is trade creation. Trade diversion is the opposite of trade creation.

It was Jacob Viner (1950) who discussed the benefits and costs of economic integration for the first time, in terms of trade creation and trade diversion. While the trade creation has beneficial welfare implications, trade diversion may be injurious. Explaining the difference between the these two terms, Viner says that when the locus of production shifts from a high cost point to a low cost point, the resources will tend to move from a less efficient use to a more efficient use. This would be a trade creating effect. On the contrary, the movement of production and resources in the opposite directions leads to trade diversion. Suppose the price of a single commodity *X* in three countries, *A*, *B*, and *C* at existing exchange rates is respectively, \$36, \$25, and \$20. In the absence of any regional integration scheme, Country *A* imposes a tariff of 100 per cent, which is sufficient to protect its own industry. But, if Country *A* forms a customs union with Country *B*, it will prefer to import that commodity from Country *B* instead of using its own product inasmuch as import will be cheaper. This would lead to a movement of resources from Country *A* to Country *B* or from a high cost point to a low cost point, and would be treated as trade creation. Had there been a different rate of tariff, the trade pattern would have been different. For example, if Country *A* imposes 50 per cent tariff on the import of commodity *X*, this commodity would be imported from Country *C* in absence of any customs union. But when there is a customs union between Country *A* and Country *B*, the commodity will be imported from Country *B* as there is no tariff imposed on intra-region trade. In this case, the source of supply shifts from a low-cost point to a higher-cost point, that is from Country *C* to Country *B*, and this will cause trade diversion. The concept of trade creation and trade diversion can be explained with the help of a diagram. Figure 7.1 shows the trade-creating effect of a customs union. Suppose D_X and S_X are, respectively, the demand and supply of Commodity *X* in Country *A*. Prior to the formation of a customs union, Country *A* imposes tariff of 100 per cent in order to protect its own industry from the cheaper imports from Country *B*. The tariff-inclusive price is Rs. 4. The total demand for the product in Country *A* following the imposition of tariff is 71, out of which 23 are produced domestically and 48 are imported from Country *B*. Country *A* does not import the product from a third country in as much as the tariff-inclusive price is higher than Rs. 4.

Suppose, further that a customs union is formed between Country *A* and Country *B*. The tariff is now zero on the trade between the two countries. The price of the product in absence of the tariff falls to Rs. 2. In the wake of the falling price, the demand for the product rises to 85, out of which

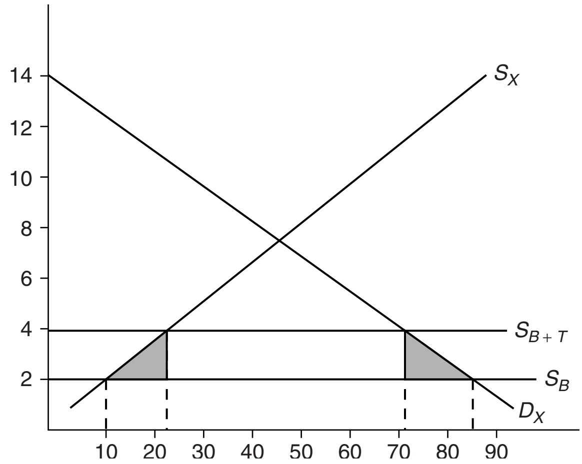


FIGURE 7.1 Trade-creating Effect of Customs Union in Country A

10 are produced domestically and 75 are imported from Country *B*. Here, Country *A* imports 27 more units from Country *B* that substitutes the domestic production in Country *A*. In other words, the locus of production for producing 27 products shifts from a high-cost point in Country *A* to a low-cost point in Country *B*. This is the trade-creating effects of a customs union. The gains accruing to Country *A* are:

$$[\{(23 - 10)/2\} + \{(85 - 71)/2\}] \times (4 - 2) = \text{Rs. } 27$$

As far as trade diversion is concerned, Figure 7.2 shows that D_X and S_X are the demand and supply of product *X* in Country *A*. S_B and S_C are the perfectly elastic supply line, respectively, in Country *B* and Country *C*. In order to protect its own industry, Country *A* imposes tariff of 100 per cent on its import

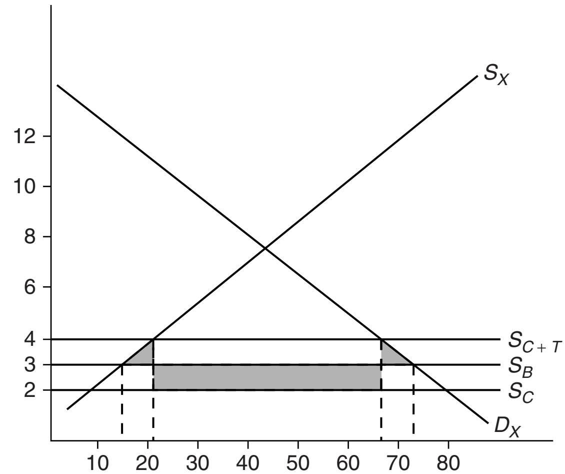


FIGURE 7.2 Trade-diverting Effect of Customs Union in Country A

and imports product X from Country C at the tariff-inclusive price of Rs. 4. At this point, the total demand for the product in Country A is 65, out of which 22 units are produced domestically and 43 are imported from Country C.

Suppose, further that Country A forms a customs union with Country B. The tariff is zero on the trade between Country A and Country B. Now, Country A finds the goods produced in Country B cheaper in absence of tariff and begins importing the product from Country B instead of Country C. At this point, the total demand is 72, out of which 15 units are produced domestically and 57 units are imported from Country B. The locus of production for producing units of the product shifts from a low-cost point (Country C) to a high-cost point (Country B). This is trade diverting effect. It is true that Country A gets the product at a lower price after the formation of the customs union, but loses the tariff income. Thus, the loss of welfare in Country A is equal to the difference between the gain in price and the loss of tariff revenue. To be precise, it is:

$$\{(65 - 22) \times (3 - 2)\} - [\{(22 - 15)/2\} + \{(72 - 65)/2\}] \times (4 - 3)$$

$$= \text{Rs. } 43 - 7 = 36$$

However, Meade (1956) is not satisfied with Viner's explanation. In his view, it is not the difference of the total volume of trade on which costs have been raised from the total volume of trade on which costs have been lowered that indicates the net gain or loss. Rather, it is the extent to which the costs have been lowered on each unit of the newly created trade that indicates the trade creating effect. This effect should, of course, take into account the loss of revenue to the State Exchequer on account of abolition of tariff on intra-region trade, unless other taxes are raised to compensate such losses.

Viner is very particular regarding the choosing of a union member so that the gains could be maximised. He prefers partners that are competitive, and not complementary, in the range of commodities protected by tariff. This is because in this case, the most efficient partner would capture the entire market of the customs union; and consequently, resources would be allocated to the most efficient point. Makeower and Morton (1953) explore this issue further and believe that the gains could be maximised if the difference between the cost at which the same commodity is produced in different member countries is the largest.

Regional Economic Integration

Benefits:

- Trade creation when locus of production shifts from a high cost point to a low cost point.
- Inter-commodity substitution in favour of goods produced within the union.
- Dynamic effects in form of gains arising from the increased size of market, from economies of scale and external economies, and from growing competition and technological change

- Development of collective self-reliance among member countries, especially through harmonisation of economic policies.
- Increased foreign direct investment within the union and from outside the union, especially in view of the larger market.

Costs:
- Trade diversion when locus of production moves from a low-cost point to a high cost point.
- Trade deflection when outside goods enter a free trade area through a member country having lowest tariff.
- Polarisation of benefits from integration moving away from the weaker partner in favour of the economically stronger partner, leading to intra-region inequality

7.2.2 Inter-commodity Substitution and Consumption Gains

Viner's analysis is limited to the inter-country substitution of goods. But, as Meade (1956), Gehrels (1956), and Lipsey (1960) believe, there exists also the scope for inter-commodity substitution. The induced changes in the relative prices, as a result of customs union, may have an influence on the consumption pattern. It is expected that the union members will increase their consumption of commodities imported from the member countries, which will supplement their reduced consumption of goods imported from a third country. This sort of intra-union trade will raise the welfare gains and partly offset any loss from trade diversion. Gehrels and Lipsey observed that even if the country does not shift its import from a third country, the higher price of the commodity in question will force consumers to shift their demand in favour of a cheaper substitute produced domestically or imported from a member country. This effect may outweigh the unfavourable effects of trade diversion and cause a net rise in welfare. The basic premise of their argument is that the relative price between the imports from the member country and domestic goods are made conform with the real rates of transformation, which tends to raise welfare. But, if the relative price between the imports from within the region and the imports from a third country tends to move away from being equal to the real rates of transformation, welfare would decrease.

> The induced changes in the relative prices, as a result of customs union, may have an influence on the consumption pattern.

7.2.3 Trade Deflection in a Free Trade Area

The theory of customs union may not be completely applicable to a free trade area as the latter does not have a common external tariff. Trade

> Trade deflection refers to goods produced in a third country entering a free trade area through a member country having lowest tariff.

deflection, which is not a problem in a customs union, may emerge in a free trade area. Since the member countries in a free trade area have their own external tariff wall, the goods produced in a third country find their way into the free trade area via the member country that has the lowest tariff. This kind of trade deflection negates the protective efforts of a market integration scheme. This is why some of the free trade areas have a provision known as the rules of origin, which necessitates that a certain minimum percentage of the price of the goods should be represented by the cost of the material produced in the region. This provision performs the function of a common external tariff to a certain extent and minimises the effects of trade deflection. Nevertheless, as Shibata (1967) feels, a few differences do exist between a customs union and a free trade area. For instance, consumers of a product in a country with the lowest tariff are not worse off with the formation of a free trade area; but in a customs union, they have to face a higher common union price till the common external tariff is brought down to the lowest previous duty. Again, with increasing cost of area-origin inputs, free trade area manufacturers with no access to non-region-origin inputs are at disadvantage. On the contrary, in a customs union, the common external tariff makes all manufacturers competitive, provided the assumption of perfect mobility of factors of production holds good. Yet again, highly specialised member countries prefer a free trade area as they do not require protection through common external tariff. Last but not least, countries that complement each other prefer to have a free trade area, while those that are competitive prefer to form a customs union.

Countries that complement each other prefer to have a free trade area, while those that are competitive prefer to form a customs union.

7.2.4 Dynamic Effects

The dynamic benefits include the gains arising from the widening of the size of the market, economies of scale and external economies, growing competition, and technological change lead to economic growth.

Besides the issue of trade creation, trade diversion, and trade deflection, which are all more or less of static nature, there are some dynamic benefits from regional grouping. The dynamic benefits include the gains arising from the widening of the size of the market, economies of scale and external economies, growing competition, and technological change. The regional groupings reap gains that induce production and lead to economic growth (Balassa, 1962; Scitovsky, 1958). However, as Thorbecke (1963) feels, the dynamic effects may sometimes outweigh the static effects and help move the terms of trade against the union. The argument is that the economic growth, as a sequel to the dynamic effects, may raise the demand for imports via real income effect as also the productive efficiency may reduce the cost of production that, as a combined effect, may influence the terms of trade in an unfavourable direction.

The dynamic effects of a regional integration scheme are more significant in the case of a developing country. This is one of the reasons that the dynamic effects have been exclusively discussed in the context of developing countries (Dell, 1963; Bhambri, 1962; Mikesell, 1963; Balassa and Stoutjesdijk, 1975; Dosser, 1972). It is generally believed that the national market in developing countries is often too small to allow manufacturers to achieve economies of scale and fully utilise their capacities. Regional cooperation schemes help widen the market, facilitate larger production, and permit large size plants with greater specialisation. This is why the cost of protection is often lower in a regional grouping than in an individual country. Mikesell feels that the widening of market creates new opportunities for innovation and brings about changes in the investment pattern, which constitutes the dynamic elements of growth. He attaches importance to the issue of economies of scale in view of the fact that the investment as well as intermediate goods cannot be economically produced if the market is small. Balassa and Stoutjesdijk have statistically shown that no national market of any developing country is sufficiently large for this purpose. Economic integration is naturally a viable alternative in this context. Firms reaping the benefits of scale are able to supply goods at a lower cost within the region as well as outside. The export base of the region as a whole widens.

Again, the competition generated by the formation of economic integration scheme often leads to a healthy competitive environment. Mikesell is of the opinion that it is primarily the emergence of impersonal competitive forces. Firms that previously had an oligopolistic or monopolistic position in an individual country will now have to face competition from other firms in the region. Consequently, they employ cost reducing methods. The improvement in the competitive position of firms leads to an increase in their export outside the region. Larger export leads to larger production and investment, and greater specialisation at home. This may push the relative prices and consumption pattern towards optimum conditions.

7.2.5 Collective Self-reliance

Member countries of a regional grouping are able to develop collective self-reliance through intra-region trade, movement of factors of production, harmonisation of economic policies, and they need not depend on the wishes of other countries. This is very important in the case of developing countries that have to depend on developed countries for their economic needs. Economic integration provides them with greater strength while bargaining collectively with others.

7.2.6 Increased Foreign Direct Investment

> Economic integration leads to larger market and thereby to greater demand and increased intra-bloc and inter-bloc FDI.

The trade liberalisation aspects of regional economic integration have a positive influence on foreign direct investment (FDI) especially on the flow of intra-bloc FDI. Economic integration leads to a larger market and, in turn, to greater demand. Consequently, inter-bloc as well as intra-bloc FDI flows to respond to the increased demand. Regional firms move abroad (within the bloc) to operate at the least-cost location. When integration results in the convergence of regulatory regimes of member countries or when pressure is built on non-member countries to converge their policies in tune with the member countries, FDI will definitely be promoted.

In fact, it was experienced in case of Bulgaria and Romania that during the process of convergence preceding their accession to the European Union on January 1, 2007, the magnitude of FDI inflow into these two countries increased considerably. Bulgaria's rank in the UNCTAD FDI performance index moved up to 7th during 2004–2006 from 92nd in 1990–1992. Romania's ranking improved from 101st to 21st during the same period (Based on WIR, 2007).

Strange (1997) explains six different motivations behind FDI that are stimulating in the wake of regional economic integration. (i) when firm-specific factors such as technology are available in the host country, which is not transferable to the home country, FDI flows to the host country. (ii) when the host-country government provides various incentives to foreign investors, the inflow of FDI begins to rise. (iii) when the motive is to gain access to one another's product ranges, there is often mutual investment in different member countries of the regional grouping. (iv) when firms intend to secure access to customers in the host country, they make investment in those countries. (v) the high tariff wall of a regional integration scheme often discourages imports from a third country. In such cases, companies of the third country begin to operate in the regional bloc in order to avoid the tariff barrier. Such FDI is often known as tariff-jumping FDI. (vi) when there is international competition among similar products, technical change often shifts comparative advantage in favour of foreign firms. The host country makes greater imports. In such cases, foreign firms collaborate with the host country firms in order to meet the greater demand for the product.

7.2.7 Polarisation of Benefits

In the ANDEAN Pact, the distribution of national income during 1960s and early 1970s was obviously unequal.

There is one school of thought that believes in the reduction of inequality in income and wealth through economic integration. It is perhaps because increased trade should reduce disparity between factor prices (Edel, 1969; Samuelson, 1949). But this argument is refuted on the grounds that the introduction of monopoly elements and trade through unequal exchanges lead to intra-region inequality. Vaitsos (1978) has presented some empirical findings to show that despite special consideration to distributional aspects in the ANDEAN Pact, the distribution of national income during 1960s and early 1970s was obviously unequal. Around 40 per cent of the population within this region received 9 to 13 per cent of the national income, whereas the top 5 per cent of the population had 40 per cent of overall earnings.

Bird (1965) too feels that the polarisation forces, that is growth in one part of the region attracts further growth in that part, are often more prominent than the spread of growth in other parts. In the developed world, where even the least advanced country possesses the minimum industrial impulses, polarisation forces are not very apparent. But in the developing world, where such impulses are lacking, the formation of a regional integration scheme is fraught with such problems. Bird maintains that the emergence of economies of scale and the operation of external economies push down the cost. Trade creating forces tend to appear shifting the productive resources and factors of production away from high cost centres. Industrial agglomeration gets an impetus, which further gives rise to external economies, encouraging, in turn, further industrial agglomeration in specific parts of the region. There are of course social costs associated with this trend, but private entrepreneurs hardly care for them.

Polarisation forces become active when a particular member country does not augment export but simply shifts its imports from a low cost source to a high cost source. This leads to deterioration in terms of trade. Besides, large imbalances appear on the payments count due to large intra-region trade imbalances. However, Balassa and Stoutjesdijk feel that such imbalances may be offset by changes in extra-region trade.

Polarisation forces become active when a particular member country does not augment export but simply shifts its imports from a low cost source to a high cost source. This leads to deterioration in terms of trade. Besides, large imbalances appear on the payments count due to large intra-region trade imbalances.

Whatever may be causes for polarisation, its continuance leads to heterogeneity among member economies with respect to the level of income and industrial development. Weaker countries feel dissatisfied with such developments that affect cordial relations within the region. The members oppose harmonisation of economic policies, which negates the very objective of economic integration. Germanico Salgado Penaherrera (1980–81) gives an account of such a situation in a few regional groupings and of equalisation mechanisms that have followed to correct the imbalances and differences. He finds that such mechanisms have a very low success rate.

7.3 SOME ECONOMIC INTEGRATION SCHEMES

7.3.1 The European Case

Early Attempts: The first exercise towards economic integration was made in 1948 when the Organisation for European Economic Cooperation (OEEC) was established for the purpose of administering the Marshall Plan aid meant for the reconstruction of the war devastated economies. In 1952, six European countries, that is, West Germany, France, Italy, Belgium, the Netherlands, and Luxembourg formed the European Coal and Steel Community (ECSC). The purpose was to establish a common market for coal and steel among the member countries.

European Union: A major step towards regional grouping was manifest in the creation of the European Economic Community (EEC) among the ECSC countries in 1957 under the Treaty of Rome. It was basically a common market that had a customs union along with a provision for free internal movement of goods, services, labour, and capital. The process of abolition of internal tariff began in 1959 and was completed by 1968.

The Common Agricultural Policy (CAP) established in 1962 incorporated various measures of tariff and price support and helped restrict the import of agricultural products in the interest of domestic agriculture and the farmers engaged in it. In 1967, the ECSC, EEC, and the European Atomic Energy Community (EAEC) were merged under a new banner of the European Community (EC). Denmark, Ireland, and the United Kingdom joined the EC in 1973. Greece joined it in 1981; Portugal and Spain in 1986; and Austria, Finland, and Sweden in 1995. The size of the European Union increased in 2004 when ten new countries joined it. The new members were: Cyprus, the Czech Republic, Estonia, Hungary, Lativa, Lithuania, Malta, Poland, Slovakia, and Slovenia. Two more countries, viz. Bulgaria and Romania joined the EU subsequently. The number of member countries rose to 27.

In 1987, the Single European Act was implemented in order to add more vigour to the EC as it provided for harmonising product standards throughout the region and removing barriers to internal trade and the flow of financial services.

The members of the EC met in 1991 at Maastricht, the Netherlands, to plan for more advanced stages of economic integration. The Maastricht Treaty, which was signed in February 1992 and came into force from November 1993, renaming the EC as the European Union (EU), called for a close link between the European economic union and the European monetary union. It set up monetary and fiscal targets for the countries participating in the monetary union. Of the then 15 EU members, there were only 11 members of the EMU as Greece and Sweden were not able to meet the convergence criteria and Denmark and the United Kingdom are still opposed to the single currency, Euro replacing their currency by 2002. However, Greece joined the Euro club in January 2001, raising the number of Euro club members to 12. Again, it called for political union among the members, that is, to include a common defence and foreign policy and a common citizenship.

The organisational structure of the EU primarily embraces five institutions. The European Commission initiates proposals for legislation and executes the policies. The European Parliament has legislative powers and it supervises the executive decisions. It is rather a consultative body that debates and amends legislation proposed by the European Commission. The Council of Ministers composed of the ministers from the member countries votes on the passage of the law. The Court of Justice, composed of one justice from each member country, hears the case when a country does not abide by the rules framed by the Union or when the Commission or the Council does not perform its duties well. The Court of Auditors looks after the management of the EU budget.

These five institutions are flanked by five other important bodies. They are: (1) the European Economic and Social Committee looking after economic and social issues; (2) the Committee of the Regions, expressing the views of the regional authorities; (3) the European Central Bank, responsible for the management of monetary issues; (4) the European

Ombudsman, dealing with citizens' complaints; and (5) European Investment Bank, responsible for financing investment projects.

European Economic and Monetary Union: The European Economic and Monetary Union was born in the mid-1970s with the creation of the "snake in the tunnel", which took a more concrete shape in the form of the European Monetary System (EMS) in 1979. The European Currency Unit (ECU) was then the monetary unit of the EMS. ECUs were created and allocated among the EMS member countries. It was a composite monetary unit made up of a basket of a specified amount of the currencies of the 12 EU member countries. The specified amount was determined on the basis of the country's GDP and foreign trade. One unit of the ECU was equal to the sum of the fixed amount of such currencies.

"Snake in the tunnel" refers to an attempt towards monetary integration among six West European nations in 1972, the purpose of which was to narrow the fluctuation in those currencies.

ECUs were created by revolving three-month swaps of gold and US dollars between the members' central banks and the European Monetary Co-operation Fund (EMCF). The EMCF was renamed as the European Monetary Institute (EMI) in 1994 and again, with greater functions and powers, as the European Central Bank, in 1998. The central bank of a member country, if it had held ECUs more than the allocated amount, got interest on the additional amount. If its holdings of ECUs were lower than the allocated amount, it had to pay interest.

ECU helped determine the parity grid or the grid of bilateral rates of exchange. This meant that the exchange rate between the two currencies was fixed through their share in the ECU valuation. Any fluctuation in the bilateral parity grid was not unexpected in view of the widely differing macroeconomic variables in the different member countries. So, a fluctuation band was prescribed that was initially +/– 2.25 per cent, except for the Italian lira, where it was 6.00 per cent. Any fluctuation beyond the prescribed limit was restricted through intervention by the central banks. In practice, intervention was made much before the prescribed limit had reached. This type of optional intervention prevented any compulsory intervention that had to be made when the prescribed limit had been reached.

Again, there was a provision for monetary support. It originated from the EMCF or the EMI, now the European Central Bank, and had varying maturity limit. The very short term credit was to assist central banks in intervention. Short term credit met the balance of payments deficit. The medium term credit was meant for a medium term balance of payments support. Besides all these, there was also a provision for medium term financial support for fostering convergence between economically weak and the economically strong member countries. Such credits flowed from the European Investment Bank.

Exchange rate stability, which could not be achieved completely over the years, was to be achieved by reducing disparity in the macroeconomic performance of the member countries. This was possible through the convergence of economic policies among the members. In order to bring about a greater degree of convergence, the Committee for the Study of Economic and Monetary Union, 1989, put forth a three-stage plan. This was commonly known as the Delors Plan approved at Maastricht in February 1992.

The first stage, which was formally to begin from July 1990, emphasised on currency convertibility through removal of exchange control and through encouraging free capital movement. The second stage, beginning from January 1994, focused on institutional development. The European System of Central Banks (ESCB) was to be set up for the purpose of envisaging a common monetary policy. Exchange Rate Mechanism (ERM) was to be hardened through narrowing the exchange rate fluctuation band. The time-table for the third stage was to begin from January 1999. In the first year, budgetary coordination was to be brought about. The EMI, now the European Central Bank (ECB), was responsible for fostering monetary coordination in the then proposed framework of the new European currency, the euro, that was created in January 1999. In the following three years, the exchange rate of member currencies was to be irrevocably pegged to one another. From 2002, the national currencies of the member countries were to retire in favour of the euro.

The Delors Plan suggested a full convergence of economic and monetary policies, focussing specifically on the size of inflation, interest rates, fiscal deficit, and government debt. However, it is difficult to say how far the convergence criteria will be met.

In January 1999, the Euro was created as the currency of the EMU. It replaced the ECU on a one-for-one basis, with the result that the ECU ceased to exist. One unit of euro comprised of 100 euro cents. The exchange rate between euro and the members' currency came to be fixed. This was done with a view to avoid fluctuation in the bilateral parity grid. Table 7.1 shows the Euro-member currency rates.

Table 7.1 Intra-EMU Exchange Rate

As on 1 January, 1999

Member's Currency	*Value per unit of Euro*
DM	1.95583
French franc	6.55957
Italian lira	1936.27
Spanish peseta	166.386
Dutch guilder	2.20371
Belgian franc	40.3399
Austrian shilling	13.7603
Portuguese escudo	200.482
Finnish markka	5.94573
Irish pound	0.787564
Luxembourg franc	40.3399

Note: Cyprus and Malta joined on 1 January, 2008 and on 1 January, 2009, Slovakia joined the EMU

On this count, the post-euro regime is different from the pre-euro regime. The bilateral parity grid is not expected to be constrained because the European System of Central Banks (ESCB), composed of the central banks of the participating countries, and the ECB will frame and implement a common monetary policy in all the member countries. However, the exchange rate between the euro and the non-member currency is subject to market forces. When the euro came into being, its value in relation to the US dollar was US \$1.1665/euro.

On January 1, 2002, Euro notes and coins were introduced in the 12 member countries. By the end of February 2002, the euro completely replaced members' currencies. Euro bank notes are issued by both the European Central Bank and the national central banks with full understanding between them. Out of the total size of the issue, 8 per cent are allocated to the ECB. The coins are minted by the national authorities.

The euro has some benefits, but at the same time, there may be costs too. First of all, the benefits manifest in eliminating transaction costs that occur on account of exchanging one member currency for another. Secondly, goods produced in different member countries are priced in a single currency, which leads to price transparency and encourages market integration. Thirdly, there is no exchange rate changes and, thereby, no foreign exchange exposure in intra-union trade. With no exchange rate exposure, intra-union trade will expand, leading to increase in capital productivity and national income. Fourthly, the existence of a single currency is expected to minimise market imperfections that will be apparent more in financial services. In a nearly perfect financial market, the number of participants will increase. All this will help develop the financial market within the Union. Fifthly, there will be no problem in the consolidation of accounts by multinational corporations operating within the Union as translation of currency will not be required. But, on the other hand, in the absence of a multiple currency system, the number of transactions exchanging one currency for another will significantly reduce bankers' income.

> Euro has some benefits: 1. No transaction cost involved in exchange of currencies, 2. Price transparency, 3. No exchange rate exposure in intra-EU trade, 4. Market imperfections being minimum, 5. No problem in consolidation of accounts by MNCs.

Again, as far as the use of the euro for invoicing of trade with a third country is concerned, its success depends upon the stability of its value in the foreign exchange market and on the demand for it in international transactions. In fact, this is the reason that the US dollar is invariably the currency of invoice even where the United States of America is not involved in the trade. If one looks at the figures, it is found that 37 per cent of world trade is invoiced in the EU member countries' currency as against 48 per cent of the world trade invoiced in the US dollar. On this basis, one can be confident about the successful use of the euro in international transactions. Moreover, there is an indication that the Bank of Japan is holding euros in its reserves. If it is followed by the central bank of other countries, euro has a good prospect. Presently, the bonds denominated in EMU member currencies account for around one-half of dollar-denominated bonds. If these currencies retire in favour of the euro, euro-denominated bonds will be commonly used.

However, the experience in the two years after the euro came into being was not very impressive. It depreciated against the US dollar during this period. The reasons were perhaps the larger current account deficit in the EMU than in the United States of America and the falling rate of industrial production in the EMU compared to that in the United States of America. Nevertheless, these trends were not permanent. In recent past, euro has appreciated against the US dollar. If the macroeconomic variables of EMU improve, the euro definitely has good prospects.

European Free Trade Association (EFTA): There were some countries in Europe during late 1950s that did not relish the idea of relinquishing national sovereignty despite favouring free intra-group trade. They did not join the EEC at the time, rather they formed the EFTA under the Stockholm Convention of May 1960 where they adopted free trade within the group but maintained their own tariff while trading with third countries. Originally, there were seven member countries in the EFTA, namely, Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. However, in due course of time some of them left and joined the EU, while a few countries joined EFTA. Presently, there are only four members, namely Iceland, Liechtenstein, Norway, and Switzerland.

7.3.2 The American and Caribbean Schemes

The American continent has also witnessed economic integration schemes. They are either between two developed countries, between two or more developing countries, or between developed and developing countries. Some of them have not been successful, while others are doing well.

US-Canada Free Trade Agreement: In January 1989, a free trade agreement was signed between Canada and the United States of America with a view to eliminate tariff from bilateral trade in three stages during one decade. A tribunal was established to settle disputes in this respect. It was expected that in the wake of tariff reduction or elimination, trade would rise; and it did rise by over 60 per cent during the first decade. In 2000s, Canada's trade with the USA was as large as around 50 per cent of the former's GDP.

North American Free Trade Agreement (NAFTA): The NAFTA, embracing three member countries, namely, the United States of America, Canada, and Mexico, came into force from January 1994. In the wake of peso devaluation during 1995, there were some problems, but since 1996 it has regained strength. The grouping aims at dismantling trade barriers and liberalisation of government procurement rules and the rules concerning trade in services, intellectual property rights, and environment. The US and Canadian firms have reaped advantage from the cheap surplus labour of Mexico. This is one of the reasons that there has been large flow of investment from the US and Canada to Mexico. Moreover, intra-union trade has multiplied. Mexico became the largest user of US goods, only next to Canada. Mexican export to these countries rose primarily on account of intra-firm trade. However, there were strict local content requirements in case of trade availing of duty free provisions.

Andean Community: The Andean Community, initially known as the Andean Pact, was created in 1969 only after the Latin American Free Trade Association (LAFTA) failed to meet its desired objective. Initially, five countries, namely, Bolivia, Chile, Colombia, Ecuador and Peru were its members. Venezuela joined the community in 1973 but subsequently, Chile left the community. During the first two decades, the grouping did not fare well on account of political differences among the member countries. But in 1990, there was a revival as the members planned to create a free trade area by 1992, a customs union by 1994, and a common market by 1995. It is a fact that the implementation of these decisions is only partial, covering only a limited number of members and products, yet there has been expansion in trade with the revival of the integration scheme.

Southern Common Market (MERCOSUR): Initially, in 1991, the two members, namely, Argentina and Brazil, formed MERCOSUR, which expanded subsequently to cover Paraguay, Uruguay, Bolivia, and Chile; the last two being only associate members. It covers a large area and over one-half of the total economic output of Latin America. The group implemented common external tariff in 1995 and abolished tariff on intra-group trade in 1996. It is doing well as intra-group trade and investment has increased manifold.

Central American Common Market (CACM): The CACM was created in 1960 by the Treaty of Managua, with Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama as its members. The member countries had contemplated establishing a common market, but it could not be done due to civil war and bloody conflict between the Honduras and El Salvador. However, since 1991, the member countries have started stressing more on industrial deregulation, harmonisation of economic policies, and so on.

Free Trade Areas of Americas (FTAA): The scheme is still in the making, but when complete, it will cover the entire American continent, from extreme north to the extreme south, except Cuba. It will be the biggest regional grouping in the world covering different sets of economies. Around 30 countries have shown interest but the chances for comprehensive trade agreement are very little.

Caribbean Community and Common Market (CARICOM): Created in 1973, CARICOM gives special emphasis on the free movement of factors of production and free movement of tourists within the region that covers Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Kitts-Nevis, St Lucia, St Vincent, Suriname, and Trinidad and Tobago. Some of the member countries have eliminated tariff and established a common external tariff. But the process is yet to be completed.

7.3.3 Integration Schemes in Africa and the Middle-East

Economic Community of West African States (ECOWAS): The ECOWAS was formed in 1975, but remained quite inactive for the first one and a-half decades. It was only in 1992 that fresh initiatives were taken to establish a customs union and then a common market. It includes Benin, Burkina Faso, Cape Verde, Cote d'lvoire Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Nigeria, Senegal, Sierra Leone, and Togo. Guinea and Niger were suspended, respectively, in 2008 and 2009. The group is striving to give a final shape to its integration scheme, but the low rate of economic development and other economic problems in these countries are hindering the process.

Besides ECOWAS, there are some other regional grouping schemes in Africa. They are the Afro-Malagasy Economic Union, the East Africa Customs Union, the West African Economic Community, the Maghreb Economic Community, the Organisation of African Unity, the Southern African Development Community, and so on. All of them face the same fate, with poor economic infrastructure and low rate of economic development marring their progress.

Gulf Cooperation Council (GCC): The GCC was formed in 1980 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates as a defensive measure to counteract the expected threat from Iraq-Iran War. Its purpose was to deal with the regional groups of Europe such as EU and EFTA. It permits the citizens to move freely and own property freely within the region. It is more a political union than an economic union.

7.3.4 Economic Co-operation Schemes in Asia and Pacific

Association of South East Asian Nations (ASEAN): The ASEAN was formed in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Brunei joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999. The group officially formed the ASEAN Free Trade Area in 1993. It was decided that the tariff on intra-region trade was to be cut to 5 per cent by 2007, although the poorer countries could take even more time. The main objective of this grouping is to promote economic, social, and cultural development and safeguard political and economic stability in the region. The financial crisis during late 1990s had dampened the spirit of the member countries towards cooperation, but the recovery has definitely helped this grouping to perform well and achieve its objectives.

Asia-Pacific Economic Co-operation (APEC): Formed in 1989, it now covers 21 countries of Asia and the Pacific region, namely, Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, South Korea, Taiwan, Thailand and the United States of America. It expects to have free trade and investment by 2010, although the poorer countries may abide this norm by 2020. It has softened the restrictions on the movement of professionals in the region and has started simplifying custom procedures.

Association for South Asian Regional Co-operation (SAARC): The SAARC is a regional grouping scheme among seven South Asian countries, namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. The need for a economic cooperation scheme for this region had long been felt. As far back as in September 1978, the MargaInstitute of Colombo initiated discussions on the prospect of economic cooperation in this region. In 1980, the then President of Bangladesh, Zia-ur-Rahman proposed to hold a regional summit and circulated a paper to other member governments on the modalities for creating an institutional mechanism aiming at a common regional approach to international developmental issues and at removing regional disparities. The foreign secretaries of the seven countries met in Colombo in April 1981 and agreed on some basic principles of regional cooperation. They agreed to focus on matters of common interest, excluding from its ambit bilateral and contentious issues. A Study Group was set up for identifying the areas for possible cooperation. A long term programme of action was chalked out to assess the needs and resources, to prepare specific projects of regional nature, and to finalise the financing modalities.

The Heads of the seven States adopted the SAARC charter in Dhaka in December 1985, and the SAARC came into being with a secretariat at Kathmandu.

The second meeting of the Secretaries was held in Islamabad during August 1982. It endorsed the recommendations of the Study Group and resolved to ensure their speedy implementation. At the following three meetings in Dhaka and New Delhi, some preparatory steps were taken, leading to the meeting of the Foreign Ministers. The Foreign Ministers signed the Declaration on South Asian Regional Cooperation comprising the basic objectives and provisions for institutional and financial arrangements. On their recommendations, the Heads of the seven States adopted the SAARC charter in Dhaka in December 1985, and the SAARC came into being with a secretariat at Kathmandu.

At different annual summits, different issues related to economic development in the region were taken up and the necessary follow up actions were taken. In December 1995, the SAARC Preferential Trading Arrangement (SAPTA) became operational. During the first round of the SAPTA, the seven governments offered a consolidated schedule of 226 items for tariff concession. The depth of tariff cut ranged between 10 per cent and 100 per cent. At SAPTA II, which became effective from June 1997, the number of products involving tariff concession increased to 2013. At SAPTA III, which became operational from June 1999, concessions were multi-lateralised in all cases except those availed by the least developed countries of this region (Bangladesh, Bhutan, Maldives, and Nepal).

In January 2004, it was agreed that the South Asian Free Trade Area would function from 2006. A charter on social issues was signed and investment cooperation agreement was also signed.

The Ninth SAARC Summit held in Male during 1997 constituted the Group of Eminent Persons (GEP) for the purpose of a comprehensive appraisal of SAARC and to suggest measures to redress its functioning.

The GEP recommended, among other things, the creation of a South Asian Free Trade Area by 2008, a South Asian Customs Union by 2015, and a South Asian Economic Union by 2020. It also recommended, for the development of a common investment area, known as SAARC Investment Area, the establishment of the South Asian Development Bank; augmentation of the size of the South Asian Development Fund; coordination of the macroeconomic policies of the member governments, and many other plans for the socio-economic development of the region. However, the required political will is lacking owing to strained bilateral relations between some of the members. The 12th Summit of the SAARC, which was scheduled to be held in November 1999, was postponed sine die. Nevertheless, in January 2004, the SAARC Summit could be held in Islamabad, where some important decisions could be taken. The agreement on the South Asian Free Trade Area was concluded and it was agreed to implement it from 2006. A charter on social issues was also signed, which attempts inter alia to eradicate poverty from this region. Again, an investment cooperation agreement was signed, which should encourage intra-region investment in the near future.

The 13th Summit was held at Dhaka in November 2005 where poverty alleviation was stressed upon and the implementation of the SAFTA was ensured. The South Asian Free Trade Area (SAFTA) came into operation on the first day of 2006. The member countries have begun tariff reduction, which is expected to be complete within a decade. But it will not do much unless and until other problems relating to transportation, customs and infra-structure, etc. are sorted out. It is marked that over one thousand trucks are lined up at the Indo-Bangladesh border for four to five days simply for paper work. Indian goods take a sea-route to enter Pakistan. All this adds to the transportation cost. According to an UNCTAD estimate, the transaction cost in intra-SAARC trade is the highest in the world. It is around 15 per cent compared to only 3 per cent in ASEAN and EU. In fact, these are the reasons that the intra-region trade in South Asia is only 6 per cent of the total trade of the region compared to 70 per cent in Western Europe, 53 per cent in East Asia and Pacific, 40 per cent in North America, 18 per cent in Sub-Saharan Africa and 16 per cent in Latin America and Caribbean (Hindustan Times, 9.4.2007).

More recently, at the 14th SAARC Summit in New Delhi, the member countries agreed on a 25-point charter. The more important among them are establishment of a South Asian University, incorporation of trade in services into SAFTA, operation of a $ 300-million SAARC Development Fund, establishment of a telemedicine network, rationalisation of telecom tariff, taking up of basic issues, such as energy, food, environment, etc. Moreover, because Afghanistan is the eighth member of this regional grouping.

The 15th Summit held at Colombo in August 2008 resolved for initiating people-centric projects and for reviewing the SAARC Development

Goals by 2009. It also resolved for looking into the non-tariff barriers and para-tariff barriers so as to foster the objectives of the SAFTA.

SAARC: A Calendar of Events

1981 – Colombo	First formal meeting of the foreign secretaries of the region for venturing into institutionalised regional cooperation was held.
1983 – New Delhi	The second stage towards regional cooperation was marked with the convening of the meeting of the foreign secretaries. The Integrated Programme of Action (IPA) was launched here through the declaration of the South Asian Regional Cooperation (SARC).
1985 – Dhaka	The first SARC Summit was held and the heads of state or government decided to establish South Asian Association for Regional Cooperation (SAARC). For the first eight years of its existence, hardcore economic issues, such as trade, industry, money and finance were to be kept outside the scope of cooperation under SAARC.
1991 – Colombo	An Inter-Governmental Group (IGG) was set up to formulate an agreement to establish a SAARC Preferential Trading Agreement (SAPTA) by 1997.
1993 – Dhaka	The framework agreement on SAPTA was finalised. SAARC and UNCTAD signed a Memorandum of Understanding too.
1995 – New Delhi	SAPTA formally came into existence, well in advance of the date stipulated by the Colombo Summit. The SAPTA provided for a transition to a South Asian Free Trade Area (SAFTA). Earlier it was envisaged that SAFTA would be achieved by the year 2005. Three rounds of negotiations have taken place under SAPTA. In the last round of negotiations, a total of 3456 commodities were offered for tariff concessions.
1997 – Male	At the Summit, the heads of state or government decided to bring forward the date of achieving SAFTA to 2001.
1998 – Colombo	The tenth Summit decided that deeper tariff concessions should be extended to products which are being actively traded or are likely to be traded among members, in order to accelerate the progress in the next round of SAPTA negotiations.
2004 – Islamabad	Agreement on SAFTA, a charter on social issues and an investment co-operation agreement were signed.
2005 – Dhaka	Stress on Poverty alleviation and on the implementation of SAFTA.
2007 – New Delhi	Agreement on a 25-point programme.
2008 – Colombo	Taking up of people-centric projects and review of SAARC Development Goals by 2009. Resolution of NTBs and PTBs in order to make SAFTA more effective.

SUMMARY

- Trade and investment is also regulated at the regional level through the creation of regional economic cooperation/integration schemes. The economic integration may be of varying intensity/levels such as free trade area, customs union, common market, economic union, and political union.
- Regional integrative schemes make a definite impact on the intra-region trade and investment, although the impact varies slightly depending upon the nature and intensity of integration. Trade is created and diverted through inter-country and inter-commodity substitution. There are also dynamic benefits from regional integrative schemes such as widening of the size of the market, reaping of the economies of scale, etc. Building up of self-reliance among the member countries and increased foreign direct investment are the other benefits. However, if the different member countries are of varying economic strata, benefits may be polarised in favour of the well-off member countries leadings to intra-region inequality.
- Regional cooperation schemes are found almost in all parts of the globe. It was started in Europe during the 1950s. The European Union, including the European Monetary Union, is the biggest and the most important regional integrative scheme. These schemes have also been created in America, Africa and the Asia.

REVIEW QUESTIONS

1. Explain the different levels of regional economic integration.
2. Discuss some more important benefits and costs of regional economic grouping.
3. Comment on the recent developments in the European economic and monetary integration scheme.
4. Distinguish between trade creation and trade diversion as explained by Jacob Viner.

REFERENCES

Books

Balassa, B. (1962), *The Theory of Economic Integration* (London: George Allen & Unwin).

Dell, S. (1963), *Trade Blocs and Common Markets* (New York: Alfred A. Knopf).

Dosser, D. (1972), "Customs Unions, Tax Unions, Development Unions", in Bird, R. M. and J. G. Head (eds.), *Modern Fiscal Issues in Honour of Carl S. Shoup* (Toronto: Toronto University Press), pp. 86–104.

Edel, M. (1969), "Regional Integration and Income Redistribution: Complements and Substitutes" in Hilton, R. (*ed*.), *The Movement toward Latin American Unity* (New York: Praeger), pp. 185–202.

Meade, J. E. (1956), *The Theory of Customs Union* (Amsterdam: North Holland Publ. Co).

Mikesell, R.F. (1963), "The Theory of Common Market as applied to Regional Arrangements among Developing Countries" in Harrod, R.F. and D.C. Hague (*eds*.), *International Trade Theory in a Developing World* (London: Macmillan) pp. 205–29.

Scitovsky, T. (1958), *Economic Theory and Western European Integration* (London: George Allen & Unwin).

Shibata, H. (1967), "The Theory of Economic Unions, Free Trade Areas and Tax Unions" in Shoup G. (*ed*.), *Fiscal Harmonisation in Common Markets* (Columbia: Columbia University Press).

Strange, R. (1997), "Trading Blocs, Trade Liberalisation and Foreign Direct Investment", in Chryssochoidis, G. *et al* (*eds*.), *Internationalisation Strategies* (London: Macmillan) pp. 19–42.

Viner, J. (1950), *The Customs Union Issue* (London: Stevens).

Journals

Balassa, B. and A. Stoutjesdijk (1975), "Economic Integration among Developing Countries", *Journal of Common Market Studies*, XIV (1), 37–56.

Bhambri, R. S. (1962), "Customs Unions and Underdeveloped Countries", *Economia Internazionale*, XV (2), 235–58.

Bird, R. (1965), "The Need for Regional Policy in a Common Market", *Scottish Journal of Political Economy*, XII (2), 225–42.

Gehrels, F. (1956), "Customs Union from a Single Country Viewpoint", *Review of Economic Studies*, XXIV (1), 61–64.

Germanico Salgado Penaherrera (1980–81), "Viable Integration and Economic Co-operation Problems of the Developing World", *Journal of Common Market Studies,* XIX (2), 175–88.

Lipsey, R.G. (1960), "The Theory of Customs Union: A General Survey", *The Economic Journal*, LXX (2), 496–513.

Makower, H. and G. Morton (1953), "A Contribution towards a Theory of Customs Union", *The Economic Journal* LXIII (2), 33–39.

Samuelson, P. (1949), "International Factor Price Equalisation Once Again", *The Economic Journal*, LIX (233), 181–97.

Thorbecke, E. (1963), "European Economic Integration and the Pattern of World Trade", *American Economic Review*, LIII (Paper & Proceedings), 147–74.

Vaitsos, C.V. (1978), "Crisis in Regional Economic Co-operation (Integration) among Developing Countries: A Survey", *World Development*, VI (6), 719–69.

SELECT FURTHER READINGS

Robson, P. (1980), *The Economics of International Integration* (London: Allen & Unwin).

Tsoulakis, L. (1993), *The New European Economy* (Oxford: Oxford University Press).

Stoeckel, A. et al (1990), *Western Trade Blocs* (Canberra: Centre for International Economics).

* Indonesia is the world's largest LNG producer in 2005 and a leading LNG exporter. It had 97.8 trillion cubic feet (Tcf) of proven natural gas reserves as of January 2007. It produces LNG from it's Botang facility in Badak, East Kalimantan Indonesia. It's major exporters are Japan, South Korea and Taiwan.

This page is intentionally left blank.

Akihabara, Tokyo, Japan*

8

Political and Legal Environment

CHAPTER OBJECTIVES

The political and legal environment varies from one set of countries to the other. MNCs must be well acquainted with it for ensuring smooth operations. The present chapter attempts to:

- ✦ Explain the different forms of political and legal set-ups.
- ✦ Show how political and legal environment in the home country influences international business.
- ✦ Explain the nature of political risk MNCs often have to face in the host country.
- ✦ Describe how political risk is assessed.
- ✦ Explain how political risk is managed at the different stages of operation.
- ✦ Describe the move towards standardisation of legal issues across countries.

Besides the regulation of trade and investment at the national, regional and international levels, it is also the political and legal environment that plays a crucial role in international business. A firm cannot ignore the political situation and legal formalities existing either in the home country or in the host country if it has to operate successfully abroad. It is from this viewpoint that the present chapter discusses the various aspects of the politico-legal environment.

8.1 CONCEPT OF POLITICAL ENVIRONMENT

8.1.1 Political Diversity and Political Similarity

The political scenario in a country is the outcome of the interacting influence of various interest groups such as individual households, firms, politicians, bureaucrats, and many others. The stronger a particular interest group, the more prominent its ideology will manifest in the overall political scenario. In a country with federal character, where different interest groups are prominent at different levels, different ideologies exist side by side at the same juncture. The political scenario in different states may be different. Even at the centre, the political scenario may change with changes in the dominant interest group.

As opposed to diverse political environments in a particular country, a particular political ideology may be found in more than one country. It is because the ethnic background, language, religion, and so on bring many countries within the fold of one common political ideology. For example, it was the ethnic consideration that brought Serbs of the neighbouring regions into one political umbrella known as Greater Serbia. Thus, political environment is marked by, both, diversity and uniformity.

8.1.2 Democracy Versus Totalitarianism

A democratic political system involves citizens directly or indirectly, in the policy formulation of a country.

The political scenario often varies between the two extremes—democracy on the one hand and totalitarianism on the other. The purest form of democracy represents direct involvement of citizens in policy making. This is because, the democratic set-up is "of the people, for the people, and by the people". The Greeks experimented with pure democracy many centuries ago when all citizens participated freely in the political process. But with growing time and distance barriers over time, it did not remain feasible for all citizens to participate in the political process; and as a result, democracy turned into a representative democracy where only the elected representatives have a say in political decisions. Whatever may be the form of democracy, the people enjoy fundamental rights of various kinds of freedom and civil liberties. However, in parliamentary democracy, political decisions are influenced by widely varying interest groups. On the contrary, they are comparatively centralised in presidential democracy, although the head of the government is an elected representative.

Totalitarianism, at the other extreme, represents monopolisation of political power in the hands of an individual or a group of individuals with virtually no opposition. The policy is simply the dictates of the ruler. Constitutional guarantee are denied to the citizens. Germany under the rule of Adolf Hitler and Stalin's Soviet Union were historical examples of a totalitarian regime. Presently, Cambodia, China, Cuba, Democratic Republic of Congo, and Myanmar are examples of totalitarian governments.

Totalitarianism is a political system where political power lies in few hands with virtually no opposition.

Forms of Political Systems

- Democracy
  1. Parliamentary democracy
  2. Presidential democracy
- Totalitarian system
  1. Secular totalitarianism
  2. Theocratic totalitarianism
- Mixed political system with elements of both democracy and totalitarianism

Totalitarianism may represent either a theocratic government or a secular government. In the former, it is the religion that dictates the political philosophy. For example, Iran and a large part of Afghanistan controlled by pro-theocracy clergymen come under this group. On the contrary, in secular totalitarianism, political leaders rely either on military power or bureaucratic power. One form of secular totalitarianism is communism, which does not differentiate between the economic and the political bases of the government. It institutes a socialist economic system where the State owns and operates economic activities. East European countries set earlier an example of communism. The other form of secular totalitarianism is a tribal government when one ethnic group dominates the national identity. The other ethnic groups remain only silent spectators. Kenya, Burundi, Nigeria, and Rwanda are the examples of tribal totalitarianism.

In real life, neither the purest form of democracy nor the purest from of totalitarianism is found. In the United Kingdom and the United States of America which are emblems of democratic institutions, many restrictive political decisions are taken, while in China's communist regime, foreign investors play a free role in the special economic zones. It is, thus, the mixture of the two extremes in varying proportions that is found in different countries. Higher doses of democracy in the mixture make a country politically free. On the other hand, a higher proportion of totalitarian element in the mixture reduces freedom. Adrian Karatnycky (1995) surveys a large number of countries and groups and divides them into three categories, such as free, partly free and not free. The survey identifies

Australia, Bahamas, Belgium, Canada, Chile, and so on as free countries; Brazil, Burkina Faso, Cambodia, and so forth as partly free; and Algeria, China, North Korea, Nigeria, and some others as not free countries.

8.2 HOME COUNTRY PERSPECTIVE

It is true that firms move to a country with a stable political and less restrictive legal environment. So the political and legal environment prevailing in the host country is much more significant. But it does not mean that such an environment is not important in the home country. This is why the home-country perspective is dealt with first and then the host-country perspective will be discussed at greater length.

The political and legal environment in the home country may be encouraging. For example, the Indian government has announced incentives and has eased procedural formalities for the overseas operation of domestic firms. It has also encouraged export activities. If this is the home country environment, it will have a positive impact of the internationalisation of Indian firms.

Embargo is the complete prohibition of trade. Sanctions are not so broad in coverage but they also distort trade.

However, the political and legal environment in the home country is not always encouraging. It is often restrictive. The restrictions are manifest in various types of curbs on export and other forms of business. The extremely intense curb on export is manifest in the form of sanctions and embargo. Embargo is the complete prohibition of trade. Sanctions are not so broad in coverage as embargoes are, but they also distort trade in various ways, such as negation of trade financing or prohibition of high technology trade, and so on. Whatever the manifestation may be, the factor behind it is political and the purpose behind it is to compel the country in question to follow peace. Sanctions and embargoes are not very rare. There were as many as 46 between 1971 and 1983 (Hufbauer and Schott, 1984).

Sanctions and embargoes are not so frequent. More frequent are the *subtler forms of export restrictions*. A country puts certain items on the prohibited list of exports or the restricted list of exports. Such restrictions involve products that are important from the viewpoint of national security. However, the explanation of national security differs from one country to another. For example, German government feels that Patriot missile is made up of simple parts that can be exported (Czinkota, et al, 1999). Others may not think so.

It is not only trade. The home government, sometimes imposes restrictions on other forms of business too. In some countries, anti-trust laws are strictly implemented. The government does not allow national firms to move abroad if they lead to thwart competition. Again, some governments discourage their national firms from involving themselves in corruption and bribery in foreign countries. In some of the developing countries, foreign investment is approved in many cases where the bureaucrats or politicians demand some kind of benefit. If, in such cases, the home government does not allow the firms to be involved in bribery, international business is adversely affected (Elliot, 1997). Yet again, in some home countries, environmental protection is given the top priority, even if it is not so in the host country. In such cases, the home government does not allow the firms to move to such host countries. For example, the US government is against the cutting of forests for environmental reasons. But in Brazil, cutting of rain forest is allowed. In such cases, US firms cannot move to Brazil in this area of business. These are just some aspects of home country regulations. There are many more that affect international business.

8.3 HOST COUNTRY PERSPECTIVE

Firms moving abroad are well acquainted with the political and legal environment prevailing in the home country. But they are not necessarily in touch with those of the host country, particularly when different host countries have different environments. This is why there is always some risk involved in international business on account of differing political scenarios in host countries. This is known as political risk, which needs proper management for a successful international business operation. In other words, the study of political and legal environment in international business is essentially the study of political risk evaluation and management.

8.3.1 Meaning and Forms of Political Risk

Let us first explain what political risk is. There is no precise definition. However, in Thunell's view (1977), political risk is said to exist when sudden and unanticipated changes in political set-up in the host country lead to unexpected discontinuities that bring about changes in the very business environment and corporate performance. For example, if a rightist party wins election in the host country and the policy towards foreign investment turns liberal, it would create a positive impact on the operation of MNCs. On the other hand, if a left party comes to power in the host country, it will have a negative impact on the operation of MNCs. It is the negative impact that is normally the focus of attention of transnational investors.

> Political risk is unanticipated changes in political set-up in the host country leading to unexpected discontinuities that bring about changes in the very business environment.

For a long period, political risk was narrowly interpreted in terms of expropriation of assets. But for the past few decades, the coverage of political risk has come to be wider, also including risk from ethnic, racial, religious or civil strife, political corruption, and blackmail. Czinkota (1999) classifies political risk as (1) ownership risk, (2) operating risk and (3) transfer risk. Ownership risk exposes property and life. Operating risk includes interference of the host government with the ongoing operations of the firm. Transfer risk concerns the transfer of funds, either to home country or to any other country. Stephen Kobrin (1982) classifies political risk as:

1. Macro risk or country-specific risk, and
2. Micro risk or firm-specific risk.

The macro political risk affecting all foreign firms in a country emerges on account of expropriation, ethnic and other strife, currency inconvertibility, refusal of debt, and so on. The micro political risk affecting a particular industry or firm emerges on account of conflict between the bonafide objectives of the host government and the operation of the MNC or on account of corruption, which has become a way of life in many countries. Some of the forms of political risk are explained here.

Expropriation: Expropriation means seizure of private property by the government. Confiscation is similar to expropriation, but the difference between the two is that while expropriation involves payment of compensation, confiscation does not involve such payments. International law provides protection to foreigners' property. It provides for compensation in case of unavoidable seizure. But the process of compensation is often lengthy and cumbersome. The firm usually requires going-concern value tied to the present value of lost future cash flows. On the other hand, the government prefers depreciated historical book value, which is lower in the eyes of the firm.

Expropriation and Confiscation refer to seizure of private property by government. Expropriation involves payment of compensation while confiscation does not.

The reason behind expropriation has mainly been political turmoil or specific political ideology. In the post-war period, foreign and domestic firms were nationalised in China and Eastern Europe after the imposition of communist regime. The same factor was responsible for nationalisation of private sector firms in Cuba in 1960. However, it is sometimes economic compulsion motivating expropriation. The Swedish government nationalised the ship-building industry at a time when this industry was hit hard by worldwide recession (Walters and Monsen, 1981). An estimate reveals that around 12 per cent of all foreign investment made in 1967 was nationalised within less than a decade (Jodice, 1980).

There are still subtler forms of expropriation. For example, when Colonel Qadaffi headed Libya in 1969, wages were increased as well as taxes were revised upwards. Bank accounts of ESSO were seized and the government acquired majority interest in the foreign enterprise (Schnitzer, et al, 1985).

Host government enacts law prohibiting foreign companies from taking their money out of the country.

Currency Inconvertibility: Sometimes the host government enacts law prohibiting foreign companies from taking their money out of the country or from exchanging the host country currency for any other currency. This is a financial form of political risk. The reasons are both economic and political. Economic factors are concerned with the balance of payments problem. The political factor manifests in drastic changes in the internal politics of the country. The Government of Nigeria imposed such restrictions a couple of decades back in order to serve its economic and political objectives.

Refusal to honour a financial contract with a foreign company is credit risk.

Credit Risk: Refusal to honour a financial contract with a foreign company or to honour foreign debt comes under this form of political risk. The reason is sometimes economic, like when Mexico expressed its inability to repay its debt in the early 1980s. But sometimes the political reasons are more prominent. When Khomeini came to power in Iran, the Iranian government refused to pay its debt on grounds that loans were taken during Shah's regime (Micallef, 1981).

Risk from Ethnic, Religious, or Civil Strife: Macro political risk arises on account of war and violence and racial, ethnic, religious, or civil strife within a country. Recent examples of such risks are slaughter in Bosnia and Herzegovina, break-down of local authority in Somalia and Rwanda, the upsurge of Islamic fundamentalism in Algeria and Egypt, and many more. Such developments become major political risks for MNCs operating in these countries.

Conflict of Interest: The interest of MNCs is normally different from the interest of the host government. The former manifests in the maximisation of corporate wealth, while the latter is evident in the welfare of the economy, in general, and of the citizens of a constituency, in particular. It is the conflicting interest that gives rise to micro political risk. To elaborate on the nature of conflict, it may be said that the host government desires to have a sustainable growth rate, price stability, comfortable balance of payments, and so on, but the policy of MNCs operating there is sometimes found interfering with the smooth implementation of the policy. For example, transfer of funds by MNCs may influence the money supply and may cause inflation or deflation. MNCs may adopt transfer pricing techniques that may cause loss of tax revenue. Similarly, the payment of exorbitant amount of royalty, and other such dues by the subsidiary may worsen the balance of payments.

It is not simply the economic issues that are the source of conflict. There are also non-economic issues such as national security, and so on. The US government did not permit the Japanese purchase of Fairchild Industries on the grounds of national security.

Corruption: Corruption is endemic in many host countries, as a result of which MNCs have to face serious problems. McNulty (1994) gives an example of Cambodia, where greedy bureaucrats created problems for foreign firms. Foreign firms in Kenya had to sell a part of the equity to powerful politicians there (Eiteman, 1995). Transparency International has surveyed 85 countries and has brought out the Corruption Perception Index. Many countries rank high on this index. This is perhaps the reason that in February 1999, 34 countries, including the OECD members, and five others signed a convention to ban bribery of foreign public officials in international business transactions (*The Economic Times*, 1999).

> OECD members, and five others signed a convention to ban bribery of foreign public officials in international business transactions.

8.3.2 Evaluation of Political Risk

Assessment of political risk is an important step before a firm moves abroad. It is because if such risks are very high, the firm would not like to operate in that country. If the risk is moderate or low, the firm will operate in that country, but with a suitable political-risk management strategy.

But any such strategy cannot be formulated until one assesses the magnitude of political risk. The ways of assessment may be either qualitative or quantitative.

Qualitative approaches involve inter-personal contact. Persons may come from within the enterprise or may come from outside the firm.

Qualitative Approach: Qualitative approaches involve inter-personal contact. Persons are often available who are well acquainted with the political structure of a particular country or region. They may come from within the enterprise, particularly those who are posted in that area. They may come from outside the firm—from academic institutions or from foreign offices of the government or from the field of journalism, especially correspondents in that area. Despite the fact that different persons present different versions of the same fact, this approach has become common. Kraar (1980) has cited the example of Gulf Oil, which hired persons in government and from universities to find out whether investment in Angola would be safe. The experts said "yes" and the investment turned out to be a successful venture even in the Angolan Marxist regime.

Sometimes a company sends a team of experts for on-the-spot study of the political situation in a particular country. This step is taken only after a preparatory study yields a favourable feature. This method gives a more reliable picture but it is always subject to availability of correct information from the local people in the host country.

The qualitative approach also involves the examination and interpretation of diverse secondary facts and figures. Future trends are assessed based on the past trends of events (Kramer, 1981). For this purpose, companies maintain an exclusive risk analysis division. Exxon is a case in point that developed relation with specific influence groups such as politicians, labour unions, and the military that influence the political stability of the country (Schnitzer, 1985).

Quantitative Models of Political Risk: Quantitative tools are also used to estimate political risk. American Can uses a computer programme known as primary risk investment screening matrix involving about 200 variables and reducing them to two numbers. It represents an index of economic viability as also an index of political stability. The variables include, in general, frequency of changes in government, level of violence in the country, number of armed insurrections, conflicts with other nations, and economic factors such as inflation rate, external balance deficit, growth rate of the economy, and so on.

Robert Stobaugh (1969) uses a decision-tree approach to find out the probability of nationalisation. He begins his analysis from the very contention whether there will be change in the government. If there is change, the new government may or may not opt for nationalisation. If it does opt for nationalisation, the question of whether it will pay adequate compensation arises. Thus, in each possible event, there are many possible sub-events. Probabilities of the events occurring are indicated along the tree branches. Probabilities are multiplied along the branches and then they are summed up.

Example: There is 50 per cent probability of change in government and 50 per cent probability for no change in government. If the government changes, there is 40 per cent probability for nationalisation and 60 per cent probability for no nationalisation. Again, if there is nationalisation, there is 60 per cent probability for adequate compensation and 40 per cent probability for inadequate compensation. With these figures, the probability of nationalisation without adequate compensation would be:

$$0.5 \times 0.4 \times 0.4 = 0.08.$$

Harald Knudsen (1974) uses comparatively measurable variables and not very subjective ones. Notable among his variables are the: degree of urbanisation, literacy rate, degree of labour unionism, national resource endowment, infant survival rate, calorie intake, access to civic amenities, per capita GNP, and so on. Basing on these variables, he measures the national propensity to expropriate. It is found that Knudsen's measure successfully identified nationalisation in some Latin American countries.

Haner (1979) uses a scale beginning from zero to seven in order to rate political risk. He groups the factors leading to political risk into two parts—internal and external. Internal factors are: (1) fractionalisation of the political spectrum, (2) fractionalisation of the social spectrum, (3) restrictive measures required to retain power, (4) xenophobia, (5) socio-economic conditions, (6) strength of radical left government. Similarly, the external factors are: (1) dependence on a hostile major power, and (2) negative influence of regional political forces.

After adding up the rating points, if the total is 19 or below, Haner is of the view that the political risk is only minimal. If the total lies between 20 and 34, the risk may be acceptable. If the total lies between 35 and 44, the risk is suppose to be very high. Lastly, if the total exceeds 44 rating points, it is not advisable to invest in that country.

Again, Euromoney (1993) takes into account three types of indicators for rating. The first is the economic indicator, which comprises the debt service ratio, current account deficit/GNP ratio, and external debt/GNP ratio. This indicator has 40 per cent weight. The second indicator is known as the credit indicator, which embraces debt service record and ease of rescheduling. It has 20 per cent weight. The third is known as market indicator, which has a 40 per cent weight. It includes access to bond market, sell down of short term papers, and access to forfeiting market.

The Euromoney formula ranks countries from the highest risk to the lowest risk. The ranking is formulated as follows: the highest figure in each category receives full marks for weighting. On the other hand, the lowest receives zero. The scores for other figures are calculated proportionately, according to the following formula:

$$X\left[\frac{(ED_X - 1)}{\left(1 + ED_X\right)}\right] + M\left\{\frac{\left[ED_m \times \left(1 + \frac{1}{ES_m}\right)\right]}{\left(ED_m + 1\right)}\right\} > 0$$

Simon (1982) provides a predictive analysis, which he calls an early warning system. The technique involves the selection of lead indicators that would presage the emergence of a particular political risk. For example, continued demonstration and riots may lead to internal disorder and to overthrow of the government. The early warning may be country-specific or industry-specific. In both the cases, the lead indicators are monitored and the results are communicated to the management for evolving adequate strategy.

There are some other rating methods. However, MNCs should not rely heavily on these ratings. It is because the ratings do not include an in-depth analysis necessary for investment decision. Individual countries must be assessed in details.

8.3.3 Management of Political Risk

Primarily, as Gregory (1989) feels, there are two approaches to political risk management. While one is known as defensive approach, the other is known as integrative approach. The former aims to protect and preserve the firm's strength through reducing its dependence on a single subsidiary. Borrowing from the host country sources or obtaining guarantee from the host government, minimising the role of host country nationals in the management, concentrating on R&D in the home country, maintaining a single global trademark are some of the steps related to the defensive approach. On the contrary, the aim of the integrative approach is to make the foreign unit an integral part of the host country. Employment in large measure of local personnel, developing proximity with the political elite, use of local distributors and professionals are some of the steps of the integrative approach.

The experience shows that majority of the international companies adopt a mix of the two approaches in varying proportions. While a global firm emphasises on the defensive approach, a multi-domestic company adopts more of an integrative approach.

The political risk management strategy depends upon the type of risk and the degree of risk the investment carries. It also depends upon the timing of the steps taken. For example, the strategy will be different if it is adopted prior to investment from that adopted during the life of the project. Again, it will be different if it is adopted after expropriation of assets.

Management Prior to Investment: Investment will prove a viable venture if political risk is managed from the very beginning—even before the investment is made in a foreign land. At this stage, there are five ways to manage it.

1. In the first method, the factor of political risk is included in the very process of **capital budgeting**, and the discount rate is in-

creased. But the problem is that it penalises the flows in the earlier years of operation, whereas the risk is more pronounced in the later years.

2. The risk can be reduced through **reducing the investment flow** from the parent to the subsidiary and filling the gap through local borrowing in the host country. In this strategy, it is possible that the firm may not get the cheapest fund, but the risk will be reduced. The firm will have to make a trade-off between higher financing cost and lower political risk.
3. Can political risk also be reduced by negotiating **agreements with the host government?** If the investing company undergoes an agreement with the host government over different issues prior to making any investment, the latter shall be bound by that agreement. Ordinarily, it will not back out from the agreement.
4. **Planned divestment** is yet another method of reducing risk. If the company plans an orderly shifting of ownership and control of business to the local shareholders and it implements the plan, the risk of expropriation will be the minimal. In fact, the very plan is negotiated with the host government at the very beginning of investment.
5. Political risk can also be reduced by the **insurance of risk.** The investing firm can be insured against political risk. Insurance can be purchased from governmental agencies, private financial service organisations, or from private property-centred insurers. The programmes for insurance are either multilateral or bilateral in character. The Foreign Credit Insurance Association and Overseas Private Insurance Corporation are bilateral agencies located in the United States of America.

Planned divestment refers to gradual shifting of ownership of company to local shareholders.

At the multilateral level, it is the Multilateral Investment Guarantee Agency (MIGA), set up in 1988 as a sister unit of the World Bank that covers the non-commercial risk. MIGA insures *eligible projects* against losses relating to *currency transfer restrictions*, *expropriation, war and civil disturbance* and *breach of contract*. It resolves potential investment disputes before they reach claim status. Its guarantee helps investors to obtain project finance from banks.

Since 1997, MIGA has successfully used reinsurance to leverage its guarantee capacity, manage the risk profile of its portfolio and foster the growth of the private political risk insurance market. Whenever a project exceeds MIGA's own capacity, it reinsures itself, through a *syndication process*, with private and public sector (re)insurance companies in order to meet its clients' needs. MIGA's main programs are facultative reinsurance and the *co-operative underwriting program* (CUP). So far, MIGA has attracted more than $2 billion in capacity through facultative reinsurance and $0.6 billion in capacity through the CUP. Besides, MIGA provides technical assistance to projects to help them come up to the investors' requirements.

Beginning from 1990 to the end of June 2009, 952 guarantee contracts were signed by MIGA that covered 99 countries and that involved $20.9 billion. The trend in the recent years is shown in Table 8.1.

Table 8.1 Guarantee Contracts Issued by MIGA: 2005–2009

Year	*No. of Guarantees*	*Projects Covered*	*Amount of Guarantee ($ bill)*	*Gross Exposure ($ bill)*
2005	62	41	1.2	5.1
2006	46	41	1.3	5.4
2007	45	29	1.4	5.3
2008	38	21	2.1	6.5
2009	30	26	2.4	7.3

Source: Based on MIGA Annual Report: 2009

Risk Management during the Life Time of the Project: Management of risk during the pre-investment phase lessens the intensity of risk, but does not eliminate it. So the risk management process continues even when the project is in operation. There are four ways to handle the risk in this phase.

In case of concession agreements, the government of the host country retains ownership of the property and grants lease to the producer.

1. The first method is the **joint venture and concession agreement.** In a joint venture agreement, the participant are local shareholders who have political power to pressurise the government to take a decision in their favour or in favour of the enterprise. In case of concession agreements that are found mainly in mineral exploration, the government of the host country retains ownership of the property and grants lease to the producer. The government is interested in earning from the venture and so it does not cancel the agreement. However, this is not a permanent solution. When the technology becomes standardised, the host government often cancels the agreement. Again, if a new government is formed, there is every possibility of the cancellation of agreements concluded under the previous regime.
2. Risk can also be managed with **political support.** International companies sometimes act as a medium through which the host government fulfils its political needs. As long as political support is provided by the home country government, the assets of the investing company are safe. However, such a relationship may change and the political alliance may be disturbed when a new government is formed.

Structured operating environment creating a linkage of dependency between the operation of the firm in high risk country and the operation of other units of the same firm in other countries.

3. The third method is through a **structured operating environment.** Political risk can be reduced by creating a linkage of dependency between the operation of the firm in high risk country and the operation of other units of the same firm in other countries. If the unit in a high risk country is dependent on its sister units in other countries for the supply of technology or raw material or for marketing of its products, the former

is normally not nationalised so long as dependency is maintained. It is because the high risk unit will not be in a position to operate without the imported technology or raw material. In fact, this was an important reason for the fearless operation of international oil companies in the Middle East for a long time. But, when the host governments in the Middle East came to possess the necessary skill, many of the oil companies were nationalised.

4. **Anticipatory planning** is also useful tool in risk management. It is a fact that the investing company takes necessary precautions against the political risk prior to the investment or after the investment. But it is of utmost significance that it should plan the measures to be taken quite in advance. Gonzalez and Villanueva (1992) call it crisis planning. They give an example of the Philippines during the Marcos' regime. Years before the 1986 revolution, the foreign companies began to foresee the fall of Marcos regime. They began assessing every move of the opposition in the country and they took necessary measures well in advance.

Risk Management Following Nationalisation: Despite care taken by the international firms for minimising the impact of political risk, there are occasions when nationalisation takes place. In such cases, the investing company tries to minimise the effects of such a drastic measure. There are many ways to do it.

1. The investing company **negotiates** with the host government on various issues and shows its willingness to support the policy and programmes of the latter. Sometimes the investing company foregoes majority control in order to please the host government (Hoskins, 1970).
2. On failure of negotiation with the host government, the investing company tries to put **political and economic pressure.** Embargo on trade is one of the examples. But there are occasions when such pressures deepen the rift. Thus, firms should be cautious before taking such measures.
3. If nationalisation is not reversed through negotiation and politico-economic pressure, the firm goes for **arbitration**. It involves the help of a neutral third party who mediates and asks for the payment of compensation. But there are cases when the host government does not honour the verdict of the arbitrator.
4. When arbitration fails, the only way out is to **approach the court of law**. The international law suggests that the company has, first of all, to seek justice in the host country itself. If it is not satisfied with the judgement of the court, the company can go to the international court of justice for fixation of adequate compensation. However, there are occasions when the host government has failed to honour the verdict of the court. For example, the Cuban Government failed to pay compensation to US companies expropriated during 1959–1961 (Globerman, 1986).

8.4 LEGAL ENVIRONMENT

8.4.1 Legal System

A country's legal system, which embraces its law and regulations, is closely related to its political system. For example, in a totalitarian political set up, the laws favour state ownership of industries. In a free political set up, on the other hand, laws tend to encourage private initiatives. Again, in free countries, laws are quite independent of political control, while they are a part of the political policy in totalitarian or semi-totalitarian regimes. In other words, political environment shapes the legal environment and legal environment influences international business. The strategy of a firm will be different in a country with no restrictive regulations as compared to that in a country with too many restrictive regulations.

Civil Law is a system of law where rules and regulations are written in detail.

Common Law is a law based largely on interpretation, tradition and precedence.

Theocratic Law is a law based primarily on religious preaching.

On the global level, there are broadly three types of legal systems. The first is known as civil law, which had originated in Rome as far back as in the 5th century BC. It is marked with a detailed set of written rules and regulations, with the result that there is seldom any interpretation of the law by the court. Civil law is usually found in Central and South America, some West European countries and some Asian and African countries.

The second is known as the common law, which originated in England as back as in the 11th century. In this case, there is ample scope for the interpretation of law by the court. The interpretation is based on tradition and precedence. And so, a particular law can be interpreted in different ways in different cases. If the interpretation is novel, it can set precedence for subsequent similar cases. In this way, this legal system is more flexible than civil law. Common law is found usually in the United Kingdom, the United States of America, Australia, Canada, and in some parts of Asia and Africa.

The third is the theocratic legal system. In this case, law is based on religious teachings. The most important example of theocratic law is Islamic law, which is based on the Koran or the sayings of Prophet Mohammad. Islamic law was initially a guiding factor for ethical behaviour, but subsequently it was extended to commercial transactions. Under this law, a bank cannot demand interest on its loan, nor it can pay interest on deposits. So it will be difficult for international banks to operate in countries adopting Islamic law.

8.4.2 Principles of International Business Law

The international business law embraces the law of different countries as well as the bilateral and multilateral treaties and conventions. The principles governing international business law are as follows:

1. Rules of sovereignty and sovereign immunity
2. Rules related to international jurisdiction

3. Doctrine of comity
4. Rules related to aliens

Sovereignty of state means that every state has complete freedom and power to govern. Sovereign immunity means that the court of a particular country does not have the jurisdiction to settle dispute and impose punishment in any other country. If the government of a country expropriates the property of a foreign company, it cannot be questioned in the courts of the home country, although there can be negotiation between the company and the host government.

However, there are some exceptions under the concept of international jurisdiction. It involves the nationality principle as per which an Indian manager involved in corrupt practices abroad can be tried in India. Moreover, under the concept of protection, every country has jurisdiction over any kind of behaviour that entails upon national security, even if such conduct is committed abroad or by a foreign citizen.

The doctrine of comity states that each country should have respect for the other country's law. In fact, it is a normal custom that different countries and governments maintain. Again, a government can refuse to admit foreign citizens and can limit the area for their conduct. The government has the right to deport them. Thus, equality between a domestic citizen and a foreign citizen cannot be presumed under the international law.

8.4.3 Wide Variance in National Business Laws and the Issue of Legal Standardisation

There are many areas where the national business law differs widely and that causes irk to the international business managers. To mention a few of them, for example, the provisions of anti-trust law differ widely from one country to the other. Again, the financial laws vary widely. There are cases where the majority of the assets of a company lie in one country but a large share of the liabilities is related to some other country. If the law of the two countries differs, there will be a serious problem for the company while managing liquidation. Yet again, there may be trade disputes depending upon different rules followed in different countries. Similarly, MNCs find it difficult to protect intellectual property rights in a country where the laws are implemented loosely.

However, these problems can be controlled with the standardisation of legal issue across countries. Such efforts are afoot, although it is a very lengthy process and moreover, the political and the business environment in different countries are different with the result that many governments may not reach a consensus. Sometimes legal issues of global importance are dealt with differently in different countries, and they have an adverse impact on international business. This is why some international or the regional agencies are trying to bring about standardisation or uniformity with regard to such issues in respect of them. The WTO has made a move in this regard. The European Union too has brought about standardisation of some of the legal issues among member countries. Two of the more important of these legal issues are intellectual property rights and taxation.

Intellectual Property Rights: Intellectual property is a property that is the outcome of the people's intellectual talent and abilities, for example, specific designs, formula, and so forth. Since this type of property helps generate income, those developing the designs and formula need some sort of protection under the law so that they are able to generate income over a long period of time.

Intellectual property that embraces industrial property and copyrights, is protected through patents and trademark.

Intellectual property embraces industrial property and copyrights. Industrial property stands protected under the Paris Convention, to which around 100 countries are the signatories. It is normally protected through patents and trademarks. A patent is a sort of protection granted to the inventor of the product or the process that does not allow others to make use of such inventions. Trademark is a symbol that differentiates a product from similar products. So long as the symbol is there, the product continues to remain differentiated. Similarly, copyrights are related to published material and they protect the publication from being copied.

There are laws for patents and trademarks in many countries, but in most of the cases, they are very liberal and so ineffective. Wild et al (2000) have mentioned how these laws are broken in a number of countries. In their opinion, illegal copies of software accounted for 27 per cent of the US domestic market, for 96 per cent of the Chinese market, and for 99 per cent in Ukraine. Thus, in order to provide effective protection to intellectual property rights and to encourage international firms to operate overseas, the WTO has made an attempt to standardise such laws. Under the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS), this international organisation has set minimum standards of protection that each member nation has to provide. It grants patents for a period of twenty years, which begins from the date of filing of patent application with the country's patent authorities.

Taxation: Taxation is another aspect where efforts are afoot to standardise rates. International firms move to a country where, among other things, the tax rate is low. In case the tax rate is high, these firms adopt transfer pricing in order to siphon off the before-tax profits to a country where tax rate is low. Alternatively, they transfer their dividends to be received from subsidiaries to tax haven countries. All this may be in the interest of the firm, but certainly has a negetive affect on the interests of the host country government or the home country government. Sometimes it becomes the bone of contention between the government and the firm, which has an adverse impact on foreign investment. Thus, in order to avoid these malpractices, the Organisation of Economic Cooperation and Development (OECD) has requested the government of the tax haven countries to equate the tax rate with that prevailing in the OECD countries.

SUMMARY

- The political and legal environment are important factors that influence international business, especially when they are different between the home country and the host country. Political set up vary widely between the two extremes—democracy on the one hand and totalitarianism on the other. The existence of civil rights and fundamental rights is seen in democracy, while totalitarianism represents monopolisation of political power. Normally, different countries are found blending the features of these two extremes.
- Again, the legal system is largely dependent on the political set up. In a free political set up, private initiatives are encouraged, while state ownership is common in totalitarian system. The legal system is based on civil law, common law, or on religious laws.
- When the home country has a liberal legal syatem, trade and investment find least restrictions. In a restrictive legal system there are curbs on trade and investment. There are different modes of restrictions, beginning from embargo and sanctions to less restrictive modes.
- The host's country legal and political system is normally not fully known to international investors and so there is always some amount of political risk prevailing in the host country. The risk may be of micro or macro nature, manifesting in expropriation of assets, currency inconvertibility, credit risk, risk of ethnic and religious strife, corruption, and so on. The first step is, therefore, to evaluate such risks either qualitatively or quantitatively or both.
- If political risk exists, it needs proper management. It can be managed even before making investment through its incorporation in the capital budgeting technique, negotiations, planned divestment, insurance, and so on. During the life time of the project, it can be managed through anticipatory planning, economic and political support, structured operating environment, and so forth. If the assets are expropriated even thereafter, various steps such as negotiation, arbitration, and in and out-of-court settlement may be taken.
- Again, for making the legal system smooth, standardisation of legal issues can be attempted. A few international institutions have taken up this matter.

REVIEW QUESTIONS

1. How is a totalitarian political set up different from a democratic political set up?
2. Explain the different types of legal system.
3. How does the home country government restrict international business?

4. What is political risk? How is it assessed? What are the different modes of its management?
5. Comment on the standardisation of legal issues.

Study topic

Corruption in International Business

Corruption is simply unethical. It is also treated as a form of political risk related to international business. There are thousands of corruption cases reported in the newspaper. As reported, the senior officials of a global giant automobile company had sought to profit through having undisclosed shareholding in an Angolan company. Similarly, money was reported to have flowed into the hands of some middlemen in India for a comfortable location of the plant of the same automobile company. Some fabulous parties were arranged costing $1.1 million and they were shown as the company's expenditure. These are the events related to a single company. Many such examples are found. Now, the question is how does bribing affect the home country or the host country. The host country does not get the best possible technology because bribing helps the inferior technology to flow to it. The competitors in the home country do not get the contract if they do not bribe. A survey has been made by Control Risks Group Limited alongwith Simmons and Simmons which reveals that over 40 per cent of the 350 multinational corporations in the sample did express such views. Again, bribe helps to raise the cost of the project, as it is found in the survey, the magnitude of the bribe varies from 5 per cent to 25 per cent of the project cost. In construction, it was estimated at 29 per cent.

The issue is not confined to a particular country/company or to a particular sector. Hong Kong companies, as reported in the survey, were on the top. Over three-fourths of the respondents expressed such views. Again, bribing is found common in construction, pharmaceuticals, financial services, etc. Even defence sector has not remained untouched.

Again, the question is whether the international companies are really concerned about such practices. On one extreme, there is a belief that corruption should thoroughly be investigated, authorities should be informed and appropriate punishment should be prescribed. Some of the Dutch companies were found pulling out of their proposed investment because bribe, they thought, would tarnish their image. But, on the other extreme, there are views that corruption is a part of business and there should be no problem, especially when the authorities themselves are involved in such practices.

If corruption is unethical, there should be enactment to control it. In almost all the countries, there are laws that deal with corruption cases and that prescribe punishment. But the problem is that majority of the senior officials of the companies are not fully aware of such laws. The governmental machinery in many countries is too weak to curb corruption. In many countries, the government does not review the legal mechanism and no effort is made to make it more stringent. In many cases, the law becomes ineffective because the bribing company proceeds through a middleman. The company simply denies the charges.

However, corruption can be curbed through effective management practices. Some of the companies maintain a code to avoid bribing. Such codes are common among the companies headquartered in the USA, the UK, the Netherlands and Germany.

Secondly, a large number of companies have initiated training programmes for the managers. They are trained about ethical behaviour. The US companies are very serious about the training programme.

Thirdly, a practice is followed among some companies that requires senior managers to sign periodically a formal statement that are not indulged in corruption and such other bad practices.

Fourthly, many companies verify the integrity of the middlemen through whom they proceed for a contract. Such practices are now common with the companies of the USA and the western world.

Nevertheless, the survey reveals that despite efforts limiting corruption, around one-third of the respondents in the sample believed that corruption cases would increase.

QUESTIONS

1. How does bribing affect the interest of the host country?
2. Why are laws not very effective in controlling corruption cases?
3. Describe some of the measures that are followed to curb corruption.

Source: Based on Deutsche Press Release, 11.11.2005 and International Business Attitudes to Corruption Survey: 2006.

References

Books

Czinkota, M. R. *et al* (1999), *International Business* (New York: Harcourt Brace).

Eiteman, D. K., *et al* (1995), *Multinational Business Finance* (Readings Mass.:Addison-Wesley), Chap. 18.

Elliot, K. A. ed. (1997), *Corruption and the Global Economy*, Washington D.C.: Institute for International Economics.

Euromoney (1993), *The Euromoney Country Risk Method*, London, September.

Globerman, S. (1986), *Fundamentals of International Business Management* (Singapore: Prentice-Hall), p. 131.

Gregory, A. (1989), "Political Risk Management" in A. Rugman (ed.), International Business in Canada, pp. 301–29 (Scarborough: Prentice-Hall).

Hufbauer, G. C. and J. J. Schott (1984), "Economic Sanctions: An Often Used and Occasionally Effective Tool of Foreign Policy" in M. R. Czinkota (*ed.*), *Export Controls* (New York: Praeger), pp. 18–33.

Karatnycky, A. (1995), *Freedom in the World* (New York: Freedom House).

Schnitzer, M.C. *et al* (1985), *International Business* (Ohio: South Western Publishing Company).

Thunell, L. (1977), *Political Risks in International Business* (New York: Praeger).

Wild, J. J. *et al* (2000), *International Business: An Integrated Approach* (New Jersey: Prentice-Hall).

Journals

Gonzalez, M.V. and E. Villanueva (1992), "Steering a Subsidiary through a Political Crisis", *Risk Management*, October, 16–27.

Haner, F. T. (1979), "Rating Investment Risks Abroad", *Business Horizons*, XXII (1), 18–23.

Hoskins, W. R. (1970), "How to Counter Expropriation", *Harvard Business Review*, XLII (September–October), 110–12.

Jodice, D. A. (1980), "Sources of Change in Third World Regimes for Foreign Direct Investment: 1968–76", *International Organisation*, XXXIV (2), pp. 177–206.

Knudsen, H. (1974), "Explaining the National Propensity to Expropriate: An Ecological Approach", *Journal of International Business Studies*, V (1), 54.

Kobrin, S. J. (1980), "The Assessment and Evaluation of Non-economic Environments by American Firms: A Preliminary Report", *Journal of International Business Studies,* XI (1), 32–47.

Kraar, L. (1980), "The Multinationals Get Smarter about Political Risks", Fortune, March 24, 86–100.

Kramer, R. D. (1981), "Political Risk Assessment: A Brief Review of the State of the Art", *New International Realities*, VI (1), 23.

McNulty, S. (1994), "Welcome to Cambodia's Business Wilderness", *Asian Wall Street Journal*, January 13.

Micallef, J.V. (1981), "Political Risk Assessment", *Columbia Journal of World Business*, XVI (1), 47–52.

Pincus, L.B. *et al* (1991), "Legal Issues Involved in Corporate Globalisation", *Columbia Business Law Review*, (2), 269–85.

Simon, J. D. (1982), "Political Risk Assessment: Past Trends and Future Prospects", *Columbia Journal of World Business*, XVII (1), 62–70.

Stobaugh, R. (1969), "How to Analyse Foreign Investment Climates" Harvard Business Review, XLVII (September–October), 100–108.

The Economic Times (New Delhi Daily), February 16, 1999.

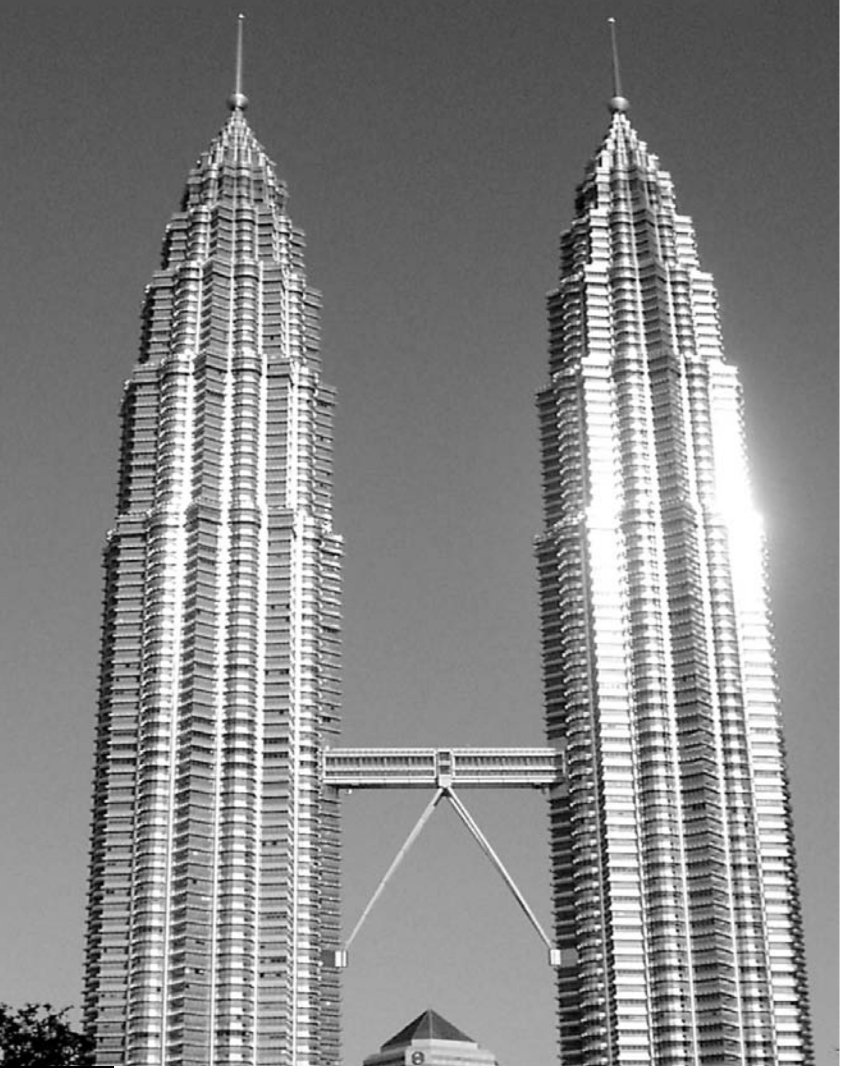
Walters, K. D. and R. J. Monsen (1981), "The Spreading Nationalisation of European Industry", *Columbia Journal of World Business*, XVI (1), 64–72.

SELECT FURTHER READINGS

Heidi Vernon-Wortzel and Lawrence H. Wortzel, eds. (1997), *Strategic Management in the Global Economy* (New York: John Wiley).

Rogers, J. ed. (1986), *Global Risk Assessments: Issues, Concepts and Applications* (California: Global Risk Assessments).

* During the 1950s and mid-1960s, Japan experienced what is widely described as the ‘economic miracle’, which transformed the nation from wartime devastation to the world’s second-largest economy by 1966. As a result, Japan came to dominate a range of industries including steel, ship-building, semiconductors, automobiles and consumer electronics. Akihabra area (as shown) in the picture is considered to be the main centre for electronic goods in Tokyo. In recent years, it has also gained fame as a centre of gaming, manga and animation culture.



PETRONAS towers, Kuala Lampur, Malaysia*

9

Economic Environment

CHAPTER OBJECTIVES

The economic environment is no less important than the political and legal environment. The present chapter discusses the issues relating to economic environment from the viewpoint of international business. The objective is to:

- Describe different economic systems.
- Show how primary economic indicators influence international business.
- Show how the economic environment is analysed/evaluated.

Apart from the political and legal environment, the economic environment also influences international business decisions. This is because the decision to trade or to locate manufacturing operations varies from one host country to the other, depending on the form of the economic system existing there and on the various economic parameters prevailing there, for example level of income and inflation; health of industrial, financial and external sectors; fiscal and monetary policies; and many others. The present chapter discusses these issues at some length.

9.1 FORMS OF ECONOMIC SYSTEM

Centrally Planned Economy is an economy where production and distribution system is owned by the government.

Market based Economy is an economy where the market forces of demand and supply reign supreme.

Mixed Economy is a compromise between CPE and market-based economy where private and public sectors exist side by side.

There are primarily two forms of economic systems, that is, the centrally planned economy (CPE) and the market-based economy. The two forms lie on the two extremes and so the third form, known as the mixed economy, is a compromise between the two. In other words, the system of mixed economy possesses the features of the first two systems. It is a more common form of the economic system insofar as neither of the first two systems is found in the purest form.

A CPE is defined as an economy where decisions regarding production and distribution of goods is taken by a central authority, depending upon the fulfilment of a particular economic, social, and political objective. The government designs the investment and coordinates the activities of the different economic sectors. Ownership of the means of production and the whole process of production lies in the hands of the government. The former USSR and East European countries were apposite examples of this type of economic system.

At the other extreme, in the market based economic system, the decision to produce and distribute goods is taken by individual firms based on the forces of demand and supply. The means and factors of production are owned by individuals and firms and they behave according to the market forces. The firms are quite free to take economic decisions. They take such decisions for the purpose of maximising their profit or wealth. Consumers are sovereign, they are free to decide what they want to buy. This is nothing but economic freedom, which manifests normally in freedom from governmental restrictions on, or interference with, economic activities. The United States of America and West European countries are examples of the market based economic system.

Between the two extremes, there is the mixed economic system. As mentioned just above, there is no country that represents any of the two systems in its purest form. In China, which is a CPE, the government has demarcated an area, known as special economic zone where private initiatives are allowed. On the other hand, in the United States of America, which has been a staunch advocate of the free-market economy, some economic activities are owned and regulated by the government. Thus, mixed economy, which represents a mixture of state control on one hand and the economic freedom of entrepreneurs and consumers on the other is the natural outcome. In other words, one can say that it is a system that involves greater governmental intervention than found in a market based economy or that relies more on market forces than experienced in a centrally planned economy. To cite an example, the Indian economy represents a mixed economic system. Economic activities that are fraught with social considerations are owned and regulated by the government. The others are owned and performed in the private sector.

Again, the Commonwealth of Independent States (CIS)—representing 15 nations coming out of the former USSR-fold and some countries of central and eastern Europe, especially Albania, Bulgaria, the Czech and Slovak Republics, Hungary, Poland, and Romania—were one time representing a CPE but from the beginning of 1990s, they have converted to a market based economic system. In some cases, the process of transition is near completion, but in many of them, the transition is much delayed as a result of a number of economic problems.

The nature of doing business with these different sets of countries is naturally different. In case of a CPE, it is normally the state trading corporation that participates in international trade. On the other hand, in a market based economy, trade is handled by individual firms. In a mixed economy, both the trading systems are found. Thus, the trade process and the involved procedural formalities differ widely in these cases. The procedural formalities also differ in case of manufacturing of a product or providing services in these different sets of countries. For example, countertrade was more common in case of east-west trade than in intra-west trade. Even in the Indian case, trade with then Soviet Union was based on a different footing, as compared to its trade with market based countries. Again, the nature of doing business with the transition economies of central and eastern Europe is different insofar as their economic problems are different. Thus, in short, whenever a firm trades with any other country, or when it tries to locate its manufacturing operations there, it takes into account the existing economic system in the host country and accordingly shapes its trade and foreign operation policies.

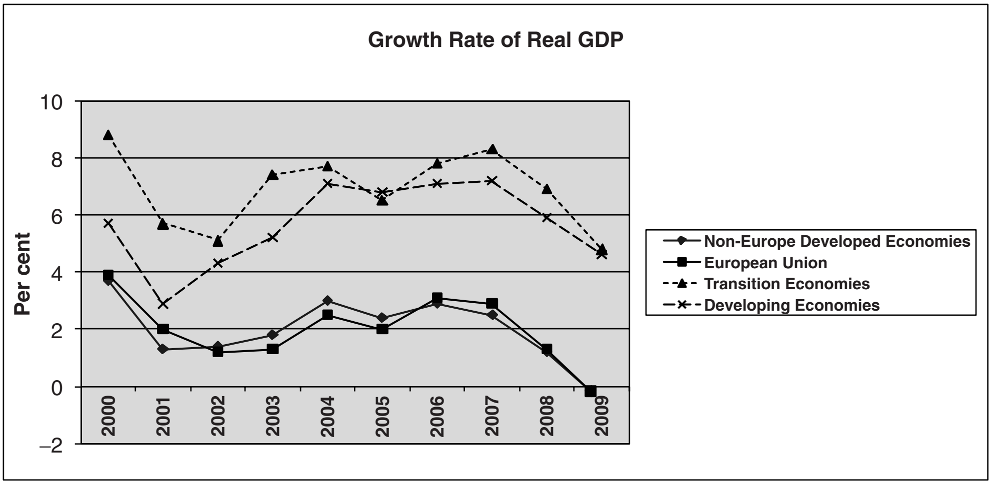
> In case of a CPE, it is normally the state trading corporation that participates in international trade. In a market based economy, trade is handled by individual firms. In a mixed economy, both the trading systems are found.

9.2 PRELIMINARY ECONOMIC INDICATORS

Whenever a firm moves abroad for international business, it takes into account some preliminary economic indicators of the host country at a particular point of time, as well as over a particular period. These economic indicators help the firm know, among other things,

1. The size of demand for its product,
2. The expected cost of production and the net earning, so as to ascertain its competitive edge, and
3. Whether it will be able to smoothly repatriate its earnings back to its home country.

The size of demand depends inter alia upon the level of income and its distribution, the propensity to consume, and rate of inflation. The cost of production depends upon the availability of human and physical resources; development of infrastructure; and on the fiscal, monetary, and industrial policies. Similarly, smooth repatriation of income and profit depends upon the strength of the external sector. These economic variables need some explanation here (Figure 9.1).



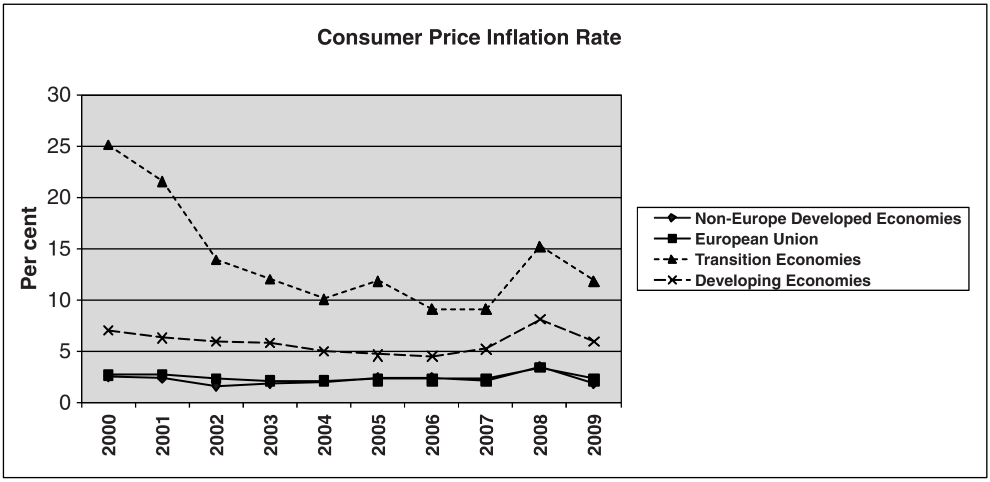


FIGURE 9.1 Source: Based on figures of World Development Indicators various issues.

9.2.1 Level of Income and Its Distribution

The size of demand for a product is dependent upon the size of income of its buyer. This is why a firm doing business with a foreign country evaluates the income level existing in that foreign country. The level of income is normally represented by the gross national product (GNP) or gross domestic product (GDP). GDP is the aggregate of the total output of goods and services provided during a year. If one adds to it the income from abroad, the sum is known as GNP. However, strictly speaking, GNP or GDP in absolute terms does not carry much meaning insofar as per capita income may be smaller and the per capita purchasing power may be lower if population in that country is very large, despite its large GDP. Thus the income level in a particular country should better be evaluated in terms of per capita income. It is on this basis that the World Bank (2008) has classified different countries as:

1. low income country
2. middle income country
3. high income country

The per capita income levels in these different groups of countries is as follows:

Country classification	*Per capita income based on 2007 dollar*
Low-income country	$ 935 or less
Lower middle-income country	$ 936–3705
Upper middle-income country	$ 3706–11455
High-income country	$ 11456 or more

Based on the level of income and some other economic and socio-economic indicators, one can group the countries into: (1) developed and (2) developing. The industrialised countries of North America, Western Europe, Asia, and the Australian continent are designated as developed countries. In the developing world, some of the countries have made fast strides towards industrialisation and have witnessed a high growth rate. They are known as newly industrialising countries (NICs) or emerging market economies. The others are the less developed countries in general. However, at the wrong end of the less developed countries are the least developed countries, presently numbering 50, that have very poor economic and socio-economic indicators.

Least developed countries are an economy with very weak economic and socioeconomic indicators that put them on the lowest rung of the less developed world.

Low income level means low purchasing power. Thus, multinational firms market or manufacture low price goods in such countries. The scope for a costly product in such countries is very limited. This is why a luxury car manufacturer will move to a country that is either a middle income country or a high income country.

However, on the basis of experience, it can be said that multinational firms also often move to low income countries for manufacturing high price goods. There are two reasons for this. First, when the population is quite large and the wage level in general is very low in view of the large supply of labour. In other words, MNCs move to such countries to take advantage of their cheap labour force, which has a positive impact on the cost of production. Secondly, high price items can have a market if the national income is not equally distributed. Suppose a country has a population of 500 million and 10 per cent of the population share 60 per cent of the national income. This means that there are 50 million persons that can buy even costlier goods. If this is the case, it is easy for multinational firms to market or to manufacture high-price goods in such countries. On the contrary, if the income is equally distributed, they will have the scope for marketing only low price goods. In brief, it is not simply the per capita income level that influences the international business decision, but more importantly, it is the distribution of the national income that is relevant in this context.

If national income is highly unequally distributed, MNCs go for market segmentation selling low cost good in low income segment and high cost goods in high income segment.

The distribution of income in the host country is important for multinational firms for attempting market segmentation. They can market a simple version of a particular product at low prices among low-income consumers. At the same time, they can market a sophisticated version of the same product at very high price among the wealthy people in the same country. This is possible if national income is highly unequally distributed. Seiko, a Japanese watch company manufactures low price watch, Seiko, for low income consumers and high price watch, Hittari, for affluent consumers in the same country.

As regards unequal distribution of income, the World Bank study (1996) finds that the widening gap between the rich and the poor has become a world wide phenomenon. The ratio between the national average of the per capita GNP and the average income of the poorest one-fifth of the population is 9:1 in the United States of America. It is almost similar in Brazil, although around 4:1 in the United Kingdom. But if the poorest section of the society has an income level that is sufficient for maintaining a good standard of living, income distribution does not matter much.

9.2.2 Inflation

It is a fact that the size of demand for a product depends not only on the level of income and its distribution, but it is also subject to the level of inflation in the country. It is because the purchasing power of the consumers depends on their real income. The higher the level of inflation, the lower is the real income and the purchasing power of the consumers. Thus, when a multinational firm decides to set up a manufacturing unit in a foreign country, it has to take into account the rate of inflation in the host country.

The rate of inflation is also important from the viewpoint of cost of production. If it is high in the host country, the production cost of the host country plant will be higher. The price may be competitive for the host country market because the other manufacturers in that country too face the same problem. But exports from the host country to markets with a lower rate of inflation will definitely be affected on account of higher cost. However, if the multinational firm exports its products to the high-inflation country instead of setting up of a manufacturing unit there, the exports may have a competitive edge in view of the lower rate of inflation at home. When one examines the impact of inflation on the foreign trade of the country, it should not be done in isolation of the changes in the exchange rate. It is because the changes in the exchange rate may nullify the effects of inflation rate changes.

Multinational firm exports its products to the high-inflation country instead of setting up of a manufacturing unit there.

Again, inflation has varying impact on different sections of the society. Fixed-wage earners are the worst hit. Inflation causes diminution in their purchasing power. But, on the other hand, the business community is well off. Profit is higher, which means nothing but rise in purchasing power. If the multinational firm pinpoints this particular consumer group and manufactures goods to meet its specific demand, it would be a profitable venture.

Besides the level of inflation, the way in which the monetary authorities tackle the growing inflation is also important. If they raise interest rates to bring down the rate of inflation, the rate of industrial growth would be adversely affected on account of availability of costly funds. Industrial stagnation may also be a factor inhibiting inflow of foreign investment.

9.2.3 Consumption Behaviour

Consumption behaviour or the pattern of consumption influences the demand for a particular product to a sizeable extent. In a low income country, where the consumers care more for price rather than for the quality of the goods, multinational firms find it very difficult to sell their improved quality, high price products, even if they are for the daily use of common people.

Again, in rural areas of less developed countries, people attach importance to saving or to real estate investment. As a result, their marginal propensity to consume is very low. This has a bearing on the demand for general consumption goods. Yet again, in less developed countries, it is found that a large segment of income is spent on food and housing, with the result that the demand for other goods languishes considerably.

Consumption behaviour depends on: 1. Preference for price/quality of the product, 2. Propensity to save, 3. Quality of population, 4. Existence of social security schemes.

In fact, the decision to save more or to consume more depends on the quality of population or on the social security schemes provided by the government. If the population is literate, it will have a different approach towards consumption. People will demand good quality products even if they are available at higher prices. On the contrary, uneducated people are price conscious and not quality conscious. Again, in absence of social security schemes, people prefer saving in order to meet exigencies, the propensity to consume is naturally very low. But where such schemes are ample, the propensity to consume is high. Thus, whenever a multinational firm selects a particular host country, it certainly takes into account the consumption pattern and the quality of the population.

9.2.4 Availability of Human and Physical Resources

Easy availability of human and physical resources makes the manufacturing process easier and at the same time lowers the cost of production so as to confer upon the firm a competitive edge. This is because if such resources are in abundance, they are available with no difficulty and at a lower cost.

> A multinational firm looks at the availability of technical and managerial personnel whenever it analyses the economic environment in the host country.

It is not feasible for a multinational firm to transport the entire labour force from the home country. It normally employs its own men at the very senior positions and employs the rest of persons from the local manpower market. But this is possible only if skilled manpower is available locally. This is why a multinational firm looks at the availability of technical and managerial personnel whenever it analyses the economic environment in the host country.

Besides the issue of human resources, it is also necessary for multinational firm to assess the availability of physical resources. By physical resources, we mean various inputs necessary for manufacture. Moreover this fact lies at the core of the locational theory of foreign direct investment. Indian firms have moved to Sri Lanka for the manufacture of rubber products and to Nepal for the manufacture of herbal products. This is primarily because the required raw material is available in abundance in the host country.

9.2.5 Network of Infrastructure

> In India, an important reason for the gap between the approval of foreign direct investment and its actual inflow is the lack of supportive infrastructure.

Building up of supportive infrastructure is a prerequisite for the development of industry. For successful operation, a firm needs uninterrupted power supply, good road/rail link, efficient communication system, and so on. This is why multinational firms must take into account the availability of infrastructure while analysing the economic environment in a host country. When US economic aid began flowing to developing countries for financing infrastructure projects as back as in the early 1950s, the primary objective was to pave the way for US investment in those countries (Ohlin, 1966). Presently, in India, an important reason for the gap between the approval of foreign direct investment and its actual inflow is the lack of supportive infrastructure.

9.2.6 Fiscal, Monetary, and Industrial Policies

> Corporate income tax, excise duty and tariff on import in the host country do influence international trade and investment.

Various forms of economic policies pursued in the host country make the economic environment either congenial or act as a deterrent to the operation of a multinational firm. A firm never relishes a high rate of corporate income tax, as it lowers the net profit. Sometimes firms employ various techniques, for example transfer pricing devices, to lower the incidence of tax, but the management is not very easy. However, there are often tax treaties between the home government and the host government, which help reduce the burden of tax and so they act as a motivating factor for foreign direct investment. Similarly, in some countries, in order to attract foreign direct investment, tax holiday schemes are provided to the foreign investor for a specific period. This too lowers the burden of taxes.

The case of excise duties too is similar as such duties cause cost appreciation. In some countries, they are levied on the amount of output. In others, they are levied on the amount of value addition. So firms have to see which type of duties are less harmful to their interests.

Besides the corporate income tax and excise duties, there is tariff or import duty. As it is mentioned in Chapter 6, such duties are either ad valorem, based on the value of the import, or specific, based on the quantity of the specific import, or mixed, combining both of them. Whatever may be the form of import duty, it raises the price of the imported item in the hands of the consumers. Thus, whenever a firm exports goods to a foreign country, it has to assess the size of such duty. In case of foreign manufacturing too, this duty prevailing in the host country affects the cost of production if various inputs are imported either from the home country or from any other country. However, in case of a free trade area or a customs union, when tariff is abolished from the intra-region trade, the abolition encourages intra-region international business.

The fiscal policy does not deal simply with various taxes and duties, but it is more concerned with the budgetary deficit or fiscal deficit. If the fiscal policy in a host country is not effective in curbing high fiscal deficit, it will have a dampening impact on the monetary sector, external sector, and many other sectors and thereby will adversely influence the interest of the multinational firm.

> If the monetary policy keeps inflation within manageable limits, keeps the interest rate low, and strengthens credit availability, all this will have a positive impact on the operational cost of a multinational firm.

With regard to the monetary policy, it is found that it has a definite influence on the money supply and the rate of inflation, rate of interest and the cost of credit, and on the general health of the financial sector. If the monetary policy is such that it keeps inflation within manageable limits, keeps the interest rate low, and strengthens the health of financial institutions and banks, credit availability for a firm will be easier and cheaper. All this will have a positive impact on the operational cost of the firm, which means greater competitive strength. A multinational firm may not be in a better position compared to other local firms as they too get easier and cheaper credit, but it will certainly be on a better footing compared to firms in other countries with not so effective monetary policies.

> Industrial policy if restrictive permits foreign investors only into a very limited area of the industrial economy.

Again, one of the aspects of the industrial policy is related to the area where foreign investors can invest. If the policy is restrictive on this count, it permits foreign investors only into a very limited area of the industrial economy. On the contrary, a liberal policy environment helps attract foreign investment. India's industrial policy was made more liberal in 1991, with the result that large number of foreign investors came to invest in this country during the period of liberalisation.

9.2.7 Strength of External Sector

Multinational firms are greatly interested in repatriating profits to their parent unit. Repatriation is easier when the monetary authorities in the host country pursue a liberal policy in this respect. The policy is liberal only when the balance of payments position is strong enough and the size of foreign exchange reserves is comfortably large.

It is a fact that the majority of the developing countries face deficit on current account balance in view of the fact that their import needs are large and they face both demand constraints and supply constraints on their exports. Their invisible trade is not big enough to cover the trade deficit. However, in some cases, the current account deficit is met by capital account flows. Such flows are so large that they not only make up the current account deficit but also, after meeting such deficit, add to the foreign exchange reserves. This is found in cases where ample incentives are given to foreign investors and the foreign investors find a safe place to invest on account of congenial economic and political environment. Thus, when a multinational firm has to select a host country, it analyses the health of the external sector of the host country. It relies on various ratios, such as export-import ratio, current account balance/GDP ratio, or current receipt/GDP ratio, import cover of foreign exchange reserves in terms of the number of months, external debt/GDP ratio, debt service ratio, and so forth. The stronger the health, the better the economic environment and the greater the foreign investment.

> When a multinational firm has to select a host country, it analyses export-import ratio, current account balance/GDP ratio, or current receipt/GDP ratio, import cover of foreign exchange reserves, external debt/GDP ratio, debt service ratio, and so forth.

9.3 PROCESS OF ANALYSING ECONOMIC ENVIRONMENT

The preceding section incorporates some major economic indicators that are taken into consideration by a multinational firm. The firm judges these indicators prevailing at a particular point of time, mainly at the time of export or of setting up of a venture. But this is not enough. The firm has to analyse the trend of these variables over a specific period. For the past, there is no problem. This is because historical data is normally available. But for the future, the firm relies on the forecast that may be made on the basis of the past.

The first step in this process is to collect data. Collection of secondary data is easy and inexpensive. It may be collected from international publications. International organisations such as the IMF, the World Bank, the United Nations, and others as well as some private international agencies regularly publish the vital statistics of different countries. Country reports are exclusively published by some of them. However, the statistics published by governmental agencies of a particular country can also be relied upon as they are sometimes more informative.

Sometimes firms are interested in the collection of primary data, either through its own resources or through any agency or consultant. But this process is more expensive. Moreover, physical distance and cultural differences between the countries, language and comprehension problem, and other such obstacles make it difficult to conduct research.

The second step begins after the collection of data. In this process, the total market potential is evaluated. If necessary, a forecast is made for this purpose. The statistics concerning the existing consumption pattern and the growth rate of income are taken into account and on that basis the future demand for the product is determined. Sometimes an input-output table is constructed where output in one sector/country becomes the input for another sector/country. If this information is analysed in the light of the expected future economic trend, the demand can be predicted. If desired statistics for a particular country is not available, the statistics of another similar country can be used. In fact, the methodology varies from one firm to another. But the ultimate goal is to determine the size of the market in a desired host country.

SUMMARY

- Economic environment as a determinant of international business decisions is very significant in the sense that it normally differs between the home country and the host country and among different host countries. Broadly, there are two extremes: one being the free market economy and the other being the centrally planned economy. There are a number of countries that possess the features of both types of economics in varying proportions and they represent a mixed economic system. The transition economies fall, more or less, in this group until their transition to a market based economic system is complete. The nature of international business decision vary from one economic system to the other.
- Before making international business decisions, a firm makes an analysis of the broad economic indicators prevailing in the host country, such as the level of income and its distribution; inflation rate; consumption behaviour; availability of physical and human resources; network of infrastructure; fiscal, monetary, and industrial policy; and strength of the external sector.
- It gathers information based on primary and secondary data and evaluates them. Only then it takes a decision.

REVIEW QUESTIONS

1. What are the different forms of economic system? Do they influence international business decisions?
2. Briefly explain the major economic indicators that managers take into account before taking any international business decision.

STUDY TOPIC

Economic Environment Among Different Groups of Countries During 2008 and 2009

The US sub-prime crisis during 2008 had its impact not only on the entire US economy but also on different quarters of the world economy. The overall economic environment in the different countries or different groups of countries vitiated from that during 2007. Here, one can find such changes in very brief.

Developed Economies

As far as the developed countries outside Europe are concerned, they experienced recession during 2008–2009. The growth rate of real GDP fell from 2.5 per cent in 2007 to 1.2 per cent in 2008 and, as expected to −0.5 per cent during 2009. Let us take, first, the case of the USA. Following a slump in the housing sector and in the banking activities, the credit position was tight that led in turn to lower industrial activities, lower profits, falling equity prices and to lower business capital spending. The lower industrial activities led also to greater unemployment and thereby to lower household consumption spending. The real GDP growth rate plummeted from 2.0 per cent in 2007 to 1.2 per cent in 2008 and to an anticipated figure of −0.1 per cent during 2009. The government allocated a huge sum of $700 billion to recapitalise banks, but this measure was too late to revive the real economy. The federal funds rate was lowered and the tax rates were axed. But all this failed to hasten the revival of the economy.

As far as the euro area is concerned, the majority of the countries were found in recession. The consumption spending tended to shrink during the first half of 2008. High inflation was an important factor behind lower disposable income. Tightened credit limited the size of household lending. The investment spending too contracted in view of falling profitability and equity prices. Unemployment and wage prospects were diminished. The exports decelerated fast. Their growth rate was barely at 3.8 per cent and was expected to decline further in 2009. The imports were also low but not as low as the exports. This affected adversely the balance of trade. Some fiscal measures were taken up in majority of the countries in this area. State-backed guarantee of bank loans, greater deposit insurance and actual bail-out of financial firms were common. Similarly, monetary measures were apparent in lower interest rates. However, since euro remained volatile, especially against the US dollar and Japanese yen, exchange rate risk was high. When, during summer of 2008, euro had appreciated, the EU exporters were out of the key markets.

Japan too was sailing in the same boat. Slackened demand from abroad and the negative exchange rate effects coupled with rising input cost, especially on account of energy consumption were responsible for decreased economic activities. The real GDP growth rate was barely 0.4 per cent in 2008 which was expected to be lower at −0.3 per cent during 2009. The high rate of inflation eroded the purchasing power which was responsible for lower consumption spending that in turn influenced adversely the economic activities. The fiscal measures were not substantial in view of the already existing huge burden of public debt. However, monetary measures in the form of reduced interest rates were taken to revive the economic activities.

Transition Economies

The overall picture of the transition economies was different during 2008. The economic growth rate was high at 7.1 per cent in Commonwealth of Independent States (CIS) and 5.2 per cent in South-East Europe. The reason was that the domestic demand was high and also that these countries remained a bit aloof of the contagion effect of the world economic crisis. As far as CIS were concerned, Russia experienced a boom in agricultural production. The employment generation was normally sizeable but inflation rate remained higher. In some of the countries, such as Azerbaijan, Kazakhstan, Kyrgyzstan, Tazikistan and Ukraine, the rate of inflation was as high as 20 per cent. Russia and Ukraine followed liberal monetary policy. In early 2009, when there were some signs of the effects of international financial crisis, and particularly when real interest rates were negative in view of the high inflation rate in some countries, the government of those countries helped increase the liquidity position in the market. When the capital flow got reversed and when the trade deficit turned wider in 2009, there was found large-scale intervention by monetary authorities in the foreign exchange market in order to maintain stability in exchange rate.

In South-East Europe too, the growth rate of the economy slumped during 2009 despite the employment generation picture being buoyant. Fiscal deficit tended to widen during 2009 but it was expected to remain within limits. On the monetary policy front, of course, the rising rate of inflation led the government to raise the interest rate especially in Albania, Serbia and Macedonia. In Bosnia and Herzegovina and Croatia, the cash reserve requirements were increased.

Developing Economies

The growth rate of real GDP in the developing countries as a whole slumped from 7.1 per cent in 2007 to 5.9 per cent in 2008. In case of the African countries, the slump was recorded from 6.0 per cent in 2007 to 5.1 per cent in 2008 and to an expected level of 4.1 per cent in 2009. The reason was the slump in household spending consequent on high inflation and high interest rates, growing unemployment and the weakening of the commodity boom. Inflation rate climbed up by over 60 per cent in 2008 over the previous year in 90 per cent of 51 African countries. However, oil-exporting African countries were not so hard-hit. The monetary measures were focussed on the control of inflation and so it was basically a tight monetary policy.

In East Asia, the growth rate of real GDP dropped from 9.0 per cent in 2007 to 6.9 per cent in 2008 and to an expected level of 6.0 per cent in 2009 primarily in view of the fact that this region was more prone to the international financial crisis. With slowing growth rates, unemployment rate increased by one percentage point in 2009 over 2008. Again, the current account surplus of the countries in this region turned greatly eroded.

As regards monetary measures, interest rates were increased initially but with decreasing interest rates in the developed world, interest rates were cut. The fiscal policy remained expansionary. Some of the governments, such as those of Republic of Korea and China announced economic stimulus packages.

In South Asia, the growth rate of real GDP diminished from 7.9 per cent in 2007 to 7.0 per cent in 2008 and to an expected level of 6.4 per cent in 2009. In India and Pakistan, large outflow of foreign capital impinged upon the liquidity in financial market and on shrinking of foreign exchange reserves. In Bangladesh, Nepal and Sri Lanka, it was mainly the weaker performance in the commodity producing sector and in the services sector. Moreover, the inflation rate was high moving between 6.4 per cent and 20.0 per cent. In the sequel, the monetary measures were tight.

Remittances stood large among many countries of this region in so far as a large number of persons had have migrated to oil-exporting Gulf countries. So, with the rising oil prices, remittances tended to increase. In Bangladesh, the increase was over 20.0 per cent during 2008. But with slow-down of petroleum prices, the remittances were affected badly in 2009. Thus, on the whole, international economic shocks were the main reason for decelerating growth rate.

In Latin America and the Caribbean region, the growth rate of real GDP plummeted from 5.5 per cent in 2007 to 4.3 per cent in 2008 and to an expected level of 2.3 per cent in 2009. A majority of currencies depreciated against dollar and other major currencies. There was a decline in the household spending in 2009. Those South American countries being dependent on metal and mineral products were badly hit on account of lower commodity prices.

Again, in majority of Latin American and Caribbean countries, inflation rate remained high at 8.1 per cent during 2008, although it was expected to ease to some extent during 2009 on account of reduced commodity demand expectations. Unemployment rate, which was 7.5 per cent in 2008, was expected to move up to over 8.0 per cent in 2009. The current account deficit was expected to be higher during 2009. Public revenue was also expected to fall leading to fiscal crisis. Interest rates were increased in 2008 to help ease inflation but with changed economic environment in 2009, they were cut at least to some extent.

Thus, on the whole, the world economic environment during 2008 and 2009 was not in a good shape.

Source: Based on the figures available from: 1. World Development Indicators, 2009
2. World Development Report: 2009.

QUESTIONS

1. Comment on the economic scenario in developed market economies during 2008 and 2009.
2. In what way were the transition economies different from the developed economies during 2008 and 2009?
3. How did the developing countries fare during 2008? Was there any change in 2009?

REFERENCES

Books

Ohlin, G. (1966), *Foreign Aid Policies Reconsidered* (Paris : OECD).

Journals and Report

The Economist (1993), *Country Report*, Economic Intelligence Unit.
The Economist (1995), *Country Report*, Economic Intelligence Unit.
The World Bank (2008), World Development Indicators: 2008 (Washington, D.C.).

SELECT FURTHER READINGS

Garten, J. E. (1997), "Troubles Ahead in Emerging Markets", *Harvard Business Review*, LXXV (May–June), 38–50.
The World Bank (1996), *World Development Report: 1996* (New York: Oxford University Press).
Woo, W. T. *et al* (eds) (1997)*, Economies in Transition; Comparing Asia and Europe* (Cambridge M. A.: MIT Press).

* PETRONAS, short for Petroliam Nasional Berhad, was incorporated on 17 August 1974 as the national oil company of Malaysia, vested with the entire ownership and control of the petroleum resources in the country. With a strategy of integration, adding value and globalisation, it continues to deliver excellence and has forayed into other domains like Exploration and Production, Oil, Gas, Petrochemicals, Logistics and Maritime, Research and Technology. It is ranked among the FORTUNE Global 500 largest corporations in the world.

This page is intentionally left blank.

Bombay Stock Exchange, Mumbai, India*

10

Socio-Cultural and Ethical Environment

CHAPTER OBJECTIVES

The socio-cultural and ethical environment varies among countries. Managers must be acquainted with the environment in order to enhance performance. The objective of the present chapter is to:

- ✦ Explain the concept of culture—its meaning and essential elements.
- ✦ Analyse the different bases of cultural diversity.
- ✦ Show how cultural diversity influences an international firm's competitive advantage.
- ✦ Explain how cultural diversity is managed.
- ✦ Explain the concept of ethics and social responsibility.
- ✦ Analyse the nature of normative and relative ethics, and their influence on international business.
- ✦ Mention some of the more important ethical issues, such as human rights, environmental safety, corruption, and transfer pricing.

The socio-cultural and ethical environment is an important factor that needs to be taken into account by an international manager. Since culture or human behaviour influences, to a great extent, international business decisions, while planning overseas operations, a multinational enterprise, takes into account the socio-cultural and ethical environment of the host country. If this environment is similar in both the home and host countries, the manager will try to take the maximum advantage of the similarity for strategy formulation. If it is different, the manager will try to understand the differences and shape the strategy according to the changed environment. For example, McDonald's do not sell beef products in India because a sizeable majority of the consumers being Hindu do not take beef. The BBC dismantled its Arabic Television Service in 1996 because of differences with the Islamic fundamentalists over the programme content.

10.1 CONCEPT OF CULTURE

10.1.1 Meaning of Culture

Culture is the entire set of social norms shaping human behaviour.

Culture represents the entire set of social norms and responses that dominate the behaviour of persons living in a particular geographic or political boundary. It is a fact that cultural boundaries may differ from national/political boundaries because individuals with varying cultural backgrounds may reside in a particular nation. For example, Canada has at least three cultures—an Anglo culture, a French-speaking "Quebecois" culture and a Native American culture. Alternatively, individuals with similar cultural background may represent different countries. For example, Islamic culture is shared by the citizens of many countries in the Middle East, Asia, and Africa. Yet cultural boundaries and national boundaries are often equated. Therefore, let us discuss what the socio-cultural environment means, what are the causes and impact of cultural differences, and how such differences can be managed.

Culture, as noted earlier, represents the whole set of social norms and responses that shape the knowledge, belief, morals, attitude, behaviour, and the very way of life of a person or a group of persons. Culture is not in-born. It is acquired and inculcated. The inculcation of culture begins at the very birth of a person and lies below the level of conscious thought. This means that an individual is unaware of the learning process because he or she learns through seeing how others behave. The learning persists throughout his or her life and does not escape him/her entirely. It may be mentioned that culture is not specific to a single individual, rather it is shared by a group of persons. In fact, it is culture that enables persons to communicate with others and to distinguish between what should be done and what should not be done (Dressler and Carns, 1969; Herskovits, 1963; Luthans, 1989).

10.1.2 Elements of Culture

Based on the definition of culture, there are a few basic elements of culture. These elements are universal; meaning that they form the cultural environment of all societies. But, what is important is that they perform differently in different societies, leading ultimately to cultural diversity across different societies. Czinkota et al (1999) list these elements as follows:

1. Language
2. Religion
3. Education
4. Attitudes and values
5. Customs
6. Aesthetics
7. Social institutions
8. Material elements

> Language is the medium through which message is conveyed. It may be verbal or non-verbal.

Language: Language is the medium through which message is conveyed. It may be verbal or non-verbal. The former includes the use of particular words or how the words are pronounced. The latter embraces the gestures through which feelings are expressed. When an international manager gives the instructions to his subordinates, who normally come from the host country, the instructions must be understood properly by the latter; or when the firm's salesmen tries to convince the consumers, the latter should follow the language of the former well. There is no problem if the language spoken in the home country and the host country is similar. But, normally, it is not.

Again, even if the language is the same in the two countries, it is possible that the same word or the same phrase carries different meanings in different countries. For example, the word, *homely* means friendly and comfortable in England but plain or even ugly in the United States. American brand names sometimes carry strange meanings when translated into other languages. American Motors' Matador became 'killer' in Spanish. Ford's low-cost truck Fiera meant 'ugly old woman' when translated into Spanish. The Pepsi Cola slogan, 'Come alive with Pepsi' was translated into German as 'come out of the grave'. DeVries (1969) feels that when legal contracts are formalised across national boundaries, they sometimes alter in character as well as language. It was the problem of language that compelled Close-up to change the name of its tooth paste as Klai-chid in Thailand so as to make the consumers aware of the product. Thus, multinational managers should be very careful of what their instructions really mean.

Even if the international managers make themselves acquainted with the principal language spoken in the host country, the problem is not over. There are many dialects spoken there and it would not be very convenient for the less educated employees to follow the instructions because they may be more well versed with a regional dialect rather than with the principal language. For example, only 60 per cent of the Malaysian population is Malay, the other 30 per cent is represented by Chinese, and the rest 10 per cent by Indians. Despite the fact that Malay is the official language, the ethnic groups use their own dialect and that creates problems for multinational corporations operating there.

As far as the non-verbal language is concerned, it is also different in different countries. For example, Latin Americans prefer standing close to a person with whom they are talking, but this is not liked by the Americans or by Britons. Thus, multinational managers must also be acquainted with the non-verbal language of the host country.

Religion sets the ideals of life and thereby the values and attitude of individuals living in a society.

Religion: Religion is another element of culture. Irrespective of forms, religion believes in a higher power. It sets the ideals of life and thereby the values and attitude of individuals living in a society. These values manifest in individuals' behaviour and performance. Since different forms of religion differ in details, the attitude towards entrepreneurship or consumption, and so on varies among different societies practising different forms of religion or among different schools of the same religion. For example, protestants and catholics, both represent Christianity, but the former give weightage to accumulation of wealth, while the latter oppose it. Similarly, in Islam, prayers five times a day and fasting during *Ramzan* are emphasised upon, which in turn, effects productivity. Moreover, the *purdah* system discourages women moving out for work. Income in form of interest is also prohibited in Islam, which restricts spread of banking.

In Hinduism, the caste system comes in the way of the mobility of the work force as certain types of works are to be performed only by a certain caste. It was very rigid a few decades ago, but this factor has softened considerably in recent years. Similarly, Buddhism believes in spiritual achievement and not in material achievement and this has a dampening effect on entrepreneurship and profit making.

Again Confucian thought believes in rigid organisational structure and unanswering reverence for authority. Most of the Koreans believe in this thought and they do not question strict chains of command. The application of this philosophy among Korean subsidiaries in Western countries has led to high-profile dispute. Yet again, Shinto, a native religion of many Japanese gives importance to ethics, patriotism and loyalty. This is one of the reasons behind the success of Japanese firms abroad.

Education has a close relationship with the availability of skilled manpower.

Education: The level of education in a particular culture depends primarily on the literacy rate and on enrolment in schools and colleges. This element has a close relationship with the availability of skilled manpower, availability of workers and managers who can be sent to the home country for training, production of sophisticated products, and with the adaptation of imported technology. If the level of education is high in a particular society, it is easy for multinational firms to operate there. It is because skilled manpower will be easily available, its training will be easy and the firm will be able to produce sophisticated goods. However, it is not only the level of education but also the pattern of education that is important. If the majority of persons in the host country are educated in the area of humanities or languages, they cannot be of as much use as those educated in the area of business studies or engineering.

Attitude and Values: Values are the belief and norms prevalent in a particular society. They determine largely the attitude and behaviour of individuals towards work, status, change, and so on. In some societies, where income and wealth are emphasised upon, people work for more hours in order to earn more. On the contrary, in societies where leisure is preferred, people work only for limited hours, just to meet their essential wants necessary for survival. However, the preference for leisure can change if people are influenced by the demonstration effects of higher living standards.

Values determine largely the attitude and behaviour of individuals towards work, status, change, and so on.

Again, the attitude towards social status is an important factor. Those who believe in higher social status spend even more; and to this end, they work more and earn more. For example, in Japan, youth pay a higher price for Levi's jeans because such jeans give them higher social status. It is the status that motivates individuals to opt for a particular branch of study. In less developed countries, bureaucracy is believed to the best profession. But in the United States of America and many other societies, business professionals have a higher social status. International managers will be able to reap larger benefits in the latter group of societies.

Yet again, in some societies, the attitude of the individuals does not favour change. To this end, they like to protect their own culture with elaborate sets of sanctions and laws. This means that individuals who deviate from their own culture are punished under the law. In such cases, the international manager tries to find out a way that does not deviate widely from the existing culture in the host country.

Customs: Customs and manners vary from one society to another. In the United States of America, silence is taken as negation, while it is not so in Japan. Similarly, Britons prefer instant coffee, while in the USA, ground coffee and instant coffee both are popular. Campbell's sells large cans of soup in Mexico in order to cater to the needs of large families, while in Britain, it is not so. In view of such differences, it is imperative for international managers to be aware of varying manners and customs.

Aesthetics: Aesthetics is concerned with the sense of beauty, good taste, and with the particular symbolism of colours. Colour symbolism, for example, is very important in international business. Black is the symbol of mourning in the United States of America and the United Kingdom, while it is white in Japan and some other Far Eastern countries. Green is popular in Islamic countries. Thus, while designing the advertisement programme or while packaging products, an international manager must take into account these facts so that the aesthetic sensibilities of the host country people are not marginalised and product marketing is smooth.

Social Institutions: Social institutions form an integral part of culture. They are concerned mainly with the size of the family and social stratification. In the United States of America and the United Kingdom and most other developed countries, the size of the family is small, comprising of a husband, wife, and children. But in many other countries, especially in developing ones, grand parents too are a part of the family. In yet another group of countries, the family is larger, comprising of cousins, aunts, and uncles. In India, the joint family system is still prevalent.

Similarly, in some societies, social stratification is very much apparent. Persons of different strata, may be in a single factory or in a single office, enjoy different facilities. For example, the more senior an officer, the more spacious his cabin is. On the other hand, there are countries where no such discrimination is practised. All the employees in a factory, irrespective of rank, eat lunch in the same dining hall.

Social stratification is also apparent in people's buying habits. Low income persons use low price products, while the same need of the affluent class is catered with a sophisticated variety of goods. Thus, when an international manager operates in a foreign land, he or she takes into account which segment of the society is the major buyer of the product or whether the persons employed in the firm believe in equality or unequal status.

Material Elements: Last but not least, this aspect of material culture cannot be ignored. Material culture is related to the economic, financial, and social infrastructure and to objects and things enjoyed by people. For example, Germans like beer, while the French like wine. So marketing of wine in Germany will be a bad proposal. In Japan, due to lack of space and the prevalence of small homes and apartments, marketing of lawn mowers will be a futile attempt. Similarly, in less developed countries, where power shortage is common, power generating machines can easily be marketed. But in developed countries, where the economic infrastructure is developed, marketing of time saving home appliances will turn out to be a good proposal. Social infrastructure manifests in form of housing, health and other facilities, and the level of education. If the consumers are uneducated, their consumption pattern will be different. In such cases, computer marketing will not be successful. Again, in cases where financial infrastructure is lacking, foreign companies will have to arrange funds, not from the host country financial market, but, from elsewhere. Thus, these varying elements of culture lead to cultural diversity among different societies, which need to be taken care of by international managers.

10.2 CULTURAL DIVERSITY

10.2.1 Basis of Cultural Diversity

In the preceding section, it has been mentioned how the various elements of culture vary in different societies. In some societies, individualism motivates personal accomplishment, while in others, the concept of the group is prominent. American culture comes under the former, while the Chinese and Japanese case conforms to the latter. In some societies, tradition, ceremony, and social rules do not figure, while they are maintained in other societies. Latin American managers, thus, differ from American managers who do not believe in traditions. Western culture encourages innovation in product and technology, while in some parts of the world where culture is highly rigid, people resist new products and technology. In some societies, decisions are taken only by top managers. In others, a greater number of officers take part in the decision making. The latter is found in Japan, while the former is found in the United States of America and some other western countries. It is the cultural diversity that shapes the managers as either risk averse or risk taking leaders. The former are conservative in their decisions, while the latter are aggressive. Some managers give priority to long-term goals, while the others are contended with achieving short term goals. It is the cultural background that makes the two different from each other (Reynolds, 1986).

But it is important to know that why such diversity exists. To explain the bases of diversity, a few of models have been developed. One is by Geert Hofstede (1980), the other is by Kluckhohn and Strodtbeck (1961), and the third and more recent one is by Fons Trompenaars (1994).

Hofstede's Study: Hofstede's study surveys 117,000 employees in 88 countries and suggests that cultural diversity among nations has four dimensions.

They are:

1. Individualism/collectivism,
2. Masculinity/femininity,
3. Power distance, and
4. Uncertainty avoidance.

Individualism exists when people look at themselves primarily as individuals and secondarily as members of a group. Hofstede measures this cultural difference on a bipolar continuum with individualism on one end of the continuum and collectivism on the other. Collectivism is related as loyalty to the group, where people care for one another. The survey reveals that wealthy countries have higher individualism scores, while poorer countries have represented collectivism.

> **Individualism** is a culture where the individual cares for himself and not for the group.
>
> **Masculinity** is a situation where success and money dominate the society.

Hofstede defines masculinity as a situation in which success, money, and material things dominate the society. On the contrary, femininity refers to a situation in which care for others and the quality of life dominates. Cultures with high masculinity index encourage large scale enterprises without caring for the conservation of environment. Higher level jobs are occupied by men. Women have a limited role to play. Job stress and industrial conflict are common. In a low masculinity index culture, small scale enterprises, conservation of the environment, women holding high level jobs, and so on are common. The survey finds a high masculinity index in case of Japan and a low index in case of Norway.

In cultures with high power distance index, power distribution is highly unequal, meaning that decisions are taken by high-ups and simply followed by the subordinates. In low power distance index countries, the

High power distance is the decision taken by senior managers to be followed by subordinates.

Uncertainty avoidance are beliefs that avoid uncertainty.

responsibility for decision making lies in a greater number of hands. The survey finds Mexico, South Korea, and India being high power distance countries.

Last but not least, uncertainty avoidance is related to the extent to which people have created beliefs and institutions to avoid uncertainty. Countries with a high uncertainty avoidance index maintain organisations with more written rules and regulations, risk averse management, and less ambitious employees. Organisations in low uncertainty avoidance societies have risk taking managers, less written rules, high labour turnover, and highly ambitious employees.

Hofstede has integrated all these four factors into two-dimensional plots and finds that they all do not move necessarily in the same direction and so there may be many combinations. All this shows the complexity of culture's effect on attitude and behaviour.

Kluckhohn and Strodtbeck's Study: Similarly, Kluckhohn and Strodtbeck identify five problems that tend to lead to cultural diversity. They are:

1. Human-Nature relationship,
2. Orientation towards time,
3. Beliefs about human nature,
4. Activity orientation of human being, and
5. Inter-human relationship.

Different individuals and societies have different views about nature. In Muslim countries, where nature is usually supposed to be supreme, guiding human fate, individuals being lethargic, making no attempt to innovate are common. On the contrary, in the United States of America, where individuals treat themselves as supreme, entrepreneural abilities and risk taking activities are common. In the United Kingdom, where people assign importance to themselves and at the same time try to accommodate nature, the pattern of human behaviour lies between the two.

Also culture varies because of varying orientation towards time. In China, past events matter more, while those in the United States of America are more concerned with the present. In Japan, the emphasis is normally on long-term planning. In cases where the present is emphasised upon, the reward for performance depends upon the actual performance.

It is a belief about human nature that shapes the behavioural pattern in a society. In societies where human nature is considered essentially evil, there are lot of rules and regulations so that an individual may not commit wrong acts. But where no doubt is cast on the purity of human nature, even verbal agreements are sufficient. Participative management is common in such societies.

In some societies, people are satisfied with what they have. They do not aspire to grow. But in other societies, people are "action-oriented" where they are constantly striving to achieves goals. This type of society is marked with a great deal of economic activity.

Lastly, in societies where individuals are treated as independent, they take the responsibility for their own actions. But in others, individuals do not feel themselves independent and they emphasise on lineage or organisational hierarchy. In yet other societies, the group, and not the individual, is given importance.

However, there may be changes in the social norms and the aptitude of people. The changes may be due to changes in the socio-economic environment or due to the availability of new alternatives. For example, in India, where rural people were normally averse to going to big cities for work half a century ago, rural to urban migration is very much common today.

Sometimes the cultural change takes place through imposition. This is found when a particular culture is imposed by outsiders on the local population, as in the case of many erstwhile colonies, the foreign trading companies or rulers introducted a new culture.

Fons Trompenaars' Study: Trompenaars' study covers 15,000 managers from 28 countries. It concludes that cultural diversity is found because of the existence of a few relationship orientations manifest in form of:

1. Universalism vis-à-vis particularism,
2. Neutralism vis-à-vis emotionalism, and
3. Achievement vis-à-vis ascription.

Societies believing in universalism feel that the same idea and belief can be applied all over the world. On the contrary, those believing in particularism feel that any idea or belief needs to be adapted for different societies. In the survey it was found that while American, British, and German managers subscribed to universalism, Chinese, Indonesian, and East European managers believed in particularism.

Neutralism means that the emotions are held in check and not expressed openly. On the other hand, emotionalism believes in the open expression of emotions. The Japanese and many Asian managers are found to be neutral. In contrast, Mexican, Dutch, and Swiss managers are emotional.

Again, those believing in the achievement culture rate the status of a manager on the basis of his/her performance or achievement. But those believing in ascription are of the view that status depends on who or what a person is. While American and British managers come in the former category, Venezuelan, Chinese, and Indonesian managers fall in the latter category.

Based on these attributes, host countries are clustered and, accordingly, the operational strategy is formulated by MNCs.

Universalism versus Particularism refers to universal application of ideas versus varying ideas for varying places.

Neutral and emotional culture differ as in emotions are checked in a neutral culture, while they are expressed openly in an emotional culture.

Achievement versus ascription differ as the status of a person depending on his achievement versus his status based on who and what he is.

Cultural Base in Japan and China as Different from the Western Culture

An analysis of cultural diversity focuses on the fact that one of the important factors behind the significant progress of the Japanese and Chinese economies is their specific cultural base which is very much different from the Western culture. Let us first discuss the cultural base of China.

Although there are large-sized firms in China, mostly run by the state, yet medium-and-small-sized firms dominate the industrial scene, especially in the south-eastern part of the country. Their management is based on the Confucian values that attach importance to the concept of family in the civic life. In other words, one can say that the concept of family relationship dominates the management of the industrial and business enterprises.

Confucianism is primarily based on a few cardinal values. They are as follows:

1. Filial piety which means respect for, and obedience to, the superiors and in turn due care for the juniors or subordinates by the superiors.
2. Complete loyalty of employees towards the organisation. They cannot question the policies of the organisation.
3. Sex discrimination in favour of men as far as allocation of power and duties is concerned.
4. Presence of mutual trust among the workers or between the employer and employees.

Confucianism believes in hard work and self-discipline. It also encourages frugality. It creates bondage among workers and between the employer and the employees. Every one in the enterprise feels that he or she is working in a family environment. The feeling adds to the growth of the enterprise.

In Japan, the cultural values are a bit different. The organisational structure is based on the "keiretsu". It denotes not simply the structure of the organisation, but broadly speaking, it represents a cultural value which is different from the Western culture. In keiretsu organisations, the chief executive officer is not very powerful; rather the power is exercised by a group of persons. Sometimes, the instructions move up from the bottom. The firms rely more on their retained earnings and less on external financing. As a result, retention of earnings is preferred to dividend payment. In-house development of production facilities and of technology is preferred to their outsourcing. Again, as regards human resource management, employees are regarded not as a factor of production but are treated as member of the organisation. Trade unions are not an independent union but they represent a company union. This way a sense of participation develops that is beneficial for the growth of the firm. The Japanese firms are thus found in a better position to achieve their strategic objectives and to possess competitive advantages.

10.2.2 Diverse Culture and Competitive Advantage

If an MNC moves to a country with a similar cultural environment, operational problems do not emerge on this count. But this is seldom a case. Generally, the culture in the parent company's country is found to be different from that in the country where its subsidiaries exist. This causes serious operational problems and effects the competitive advantage of the firm, which lies at the very root of every MNCs' success.

Cultural Diversity Impeding Competitive Advantage of an MNC

- Poor communication between top managers and subordinates
- Non-responsive attitude leading to inefficiency
- Lack of responsiveness towards innovated product/technology
- Buying pattern among consumers may not encourage large scale production
- Varying concept of human resource management may weaken employer-employee relationship
- Varying culture, limiting the scope for advertisement/sales promotion campaign

The operational problem is related to many aspects of culture.

1. First is the **problem of communication** or transmission of instructions from top managers to subordinates. If a company belonging to a high context culture moves to a low context culture country, the problem of communication will be immense. This is because the communication in a high context culture is indirect. The verbal part does not carry most part of the information, with the result that the message is often not understood in its right perspective.

High-context culture is the culture that lacks in direct communication.

2. It is the **attitude and temperament** that comes in the way of effective communication. It is found that Australian aboriginal workers are too slow in carrying out any instruction. This is because they think many times before doing any work. All this frustrates a manager from a western country who wants an immediate response from his subordinate employees, and at the same time, it impinges upon efficiency and productivity.
3. The operational problem is related to the **acceptance of the innovated product** in the host country. The organisational theory, explaining the fast growth of MNCs, believes that it is the firm-specific advantage arising out of innovated technology or product that provides MNCs with an edge over domestic firms in host countries. But this theory holds good only if the innovated technology or the new product is accepted in the host countries. The American company, Mattel innovated new dolls, known as Barbie dolls, and collaborated with a Japanese firm for their production and marketing. But these dolls were not accepted by Japanese children because their face, eyes, and the general appearance resembled American children and not their own. Again, when innovated technology is capital-intensive, it is opposed by trade unions in labour-surplus countries.
4. **Economies of scale** provide superiority to MNCs over domestic firms. But unfortunately, it is the cultural factor that sometimes negates this factor. This is because the size of production, price, and the quality of raw material may be influenced by cultural factors. For example, consumers living in smaller towns and villages in Japan and some European countries prefer to shop daily and so do not buy in bulk. This affects the prospect of large scale production.
5. The operational problem is concerned with the problem of **human resource management**. In the United States, promotion is based on merit-cum-seniority. In Japan, it is based on seniority and age. If an American company is operating in Japan and if it adopts the home-country policy of promotion, this will be resented in Japan. Again, the profit-sharing scheme is hardly found in the United States of America. If an American company is operating in Japan, Japanese employees will demand such scheme as it is common

in Japan. This will worsen the management-employee relationship and adversely effect productivity.

6. MNCs face a serious problem concerning advertisement due to the aesthetic and religious sentiments of certain host countries. In Islamic countries, showing a girl with far less clothes for advertisement purposes is not allowed, while it is common in western countries. Thus, if a western company is operating in these countries, it will have to narrow the scope of advertisement.

Only some of the major problems have been mentioned here that affect the competitive advantage of multinational firms while operating overseas. Infact, there are numerous problems connected with cultural diversity, as a result of which MNCs do not feel at home in a host country culture. There are many cases when they have not bagged operational success. All this, therefore, needs the management of cultural diversity, which is discussed in the following section.

10.3 MANAGEMENT OF CULTURAL DIVERSITY

10.3.1 Two Schools of Thought

Since cultural diversity tends to impinge upon the performance of MNCs, it is essential to manage cultural diversity. Two different schools of thought are relevant in this context. One is known as the practical school of thought. Black and Porter (1991) contend that good management practices are effective everywhere. If a manager is successful in domestic operation, he or she will also be successful in foreign operations. What is important is that this contention has gained empirical support. Miller (1973) has found the practical school of thought to hold good in his survey. Black (1988) and Tung (1981) have found that over two-thirds of American managers posted on foreign assignments did not undergo special training.

> Practical school of thought believes that a manager successful at home will be successful abroad. On the contrary, the cross-cultural school of thought argues for conditioning to accommodate cultural differences.

On the other hand, the cross-cultural school of thought believes that the efficiency of managers operating abroad must be looked at in the context of the cultural environment prevailing in the host countries (Farmer and Richman, 1965). Ouchi (1982) examines the relationship between the companies' profitability and their Z-ness with respect to US-Japanese business and finds results in favour of the cross-cultural school of thought.

Compromising between the two schools of thought, we can say that there are some aspects of the communication process and some process related attitudes and behaviour that are no doubt universal, but the overall attitude and behaviour is diverse. The management process in general, thus, needs conditioning to accommodate cultural differences. If this is not done, it will be a blunder on the part of the MNCs.

10.3.2 Management Process

Lee (1966) outlines a procedure for decision making in different cultural setups. It is a four step model. The successive steps are:

1. To define the business goal from the home country perspective;
2. To define the same goal from host country perspective;
3. To compare the two and note the differences, and
4. To eliminate the difference and to find an optimal solution.

Elimination of differences normally means adaptation to the host country culture. However, sometimes, the management does not passively adapt to the ever changing pattern of cultural differences within which it is operating; rather it makes an effort to induce changes in, at least, some aspects of the host country culture. Let us now see how cultural differences are assessed, how the firm adapts to a local culture in the host country and how the home country culture is transfused in the host country.

Cultural Assessment: It never means that managers should be cultural anthropologists, but they should develop skills to assess basic cultural differences that have a bearing on their performance. The method differs according to the business decisions. However, broadly, there are two methods. One is partial assessment and the other is comprehensive assessment. When the differences are narrow and limited to only a few aspects, comprehensive assessment would be unnecessarily time consuming and costly.

In case of partial assessment, the aspects that are looked into are normally the attitude towards work and achievement, attitude towards the future, attitude towards authority, expression of disagreement, social structure, and so on. In a society, where wealth is not a significant motivation, employees do not care for work. They come to work only when they have exhausted their previous earnings. Those who are achievement motivated are serious regarding work. Again, when people have faith in the future, long term planning can be employed. Yet again, in an autocratic culture, decisions are centralised in the hands of top managers. In a democratic culture, it is distributed among different persons. Similarly, as regards expression of differences, some persons are straight forward, while others hesitate. Social status matters in some societies. In some cases, intra-class mobility is very low. So these aspects are carefully assessed.

In case of comprehensive assessment, all aspects of cultural diversity are taken into account. Farmer and Richman (1965) use a matrix approach, listing critical environmental constraints against which they set 77 critical elements in the managerial process.

Adaptation to Local Culture: Adaptation concerns many aspects of culture. However, according to Robock and Simmonds (1983), three classes of adaptation are important and relevant. The first is adaptation in **product policies**. This incorporates redesigning of market strategies that are in conformity with the host country market strategies. Here one can refer to the marketing strategy adopted by Singer Sewing Machine Company in some Islamic countries. Since the female population there maintains *purdah*, due to which women do not interact with strangers, the company first convinced the husbands about the utility of the machine, following which the women were automatically convinced.

The second type of adaptation relates to **individual adjustment**. This means that the managers should undergo personal changes. They should learn the local language, local manner of dealing with the people, and local behaviour. Only then will the managers be able to interact with the local employees, local consumers, and local suppliers.

The third type of adaptation is known as **institutional adaptation**. It incorporates changes in the very organisational structure and policies so as to resemble the local culture. In a host country, where caste system is very rigid, persons of different castes do not like to work together. In Lebanon, for example, Palestinian muslims hesitate to work with Lebanese Christians. If such is the case, the company has to bring about necessary changes in its recruitment policy.

> An MNC is able to transplant the home. country culture if it:
> 1. assures large benefit,
> 2. protects the consumers and workers, and
> 3. works with opinion leaders who influence the workers and consumers.

Transfusion of Home Country Culture: It is a fact that there is ample evidence of cultural rigidity, but with the development of the visual media and of transport and communication, people living in one part of the globe have come in touch with the cultural environment prevailing in other parts of the globe. In some cases, they like the culture of others and they try to copy it. All this shows gradual diminution in the rigidity of attitude. MNCs take advantage of this fact and sometimes they try to transfuse their own culture into the cultural environment of the host country. The normal procedure is to discover the ways and incentive characteristics of the culture, which are likely to result in acceptance. The home country culture is easily transplanted if its benefits are exceptionally large. If a company supplies an innovated product that is not accepted by the local consumers, the common practice to be adopted is to promise and to ensure the after-sales service as well as to give a long term guarantee, in which case there is every possibility of the product being accepted by the local consumers. It has been found that if the company takes up measures to protect those adversely affected by the new product in terms of income, social status, dignity, and so on there will be no resentment towards the new product. Sometimes the company works through opinion leaders who influence others. In short, these techniques are normally adopted by MNCs to transfuse their own culture into host country operations.

10.4 ETHICS AND SOCIAL RESPONSIBILITY

When companies spread activities to foreign lands, managers are exposed to varying concepts of ethical behaviour and varying guidelines of social responsibility. Confronted by such unfamiliar elements, they sometimes adapt to the changed ethical behaviour and social responsibility. They change the product, follow a different production and marketing strategy, modify their human resource practices, and sometimes make changes in the very organisational structure. But there are cases when they stick to their own ethics and social behaviour, which is often a source of conflict with the host government.

10.4.1 Concept

Let us explain what ethics and social responsibility really mean. Ethical behaviour is primarily personal behaviour that should be in conformity with the rules or standards for right conduct or morality. On the contrary, social responsibility refers to the behaviour of the organisation, which should also be ethical and balance its commitments to investors, workers, customers and the societies in general. This means that shareholders should be given a fair and regular dividend and consumers should be asked to pay a fair price (Goyder, 1951). This is because the socially responsible behaviour of a company benefits every one related to it in the long run. Highlighting corporate social responsibility, the High-powered Expert Committee on Companies and the MRTP Act (1978) observes that a company must behave as a responsible member of society and it therefore, cannot shun moral values. Profit, although being an important consideration for business, is not the sole objective.

Ethics are standards for right conduct or morality.

Social responsibility is the ethical behaviour of an organisation towards different sections of the society.

Again, the nature of the ethical code of corporate behaviour is clear from the statement of R Kaku of Canon Inc., which is based on three value premises. They are:

1. **Human Dignity:** The dignity of an individual working in a corporation should not be violated even for the sake of fostering gains for the corporation.
2. **The Minnesota Principles:** A company should give due attention to the stakeholders, which includes not only the shareholders but also customers, employees, suppliers, competitors, and the local community.
3. **Philosophy of Co-existence:** A company should maintain a balance between healthy and fair competition on one hand, and mutual prosperity through co existence on the other (Suzumura, 1994).

10.4.2 Normative and Relative Ethics

When one talks about ethics or social responsibility in the context of international business, there is one view that the managers/companies should not bother about the varying norms of morality in the host country; they should implement their home country norms. The idea is based on Kantian normativism, which states that there are universal standards of human behaviour and every one, irrespective of their origin, personal preference, demands of the situation, and so on, should follow it. In fact, this type of normativism or universalism has come to be significant in the present-day world for matters such as civil rights, justice, fairness, equality of citizens, and employees.

Normativism states that there are universal standards of human behaviour. On the other hand, the proponents of ethical relativism believe in the saying, "While being in Rome, do as the Romans do".

On the other hand, the proponents of ethical relativism believe in the saying, "While being in Rome, do as the Romans do". It means that the managers/companies should follow the ethical norms prevalent in the host country. When the US company, Pizza Hut set up restaurants in Saudi Arabia, they built separate cabins for single men and for families in consonance with the Saudi value system. Similarly, McDonald's does not use beef in India as the majority of the Indian population are Hindus. Many oil companies operating in the United States of America profess that men and women should be treated equally and that bribery is wrong. But when they operate in the Middle East, women are regarded as subordinate to men and bribery is widely accepted. All this is nothing but representing the concept of relativism, which means that ethical truth is relative to groups holding it. Any action may be a right course of conduct in one country, but may be unethical in the other country.

Ethical relativism, despite being more suitable for a heterogeneous environment among widely dispersed host countries, is often refuted. It is said that it is based on non-sequitur. When two groups of persons have different beliefs, it is quite clear that one of the two beliefs is wrong. Again, there are specific norms that are a necessary condition for the very survival of the well being of any society. They cannot be different for different societies. Yet again, the apparent moral differences between societies often blur the fundamental moral similarities. Manuel Velasquez (1994) presents an example of an American manager making income disclosure to the income tax authorities in Italy. In Italy, since it was a usual practice to understate profits, the tax authorities overstated the profits and imposed a greater amount of tax. The American manager, who was not aware of this, presented the exact income with the result that the tax authorities overstated the income and imposed greater amount of tax, which was unjustified. This type of problem emerged because the American manager followed the ethics of his own country which was not fit for Italy. Velasquez is of the view that Italian tax practices were really not in conflict with American values. It looked different because Italian managers valued personal bargaining over rigid rules.

MNCs, combine both normativism and relativism. They try to impose their home country ethics till it is not opposed by the host country government.

If one makes a survey of ethical behaviour among MNCs, it is evident that a number of them combine both normativism and relativism. They try to impose their home country ethics on the host country to the extent it does not entail upon their profitability or till it is not opposed by the host country government. In some other cases, it is neither the host country ethics in totality nor the home country ethics in totality, but a mix of the ethical standards prevalent in all the countries of the firm's operation that is followed. Infact, ethical behaviour and social responsibility depends upon whether an MNC is ethnocentric, polycentric, or geocentric in character.

This analysis shows to what extent an international manager should stick to home country ethical norms and to what extent he should consider the local business ethics of the host country. Here we may mention the views of Donaldson (1996), which stress on respecting core human values that are basic to all business activities; on considering the local customs and tradition and on the manager's own judgement as to what is wrong and what is right in a particular situation.

10.4.3 Some Ethical Issues in International Business

It would be relevant to mention some ethical issues that have been a subject of debate among international managers in recent years. They are, for example, human rights, safety and environmental issues, corruption, and so on, which need some explanation here.

Ethics and Human Rights: It is often debated whether an international firm should move to a country, say, to China where human rights are found violated. One view is that trade with and investment in such countries hardly deter human rights abuses as it has been experienced in the case of western trade and investment relations with China. On the contrary, dismantling of apartheid in South Africa was possible through economic sanctions by some western countries.

If foreign trade and investment bring about improvement in the living standards, human rights abuses would be contained.

The other view is that economic prosperity and political freedom go side by side. If foreign trade and investment bring about improvement in the living standards, human rights abuses would be contained. It is said that this was the philosophy behind President Clinton's decision to decouple human rights issues from foreign trade policy formulation.

MNCs should abide by the local customs so long as they are tolerable by its own standards.

Safety and Environmental Issues: It is often debated whether the multinational corporations should implement home country norms of safety and pollution measures in the host country. As one finds, the safety and environment protection rules are very strict in western countries. If those rules are followed in developing host countries, the cost of production will be higher and the competitive strength vis-à-vis the local manufacturers will be eroded. If they are not followed, it goes against the ethical norms of the multinational company. One such case is the employment of child labour, which is unethical according to western countries norms but very common in most developing countries. What then should the multinational corporation do? Here we may quote the views of Richard T De George (1993) that in such cases the company should adopt consistency. This does not mean that the company should act consistently everywhere its subsidiaries exist. It should abide by the local customs so long as it is tolerable by its own standards. If it is beyond tolerance, the company should stick to its own ethical norms.

Issue of Corruption: In western countries, bribery is highly unethical. In the United States of America, there is a Foreign Corrupt Practices Act that prohibits companies from bribing any foreign official. The OECD countries do not allow their companies to enjoy tax deductions for bribing overseas. Sometimes it is said that making illegal payments speeds up

An international manager has to draw a line between what is ethical from the viewpoint of local custom and what is clearly unethical and then to take a decision.

the approval and the multinational corporations have not to wait longer for entry. But it cannot be denied that since money moves to bureaucrats/politicians that remains unproductive and that weakens the growth rate of the economy. In other words, bribery and corruption is counter productive (Mauro, 1995). On the contrary, there are many cases of illegal payment reported from different corners of the globe. In China reciprocal gifts are common and not unethical. In such cases, an international manager has to draw a line between what is ethical from the viewpoint of local custom and what is clearly unethical and then to take a decision.

A German engineering giant, Siemens is reported to have bribed potential customers at least in 10 countries to win business contracts. A sum of €1.3 billion has been found as a suspicious transaction. A German court has penalised such wrongdoings by Siemens. Many senior executives have left the company.

Again, a German automobile company, Volkswagen was found bribing labour representatives for their support. The chief executive was fined by a court.

Yet again, the petrochemical unit of a Swedish engineering company, ABB Ltd. bribed the local officials in Angola, Nigeria and Kazakhstan €1.0 billion in order to win contracts during 1997–2002. Its two officials were fined and the company agreed to return $5.9 million of profits without admitting/denying the allegations that it had violated the provisions of the Foreign Corrupt Practices Act.

—Based the reports published in *Mint*, 7.5.2008

Multinational companies market a number of medicinal products that are banned in their home country. They should care for social responsibility wherever they operate.

Issue of Consumerism: In developed countries, a lot of consumer protection activities take place. But in developing countries, they are lacking. It is reported that multinationals sell many harmful products in emerging economics. For example, companies market a number of medicinal products that are banned in their home country. They often perform human trials, especially on those who are uneducated. Companies manufacturing tobacco products sell them in developing countries without sufficient warning, whereas in the home market, they are sold under heavy marketing restrictions. Thus, it is advisable for multinational companies to care for social responsibility wherever they operate. They need apply home country norms in order to abide by ethical norms.

Transfer pricing lowers the tax burden of the firm as a whole and smoothens the firm's international cash management, but it is unethical as it brings about loss to the exchequer in both the home country and the host country.

Issue of Transfer Pricing: Transfer pricing is a means to encourage illegal transfer of funds among the different units of a company through over invoicing/under invoicing of export and imports. In many countries, there are strict rules restricting transfer pricing. Customs authorities are vigilant to check such practices. Even so, such practices are common. It is a fact that such practices lower the tax burden of the firm as a whole and smoothens the firm's international cash management, but it is unethical as it brings about loss to the exchequer in both the home country and the host country.

SUMMARY

- The performance of a firm depends largely on human behaviour. Human behaviour, in turn, depends on the socio-cultural and ethical environment. In other words, the socio-cultural and ethical environment influences international business decisions. If the environment is similar between the home country and the host country, the manager endeavours to reap maximum advantage from the similarity. If it is different, he or she tries to bridge the difference.
- Culture involves a whole set of social norms that shape human behaviour. The elements of culture are language, religion, education, attitudes and values, custom, aesthetics, social institution, and materialism. There is wide diversity among nations and regions as far as these elements are concerned. One study finds that there are four bases of cultural diversity. They are, for example, individualism/collectivism, masculinity/femininity, power distance, and uncertainty avoidance. An other study identifies five factors leading to cultural diversity. They are human-nature relationship, orientation towards time, beliefs about human nature, activity orientation of human being and inter-human relationship. Yet another theory emphasises on three factors, such as universalism/particularism, neutralism/emotionalism, and achievement/ascription.
- Cultural diversity influences competitive advantage. It effects communication between different levels of management, size of production, marketing of the product, and also upon employer-employee relationships.
- Cultural diversity should first be assessed and then managed. If diversity is only meagre, its partial assessment is sufficient. But if it is wide, comprehensive assessment is required. After an assessment is made, there is need for adaptation. Adaptation can be made to product policies. It can be done on an individual level or it can be institutional adaptation. Sometimes, when adaptation is not easy, the firm attempts to transfuse the home country culture into the host country operations.
- Ethics and social responsibility are very much related to culture. As far as international business is concerned, there is a long debate regarding whether MNCs should stick to their home country ethics or if they should adapt to the host country ethics.

REVIEW QUESTIONS

1. What is culture? What are its elements?
2. What are the factors that lead to cultural diversity? Does cultural diversity influence competitive advantage?
3. Explain how cultural diversity is managed.
4. What are ethics and social responsibility? Do you agree with the view that MNCs should stick to their home country ethics while operating in the host country.

References

Books

Czinkota, M.R. *et al* (1999), *International Business* (New York: Harcourt Brace).

De George, Richard T. (1993), *Competing with Integrity in International Business* (New York: Oxford University Press).

Donaldson, T. (1996),"Values in Tension: Ethics Away from Home" *Harvard Business Review,* XXIV (Sept.–Oct.), 26–34.

Dressler, David and Donald Carn (1969), *Sociology: The Study of Human Interactions* (New York: Knopf).

Dunning, J.F. (1993), *The Globalisation of Business* (London: Routledge).

Farmer, R.N. and B.M. Richman (1965), *Comparative Management and Economic Progress* (Illinois: Richard D. Irwin).

Goyder, G. (1951), *The Failure of Private Enterprise: A Study in Responsibility* (Oxford: Basil Blackwell).

Hofstede, G. (1980), *Culture's Consequences: International Differences in Work-related Values* (Beverly Hills: Sage Publishers).

Kluckhohn, C. and F. Strodtbeck (1961), *Variations in Value Orientations* (Westport, Conn., Greenwood Press).

Luthans, F. (1989), *Organisational Behaviour* (New York: McGraw Hill).

Robock, S.H. and Kenneth Simmonds (1983), *International Business and Multinational Enterprises* (Homewood: Richard D. Irwin).

Suzumura, K. (1994),"On the Social Responsibility of Corporations under Competition", in F. Neil Brady (ed.), *Ethical Universals in International Business*, (Berlin: Springer) pp.40–57.

Trompenaars, Fons (1994), *Riding the Waves of Culture* (New York: Irwin).

Velasquez, M. (1994), "Ethical Relativism and the International Business Manager" in Brady (ed.), *op.cit.*, pp. 15–26.

Journals

Black, J.S. (1988),"Work-role Transition: A Study of American Expatriate Managers in Japan", *Journal of International Business Studies*, XIX (2), 277–94.

Black, J.S. and L.W. Porter (1991), Managerial Behaviours and Job Performance: A Successful Manager in Los Angeles May Not Succeed in Hong Kong", *Journal of International Business Studies*, XXII (1), 99–113.

DeVries, H.P. (1969),"The Language Barriers", *Columbia Journal of World Business*, IV (1), 69

Government of India (1978), *Report on the High-powered Expert Committee on Companies and MRTP Acts* (New Delhi: Controller of Publications).

Lee, J.A. (1966),"Cultural Analysis in Overseas Operations", *Harvard Business Review*, XLIV (Mar–Apr.), 106–14.

Mauro, P. (1995),"Corruption and Growth". *Quarterly Journal of Economics*, no. 110, 681–712.

Miller, E.L. (1973), "The Selection Decision for an International Assignment: A Study of the Decision-maker's Behaviour", *Journal of International Business Studies*, IV (1), 49–65.

Mujtaba, B.G. (2004), "McDonald's Success Strategy and Global Expansion through Customer and Brand Loyalty", *Journal of Business Case Studies,* 3 (3), 17–23.

Reynolds, P.D. (1986), "Organisational Culture as Related to Industry, Position and Performance: A Preliminary Report", *Journal of Management Studies*, VII (3), 333–345.

Tung, R. (1981), "Selection and Training of Personnel for Overseas Assignments", *Columbia Journal of World Business*, XVI (Spring), 68–78.

SELECT FURTHER READINGS

Donaldson, T. (1989), *The Ethics of International Business* (New York: Oxford University Press).

Hofstede, G. (1997), *Culture and Organisations: Software of the Mind* (New York: McGraw-Hill).

Jamieson, I. (1982–83), "The Concept of Culture and its Relevance for an Analysis of Business Enterprise in Different Societies", *International Studies of Management and Organisation*, XII (1), 75–105.

Mead, R. (1994), *International Management: Cross-cultural Dimensions* (Oxford: Basil Blackwell).

Terpstra, V and K. David (1991), *The Cultural Environment of International Business* (Cincinnati: South-Western Publisher).

* What is now popularly known as the BSE was established as "The Native Share & Stock Brokers' Association" in 1875. It is the oldest stock exchange in Asia. Over the past 135 years, BSE has facilitated the growth of the Indian corporate sector by providing it with an efficient capital raising platform. The number of listed companies on BSE is 4900 and it is in the top ten of global exchanges in terms of the market capitalisation of its listed companies (as of December 31, 2009). The companies listed on BSE have total capitalisation of USD Trillion 1.28 (as of February, 2010)

NASDAQ, New York, America*

11

International Financial Environment: Exchange Rate

CHAPTER OBJECTIVES

International business operations are highly subjected to the international financial environment. The operations are conducted within the prevailing international monetary system, in which the exchange rate plays a very crucial role. The objective of the present chapter is to:

- ✦ Discuss the exchange rate regime beginning from the early days to the present one.
- ✦ Show how exchange rates are quoted.
- ✦ Explain how the exchange rate is determined in the spot market as well as in the forward market and the factors influencing exchange rate determination.
- ✦ Describe the theories of exchange rate behaviour.
- ✦ Show how exchange rate is forecast.

The international financial environment is an important factor in international business, influencing its size, pattern, and direction. For the convenience of the readers, the international financial environment is discussed in two chapters. The focus in the present chapter lies on the various aspects of the exchange rate, particularly regarding the evolution and development of the exchange rate system and exchange rate determination and forecasting. The following chapter will concentrate on the international financial and foreign exchange markets.

11.1 INTERNATIONAL MONETARY SYSTEM

11.1.1 Early System

The international monetary system discusses, among other things, the system of exchange rate or the relationship between the value of any two currencies. Centuries ago, when there was no established system and when the coins were made of valuable metal, the exchange rate was determined on the basis of the value of metal contained in the two currencies. The system was known as the commodity specie standard. The commodity specie standard was followed by the gold standard, which was considered of vital importance between 1870s and 1914. The gold standard was suspended during the Great War, after which it was readopted. But with substantial changes in the international economic scenario, it did not remain tenable; and by 1930s, it was finally abandoned.

> Gold Standard is a monetary system wherein the government holds gold coins in reserve against bank currency notes that are in circulation. The bank notes can be exchanged for gold on demand.

The form of gold standard was not essentially the same in the different countries adopting it. In the gold specie standard, gold coins were minted. Bank notes were exchanged for gold on demand. The price of gold was officially set, at which it was bought and sold. In the case of the gold bullion standard, however, there was no compulsion to maintain gold coinage. Individual bank notes were convertible into gold only through the purchase of gold bars at fixed rates, and not directly as in case of gold specie standard. The gold exchange standard was even more liberal as the currency was convertible into gold only through a currency being on gold specie standard. Russia had adopted the gold exchange standard and so the rouble was convertible into the British pound which was convertible into gold.

The gold standard possessed some inherent merits. Since the fixed weight of gold had formed the basis for a unit of the currency and since the free flow of gold was allowed among countries, the gold standard had provided for domestic price stability and for automatic adjustment in exchange rates and in the balance of payments. The supply of gold was fixed and so was the money supply. As a result, the domestic price level was stable. Again, any deficit in the balance of trade was made up through the price-specie flow mechanism. If a country experienced deficit on the trade account, the consequent outflow of gold led to shrinkage in money supply and to a lower price level. The lower price level made the exports competitive, which in turn wiped out the trade deficit. Yet again, any deviation from the mint parity could be avoided through the free flow of gold from one country to the other. During the pre-War period, one ounce of gold was equal to £4.24 or to $20.67, meaning that $4.87 was equal to one pound. If the value of dollar had depreciated to $5.25 a pound, arbitrageurs bought one ounce of gold in the United State of America for $20.67 and exchanged gold for £4.24 in the United Kingdom. They exchanged the pound for the dollar at the rate of $5.25/£ getting $22.26. This way they earned $22.26−20.67 or $1.59. The process continued till the deviated rate went back to mint parity.

11.1.2 Bretton Woods System of Exchange Rates

The demise of the gold standard led to large scale oscillation in the exchange rate. Three currency blocs were created, namely, Sterling Area, Dollar Area, and Gold Bloc. The exchange rates were fixed within a currency bloc, but oscillations in inter-bloc exchange rates could not be checked. All this required the creation of an international body that could help create an orderly exchange rate regime and could have surveillance over it. The Bretton Woods Conference of July 1944 resolved to create the International Monetary Fund (IMF) for this purpose. The IMF was established in 1945. A new system of exchange rate evolved. Since this new system was the aftermath of the Bretton Woods Conference, it was known as the Bretton Woods system of exchange rates.

Features of the Bretton Woods System of Exchange Rates

- The value of members' currency set in terms of gold or US dollar, meaning that the exchange rate was fixed.
- Provision for adjustable pegs, meaning that a country could devalue its currency to remedy its continued balance of payments problem
- Similarly, as in gold exchange standard, members' currencies were convertible into the US dollar and the US dollar was convertible into gold. This means the dollar was as strong as gold.

The Bretton Woods system of exchange rates represented a fixed parity system with adjustable pegs. Each member country was to set a fixed value, called the par value, of its currency in terms of gold or the US dollar. It was the par value that determined the exchange rate between any two currencies. Minor fluctuations, if any, within a band of ±1.0 were expected to be corrected through the active intervention of the monetary authorities. But if a country faced "fundamental disequilibrium" in its balance of payments, it could devalue its currency. It did not require approval of the IMF for the changes up to 5.0 per cent in the value of the currency, but beyond this percentage, the IMF's approval was necessary. Again, the Bretton Woods system was

Fixed parity with adjustable pegs is a fixed exchange rate system along with provisions to devalue/revalue the currency vis-á-vis a foreign currency.

Fundamental Disequilibrium is consistent balance of payments deficit reaching an unmanageable level.

like the gold exchange standard. The US dollar was convertible into gold at a fixed rate of $35 per troy ounce of gold. Other currencies were convertible into gold via the US dollar. In this system, the US dollar came to be the intervention currency, replacing the British pound that had played this role during the early decades of the twentieth century.

The Bretton Woods system did bring about stability in the exchange rate, but it could not go a long way. It was primarily the loss of confidence in the US dollar following deterioration in the US balance of payments since the late 1950s that hindered the smooth functioning of this system and led to its collapse by 1973. Since the US dollar was the strongest currency in the post-war years and since it was convertible into gold, a number of central banks held a large amount of dollar denominated securities as reserves. When the US balance of payments began deteriorating in the late 1950s and the real value of the dollar was expected to be lower, the central banks started converting these securities into gold. This caused a huge outflow of gold from the US Treasury, which in turn weakened the dollar. The weakening of the dollar led to further conversion of dollar denominated securities into gold. Barring US citizens from buying gold eroded their confidence further. Expectation of a record deficit in 1971 in the US balance of payments resulted in massive selling of dollar in the international financial market. The gold price in the free market rose, disturbing the relationship between the dollar and gold. There was a speculative run on the dollar. By August 1971, a full-blown crisis appeared against the dollar. Only during the first half of this month did the US government's reserves fall by $1.1 billion. The Nixon administration suspended the convertibility of the dollar into gold and this was a serious blow to the fixed parity system.

In December 1971, the Smithsonian Arrangement helped realign the par value of major currencies. For example, the US dollar was depreciated by 8.57 per cent. On the other hand, the currencies of the surplus countries were appreciated by percentages ranging from 7.4, for the Canadian dollar, to 16.9, for Japanese yen. Moreover, the fluctuation band of the par values was raised from +/−1.0 per cent to +/−2.25 per cent in order to provide greater room to member countries to manage their exchange rates. But this arrangement too could not go far. There was a tide of speculation against the dollar. The US Government devalued dollar further by 10.0 per cent in February 1973, but it failed to improve the situation. The foreign exchange markets were closed in 1973 to avert a crisis. But when they reopened, major currencies came on to float, thus delivering a death blow to the Bretton Woods system of exchange rates.

11.1.3 Exchange Rate Regime since 1973

In the wake of the collapse of the Bretton Woods exchange rate system, the IMF appointed the Committee of Twenty which suggested various options for the exchange rate arrangement. These suggestions were approved at Jamaica during February 1976 and were formally incorporated into the text of the Second Amendment to the Articles of Agreement, which came into force from April 1978. The options were broadly:

1. Floating—independent and managed
2. Pegging of currency
3. Crawling peg
4. Target zone arrangement

Floating Rate System: In a floating-rate system, it is the market forces that determine the exchange rate between two currencies. The following section of this chapter deals with how market forces help determine the exchange rate. The advocates of the floating rate system put forth two major arguments. One is that the exchange rate varies automatically according to the changes in the macroeconomic variables. As a result, there is no gap between the real exchange rate and the nominal exchange rate. The country does not need any adjustment, which is often required in a fixed rate regime and so it does not have to bear the cost of adjustment (Friedman, 1953). Secondly, in the long run, the exchange rate hovers around the equilibrium. In fact, it is the natural outcome of the market forces. The third argument is that this system possesses insulation properties, meaning that the currency remains isolated from the shocks emanating from other countries. It also means that the government can adopt an independent economic policy without impinging upon the external sector performance (Friedman, 1953). Last but not least, it provides for greater stimulus to trade and investment which is not possible is a fixed-rate system.

In a **floating-rate system**, it is the market forces that determine the exchange rate between two currencies. The merits of this system are:

1. Exchange rate is automatically adjusted according to the changes in macroeconomic variables.
2. Exchange rate is almost stable around the equilibrium in the long run.
3. It has insulation properties.
4. Trade and investment get greater stimulus.

However, empirical studies do not necessarily confirm these views. MacDonald (1988) finds that the exchange rates among countries on a floating rate system during 1973–85 were much more volatile than warranted by changes in the fundamental monetary variables. Dunn (1983) finds absence of insulation properties. During the early 1980s, when the United States of America was practising a tight monetary policy through raising interest rates, the European countries raised interest rates so as to prevent a large outflow of capital to the United States of America. Again, since the nominal exchange rate tended to adjust more rapidly than the market price of goods, the nominal exchange rate turbulence was closely related to real exchange rate turbulence (Frenkel and Mussa, 1980). Cushman (1983) feels that uncertainty in the real exchange rate did affect trade among several industrialised countries. Dunn (1983) gives an example of Canadian firms borrowing long term funds from the United States of America, which subsequently faced heavy losses due to 14 per cent real depreciation of Canadian dollar during 1976–79. He also finds that the large appreciation in the real value of pound in late 1970s had led to insolvency of many United Kingdom firms as their products turned uncompetitive in the world market.

Besides, developing countries in particular do not find floating rates suitable to their needs. Since their economy is not diversified and since their export is subject to frequent changes in demand and supply, they face frequent changes in exchange rates. This is more especially when foreign demand for their products is price-inelastic. When the value of

Clean floating represents no intervention by the monetary authorities in the foreign exchange market, while dirty floating involves frequent intervention.

their currency depreciates, export earnings usually sag in view of inelastic demand abroad. Again, greater flexibility in exchange rates between a developed and a developing country generates greater exchange risk in the latter. This is because of the low economic profile of developing countries and also because they have limited access to the forward market and to other risk reducing mechanisms.

The floating rate system may be either independent or managed. Theoretically speaking, the system of managed floating involves intervention by the monetary authorities of the country for the purpose of exchange rate stabilisation. The process of intervention interferes with the market forces and so it is known as "dirty" floating as against independent floating, which is known as "clean" floating. However, in practice, intervention is a global phenomenon. Keeping this fact in mind, the IMF is of the view that while the purpose of intervention in case of an independent floating system is to moderate the rate of change and to prevent undue fluctuation in the exchange rate, the purpose of the managed floating system is to establish a level for the exchange rate.

Leaning-against-the-wind Intervention refers to intervention meant to check the exchange rate from moving away from equilibrium.

Intervention is direct as well indirect. When the monetary authorities stabilise the exchange rate through changing interest rates, it is indirect intervention. On the other hand, in case of direct intervention, the monetary authorities purchase and sell foreign currency in the domestic market. When they sell foreign currency, its supply increases. The domestic currency appreciates against the foreign currency. When they purchase foreign currency, its demand increases. The domestic currency tends to depreciate vis-á-vis the foreign currency. The IMF permits such intervention. If intervention is adopted to prevent long term changes in the exchange rate, away from equilibrium, it is known as "leaning-against-the-wind" intervention. On the contrary, if the purpose is to support the current trend of exchange rate movement towards equilibrium, it is known as "leaning-with-the-wind" intervention.

Intervention also helps move the value of domestic currency up or move down through the expectations channel. When the monetary authorities begin supporting the foreign currency, speculators begin buying it forward in the expectation that it will appreciate. Its demand rises and, in turn, its value appreciates vis-á-vis the domestic currency.

Intervention may be stabilising or destabilising. Stabilising intervention helps move the exchange rate towards equilibrium, while destabilising intervention is found in cases where the rates are moving away from the equilibrium despite intervention. The former causes gains of foreign exchange, while the latter causes loss of foreign exchange. Suppose the rupee depreciates from 33 a dollar to 36 a dollar. The Reserve Bank of India sells US $1000 and rupee improves then to 33. The RBI will be able to replenish the lost reserves by buying the dollar at Rs. 33/US $. The gain will be US $(36000/33−1000) or US $91. But after intervention, if the rupee falls to 40 a dollar, the loss will be US $(36000/40−1000) or US $100. The monetary authorities do not normally opt for destabilising intervention, but it is very difficult to know in advance whether intervention would be really destabilising. Empirical studies show both stabilising and destabilising intervention. Longworth's study (1980) finds stabilising intervention in the case of the Canadian dollar, while Taylor (1982) finds destabilising intervention in case of some European countries and Japan during the 1970s.

Again, intervention may be sterilised or non-sterilised. When the monetary authorities purchase foreign currency through created money, the money supply in the country increases. It leads to inflation. This is an example of non-sterilised intervention. But if simultaneously, securities are sold in the market to mop up the excess supply of money, intervention does not lead to inflation. It takes the form of sterilised intervention. Obstfeld's (1983) study reveals that non-sterilised intervention is common, for sterilised intervention is not very effective in view of the fact that it does not change the ratio between the supply of domestic currency and that of the foreign currency very evidently. However, on the whole, Loopesko (1984) confirms the effect of intervention on the exchange rate stabilisation.

Sterilised Intervention is intervention negating any increase in money supply.

Last but not least, there has also been a case of coordinated intervention. As per the Plaza Agreement of 1985, G-5 nations had intervened in the foreign exchange market in order to bring the US dollar in consistence with the prevailing economic indicators.

Pegging of Currency: Normally, a developing country pegs its currency to a strong currency or to a currency with which it conducts a very large part of its trade. Pegging involves fixed exchange rate with the result that trade payments are stable. But in case of trading with other countries, stability cannot be guaranteed. This is why pegging to a single currency is not advised if the country's trade is diversified. In such cases, pegging to a basket of currencies is advised. But if the basket is very large, multi-currency intervention may prove costly. Pegging to SDR is not different insofar as the value of the SDR itself is pegged to a basket of five currencies. Ugo Sacchetti (1979) observes that many countries did not relish pegging to the SDR in view of its declining value.

Pegging involves fixed exchange rate. A currency can be pegged to: 1. a single currency, 2. basket of currencies, and 3. SDRs. In a currency-board arrangement, the currency is pegged to a foreign currency whose reserves are maintained to bring in exchange rate stability.

> The Russian Central Bank devalued rouble for the second time in the week by a total of 8.7 per cent. The rouble fell to a four-year low of 37.5481 per euro (the basket being composed of euro and US dollar). This decision was in view of a drain of 27 per cent of foreign exchange reserves and a 16 per cent fall in the value of the currency vis-à-vis US dollars consequent upon a 69 per cent fall in oil prices.
> —*Financial Express*, 16.12.2008

Sometimes, pegging is a legislative commitment that is often known as the **currency board arrangement**. The currency board pegs the domestic currency to the currency of another nation and buys and sells the foreign currency reserves in order to maintain the parity value. Again, it is a fact that the exchange rate is fixed in case of pegging, yet it fluctuates within a narrow margin of at most ± 1.0 per cent around the central rate. On the contrary, in some countries, the fluctuation band is wider and this arrangement is known as "pegged exchange rates within horizontal bands".

Crawling Peg allows the peg to change gradually over time to catch up with changes in the market determined rates.

Target-zone Arrangement is a sort of monetary union with fixed exchange rate within the union.

Crawling Peg: Again, a few countries have a system of a crawling peg. Under this system, they allow the peg to change gradually over time to cach up with changes in the market determined rates. It is a hybrid of fixed-rate and flexible rate systems. So this system avoids too much of instability and too much of rigidity. Edwards (1983) confirms this advantage in case of a sample of some developing countries. In some of the countries opting for the crawling peg, crawling bands are maintained within which the value of currency is maintained.

Target Zone Arrangement: In a target zone arrangement, the intra-zone exchange rates are fixed. An apposite example of such an arrangement was found in European Monetary Union (EMU) before coming in of Euro. However, there are cases where the member countries of a currency union do not have their own currency, rather they have a common currency. Under this group, come the member countries of the Eastern Caribbean Currency Union, the Western African Economic and Monetary Union, and the Central African Economic and Monetary Community. The member countries of the European Monetary Union too came under this group with the euro substituting their currency in 2002.

Global Scenario of Exchange Rate Arrangements: Firms engaged in international business must have an idea about the exchange rate arrangement prevailing in different countries as this will facilitate their financial decisions. In this context, it can be said that over a couple of decades, the choice of the member countries has been found shifting from one form of exchange rate arrangement to the other, but, on the whole, preference for the floating rate regime is quite evident. At present, as many as 25 of a total of 187 countries have an independent float, while the other 51 countries have managed floating system. The other 5 countries have a crawling peg, while 65 countries have pegs of different kinds. The EMU and other 20 countries of Africa and the Caribbean region come under some kind of economic and monetary integration scheme in which they have a common currency. Lastly, nine countries do not have their own currency as legal tender. The list is given here in Table 11.1.

Table 11.1 Exchange Rate Arrangements among Different Countries (As on July 31, 2006)

Sr. No.	*Exchange Rate Regime (Number of countries)*	*Countries*
1.	Exchange rate arrangements where the currency of another country circulates as sole legal tender (9)	Ecuador, El Salvador, Kiribati, Marshall Islands, Micronesia, Palau, Panama, San Marino, Timor-Leste
2.	Exchange rate arrangements where the members of the currency union share the same legal tender (32)	**Eastern Caribbean Currency Union:** Antigua and Barbuda, Dominica, Grenada, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines

	West African Economic and Monetary Union: Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo **Central African Economic and Monetary Community:** Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon **European Union:** Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain
3. Currency Board Arrangements (7)	Bosnia and Herzegovina, Brunei Daresalam, Bulgaria, China—Hong Kong SAR, Djibouti, Estonia, Lithuania
4. Conventional Fixed Peg Arrangements (52)	**Against a single currency (47)**: Aruba, Bahamas, Bahrain, Barbados, Belarus, Belize, Bhutan, Bolivia, Cape Verde, China, Comoros, Egypt, Eritrea, Ethiopia, Guyana, Honduras, Iraq, Jordon, Kuwait, Latvia, Lebanon, Lesotho, Macedonia FYR, Maldives, Malta, Mauritania, Namibia, Nepal, Netherlands Antilles, Oman, Qatar, Pakistan, Rwanda, Saudi Arabia, Seychelles, Sierra Leone, Solomon Islands, Suriname, Swaziland, Syrian Arab Republic, Trinidad & Tobago, Turkmenistan, Ukraine, United Arab Emirates, Venezuela, Vietnam, Zimbabwe. **Against a composite(5)**: Fiji, Libya, Morocco, Samoa, Vanuatu.
5. Pegged Exchange Rates within Horizontal Bands (6)	Cyprus, Denmark, Hungary, Slovak Rep., Slovenia, Tonga.
6. Crawling Pegs (5)	Azerbaijan, Botswana, Costa Rica, Iran, Nicaragua.
7. Managed Floating (51)	Afghanistan, Algeria, Angola, Argentina, Armenia, Bangladesh, Burundi, Cambodiá, Colombia, Croatiá, Czech Republic, Dominican Rep., Gambia, Ghana, Georgia, Guatemala, Guinea, Haiti, India, Jamaica, Kazakhstan, Kenya, Kyrgyz Rep., Lao PDR, Liberia, Madagascar, Malawi, Malaysia, Mauritius, Moldova, Mongolia, Mozambique, Myanmar, Nigeria, Papua New Guinea, Paraguay, Peru, Romania, Russia, Sao Tome and Principe, Serbia and Montenegro, Singapore, Sri Lanka, Sudan, Tajikistan, Thailand, Tunisia, Uruguay, Uzbekistan, Yemen, Zambia.
8. Independently Floating (25)	Albania, Australia, Brazil, Canada, Chile, Democratic Republic of Congo, Iceland, Indonesia, Israel, Japan, Korea, Mexico, New Zealand, Norway, Philippines, Poland, Somalia, South Africa, Sweden, Switzerland, Tanzania, Turkey, Uganda, United Kingdom, United States of America.

Source: *Based on IMF database.*

11.2 EXCHANGE RATE QUOTATION

11.2.1 Direct and Indirect Quotes

Exchange rates are quoted either directly or indirectly. A direct quote gives the home currency price of a certain quantity of foreign currency, usually one unit or 100 units. If India quotes the exchange rate between the rupee and US dollar directly, the quotation will be written as Rs. 45/US \$. On the other hand, in case of indirect quoting, the value of one unit of home currency is presented in terms of foreign currency. If India adopts indirect quote, the banks in India will quote the exchange rate as US \$0.022/Re.

11.2.2 Buying and Selling Rates

Normally, two rates are published—one being the buying rate and the other being the selling rate. Buying rate is also known as the bid rate. Selling rate is known as ask rate or offer rate. Bid rate is always given first, which is followed by the ask rate quote. Suppose the rupee-US dollar rate is Rs. 45.00−45.30/US \$, the former is the buying rate and the latter is the selling rate. The former is the rate at which the banks purchase a foreign currency from the customer. The selling rate is the rate at which the banks sell any foreign currency to their customers. Since the banks need some profit in these transactions, the selling quote is higher than the buying quote. The difference between these two quotes forms the banks' profit and it is known as spread. The bid-ask spread is often stated in percentage terms that can be computed as follows

$$\text{Spread} = \frac{\text{Ask price} - \text{Bid price}}{\text{Askprice}} \times 100 \qquad \text{...(11.1)}$$

11.2.3 Forward Rates

The quotes for the forward market are also published in the newspaper and periodicals. There are two ways of quoting forward rates. One is known as an outright quote, while the other is known as swap quote. The outright quote for the US dollar in terms of the rupee can be written for different periods of forward contract, as follows:

Spot	One month	Three months
Rs. 40.00−40.30	Rs. 39.80−40.40	Rs. 39.60−40.50

The swap quote, on the other hand, expresses only the difference between spot quote and forward quote. It can be written as follows:

Spot	One month	Three months
Rs. 40.00−30	(20)−10	(40)−20

It may be noted that decimals are not written in swap quotes.

In the above quotes, it is found that the longer the maturity, the greater the change in the forward rates. Again, with longer maturity, the spread too gets wider. This is because of uncertainty in the future, which increases with lengthening of maturity. The change in forward rates may be upwards or it may be downwards. With such movements, disparity arises between the spot and forward rates, which is known as forward rate differential.

If the forward rate is lower than the spot rate, it will be a case of forward discount. On the contrary, if the forward rate is higher than the spot rate, it would be known as the forward premium. Forward premium or discount is expressed as an annualised percentage deviation from the spot rate. It is computed as follows:

Forward premium (discount)

$$= \frac{n - \text{day forward rate} - \text{spot rate}}{\text{spot rate}} \times \frac{360}{n} \quad ...(11.2)$$

where n is the length of forward contract expressed in number of days.

Applying the above example of one month forward quotation, we get:

$$\frac{39.80 - 40.00}{40.00} \times \frac{360}{30} = -\ 0.06 \text{ or } 6\% \text{ forward discount}$$

11.2.4 Cross Rates

Sometimes the value of a currency in terms of another is not known directly. In such cases, one currency is sold for a common currency; and again, the common currency is exchanged for the desired currency. This is known as the cross rate trading and the rate established between the two currencies is known as cross rate. Suppose, a newspaper quotes Rs. 35.00 − 35.20/US $; and at the same time, it quotes C $0.76 − 0.78/US $, but does not quote the exchange rate between rupee and Canadian dollar. Thus, the rate of exchange between the rupee and the Canadian dollar will be found out through the common currency, the US dollar. The technique is similar for both the spot cross rates and the forward cross rates.

> One currency is sold for a common currency; and again, the common currency is exchanged for the desired currency. This is known as cross rate trading.

The selling rate of the Canadian dollar in India can be found out by selling the rupee to the bank for US dollars at Rs. 35.20/US $ and then buying the Canadian dollar with the help of the US dollar at C $0.76/US $. This means,

> Cross rate is exchange rate between two currencies determined via a common currency.

$$\text{Rs. } 35.20/\text{US } \$1 \times \text{US } \$1/\text{C } \$0.76 = \text{Rs. } 46.32/\text{C}\$$$

The Buying rate of the Canadian dollar in India can be found out by buying the Indian rupee from the bank for the US dollar at Rs. 35.00/US $ and selling the Canadian dollar for the US dollar at C $0.78/US $. This means,

$$\text{Rs. } 35.00/\text{US } \$1 \times \text{US } \$1/\text{C } \$0.78 = \text{Rs. } 44.87/\text{C}\$$$

Combining the two, one gets

$$\text{Rs. } 44.87-46.32/\text{C}\$$$

11.3 DETERMINATION OF EXCHANGE RATE IN SPOT MARKET

11.3.1 Process of Determination

It is the interplay of demand and supply forces that determines the exchange rate between two currencies in a floating-rate regime. The exchange rate between, say, the rupee and the US dollar depends upon the demand for the US dollar and the supply of US dollar in the Indian foreign exchange market. The demand for foreign currency comes from individuals and firms who have to make payments to foreigners in foreign currency, mostly on account of import of goods and services and purchase of securities. The supply of foreign exchange results from the receipt of foreign currency, normally on account of export or sale of financial securities to foreigners.

In Figure 11.1, the exchange rate designated by the price of the US dollar (foreign currency) in terms of the rupee is shown on the vertical axis and the supply of, and demand for, the US dollar is shown on the horizontal axis. The demand curve slopes downward to the right because the higher the value of the US dollar, the costlier the imports and the importers curtail the demand for imports. Consequently, the demand for foreign currency falls. Similarly, a higher value of the US dollar makes exports cheaper and, thereby, stimulates the demand for export. The supply of the US dollar increases in the form of export earnings. This is why the supply curve of the US dollar moves upward to the right with a rise in its value. The equilibrium exchange rate arrives where the supply curve intersects the demand curve at Q_1. This rate, as shown in the figure 11.1, is Rs. 40/US $.

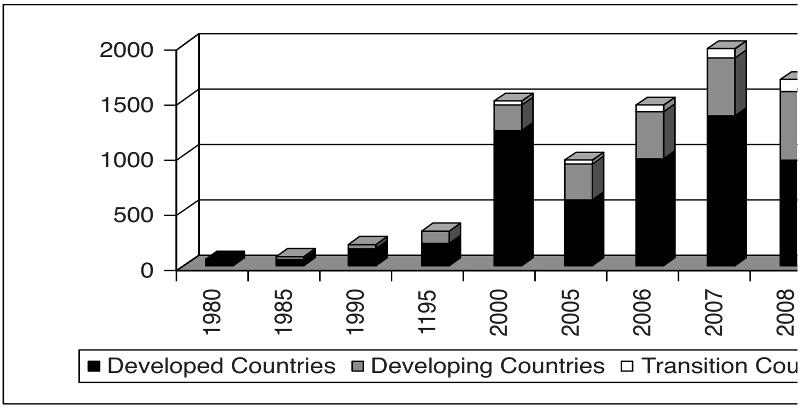


FIGURE 11.1 Exchange Rate Determination

If the demand for import rises owing to some factors at home, the demand for the US dollar will rise to D_1 and intersect the supply at Q_2. The exchange rate will be Rs. 42/US $. But if export rises as a sequel to decline in the value of rupee and the supply of dollar increases to S_1, the exchange rate will again be Rs. 40/US $. Quite evidently, frequent shifts in demand and supply conditions cause the exchange rate to adjust frequently to a new equilibrium.

11.3.2 Factors Influencing Exchange Rate

The most important factor influencing the exchange rate are

1. Flow of funds on the current and capital accounts
2. Rate of inflation
3. Rate of interest
4. Market intervention by the Central Bank
5. Psyche

The market intervention mechanism has already been discussed. So the other three factors will be discussed at some length.

Flow of Funds on the Current and Capital Accounts: A country with current account deficit experiences a depreciation of its currency. It is because there is a demand for foreign currency to make payment for imports. On the contrary, a current account surplus country possesses a large supply of foreign exchange with the result that the country experiences an appreciation of its currency. An apposite example of current account deficit country is the USA whose trade deficit was one of the more important causes for depreciation in dollar during post 2002 years. On the other hand, the currency of Japan and Switzerland appreciated in view of surplus current account. However, the current account alone is not responsible for this state of affairs. Sometimes, capital account flows help change the situation. There are countries, such as Australia, Britain, Iceland and New Zealand that experienced greater appreciation in their currency in the first half of 2008 even after having large deficit on their current account relatively to Japan and Switzerland that witnessed surpluses on their current account and, at the same time, smaller appreciation in their currency. In fact, this paradox is the result of carry trade that explains why trade flows are dwarfed by capital flows on account of interest rate differential.

Impact of Inflation: It is normally the inflation rate differential between two countries that influences the exchange rate between their currencies. The influence of inflation rate finds a suitable explanation in the Purchasing Power Parity (PPP) theory (Cassel, 1921; Officer, 1976). The theory suggests that at any point of time, the rate of exchange between two currencies is determined by their purchasing power. If e is the exchange rate and P_A and P_B are the purchasing power of

Purchasing Power Parity Theory suggests that at any point of time, the rate of exchange between two currencies is determined by their purchasing power.

the currencies in the two countries, A and B, the equation can be written as:

$$e = \frac{P_A}{P_B} \qquad ...(11.3)$$

In fact, this theory is based on the theory of one price in which the domestic price of any commodity equals its foreign price quoted in the same currency. To explain it, if the exchange rate is Rs. 2/US $, the price of a particular commodity must be US $50 in the United State of America if it is Rs. 100 in India. In other words,

US $ price of a commodity × price of US $
= Rupee price of the commodity ...(11.4)

If inflation in one country causes a temporary deviation from the equilibrium, arbitrageurs will begin operating, as a result of which equilibrium will be restored through changes in the exchange rate. Suppose, the price of the commodity soars up in India to Rs. 125, the arbitrageurs will buy that commodity in the United States of America and sell it in India earning a profit of Rs. 25. This will go on till the exchange rate moves to Rs. 2.5/US $ and the profit potential of arbitrage is eliminated.

The exchange rate adjustment resulting from inflation may be explained further. If the Indian commodity turns costlier, its export will fall. At the same time, its import from the United States of America will expand as the import gets cheaper. Higher import will raise the demand for the US dollar raising, in turn, its value vis-á-vis rupee.

However, this version of the theory, which is known as the absolute version, holds good if the same commodities are included in the same proportion in the domestic market basket and the world market basket. Since it is normally not so, the theory faces a serious limitation. Moreover, it does not cover non-traded goods and services, where the transaction cost is significant.

Relative version of the PPP theory states that the exchange rate between the currencies of the two countries should be a constant multiple of the general price indices prevailing in the two countries.

In view of the above limitation, another version of this theory has evolved, which is known as the **relative version of the PPP theory**. The relative version of PPP theory states that the exchange rate between the currencies of the two countries should be a constant multiple of the general price indices prevailing in the two countries. In other words, percentage change in the exchange rates should equal the percentage change in the ratio of price indices in the two countries. To put it in the form of an equation, where I_A and I_B are the rates of inflation in Country A and Country B, e_o is the A's currency value for one unit of B's currency at the beginning of the period and e_t is the spot exchange rate in period t, then:

$$\frac{e_t}{e_0} = \frac{(1 + I_A)^t}{(1 + I_B)^t} \qquad ...(11.5)$$

For example, if India has an inflation rate of 5 per cent and the United State of America has a 3 per cent rate of inflation and if the initial exchange rate is Rs. 40/US $, the value of the rupee in a two year period will be:

$$e_2 = 40\left(\frac{1.05}{1.03}\right)^2$$

or Rs. 41.57/US $.

Such an inflation-adjusted rate is known as the real exchange rate. When government sticks to a particular exchange rate without caring for inflation prevailing there, there emerges a gap between the real and the nominal exchange rates, which effects export competitiveness. This is why this theory suggests that a country with a high rate of inflation should devalue its currency relative to the currency of the countries with lower rates of inflation.

The theory holds good only if: (1) Changes in the economy originate from the monetary sector, (2) The relative price structure remains stable in different sectors in view of the fact that changes in the relative prices of various goods and services may lead differently constructed indices to deviate from each other, and (3) There is no structural change in the economy, such as changes in tariff, in technology, and in autonomous capital flow.

Again, if difference of the inflation rate between two countries is small, its effect on competitiveness may be offset by other factors, such as its balance of payments performance, development in real income, interest rate differential, and so on. As a result, comparison of inflation rates may not explain changes in exchange rates.

A number of studies have empirically tested the two versions of the PPP theory. The absolute version has been tested by Isard (1977) and McKinnon (1979). Both of them find violation of the theory in the short run, but in the long run, they find the theory holding good to some extent.

As regards the relative version, studies made till the early 1980s found that normally the rate of inflation and the exchange rate were related, especially in the long run (Aliber and Sickney, 1975; Dornbusch, 1976; Mussa, 1982). But subsequent studies also find clear-cut violation of the theory in the long run (Adler and Lehmann, 1983; Edison, 1985). Taylor (1988) finds very little evidence of PPP holding good. In a review of 14 cases, MacDonald (1988) finds that in 10 cases, the theory is not applicable even in the long run, but in four cases it holds good in the long run.

Primarily, there are three factors why the PPP theory does not hold good in real life. First, the assumptions of this theory do not necessarily hold good in real life. Secondly, there are other factors such as interest rates, governmental interference, and so on that influence the exchange rate. In early 1990s, some of the European countries experienced a higher inflation rate than in the United States of America, but their currency did not depreciate against dollar in view of high interest rate attracting capital from the United States of America. Thirdly, when no domestic substitute is available for import, goods are imported even after their prices rise in the exporting countries.

Interest Rate: Experts differ on how changes in interest rate influence the exchange rate. The flexible price version of monetary theory explains that any rise in domestic interest rate lowers the demand for money. Lower demand for money in relation to the supply of money causes depreciation in the value of domestic currency. On the contrary, the sticky price version of monetary theory has a different explanation. According to this version a rise in interest rate increases the supply of loanable funds, which means a greater supply of money and a depreciation in domestic currency. But at the same time, it shares the view of the balance of payments approach where a higher interest rate at home, than in a foreign country, attracts capital from abroad in anticipation of higher return. The inflow of foreign currency will increase the supply of foreign currency and raise the value of the domestic currency.

However, Fisher suggests, this proposition cannot be thought of in isolation of inflation, inasmuch as inflation negates the return on capital to be received. If the interest rate is 10 per cent and the rate of inflation is 10 per cent, the real return on capital would be zero. This is because the gain in the form of interest compensates the loss on account of inflation. In fact, it was Irving Fisher who decomposed nominal interest into two parts—real interest rate and the expected rate of inflation. And so, **the relationship between nominal interest rate and the expected rate of inflation is known as the Fisher Effect.**

Fisher effect states that a particular nominal interest rate, covers both the expected inflation and the required real interest rate.

The Fisher effect states that whenever an investor thinks of an investment, he is interested in a particular nominal interest rate, which covers both the expected inflation and the required real interest rate. In form of an equation, it can be shown as:

$$1 + r = (1 + a)\,(1 + I) \qquad \ldots(11.6)$$

Where r is the nominal interest rate;
a is the real interest rate; and
I is the expected rate of inflation.

Suppose, the required real interest rate is 4 per cent and the expected rate of inflation is 10 per cent, the required nominal interest rate will be:

$$1.04 - 1.10 - 1 = 14.4\%.$$

Suppose, the interest rate in the United States of America is 4 per cent and the inflation rate in India is 10 per cent higher than in the United States of America. A US investor will be tempted to invest in India only when the nominal interest in India is more than 14.4 per cent.

The concept of real interest rate applies to all investment—domestic and foreign. An investor invests in a foreign country if the real interest rate differential is in his favour. But when such a differential exists, arbitrage begins in form of international capital flow, which ultimately equals the real interest rate across countries. Suppose, the real interest rate is 5 per cent in India and 4 per cent in the United States of America, capital will begin flowing from the USA to India. In the USA, declining volume of capital will raise the real interest rate, while the increasing volume of capital in India will push down the interest rate. The capital flow will continue till the real interest rate in the two countries becomes equal. This means that the process of arbitrage helps equate the real interest

Since the real interest rate is equal in different countries, a country with higher nominal interest rate must be facing a higher rate of inflation.

rate across countries. And since the real interest rate is equal in different countries, a country with higher nominal interest rate must be facing a higher rate of inflation.

However, for this type of arbitrage, it is necessary that the capital market is homogeneous throughout the globe so that the investors do not differentiate between the domestic capital market and the foreign capital markets. In real life, a homogeneous capital market is not found in view of government restrictions and varying economic policies in different countries. As a result, interest rate varies among countries. Mishkin (1984) finds that investors have a strong liking for the domestic capital market in order to insulate themselves from foreign exchange risk. Arbitrage will not occur even if the real interest rate on foreign securities is higher. The Fisher effect is helpless on this count. Again, the Fisher effect normally holds good in case of short maturity government securities and very little in other cases (Abdullah, 1986).

Empirical tests present different results. Gibson (1970, 1972) and Fama and Schwert (1977) favour the Fisher effect; while the studies of Mishkin (1984) and Cumby and Obstfeld (1984) do not support the Fisher effect.

International Fisher effect is a combination of the conditions of the PPP theory and Fisher's closed proposition.

There is also Fisher's open proposition, known as the **International Fisher Effect** or the generalised version of the Fisher effect. It is a combination of the conditions of the PPP theory and Fisher's closed proposition. It may be recalled that the PPP theory suggests that exchange rate is determined by the inflation rate differentials, while the latter states that the nominal interest rate is higher in a country with a higher inflation rate. Combining these two propositions, the International Fisher effect states that the interest rate differential shall equal the inflation rate differential. In the form of an equation, it can be written as:

The International Fisher effect states that the interest rate differential shall equal the inflation rate differential.

$$\frac{1 + r_A}{1 + r_B} = \frac{1 + I_A}{1 + I_B} \qquad ...(11.7)$$

The rationale behind this proposition is that an investor likes to hold assets denominated in currencies expected to depreciate only when the interest rate on those assets is high enough to compensate the loss on account of depreciating exchange rate. As a corollary, an investor holds assets denominated in currencies expected to appreciate even at a lower rate of interest because the expected capital gain on account of exchange rate appreciation will make up the loss on yield on account of low interest.

The equality between interest rate differential and inflation rate differential can be explained with the help of the following example. Suppose, India is expecting 8 per cent inflation rate during the next one year as compared to 3 per cent inflation rate in the United States of America. If the exchange rate in the beginning of the year is Rs. 40/US $, the value of rupee will fall vis-á-vis the US dollar at the end of the period to:

$$\text{Rs. } 40\left(\frac{1.08}{1.03}\right) = \text{Rs. } 41.94/\text{US } \$$$

Suppose that in the beginning of the period, interest rate in India is 7 per cent, as against 4 per cent in the USA. At the end of the period, interest rate in India will rise to an extent that will approximately equate the inflation rate differential. In order to find out change in interest rate, the following equation may be applied:

$$\frac{e_t}{e_0} = \frac{1 + r_{\text{IND}}}{1 + r_{\text{USA}}} \qquad \text{...(11.8)}$$

Based on the above equation,

$$\frac{41.94}{40} = \frac{1 + r_{\text{IND}}}{1.04}$$

or

$$1 + r_{\text{IND}} = 1.09$$

$$r_{\text{IND}} = 1.09 \text{ or } 9\%$$

If rate of interest in India rises to 9 per cent, the interest rate differential between the two countries will be: $\frac{1.09}{1.04}$ or 4.81 per cent, which will be approximately equal to the inflation rate differential, which is $\frac{1.08}{1.03}$ or 4.85 per cent.

Bandwagon Effect: When a speculator being dominant in the market expects a drop in the value of a particular currency, he begins selling it forward. The other speculators follow the lead. As a result, the currency tends to depreciate despite favourable impact of inflation and interest rate. This factor played a crucial role in the depreciation of rupee during the closing months of 1997.

11.4 EXCHANGE RATE DETERMINATION IN FORWARD MARKET

Forward exchange rate is normally not equal to the spot rate. The size of forward premium or discount depends mainly on the current expectation of the future events. Such expectations determine the trend of the future spot rate towards appreciation or depreciation and, thereby, determine the forward rate that is equal to, or close to, the future spot rate. Suppose, the dollar is expected to depreciate, those holding the dollar will start selling it forward. These actions will help depress the forward rate of the dollar. On the contrary, when the dollar is expected to appreciate, the holders will buy it forward and the forward rate will improve.

IRP theory states that equilibrium is achieved when the forward rate differential is approximately equal to the interest rate differential.

11.4.1 Interest Rate Parity Theory

The determination of exchange rate in a forward market finds an important place in the theory of Interest Rate Parity (IRP). The IRP theory states that equilibrium is achieved when the forward rate differential is approximately equal to the interest rate differential. In other words, the forward rate differs from the spot rate by an amount that represents the interest rate differential. In this process, the currency of a country with a lower interest rate should be at a forward premium in relation to the currency of a country with a higher interest rate. Equating forward rate differential with interest rate differential, we find:

$$A \times \frac{(n - \text{day}F - S)}{S} = \frac{1 + r_A}{1 + r_B} - 1 \qquad \text{...(11.9)}$$

On the basis of the IRP theory, the forward exchange rate can easily be determined. One has simply to find out the value of the forward rate (F) in equation 11.9. The equation shall be rewritten as:

$$F = \frac{S}{A}\left(\frac{1 + r_A}{1 + r_B} - 1\right) + S \qquad \text{...(11.10)}$$

Suppose interest rate in India and the United State of America is, respectively, 10 per cent and 7 per cent. The spot rate is Rs. 40/US \$. The 90-day forward rate can be calculated as follows:

$$F = \frac{40}{4}\left(\frac{1.10}{1.07} - 1\right) + 40$$

or $F =$ Rs. 40.28/US \$.

This means that a higher interest rate in India will push down the forward value of the rupee from 40 a dollar to 40.28 a dollar.

11.4.2 Covered Interest Arbitrage

If forward rate differential is not equal to interest rate differential, covered interest arbitrage will begin and it will continue till the two differentials become equal. In other words, a positive interest rate differential in a country is offset by annualised forward discount. Negative interest rate differential is offset by annualised forward premium. Finally, the two differentials will be equal. In fact, this is the point where forward rate is determined.

> If interest rate differential is more than forward rate differential, covered interest arbitrage manifests in borrowing in a country with low interest rate and investing in a country with high interest rate so as to reduce the interest rate differential.

The process of covered interest arbitrage may be explained with the help of an example. Suppose, the spot rate is Rs. 40/US \$ and three-month forward rate is Rs. 40.28/US \$ involving a forward differential of 2.8 per cent. Interest rate is 18 per cent in India and it is 12 per cent in the United States of America, involving an interest rate differential of 5.37 per cent. Since the two differentials are not equal, covered interest arbitrage will begin. The successive steps shall be as follows:

1. Borrowing in the United States of America, say, US \$1,000 at 12 per cent interest rate.
2. Converting the US dollar into rupees at spot rate to get Rs. 40,000/-.

3. Investing Rs. 40,000 in India at 18 per cent interest rate.
4. Selling the rupee 90-day forward at Rs. 40.28/US $.
5. After three months, liquidating Rs. 40,000 investment, which would fetch Rs. 41,800.
6. Selling Rs. 41,800 for US dollars at the rate of Rs. 40.28/US $ to get US $1,038.
7. Repaying loan in the United States of America, which amounts to US $1,030.
   Reaping profit: US $1,038 − 1,030 = US $8.

So long as inequality continues between the forward rate differential and the interest rate differential, arbitrageurs will reap profit and the process of arbitrage will go on. However, with this process, the differential will be wiped out because:

1. Borrowing in the United States of America will raise the interest rate there.
2. Investing in India shall increase the invested funds and, thereby, lower the interest rate there;
3. Buying rupees at spot rate will increase the spot rate of the rupee;
4. Selling rupees forward will depress the forward rate of the rupee.

The first two narrow the interest rate differential, while the latter two widen the forward rate differential.

Now the question is whether the IRP theory holds good in real life or the arbitrageurs respond to interest rate differential. The study of Marston (1976) shows that the IRP theorem held good with greater accuracy in the Euro-currency market in view of the fact the there existed complete freedom from controls and restrictions. Similar findings emerge from the work of Giddy and Duffey (1975). However, there are studies that identify deviation from the theorem (Officer and Willet, 1970; Aliber, 1973; Frenkel and Levich, 1975). Since different rates prevail on bank deposits, loans, treasury bills, and so on, short term interest rate cannot be specific and the chosen rate can hardly be the definitive rate of the formula. Again, the marginal interest rate applicable to the borrowers and lenders differs from the average interest rate in view of the fact that the interest rate changes with successive amount of borrowing. Yet again, the investment in foreign assets is more risky than that in domestic assets. If greater diversification is applied to foreign investment in order to lower the risk element, diminishing return may apply; and as a result, arbitrageurs may not respond to interest rate differential as expected by the IRP theorem. Moreover, there are cases when interest rate parity is disturbed owing to the play of extraordinary forces. This leads to speculation. It is basically the market expectation of future spot rates that influences the forward rate. If market expectations are strong enough, they can push forward rates beyond the point that interest rate parity would dictate. Last but not least, the proponents of the modern theory feel that it is not only the role of the arbitrageurs but of all participants in the foreign exchange market, such as the traders and hedgers and speculators that influences the forward exchange rate. Since the action of the three different participants may not be similar in a given situation of the exchange rate, there is every possibility of the forward exchange rate differing from the no-profit forward exchange rate, as explained by the IRP theorem (Grubel, 1966; Stoll, 1968).

11.5 THEORIES OF EXCHANGE RATE BEHAVIOUR

The theories of exchange rate are compartmentalised into the balance of payments approach and the asset market model. The latter is again compartmentalised into two approaches on the basis of substitutability between domestic financial assets and foreign financial assets. Perfect substitutability between the two has led to the monetary approach, while the lack of perfect substitution has led to the portfolio balance approach. The monetary approach has two versions: one being the flexible price version and the other being the sticky price version.

Exchange Rate Theories

- **Balance of Payments Theory**
  1. Higher inflation rate differential at home → greater import and lower export → greater demand for foreign currency → depreciation of domestic currency
  2. Greater real income at home → greater import → depreciation of domestic currency
  3. Greater interest rate at home → inflow of foreign capital → greater supply of foreign currency → appreciation of domestic currency
- **Monetary Approach – Flexible Price Version**
  1. Increase in money supply → higher price level → depreciation of domestic currency
  2. Money supply being less than real domestic output → excess demand for money balances → lower domestic prices → appreciation of domestic currency
  3. Rise in interest rate → lower demand for money → domestic currency depreciates
- **Monetary Approach – Sticky Price Version**
  1. Increase in money supply → depreciation of domestic currency
  2. Increase in money supply → price rise → lower real interest rate → lower inflow of capital → depreciation of domestic currency
  3. Rise in interest rate → greater inflow of capital → appreciation of domestic currency
  4. Rise in interest rate → increase in money supply (loanable funds) → depreciation of domestic currency
- **Portfolio Balance Approach**
  1. Domestic income/wealth increase → greater demand for foreign financial assets → depreciation of domestic currency
  2. Foreign financial assets being more risky → demand for them decreases → appreciation of domestic currency

11.5.1 Balance of Payments Approach

Let us begin with the balance of payments approach (Allen and Kennen, 1978). It discusses the impact of inflation, growth in real national income, and interest rate on the exchange rate. An increase in the domestic price level over the foreign price level makes foreign goods cheaper. It lowers export earnings and boosts up the import bill. Lower export reduces the supply of foreign exchange; and at the same time, greater import increases the demand for foreign exchange. The domestic currency depreciates.

Similarly, growth in real national income causes larger imports if the marginal propensity to import is positive. Larger import will cause greater demand for foreign currency and thereby depreciation in the value of domestic currency.

On the contrary, increase in the domestic interest rate causes greater capital inflow that increases the supply of foreign exchange and, thereby, causes appreciation in the value of domestic currency. The first two factors influence the current account, while the third factor influences the capital account.

Pearce's (1983) empirical study shows that none of the above mentioned variables was very significant in case of exchange rate between the Canadian dollar and the US dollar. On these grounds, he has suggested an alternative theory.

11.5.2 Monetary Approach of Flexible Price Version

The monetary approach of the flexible price version emphasises the role of demand for money and the supply of money in determination of the exchange rate (Frenkel, 1976). The exchange rate between two currencies, according to this approach, is the ratio of the value of two currencies determined on the basis of the two countries' money supply and money demand positions. The demand for money—either in the domestic economy or in a foreign economy—is positively related to prices and real output and negatively related to the rate of interest. Any increase in money supply raises the domestic price level (based on the quantity theory of money) and the resultant increase in price level lowers the value of the domestic currency. But if the increase in money supply is lower than the increase in real domestic output, the excess of real domestic output over the money supply causes excess demand for money balances and leads to a lowering of domestic prices, which causes an improvement in the value of domestic currency. This way, this explanation is contrary to the balance of payment approach where increase in real output causes depreciation in the value of domestic currency through greater imports. Again, the monetary approach is different from the balance of payments approach in the sense that the former explains that a rise in domestic interest rate lowers the demand for money in the domestic economy relative to its supply and thereby causes depreciation in the value of domestic currency. However, critics of this theory argue that since the purchasing power parity theory is not applicable in the short run, this theory does not hold good in the short run.

11.5.3 Monetary Approach of Sticky-price Version

The monetary approach of the sticky price version rests on a couple of assumptions. The first is that the money supply in a country is endogenous, meaning that it is positively related to the market interest rate. The second is that the PPP theory applies in the long run and so the expected inflation differential changes have a role to play in the determination of the exchange rate. The argument in favour of this approach is that an increase in money supply (through changes in the real interest rate differential) leads to depreciation in the value of the domestic currency. On the other hand, like the flexible price version approach, an increase in the real output helps appreciate the value of the domestic currency.

The sticky price version makes a more detailed study of interest rate differential. The interest rate differential has three components. One denotes that when the interest rate rises, the money balances held by the public come to the money market in lure of high interest rate. Money supply increases leading to currency depreciation. The other denotes that if interest rate rises, financial institutions increase the funds to be supplied to the money market. Money supply increases and the value of domestic currency depreciates. The third is that a rise in interest rate stimulates the capital inflow into the country that, like the balance of payments approach, causes appreciation in the value of domestic currency.

Again, this approach specifically mentions the expected inflation rate differential. A rise in inflation rate compared to that in the foreign country leads to depreciation in the value of domestic currency. This is because a rise in inflation rate decreases the real interest rate and discourages the capital inflow (Dornbusch, 1976).

11.5.4 Portfolio Balance Approach

The portfolio balance approach (McKinnon, 1969) suggests that it is not only the monetary factor but also the holding of financial assets such as domestic and foreign bonds that influences the exchange rate. If foreign bonds and domestic bonds turn out to be perfect substitutes and if the conditions of interest arbitrage hold good, the portfolio balance approach will not be different from the monetary approach. But since these conditions do not hold good in real life, the portfolio balance approach maintains a distinction from the monetary approach.

This approach suggests that the exchange rate is determined by the interaction of real income, interest rates, risk, price level, and wealth. If a change takes place in these variables, the investor re-establishes a desired balance in its portfolio. The re-establishment of the portfolio balance needs some adjustments which, in turn, influence the demand for foreign assets. Any such change influences the exchange rate. For example, a rise in real domestic income or a rise in interest rate abroad leads to a greater demand for foreign bonds. Demand for foreign currency will rise, in turn, depreciating the domestic currency. Again, the legal, political, and economic conditions in a foreign country may be different from those at home. If foreign bonds turn out to be more risky on these grounds, the demand for foreign currency will decrease, in turn, appreciating the value of domestic currency. Similarly, rising inflation in a foreign country makes foreign bonds risky. The demand for foreign currency will drop and the domestic currency will appreciate.

When the exchange rate changes, the above mentioned variables change, which cause a shift in the desired balance in the investment portfolio. Thus two-way forces continue to act until equilibrium is reached. But the equilibrium is only short lived.

It may be asserted that although real income, interest rate, risk, and price level have an important role to play in exchange rate determination, the significance of wealth effect is quite large. When a country's wealth increases, holding of foreign assets increases. Demand for foreign currency goes up, which causes depreciation in the value of domestic currency. In this context, the possibility of substitution effect, which outweighs the impact of wealth effect, cannot be negated completely.

The portfolio balance approach is more comprehensive. But as Bisignano and Hoover (1982) find, data do not support the hypothesis of this approach.

11.6 EXCHANGE RATE FORECASTING

11.6.1 Relevance of Exchange Rate Forecast

Before taking any international business activity, the firm essentially takes into account the expected movement in the exchange rate. To this end, it should be able to make an accurate exchange rate forecast. There is, of course, one view that the foreign exchange market is efficient, meaning that the exchange rate reflects all available information. If it is so, there is no need for a forecast. There are reasons to believe that the content of "efficiency" is found in the foreign exchange market. But even then, this does not deny the need for exchange rate forecast. Forecasts of exchange rates are worthwhile for various reasons. It is more so in case of multinational corporations that have to shape their policy decision on the basis of expected exchange rate changes. Forecast is required in order to decide whether to go for hedging or not, while making short term investment of cash, for making long term investments, for raising funds in the international financial market, and for assessment of earnings from international operations.

Forecast is required in order to decide whether to go for hedging or not, while making short term investment of cash, for making long term investments, for raising funds and for assessment of earnings.

11.6.2 Problems in Exchange Rate Forecast

There are, of course, some problems in exchange rate forecasting. First of all, the majority of forecasting techniques assume that past economic data would be a guide for the future. But it may be proven wrong, especially when the economy is prone to frequent structural shocks. In such cases, it is essential to recognise the structural changes and to modify the forecast model accordingly.

Secondly, the forecasts normally concern the nominal exchange rate changes. But if a country is consistently facing a high rate of inflation, the real rate of exchange moves far away from the nominal rate. Relying on the latter proves misleading.

Thirdly, forecasts of cases generally provide exposure management advice on a currency by currency basis. This way they are not so useful for evaluating risk in totality.

11.6.3 Techniques of Forecasting

The forecasting techniques can be grouped under four heads. They are:

1. Technical forecasting
2. Fundamental forecasting
3. Market-based forecasting
4. Mixed forecasting

Technical Forecasting: In this technique, historical rates are used for estimating future rates. This is because in the majority of cases, movements in the past give an indication about movements in the future. There are two primary methods of technical analysis: charting and trend analysis. In the former, bar charts and sophisticated computer based extrapolation techniques are employed to find a recurring pattern of rates. The latter seeks to analyse trends through the use of various mathematical computations.

> In **technical forecasting**, movements in the past give an indication about movements in the future.

Technical forecasting techniques are used for short term forecasts. Their coverage is normally not very wide. If the value of a particular currency has moved up, the forecaster assumes that the demand for the currency has moved up; and without going deeper into details, he makes a prediction about its future value.

Technical forecasts are invariably used by speculators, although the technical forecasting models helping a particular speculator in reaping profits at a particular point of time may not be helpful at another point of time. Speculators depending upon the technical forecasts often incur losses. They also have to incur large transaction costs owing to frequent trading.

Companies do not benefit much from technical forecasts as these forecasts stress on the near future and not on the distant future. Moreover, since technical forecasts fail to estimate future exchange rates in precise terms, companies rely less on this technique.

Future rates are estimated on the basis of changes in the economic variables.

Fundamental Forecasting: In this technique, historical rates do not guide future rates. Rather it is various sets of macroeconomic variables. Future rates are estimated on the basis of changes in the economic variables. If the inflation differential is the cause for exchange rate changes and if the rate of inflation in Country *A* is higher than in Country *B* by 5.0 per cent, the value of Country *A*'s currency vis-á-vis Country *B*'s currency will decline by this percentage.

Similarly, many variables are taken into account and a forecast is made with the help of regression analysis. It may be that one variable is forcing down the value of a currency, while the an other is forcing it to move up.

Suppose, for estimating the Re/US $ rate, the forecaster takes into consideration the income growth rate and the rate of inflation in India as compared to those prevailing in the United State of America. He fits the quarterly percentage change in these two differentials, inflation (I) and income (Y) into a regression equation. The value of the rupee will be defined as:

$$\text{Rs.} = b_0 + b_1 I + b_2 Y + \mu \qquad \text{...(11.11)}$$

Where b_0 is constant, b_1 and b_2 represent the sensitivity of Re to changes in I and Y, respectively, and μ represents an error term.

After the value of *b*s is generated, the movement in the value of rupee will be indicated. Suppose the value of b_0, b_1 and b_2 is, respectively, 0.002, 0.6, and 0.8 and if the inflation differential and income differential during the preceding quarter are, respectively, 4.0 per cent and 2.0 per cent, the value of rupee will tend to appreciate in the following quarter by:

$$= 0.002 + 0.6\ (4\%) + 0.8\ (2\%)$$
$$= 0.2\% + 2.4\% + 1.6\%$$
$$= 4.2\%$$

Some of the variables have immediate impact. In other cases, there may be a lag. In order to taken this problem, the forecaster uses sensitivity analysis. The more rigorous the technique, the greater it accuracy. In the age of computers, a host of factors can be taken into account. However, the probability of subjectivity cannot be completely ruled out.

It is a fact that this technique is simple and more reliable, yet it possesses a few limitations. First of all, the precise timing of impact of a particular variable is not known. There are factors that have a delayed impact and in those cases, the forecast will be fraught with error.

Secondly, there are some factors whose impact is instantaneous, although it is not very easy in all cases to know about those factors at very short notice. If they are not included, the forecast may be erroneous.

Thirdly, the coefficient derived from the regression model may change over the period. If, in our example, the US government imposes fresh trade barriers, the impact on the value of rupee will be different. However, there is always margin of error. The forecaster should take it into consideration.

Market-based Forecasting: In this technique, the estimation of future rates depends on the spot and forward rates prevailing in the market and on the expectation regarding the future. Suppose one US dollar is presently sold for Rs. 40, but due to some pressures—economic or non-economic—the dollar is expected to appreciate to Rs. 40.50 in the near future. If speculators have this kind of expectation, they will begin buying the dollar at the present point of time, so that in the near future, when the dollar become costlier, they will sell the dollar and, thereby, make profits equal to Rs. 40.50−40.00 or Rs. 0.50 per dollar. The moment the buying pressure starts, the value of the dollar rises due to greater demand and there is every possibility of reaping profits of this kind.

Estimation of future rates depends on the spot and forward rates prevailing in the market and on the expectation regarding the future.

This is not the case only with the spot rate. If the value of a currency is expected to be higher than its forward rate, of a given maturity, speculators will begin buying that currency in the forward market. At maturity, after taking the delivery of the currency, they will sell the currency at a higher rate in the open market and reap profits. The pressure of buying forward will raise the forward prices of the dollar.

Therefore, in both cases, expectation regarding the future influences the future rate. Thus, when the future value of a currency is estimated, expectation and present rates form the very basis of the forecast.

When the forecast concerns a long-run period, where the forward rate for such a long period is not available, the interest rate is taken into account. Consideration of interest rate is based on the interest rate parity theory where a country with a higher rate of interest faces a reduction in the value of its currency.

Mixed Forecasting: The techniques of forecasting explained above suffer from one limitation or the other. It usually happens that one technique is based on a particular type of information and the other technique relies on some other type of information. Relying on a particular technique may produce biased results. In order to avoid this problem, the forecaster uses a blend of different techniques. This is known as mixed forecasting. Each of the techniques is assigned a particular weight, the total weight being 1. The result of each technique is multiplied by the weight and they are finally summed up to derive the final forecast. Thus, the actual forecast of the currency would be a weighted average of the various forecasts that were developed.

In **mixed forecasting**, the forecaster uses a blend of different techniques assigning weight to each of them. They are summed up to get the final forecast.

11.6.4 Forecast Error

In the context of forecasting the exchange rate, it is not only the making of the forecast that is important, but monitoring the forecast is also very important. For this purpose, the forecaster compares the forecast with the actual value or the realised value and finds out the extent of difference between the two. The smaller the difference, the more accurate the forecast.

Forecast Error is disparity between actual and forecast exchange rate divided by actual exchange rate.

The difference between the actual value and the forecasted value is known as the forecast error. In percentage terms, forecast error is equal to:

$$= \frac{\text{Forecasted Value} - \text{Realised Value}}{\text{Realised Value}} \quad ...(11.\ 12)$$

If forecasted value is Rs. 40.32/US $ and the realised value is Rs. 40.60, the forecast error will be:

$$= \frac{40.32 - 40.60}{40.60} = -\ 0.69\%.$$

SUMMARY

- Developments in the international monetary system dates back to the commodity specie standard when metallic coins were used for international transaction.
- This was followed by the gold standard, which provided not only domestic price stability but also automatic adjustment in the exchange rate and the balance of payments. The gold standard failed to cope with the changes in international economic scenario and it was finally abandoned in 1930s. Its abandonment led to large fluctuations in exchange rates.
- A new system of exchange rate evolved in 1945 under the aegis of the Internation Monetary Funds, known as the "Bretton Woods' child". The system represented a fixed parity system with adjustable pegs. The currency of the member countries was convertible to the US dollar and the US dollar was convertible into gold. And so when the US economy turned into distress in late 1950s, the dollar failed to command confidence. Dollar denominated securities were converted into gold, in turn, depleting the stock of gold with the United States of America. The process weakened the dollar further and ultimately, the Bretton Woods system of exchange rate crumbled in early 1973.
- Post-1973, in the present system, various options are given to the member countries, such as independent and managed floating rate system, system of pegging currency, crawling peg, and target zone arrangement. The different systems no doubt have merits of their own, but they suffer from one limitation or the other.
- Exchange rates are quoted in different forms, namely, direct and indirect quote, buying and selling quote, spot and forward quote. Cross rates between two currencies are established through a common currency. They are found when the rates between any two currencies are not published.
- Exchange rate in a floating rate system is determined by the demand and supply forces. The higher the demand or the lower the supply, the greater the value of the currency in the spot foreign exchange market. The factors influencing the exchange rate are primarily the inflation rate and interest rate differentials. In the forward market it is the Interest Rate Parity theory that explains exchange rate determination.
- There are different theories explaining the exchange rate behaviour. While the balance of payments theory stresses on the current account and the capital account behaviour influencing the exchange rate, the monetary theories emphasise on the demand and

supply of money being the main force behind exchange rate behaviour. The portfolio balance approach also takes into account the behaviour of financial assets.

- Last but not least, the exchange rate is forecasted despite some problems involved in this process. The techniques are technical forecasting, fundamental forecasting, and market based forecasting. However, to get a better result, a weighted average of the results of all the three methods is computed.

SOME SOLVED NUMERICAL PROBLEMS

Problem 1 If direct quote is Rs. 45/US $, how can this exchange rate be presented under indirect quote ?

Solution
US $1/Rs. 45 = US $0.0222/Re.

Problem 2 If indirect quote is US $0.025/Re., how can this exchange rate be shown under direct quote?

Solution
Re. 1/US $0.025 = Rs. 40/US $

Problem 3 Consider the following bid-ask prices: Rs. 40 − 40.50/US $. Find the bid-ask spread.

Solution
$(40.50 - 40.00)/40.50 = 0.0123$ or 1.23%

Problem 4 Find out the bid rate if ask rate is Rs. 40.50/US $ and the bid-ask spread is 1.23%.

Solution
$(40.50 - x)/40.50 = 0.0123$
or $40.50 - x = 0.0123 \times 40.50$
or $40.50 - 0.50 = x$
or $x = 40.00$.

Problem 5 Find out the forward rate differential if spot rate of US $ is Rs. 45.00 and one-month forward rate is Rs. 45.80.

Solution
$360/30 \{(45.80 - 45.00)/45.00\} \times 100 = 21.33\%$. It will be known as a forward premium as the value of US dollar has increased.

Problem 6 Find the one-month forward rate of US dollar if the spot rate is Rs. 45.00 and the forward premium is 12%.

Solution
$360/30 \{(x - 45.00)/45.00\} = 0.12$
or $(x - 45) = 0.12 \times 45 \times 30/360$
or $x = 45 + 0.45$ or $x = 45.45$

Problem 7 Find Rs./Euro exchange rate if: the two exchange rates are: Rs. 43.93 − 43.95/US $ and Euro 0.83 − 0.84/US $

Solution
Bid rate = Rs. 43.93/0.84 = Rs. 52.30
Ask rate = Rs. 43.95/0.83 = Rs. 52.95
Cross rate = Rs. 52.30 − 52.95/Euro

Problem 8 If exchange rate at the end of 2004−2005 is Rs. 43.91/US $ and if the rate of inflation in India and the USA during 2005−2006 is 7% and 4%, respectively, then find the following:

i. Inflation rate differential between the two countries
ii. Exchange rate at the end of 2005−2006

Solution
Inflation rate differential between India and the USA: (1.07/1.04) − 1 = 0.0288 = 2.88%
Exchange rate at the end of 2005−2006: (1.07/1.04) × 43.91 = 45.18 Rs. 45.18/US $

Problem 9 If real interest rate is 5% and the inflation rate is 8%, what would be the nominal interest rate?

Solution
1.05 × 1.08 − 1 = 0.134 = 13.4%

Problem 10 If the rate of inflation in India and the USA is 7% and 4%, respectively and if the interest rate in the USA is 6%, find the interest rate in India.

Solution
$1.07/1.04 = 1 + x/1.06$
or $1 + x = 1.07//1.04 \times 1.06$
or $x = 0.0906 = 9.06\%$

Problem 11 If the interest rate in India and the USA is 9.06% and 6%, respectively and if the spot exchange rate is Rs. 43.91/US $, find the exchange rate during the next year.

Solution
1.906/1.06 × 43.91 = Rs. 45.18/US $

Problem 12 Find out the amount of profit out of covered interest arbitrage if the interest rate in India and the USA is 9% and 4.50%, respectively and the 6-month forward and spot exchange rates are Rs. 45.00 and Rs. 45.20, respectively.

Solution
There will be a covered interest arbitrage in so far as the interest rate and forward rate differentials are not equal.

To start with, borrowing $1,000 in the USA, converting it into rupee for 45,000 and investing the rupee for six months will fetch Rs. 47,025. Selling Rs. 47,025 forward will fetch $1,040. After repaying dollar loan alongwith interest for 1,022.50, the arbitrageur profits $1,040 − 1,022.50 = $17.50.

Problem 13 The value of rupee vis-à-vis US dollar for the first nine days of January 2005 is respectively as follows: Rs. 45.11, 45.10, 45.15, 45.15, 45.10, 45.30, 45.39, 45.50 and 45.41. Find a forecast of the exchange rate for the 10th day.

Solution

The average for the first four days is Rs. 45.13 and the average for the last four days is Rs. 45.40. On this basis, the actual value from the middle of 2nd and 3rd January to the middle of 7th and 8th January is Rs. 45.40 − 45.13 = Rs. 0.27. It means a daily increment in the value of dollar being Rs. 0.27/5. If the average trend value for the middle of 7th and 8th is Rs. 45.40, the exchange rate on the 10th of January will be:

$$\text{Rs. } 45.40 + 5/2 \times 0.27/5 = 45.40 + 0.1350 = \text{Rs. } 45.5350$$

Problem 14 If the average exchange rate in the first quarter of 2005 is 45.10/US $ with India having a positive interest rate differential of 2.30% and a positive inflation rate differential of 3.10% over that in the USA, and if the sensitivity of rupee to interest rate and inflation rate differential is 40%, find a forecast of the exchange rate during the second quarter assuming a constant term as 0.02.

Solution

Fitting these figures into a regression equation,

$$1 + 0.5 \times 0.023 + 0.5 \times 0.031 = 0.0470 = 4.70\%$$

Rupee will depreciate by 4.70%. The exchange rate forecast in the second quarter will be Rs. 47.22/US $.

Problem 15 The average spot rate during the first quarter of 2005 is Rs. 45.10/US $. But if there is pressure on dollars and its demand is expected to move up by 10 per cent, find out the forecast for the second quarter.

Solution

Assuming the supply of dollars being constant, the exchange rate in the second quarter should be:

$$\text{Rs. } 45.10 \times 1.10 = \text{Rs. } 49.61/\text{US } \$$$

Problem 16 The technical forecast, fundamental forecast and the market-based forecast of rupee vis-à-vis US dollar for the second quarter of 2005 are respectively as follows: Rs. 45.54, Rs. 47.22 and Rs. 49.61. If the forecaster assigns 30%, 30% and 40% weight respectively to the above forecast, what would be the weighted average of the forecasts, often known as mixed forecast?

Solution

Mixed forecast will be:

$$0.3 \times 45.54 + 0.3 \times 47.22 + 0.4 \times 49.61 = \text{Rs. } 47.67/\text{US } \$$$

Review Questions

1. How far was the fixed parity system of exchange rate different from the gold standard? Explain the factors behind the collapse of the fixed parity system.
2. Do you agree that the floating exchange rate system is more beneficial than the system of fixed exchange rate?
3. Explain managed floating. Distinguish between sterilised and non-sterilised intervention.
4. How is the exchange rate determined in the spot market? What are the major factors influencing the exchange rate?

5. Explain Interest Rate Parity Theory. Is it sufficient to explain the behaviour of the exchange rate in a forward market?
6. Explain the monetary theory of exchange rate behaviour. How is it different from the Portfolio Balance Approach?
7. Discuss how movement in the balance of payments variables influences the exchange rate.
8. What are the different techniques of exchange rate forecasting? What is a forecast error?
9. Write short notes on:
   (i) Direct and Indirect quote
   (ii) Buying and selling quote
   (iii) Cross rate quote
   (iv) Crawling peg
   (v) Covered interest arbitrage

References

Books

Abdullah, F.A. (1986), *Financial Management for the Multinational Firm* (New Delhi: Prentice-Hall of India), p. 59.

Allen, P.R. and P.B. Kenen (1978), *The Balance of Payments, Exchange Rate and Economic Policy* (Athens: Centre for Planning and Economic Research).

Cassel, G. (1921), *The World's Monetary Problems* (London: Constable).

Chakrabarti, R. (2006), *The Financial Sector in India: Emerging Issues*, New Delhi: Oxford University Press.

Cumby, R.E. and M. Obstfeld (1984), "International Interest Rate and Price Level linkages under Flexible Exchange Rates: A Review of the Evidence" in J.F.O. Bilson and R.C. Marston (eds.), *Exchange Rate Theory and Practices* (Chicago: University of Chicago Press), pp. 121−52.

Dunn, R. M. (1983), "The Many Disappointments of Flexible Exchange Rates", *Essays in International Finance*, (Princeton: Princeton University Press), No. 154.

Grubel, H. G. (1966), *Forward Exchange, Speculation and International Flow of Capital*, Palo Alto: Stanford University Press.

Hansen, L.P. and R.J. Hodrick (1983), "Risk-averse Speculation in the Forward Foreign Exchange Markets: An Econometric Analysis of Linear Models" in J.A. Frenkel (eds.), *Exchange Rates and International Macroeconomics*, Chicago: University of Chicago Press.

MacDonald, R. (1988), *Floating Exchange Rates: Theories and Evidence* (London: Allen & Unwin).

McKinnon, R.I. (1969), "Portfolio Balance and International Payments Adjustment" in R.A. Mundell and A.K. Swoboda (eds.), *Monetary Problems in International Economy* (Chicago: University of Chicago Press), pp. 199−234.

———— (1979), *Money in International Exchange* (Oxford: Oxford University Press).

Sharan, V. and I.N. Mukherji (2001), *India's External Sector Reforms*, New Delhi Oxford University Press.

Journals and Report

Adler, M. and B. Lehmann (1983).“Deviations from Purchasing Power Parity in the Long Run”, *Journal of Finance,* XXXVIII (5), 1471−87.

Aliber, R. Z. (1973),“Interest Rate Parity Theorem: A Reinterpretation”, *Journal of Political Economy*, LXXXI (6), 1451−59.

________ and C. P. Stickney (1975),“Accounting Measures of Foreign Exchange Exposure: The Long and Short of It”, *The Accounting Review,* L (1), 4−57.

Baig, T. (2001), “Characterising Exchange Rate Regimes in Post-crisis East Asia”, Technical Report, WP/01/152, *IMF,* Washington, DC.

Bisignano, J. and K. Hoover (1982),“Some Suggested Improvements to a Simple Portfolio Balance Model of Exchange Rate Determination with Special Reference to US Dollar/Canadian Dollar Rate”, *Archiv Weltwirtschaftliches*, CXVIII (1), 19−37.

Cushman, D. (1983),“The Effects of Real Exchange Rate Risk on International Trade”, *Journal of International Economics*, XV, 45−64.

Dornbusch, R. (1976),“Expectations and Exchange Rate Dynamics”, *Journal of Political Economy*, LXXXIV (6), 1161−76.

Edison, H. (1985),“The Rise and and Fall of Sterling: Testing Alternative Models of Exchange Rate Determination”, *Applied Economics,* XVII (6), 1003−21.

Edwards, S. (1982), “Exchange Rates and ‘News’: A Multicurrency Approach”, *Journal of International Money and Finance*, 1, 211–24.

_________ (1983),“The Demand for International Reserves and the Exchange Rate Adjustments: The Case of LDCs, 1964−72”, *Economica*, L (199), 269−80.

Fama, E.F. and and G.W. Schwert (1977),“Asset Returns and Inflation”, *Journal of Financial Economics*,V (1), 115−46.

Frenkel, J.A. (1976),“A Monetary Approach to Exchange Rate: Doctrinal Aspects and Empirical Evidence”, *Scandinavian Journal of Economics*, LXXXVIII (2), 200−24.

Frenkel, J.A. and R. M. Levich (1975),“Transaction Costs and Interest Arbitrage: Tranquil and Turbulent Periods”, *Journal of Political Economy*, LXXXIII (2), 325−38.

Frenkel, J.A. and M. Mussa (1980), “The Efficiency of Foreign Exchange Markets and Measures of Turbulence”, *American Economic Review*, LXX (3), 374−81.

Friedman. M. (1953), “The Case for Flexible Exchange Rates”, *Essays in Positive Economics* (Chicago: University of Chicago Press), pp. 157−203.

Gibson, W. E. (1970),“Price Expectations Effects on Interest Rates”, *Journal of Finance,* XXV (1), 19−34.

Gibson, W. E. (1972),“Interest Rates and Inflationary Expectations”, *American Economic Review*, LXII (5), 854−65.

Giddy, I.H. and G. Dufey (1975),“The Random Behaviour of Flexible Exchange Rates”, *Journal of International Business Studies*,VI (1), 1−32.

International Monetary Fund (2004), Annual Report 2003, Washington D.C.

Isard, P. (1977), “How Far We Can Push the Law of One Price”, *American Economic Review,* LXVII (5), 942−48.

Kohlhagen, S.W. (1975),“The Performance of Foreign Exchange Markets: 1971–74”,“*Journal of International Business Studies*”, 6, 33–39.

Longworth, D. (1980),“Canadian Intervention in the Foreign Exchange Market: A Note”, *Review of Economics and Statistics*, LXII (2), 284−87.

Loopesko, B. (1984),"Relationship among Exchange Rates, Intervention and Interest Rates": An Empirical Investigation", *Journal of International Money and Finance*, III (2), 257−77.

Marston, R. C. (1976),"Interest Arbitrage in the Euro-currency Markets"*European Economic Review*, VII (1), 1−13.

Mishkin, F. (1984),"Are Real Interest Rates Equal Across Countries? An Empirical Investigation of International Parity Conditions", *Journal of Finance,* XXXIX (5), 1345−58.

Mussa, M (1982),"A Model of Exchange Rate Dynamics", *Journal of Political Economy,* XC (1), 74−104.

Obstfeld, M. (1983), "Exchange Rates, Inflation and the Sterilisation Problem: Germany 1975−81", *European Economic Review*, XXIII (2), 161−89.

Officer, L.H. (1976),"The Purchasing Power Parity Theory of Exchange Rates: A Review Article", *IMF Staff Papers*, XXVII (1), 1−60.

Officer, L.H. and T. D. Willet (1970),"The Covered Arbitrage Schedule: A Critical Survey of Recent Developments", *Journal of Money, Credit and Banking*, II (2), 247−57.

Patnaik, I. (2003), "The Consequences of Currency Intervention in India", Working Paper no. 114, *ICRIER*, New Delhi.

Patnaik, R.K. *et al* (2003), "Exchange Rate Policy and Management: The Indian Experience", *Economic and Political Weekly*, May 31.

Pearce, D. (1983), "Alternative Views of Exchange Rate determination", *Federal Reserve Bank of Kansas City Economic Review*, February Issue, 16−30.

Reserve Bank of India (1992), *Report of High Level Committee on Balance of Payments (Rangarajan Committee)*, Mumbai.

__________ (2006), *Annual Report: 2005–06*, Mumbai.

Sharma, A. K. and A. Mitra (2006), "What Drives Forward Premia in the Indian Foreign Exchange Market ?", *RBI Occasional Paper*, no. 27 (1&2).

Sacchetti, U. (1979), "The SDR: Ten Years of Experience", *Banca Nazionale del Lavoro Quarterly Review*, 395−405.

Stein, J.L. (1965),"The Forward Rate and Interest Parity", *Review of Economic Studies,* XXXII (1), 113−26.

Stoll, H. (1968),"An Empirical Study of the Forward Exchange Market under Fixed and Flexible Exchange Rate Systems", *Canadian Journal of Economics*, I (1), 56−78.

Taylor, D. (1982),"Official Intervention in the Foreign Exchange Market or Bet against the Central Bank", *Journal of Political Economy*, XC (2), 356−68.

Taylor, M.P. (1988),"An Empirical Examination of Long-run Purchasing Power Parity using Cointegration Techniques", *Applied Economics,* XX (10), 1369−81.

Unnikrishnan, N. K. and R. Mohan (2003), "Exchange Rate Dynamics: An Indian Perspective", *RBI Occasional Papers*, June.

SELECT FURTHER READINGS

Frankel, J. A. (1993), *On Exchange Rates* (Cambridge Mass.: MIT Press).

Krueger, A. O. (1983), *Exchange Rate Determination* (Cambridge: Cambridge University Press).

Tew, B. (1995), *Evolution of International Monetary System* (New York: Wiley).

* **NASDAQ**, which was founded in 1971, stands for National Association of Securities Dealers Automated Quotations. It is the largest electronic screen-based equity securities trading market in the United States. With approximately 3,700 companies and corporations, it has more trading volume than any other stock exchange in the world. Its total market value is estimated at around $4.5 trillion. It is owned and operated by the NASDAQ OMX Group.

Collins Street, Melbourne, Australia*

12

International Financial Markets

CHAPTER OBJECTIVES

Foreign currencies are bought and sold in the foreign exchange market and they are borrowed and lent in the international financial market. The present chapter deals with these markets. The objective is to:

- Analyse the distinctive features of the foreign exchange market and how transactions take place in the market.
- Delineate the features of the market for derivatives, such as the market for currency futures and currency options.
- Explain the multilateral sources of funds, especially international banks.
- Present a brief idea of how the international securities market works.

Continuing the discussion about the international financial environment in the preceding chapter, the present chapter discusses the international financial market. The term, international financial market has a broad meaning. It embraces, on the one hand, the foreign exchange market, where currencies are bought and sold, and on the other, international money and capital markets, where currencies are borrowed and lent. A firm needs to evaluate the state of the financial market and the procedures adopted therein before going international.

12.1 FOREIGN EXCHANGE MARKET

12.1.1 Distinctive Features

It has already been mentioned that different currencies are bought and sold in the foreign exchange market. The market does not denote a particular place where currencies are transacted. Rather it is an over-the-counter market. It consists of trading desks at major agencies dealing in foreign exchange throughout the world, which are connected by telephones, telex, and so on. Again, it is a round-the-clock market, meaning that the transactions can take place any time within 24 hours of the day. This is because different countries are located at different longitudes. If an Indian bank buys dollars at 12 am, it will be midnight in the United States of America. From this point of view, the foreign exchange market has to operate round the clock.

> It is the timing of the actual delivery of foreign exchange that differentiates between spot market and forward market transactions. In the spot market, currencies are traded for immediate delivery at the rate existing on the day of transaction. In forward market, currencies are delivered on a future date at a rate mentioned in the contract.

The foreign exchange market is classified either as a spot market or as a forward market. It is the timing of the actual delivery of foreign exchange that differentiates between spot market and forward market transactions. In the spot market, currencies are traded for immediate delivery at the rate existing on the day of transaction. For making book-keeping entries, delivery takes two working days after the transaction is complete. If a particular market is closed on Saturday and Sunday and if transaction takes place on Thursday, delivery of currency shall take place on Monday. Monday, in this case, is known as the value date or settlement date. Sometimes there are short-date contracts where time zones permit the delivery of the currency even earlier. If the currency is delivered the same day, it is known as the value-same-day contract. If it is done the next day, the contract is known as the value-next-day contract.

In view of the huge amount involved in the transactions, there is seldom any actual movement of currencies. Rather, debit and credit entries are made in the bank accounts of the seller and the purchaser. Most markets have an electronic system for transfer of funds, which saves time and energy. The system existing in New York is known as the Clearing House Inter-bank Payment System (CHIPS).

In the forward market, on the contrary, contracts are made to buy and sell currencies for a future delivery, say, after a fortnight, one month, two months, and so on. The rate of exchange for the transaction is agreed upon on the very day the deal is finalised. Forward rates with varying maturity are quoted in the newspaper and these rates form the basis of the contract. Both parties have to abide by the contract at the exchange rate mentioned therein, irrespective of the fact whether the spot rate on the maturity date resembles the forward rate. In other words, no party can back out of the deal even if changes in the future spot rate are not in his/her favour.

The value date in case of a forward contract lies definitely beyond the value date applicable to a spot contract. If it is a one month forward contract, the value date will be the date in the next month corresponding to the spot value date. Suppose a currency is purchased on the 1st of August; if it is a spot transaction, the currency will be delivered on the 3rd of August, but if it is a one-month forward contract, the value date will fall on the 3rd of September. If the value date falls on a holiday, the subsequent date will be the value date. If the value date does not exist in the calendar, such as the 29th February (if it is not a leap year), the value date will fall on the 28th of February.

Sometimes the value date is structured to enable one of the parties to the transaction to have the freedom to select a value date within the prescribed period. This happens when the party does not know in advance the precise date on which it would be able to deliver the currency.

Broken-date contract is not a full-month forward contract.

Again, the maturity period of a forward contract is normally one month, two months, three months, and so on. But sometimes it is not for the whole month and represents a fraction of a month. A forward contract with a maturity period of 35 days is an apposite example. Naturally, in this case, the value date falls on a date between two whole months. Such a contract is known as a broken-date contract.

12.1.2 Major Participants

The participants in the foreign exchange market are individuals, firms, banks, the government, and occasionally, international agencies. Individuals are normally tourists who exchange currencies. They are also migrants sending a part of their income to their family members living in their home country. Firms that participate are generally importers and exporters. Exporters prefer to get the payments in their own currency or in a strong convertible currency. Importers need foreign exchange for making payments for the import. When firms and individuals approach the local branch of a bank, the local branch, in turn, approaches the foreign exchange department in its regional office or head office. The latter deals in foreign exchange with other banks on behalf of the customers. Thus, there are two tiers in the foreign exchange market. One tier involves the transactions between the ultimate customers and the banks. The other tier consists of transactions between two banks. It is the second tier of the market that accounts for the largest segment of the total foreign exchange transactions in the market. The reason is that the purpose of inter-bank transactions is not only to meet the foreign exchange demand of the ultimate customers, but also to reap gains out of movement in foreign exchange rates. In some cases, inter-bank dealings take place directly, without any help from intermediaries, but generally banks operate through foreign exchange brokers.

It is either because of the length of transactions passing through two tiers of the market or because of the profit motive involved in the transactions that there is often a gap between the amount of purchase and the amount of sale of a currency by banks. If a bank buys less of a currency than it contracts to sell, the position is known as a short position in that currency. The reverse position, where a bank buys more of a currency than it contracts to sell, is known as a long position in that currency. When the quantum of sale and purchase is equal, it is a square position.

From the functional point of view, the major participants in the foreign exchange market are:
1. arbitrageurs
2. hedgers
3. speculators

It is a fact that commercial banks dominate the foreign exchange market, monetary authorities too participate in this market. However, the purpose of the latter is different. They help stabilise the value of the domestic currency. Sometimes international agencies purchase and sell foreign currencies in the foreign exchange market, but this is not a routine affair.

Again, the participants may be grouped also according to their behaviour and their motive behind foreign exchange transaction. They are:

1. Non-banking entities that simply exchange currencies in order to honour their obligation or to get the desired currency.
2. Non-banking entities, such as traders, that use the foreign exchange market for the purpose of hedging their foreign exchange exposure on account of changes in the exchange rate. They are known as hedgers. Hedging is discussed in chapter 20.
3. Banks that exchange currencies on behalf of their customers. In such cases, their profit is limited to the amount of spread between the bid and the ask rates.
4. Arbitrageurs who exchange currencies because of varying rates of exchange in different markets. The varying rates are the source of their profit.
5. Speculators who buy or sell currencies when they expect movement in the exchange rate in a particular direction. The movement of exchange rate in the desired direction gives them profit.

12.1.3 Currency Arbitrage in Spot Market

Currency arbitrage refers to making profit by buying a currency cheap in one market and selling it dear in the other market at a particular point of time.

With fast development in the telecommunication system, rates are expected to be uniform in different foreign exchange markets. Nevertheless, inconsistency exists at times. Arbitrageurs take advantage of the inconsistency and reap profit by buying and selling of currencies. They buy a particular currency at a cheaper rate in one market and sell it at a higher rate in the other. This process is known as currency arbitrage. The process influences the demand for, and supply of, the particular currency in the two markets, which ultimately leads to removal of inconsistency in the two markets. The value of the currency in the two markets becomes uniform.

Suppose,

In New York: \$1.9800 – 10/£; and

In London: \$1.9700–10/£.

Arbitrageurs will sell the pound in New York and buy it in London, making a profit of \$1.9810–1.9700 = \$0.0110 per pound sterling.

In the above example, two markets and two currencies are involved. This is why it is known as two-point arbitrage. There are also examples of three-point arbitrage or triangular arbitrage where three currencies and three markets are involved.

The above example does not include transaction cost. In the real world, transaction cost lowers the amount of gain. All this indicates that arbitrage will take place only when the burden of transaction cost is lower than the gain from exchange.

12.1.4 Speculation in Forward Market

If a speculator feels that the future spot rate of a currency will be higher than the forward rate, he will buy the currency forward. On the maturity date, he will get the currency cheaper at the forward rate and immediately thereafter, he will sell that currency in the open market at a higher rate, thereby, making a profit. On the contrary, if a currency is expected to depreciate more than the forward rate, the speculator will sell the currency forward. On the maturity date, he will make a profit equal to the difference between the forward rate and the spot rate. However, if the exchange rate moves the other way, the speculator will have to bear loss.

12.2 MARKET FOR DERIVATIVES

12.2.1 Market for Currency Futures

Besides spot and forward markets, currencies are also traded in the market for currency futures and the market for currency options. These two markets are known as the market for derivatives insofar as the prices in these markets are driven by the spot market price. The market for currency futures came into being in 1972 in the United States. Presently, it is found at many important financial centres.

> **Currency Futures Market** refers to organised foreign exchange market where a fixed amount of a currency is exchanged on a fixed maturity date in the pit.

A currency futures contract is different from a forward contract. The size of a futures contract is standardised, involving a fixed amount of different currencies. The date of delivery is also fixed, whereas in a forward contract, neither the size of the contract nor the delivery date is fixed. The forward market is an over-the-counter market, while futures contracts are finalised in a pit by brokers. In every futures deal, the clearing house is necessarily involved as a party. If someone is a buyer of the currency, the clearing house is the seller of the currency. If someone is the seller of the currency the clearing house serves as a buyer of the currency.

Trading in currency futures is subject to specific margin and maintenance requirements. The margin is justified on the ground that traders represent a source of credit risk to the exchange or the clearing house. Long futures traders may not have sufficient funds to buy the underlying foreign currency. In order to cover the risk, they are required to deposit margin money with the clearing house. This is normally in the form of cash deposits, although liquid securities are also used. The initial margin amount varies from one exchange to the other. It is returned on the completion of the contract. If it is in the form of securities, the interest earned thereon is also paid to traders. In case of forward contracts, there is no question of margin and maintenance requirements (Table 12.1).

In case of forward contracts, the deal is settled on maturity. But in case of currency futures, the rates are matched everyday with the movements in the spot rates; and on this basis, gains and losses are settled everyday. This process is called 'marking to the market'.

Table 12.1 Distinction between Forward and Futures Contracts

Characteristics	*Forward Contract*	*Futures Contract*
Size of contract	Tailored to individual needs	Standardised
Maturity	Tailored to individual needs	Standardised
Method of transaction	Over-the-counter deal	Dealing on the floor of the exchange
Commission	Spread between the banks' buying and selling price	Brokerage fee
Security deposit	Not required except for compensating bank balances	Margin money to be deposited with the clearing house
Clearing operation	No clearing house	Clearing house for daily settlement
Access	Limited to very large customers who deal in foreign trade	Open to any one who needs hedging or speculation
Regulation	Self- regulating	Regulated by the rules of the stock exchange
Liquidation	Mostly settled by actual delivery; a few by offsetting contract	Mostly by offsetting contract, a few by actual delivery

Marking to Market refers to comparing today's exchange rate with yesterday's till maturity and transferring the profit/loss to a margin money account created for this purpose.

The process of marking to market can be explained with the help of an example. Suppose an investor buys Can. dollar futures (Can. \$100,000) at US \$0.75 on a Monday morning, which is to mature within two days. At the close of Tuesday, if the price moves up to US \$0.755, the investor shall profit 100,000 × (US \$0.755–0.750) or US \$500. But if the price falls to US \$0.749, the investor will have to bear the loss. The amount of loss will be deducted from the margin money. If the loss is big and as a result, the margin money falls below a certain level, which is known as the maintenance margin, the investor receives a margin call for depositing the margin money within a specified period. Again, on Wednesday, the prevailing price on that day will be compared with the price prevailing on Tuesday and the gain or loss will be determined. On the maturity day, the investor receives the amount of the contract, after the adjustment of profit/loss. However, it may be mentioned that in very few cases, the amount of the contract flows to the investor. In the majority of cases, there is a matching contract in the opposite direction. The investor gets only the difference.

The purpose of the daily settlement procedure is to create a safer futures market so that less creditworthy investors can participate. Contrary to it, forward contracts witness cash flow only on the date of maturity, which makes the contract more risky. Nevertheless, forward contracts are widely used. The reason is that:

1. They are available at many financial centres;
2. Forward contracts have no standard size and the amount can be tailored to individual needs; and
3. Maturity of thousands of transactions taking place daily is not necessarily compatible with the fixed maturity of the futures.

When a trader has to enter a currency futures contract, he informs his agent who in turn informs the commission broker at the stock exchange. The commission broker executes the deal in the pit for a commission/fee. After the deal is executed, the commission broker confirms the trade with the agent of the trader (client or principal). The agent informs the principal about the transaction and the futures price. The principal deposits the margin money with the clearing house at the very start of the next day. Settlement takes place every working day that is known as marking to the market. The final settlement is made on maturity.

Currency Futures Market in India

Rupee currency futures were started in Dubai in 2007 at the Dubai Gold and Commodity Exchange. In India, after a green signal from Raghuram Rajan Committee and the Expert Group at the RBI, three Indian exchanges, viz. BSE, NSE and MCX, applied for dealing in currency futures. RBI and SEBI released the guidelines in this respect on August 6, 2008. Finally, NSE started operating on August 29, 2008. MCX and BSE followed the suit.

The guidelines allowed only US dollar-rupee contracts with a size of $1,000 for a maturity not exceeding 12 months. The trading is done on Monday through Friday excluding public holidays between 9 AM and 5 PM and settlement is done on the last working day of the month, and not earlier. Thus, the standardised size is smaller than those at the international exchanges. The contracts are quoted and settled in rupee.

The membership of the currency futures market would be separate from the membership of derivatives/cash segment. Again, only a resident Indian, including banks, can participate in the deal. This means that the foreign institutional investors/non-resident Indians are not entitled to participate in the deal. A bank being a member must have reserves worth Rs. 5 billion, 10 per cent CRAR, an NPA of 3 per cent at the maximum and a profit record for least three years. The trading limit for an individual client is $5 million or 6.0 per cent of the total open interest, whichever is higher. For a trading member – bank or broker, it is $25 million or 15.0 per cent of the total open interest, whichever is higher.

The hedger or the client is first registered with the trading member who buys or sells the currency futures contract on behalf of the client. The marking to market is based on the daily settlement price which is arrived at after taking the weighted average of last half an hour's transactions. The loss or gain arising out of this process is settled on $t + 1$ basis. At the end of the day, net positions are reset with respect to the current day's daily settlement price and are carried forward to the next day. Finally, on the settlement day, the settlement is done in cash payable in rupee.

In the entire process, the clearing member has a crucial role to play. At the NSE, its wholly-owned subsidiary, National Securities Clearing Corporation Ltd. (NSCCL) carries out the entire clearing and settlement process. It acts as counter-party to all transactions and guarantees the final settlement. It also carries out novation which means that it helps the replacement of one obligation with another with the mutual consent of both the parties. The clearing banks help NDCCL in carrying out clearing and settlement.

The NSCCL monitors the members' operation online and asks for immediate halt of any transaction if the open position or the margin money requirements are violated. Here, it may be mentioned that the margin requirements are enforced by the NSCCL. It calculates the initial margin money requirements on the client's level using standard portfolio analysis of risk methodology and informs the trading members daily about the clients' margin liability. The trading members submit the compliance report. The extreme loss margin in case of the trading members is 1.0 per cent of the value of their gross open position.

Now the question is whether the currency futures are better than the forwards transacted in India. First of all, while in case of OTC forward contracts, the banks quote different bid-ask rates for different customers, the future rates are shown on the screen of the exchange. Thus, the price discovery is more transparent in case of futures.

Secondly, participants such as, exporters and importers can go for a forward contract only for their underlying transactions. Their purpose cannot be speculation. But in case of currency futures, no underlying securities are required.

Settlement of Transactions at the Currency Futures Market Rs. Million

	BSE		*NSE*		*MCX-SX*	
	MTM Settlement	*Final Settlement*	*MTM Settlement*	*Final Settlement*	*MTM Settlement*	*Final Settlement*
2008–2009 Aug.–Mar.	69.6	1.8	3,618.0	55.7	2,372.1	52.1
2009–2010 Apr.–Aug.	0	0	4,025.8	103.4	2,896.2	84.7

Source: *SEBI Bulletin,* various issues

12.2.2 Market for Currency Options

A currency options contract is similar as a forward contract or a futures contract in the sense that the buyer of currency options posseses the right to buy or sell foreign currency after the lapse of a specified period at a rate determined on the day the contract is made. But the currency options contract has a distinctive feature that is not found in a forward or a futures contract. It is that the buyer of a currency options has the freedom to exercise the options if the agreed upon rate turns in his favour. If it is not, he can let the options expire.

Currency Options Market refers to market for the exchange of currency where the option buyer enjoys the privilege of not exercising the option if the rate is not favuourable.

Types of Currency Options Market: The options market is of three types, namely, listed currency options market, over-the counter options market, and currency futures options market. Listed currency options market is found as a part of the stock exchanges. The size and the maturity of the contract are normally fixed. The option buyer or the seller makes the deal with the clearing house, of course, with the help of a broker. In case of the over-the-counter market, options deals are finalised with the banks. The size of the contract is normally bigger and the banks repackage the size of the contract according to the clients' needs. In the currency futures options market, the options are marked to market meaning that they undergo daily settlement, as in the case of a futures contract.

In **call options**, the option buyer contracts to buy the underlying currency. In **put options**, the option buyer contracts to sell the underlying currency.

Types of Options Contracts: Broadly speaking, there are two types of options. In a call option, the buyer of the option agrees to buy the underlying currency, while in a put option contract, the buyer of the option agrees to sell the underlying currency.

Again, the call and put options are of two types. One is known as the European option that is exercised only on maturity. The other is the American option, which may be exercised even before maturity. It is normally in the buyer's interest to exercise the option before maturity. This is why American options command a higher price than European options.

In recent years, some more variants of options have been available.

1. The first is known as a **forward reversing option**. In this case, the call option premium is paid only when the spot rate is below a specified level. The premium is quoted by the seller who charges the premium only when the options are not exercised. In this way the buyer gets a liberal term.
2. The second type is **preference options**. In this case, the buyer gets an additional privilege to designate the option either as a call option or as a put option. But this privilege is exercised only after the lapse of a specified period.
3. In case of **average rate options**, it is the arithmetic average of the spot rate during the life of the option that is taken into account, instead of the spot rate on the maturity. This type of option enables the buyer to hedge a series of daily cash inflows over a given period in one single contract.
4. A **look back option** provides the holder the right to purchase or sell foreign currency at the most favourable exchange rate realised over the life of the option. For example, the buyer of a call has the right to buy the underlying currency at the lowest exchange rate realised between the creation of the call and the expiry date. The buyer of a put option has the right to sell the underlying currency at the highest exchange rate during the life of the option. All this means that the strike rate in a look back option is not

known until the expiry date. Naturally, because of this speciality, the premium of a look back option is normally higher than the premium of the traditional option.

5. Buyers who are confronted with foreign exchange risk with respect to many currencies, buy a **basket option** where the underlying currency is not simply one but many.

Options Terminology: For a clear understanding of the currency options, readers must be acquainted with a few terms that are used in this context. They are as follows:

1. **Option buyer** is a person or a firm who holds the right to buy options. If the option buyer agrees to buy an underlying currency, he is the buyer of a call option. If he agrees to sell an underlying currency, he is known as the buyer of a put option. The option buyer is also known as the option holder.
2. **Option seller** is the party that is obliged to perform if the option is exercised. He is the party who charges a premium for granting such a privilege to the buyer. The option seller is also known as the option writer.
3. **Exercise price** is the price at which options are exercised. It is also known as the strike price.
4. **At-the-money** is the situation when the strike price is equal to the spot price on the maturity date.
5. If, in a call option, the strike price is lower than the spot rate, the situation is known as **in-the-money**. In case of the put option, an in-the-money situation warrants that the spot rate should be lower than the strike price. It is an in-the-money situation when the option buyer exercises the option. It is so because only then can the option- buyer gain. **Out-of-the-money** is the direct opposite of the in-the-money of situation. This means that the spot rate should be lower than the strike rate in case of a call option; and the spot rate should be higher than the strike rate in case of a put option.
6. **Premium** is the value or price of the option that the option-buyer pays to the option seller at the time of signing of the contract. So it is also known as the option value or the option price. It is not returned even when the option is not exercised. The amount of premium is the sum of the option's intrinsic value and the time value. Intrinsic value denotes the extent to which an option would currently be profitable to exercise. In other words, it represents the gains accruing to the holder on the exercise of the option. In case of a call option, it is the excess of the current spot rate over the strike price. The intrinsic value of a put option will naturally be represented by an excess of strike price over the current spot rate. Thus it can be said that when the option is in-the-money, it has some amount of intrinsic value. The intrinsic value of an option—put or call—may be positive. It may be zero. But it cannot be negative insofar as the option buyer will not exercise the option if the option is out-of-the-money.

In-the-money position occurs when the spot rate favours the option buyer. It is when spot rate > strike rate in a call and when spot rate < strike rate in a put.

Out-of-the-money is just the opposite of in-the-money.

The amount of **premium** is the sum of the option's intrinsic value and the time value. Intrinsic value denotes the extent to which an option would currently be profitable to exercise.

The time value of option, on the other hand, represents the sum of money that a buyer is willing to pay over and above the intrinsic value. Time value of an option exists because the spot rate of the underlying currency is expected to move towards an in-the-money position between the signing of the contract and the maturity date. On the maturity date, the time value of option is zero and the premium is entirely represented by the intrinsic value. Again, if there is an at-the-money position, it means that there is no intrinsic value and the option premium is represented entirely by the time value. Between these two positions, the premium is represented partly by the intrinsic value and partly by the time value. Suppose the strike price of a call option is Rs. 80.00/£. The premium is Rs. 0.05 per unit of British pound. The spot rate is Rs. 80.02/£.

$$\begin{aligned} \text{The amount of premium} &= \text{Rs. } 0.05 \times 62{,}500 = \text{Rs. } 3{,}125 \\ \text{Intrinsic value} &= \text{Rs. } (80.02\text{–}80.00) \times 62{,}500 = \text{Rs. } 1{,}250 \\ \text{Time value} &= \text{Rs. } 3{,}125\text{–}1{,}250 = \text{Rs. } 1{,}875 \end{aligned}$$

Here the size of British pound options contract is £62,500.

Gains and Losses to Buyers and Sellers: The gains accruing to option buyers are unlimited, while the loss borne by them is limited to the amount of premium paid by them. On the other hand, the option-seller's risk of loss is unlimited. Gain is limited to the amount of premium it receives. This is why the market for currency options provides an asymmetry between income and risk of loss. In case of a call option, the buyer will gain if the spot price is greater than the sum of the strike price and the premium. For the seller of the call option, the profit profile is simply the mirror image of the loss profile of the option-buyer. If the buyer does not exercise the option, the gain accruing to the seller will be equal to the amount of the premium. But if the buyer exercises the call option, the seller will have to face a loss equal to the excess of the spot price over the strike price, which can be any amount.

> The gains accruing to option buyers are unlimited, while the loss borne by them is limited to the amount of premium. For the seller, the profit profile is simply the mirror image of the loss profile of the option-buyer.

In case of a put option, the buyer will let the option expire if the spot rate is greater than the strike rate. The buyer will be put to a loss equivalent to the amount of premium. Profit will accrue to the buyer only if the spot price is lower than the sum of the strike price and the amount of the premium. As far as the seller is concerned, profit will be equal to the amount of premium. The amount of loss will be infinite, depending upon how much lower the spot price is.

12.3 INTERNATIONAL FINANCIAL MARKET

When a multinational enterprise finalises its foreign investment project, it needs to select a particular source, or a mix of the sources, of funds in order to finance the investment project. In this context, it may be asserted that international companies have easy access to the international financial market. Nevertheless, they should be acquainted with the different sources of funds and also with their comparative cost and benefit.

International Financial Market

A. **Official Sources:**
   1. Multilateral Agencies
      (i) International Development Banks such as the World Bank, IFC, and others
      (ii) Regional Development Banks such as Asian Development Bank, and others
   2. Bilateral Agencies or Different Governmental Agencies

B. **Non-Governmental Agencies:**
   1. Borrowing and Lending Market involving International Banks
   2. Securities Market
      (i) Debt Securities
      (ii) Equities

The international financial market can be compartmentalised into two segments. One is the international money market represented by the flow of short term funds. International banks or short term securities come under this segment. On the other hand, the international capital market forms the other segment where medium and long term funds flow. Irrespective of such a distinction between the two segments, there are a number of agencies and instruments through which funds move to resource needy institutions or firms. One can group the resource providing agencies under two heads. In one group come the official agencies; while in the other group come the non-official agencies. Among the official agencies, are, first, multilateral institutions such as international development banks and regional development banks, and, secondly, bilateral agencies such as different governmental agencies. The multilateral or bilateral funds can be concessional or they may be non-concessional. Those being highly concessional or, in other words, having large grant element, are known as official development assistance.

The non-official channel can be compartmentalised as the borrowing and the lending channel, on the one hand, in which international banks play a significant role; and on the other, the securities market in which the euro equities and debt instruments such as international bonds, medium term euro notes, short term euro notes and euro commercial papers are sold and purchased.

12.3.1 Multilateral Agencies

Up to the mid-1940s, there was no multilateral agency to provide funds. It was only in 1945 that the International Bank for Reconstruction and Development (IBRD) was established. It provided loans for reconstruction of the war ravaged economies of Western Europe and then also began providing development loans in 1948. The IBRD's function was limited to lending and so the provision of equity finance lay beyond its scope.

Moreover, it lent only after the guarantee by the borrowing government. Thus, in order to overcome these problems, the International Finance Corporation (IFC) was established in 1956 to provide loans even without government guarantee and also to provide equity finance. However, one problem remained to be solved. It was regarding the poorer countries of the developing world, which were not in a position to utilise the costly resources of the IBRD, because those funds were carrying the market rate of interest (Sharan, 1991). Another sister institution was created in 1960 for these countries and it was named the International Development Association (IDA). The two institutions—IBRD and IDA—together came to be known as the World Bank.

When IBRD was established, its main objective was not to distribute direct loans but to encourage private investment. It began lending on a large scale only when the desired amount of private investment failed to come up during the initial years. Lending naturally became the major function but the issue of encouragement to international investment remained to continue. And to this end, the Multilateral Investment Guarantee Agency (MIGA) was established in 1980s in order to cover the non-commercial risks of foreign investors. All these four institutions—IBRD, IDA, IFC, and MIGA—together are known as the World Bank Group. Talking liberally, the International Centre for Settlement of Investment Disputes (ICSID), that was set up in 1966, is also treated as a part of the World Bank Group.

> IBRD and IDA—together came to be known as the World Bank. IBRD, IDA, IFC, and MIGA—together are known as the World Bank Group.

When the World Bank Group emerged as a major funding agency, it was felt that its lending norms did not suit all member countries belonging to different regions equally. This is because the economic and political conditions as well as the requirements of the different regions of the globe were different. Thus, for tuning of the funding in line with varying requirements of the different regions, it was decided to set up regional development banks on the pattern of the international development banks. The 1960s were marked with the establishment of regional development banks in Latin America, Africa, and Asia. The Asian Development Bank, meant for the development of the Asian region, began operations from 1967.

12.3.2 Bilateral Agencies

The history of bilateral lending is not older than that of multilateral lending. During the first half of the twentieth century, funds flowed from the empire to its colonies for meeting a part of the budgetary deficit of the colonial government. But it was not a normal practice. Nor was it ever considered as external assistance, as it is in the present day context. Bilateral economic assistance was announced for the first time by the US President Truman in January 1951. In fact, the motivation behind the announcement was primarily political and economic. The cold war between the United States of America and the then Union of Soviet Socialist Republic (USSR) was at its peak during this period. The US government tried to befriend developing countries and bring them into its own camp in order to make itself politically more powerful. It could help the US economy to come closer to developing economies and also to get the desired raw material and food stuffs from them. The economic assistance could help build the infrastructural facilities in the developing countries, which could, in turn, help increase US private investment in those countries.

In the second half of 1950s, the then USSR bloc too announced its external assistance programme in order to counter the US move. By the late 1950s, many other governments of the Organisation of Economic Cooperation and Development (OECD) announced external assistance programmes. Thus, bilateral lending came to full bloom for the first time. In some cases, different governments joined hands with private agencies and the export credits came to form a sizeable part of the bilateral assistance programme.

12.3.3 International Banks

Among the non-official funding agencies, international banks occupy the top position. If one looks at their development since 1950s, distinct structural changes are evident. In the first half of the twentieth century and till the late 1950s, international banks were primarily domestic banks performing the functions of international banks. This means that they operated in foreign countries, accepting deposits from, and making loans to, the residents in the host countries. They dealt in the currency of the host countries, but at the same time, they dealt in foreign currency, making finance available for foreign trade transactions.

Euro banks deal with residents and non-residents, but not in the currency of the country where they are located.

Euro Banks: In the late 1950s and especially in the early 1960s, banks with a purely international character emerged on the global financial map. This new variety of banks came to be known as euro banks. The deposit with and the lending by the euro banks formed the euro currency market. The euro banks emerged on a footing quite different from the traditionally known international banks.

Euro banks deal with both residents and non-residents. They essentially, deal in any currency other than the currency of the host country. For example, if a euro bank is located in London, it will deal in any currency other than the British pound. The deposits and loans of the euro bank are remunerated at the interest rate set by the market forces operating in the euro currency market and not by the interest rate prevailing among the domestic banks in the host country. Again, the other difference between the traditional international bank and the euro bank is that the former is subjected to rules and regulations of the host country, but euro banks are free from the rules and regulations of the host government. The rationale behind the deregulation is that the activities of euro banks do not touch the domestic economy. This is because they are concerned normally with the movement of funds from one foreign market to another foreign market and so are neutral from the viewpoint of any direct impact on the balance of payments of the host country.

Factors behind the Emergence of the Euro Banks: There were a host of factors leading to the emergence and growth of euro banks.

1. It may be mentioned that after Stalin's death, the erstwhile USSR moved away from a closed economic policy. Its trade with the West and the South began to expand since the late 1950s and the early 1960s. During that time the US dollar was the most desired currency in international transactions. So the USSR earned US dollars through trade and tried to earn more of this currency in view of its great strength in international payments. But since the cold war between the two super powers was then at its peak, the United Soviet Socialist Republic preferred to keep its dollars in a bank outside the United States of America. London and a few other European financial centres were the best choice as they possessed the requisite infrastructure and stable political climate. The **dollar deposits in London and other European country based banks** came to be known as euro dollar. Banks accepting such deposits came to be known as euro banks.
2. The British government placed **restrictions on the use of the pound sterling for external transactions** in the wake of the foreign exchange crisis of 1955–57. Naturally, the dollar was in great demand in the United Kingdom for external transactions. In view of readily available supply of dollars, this currency was largely used in external transactions. Moreover, the emerging convertibility of some European currencies by the late 1950s led to the emergence of an active foreign exchange market in Europe linking, in turn, the US dollar with those European currencies. These links enhanced, in turn, the use of the US dollar by banks located in Europe.
3. The emergence of euro banks was supported by some **capital control measures by the US government** in the wake of its balance of payments crisis in the 1960s. In early 1965, the introduction of the Voluntary Foreign Credit Restraint Programme limited the ability of US based banks to lend directly to the non-residents, whereas this provision did not apply to the foreign branches of US banks. This shifted foreign operations of US banks from those located in the United States of America to their offices located in other countries, mainly in Europe. Data show that the number of US banks having foreign branches rose from 11 in 1964 to 125 in 1973 and the number of foreign branches of those banks moved up from 181 to 699 during the same period. The assets of those branches went up from US $7.0 billion to US $118 billion during the same period (Johnston, 1982).
4. Some of the European governments put **restrictions on holding of deposits** by non-residents in domestic currency and on paying of interest on non-resident deposits. It encouraged non-residents to hold deposits in Euro banks that were not subjected to such regulations.

5. The **interest rate ceiling** was imposed by the US government too. It means that when credit was tight and the market interest rate had risen, the US banks could not raise interest rate. On the contrary, euro banks that were not under the purview of such ceilings, raised their interest rate on deposits and lured depositors away from US based banks.
6. When **domestic credit was restricted**, companies borrowed from euro banks, normally at lower rates of interest. Increased lending and deposits contributed to the growth of euro banks. It was not only that the US banks came to be based in Europe. European banks too spread their branches overseas, perhaps as a defensive measure. Statistics reveal that the number of their overseas branches increased from 1,860 in 1961 to 3,764 in 1973. The number of foreign branches of UK based banks alone rose from 1,105 to 1,973 during the same period (Bhatt, 1991).

Offshore banking centres are International banks dealing with non-residents only and not in the currency of the country where they are located.

Off shore Banking Centres: In the 1970s, a new type of international bank emerged which was different from traditional banks or from the Euro banks and these came to be known as off shore banking centres (OBCs). The distinctive feature of the OBCs was that they dealt with the non-residents only; although like the Euro banks, they did not deal in the currency of the host country. In fact, they channelled funds from one country to the other without influencing the domestic financial market.

OBCs came to cluster at places and in countries where the:

1. the Governmental control and regulations were the least interfering;
2. Tax rates were very low;
3. Necessary infrastructure for their smooth operation, such as an improved system of communication, supportive system, existence of an experienced financial community, and so on was available; and
4. political and economic stability was found.

Looking at specific cases, one finds that it was the non-flexibility of governmental restrictions that kept Germany, France, and Japan away from the growth of the OBCs. On the other hand, it was this flexibility that helped London, Luxembourg, Singapore, Hong Kong, and many others to attract OBCs. OBCs grew in Bahamas, Luxembourg, Cayman Islands, and in Panama in view of low rates of taxes. Better communication facilities and availability of experienced personnel were the additional factors for London based OBCs. The presence of exchange control measures grew with in the growth of OBCs in Latin American countries. On the contrary, Kuwait and Bahrain attracted OBCs on account of least governmental interference. Whatever might be the reasons for their growth, OBCs attracted a large number of borrowers and lenders. The foreign currency liabilities of OBCs in European reporting countries rose from US $79.3 billion in 1970 to US $801 billion in 1979 and the total liabilities of US banks' branches in the Bahamas and Cayman Islands alone grew from US $4.8 billion to US $121.8 billion during the same period (Johnston, 1982).

Syndicated Lending: Another structural change that took place in the international banking system during the 1970s was evident in form of syndicated lending. In the wake of international oil price rise, a number of oil importing countries experienced a huge deficit in their current account. Consequently, they went for bigger loans which were normally beyond the capacity of a single bank. The banks joined hands for providing large loans. It reduced their individual risk of lending. Besides, from the borrowers' point of view, the cost of the syndicated loans was smaller than the sum of the cost of individual loans borrowed from many banks. Whatever might be the reasons for the coming together of the banks, such lending came to be known as syndicated lending. Such loans served the interest of both the lenders and the borrowers and so they took a great leap forward. Born in the early 1970s, 'Syndication' crossed US $88 billion mark by 1980 and reached US $320 billion by 1995 (IMF, 1997).

Syndicated lending is found when banks join hands to provide large loans.

Syndicated loans are different from general loans. One of the lending banks is the lead manager who originates the transaction, structures it, selects the lending members, supervises the documentation, and in many cases, services the loan after the agreement is complete. It serves as a link between the borrower and the other banks of the syndicate. It collects interest and principal from the borrower and disburses the collected amount among the co-lenders. For its functions, the lead bank charges an additional fee.

Nature of Transactions in Euro-currency Market: Financial intermediation is the primary function of international banks. It has two aspects: one is to get deposits/borrowing, while the other is lending. A sizeable segment of financial intermediation, represented by inter-bank transactions, may be at a single financial centre or spread over different financial centres. Inter-bank deposits, borrowing and lending involve short term funds and, hence, they are very important from the viewpoint of smoothening of liquidity, transfer of liquidity, and equitable allocation of international liquidity. If a bank is short of liquidity, it can borrow immediately from other banks. If, on the other hand, it has surplus liquidity, it can lend or deposit the excess cash with other banks. Again, when banks borrow and lend in different currencies in different markets, the process influences the stock of a particular currency in a particular market. The allocation of liquidity in a particular market tends to move towards optimisation.

Inter-bank deposits, borrowing and lending, lead to smoothening of liquidity, transfer of liquidity, and equitable allocation of international liquidity.

Non-bank depositors/borrowers are mainly corporate bodies and governments. Deposits in Euro banks and off shore banking centres are not subject to national regulations such as cash reserves ratio. As a result, they are able to pay a higher interest rate on deposits compared to other banks. They normally accept time deposits with maturity varying between one day and several years, but usually between seven days and six months.

Non-bank depositors/borrowers are mainly corporate bodies and governments.

In case of lending, international banks do not insist on restrictive covenants such as ratio limit, dividend restrictions, interest coverage, and so on. The loans are short term, medium term, and long term. The interest rate applicable to deposits as well as lending depends on the movement of LIBOR. However, the lending rate of short term funds is usually greater than the deposit rate by one-eighth of one per cent so that the financial intermediation proves profitable for the banks. The greater the maturity, the higher the interest rate. This means that medium term and long term loans carry a higher rate of interest than short term loans. Nevertheless, the rate of interest charged by Euro banks and OBCs for lending is often lower than those charged by other banks. This is mainly because they lie outside the purview of local regulations.

The credit creation ability of international banks is greater than the domestic banks' inasmuch as they do not have to abide by the host government's regulations.

It is not only the lending rate that is higher than the deposit rate, the amount of the loans given by the banks is often higher than their deposit base. This is because credit creation is common among international banks. It would not be an exaggeration to say that the credit creation ability of international banks is greater than the domestic banks' inasmuch as they also not have to abide by the host government's regulations (Lee, 1973; Bell, 1973; Klopstock, 1988). Fratianni and Savons (1971) estimated the credit creation multiplier among international banks between 3.0 and 7.0. Makin's estimate (1972) was higher, indicating between 10.31 and 18.45.

Besides financial intermediation, international banks are actively involved in the foreign exchange market. As mentioned earlier in this chapter, they play the role of middlemen in the foreign exchange market. They also function as arbitrageurs and speculators so they can play the role of a market maker by influencing the supply and demand of a particular currency.

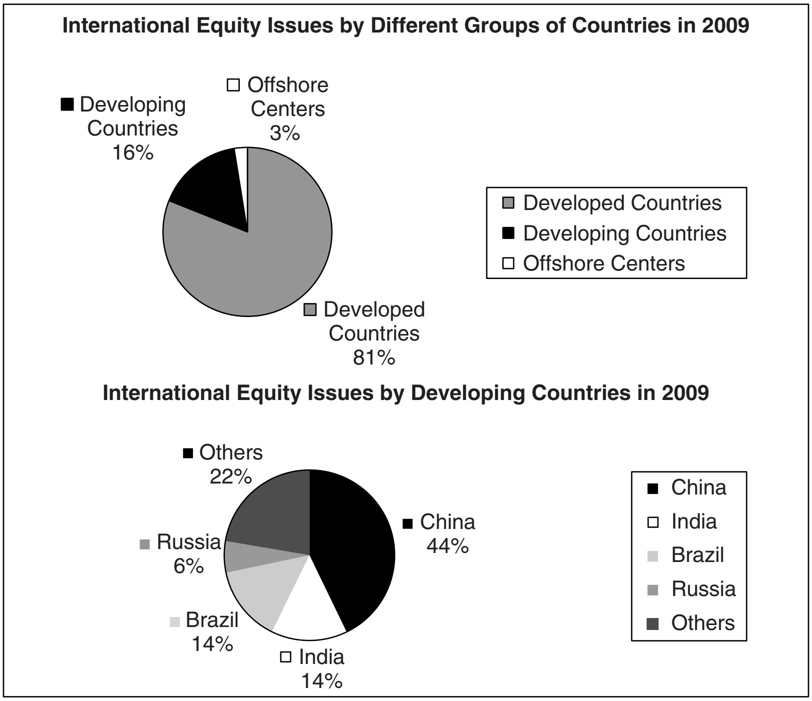
12.3.4 International Securities Market

Shift towards Securities Market: There was a big leap in bank lending during the 1960s and more particularly during the 1970s, after international banks had acquired the surplus of oil exporting countries. But during the 1980s, a number of factors emerged on the map of international economy that led to a shift from bank lending to growing securitisation in the international financial market.

1. With stagnant oil prices, international banks could not sustain any sizeable increase in loans.
2. External debts of some of the borrowing countries turned unmanageable. The borrowers found themselves unable to repay loans. Mexico's refusal to repay loans added fuel to fire. The risk of repayment grew so large that banks hesitated in lending.
3. A drop in long term interest rates during the 1980s and the reappearance of positive real interest rates, and more importantly, a rising trend in the yield from long term bonds made investors invest in international bonds.
4. The rising intermediation cost associated with bank lending moved the borrowers away from banks and brought them closer to the securities market (Honeygold, 1989).

5. The securities proved highly liquid as the investors could sell them in the secondary market which had developed along with the growth in securitisation.
6. International banks liked to compensate lost income from the lending business through their active participation in off-the-balance sheet activities. The more commonly used securities came to be international bonds and euro equities for long term funds, medium term euro notes meant for medium term funds, and euro notes and Euro commercial papers that were meant for short term funds.

International Equities: Euro equities are not debts as holders are paid dividend. They do not represent FDI as the holders do not enjoy voting rights. They represent a mixture of the two and, hence, are in great demand. (1) They are issued when the domestic market is already flooded with shares and the issuing company would not like to add further stress to the domestic stock of shares since such additions may cause a fall in share prices; (2) companies issue such shares for gaining international recognition; (3) such issues bring in scarce foreign exchange; (4) capital is available at lower cost; and (5) funds raised this way do not add to foreign exchange exposure. From the viewpoint of investors, international equities bring in diversification benefits.



Source: Based on figure obtained from BIS

For the issue, the issuing company approaches a lead manager who advises the issuer on different aspects of the issue. On getting the advice, the issuer prepares a prospectus and other documents and takes permission from the regulatory authorities. It deposits the shares to be issued with a custodian bank located in the domestic country. The custodian bank is appointed by the depository in consultation with the issuing company. After the custodian holds the shares, the depository issues global depository receipts (GDRs). The ratio between the number of shares and the number of GDRs is decided before the issue is launched. The GDRs are sold to international investors and funds move from the investors to the depository, from the depository to the custodian bank, and from the custodian bank to the issuing company. The investor has right to surrender the GDR and to take back the investment. In this case, the GDR is submitted to the depository who informs the custodian who, in turn, will issue the share certificates in exchange for the GDR. The proceeds from the sale of shares are converted into foreign exchange and remitted to the investor through the depository.

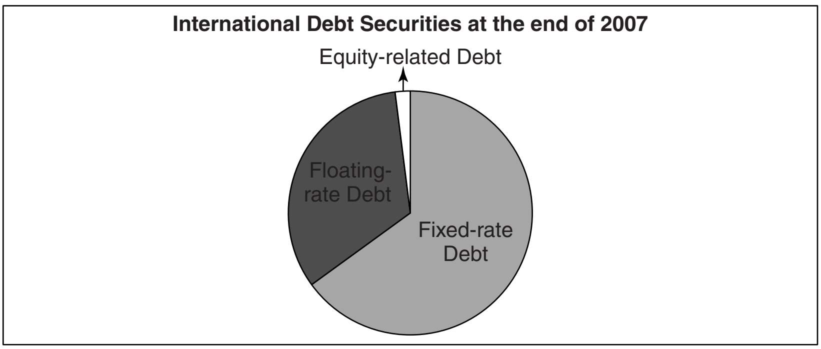
The GDRs are sold to international investors and funds move from the investors to the depository, from the depository to the custodian bank, and from the custodian bank to the issuing company.

In the process of the issue, the role of underwriting and listing is very important. The lead manager normally acts as the underwriter as well as the listing agent. After the listing formalities are over, the GDRs are traded on stock exchanges. International clearing houses facilitate the settlement of transactions.

International Bonds: International bonds may take many forms. They may be foreign bonds or euro bonds. A bond issued in a foreign country's financial market and denominated in the currency of that country is known as a foreign bond. But a euro bond being issued in a foreign country is denominated in any currency other than the currency of the country where it is issued. Foreign bonds are normally underwritten by underwriters in the country where they are issued. In case of euro bonds, the underwriters are multinational. Again, foreign bonds are normally subjected to the rules and regulations of the country where they are issued, but euro bonds are free from such regulations.

International bonds are of different kinds: foreign bonds, euro bonds, global bonds, cocktail bonds, straight bonds, floating-rate notes, convertible bonds, etc.

There are also global bonds issued for the first time by the World Bank in 1989 and now also being issued by companies. They are large in size,



Source: Based on the figures available from *BIS Quarterly*, March 2008.

carry a high rating, and are offered for simultaneous placement in different countries. When bonds are denominated in SDRs, they are known as cocktail bonds as they represent more than one currency.

The bonds are either straight bonds carrying a fixed rate of interest; floating rate notes carrying a flexible interest rate based on the movement of the LIBOR; or they may be convertible bonds, meaning that they are convertible into equities after a specific period.

The procedure of issue is simple. The firm approaches a lead manager (a commercial bank or an investment bank) who advises the issuer on different aspects of the issue—such as timing, price, maturity, size, and the buyers' potential—for a fee. The lead manager may take the help of co-managers. After getting advice from the lead manager, the issuer prepares the prospectus and other legal documents and secures the approval of the regulatory authorities. After approval, it launches the issue. The documents accompanying the issue of bonds are normally: prospectus, subscription agreement, trust deed, listing agreement, paying agency agreement, underwriting agreement, and selling group agreement.

The lead manager underwrites the issue and charges an underwriting fee. After the underwriting is done, the bonds are sold. The lead manager functions as a selling group for a fee. There are also trustees appointed by the issuer, who protect the interest of the bondholders in case of default. In many cases, the lead manager functions as a trustee. Finally, there are listing institutions for listing the bonds for secondary marketing. The secondary market for international bonds is mainly an over-the-counter market, although the bonds are listed with stock exchanges. In case of foreign bonds, listing is limited to a particular country, but that in case of euro bonds involves many financial centres. Sometimes, before the secondary market starts functioning, the particular euro bond is in great demand and it is marketed. Such trading is known as grey trading, although such cases are rare.

Euro Notes: Euro notes are promissory notes issued by companies for raising short term funds. They are denominated in any currency other than the currency of the country where they are issued. Unlike euro bonds, documentation formalities are minimal. They can be easily tailored to suit the requirements of different kinds of borrowers. Investors too prefer them in view of their short maturities.

> Euro notes are promissory notes issued by companies for raising short term funds.

For the issue of euro notes, the company hires a facility agent or a lead manager who advises them on the different aspects of the issue, underwrites the issue, and sells the notes through placement agents.

The cost components of euro notes are underwriting fee; one-time management fee for structuring, pricing, and documentation; and the margin on the notes themselves. The margin is either in form of a spread above/below the LIBOR or built in to the note price itself.

> ECP is a promissory note like the euro note. It is not underwritten and also it is issued only by highly creditworthy borrowers.

Documents accompanying these notes are the underwriting agreement, paying agency agreement, and information memorandum showing, among other things, the financial position of the issuer. The notes are settled either through physical delivery or through clearing.

Euro Commercial Paper (ECP): This is also a promissory note like the euro note but it is different from euro notes in that it is not underwritten and also it is issued only by highly creditworthy borrowers. ECPs have evolved based on pattern of US and Canadian commercial papers that were issued as back as in 1960s. But they are different from the US CPs in the sense that ECPs have a longer maturity, going up to one year, and they are structured on the basis of all-in-costs, whereas in the case of the US CPs, various charges are collected separately.

ECPs vary in size from US $10 million to over US $1 billion and carry market based rates, normally the LIBOR. Non-interest-bearing ECPs are sold at discount. On maturity, they are settled through clearing houses. They are in great demand as they involve the least possible documentation.

Medium term Euro Notes: The euro notes met the requirements for medium term funds through rolling over. But the process of rolling over involved time and cost. This problem led to the issue of medium term euro notes that do not involve the rolling over process as they are issued for a medium term. They carry either a fixed rate of interest or a variable interest rate. Of late, the euro market has come up with global medium term notes where issues of different credit ratings are able to raise funds by accessing retail as well as institutional investors.

SUMMARY

- The foreign exchange market involves purchase and sale of foreign currencies. It is an over-the-counter, round-the-clock market. The participants are individuals, firms, banks, monetary authorities, and international bodies. The purpose is genuine transaction, hedging, arbitraging, and speculation. Transactions are spot and forward. In the forward market, transactions are made for the future delivery of currency.
- There are markets for derivatives such as the market for currency futures and the market for currency options. The market for currency futures has a particular place where transactions take place through brokers. The size and maturity of the contract is fixed. There is provision for margin money and marking to market is an essential feature. The transactions in the market for currency options differ in the sense that the buyers of options have the privilege of exercising the option or letting it expire. They have to pay a premium to the options seller. Options contracts could be in different forms, such as the call option, put option, European option, American option, and so on. Such markets are either over-the-counter or they have a fixed place, known as the'pit', where transactions are finalised.
- The international financial market witnesses the borrowing and lending of different currencies. There are different sources of funds. The multilateral sources are represented by the World Bank, the International Financial Corporation, and the regional development banks. There are also bilateral or governmental agencies involved in the lending business. Among

the non-official sources, there are international banks comprising of traditional international banks, Euro banks, and off-shore banking centres. Primarily, they are engaged in financial intermediation, but they also operate in the foreign exchange market.

- International banking had its hey days during 1960s and more so during the 1970s. But due to a host of factors, their activities reached the lowest ebb by the early 1980s. As a result, the international securities market turned to be the most important source of funds. The instruments used in this market are international equities, international bonds, medium term euro notes, euro notes and euro commercial papers.

REVIEW QUESTIONS

1. Distinguish between the spot and forward foreign exchange markets. Who are the participants in the foreign exchange market?
2. How is the market for currency futures different from the forward market?
3. What are the different types of currency options contracts? Distinguish between call options and put options.
4. Explain:
   (i) In-the-money position in an options contract
   (ii) Intrinsic value and time value of an options contract
   (iii) Syndication of lending
5. Distinguish between a Euro bank and an off-shore banking centre. What were the factors responsible for the emergence and growth of the Euro banking system?
6. What led to the growth of securitisation in the international financial market? Briefly explain some, common instruments used in the international securities market.

REFERENCES

Books

Bell, G. (1973), *The Euro-Dollar Market and the International Financial System* (New York: Wiley).
Bhatt, P. R. (1991), *International Banking* (New Delhi: Commonwealth Publishers).
Honeygold, D. (1989), *International Financial Markets*, New York: Woodhead-Faulkner.
International Monetary Fund (1997), *International Capital Markets*, Washington, D.C.
Johnston, R. B. (1982), *The Economics of Euro-market: History, Theory and Policy* (New York: St. Martin's Press).
Klopstock, F. H. (1988), "The Euro-dollar Market: Some Unresolved Issues", *Princeton Essays in International Finance* (Princeton: Princeton University Press).
Sharan, V. (1991), *The World Bank Group and the SAARC Nations* (New Delhi: Anmol Prakashan).
________ (2009), *India's Financial Market: An Era of Reforms*, New Delhi: Sage Publishers, p. 176.

Journals

Fratianni, M. and P. Savons (1971), "Euro-dollar Creation: Comments on Professor Machlup's Propositions and Developments", *Banca Nazionale del Lavoro Quarterly Review* 103, 13–22.
Lee, B. E. (1973),"The Euro-dollar Multiplier", *Journal of Finance*, XXVIII (4), 867–74.
Makin, J. H. (1972), "Demand and Supply Functions for Stocks of Euro-dollar Deposits: An Empirical Study", *Review of Economics and Statistics*, LIV (4), 381–91.

SELECT FURTHER READINGS

Giddy, I. H. (1994), *Global Financial Markets* (Lexington: D. C. Heath).
Joshi, P. R. (1996), *Global Capital Markets* (New Delhi: Tata-McGraw Hill).
Park, Y. S. and J. Zwick (1985), *International Banking in Theory and Practice* (Reading Mass.: Addison-Wesley Publishers).

---

* **Melbourne** is the capital and most populous city in the state of Victoria, and also the second most populous city in Australia. As of late 2009, the greater geographical area had an approximate population of 4 million. Today, it is a centre for the arts, commerce, education, entertainment, sport and tourism. Melbourne is less than 200 years old and never sits still with industries like foundries works, oil refineries, textile mills, food processing and large printing establishments.

The Collins Street (as shown in the picture) is city's premier commercial streetscape and home to big corporations and the stock exchange. It is major financial hub and a boulevard of chic designer shopping, five-star hotels, exclusive jewelers, grand heritage buildings and private clubs. It boasts of the brands like Chanel, Giorgio Armani, Tiffany & Co and Louis Vuitton.

PART

3

Strategy of International Business

This page is intentionally left blank.

Seoul, South Korea*

13

Strategy, Planning, Organisation and Control

CHAPTER OBJECTIVES

International business operations are not at random. A proper strategy is formulated, planning follows to define the means to attain the goal, organisational structure provides a route for decision-making and the control assesses the extent to which the goals have been achieved. The present chapter deals with these issues and aims to:

- ✦ Explain the different approaches to strategy formulation.
- ✦ Delineate the areas for strategy formulation.
- ✦ Indicate the different levels at which strategy is formulated.
- ✦ Explain the nature of the different steps in the process of strategic planning.
- ✦ Distinguish between centralised and decentralised planning.
- ✦ Explain the different types of organisatonal set up.
- ✦ Describe the features and the design of an effective control system.

After a firm decides to involve itself in international business through any of the entry modes, it begins devising a strategy to achieve the goal of maximising corporate wealth. There are different approaches to devising strategies. The international manager relies on any one, or a combination, of strategies. Moreover, the strategy varies from case to case. In some cases, the parent unit likes to have a greater say in the functioning of the entire organisation, which means a great deal of centralised decision making. In others, the parent unit does not interfere much with the subsidiaries' performance, which means the subsidiaries have reasonable amount of freedom. Irrespective of the approach, the strategy is set by the process of planning. Planning shapes the strategy as well as defines the means to attain the goal. Thus, there is a close link between the goals of the firm, strategy, and the process of planning.

Again, it is the control process that measures how far the goals have been achieved; and if there are deviations, it tries to find out the factors behind the deviations and helps acquaint the management with the corrective measures. Thus, the mechanism of control too has a close relationship with strategy and planning.

Yet again, it is the structure of an organisation that provides the framework for planning and control. It helps identify the works to be performed and ensures the desired communication between the different functionaries of the enterprise, so that the accomplishment of the chosen strategies is facilitated.

The formulation of strategies, the process of planning and control, and the organisational structure are much more complex in international business than in a domestic business. It is because international firms operate in a heterogeneous environment. In some cases they enjoy some privileges, while in others, they have to face tough challenges. This is why any discussion regarding these issues is of much concern for international business.

13.1 STRATEGIES

13.1.1 Different Approaches to Strategy Formulation

Strategy is a managerial action to attain specific goals of a firm.

The strategy of a firm is of course to achieve superior performance (competitive advantage) on a sustainable basis. There is no single answer as to how this can be achieved. Experts on international business differ on this issue. A couple of views need reference here.

Porter (1985) is of the view that a firm's competitive advantage depends on the selection of the most appropriate generic strategy, which incorporates three elements, namely, cost leadership, differentiation, and focus. If the cost of a product is lower than the competitors', the firm can maximise its sale/profit. Similarly, if the product is unique, differentiated from the rivals' product, and it meets consumers' preference, the firm will be able to maintain an edge over its rivals. Again, if the firm has focus on a particular segment of the market, either with a low-cost product or a differentiated product, the concentrated effort will definitely confer a competitive advantage upon it.

Approaches to Strategy Formulation

- Porter (1985, 1986, 1990)
  - (a) Selection of an appropriate generic strategy
    - Cost leadership
    - Product differentiation
    - Focus on a specific segment of a market
  - (b) Application of the generic strategy for international business
    - Configuration
    - Coordination
- Prahlad and Hamel (1990); Kay (1993)
  - Development of core competence
    - Unhindered availability of least-cost resources
    - Better network of relationship within and outside the firm
    - Improved features of product
    - Improved communication links with the consumers
    - Improvement in the market position
- Yip (1992)
  - Adoption of total global strategy
    - Development of core business strategy
    - Internationalisation of core business strategy
    - Coordinating activities of the firm in different countries

Porter (1986, 1990) developed the generic strategy theory for international business through the incorporation of the concept of configuration and coordination. The concept of configuration is based on the value chain concept. It shows whether it is better to concentrate the manufacturing activities in one or two nations and cater to the outside demand through export, or to disperse the manufacturing activities over a number of countries. However, Porter is of the view that configuration alone does not assure competitive advantage unless and until the activities in different countries are properly coordinated. Prahalad and Doz (1987) support this view and are of the opinion that a sound global management requires (1) centralised management of the dispersed activities, (2) coordination of R&D, pricing and intra-firm technology transfer, and (3) the subsidiaries' ability to make decisions with respect to local issues.

The concept of **configuration** shows whether it is better to concentrate the manufacturing activities in one or two nations or to disperse the manufacturing activities over a number of countries.

The other approach, which has been developed by Prahalad and Hamel (1990) and Kay (1993) is known as competence-based strategy. It is the core competence or the distinctive capability of the firm that puts it in a superior position. Core competence can be possessed if the resources—physical, financial, technological, and human—are available at the least cost, conveniently and, without interruption. Again, the existing core competence can be strengthened and new core competence can be built up.

Kay is of the view that core competence can be improved through (1) better network of relationship within and outside the firm, (2) improvement in the quality and features of the product and in communication links with the consumers, and (3) improvement in the market position.

While Porter emphasises on generic strategies and Prahalad and Hamel on the competence-based strategy, Yip (1992) talks about the total global strategy. He suggests a three-stage move towards total global strategy. In the first stage the core business strategy is developed, which includes decisions on type and pricing of product, customers, markets, and so on. In the second stage, the core strategy is internationalised, which involves, inter alia, adaptation of the product for the global market. Lastly, in the third stage, all the activities of the firm, in different countries, are integrated. This way Yip supports the two views mentioned above but places greater stress on the global aspect.

The above views boil down to the simple fact that the international business strategy of a firm manifests in, first, the development of core competency, which helps the firm either to market an innovated/differentiated product or to reduce the cost of the existing product so as to earn large profits; and, second, adaptation of the technology and product, which is known as local customisation, to suit the local consumers in different markets, leading to large profits. Normally, an international firm combines both these strategies. However, either of the two strategies varies from one case to the other. In one case, development of the core competency gets greater emphasis; in the other, local customisation gets greater emphasis; in yet another case, both are given equal importance.

13.1.2 Spectrum of Strategy Formulation

The **spectrum** of IB strategy deals with: 1. Sources of funds, 2. Location of manufacturing, and 3. Market and product diversification.

The spectrum of strategies in international business covers financial, production, marketing, human resource and other related aspects. In view of the varied sources of funds, an international manager has to decide from where he can raise funds. He compares not only the cost of the funds among different sources, but also considers the fluctuation in the exchange rate of different currencies that are borrowed. This is because large fluctuation in the exchange rate raises the effective cost of funds to be raised. Therefore, it is the least effective cost of funds that shapes, among other things, the financial strategy.

Production strategy is also complex as the firm has to select the most suitable location for the manufacture of the product or for the purchase of inputs. The selection is quite difficult as the economic and political scenarios of different locations vary widely.

Marketing strategy is even more complex in view of varied background of consumers in different markets. A firm likes to move abroad to reap benefits from the firm-specific advantage possessed by it. It also moves abroad when its business at home is consistently unprofitable. Its move is successful when the market characteristics abroad are different from those in the home market. It may be that the foreign market is still in a "new product" stage, while the domestic market is already saturated with the product. In such cases the market diversification will tend to reduce risk and to offer ample returns.

It is not only market diversification but also product diversification that is often a crucial strategy of an international firm. If the firm's strategy is to go for product diversification or to enter a new product line, its success depends on whether the revenue stream in case of the new product is negatively correlated with that of the existing product. Because, only then would the risk be lower with a given return. However, the diversification should preferably be in related, upstream or downstream, businesses. Most of the leading international oil firms have varieties of related items on their selling list, such as gasoline, petrochemicals, and so on, besides oil exploration and refining. Diversification helps achieve physical and financial economies of scale. But its success depends on the strength of the rival firms in the market.

If a firm relies on a single product, it possesses the advantage of a single brand name. A single brand name is more familiar with the consumers of different markets and this ultimately pushes up sales. But what is often needed is to adapt the features of the product to the varying features of different markets. We know that the international market is segmented on account of the varying economic and socio-cultural environment. A particular product that is in great demand in a particular market may not be in demand in other market. So the product with the same brand name needs adaptation to the local requirements.

As regards human resource, the strategy varies from one country to the other. As McGregor (1960) believes, it is a choice between Theory *X* and Theory *Y*. Theory *X* holds that the workers are generally irresponsible and more often are unwilling to work. They need persuasion by the employer to work. On the contrary, Theory *Y* explains that the workers are themselves well-motivated to perform their task, barring very exceptional circumstances. It is found that the strategy of the American and European management is normally Theory *X*-oriented. The Japanese management strategy, on the other hand, is normally Theory *Y*-oriented. On comparing the American and the European management, the strategy is found somewhat different. While in America, the lower-level employee does not participate in the management, the European management involves such employees in decision-making at least to some extent.

In short, the strategy of international firms—its product strategy, or market strategy or its financial strategy—differs from one case to another depending upon the varying environment and the varying secondary goals.

13.1.3 Various Levels of Strategy Formulation

Strategy at the international level depends on whether the structure of the international firm is ethnocentric, or polycentric or geocentric.

Strategy at the International Level: It was Perlmutter (1967) who suggested that three broad and distinct types of strategies—ethnocentric, polycentric and geocentric—shaped the structure of international firms. In his view, ethnocentrism is compatible with dominance of the parent company over the entire network of the firm. The products are standardised and designed primarily for the home country market. But they are sold without any virtual change by different subsidiaries in different markets. It is not necessary that the products are manufactured in the home country itself. They may be manufactured by any of the subsidiaries where the cost is the lowest, either on account of cheap labour or cheap raw material. It may also be that a part of the manufacturing process is located in one country and the other part in any other country with a view to minimising the cost of production. Again, since the product characteristics are the same, the pricing is global and not different for different markets. The financing, marketing, and other decisions are centralised, at the parent unit.

Since products are uniform throughout the world, bulk production is possible, which reaps economies of scale, which in turn fosters the competitive power of the firm. But the greatest demerit of this strategy is that markets requiring adaptation of the product in order to suit the consumption pattern of the local consumers is out of reach for the firm. Moreover, ethnocentrism can lead to problems connected with industrial relations and can hamper the firm's relations with the host government.

Polycentrism is opposite to ethnocentrism and so it is opposed to centralised control. It means that polycentric international firms have free standing subsidiaries that do not have much operational linkage among themselves or with the parent unit. Their products are not standardised. They are adapted freely to suit the local demand in different countries, with the result that the price decision is taken by the subsidiaries, which are often more aggressive while taking such decisions.

The relative freedom enjoyed by the subsidiaries does not mean that this strategy is not going to confer benefits on the parent unit. The parent unit does reap benefit from geographic diversification. Since economic conditions in different countries often vary, the revenue stream of different subsidiaries are often negatively correlated and, as a result, there is stability in the revenue stream, which reduces risk with a given return. Besides geographic diversification, there is also product diversification in the form of a more dispersed production structure, which reduces the risk with a given return.

All this does not mean that revenue does not rise. Because of freedom in pricing, according to what is suitable to individual markets, revenue can be maximised and huge profits can be generated. An ethnocentric firm cannot generate profits in this manner. However, the greatest demerit polycentric organisations suffer from is that the communication medium among the subsidiaries or with the parent units gets weaker and, as a result, potential synergies are not realised. Moreover, the products of a particular subsidiary are not accepted universally. The firm is not known throughout the world by its brand name.

Geocentricism lies between the two—ethnocentrism and polycentrism. It means that this strategy, like ethnocentric strategy, has a global perspective aiming at maximising the global profit, but at the same time, like a polycentric strategy, it has a multi-product production system. This strategy reaps the benefits of both the strategies discussed above and so it is more proximate to real life.

Corporate level Strategy: Companies having more than one line of business formulate a corporate level strategy that coordinates the different business level strategies. Since business level strategies may differ among themselves, it is necessary to formulate a corporate level strategy so that none of the business level strategies go against the corporate level strategy. The corporate level strategy may stress growth, retrenchment, or stability, or a combination of the three. The growth strategy is common as companies usually aim at gradual expansion of their operations. But sometimes they adopt a retrenchment strategy, when they have to curtail their operations in view of tough competition or macroeconomic downtrends. Rarely do companies adopt the strategy of stability, in which they are satisfied with what they have. However, a combination of strategies can also be formulated when the corporate strategy allows successful business lines to grow, unsuccessful business lines to cut short their activities, and allows still others to maintain stability.

> **Corporate level strategy** allows successful business lines to grow, unsuccessful business lines to cut short their activities, and allows still others to maintain stability.

Business level Strategy: If the company has only one line of business, a business level strategy is not formulated. But it becomes essential in cases where there is more than one line of business. Although the purpose is served by the corporate level strategy, the business level strategy is formulated for either minimising costs or for differentiating the product by adding special features therein. The cost minimising strategy, normally possible either through the achievement of economies of scale or through the use of cost-reducing technology, may help grab a larger share of market and enhance the total profit. This strategy is more useful when the demand for the product is highly price elastic.

> **Business level strategy** is formulated for either minimising costs or for differentiating the product by adding special features therein.

The product differentiation strategy, either by creating a brand image or by creating a unique design, helps establish an oligopolistic status for the firm which may lead to market leadership and maximisation of revenue. Consumers of the differentiated product do not mind paying high prices if it is superior quality. But differentiation is useful only when consumers are loyal to the product and the revenue is large enough to compensate the high cost of producing and marketing the unique product.

Sometimes the two strategies—cost-economising and the product differentiation—are simultaneously adopted by the firm at the business level. Dave Barry gives an example of this strategy, narrating how coffee beans are taken out of the waste of animals eating coffee berries and how they are processed into coffee and sold at a much lower price than the coffee processed out of original beans. The new variety of coffee has lower cost and at the same time carries a distinctive taste liked by its consumers (Wild, et al, 2000).

Department level Strategy: The efficacy of the department level strategy is a prerequisite for sound corporate level/business level strategy. This is because, at the department level, customer value is created through low cost and differentiated products. Primary activities—consisting of manufacturing activities, logistics, and marketing activities—have a crucial role to play in lowering the cost or in making a differentiated product. However, this does not mean that supportive activities are less important. Strengthening of R and D activities, human resource, and accounting and financial activities does support cutting of cost and making the product unique. Thus, if the department level strategy is sound, the corporate level and business level strategy gets valuable support.

13.2 PLANNING

13.2.1 Nature of Planning Process

The **process of planning** seeks to answer question regarding what the firm expects to achieve and what method the firm is going to use to this end.

It has already been mentioned that planning shapes strategy and defines the means to achieve goals. It is rather the matching of markets with products and other corporate resources so that the long term competitive advantage of the firm gets strengthened. In other words, the process of planning seeks to answer question regarding what the firm expects to achieve and what method the firm is going to use to this end. It decomposes problems and issues, applies rational tools on the basis of available information, and finalises action to achieve the goal. In a small firm, planning may be ad hoc. But in large firms, especially in multinational corporations that operate in varying environments, the process of planning is more systematic and comprehensive.

The process of planning may be short term or long term. The former is known as operating planning and is concerned with day-to-day operations. On the contrary, long term planning, called strategic planning, precedes the operating planning. Moreover, strategic plans are broader and more comprehensive. Inputs for the process come from all parts of the organisation and only senior executives involved in the firm's worldwide activities participate in strategic planning.

13.2.2 Steps in the Process of Strategic Planning

There are different steps in the process of strategic planning, which are adopted in sequence, although sometimes they occur simultaneously. The steps are:

1. Assessment of the external environment and internal resources

2. Formulation of global strategy
3. Development of global programme

Assessment of the external environment and the internal resources: The assessment of the external environment has a greater relevance in case of an international company as host countries present varying environments. The assessment takes into consideration the present position and the future trends in relation to the size of the market, consumption pattern in different markets, the intensity of competition, and the business linkages in different markets. Only then can the firm's share of the market and the amount of its output be known. It is also decided as to whether the firm has to adapt its products to local requirements in the host countries and what benefits it can derive from the backward and forward linkages in the host countries. A number of executives coming from different functional areas and from different geographic regions participate in the discussion and make the assessment. The usual practice is to begin with broad groups of regions and to come down to specific countries. Data used for the assessment comes from the publications of the different countries. The experience of executives working in those regions or countries is also valuable. If additional information is required, the firm approaches international or national information agencies.

When the assessment of external factors is complete, the firm assesses how far the resources available at its disposal are able to meet the desired objectives. If the resources fall short of the requirements, the firm plans for supplementing them. The assessment of resources includes that of financial resources, human resources, and product resources. For the assessment of financial resources, the firm evaluates the present and future cash flows, availability of capital, ability to transfer funds from one unit to the other, and the profits and dividend target.

> When the assessment of external factors is complete, the firm assesses financial resources, human resources, and product resources.

Similarly, human resource assessment is concerned with the availability of skilled persons and their attitude towards employment in a foreign country. It is not very difficult to get persons having general skills but it is difficult to get persons with specific skills, and still more so to get persons suitable for foreign country postings. A person to be posted in a foreign country should be acquainted with language, socio-cultural and political environment, and other factors prevalent in that country.

Apart from the financial and human resources, the firm has to assess whether its product can be adapted to the requirements of the host country's consumption pattern. The assessment takes into consideration some other factors too, such as the capacity utilisation, monopolistic characteristics of the product, economies of scale, transportation facilities, and so on. This is because these factors are very important from the viewpoint of establishing competitive advantage.

> A market is selected that represents large demand, least competition and that resembles with the existing market.

Formulation of global strategy: This strategy involves the market as well as the product. As far as the market strategy is concerned, a suitable market representing a sufficiently large demand for the product or having the least competition is selected. The ease with which the parent company can allocate resources is yet another factor that influences market selection. Also, a foreign market that has some kind of resemblance with its existing markets is preferred, as in this case, it will be easier for the firm to cope with the market demand.

Sometimes, the strategy involves market segmentation. This means creation of various groups in a particular market in order to address the unique needs and expectations of specific sections of consumers. Segmentation is based on the principle that a particular society possesses persons of varying tastes. The wealthier and better-educated people refuse consumer stereotypes and appreciate exclusive products. This might be the reason that the Seiko Watch Company makes a costlier watch under the brand name of Hittari in order to meet the demand of affluent-class consumers in different markets. However, the segmentation strategy suffers from certain limitations. The first is that the number of consumers in the segmented group should be fairly large. Secondly, segmentation of the market does not allow achieving the economies of scale that is easily achieved in case of standardised production. It is often said that segmentation is not usually required because the same standardised product can be demanded by different classes of consumers, based on different considerations (Baalbaki and Malhotra, 1993). Thus, when market strategy is formulated, the firm weighs the merits of segmentation or non-segmentation based on several considerations.

Product strategy normally combines differentiation with cost containment strategy.

Apart from the market strategy, product strategy also needs formulation. In case of product strategy, the emphasis lies on a single product vis-à-vis a multiple product strategy. Single product theory is advocated on the grounds of economies of scale, awareness of the consumers, and market leadership. Product differentiation, on the other hand, helps the firm reap oligopolistic advantages, although the process of differentiation may lead to cost escalation. Thus, it is evident that combining product differentiation with cost containment and, thereby, in expanding the market share is the best strategy.

Development of global programme: This step includes planning, mainly with the respect to the degree of product standardisation, marketing programme, and location for production. Both standardisation of product and adaptation of product have merits and demerits. Therefore, the firm needs to asses how much adaptation/standardisation of the product can be recommended so as to achieve economies of scale and at the same time attract the consumers abroad. Similarly, planning is done with respect to marketing and advertising techniques—whether they should be uniform in different countries or different for different countries. It of course takes into account the disparity in the taste of the consumers in different markets. Again, the firm plans the location of the plant and the service centre based on a couple of factors. The first factor is the cost consideration, while the second is consumer convenience. Infact, it is because of the cost consideration that international concerns have started manufacturing in the developing countries where labour or raw material is cheap. Planning offshore production is a case in point. However, the cost of transport to

The firm plans the location of the plant on cost consideration and consumer convenience.

carry the manufactured goods to the market centre and making the products easily available to the consumers cannot be overlooked.

13.2.3 Centralised versus Decentralised Planning

When decisions related to the process of planning are taken at the parent office it is known as centralised planning. On the contrary, when the planning process evolves at the subsidiary level, it is called decentralised planning. In real life, neither of the two exists in its purest form. There is usually a combination of the two.

Planning decision taken at the parent unit is known as centralised planning, but those taken at subsidiary level are decenteralised planning.

When a product involves intricate technology developed at home, it is often globally standardised. And, in this case, the planning is carried on at the parent unit, the subsidiaries have virtually no say in the decision. Again, when different units of a firm are closely interlinked and when host governments do not impose control over the cross-border mobility of funds and other factors of production, it is often due to centralised planning. Yet again, when pricing and product decisions in one country are expected to influence the demand in other countries, centralised planning is often evident. This is because executives at the parent unit have a better idea of pricing and demand in all the host countries.

On the contrary, when products need adaptation on account of widely differing economic and socio-cultural environments, planning needs more local inputs and it is decentralised. Executives at the subsidiary level have a better idea of the local issues and so decentralised planning in this case is closer to reality. However, in most of the cases, it is the hybrid of centralised and decentralised planning that is often called transnational planning.

13.3 ORGANISATIONAL STRUCTURE

Organisational structure provides a route and locus for decision making. It also provides a system, or a basis, for reporting and communication networks. The basics of an organisation chart, which can be found in any book on management concepts, are similar for both domestic firms and international firms. But since international firms have to face complex problems, the form of the organisational structure is specific to them. The structure of an organisation becomes complex with the growing degree of internationalisation.

Organisational structure is a structure of linkages among organs of a firm establishing the route and locus of decision-making

13.3.1 Absence of Formal Organisational Structure

In the beginning, when a firm has just begun international transactions, and that too on an ad hoc basis, meaning that the export is only fortuitous, it is the domestic division that handles export. The organisational structure is not different from that of a domestic company despite occasional involvement in international business. The structure is either a functional structure or a product structure. In a functional structure, below the chief executive officer, the organisation is divided into different functional divisions,

Functional structure is organisational structure based on the nature of functions.

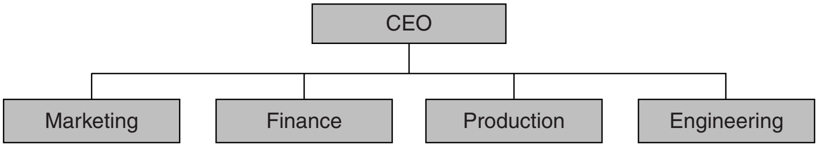


FIGURE 13.1 Functional Structure

Product structure is organisational structure based on the nature of products.

such as marketing, finance, production, and so on and power centres are located in these different divisions. Figure 13.1 shows a functional structure.

On the other hand, in a product structure, below the chief executive officer, the organisation is divided into different product groups that allows the firm to segment internal operations in order to comply with product and market variations. Figure 13.2 shows a product structure.

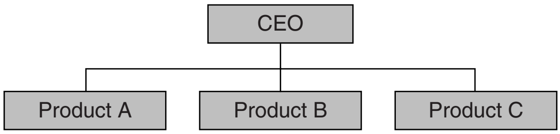


FIGURE 13.2 Product Structure

13.3.2 Creation of Export Department

With export activities being deliberate, the firm sets up an export department as a sub-department of marketing.

The organisational structure changes the moment the firm begins exporting on a continuous basis. Export activities do not remain fortuitous, rather they are deliberate. In such cases, the firm may set up an export department as a sub-department of marketing, manned by experts in the field of international business. If the international business becomes a permanent phenomenon, the export department will have some freedom to operate and an international organisational structure will begin to emerge. Nevertheless, priority in this type of organisation is mainly the domestic market, rather than on the foreign market, with the result that the domestic marketing department maintains an overall control over the export department. Figure 13.3 presents a clear picture of this type of structure.

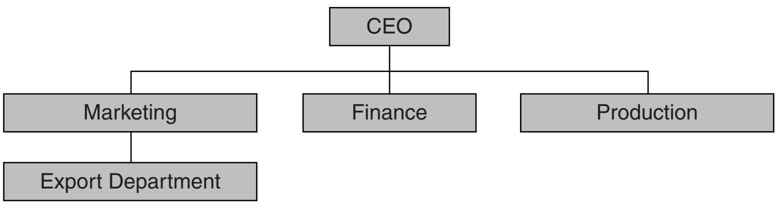


FIGURE 13.3 Creation of Export Department

13.3.3 International Division

With exports moving on to a stronger footing and sometimes with growing competition for the same market, the firm's attitude towards the organisational structure changes and it sets up an independent functional division, that is, an international division that assumes the entire responsibility for international business. It may be a part of the firm; or it may be incorporated as a separate entity, depending upon how the objectives of the firm are accomplished more easily.

With exports moving on to a stronger footing the firm sets up an independent international division that assumes the entire responsibility for international business.

There are often cases when the domestic market is preferred despite a clear focus on the international market. It is found in cases when the firm believes that better domestic opportunities still exist. In such cases, though the domestic division concentrates on manufacturing and on other domestic activities, the international division performs its function freely under the supervision of a separate vice-presidency. Proper coordination is of course maintained between the two divisions—the domestic division, on the one hand, and the international division, on the other. However, the international division fails to cope with the multiplicity of products and with greater international diversity. This was perhaps the reason that in the 1970s many US based firms changed their organisational structure from a traditional international division based one to more sophisticated structures (Davidson and Haspeslagh, 1982). Figure 13.4 presents this type of organisational structure, particularly when the international division is a part of the firm.

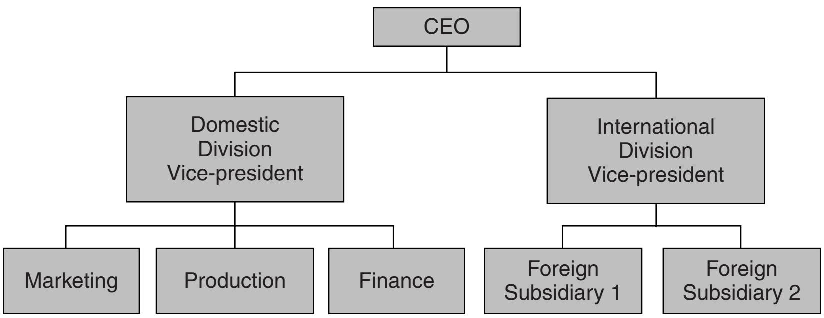


FIGURE 13.4 International Division

13.3.4 Global Division

The international division is successful only when the domestic purpose dominates the firm's activities and the international activities are simply an extension or a part of the domestic activities. But when a firm starts its foreign operation, the foreign subsidiary may need transfer of technology or certain components, which means considerable attention to the foreign

With foreign operation being more complex and being the prime motive, the firm sets up a global division. The global structure may be product structure, area structure, functional structure, and customer-oriented structure.

operation by lower-level management and technical staff. Consequently, the organisational structure needs a change in favour of a global division. In this structure, global operation is the prime motive; domestic operation is simply a part of the firm's global operation.

The global structure may vary from case to case. If it emphasises on the product, the product division performs the job of manufacturing and world wide marketing. Alternatively, the global structure may be area oriented, where the geographic divisions are responsible for manufacturing and marketing in their respective areas. Yet again, the global structure may be based on the functional areas where the different divisions, such as manufacturing, marketing, finance, and personnel are responsible for global operation of their own functional area. Last but not least, the global structure is sometimes customer oriented, where worldwide customers are segmented into different classes and the firm's operations are structured accordingly.

1. ***Product structure*** is more common in international business and more suitable in case of a multiple brand system (Franko, 1977). In this case, there are different product divisions. In each division, there are sub-divisions—one sub-division looking after the manufacturing and sales at home and the other sub-divisions looking after the sales of foreign subsidiaries. The centralisation of manufacturing leads to economies of scale, while decentralisation of marketing is often more effective. In this structure, product-specific attention is possible, which is significant for competing in different markets. This structure is useful also in the sense that the various functional inputs needed for a product can easily be balanced. However, coordination among various product groups operating in the same market is very important in order to avoid duplication of the basic functions. A global product structure is depicted in Figure 13.5.
2. In case of ***area structure***, organisation is based on the geographic areas, namely, Asia, Africa, Latin America, and so on and

Area structure is organisational structure based on geographic area.

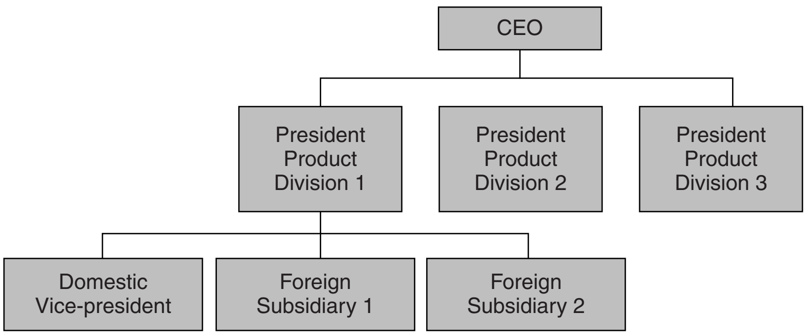


FIGURE 13.5 Global Product Structure

the operation is divided accordingly. The parent unit, however, provides coordination support for worldwide planning. Similarly, as in product structure where product-specific attention is possible, area/market-specific attention is possible in area structure. When a particular region requires greater attention in view of its own problems it is given the attention. This structure is more suitable where brands are few but disparity in host country market is quite large. However, it is necessary that experts for each product group are appointed in each of the regions so that any duplication in product management is avoided. Figure 13.6 gives a clear picture of global area structure.

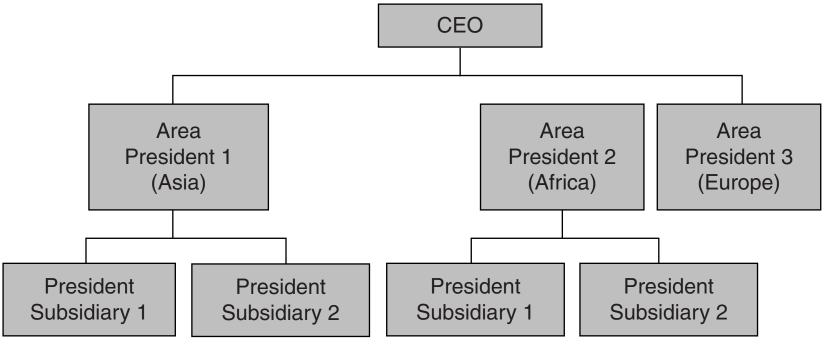


FIGURE 13.6 Global Area Structure

3. The ***functional structure*** emphasises on specific functions such as manufacturing, marketing, finance, and so on. It is more suitable where the products and customers are few and homogeneous. The only problem is that of coordinating personnel of different functional groups. Figure 13.7 gives a clear view of this structure.

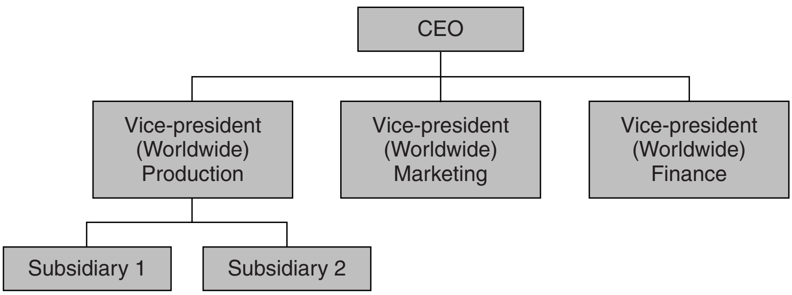


FIGURE 13.7 Global Functional Structure

4. The ***customer-oriented structure*** is more relevant where customers are widely heterogeneous and their consumption pattern differs widely. This structure helps emphasise all the different classes of customers.

13.3.5 Multidimensional/Matrix Structure

Matrix structure is a combination of product, area, and functional structures.

The global matrix structure is more complex when it combines all the three aspects — product, area, and function. This is found in multi-product firms where one group of products needs area structure of organisation, while the other group of products needs functional structure, and for yet another group, product structure is found more appropriate. A firm reaches this particular stage when economies of scale in production reaches a new high and the different subsidiaries are able to expand their market beyond their traditional domain. In this case, country level managers report to both regional and product managers, as a result of which a balance is created between global/regional needs and the local needs. The matrix structure encourages team response that is very much pertinent in cases where no single person possesses all the information required. This type of structure is presented in Figure 13.8.

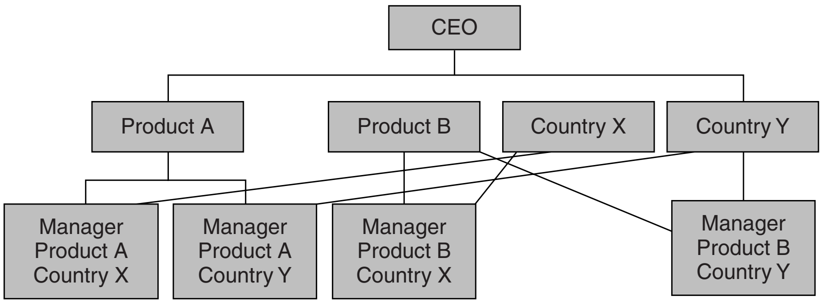


FIGURE 13.8 Matrix Structure

13.3.6 Some other Structures

The above mentioned structures are normally based on the American experience. It is not necessary that international companies of other countries follow the same hierarchical structure. In this sense, the organisational structure is more flexible than that mentioned above. Punnett and Ricks (1997) mention a few other structures followed in other countries. For example, European companies use "mother-daughter" structure where subsidiaries are substantially autonomous. Each subsidiary reports directly to the top management. In China, the industrial organisational structure interweaves various levels of the governmental functionaries.

In some developing countries, a matrix of government structure is used where various ministries and central agencies come between the highest body of the government and the industrial organisation.

13.3.7 Coordination among the Sub-units

It is quite evident from different organisational structures that the units/sub-units are widely dispersed. The dispersion is product based, functional, or geographic. Whatever may be the form of dispersion, the different units/sub-units need to be well coordinated in order to make the organisational structure effective. Proper coordination smoothens communication between one unit and another. It is true that there are impediments to effective coordination. Managers at different units may have varying orientation. The geographic distance may be too much to ensure effective coordination. But these problem can be sorted out.

Proper co-ordination—formal or informal—smoothens communication between different units.

The coordinating mechanism can be either formal or informal. Formal coordination can be ensured through direct contact among the managers of different sub-units. It can also be ensured by giving a manager of a unit the responsibility for coordinating with his counterpart in another unit. A number of international firms have adopted the practice of direct reporting to headquarters by managers.

In a system of informal coordination, a management network is established through which information is disseminated throughout the organisation. The managers of different units know one another either directly or throughanother manager. The use of intra-firm communication devices helps in this respect. Managerial development programmes too fosters proximity among the managers of different units. However, the success of coordination efforts depends on how far the organisational culture is developed, meaning that how far the team spirit prevails among the managers.

13.4 PROCESS OF CONTROL

The process of control had been discussed earlier in this chapter. Infact, it involves examination of the facts to verify whether the set goals have been achieved. To this end, it identifies deviation, if any, from the set goals and suggests measures to do away with the factors behind the deviation. The process of control, as it has been said, is more crucial for a multinational enterprise in view of its complex operation, especially on account of large physical and cultural distances and in view of a substantial degree of delegation of authority. Thus, it is very significant to know what the shape of an effective control system should be.

13.4.1 Features of an Effective Control System

An effective control system must be based on accurate information and the information regarding performance should be compared with a set standard. If the parent unit and the subsidiary maintain their accounts in the same currency, there is normally no problem in getting accurate information. But if the currency of the accounts differs, the changes in the exchange rate may blur the reliability of information. Similarly, the standard for performance may differ from one set of business environment to another. A particular data, which may be standard for a subsidiary operating in one particular country, may not be standard for the same firm operating in some other country. Thus, the firm must set a particular standard incorporating the local variations on the one hand and at the same time reflecting an overall view of the company on the other; and only then the performance may be judged against the set standard.

The firm must set a particular standard incorporating the local variations, reflecting an overall view of the company and then the performance may be judged against the set standard.

Secondly, the control system should be cost-effective. It is a fact that refinements brought in the setting of the standard should be preferred. But incorporation of too many refinements raises the cost of the control system. A very costly control system may prove counter-productive. Thus, there should be frequent appraisal of the control system from the viewpoint of its cost effectiveness. It would maintain the costs within manageable limits.

An effective control system must be: (1) based on accurate information, (2) based on timely information, (3) cost-effective and (4) based on objectivity.

Thirdly, whatever information is available, should be available in time. It is because only then can any strategy of control be applied effectively. Untimely or delayed information loses its relevance. However, in international business it is the geographic distance that often causes delay. Sometimes, it is the cultural attitude that is the reason behind delayed information. For example, Latin Americans do not generally attach importance to timeliness. On the contrary, in the United States of America and the United Kingdom, accurate timing is maintained.

Last but not least, the information should be objective, which means possessing the least possible subjectivity. This is because it is easier to interpret objective information. At the same time, objective decisions lead to unbiased decision, which is essential for initiating a correct control strategy.

13.4.2 Design of Control

Control mechanisms can be designed in many ways. They vary from one location to the other or from one firm to the other. However, some of the techniques are common. Some of the common techniques are discussed here.

Accounting and audit control: Accounting and auditing control is normally designed for measuring financial results. Accounting control analyses past financial data, such as cash inflow, cash outflow, profits, assets, liabilities, and so on with the help of various accounting techniques, such as ratio analysis, funds/cash flow analysis, and so forth and reaches a particular conclusion. The analysis may show whether the firm is operating up to the set standard or the performance is below the mark. The technique known as standard costing and variance analysis is very common. It shows whether the material used, labour used, or the overhead cost incurred is compatible to the set standard or whether there is any variance. On the contrary, audit control verifies the information provided by financial statements. In other words, it ensures reliability and validity of the reported financial statements.

Accounting control analyses past financial data and compares them with the set standard. Audit control verifies the available financial information.

However, the problem is that accounting procedures and practices vary widely in different countries (Rathore, 1996). It is beyond the scope of this book to discuss the various practices followed in different countries. Nevertheless, it needs to be stressed that it is very difficult to set the standard against which performance is judged in view of the varying practices.

Control through Plans, Policies and Procedures: This is also known as bureaucratic control or formalised control. It has already been stated that planning and control are closely interrelated. Plans are both long term and short term. They may be for whole of the firm or for different units located in different geographic regions. The short term plans are often accompanied by annual budgets and the annual budgets serve the purpose of a control mechanism as they refer to short term guidelines regarding production, marketing, personnel, and other aspects. Again, at frequent intervals, the actual performance is evaluated against the set plans. If the actual performance differs from the set plans, which is often the case, measures are taken to correct the deviations. The long term plans are more qualitative in nature and they stress long-term goals.

Actual performance is evaluated against the set plans and measures are taken to correct the deviations. Policies and procedures are also formalised to maintain a balance between the global procedures and policies and the procedures adopted in different host countries.

Similarly, as plans are formulated, the policies and procedures are also formalised for the whole of the firm and for each and every unit. Sometimes, the same policy and procedures are formulated for all the units located in different countries. It no doubt brings in similarity of operation among different units and facilitates coordination of activities and transfer of personnel from one unit to another, but leads to confrontation with the host country regulations and practices. So, the normal practice is to maintain a balance between the global procedures and policies and the procedures adopted in different host countries.

Cultural Control: Since bureaucratic control is too rigid, emphasis is given on corporate values and culture. Cultural control is based on the concept of socialisation where informal personal interaction is very significant. A considerable amount of resources is used for training individuals so that they can share a homogenised corporate culture. Training brings improvement to their performance. It is nothing but the process of acculturation that promotes better performance among the firms (Czinkota and Ronkainen, 1997).

Cultural control is acquainting personnel with corporate culture.

Centralised and Decentralised Control: Control may be centralised, meaning that the parent unit maintains control over the operations of the entire firm and the subsidiaries get the least freedom. In a decentralised system, the subsidiaries get greater freedom to control their operation. Both systems have their merits. Decentralisation is preferred because the management of the subsidiary is normally better acquainted with the market behaviour and it can react quickly to changes in the market. Drake and Caudill (1981) are of the view that decentralisation should be the design of control when the subsidiary has only marginal involvement in overall international business, when product is a consumer product and when the human resource of the subsidiary is capable of taking important decisions. On the contrary, centralisation of control is favoured when the firm is faced with a global competitive threat, when a large amount of research and development (R&D) is involved in the manufacturing of product, or when cultural similarity is found between the home country and the host country. However, centralisation of control is normally not feasible when the subsidiary is marked with host country dominance.

In real life, subsidiaries are given independence to take control measures, but essentially within the framework designed by the parent unit.

In real life, the two extremes are rarely found. It is usually a mix of the two—often termed as coordinated decentralisation—where subsidiaries are given independence to take control measures, but essentially within the framework designed by the parent unit. Proper coordination between the parent unit and the subsidiaries or among the different subsidiaries is maintained through frequent meetings of personnel representing different units or through intranet or internet services that are quite popular today.

SUMMARY

- Strategy involves setting of goals. The ultimate goal is the maximisation of corporate wealth, which can be achieved through superior performance (compared to the rivals) on a sustainable basis. There are different strategies to put the firm in a superior position. Some of the more important are the strategy of competitive positioning, competence-based strategy, and total global strategy. The spectrum of strategy may be broad, covering production, financial, marketing, and other vital aspects.
- Strategy is formulated at different levels. At the international level, it may be ethnocentric, polycentric, or geocentric strategy. At the corporate level, it may be a growth strategy, retrenchment strategy, stability strategy, or a combination of any two of these or more. At the business level, it may be a cost-minimisation strategy or product differentiation strategy, or both. At the department level, the strategy concerns both primary and supportive activities.
- Planning shapes strategy and defines the means to achieve goals. The process of planning has three sequential steps. The first is the assessment of the external environment and internal resources. The second is the formulation of global strategy, which involves identification of the market and matching of the products with market-specific needs. The third step is to develop a global programme that includes planning with respect to the degree of product standardisation, marketing programme, and the location for manufacturing. The planning may be centralised. Alternatively, it may be decentralised, leaving it to different strategic business units (SBUs). The choice depends, among other

things, upon the level of technology used, mobility of funds and other factors of production, and the heterogeneity of host country environment.

- The organisational structure facilitates the implementation of measures designed through the planning process. When the involvement of a firm in international business is only ad hoc and fortuitous, the domestic division looks after the international business too, and as a result, the organisational structure of the international firm is not different from that of a domestic company. But with growing export of a permanent character, an export department is added to the marketing department.
- With massive growth in export, when the export department proves incapable of handling export, an international division is created independent of the domestic marketing department, although proper coordination is maintained between the domestic division and the international division. However, when the firm begins international operation, the challenges appear far greater. The organisational structure becomes global. The emphasis is the on product structure, area structure, or still on the functional structure.
- The growing complexities in the organisational structure do not end here. If, with growing international involvement, all the three structures—product, area, and the function—need to be combined, the structure turns to be a global matrix structure that permits different types of inter-linking between products and areas. However, the organisational structure has also come to evolve in different shapes in different sets of countries.
- Lastly, the process of control involves examination of whether the set goals have been achieved and also corrective measures in case of deviations from the set standards, if any. An effective control system is based on correct and timely information, which is judged against the set standards. It is difficult to set standards in view of wide heterogeneity in the international environment. Nevertheless, the standard maintains a proper balance between the firm's overall view and host country variations.
- There are various techniques for control. One is accounting and audit control, used mainly for judging the financial performance. The other is control through plans, policies, and procedures, where performance is compared with the actual plans and policies. Procedures differ from one country to another and so they come in the way of process of control. Cultural control is based on the concept of socialisation where informal personal interaction is very significant. Again, the process of control may be centralised or decentralised, or a mixture of the two known as a coordinated decentralisation approach.

Review Questions

1. What are the different approaches to strategy formulation? Explain its broad spectrum.
2. "The characteristics of strategy formulation at different levels are different." Comment.
3. What are the different steps in the process of strategic planning? Distinguish between centralised planning and decentralised planning.
4. "The nature of organisational structure depends on the extent of the firm's involvement in international business." Discuss.
5. What are the features of an effective control mechanism in international business? Explain the techniques of control.

References

Books

Davidson, W. H. (1982), *Global Strategic Management* (New York: John Wiley and Sons).

Franko, L. G. (1977), "Organisational Structures and Multinational Strategies of Continental European Enterprises" in Ghertman, M. and J. Leontiades (eds.), *European Research in International Business* (Amsterdam: North Holland Publishing Company).

Kay, J. (1993), *Foundations of Corporate Success* (Oxford: Oxford University Press).

McGregor, D. (1960), *The Human Side of Enterprise* (New York: McGraw Hill).

Porter, M. E. (1985), *Competitive Advantage* (New York: Free Press).

——— (1990), *The Competitive Advantage of Nations*, New York: Free Press.

——— and Y. L. Doz (1987), *The Multinational Mission: Balancing Local and Global Visions* (New York: Free Press).

Punnett, B.J. and D.A. Ricks (1997), *International Business* (Oxford: Basil Blackwell).

Rathore, S. (1996), *International Accounting* (New Delhi: Prentice-Hall of India).

Wild, J. J. *et al*. (2000), *International Business: An Integrated Approach* (New Jersey: Prentice Hall).

Yip, G. S. (1992), *Total Global Strategy: Managing for World-wide Competitive Advantage* (Englewood Cliffs: Prentice-Hall).

Journals

Baalbaki, I.B. and N. K. Malhotra (1993), " Marketing Management Bases for International Market Segmentation: An Alternate Look at the Standardisation/ Customisation Debate", *International Marketing Review*, 10 (1), 19–44.

Czinkota, M. R. and I. A.Ronkainen (1997),"International Business and Trade in the Next Decade: Report from a Delphi Study", *Journal of International Business Studies*, XXVIII (4), 676–94.

——— and P. Haspeslagh (1982),"Shaping a Global Product Organisation", *Harvard Business Review*, LIX (Mar.–Apr.), 69–76.

Drake, R. and L. M. Caudill (1981), "Management of the Large Multinational: Trends and Future Challenges", *Business Horizons*, XXIV (May–June), 83–91.

Perlmutter, H.V. (1967),"L'Entreprise internationale trois conceptions", *Quarterly Journal of AISEC International* (translated form), August Issue.

——— (1986),"Changing Patterns of International Competition", *California Management Review*, XXVIII (2), 9–40.

Prahalad C. K. and G. Hamel (1990),"The Competence of the Corporation", *Harvard Business Review*, LXVIII (May–June), 79–91.

SELECT FURTHER READINGS

Davidson, W.H. and Jose de la Torre (1989), *Managing the Global Corporation* (New York: McGraw-Hill).
Garland, J. *et al* (1990), *International Dimensions of Business Policy and Strategy* (Boston: Kent Publishing).
Higgins, J.M. (1983), *Organisational Policy and Strategic Management* (Hinsdale: Dryden Press).
Prahalad C. K. and Y. L. Doz (1987), *The Multinational Mission: Balancing Local and Global Visions* (New York: Free Press).

* **South Korea**, officially the **Republic of Korea (ROK),** is a developed country in East Asia and classified as a high-income economy by the World Bank, an advanced economy by the IMF and CIA. The South Korean economy is led by large conglomerates known as Chaebol. These include global multinational brands such as Samsung, LG and Hyundai-Kia. Samsung and LG are among the top three manufacturers of televisions and mobile phones. Samsung is currently the world's most valued consumer electronics brand.

Its capital, Seoul, is consistently placed among the world's top ten financial and commercial cities and was named the world's sixth most economically powerful city by Forbes with a GDP per capita of $32,171 in 2008. Almost half of South Korea's population lives in the Seoul National Capital Area, and nearly a quarter in Seoul itself, making it the country's foremost economic, political, and cultural centre.

Rome, Italy*

14

International Investment and Financing Strategy

CHAPTER OBJECTIVES

Financial strategy is yet another significant aspect of an MNC. It incorporates a number of issues that are discussed in the present chapter. The objectives are to:

- ✦ Discuss the process of international capital budgeting, which primarily includes the calculation of cash flows and the cost of capital.
- ✦ Show how a particular source/form of fund is selected.
- ✦ Acquaint readers with the nature of financial swap, especially the interest-rate swap and currency swap.
- ✦ Analyse international cash management, which includes the assessment of cash requirements, optimisation of cash needs, and the investment of surplus cash.

Financial strategy in international business begins from the very investment decision. This is because investment is believed to be fruitful only when it represents a net cash inflow into the firm. The technique of evaluation, known as international capital budgeting, is an essential aspect of financial strategy.

When an investment decision is made, the sources of the funds should be determined. Selection of the sources or the types of funds is important. If the desired type of funds is not available, the firm often opts for a swap. Thus, the swap is a meaningful strategy in the context of raising of funds.

Besides, maintenance of sufficient liquidity among the different units of a firm, without impairing profitability, is no less significant and so international cash management is yet another important aspect in this respect. The present chapter deals with all these aspects of the financial strategy.

14.1 INTERNATIONAL CAPITAL BUDGETING

Net present value (NPV) is present value of future cash flow minus initial investment.

Internal rate of return (IRR) is the discount rate equating future cash flow with initial investment.

Profitability ratio is present value of future cash flow divided by initial investment.

Salvage value refers to sale proceeds of assets at the end of the life of the project.

There are different methods of capital budgeting, such as accounting rate of return, pay back period, net present value, internal rate of return, profitability ratio, and so on. The purpose of these techniques is to find out whether the cash inflow is greater than the cash outflow. Some of the techniques are discounting techniques where future cash flows are discounted to the present value and then they are compared with the initial investment. Nevertheless, the discounting and non-discounting techniques apply to both, domestic capital budgeting and international capital budgeting. Books on corporate financial management would contain a more elaborate discussion regarding the evaluation criteria, which is beyond the scope of this book.

14.1.1 Computation of the Cash Flow

Any investment for a new project demands a part of the firm's current wealth, but, in return, it brings in funds and adds to the firm's stock of wealth in the future. The former results in cash outflow from the firm, while the latter is represented by cash inflows into the firm. Cash outflow occurs on account of capital expenditure; other expenses, excluding depreciation; and the payment of tax. Cash inflow includes revenue on account of additional sale or cash from eventually selling off an asset, which is known as salvage value. Thus, cash flows are grouped under three heads. One is the initial investment during the period, t_0; the other is the operating cash flow during the period, t_1 to t_n; and yet another is the terminal cash flow or the salvage value that emerges at the end of the period, t_n.

Complexities in Cash Flow Computation: The computation of cash flow is complex in international firms. At the very onset of multinational capital budgeting, a decision needs to be taken regarding whether the cash flow should be computed from the viewpoint of the parent company or from the viewpoint of the subsidiary. This is because the cash flow accruing to the subsidiary may not be represented entirely by the cash flow accruing to the parent company. In some cases the cash outflow of the subsidiary is treated as the cash inflow of the parent company. It is also possible that the cash inflow accruing to the subsidiary may be large enough to justify the investment proposal, but its size accruing to the parent company may be too small to justify the investment proposal. In such cases, it seems difficult to take a decision regarding acceptance or rejection of the investment proposal.

Infact, there may be many situations when disparity in the cash flow between the parent and its subsidiary arises.

1. If the tax rates in the home country and the host country are different, disparity will arise in the cash flow. It is possible that on account of lower tax rates in the host country, after tax cash inflow is large enough to justify the investment proposal. On the other hand, owing to high tax rates in the home country, the investment proposal may not be feasible from the viewpoint of the parent company.
2. The parent company may not accept the investment proposal due to low inflow of cash on account of exchange control applied by the host government, despite the fact that the cash flow of the project in question is sufficient for implementation.
3. When the parent company charges an exorbitant price for technology and management, the cash inflow accruing to the parent company will be larger, justifying the investment proposal. But such exorbitant payments may lower the cash flow of the subsidiary and the subsidiary may not like the investment proposal.
4. Changes in the exchange rate may change the cash flow of the parent company. When the currency of the host country appreciates, the parent company gets a larger flow of cash in terms of its own currency. This may change its accept-reject decision.

However, the ethics of the corporate financial management is very clear on this issue; that is, the value of the project is determined by the net present value of the future cash flows available to the investor. Since the parent company is the investor, it is the cash flow of the parent company that is primarily taken into account in the context of international capital budgeting. This is why cash flowing from the subsidiary to the parent company, either in the form of royalty and technical service fees or in any other mode, is treated as cash inflow. On the contrary, any flow of cash flowing from the parent company to the subsidiary is treated as cash outflow. The parent company will agree to invest in a foreign project only if the net present value of the cash flow is positive from its own point of view.

Parent's Perspective: The computation of cash flow in the context of international capital budgeting incorporates factors that influence the very size of the cash flow at different stages. These factors operating at different stages of cash flow need to be analysed here.

Initial Investment: If the entire project cost is met by the parent company, the entire amount of initial investment is treated as the cash outflow (Figure 14.1). In some cases, the project is partly financed by the subsidiary itself through local borrowing. But such borrowings of the subsidiary do not form a part of the initial cash outflow.

Again, in some cases, the subsidiary makes additional investment for expansion out of the retained earnings. At the first instance, there is apparently no flow of cash from the parent company to the subsidiary. But it should be treated as an opportunity cost insofar as in the absence of retention of earnings, these funds could have been remitted to the parent company rather than invested in the project in question. Thus, investment out of retained earnings should be treated as cash outflow from the parent's perspective.

Initial Investment	=	Fresh Investment Made by Parent	+	Use of Retained Earning, if any	+	Use of Blocked Funds, if any

FIGURE 14.1 Initial Investment

Blocked Funds: Profit of subsidiary not repatriated to parent due to exchange control.

Yet again, the issue of blocked funds is very pertinent in this respect. Sometimes the host government imposes exchange control and does not allow any cash to flow to the parent company. These funds are known as blocked funds. Thus, this part of the cash inflow of the subsidiary, which is represented by blocked funds, is not treated as cash inflow from the parent's perspective. Suppose the incremental cash inflow of the project is $20 million, out of which only $15 million is allowed to flow to the parent company by the host government. In this case, a sum of $15 million will be treated as the cash inflow. But if the blocked funds are invested in some new project, that amount is treated as an investment by the parent company and is recorded as a cash outflow.

Last but not least, if the host government provides subsidised initial establishment for the subsidiary, the gain on this account should not be included in the initial investment of the parent company.

Operating Cash Flow: The operating cash flow is computed on an after tax basis as well as on an incremental basis. It does not consider depreciation as it is a non-cash expense. Depreciation, however, helps arrive at the pre-tax profit. Financing cost is also not included despite the fact that capital has a cost. The reason is that such costs are considered elsewhere while determining the project's required rate of return.

As a normal practice, the revenue generated through the sale of subsidiary's product in the local market as well as in other countries is shown as the operating cash inflow from the parent's perspective. But it is subject to downward adjustment by the lost income on sales previously realised through the parent company's export to these markets. On the contrary, if the operation in the subsidiary leads to import of components and raw material from the parent company, the value of such imports will be added to the revenue.

The operating cash flow is influenced by some other factors too.

1. If the subsidiary pays royalty to the parent company, the operating cash inflow will rise. But if the parent company faces loss on account of lack of economies of scale, due to shifting of production to the host country, the operating revenue will come down.
2. The operating cash flow is influenced by **transfer pricing** when the parent company or any other unit of the firm charges

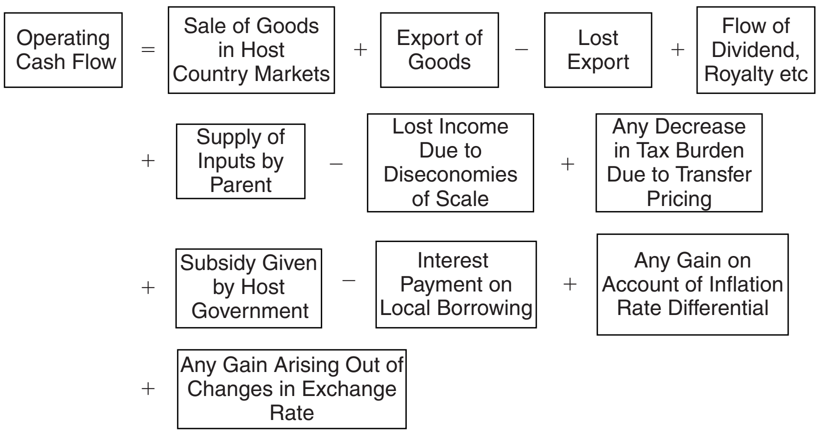


FIGURE 14.2 Factors that Influence Operating Cash Flow

arbitrary prices for intra-firm movement of intermediate goods (Figure 14.2). It may be noted here that transfer pricing is adopted either for better working capital management or for reducing the overall burden of taxes of the company through shifting of the before tax profit to a country with lower tax rates. If transfer pricing lowers the overall tax burden of the company and thereby increases the revenue of the parent company, the additional revenue or saving should be treated as cash inflow. However, it may be noted that such inflows are discounted at a higher rate because they involve greater risk.

3. If the host government offers **incentives**, they should be included in the capital budgeting decision. For example, if the host

government offers tax incentives or provides loans at subsidised rates, the amount of gain on this account should be added to the operating cash inflow.

4. When the subsidiary avails of **local borrowing** for meeting a part of the initial investment and pays interest on such borrowings, the amount of interest payment is deducted from the operating cash inflow. Had it been domestic capital budgeting, the interest payment on such borrowing would not have formed a part of cash flow insofar as financing cost is included in the discount rate. But in case of international capital budgeting, the cash remitted to the parent company will stand overstated if interest payments are not treated as cash outflows for the subsidiary. This is why it is very much necessary that the investment made by the subsidiary out of local borrowings is separated from the investment made by the parent. The present value of cash flow received by the parent company should take into consideration the interest paid by the subsidiary on the local borrowing and only then should it be compared with the initial investment made by the parent company.
5. The **inflation rate differential** needs to be taken into account. Inflation influences, both, the cost and revenue streams of the project. If the inflation rate is higher in the host country and if the import from the parent company constitutes a significant portion of the input of the subsidiary, the cost will not become very high. But if the inputs are obtained locally, the cost will become very high. Also, as far as revenue is concerned, it will move up if there is no competition from foreign suppliers and if the demand for the product is price inelastic. So the computation of cash flow relies on the inflation forecast in the host country and its possible effects. However, if the inflation is quite volatile from year to year, as it is found in many developing countries, it is difficult to make an accurate forecast.
6. **Exchange rate fluctuation** influences the size of the cash flow. It is a fact that changes in the exchange rate are tagged to changes in the rate of inflation. But there are other factors too that shape exchange rate fluctuations. It is difficult to predict the behaviour of all those factors. Nevertheless, the cash flow computation process incorporates different scenarios of exchange rate movements. From the parent company's point of view, appreciation in the currency of the host country will be favourable and will increase the size of the cash inflow in terms of the home country currency. A joint effect of inflation and exchange rate changes may produce a partial offsetting effect on the net cash flows of the subsidiary. But if the rate of inflation is expected to be lower in the future, appreciating the value of the host country's currency, the subsidiary may locally invest the amount of its payments to the parent company till the currency

strengthens. The accumulated earning of the parent company will be larger after the appreciation of the host country's currency.

Terminal Cash Flow: Besides adjustments in the initial investment and in the operating cash flow, some adjustments have to be made for the salvage value that influences the terminal cash flow.

1. If there is a provision in the foreign collaboration agreement for the reversion of the project to the host government after a certain period of time on the payment of a specific amount, the specific amount is treated as the terminal cash inflow.
2. If the first condition is not present, the net cash flow generated in the terminal year is multiplied by the specific number of years and the product is treated as the terminal cash inflow.
3. If the project is dismantled in the terminal year, the scrap value is treated as the terminal cash inflow.
4. When the salvage value is uncertain, the parent company makes various estimates of the salvage value or terminal cash flow and computes the NPV based on each possible outcome of the terminal cash flow. Alternatively, it computes the **break-even salvage value**, which is the terminal cash flow necessary to achieve a zero NPV for the project. The break-even salvage value or the break-even terminal cash flow is then compared with the estimated terminal cash flow. If the estimated terminal cash flow is less than the break-even salvage value, the investment proposal will be rejected. This is because in this case, the NPV will be negative. On the contrary, if the parent company assesses that the subsidiary would sell for more than the break-even salvage value, it will incorporate this assessment into its accept-reject decision.

For computing the break-even salvage value, the cash flow beginning from the first year to the *n* th year is segregated into the operating cash flow, OCF_t, and the terminal cash flow, TCF_n. The break-even salvage value is derived as follows:

$$NPV = \sum_{t=1}^{n}\left[\frac{OCF_t}{(1+k)^t}\right] + \left[\frac{TCF_n}{(1+k)^n}\right] - I_0$$

$$0 = \sum_{t=1}^{n}\left[\frac{OCF_t}{(1+k)^t}\right] + \left[\frac{TCF_n}{(1+k)^n}\right] - I_0$$

$$I_0 - \sum_{t=1}^{n}\left[\frac{OCF_t}{(1+k)^t}\right] = \frac{TCF_n}{(1+k)^n}$$

$$TCF_n = \left[I_0 - \sum_{t=1}^{n}\left\{\frac{OCF_t}{(1+k)^t}\right\}\right] \times (1+k)^n \qquad 14.1$$

Suppose the net cash inflow in a three-year period, which is the life span of the project, is respectively \$10,000, \$12,000 and \$13,000. The initial investment is \$20,000 and the discount rate is 10 per cent. The break-even salvage value will be:

$$\$\left[20{,}000-\left\{\frac{10{,}000}{1.10}+\frac{12{,}000}{1.10^2}-\frac{13{,}000}{1.10^3}\right\}\right]\times(1.10)^3=\$-11{,}680$$

Parent-Subsidiary Perspective: An Alternative Approach: The analysis of project appraisal so far takes into account the parent unit's perspective, of course, based on valid reasons. Even in this case, the parent unit takes into account the subsidiary's perspective, at least to some extent, and makes adjustment in the cash flow and the discount rate under the NPV framework. But it is often argued that for a more transparent appraisal of the investment project, the project appraisal needs to be made in greater detail—both from the parent's point of view and from the viewpoint of the subsidiary. It is for this reason that in a survey of 121 US MNCs operating in early 1980s, 48 per cent of the decisions were made on the basis of the project's cash flow, 36 per cent were taken on the basis of the parent's cash flow, and 16 per cent of the decisions considered both viewpoints (Stanley and Block, 1983).

The very rationale of this argument is that if a project's NPV is positive, it is bound to add to the corporate wealth of the firm as a whole. Under this approach, two NPV_S are computed. One is the NPV from the parent's perspective (NPV_P) and the other is the NPV from the viewpoint of the project itself, which is known as the subsidiary's perspective (NPV_S). Finally, the acceptance/rejection decision of the project is based on the NPV of both of them.

In order to find out the NPV_P, the following successive steps are taken:

1. Estimate the cash flow in the host country currency
2. Estimate the future spot exchange rate on the basis of available forward rates
3. Convert the host currency cash flow into the home country currency
4. Find NPV in home country currency using the home country discount rate

Here the cash inflow represents all cash flowing towards the parent unit in a manner similar to what has been explained earlier. Cash outflow will represent cash flowing out of the parent unit.

Similarly, to find out the NPV_S, the following steps are taken:

1. Estimate the cash flow in host country currency
2. Identify the host country discount rate
3. Discount the host currency cash flow at the host country discount rate
4. Convert the resultant NPV into the home country currency at the spot exchange rate

In this case, the cash inflow represents the earnings of the project in the host country currency irrespective of the fact whether cash moves towards, or away from, the parent unit.

These two methods assume an all-equity capital structure and so, if the parity conditions existed in the real world, the result of the two approaches would be the same. But in the real world, debt is normally included in the capital structure in order to lower the cost of capital; and, moreover, parity conditions do not exist. Naturally, the result of the two approaches will differ. The possible results will be:

1. NPV_P and NPV_S are, both, negative. In such a case, the project cannot be accepted.
2. NPV_P and NPV_S are, both, positive. In such a case, the project is accepted.
3. $NPV_P > 0 > NPV_S$. The project is attractive from the viewpoint of the parent unit but not attractive from the subsidiary's viewpoint. In such a case, the project may be accepted but there will be chances of loss in value, in terms of the host country currency.
4. $NPV_P < 0 < NPV_S$. The project is attractive from the subsidiary's perspective but unattractive from the parent's perspective and though it may be accepted, it is doubtful how far the project will be useful to the parent unit.

14.1.2 Cost of Capital

In discounting methods of capital budgeting, the future cash flow is discounted to the present value. The discounting factor is nothing but the cost of capital, incorporating the risk factor.

The cost of capital is simply the weighted average of the cost of equity and the cost of debt. The debt-equity ratio has a definite bearing on the average cost of capital. An elaborate discussion on the cost of capital and effects of the debt-equity ratio lies beyond the scope of this book. Any book on corporate financial management would be suitable for this purpose. At present moment, the focus of discussion lies on how far the computation of the cost of capital in an international firm is different from that in domestic business finance.

> The cost of capital is simply the weighted average of the cost of equity and the cost of debt.

1. In case of domestic investment, the cost of retained earnings is not calculated separately because the market price of shares, which determines the cost of equity, also embodies the influence of retained earnings. But in case of international investment, the cost of retained earning is calculated separately because the earnings repatriated by the subsidiary to the parent company are subject to tax. The after-tax cost of retained earnings is,

$$K_s = k_e (1 - t) \tag{14.2}$$

2. The large size of an MNC ensures it to get preferential treatment from creditors. The size of its issue is quite large, involving lower floatation cost per share or bond.
3. The firm has easy access to the international capital market and so it gets funds from the least-cost source. The subsidiary too borrows from the domestic capital market if it finds the cost of capital low there.
4. An MNC can internationally diversify its sources of funds and so the inflow of funds is more stable. It reduces the probability of bankruptcy and lowers the cost of capital.

On the contrary, the cost of capital in case of an MNC's operation is higher insofar as the flow of funds in a multinational operation is highly exposed to exchange rate exposure. It raises the bankruptcy cost and compels creditors and shareholders to require a higher rate of return on the capital. Again, the international operation is subject to political risk, which too deserves a higher rate of return on capital.

Thus, computation of the cost of capital in the context of multinational investment needs to incorporate these facts. In other words, the MNC needs to adjust its own (parent unit's) cost of capital to some more important variables while evaluating its foreign investment projects. However, those who believe in an efficient capital market suggest that the cost of capital in different countries is analogous and hence the parent company's cost of capital may be used for discounting the cash flow from foreign operations. But, in practice, the international capital market is segmented, requiring adjustments to the parent unit's cost of capital.

1. The cost of capital should be adjusted for **variations in capital structure norms**, which are very much evident in international investment. Normally, MNCs, whose operation is well diversified across countries, have a comparatively stable cash flow and can handle more debt. They have a large share of debt also because they have easy access to credit as well as they are exposed to lower credit risk. On the other hand, MNCs, whose profit is relatively large, use more retained earnings and not debt.

   Capital structure norms depend also on the rules and regulations in the host country. In host countries where foreign equity participation is restricted to lower limits, the debt-equity ratio is generally high. Again, when the subsidiary is more exposed to exchange rate risk, a higher debt-equity ratio is desirable. Yet again, when political risk is very high in the host country, the MNC relies more on loans from the host country creditors. It is because the creditors will put pressure on the local government to maintain good relations with the MNC. But, if the interest rate is high in the host country, as it is often found in many developing countries, the MNC uses more of equity capital. Thus, the capital structure norms vary from one host country to another and from one MNC to another. If the same MNC invests in different countries, its target capital structure in each host country will differ from its global target capital structure. In order to minimise this difference, the MNC adopts different norms in different host countries. If it relies more on debt in one host country, it tries to rely more on equity in some other host country. If the debt-equity mix in all the subsidiaries taken together does not match its own (parent unit's) capital structure norms, the MNC tries to adjust its (parent unit's) norms to the global target capital structure norms by adding a premium to, or making a discount from, the parent unit's cost of capital.

2. The parent unit's cost of capital is adjusted according to how far the subsidiary is able to get funds at a lower cost, either from the **domestic financial market** or from international financial market. If the cost is lower than the cost of capital of the parent unit, the discount rate needs to be reduced.
3. The discount rate needs **adjustment for inflation**. There are two ways of doing this. If the cash flow is adjusted for inflation, it should be discounted by the real discount rate or the inflation adjusted discount rate. But, if the cash flow is not adjusted for inflation, it should be discounted by nominal discount rate.
4. The discount rate is adjusted for various types of **risks prevalent in the host country**. Such risks may be political, may be economic, or both. If these risks are expected to be present in the host country, the discount rate needs an upward revision. The extent of upward revision depends upon the severity of the risk.

14.1.3 Adjusted Present Value Approach

Lessard (1985) has developed a technique that is known as the adjusted present value (APV) technique (Figure 14.3). It incorporates most of the complexities emerging in the computation of cash flow and in the determination of the discount rates that have been explained in the preceding sections.

Adjusted present value (APV) refers to a capital budgeting technique for evaluating international projects.

Under the APV technique, the initial cash flow consists of the capital cost of the project minus blocked funds, if any, activated by the project, in the host country. This amount is converted into the home country currency at the spot exchange rate.

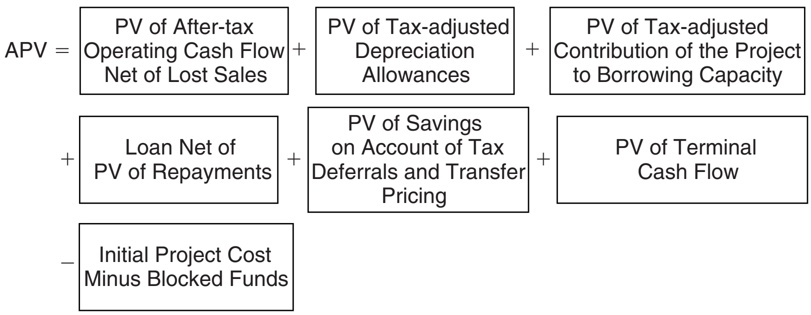


FIGURE 14.3 Adjusted Present Value Approach

Similarly, the operating cash flow under the APV technique consists of:

1. Present value of after tax cash flow from the subsidiary to the parent, converted into the home country currency at the expected spot rate minus the profits on the lost sales of the parent company;
2. Present value of tax adjusted depreciation allowances in terms of the home country currency;
3. Present value of the contribution of the project to the borrowing capacity in terms of home country currency, subject to adjustment for taxes;
4. Face value of loan in the host country currency minus the present value of repayments converted into the home country currency;
5. Present value of the expected savings on account of tax deferrals and transfer pricing; and
6. Present value of expected illegal repatriation of income.

Terminal cash flow consists of the present value of the residual plant and equipment.

It may be noted that for tax adjustment, the APV technique takes into account the higher of the home country and host country tax rates. This technique is unique in the sense that it uses different discount rates for different types of cash flows. The cash flow on account of sales and other such revenue is discounted at the all equity cost of capital. Depreciation allowances are discounted at the nominal rate. The contribution of the project to the borrowing capacity is discounted by the riskless rate. The repayment of loans in host country currency is discounted at the nominal interest rate prevalent in the host country. Again, the rate used for discounting savings on account of taxes and of transfer pricing and illegal repatriation includes the risk premium.

Despite the uniqueness of the APV technique, it has been found that if the complexities are incorporated in the cash flow and if the risk adjusted weighted average cost of capital is taken as the discount rate, the adjusted present value approach is not different from the NPV approach (Booth, 1982).

14.1.4 Non-financial Factors in Capital Budgeting

The international capital budgeting is influenced also by: 1. views of the managers with disparate backgrounds, and 2. business strategy of the firm.

In the international capital budgeting process, financial factors dominate, explaining how much cash flow the project is going to generate and what should be the discount rate. But it does not mean that the non-financial factors are negated. Rodriguez and Carter (1984) group these factors as, first, the behavioural characteristics of the organisation, and, second, the business strategy.

Any firm has various levels of management, depending upon its organisational structure. In an international set up, the structure is more complex. The design is based normally on the line-and-staff or functional pattern. Any decision passing through the different levels of management is influenced by the attitude of the managers. The view of one manager is normally different from that of another as they come from disparate socio-cultural backgrounds. Naturally, the final decision is the result of bargaining among the different levels of management.

Apart from the organisational behaviour that influences the capital budgeting decision, proposals meeting the financial norms must fit into the corporate strategy. The management frames the combinations of strategies depending upon its preferences and capabilities and then fits the financially viable projects into the strategy framework.

14.2 SELECTION OF THE SOURCES AND FORMS OF FUNDS

Selection of a particular source or form of funds is done to suit the corporate objectives, such as minimisation of the effective cost of funds, matching of the raised funds with its target debt-equity ratios, matching the raised funds with its target current liability-long-term liability ratio, avoidance of lengthy legal and procedural formalities, and so on.

14.2.1 Minimisation of Cost of Funds

The effective cost of funds depends *inter alia* on the rate of interest and the changes in the exchange rate or in the value of the borrowed currency. In the form of an equation, the effective cost of borrowing from a foreign market is,

$$k_{bf} = (1 + r_f)\,(1 + E_f) - 1 \qquad (14.3)$$

Where r_f is the rate of interest in the foreign market, and
E_f is the change in the exchange rate.

Suppose the interest rate in the London money market is 12 per cent compared to 14 per cent in New York and the pound sterling is expected to appreciate by 4 per cent. The effective cost of borrowing in pound would be:

$$(1.12 \times 1.04) - 1 = 16.48\%$$

In this case, the multinational enterprise will borrow from the New York money market despite the fact that the rate of interest is lower in the London money market. This is because the effective cost of borrowing pounds is greater than that of borrowing dollars.

In cases where the firm borrows from more than one financial market, the weighted average of the effective cost of borrowing in different currencies is computed. Again, the effective cost of total borrowing will be lower if there is negative correlation in the movement of the value of different currencies. The cost may move up if the correlation coefficient is positive. So the firm takes into account not only the expected change

The effective cost of total borrowing will be lower if there is negative correlation in the movement of the value of different currencies.

in the value of the currencies but also the correlation coefficient of the expected change in the value of different currencies so as to lower the effective cost of total borrowing.

14.2.2 Borrowing to Conform to Capital Structure Norms

There are different capital structure theories each suggesting a different point of optimal capital structure. These can be found in any book on corporate financial management. However, as noted earlier, the capital structure norms in a multinational company set up are complex. The study of Sekely and Collins (1988) examines the capital structure norms among 677 firms in 9 industries in 23 countries and finds that the debt ratio may be large or small, depending upon economic, social, cultural, and political factors. Since these factors vary among countries, capital structure norms also vary widely among countries. On the whole, debt ratio is found to be large in the Scandinavian, Mediterranean, and some Asian countries. It is low in case of some of the South Asian, Latin American, and Anglo-American countries.

In this context, an important question arises regarding whether the affiliates of multinational corporations should follow host country norms or they should be guided by the parent company norms. If the norms in the home country and the host country are similar, there is no problem. But if they are different, it becomes an important decision. If the capital structure norms conform to the local norms in the host country, they are well in line with the monetary and financial policy of the host government. They help evaluate return on equity investment relative to local competitors in a particular industry. On the other hand, when the norms conform to the parent company's global target debt ratio, they are, first of all, more suited to maximising the global profit; secondly, there is every possibility that they have a comparative advantage over the local firms in the host country; and thirdly, a high debt ratio in one country may offset the low debt ratio in another country; and on the whole, it is best suited for the firm as a whole.

> Long-term capital is more liquid but lowers profitability. Short term capital may push up profitability but it is less liquid. The finance manager uses perfect trade off between short term capital and long term capital.

14.2.3 Selection of an Optimal Maturity

While raising funds from the international financial market, a multinational firm likes to maintain a proper balance between short term liabilities and the long-term liabilities. There is no confusion in case of financing fixed assets because they are financed with long term capital. But in case of financing of current assets, a decision needs to be made regarding the ratio between the long term capital and the short term capital. The normal view is that permanent current assets should be financed with long term capital and the fluctuating part of the current assets should be financed with short term capital. This is nothing but a tradeoff between liquidity and profitability. Long-term capital is more liquid but lowers profitability. Short term capital may push up profitability but it is less liquid.

However, if the finance manager is conservative, he uses more of long term capital. If he is aggressive, short term capital is greatly used. Thus, whenever a multinational enterprise raises funds, it has in mind a perfect tradeoff between short term capital and long term capital.

14.2.4 Avoidance of Legal and Procedural Formalities

Any firm raising funds does not like to undergo too many procedural formalities. From this viewpoint, the issue of international bonds is complex; much more so than in the case of euro notes. Again, the borrowing programme can be designed only within the framework of local laws. If the government prohibits the issue of a particular instrument, the borrower cannot issue it despite its cost efficiency. For example, prior to 1992, the Indian government had not allowed the Indian companies to issue euro equities or euro convertible bonds. Sometimes these considerations become really significant.

14.3 FINANCIAL SWAP

Very often a borrowing firm may not have easy access to a segment of its own choice in the financial market. For example, a firm needs fixed-rate funds, but has an easy access to floating-rate funds. Similarly, a firm needs borrowing from the US dollar market, but has an easy access to the euro market. In this case, it can borrow the funds from easily available sources and then can exchange its liability into another form of liability of its own choice. This exchange is called a swap. The swap may be either a interest-rate swap or currency swap. These two forms are discussed here.

14.3.1 Interest-rate Swap

Interest rate swap involves the exchange of interest payments. It usually occurs when a person or a firm needs fixed rate funds but is only able to get floating rate funds. It finds another party who needs ony floating rate loan but is able to get fixed rate funds. The two, known as counter parties, exchange the interest payments and the loans according to their own choice. It is the swap dealer, usually a bank, that brings together the two counter-parties for the swap. The essential condition for the interest-rate swap is that the amount of loan is identical in the two cases and the periodic payment of interest takes place in the same currency. At the same time, there must be coincidence between the two parties—one getting cheaper fixed rate funds and the other getting cheaper floating rate funds.

Interest-rate swap refers to exchange of interest payments through a swap dealer, normally between fixed-rate loans and floating-rate loans.

Since the principals are identical in size, they are not exchanged. They are only notional. It is the interest payment that is exchanged on periodic payment dates. The interest payments are called the legs of the swap and the fixed rate is called the swap coupon. The process of interest rate swap will be clear from the following example.

Example: Suppose Firm *A* needs fixed rate funds, which is available to him at the rate of 10.50 per cent to be computed half yearly, but it has access to cheaper floating-rate funds available to it at LIBOR + 0.3 per cent.

Firm *B* needs floating rate funds, available to it at 6-month LIBOR flat, but has access to cheaper fixed rate funds available to it at the rate of 9.50 per cent to be computed half yearly.

Both the principals are identical in size and maturity and are in the same currency.

The interest rate swap will take place in the following stages (Figure 14.4):

Stage 1: If Firm *A* has access to the floating rate loan market, it will borrow from the floating rate loan market. Similarly, Firm *B* having access to the fixed rate loan market, will borrow a fixed rate loan.

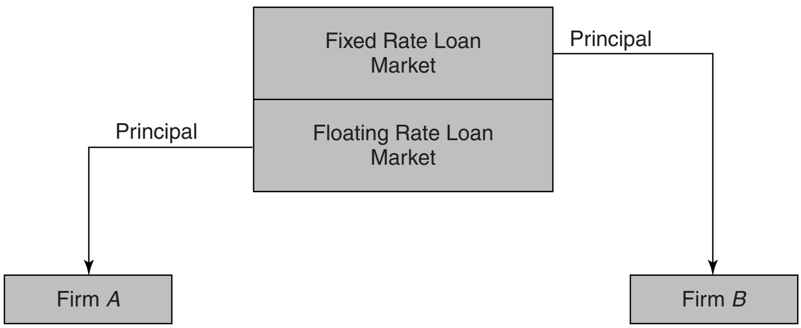


FIGURE 14.4 Stage 1 of Interest Rate Swap

Stage 2: Both the counterparties approach a swap dealer. Since Firm *A* needs a fixed rate loan, the swap dealer asks firm *A* to pay fixed rate interest to it (swap dealer) as if it has borrowed fixed rate loan. The fixed rate of interest payable through the swap dealer is higher than what firm *B* has to pay to the lender in the fixed rate loan market but lower than what firm *A* has to pay to the lender if it had borrowed from the fixed rate loan market. It is, say, 9.75 per cent. In exchange, the swap dealer pays firm *A* the interest at 6-month LIBOR. Firm *A* pays LIBOR + 0.3 per cent to the lender on its floating rate borrowing.

On the other hand, the swap dealer asks firm *B* to pay 6 month LIBOR as if it has borrowed a floating rate loan. In exchange, the swap dealer pays firm *B* fixed rate interest, which is higher than what Firm *B* has to pay to the ultimate lender. This is the interest rate that the swap dealer has received from firm *A* minus its (swap dealer's) own commission. It is, say, 9.65 per cent. Here firm *B* gets interest from the swap dealer at 9.65 per cent and pays interest to the fixed rate lender at 9.50 per cent (Figure 14.5).

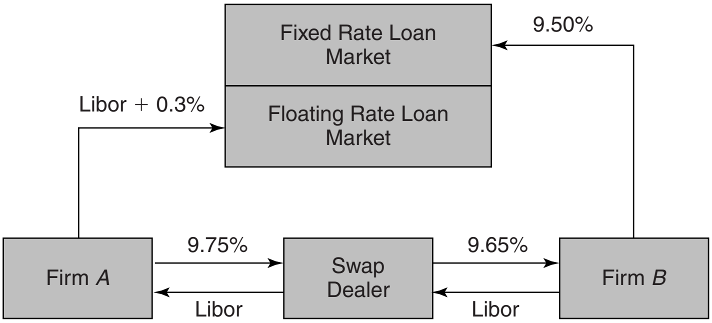


FIGURE 14.5 Stage 2 of Interest Rate Swap

Firm *A* is attracted to the swap deal as it uses the loan according to its own choice and also because the fixed rate of interest payable by it is lower than what it had to pay in case it borrowed from the fixed rate loan market. Firm *B* is attracted to the swap deal not only because it is using the loan according to its own choice but also because the swap dealer gives an interest rate that is higher than what it has to pay to the ultimate lender. The swap dealer is attracted to the swap deal because it earns from such a deal.

Stage 3: At maturity, the two firms repay the loan. Firm *A* repays the floating rate loan and Firm *B* repays fixed rate loan (Figure 14.6).

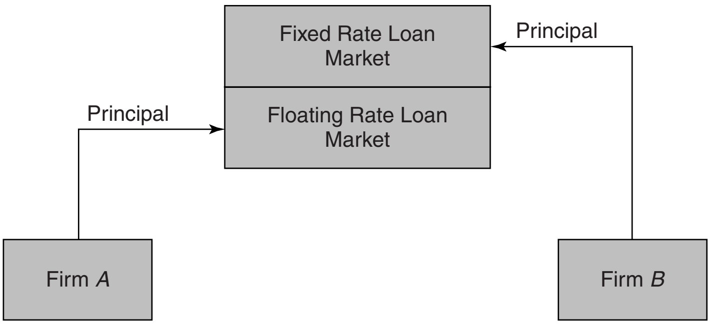


FIGURE 14.6 Stage 3 of Interest Rate Swap

Firm *A*'s cost of borrowing:

Cost of floating-rate loan	… LIBOR + 0.3%
Less floating interest rate received	… LIBOR
Net cost differential	… 0.3 %
Converting the cost differential from money-market yield to bond equivalent yield	… $0.3\ \% \times \frac{365}{360} = 0.304\%$

Add swap coupon	… 9.75%
Total cost of borrowing	… 10.054%

Had firm *A* borrowed the fixed rate loan that it actually needed, it would have to pay interest at the rate of 10.50 per cent. But as a result of swap deal, it has to pay interest only at 10.054 per cent. This means, it is saving interest payment at 0.446 per cent.

LIBOR refers to interest rate at which major banks in London offer deposit to the others among them.

(**Note:** LIBOR is quoted as an annual money-market yield which involves 360 days a year. On the contrary, the fixed rate is quoted as semi-annual bond-equivalent yield. Here one has to convert the floating-rate differential into the bond-equivalent yield and then to add the latter to the fixed rate cost. The bond-equivalent yield involves 365 days a year.)

Firm *B*'s cost of borrowing:

Cost of fixed rate borrowing	… 9.50%	
Less fixed rate received	… 9.65	
Net cost differential	… –0.15%	
Converting the net cost differential from *BEY* to *MMY*	.... $0.15\ \% \times \frac{360}{365}$	… –0.148%
Total cost of borrowing	… LIBOR – 0.148%	

Had firm *B* taken the floating rate loan, it would have to pay LIBOR. But as a result of the swap deal, it has to pay LIBOR –0.148 per cent. This means, it has saved interest payment equivalent to 0.148 per cent.

Gain to Swap dealer:

Interest rate received	… 9.75%
Interest rate paid	… 9.65%
Net gain	… 0.10%

The original structure of the interest rate swap, as discussed above, is known as a generic swap or plain vanilla swap. In practice, there are often minor variations in the original structure, depending upon the need and character of borrowing and lending. Some of them are, for example, the zero coupon swap where the fixed rate loan is a zero coupon loan; floating-for-floating rate swaps where both legs are floating; fixed-for-fixed rate swap when the cash flow stream of the firm opting for the swap is highly volatile; option swap where the purchaser of the swap has the privilege to enforce, or not to enforce, the deal and so on.

14.3.2 Currency Swap

Currency Swap is exchange of one borrowed currency for the other borrowed currency through a swap dealer.

A currency swap is different from the interest-rate swap insofar as it (currency swap) involves two different currencies. This is the reason that the two currencies are exchanged in the beginning; and again at maturity they are re-exchanged. The exchange of currencies is necessitated by the fact that one counter-party is able to borrow a particular currency at a lower interest rate than the other counter-party. Suppose firm *A* can borrow the euro at a fixed rate of 8.0 per cent or the US dollar at a floating rate of one-year LIBOR. Firm *B* can borrow euro the at a fixed rate of 9.2 per cent and can borrow the US dollar at one-year LIBOR. If firm *B* needs the fixed rate euro, it will approach the swap dealer, provided that firm *A* needs the floating rate US dollar. The swap deal will be conducted in different stages, as follows:

Stage 1: In the first stage, firm *A* borrows euro at 8.0 per cent interest rate. Firm *B* borrows US dollar at LIBOR.

Stage 2: The two firms exchange the borrowed currencies with the help of the swap dealer. After the exchange, firm *A* will possess US dollars. Firm *B* will possess euros (Figure 14.7).

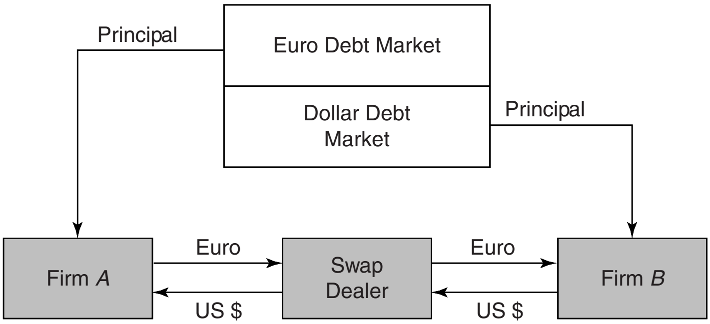


FIGURE 14.7 Stage 1 and 2 of Interest Rate Swap

Stage 3: Interest payment will flow. Firm *A* will pay LIBOR on the US dollar that will reach the US dollar market first, through, the swap dealer and then through Firm *B*. Similarly, firm *B* will pay a fixed rate interest that will flow to the fixed rate DM market through the swap dealer and through firm *A*. Firm *B* will pay a fixed rate of interest to the swap dealer, which will be more than 8.0 per cent but less than 9.20 per cent. It will be, say, 8.60 per cent. The swap dealer will take its own commission and shall pay to firm *A* in this case only, say, 8.40 per cent.

Stage 4: The two principals are again exchanged between the two counter-parties. Firm *A* gets back euro and repays them to the lender. Firm *B* gets back US dollars and repays it to the lender (Figure 14.8).

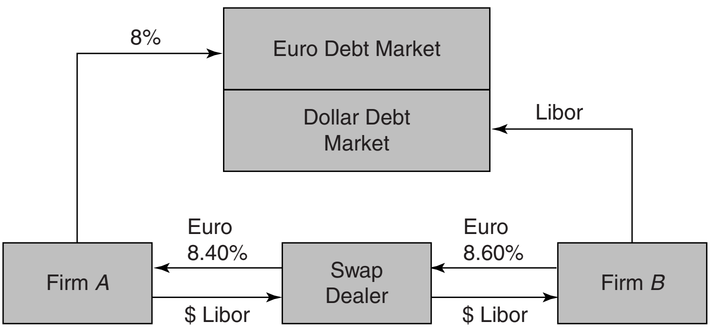


FIGURE 14.8 Stage 3 of Interest Rate Swap

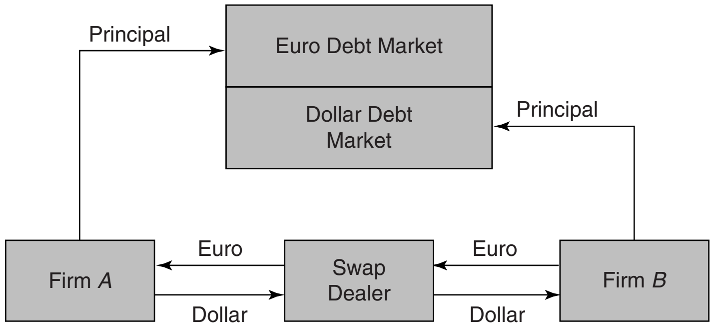


FIGURE 14.9 Stage 4 of Interest Rate Swap

Benefits from the Currency Swap: Firstly, firm *A* gets the currency of its own choice. Firm *B* gets the currency of its own choice.

Secondly, the cost of borrowings are reduced, which brings in gains to firm *A* as well as to firm *B*.

Cost to Firm *A*:

Cost of US dollar debt in absence of swap	…LIBOR
Cost of US dollar debt after swap:	
Interest paid minus interest received	… 8.0% + LIBOR – 8.40%
	= LIBOR – 0.40%

This means that the cost of the dollar debt used by firm *A* is 0.40 per cent less under the swap arrangement. This is the gain accruing to firm *A*.

Cost to Firm *B*:

Cost of DM debt without swap	…9.2%
Cost of DM debt after swap:	
Interest paid minus interest received	… 8.60% + LIBOR – LIBOR
	= 8.60%

This means that the cost of DM loan used by firm *B* is 9.20 per cent – 8.60 per cent = 0.60 per cent less under the swap arrangement. This is the gain accruing to firm *B*.

Normally, a currency swap is a fixed-for-floating currency swap. But there are cases where both counter parties pay a fixed rate of interest. In this case, the swap is called a fixed-for-fixed currency swap. It is adopted when one counter-party maintains an advantageous position while borrowing a particular currency. Suppose a German firm is able to borrow from the German market at a fixed rate of 8.50 per cent, while it can borrow from the US dollar market at a fixed rate of 10.50 per cent. On the other hand, an American firm is able to borrow at 10.75 per cent from the US dollar market, while it can borrow at 9.25 per cent from the German market.

In this case, the German firm will borrow euro from the German market. The American firm will borrow US dollars from the dollar market. The two will exchange the currency through a swap dealer. After the exchange of the principal amount, the German firm possesses US dollars and the American firm possesses euro. The German firm pays interest on the dollar loan to the American firm at 10.50 per cent. The American firm adds to it 0.25 per cent interest and pays 10.75 per cent interest rate to the lender. At the same time, the American firm pays to the swap dealer an interest at 8.80 per cent on the euro loans. The swap dealer deducts its commission at 0.05 per cent and passes on the remaining interest at 8.75 per cent to the German firm. The German firm pays interest to the German lender at 8.50 per cent and saves 0.25 per cent. This means that the German firm uses dollar loan only at 10.50 per cent – 0.25 per cent = 10.25 per cent. Had it not swapped the currency, it would have to pay 10.50 per cent for the dollar loan. There is a distinct gain of 0.25 per cent.

Similarly, the American firm is paying 0.25 per cent more to the dollar market lender than what it receives from the German firm, but since it is saving 9.25 per cent – 8.80 per cent = 0.45 per cent on the euro loan, its net gain on the borrowing is 0.45 per cent – 0.25 per cent = 0.20 per cent. Both the counter parties gain on account of fixed-for-fixed currency swap.

This second form of currency swap is known as the floating-for-floating currency swap. In this case, both counter parties pay a floating rate of interest. This type of swap can be achieved through a single swap agreement or through a double agreement. In the latter, it is a combination of one fixed-for-floating currency swap and one fixed-for-floating interest-rate swap. The combination is usually known as a circus swap. The currency swap is used for the initial transaction, while the interest rate swap is used for converting fixed rate side to floating rate. If the two fixed rate payments are equal, the net result is manifest in the flow of floating rate interest.

14.4 INTERNATIONAL CASH MANAGEMENT

After raising funds, the firm begins operation. During operations, an optimum cash balance is maintained so as to ensure adequate liquidity without impinging upon profitability. In an international firm, management of cash is a complex task in view of intra-firm transfers of cash and the restrictions imposed on them by the home and the host governments.

The management of cash basically involves four steps. They are:

(i) Assessment of the cash requirements
(ii) Optimisation of cash need, by restructuring inflows and outflows
(iii) Selection of sources from where cash could be brought in
(iv) Investment of surplus cash, if any, into near-cash assets

Selection of the sources of funds has already been discussed in the present chapter; the other issues are discussed here.

14.4.1 Assessment of Cash Requirements

The first step in international cash management is to establish the need for cash during a specific period, which may be a week, a fortnight, or a month. It is computed on the basis of the expected amount of cash disbursements vis-à-vis expected inflow of cash during a particular period. The outflow and inflow of cash occurs mainly on account of various transactions. The firm holds cash also to meet precautionary and speculative needs, but such needs are fixed and the amount of cash for these purposes is determined on the basis of experience and the general trend of the business environment.

For the assessment of cash needs, a cash budget is prepared for each subsidiary. The figures are consolidated in order to assess the cash need of the firm as a whole.

For the assessment of cash needs, a cash budget is prepared for each subsidiary. Any book on corporate financial management would contain a detailed discussion regarding the preparation of cash budget. After assessing the cash need of each of the subsidiaries, the figures are consolidated in order to assess the cash need of the firm as a whole. It is because in a multinational enterprise, it is the cash flow of the firm as a whole that is taken into account and which needs to be managed.

14.4.2 Optimisation of Cash Needs

After the preparation of the cash budget and the estimation of the cash requirements, the firm needs optimisation of cash level at different units. It can be done in three ways. First, it is through cash flow from a cash-surplus unit to a cash-deficit unit. Second, the required cash level is minimised during a particular period through restructuring of inflows and outflows. The inflows are accelerated; and at the same time, outflows are delayed, so as to lower the cash needs at a particular point of time. Third, netting of payments is adopted especially with respect to intra-firm transfers, which reduces the cash needs.

Intra-firm Transfer of Cash: When a particular unit faces a shortage of cash, it gets it from a cash surplus unit, may it be the parent unit or any other sister subsidiary. It may raise funds from outside the firm if outside funds are cheaper and easier than the intra-firm flow of cash in view of governmental restrictions on such flows. However, the unit often prefers intra-firm transfer of cash in view of the fact that the surpluses of the other units are utilised. This is perhaps why funds are transferred from one unit to the other, circumventing the restrictions. The modes are: transfer pricing, leads and lags, parallel loans, changes in the rates of royalty, dividend, and so on. Transfer pricing is discussed in Chapter 17. Leads and lags and parallel loans are explained in Chapter 20.

Accelerating Inflows and Delaying Outflows: There are two types of delays in the collection of cash. One is the mailing delay and the other is the processing delay. In collection from across the border, long procedural formalities and governmental restrictions too come in the way.

As regards curbing of mailing delay, the use of cable remittances is often suggested. In this respect, the Society for Worldwide Inter-bank Financial Telecommunications (SWIFT) is doing a commendable job. It has brought into its fold around one thousand banks among which funds are transferred electronically with ease. Again, the firm opens up regional mobilisation centres and instructs customers to make their payments to the centres falling in their respective vicinity. Sometimes, a postal box are set up in post-offices within customers' vicinity. The postal box is operated by the local offices of the bank authorised by the firm. This method is commonly known as the lock-box system.

Mailing delay is cut through:
1. electronic transfer of funds
2. opening of regional mobilisation centres
3. operating of lock-box system.

As far as processing delay is concerned, there are some multinational banks that provide "same-day-value" facilities. Under this facility, the amount deposited in any branch of the bank in any country is credited to the firm's account on the same day. This is done through electronic devices. Thus, it is suggested that the firm should take help from such banks to cut short processing delays. Again, some firms adopt a pre-authorised payment system in which they are authorised to charge a customer's bank account up to a specific limit.

Besides, disbursements are delayed in order to conserve cash, at least for some time. But the firm should be careful that making such delays does not effect its creditworthiness. Again, when disbursements are delayed, there are chances for retaliatory measures. Thus, the process of disbursements demands extra care.

Since accelerating cash inflow and decelerating disbursements involve additional cost, it is advisable for the company to follow them as long as their marginal returns exceed their marginal cost.

Netting of Intra-firm Payments: Another step towards lessening the requirements for cash at a particular point of time is to encourage netting of intra-firm payments. There is usually a large volume of intra-firm payments. Such payments require not only a huge amount of cash, but also transaction cost, inter-currency conversion cost, and opportunity cost of float. The different units of a firm require cash not only for making payments but also for meeting such costs. Netting is a solution to this problem.

Netting is in fact the elimination of counter payments. This means that only the net amount is paid. For example, if the parent company is to receive US \$3.0 million from its subsidiary and if the same subsidiary is to get US \$1.0 million from the parent company, these two transactions can be netted to one transaction, where the subsidiary will transfer US \$2.0 million to the parent company. The cost of transfer too will be lower.

Netting is in fact the elimination of counter payments. This means that only the net amount is paid.

Netting can be bilateral, involving two units. It may be multilateral, involving more than two units. Suppose *A*, *B*, and *C* are the three units of a firm. *A* has to receive US \$15.0 million from *B* and US \$12.0 million from *C*. *B* has to receive US \$20.0 million from *C* and US \$20.0 million from *A*. *C* has to receive US \$30.0 million from *A* and US \$6.0 million from *B*. In

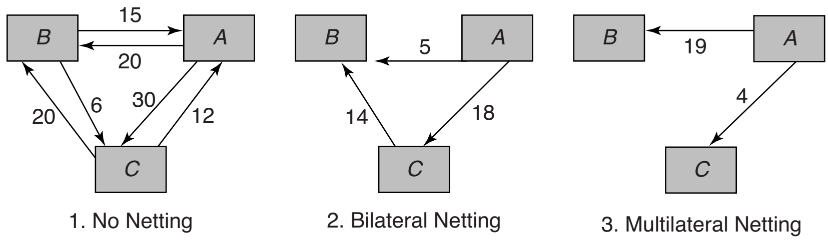


FIGURE 14.10 Netting of Payments

the absence of netting, there will be 6 transactions involving US $103 million. If it is bilateral netting, there will be three transactions involving US $37.0 million. If it is a multilateral netting, there will be only two transactions involving only US $23.0 million.

Problems with the Cash Optimisation Process: The problems coming in the way of accelerating and decelerating of cash flows or the netting process may be grouped as:

(i) Firm-related problems
(ii) Governmental restrictions
(iii) Deficiency in the banking system
(iv) Opposition by subsidiaries

(i) When a multinational enterprise has a large number of subsidiaries and there is large fluctuation in host country currencies, the acceleration or deceleration of cash flows or netting of payments will turn out to be too complicated. It is a fact that owing to computers, the problem can be solved to a great extent. But in view of complications, the parent company finds it difficult to take a correct decision.
(ii) There are many host governments that practise exchange control mechanisms in view of their weak balance of payments. The parent company's decision to accelerate or decelerate cash flows of a subsidiary or to net the payments cannot be carried out unless the government of the host country permits such actions.
(iii) There are still a number of international banks that have not developed sophisticated system of collections and payments. In these cases, acceleration of collection and netting of payments cannot be effective.
(iv) The acceleration or deceleration of cash flows may be beneficial for one unit or one firm, but it may not be beneficial for the other unit or another firm. In such cases, the subsidiaries or firms that are at loss resent such a move. Affected firms may take retaliatory measures. Subsidiaries, over which the parent company has only meagre control, may come in the way of such moves.

14.4.3 Investment of Surplus Cash

The cash balance for precautionary and speculative purposes is fixed and so it is held in the form of near-cash assets. Surplus cash in excess of transaction purposes too is held in the form of near-cash assets or short-term marketable securities. The reason is that near-cash assets earn for the firm and are definitely preferable to an idle cash balance. In this context, a few questions need to be probed. They are:

1. Should the surplus cash balance of the entire firm centralised and only then invested?
2. How much of the surplus cash balance should be invested in near-cash assets?
3. Which currency should be preferred for investment?

Centralisation of Surplus Cash: The process of centralisation of surplus cash can take two forms. One is the centralised control of the parent company over the surplus cash of different units. In this case, cash does not actually move to a centralised pool, but its movement to a cash-deficit unit or for investment in near-cash assets is strictly guided by the parent company. The other form manifests in the actual movement of cash to a centralised pool. Any investment in near-cash assets takes place only out of the centralised pool.

Centralisation is preferred as the funds of the firm are invested in the most desirable way so as to avoid the weaknesses of some of the host country currencies. Whenever any unit falls into liquidity distress, funds are immediately rushed to it. It also reaps economies of scale. There are many investment avenues that need large sums of money. The centralised pool with a large amount of cash can tap such avenues of investment. However, the success of the centralisation approach depends on how the intra-firm transfer of cash is restriction free and how efficient the intra-firm information system is.

> The success of the centralisation approach depends on how the intra-firm transfer of cash is restriction-free and how efficient the intra-firm information system is.

Again, the centralised pool may be located either in the host country or in the home country or in a third country. A particular location is preferred where the local currency is strong, the money market is developed, tax rates are low, the political climate is stable, and the attitude of the government is congenial.

How Much of the Surplus to be Invested: Surplus cash should not lie idle. It should be invested. The larger the investment, the greater the interest earned, but at the same time the great risk is of illiquidty. Lower the investment, liquidity will improve but earning on the investment will be lower. Thus, an optimal division of funds between cash and near-cash assets requires a tradeoff between liquidity and profitability.

The optimal ratio between cash and near-cash assets is also influenced by the transaction cost or the cost of conversion from cash to securities and back in the form of brokerage, and so on. The larger the near-cash assets, the greater the transaction cost. On the contrary, a larger cash balance does involve large opportunity cost in the form of interest foregone

Surplus cash should be invested to a point where the sum of transaction cost and opportunity cost is the minimum.

that the near-cash assets could have earned. The optimal level, therefore, represents a point where the sum of transaction cost and opportunity cost is the minimum.

While making an investment in near-cash assets, the international finance manager has to take care of a number of facts, of which the following are important.

1. Portfolio should be diversified so as to maximise yield for a given level of risk.
2. The portfolio should be reviewed daily so as to decide which particular investment has to be liquidated or which particular securities should remain undisturbed.
3. Investment should only be made in assets where liquidity prevails.
4. The maturity structure of investment should coincide with the need for cash so that securities can be easily converted back into cash whenever the need for fresh cash arises.

Currency of Investment: Normally, the surplus cash is invested in a country where the interest rate is higher. However, the answer is not so simple. In fact, the firm has to take into account the effective yield/ return that depends not simply on the rate of interest but also on the changes in the exchange rate. If the currency of the country where the funds are invested depreciates vis-á-vis the home-country currency, the return in terms of home country currency will be lower. More often, a firm makes multiple-currency investments and reaps the benefit of diversification. Uncertainty in exchange rate changes is greatly reduced if there is negative correlation in the changes in the exchange rate of different currencies.

Thus, whenever a firm has surplus cash, it is better to have a centralised pool located in the most suitable place. The centralised funds should be translated into a multiple-currency investment. However, care should be taken that the cost of investment does not exceed the benefits from it.

SUMMARY

- International financial strategy is multi-pronged. It begins with capital budgeting, where only those foreign operations, that represent excess of cash inflow over the cash outflow over a specific time period, are accepted. The computation of cash flow is complex in international operations. This is because the same cash flow may be cash outflow for the subsidiary and cash inflow for the parent unit. This is why cash flow and NPV are calculated from the viewpoint of both the parent and the subsidiary. Similarly, the computation of discount rate or the risk-adjusted cost of capital in international investment is complex in view of varying debt-equity norms, inflation rate differential, exchange rate risk, political risk, and many other factors. The adjusted present value approach uses different discount rates for different types of cash flow. However, it is not only the financial factors but also the non-financial factors, such as the behavioural pattern of the organisation and the corporate business strategy, that influence the capital budgeting decision.

- The funds raising strategy involves the selection of the least cost source on the basis of interest rates and exchange rate changes, matching with the company's global debt-equity norms as well as with such norms in the host country, matching with maturity norms and the avoidance of lengthy procedural formalities.
- If the desired type of funds are not available, the firm goes for swap where fixed rates are exchanged for floating rates and vice versa, and where the currency of borrowing is exchanged for the desired currency through a swap dealer.
- When the firm begins operation, the strategy is to ensure optimal level of cash among the different units. This involves, (1) estimation of cash needs; (2) optimisation of the cash level through transfer of funds to cash deficit units, accelerating inflows, delaying disbursements and through netting of payments; and (3) determination of investment in near-cash assets.

REVIEW QUESTIONS

1. What are the distinctive features of the cash flow calculation in international capital budgeting? Explain.
2. What are the factors influencing the discount rate in the context of international capital budgeting?
3. Write a short note on Adjusted Present Value Approach of international capital budgeting.
4. Explain the factors taken into account while funds are raised by an international firm.
5. Write short notes on:
   (a) interest-rate swap
   (b) currency swap
6. Describe the different steps involved in international cash management.

STUDY TOPIC

HSBC Payments and Cash Management in the Asian Region

In view of the regulatory environment following the recession of 1997–1998 and the subsequent slow growth of the economy, many Asian governments tightened their regulatory measures so as to control money supply and help improve the balance of payments. Consequently, a number of banks withdrew from the local market. Liquidity went down. The market for derivatives squeezed; margins had widened; and pricing transparency had reduced. In countries where the pegged exchange rate regime had been followed, the rates were oscillated widely. The hedging strategy had become the order of the day. But the problem was that hedging was not risk free in the face of wide disparity in interest rate among countries and its unhealthy impact on forward transactions. Even forward and swap markets were not found in many countries. Options were still rare. Thus, there was a need for a well designed hedging policy.

This is not all. Disparity in interpretation and application of taxation was another problem. Corporation tax varied from being based on all income sourced within a particular jurisdiction to being residence based, with the interpretation of residents differing in each jurisdiction. Tax was an important issue while establishing new liquidity arrangements. In some countries, notional pooling was treated as an inter-company loan even when there was no physical movement of funds. Yet another issue was the requirement to prove the transaction between a regional treasury and a local entity taking place at the arm's-length rate. This was of particular concern to cross country liquidity arrangements.

Again, except for Hong Kong, Singapore, and Japan, there was an acute dearth of regional clearing houses. In China, the clearing of cheques took around a fortnight's time. Similarly too with Malaysia. However, efforts were on in many countries to change over to automated clearing.

The MNCs were increasingly looking for centralising the payables and receivables for easing regional liquidity problems. But the question was whether this will be feasible. The establishment of in-country pooling or the cash concentration arrangements followed by reliable cash flow forecasting precedes such a decision. To sum up, cash management among an MNCs' units was very difficult in the Asian region.

***Source*:** Based on "The Guide to Cash Management". *Euromoney*, January 2000.

QUESTIONS

1. Explain reasons why MNCs find it difficult to manage cash in Asian region?
2. Does processing delay loom large in the management of cash in the Asian region?
3. What suggestions would you like to make for improving the cash management by MNCs in the Asian region?

REFERENCES

Books

Lessard, D. R. (1979), "Evaluating International Projects: An Adjusted Present Value Approach" in D. R. Lessard (ed.), *International Financial Management: Theory and Application* (Boston Mass.: Warren Gorham & Lamont) pp. 577–92.

Rodriguez, R. M. and E. E. Carter (1984), *International Financial Management* (Englewood Cliffs: Prentice-Hall), Chap. 17.

Journals

Booth, L. D. (1982),"Capital Budgeting Frameworks for the Multinational Corporation", *Journal of International Business Studies*, XIII (1), 113–23.

Sekely, W. S. and J. M. Collins (1988),"Cultural Influences on International Capital Structure" *Journal of International Business Studies*, XIX (1), 87–100.

Stanley, M. T. and S. B. Block (1983),"An Empirical Study of Management and Financial Variables influencing Capital Budgeting Decisions for Multinational Companies in the 1980s", *Management International Review*, XXIII (3), 61–72.

SELECT FURTHER READINGS

Marshall, J. F. and K. R. Kapner (1993), *The Swap Market* (Miami: Kolb Publishers).

Smith, K. V. *ed.* (1980), *Readings in Management of Working Capital* (St Paul, Minnesota: West Publisher).

Stonehill, A. I. and L. Nathanson (1968),"Capital Budgeting and Multinational Corporation", *California Management Review*, XI (Summer), 39–54.

* Rome is the capital of Italy. The economy of Rome is largely dominated by services, high-technology companies (IT, aerospace, defense, telecommunications), research, construction and commercial activities (especially banking). The huge development of tourism is very dynamic and extremely important to its economy. With a 2005 GDP of €94.376 billion (US$121.5 billion), the city produces 6.7% of the national GDP.

This page is intentionally left blank.

Hong Kong*

15

Management of Exchange Rate and Interest Rate Risk

CHAPTER OBJECTIVES

A study of financial strategy is not complete without the study of the risks involved in this type of strategy. The present chapter acquaints readers with such risks. The objective is to:

- ✦ Explain the nature of different forms of exchange rate risk and how they are measured.
- ✦ Describe the contractual, natural, and other hedging techniques to manage exchange rate risk.
- ✦ Explain the nature of interest rate risk and the techniques to manage such risks.

While the preceding chapter discusses important financial strategies aimed at maximising corporate wealth and putting the firm in a competitive position, the present chapter, continuing of the preceding discussion, focuses especially on the risk/exposure management strategy. The gain or loss arising on account of unanticipated exchange rate changes is known as exchange rate exposure. Similarly, the gain or loss arising in the sequel of interest rate changes is the interest rate exposure. The purpose of exchange rate and interest rate risk management is to minimise/eliminate the loss accruing on account of exchange rate and interest rate changes.

15.1 NATURE AND MEASUREMENT OF EXCHANGE RATE EXPOSURE

15.1.1 Translation Exposure

Translation exposure refers to exchange rate risk arising out of the translation of the functional currency into the reporting currency.

Exchange rate exposure is classified as translation exposure, transaction exposure, and real operating exposure. Translation exposure, which is also known as accounting exposure, does not involve cash flow. It emerges on account of consolidation of the financial statements of different units of a multinational firm for the purpose of ascertaining overall profitability and evaluation of the comparative performance of different subsidiaries. When the currency of any of the host countries changes its value, its translated value in the domestic currency of the parent company (home-country currency) changes and the picture of the consolidated statement changes. The extent of this change represents the magnitude of translation exposure. It is a fact that if the subsidiary maintains its account in the reporting currency (domestic currency of the parent company), as it is sometimes done by the extended departments of a firm abroad, translation exposure does not emerge. But since the subsidiaries normally maintain their accounts in a functional currency, which is normally the currency of the host country, there is every possibility of the translation exposure emerging in subsequent exchange rate changes. The larger the fluctuation in the value of host country currency, the greater the size of accounting exposure.

The size of exposure also depends on the methods of translation. There are different methods of translation. In the current method, all the items of the financial statements are translated at current or post-change rates. In the current/non-current method, current liabilities and current assets are translated at post-change rates. Long term liabilities and fixed assets are translated at pre-change or historical rates. In monetary/non-monetary method, current assets except inventroy and all the liabilities are translated at current rates. Fixed assets and inventory are translated at historical rates. The temporal method is different from the monetary/non-monetary method insofar as inventory is translated at pre-change rate only if it is not shown at market rate. Different methods are adopted in different countries and hence the size of translation exposure has to vary from one case to the other (Sharan, 2003).

15.1.2 Transaction Exposure

Transaction exposure refers to changes in the exchange rate causing changes in the present cash flow.

Transaction exposure involves changes in the present cash flows, on account of:

1. Export and import of commodities on open account
2. Borrowing and lending in a foreign currency or
3. Intra-firm flows.

If a firm has to make payments for imports in a foreign currency and the foreign currency appreciates, the firm will have to incur loss in terms of its own currency. Similarly, if an exporter has to receive foreign currency for its export and the foreign currency depreciates, the exporter will have to face loss in terms of its own currency. Similarly, the borrower of a foreign currency is put to loss if that particular foreign currency appreciates. Again, changes in exchange rate alters the value of the intra-firm cash flow. The extent of change in the value of cash flow as a sequel to exchange rate changes denotes the amount of transaction exposure.

When transaction exposure of a multinational corporation is referred, it should be considered in terms of **consolidated net exposure**. The word, "net" means that both the inflows and outflows of funds have to be considered and it is the net amount that determines the size of transaction exposure. If the Indian subsidiary of a US company is repatriating dividend to the parent company, any depreciation of the rupee will lower the value of dividend to be received by the parent company in dollar terms. But if the Indian subsidiary exports goods to its parent company invoiced in rupees, the parent company will have to pay a lesser amount in terms of dollars for this transaction due to the rupee's depreciation. So the loss on account of dividend has to be adjusted with the gain on account of trade transaction and it is only the net amount that will determine the size of transaction exposure.

Again, the term consolidated is used when the subsidiaries of a firm are located in different countries. The currency of two or more host countries may change. The change in the value of different currencies may push the transaction exposure in different directions. This means that change in the value of a particular currency may cause gain to the parent company, while change in the value of other currencies may cause loss to the parent company. Thus, it is the consolidated net figure of cash flow with which the parent company is concerned. The severity of exposure, thus, depends upon the correlation between the changes in the value of different currencies. If it is a positive correlation, the magnitude of transaction exposure will be large. But if it is a negative correlation, the loss in one case is compensated by gain in the other. The result is that the size of transaction exposure will be small.

Again, if the transaction exposure manifests in terms of gain, it has to be treated for tax. This is because the gain adds to the profitability and it is the net profit (after taxes) that really matters.

Real operating exposure refers to changes in the exchange rate together with rates of inflation that cause change in the future cash flow.

15.1.3 Real Operating Exposure

Real operating exposure arises when changes in exchange rate, together with rates of inflation, alters the amount and risk element of a company's future revenue and cost stream. The extent of the change in the present value of future cash flows denotes the real operating exposure. There may be different scenarios for such changes and so the different results are put to sensitivity analysis to find out the exact size of exposure.

The word "real" denotes the concept of real exchange rate, which means nominal exchange rate adjusted for inflation. The word "operating" is used because it considers the operating cash flow, a change which causes change in the value of the firm. The measurement of real operating exposure is not very easy, insofar as the measurement of inflation rate differential in the years to come is not easy, especially when the countries are experiencing a highly volatile rate of inflation. However, if the inflation rate differential is forecasted correctly, real operating exposure can be estimated. To mention a very simple example, if the rupee depreciates by 10 per cent, Indian exports will turn competitive as well as imports will be costlier. This will have an impact on the cash flows. But if the inflation differential in India is higher by 10 per cent, the ultimate result may manifest in zero real operating exposure.

Again, changes in the exchange rate will tend to influence the value of imported inputs as well as the value of export. This will, in turn, change the revenue and cost stream in the years to come.

15.2 MANAGEMENT OF EXCHANGE RATE EXPOSURE

15.2.1 Transaction Exposure

The techniques for hedging transaction exposure are sometimes grouped under internal and external techniques (Figure 15.1). The former form a part of the firm's regulatory financial management and do not involve any contractual relationship with any party outside the firm. The latter involve

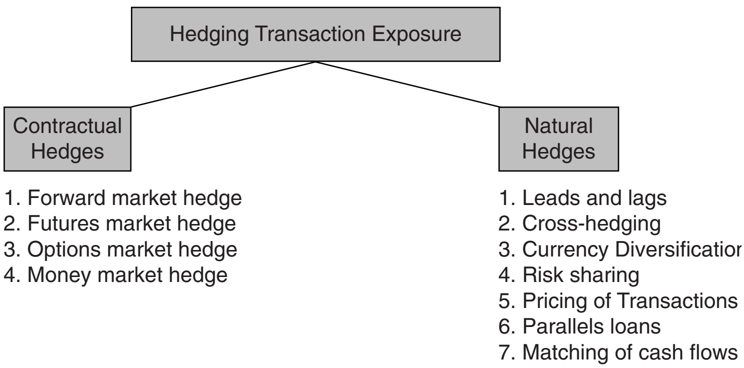


FIGURE 15.1 Techniques for Hedging Transaction Exposure

contractual relationships with parties outside the firm for ensuring that potential foreign exchange loss do not occur (Buckley, 1996).

However, we group the hedging techniques as:

1. Contractual hedge
2. Natural hedge

Hedging refers to minimising the exchange rate risk through buying and selling of currency in the foreign exchange market or in the market for derivatives.

Contractual Hedges: They include the forward market hedge, money market hedge, futures market hedge, and the options market hedge. In the forward market hedge, the exporter sells forward, and the importer buys forward, the foreign currency in which the trade is invoiced. Suppose an Indian exporter signs a contract for leather export to USA for US $1,000. The export proceeds are to be received within three months. The exporter fears a drop in the value of the US dollar, which may diminish the export earnings. To avoid this diminution, the exporter goes for a three-month forward contract and sells US $1,000 forward. The spot as well as the forward rate is Rs. 40/US $. If the dollar depreciates to Rs. 39 after three months, the export earnings in the absence of any forward contract would have diminished to Rs. 39,000. But since the exporter has already sold forward a similar amount of dollars, the loss occurred due to depreciation of the dollar will be met through the forward contract. Selling the dollars on maturity, would fetch him Rs. 40,000, which will be equal to the original export value.

RBI Guidelines for Forward Contracts

Forward Contracts in India—Residents

- Residents were allowed to book forward contracts and participate in hedging instruments for managing risk in the foreign exchange market. Authorised Dealers (ADs) were allowed to offer foreign currency-rupee options on a back-to-back basis or run an option book as per specified terms and conditions.
- Residents were permitted to book forward contracts for hedging transactions denominated in foreign currency but settled in rupees.
- Resident entities were also allowed to hedge their overseas direct investment exposure against exchange risk.
- The eligible limit for booking of forward contracts by exporters/importers was increased to 50 per cent (from 25 per cent earlier) of the average of the previous three financial years' actual import/export turnover or the previous year's turnover, whichever is higher, (from only average of past three years' turnover earlier) without any limit (US $100 million, earlier). Importers/exporters desirous of availing limits higher than the overall ceiling of 50 per cent were allowed to approach the Reserve Bank for permission.
- ADs were permitted to enter into forward/option contracts with residents who wish to hedge their overseas direct investment in equity and debt. These contracts could be completed by delivery or rollover up to the extent of market value on the due date.

Forward Contracts in India—Non-residents

- Non-residents were permitted to enter into forward sale contracts with ADs in India to hedge the currency risk arising out of their proposed FDI in India.
- Holders of FCNR(B) accounts were permitted to book cross-currency forward contracts to convert the balances in one currency into another currency in which FCNR(B) deposits are permitted.
- FIIs were permitted to trade in exchange traded derivative contracts approved by the SEBI subject to the limits prescribed by it.
- NRIs were allowed to invest in exchange traded derivative contracts approved by the SEBI out of rupee funds held in India on a non-repatriable basis.

Source: *RBI Annual Report*, 2003–04

Similarly, an Indian importer buys goods from United States of America for US $1,000. If the importer fears an appreciation in the value of US dollar, he will buy the same amount of dollars forward. If the dollar appreciates to Rs. 41 after the three-month period, the importer, in the absence of any forward deal, would have to pay Rs. 1,000 more. But if he has gone for a forward deal for buying a similar amount of dollars, he will purchase US $1,000 with Rs. 40,000 in the forward market and pay US $1,000 to the US exporter. This way the importer saves himself from a loss of Rs. 1,000.

Hedging in a futures market is similar. The only difference is of the procedure, with a view to the varying characteristics of the futures market, which have been explained in Chapter 13 of this book.

The importer buys a call option or sells a put option or performs both functions at the same time. The exporter buys a put option and sells a call option or performs both functions simultaneously.

For hedging in the currency options market, the importer buys a call option or sells a put option or performs both the functions at the same time. The exporter buys a put option and sells a call option or performs both the functions simultaneously. Suppose an Indian firm is importing goods for £62,500. The amount is to be paid after two months, which coincides with the maturity in the options market. If an appreciation is expected in the value of the pound, the importer will buy a call option on pounds with maturity coinciding with the payment for import. If the strike price is Rs. 84.00/£, the premium is Rs. 0.05 per sterling pound and the spot price at maturity is Rs. 84.20/£, the importer will exercise the option. It will have to pay Rs. 84.00 $\times$ 62,500 + 3,125 = Rs. 52,53,125. If the importer does not go for buying an option, it will have to pay Rs. 62,500 $\times$ 84.20 = Rs. 52,62,500. Buying the call option reduces the importer's obligation by Rs. 52,62,500 − 52,53,125 = 9,375. If, on the other hand, the pound falls to Rs. 83.80, the importer will not exercise the option. His obligation will be reduced even after paying of the premium.

Suppose an Indian exporter exports goods for £62,500. He fears a depreciation of the pound within two months, when payments are to be made. In order to avoid the risk, he will buy a put option for selling pounds for a two-month maturity. Suppose the strike rate is Rs. 84.00, the premium is Rs. 0.05, and the spot rate at maturity is Rs. 83.80. In case of a hedge, he will receive Rs. 62,500 × 84.00 − 3,125 = 52,46,875. In the absence of a hedge, he will receive only Rs. 52,37,500. This means, buying of a put option helps increase the exporter's earnings, or reduces his exposure, by Rs. 52,46,875 − 52,37,500 = 9,375.

Hedging through selling of options is advised when the volatility in the exchange rate is expected to be only marginal. Suppose the Indian importer imports for £62,500. He fears an appreciation in the pound and so he sells a put option on pounds at a strike price of Rs. 84.00/£ and at a premium of Rs. 0.15 per pound. If the spot price at maturity goes up to Rs. 84.05, the buyer of the option will not exercise the option. The importer, as a seller of the put option, will receive premium of Rs. 9,375 which will be a relief for him while making payments for import as compared to no relief in case of no option.

Exporters sell a call option. An Indian exporter exports goods worth £62,500. He fears that the pound will depreciate and sells a call option on pounds at a strike price of Rs. 84.00 and at a premium of Rs. 0.15 per pound. If the spot rate at maturity really falls to Rs. 83.95, the buyer of the call option will not exercise the option. The exporter being the seller of the call option will get Rs. 9,375 as premium.

Foreign exchange exposure can also be hedged through the use of tunnels or, in other words, through simultaneous sale and purchase of options. It depends upon the degree of exchange rate changes, whether the two options will be out-of-money or one of the options will be in-the-money.

Money market hedge is just taking a money market position to cover future payables or receivables position.

Money market hedge is just taking a money market position to cover future payables or receivables position. An importer, who is to cover future payables, firstly, borrows local currency; secondly, converts the borrowed local currency into the currency of payables; and finally, invests the converted amount for a period matching with the payments to be made for imports. On the contrary, an exporter hedging receivables, firstly, borrows the currency in which the receivables are denominated; secondly, converts the borrowed currency into local currency; and finally, invests the converted amount for a maturity coinciding with the receipt of export proceeds. The money market hedge may be covered or uncovered. If the firm makes sufficient money out of business operations to buy the foreign currency or to repay the foreign currency loan, it is called a covered hedge. However, purchasing foreign currency out of borrowed funds or repaying foreign currency loan by purchasing foreign currency in the spot market is known as an uncovered money market hedge.

A simple example will make the process clear. Suppose an Indian importer has to make payments for imports worth US $1,000 after 90 days. If it is a covered hedge, it creates a 90−day investment in the foreign currency in which the import is invoiced. The amount of initial investment will be such that the principal plus interest after 90 days equals the payments for import. If the rate of interest on investment is 12 per cent per annum and if the amount of import is US $1,000, the sum of initial investment will be:

$$\text{US } \$ \frac{1{,}000}{1.03} = \text{US } \$970.87$$

On the day imports will be paid, the importer will receive US $1,000 from investment and there will be no problem even if the exchange rate changes.

If it is an uncovered hedge, the importer borrows Rs. 970.87 × 40 (assuming a spot rate of Rs. 40/US $) = Rs. 38,834.80, it will convert the rupee amount into US dollar to get US $970.87 and invest it at 12 per cent per annum interest rate. On the day the imports are paid, the importer will get US $1,000 and there will be no problem in paying for the imports. The only cost it has to bear is the interest payment on borrowing.

In case of 90−day receivables, if it amounts to US $1,000, the exporter will borrow US $970.87, convert this amount into Rs. 38,834.80 and invest this amount at 12% p.a. interest rate. On the day the export proceeds are received, the investment (principal + interest) will amount to Rs. 40,000. The exporter will not be exposed to exchange rate changes, if any. The cost of hedging borne by it is the payment of interest on borrowing.

Natural Hedge: Firms go for natural hedges because contractual hedge provides only temporary protection against exchange rate movement and sometimes the market for contractual hedge is not well developed. Some important natural hedge techniques need to be mentioned here.

> **Lead** means accelerating or advancing the timing of receipt or payment of the foreign currency. Lag is just the reverse.

Leads and Lags: Lead means accelerating or advancing the timing of receipt or payment of the foreign currency. Lag is just the reverse, which means decelerating or postponing the timing of receipt or payment of foreign currency. Suppose a firm is located in a weak currency country and it has to pay debt denominated in hard currency. There is every possibility of the hard currency appreciating against the weak currency. In such a situation, the debtor firm will like to lead the payments. On the contrary, if a firm located in hard currency country has to pay debt denominated in weak currency, it would like to lag the payment. In both the cases, the purpose is to lower the debt burden.

Leading and lagging is practised between two independent firms or in intra-firm transactions. In case of inter-firm transactions, practising of this technique is normally opposed. It is because if one firm reaps the gain, it will cause loss to the other firm. But within a firm, it is a common strategy.

> **Cross hedging** refers to hedging in some other currency correlated with the desired one.

Cross-hedging: It is adopted when the desired currency cannot be hedged. In this case, the firm has to identify a foreign currency that can be hedged, the volatility of which is highly correlated with that of the desired currency. The hedging of the identified currency in the forward market will be a substitute for the forward market hedging of the desired currency.

Currency Diversification: If transactions are diversified over a number of currencies and if there is negative correlation in the change of their values, the exchange rate risk is automatically minimised. The greater the diversification, the lesser is the risk.

Risk sharing: Risk sharing is a contractual arrangement through which the buyer and the seller agree to share the exposure. Both parties normally agree to such a proposal if their business relationship is a long term one. Under this arrangement, a base rate is fixed with mutual consent, which is generally the current spot rate. A neutral zone is also agreed upon, which is a few points minus and plus the base rate. When the exchange rate changes within the neutral zone, the transaction takes place at the base rate. But if the exchange rate crosses the neutral zone, the risk is shared equally by the two parties.

Pricing of Transactions: Pricing policy is adopted in two ways. One is price variation and the other is currency of invoicing. Price variation involves marking up/marking down of sale price in order to counter the adverse effects of exchange rate changes. The normal rule is to charge the price in foreign currency on the basis of the forward rate and not the spot rate. In case of sequential payments to be made or received at different time points, a weighted average of forward rates of different dates is computed. Charging of a different price from the arm's-length price is a usual practice in case of intra-firm transactions. But for the purpose of exposure management, this practice is also adopted in inter-firm transactions.

As far as invoicing of transaction is concerned, the exporter is willing to invoice the bill in its own currency or in the currency in which it incurs the cost so that the transaction exposure is avoided. But, if the importer is dominant, the bill is normally invoiced in the importer's currency. In other cases, the exporter follows the market leader or its major competitors.

It may be noted here that in intra-firm transactions, this technique does not figure large as the gain accruing to one unit is offset by the loss incurred by the other unit of the firm. Nevertheless, the advantages appearing on account of tax differential between two countries encourage intra-firm transactions to be invoiced in either the appreciating or depreciating currency. Suppose there are two subsidiaries of a firm located in Country *A* and Country *B*. The marginal tax in Country *A* is higher than in Country *B*. In such a case, other factors remaining the same, the subsidiary in Country *A* shall invoice the transaction with *B* in a weak currency. The subsidiary in Country *B* shall invoice the transaction in a strong currency. This way, the before-tax profit of the subsidiary in Country *A* can be passed on to that in Country *B*, if the currency depreciates further. Ultimately, the tax burden of both the subsidiaries taken together will be lower.

Parallel Loans: A parallel loan is often known as back-to-back loan or a credit swap loan. Under this arrangement, the amount of the loan moves within the country but it serves the purpose of a cross-border loan. At the same time, such loans are not exposed to changes in exchange rate because the funds do not move across the national border. Suppose a US company (parent company) has a subsidiary in India. At the same time, an Indian company (parent company) has a subsidiary in United States of America. Suppose further that the US parent company has to lend US $1,000 to its subsidiary in India for a specific period. The Indian parent company too has to lend a similar amount for the same maturity to its

> **Parallel loan** is the simultaneous borrowing and lending involving four parties in two countries.

subsidiary in United States of America. If the funds move between the two countries and if the exchange rate changes, transaction exposure will be caused. Thus, in order to avoid the exposure, the Indian parent company will lend the above amount converted into the rupee at the spot exchange rate to the US subsidiary. Simultaneously, the US parent company will lend a similar amount, in terms of US dollars, to the Indian subsidiary. At the expiry of the specified period, the two loans will be repaid to the respective lenders. Figure 15.2 shows how the transactions take place in a back-to-back loan arrangement.

This is no doubt an efficacious technique of hedging the transaction exposure, but it is difficult to find a firm that has to lend a similar amount for similar maturity. If such a firm, known as a counter-party, is located, it cannot be guaranteed that the counter-party repays the loan within the specified period. If it fails to make repayments, counter-party risk will emerge. It is this particular limitation with the parallel loan that has made the currency swap popular.

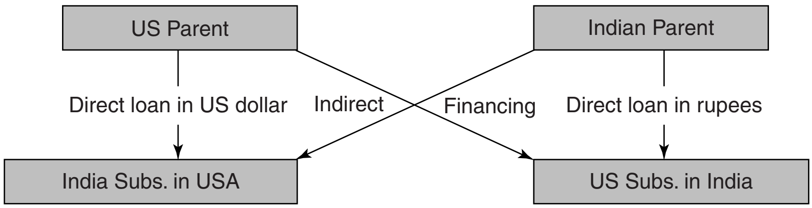


FIGURE 15.2 Creation of Back-to-back Loan

Matching of Cash Flows: Under this mechanism, a firm matches its foreign currency inflow with the outflow in that currency not only in respect of size but also in respect of timing. But, for this purpose, it is necessary that the firm has both inflows and outflows in the same currency.

15.2.2 Hedging of Real Operating Exposure

Since the area of real operating exposure extends to future cost and revenue streams, the steps taken to manage such exposure must consider the management of future cost and revenue. So it is not only the domain of the finance manager, but also of the production and marketing managers. In other words, the management of real operating exposure includes strategy concerning finance, production, and marketing (Figure 15.3).

Financial Strategy: The hedging techniques used for transaction exposure, especially those that are used for long term transaction exposure, are also used for managing real operating exposure. However, they are of little use in this case because the effects of currency changes on the expected cash flows are hard to predict. It is, therefore, better to use sophisticated computerised tools for this purpose.

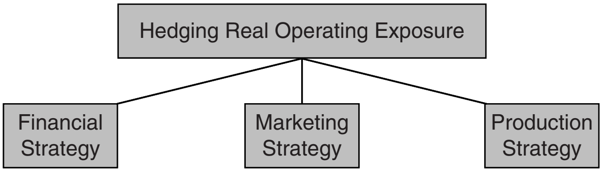


FIGURE 15.3 Strategies for Management of Real Operating Exposure

Nevertheless, while developing a financial strategy, the finance manager has to ensure that the firm's liabilities during the application of marketing and production strategies are so structured that they could match a reduction in assets' earnings during that period. This means that if assets' earnings drop, the servicing burden of liabilities too should be lower. To this end, assets and liabilities are restructured.

> The finance manager has to ensure that the firm's liabilities are so structured that they could match a reduction in assets' earnings during that period. The marketing strategy includes, among other things, selection of market, product planning, and pricing policy.

Marketing Strategy: The marketing strategy includes, among other things, selection of market, product planning, and pricing policy. The policy in this respect is influenced by the geography of the market, dominance of the firm in the international market, and the elasticity of demand for the product.

If the domestic currency appreciates, export would turn uncompetitive on account of price. The strategy in this case should be to pull out of the existing market and to develop new markets. The market segmentation approach within a particular importing country may be adopted. If the product is demanded more by an affluent class of consumers, appreciation of domestic currency may not matter much. The strategy of market segmentation should, therefore, be to concentrate on this class of consumers. Again, if the firm is a dominant supplier of the product or if the price-elasticity of demand for the product is low, the firm can stick to the existing market without making changes in the price.

The firm can respond to changes in the exchange rate by modifying the product strategy. It can innovate and introduce a new product or can make the product differentiated and, thereby, charge a higher price for the product to compensate the loss on account of exchange rate changes.

Similarly, it may adopt a different pricing policy. It may raise or lower the price of the product due to exchange rate changes, depending upon the price elasticity of demand, availability of the substitutes, and so on.

Production Strategy: Production strategy concentrates primarily on product sources, input mixing, and plant location. If the currency of a country supplying inputs appreciates, the input buying firm has to find out some other sources of supply that may be cheaper. If the home currency appreciates, it would be in the interest of the input buying firm not to change the source of supply, and preferably buy inputs from the countries to which it exports its final product. This is to ensure that its terms of trade will improve. This step would be highly beneficial if the imported inputs account for a lion's share of the total inputs. Sometimes the

> Production strategy concentrates primarily on product sources, input mixing, and plant location.

strategy begins with establishing multiple sources of inputs. This is to save the foreign exchange to be spent on importing inputs from an appreciating currency country.

If the firm is unable to buy cheaper inputs from any source, it can arrest the cost of production from rising by the mixture of local inputs or cheaper inputs. This requires expenditure on research and development so that a new technology using cheaper inputs in a greater proportion could be evolved. For such a decision, it is required to weigh the benefit of input mixing against the cost of research and development.

Alternatively, the firm can locate the plant in a country whose currency has depreciated, provided that the inputs are available there. In cases where inputs are available only in a particular country, the firm will have to import them even if the currency of the input supplying country appreciates.

There are, thus, different options open for improving the future cost-revenue streams. The firm chooses any one of them or combines more than one of them, depending upon their suitability in a particular case.

15.2.3 Managing Translation Exposure

There is one view that there is no need for hedging translation exposure as it does not affect the cash flow. But firms try to hedge it in view of its potential impact on the reported consolidated earnings.

> **Balance sheet** means if the liabilities are lower than the assets, fresh borrowings are made. If the liabilities exceed assets, fresh investments are made to eliminate the mismatch. Borrowings are made in weaker currencies and investment is made in stronger currencies.

The commonly used technique with respect to hedging of translation exposure is known as the balance sheet hedge. Since translation exposure arises out of mismatch between the size of assets and the size of liabilities resulting from the convertion of figures in the functional currency to those in the reporting currency using different methods of conversion, balance sheet hedge eliminates such mismatches. If the liabilities are lower than the assets, fresh borrowings are made. If the liabilities exceed assets, fresh investments are made to eliminate the mismatch. But it may be noted that borrowings are made in weaker currencies and investment is made in stronger currencies. This is because weaker currencies tend to depreciate vis-à-vis strong currencies. So the exposure can be hedged if strong currency assets substitute weak currency assets and weak-currency liabilities substitute the strong currency liabilities.

If borrowings/investments are made under the process of balance sheet hedge, there is every possibility of the emergence of transaction exposure in face of changing exchanges rates. If this is the case, contractual and natural hedges may be adopted.

15.3 NATURE OF INTEREST RATE RISK

With growing preference for a floating interest rate since the 1980s, the interest rate risk or exposure has become more significant. When it moves in favour of the lender, the debt burden of the borrower gets bigger. When it moves in favour of the borrower, the lender has to suffer loss on account of interest. It is not only the size of interest payment that causes exposure. Changes in interest rate influence the market price of the bond and the changes in the price of the bond are often the source of exposure.

The nature of interest rate exposure varies between a financial and a non-financial firm. For a non-financial firm, changes in interest rate lead to changes in financial cost and, thereby, to changes in earnings before tax and returns from investment. But for a financial firm, changes in the interest rate affect the very assets and liabilities and, thereby, the very net worth of the firm.

Interest rate risk may be grouped under three heads:

1. Credit risk
2. Liquidity risk
3. Basis risk

Credit risk is concerned with default risk when the borrower fails to make payments of interest and principal. In order to minimise this type of risk, the lender makes loans to only borrowers who are financially sound and who have no record of default. The risk can also be minimised through diversification of lending among large number of borrowers.

Credit risk is loss on account of default of repayment of loan.

Liquidity risk, which is also known as the gap risk, is more typical of a non-financial firm. Such risk is related to the timing mismatches between cash inflows and cash outflows on account of interest payment. A non-financial firm usually possesses a comparatively small amount of interest sensitive asset, while interest sensitive debt may account for a large segment of the total liabilities. In such a situation, if long duration interest sensitive assets are financed by short duration interest sensitive liabilities, liquidity risk is bound to arise. In order to ascertain the magnitude of gap risk, the firm divides the entire planning horizon into sub-periods. For each sub-period, the difference between the assets and the liabilities is assessed.

Liquidity risk is risk on account of mismatches of cash inflow and outflow in a non-financial firm.

On the other hand, basis risk is related primarily to financial companies. It arises when the interest rate exposure on one instrument is offset by the interest rate exposure on another instrument. It also happens when floating-rate financial assets tied to one index are funded by floating rate liabilities tied to some other index. Financial companies, whose revenues and costs consist primarily of interest rate payment flows, are more prone to such risks. This is because the net interest income, that is, the difference between receipt of interest on assets and interest payment on liabilities, is of great importance for such firms.

Basis risk is risk in a financial firm owing to differences in the index to which financial assets and liabilities are tied.

Whatever the type of risk, its magnitude depends also upon how the interest is calculated. This is because the practices differ from one country to another. In Switzerland, for example, 360 days make a year for calculating interest. On the contrary, the British practice involves 365 days. With the same amount of principal, the interest will vary in these two cases.

15.4 TECHNIQUES OF MANAGING INTEREST RATE EXPOSURE

Techniques Of Managing Interest Rate Exposure: There are different techniques to hedge the interest rate risk. A particular technique is practised depending on the circumstances and the cost involved. Broadly speaking, the techniques can be grouped under three heads:

1. Yield curve based techniques, such as mismatched borrowings and forward rate agreement.
2. Derivative based techniques, such as interest rate futures and interest-rate swap.
3. Option based techniques, such as options on forward rate agreements, swaptions, caps, floors, and collars.

One can group the various techniques of interest rate management also on the basis of whether they are practised in over-the-counter markets or through organised stock exchanges. In the first category come the mismatched borrowings, forward rate agreements, interest rate and currency swaps, caps, floors, and collars; while interest rate futures come under the second category.

15.4.1 Mismatched Borrowings

The yield curve is normally supposed to be a forecast of future spot interest rates. Thus, if the yield curve is upward sloping, the future rate of interest will be more attractive for the investor. In this case, it is better to borrow short and invest long. The short term borrowing will bring funds for long term investment. At the same time, the cash inflow in the medium term on account of investment will cover the repayment of the short term borrowing.

If, on the other hand, the yield curve is sloping downward, the firm can borrow long and invest short. The long term borrowing will provide funds for making short term investments. At the same time, the inflow from short term investment will enable the firm to service the long term borrowing.

Forward Rate Agreements is a contract through which a borrower/lender locks the interest rate and protects itself from loss on account of change in interest rate.

15.4.2 Forward Rate Agreements

Forward rate agreements (FRAs) are contracts through which a borrower or a lender/investor locks the interest rate on his future borrowings or lending/investment and protects himself from unfavourable changes in the interest rate. A simple example will illustrate this. Suppose a firm needs to borrow in the near future when it expects the interest rate to move up. This means that with rising interest rate, it will have to make a larger interest payment. To protect itself from a larger interest payment, it goes for an FRA deal with its banker for an amount equivalent to its borrowing amount. The principal amount under the FRA deal will just be a notional amount and the bank will pay the firm the present value of the difference of the interest payment between the pre-change rate or the locked interest rate and at the post-change rate prevailing at the time of maturity. The interest payment differential is discounted because FRA is settled in the beginning of the period and not at the end when interest is normally paid. The discount factor is the actual (post-change) interest rate. This payment would be rather a compensation that eliminates the interest rate exposure faced by the firm.

Forward Rate Agreements (FRAs)/Interest Rate Swaps (IRS) in India: 2003–05

There was a sharp increase in the volume in FRAs/IRS market during 2003–04, both in terms of number of contracts and outstanding notional principal amounts. The number of contracts rose from 9,363 to 19,867, while the outstanding amount rose from Rs. 2,42,983 crore to Rs. 5,18,260 crore during the period April 4, 2003 to March 19, 2004. The participation in the market was broad based and included public sector banks, PDs, foreign banks and private sector banks.

In a majority of these contracts, the National Stock Exchange-Mumbai Inter-bank offered Rate (NSE-MIBOR) and Mumbai Inter-bank Forward Offered Rate (MIFOR) were used as the benchmarks. Other benchmark rates used were secondary market yields of the Government securities with residual maturity of one-year and primary cut-off yield on 364-day Treasury Bills. Activity in FRAs/IRS is expected to pick up after the regulatory and prudential norms for over-the-counter (OTC) and exchange traded derivatives are harmonised by the Reserve Bank. During 2004–05, the number of contracts rose further to 23,331 and the outstanding amount moved up to Rs. 6,11,595 crore as on May 28, 2004.

Source: *RBI Annual Report*, 2003–04.

Example: Suppose the present interest rate is 6 per cent per annum, the amount of future borrowing is \$100,000; the maturity is three months; and the risen interest rate is 7 per cent per annum. This means that at the risen rate, the borrowing firm will have to make interest payment equivalent to \$1,769.44 or \$252.77 more than that at the pre-change rate. The interest rate exposure the borrowing firm has to face is \$252.77. If it purchases FRA for an equivalent principal, it will get the following amount as compensation from its banker (seller of the FRA):

$$\frac{\left[100{,}000 \times \left\{(0.07 - 0.06) \times \left(\frac{91}{360}\right)\right\}\right]}{\left\{1 + \left(\frac{0.07 \times 91}{360}\right)\right\}} = \$248.39$$

Thus, when an interest rate rise is expected, the borrower purchases FRA. But when interest rate is expected to fall, the borrower does not go for an FRA deal. As far as lender is concerned, it will buy FRA if the interest rate is expected to fall.

15.4.3 Interest-rate Swap

When borrowers expect a rise in interest rates, they swap a floating-rate loan for a fixed rate loan. On the contrary, when they expect a fall in the interest rate, they swap a fixed rate loan for floating rate loan.

Interest rate swap has already been discussed in the preceding chapter. However, it may be pointed out that when borrowers expect a rise in interest rates, they swap a floating-rate loan for a fixed rate loan. On the contrary, when they expect a fall in the interest rate, they swap a fixed rate loan for floating rate loan.

The use of interest rate swap for hedging risk may be explained through the help of an example. Suppose a television manufacturing firm provides a loan to its customers for financing the purchase of television sets at a fixed rate of 12 per cent. Such loans are financed by medium term notes that the firm issues at LIBOR + 25 basis points. LIBOR is 7 per cent and the administrative and other costs involved in borrowing and lending come to 2 per cent. If LIBOR does not fluctuate, the firm will enjoy a margin of 12.0 − (7.25 + 2.0) = 2.75 per cent. But if LIBOR moves up, the margin will squeeze and the firm will face a loss. In order to check this squeeze, the firm will go for interest rate swap with a swap dealer. It will pay a fixed rate of interest at 7 per cent to the swap dealer; and in return, will get a floating rate of interest from the swap dealer. The receipt of floating interest rate from the swap dealer will neutralise to a great extent/eliminate the loss on account of increase in LIBOR.

After the swap, the interest margin of the firm will be equal to the difference between the interest received from the consumers as well as from the swap dealer and the interest paid to the swap dealer and to the purchasers of medium term notes. If LIBOR is 7 per cent, the margin, assuming zero administrative cost, would be:

$$(12.0 + 7.0) - (7.0 + 7.0 + 0.25) = 4.75\%$$

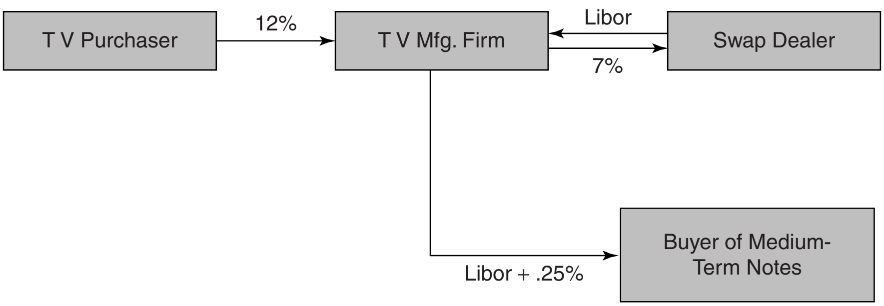


FIGURE 15.4 Hedging with Interest Rate Swap

If LIBOR goes up to 8 per cent, the interest margin will be:

$$(12.0 + 8.0) - (7.0 + 8.0 + 0.25) = 4.75\%$$

Had there been no swap, the margin would have squeezed to 3.75 per cent after an increase in LIBOR. But after the swap, the margin remains the same. This means the interest rate swap hedges the risk (Figure 15.4).

15.4.4 Interest Rate Futures

Interest rate futures (IRFs) were meant to hedge interest rate risk evolved in mid-1970s in the US financial market. Presently, they are available in many other markets and in many other currencies. The IRFs market is like the currency futures market where deals are contracted in the pit of the organised exchange through an authorised broker. A nominal amount of the contract is standardised. Maturity falls in March, June, September and December. There is usually a clearing house to record the transactions and to function as a counterparty. Margin money and margin call mechanisms are found. On maturity, the contract is reversed.

Interest rate futures refer to a contract to hedge interest rate risk made through an authorised broker.

IRFs are used, both, in case of rising interest rate and falling interest rate. The value of a bond diminishes with a rise in the interest rate, and vice versa. Firms in long position, that is, firms holding bonds incur loss with a rise in interest rates inasmuch as the value of the bond diminishes. When they suspect loss, they go for IRFs. Suppose a company is having 10-year French government bond for € 1,000,000. The interest rate, which is 10 per cent in July, is expected to move up to 1 by December, as a result of which a fall in the price of the bond is expected. The company would like to go for interest rate futures for protecting itself from this loss. It will instruct its broker to sell interest rate futures for the equivalent amount, which is a notional amount. Since the standard size of FF futures is € 500,000, two futures will be sold.

In December interest rate rises to 11 per cent and as a result, the value of the bond drops to € 991,000 (€ 941,000 as the price of the bond plus € 50,000, as the interest accrued). The broker will then go for a reverse contract, that is, for buying December delivery futures at a price of € 941,000. By doing so, the broker will gain:

Price sold − price bought

or € 1,000,000 − € 941,000 = € 59,000

Now,

1. After the future deals, the value of the company's portfolio at the end of December will be equal to:

   € 941,000 + 50,000 + 59,000 = € 1,050,000

2. If the bondholder does not opt for IRFs, the value of the investment portfolio will be equal to:

   € 941,000 + 50,000 = € 991,000

3. If there is no interest rate change and no futures deal, the value of the investment portfolio will be equal to:

$$€\ 1{,}000{,}000 \text{ as principal} + €\ 50{,}000 \text{ as the interest} = €\ 1{,}050{,}000$$

Thus, it is clear that with a rise in interest rate, the value of the investment portfolio diminishes and it puts the investors to loss. But if the investor goes for interest rate futures, the loss is hedged.

So far we have discussed that the interest rate rises as per expectation. But it may be that the rate of interest falls contrary to expectation. In that case, there will be loss on future contracts, but the loss would be compensated by an increase in the value of the bonds.

Again, if the bond holder expects a fall in the interest rate, he will buy interest rate futures for an equivalent notional amount that will be reversed on the maturity date.

15.4.5 Interest Rate Caps

Interest rate caps refer to a contract through which a borrower caps the interest rate and avoids loss owing to any rise in the interest rate.

Interest rate cap (IRC) is an option based technique practised in over-the-counter market. This technique evolved in the mid-1980s in the euro-dollar market and now it is more frequently used.

When a firm borrowing a floating rate loan fears a rise in LIBOR, it may buy an IRC for the loan equivalent amount that will help reduce the interest rate exposure. This is because the seller of the IRC, normally a bank, reimburses the buyer's loss in the event LIBOR exceeds the cap's interest rate level. In order to arrive at the net gain accruing to the buyer of the cap, the amount of premium paid by the buyer of the cap must be deducted from the amount of the reimbursement. The principal amount of the cap is notional. The total maturity is divided into a number of reset periods.

Example: Suppose a firm borrows \$100,000 for four years at 6−month LIBOR + 25 basis points. If the firm fears a rise in LIBOR, it buys IRC for an equivalent amount with the same maturity at a strike price of 7.0 per cent, which is equal to the prevailing rate. The premium is 0.5 per cent for the reset period. If, at the end of the first reset, LIBOR rises to 10.0 per cent, the amount of interest paid by the borrower will be equal to:

$$\$100{,}000 \times 10.25\% \times \frac{180}{360} = \$5{,}125$$

Moreover, the borrower will have to pay premium equivalent to:

$$\$100{,}000 \times 0.005 = \$500$$

On the other hand, the borrowing firm will receive from the bank, that is, from the cap seller an amount equivalent to:

$$\$100{,}000 \times (0.10 - 0.07) \times \frac{180}{360} = \$1500$$

As a result of the cap deal, the entire interest rate exposure of the borrower is eliminated. The only thing is that it has to pay premium for the cap. But even after taking into the amount of premium, we find that the interest rate exposure is greatly reduced.

However, if, contrary to the expectation, LIBOR diminishes at the end of the first reset period or the other reset periods, the borrowing firm will have to pay a lower amount of interest but it will have to pay the premium. The net gain depends upon the extent of changes in LIBOR and the amount of premium.

15.4.6 Interest Rate Floors

Interest rate floor (IRF) is different from IRC inasmuch as the IRF protects against a fall in the interest rates. So it is the investor or the depositor who buys IRF, whereas IRC, as we know, is bought by a borrower. However, many features of the two instruments are similar. IRF is also an over-the-counter market instrument. The seller of IRF compensates the loss of the buyer on account of change (fall) in interest rates. For this privilege, the buyer pays premium to the seller.

> Interest rate floor is a contract through which a lender avoids loss on account of decrease in interest rate.

Suppose a firm makes Euro deposits for \$100,000 at 6−month LIBOR minus 25 basis points for one year. It fears a fall in LIBOR and so buys an IRF with a strike price of 6.0 per cent per annum, which is equivalent to the prevailing LIBOR. It pays a lump sum premium at 0.5 per cent for the whole of the year. As expected, LIBOR moves down to 4.0 per cent after the six month period.

If the depositor does not go for IRF, it will receive \$1875 as interest for the six-month period, which will be lower by \$1,000 than that during the beginning of the deposit period. But if it goes for IRF, the bank will compensate this loss. The compensation is computed as:

$$\$100{,}000 \times (0.06 - 0.04) \times \frac{180}{360} = 1{,}000$$

However, the net gain accruing to the depositor will be lower by the amount of the premium.

15.4.7 Interest Rate Collars

Interest rate collar is a combination of caps and floors. It is just like a tunnel where an importer buys a call option and sells a put option simultaneously or an exporter buys a put option and sells a call option. Similarly, a borrower buys a cap and sells a floor simultaneously or an investor or a depositor buys a floor and sells a cap simultaneously. In this way the collar fixes a maximum and a minimum interest rate. A borrower limits risk owing to a rise in the interest rate, but it also limits the opportunities of benefiting from a fall in the interest rate. An investor limits the risk owing to a fall in interest rate and also limits the gains owing to rise in interest rates. The premium in both the cases is calculated in such a way that the premium received normally equals the premium paid.

> Interest rate collars are a combination of interest rate caps and floors. A borrower buys a cap and sells a floor simultaneously or an investor or a depositor buys a floor and sells a cap simultaneously.

Example: A simple example will make clear the distinctive characteristics of a collar. Suppose a firm borrows $100,000 for two years at LIBOR plus 0.25 per cent. It purchases cap with a strike price of 7.0 per cent and sells a floor at a strike price of 5.0 per cent. If LIBOR varies between 5.0 per cent and 7.0 per cent, no payment is made on the collar. The borrower pays interest at LIBOR + 0.25 per cent. If the interest rate exceeds 7.0 per cent, the bank (seller of the cap) pays the difference. If the interest rate falls below 5.0 per cent, the borrowing firm pays the difference to the bank. In the former case, the cost of the loan is 7.25 per cent; in the latter it 5.25 per cent.

15.4.8 Interest Rate Corridors

While interest rate collars present a combination of cap and floor, interest rate corridors present a combination of two or more caps. A borrower buys one cap with a specific strike rate and simultaneously sells another cap with a higher strike rate with a view to offsetting at least a part of the cost of the cap purchased. The purchased cap protects from rising interest rate; on the contrary, the sold cap obligates the borrower to pay only when it (the sold cap) is activated.

15.4.9 Options on FRAs

Options on the FRAs are normally used for short term borrowing. A borrowing firm, when it is not sure of the direction of the interest rate changes, buys a call option on the FRA. If interest rate moves up, it exercises the call option and locks itself to the lower rate. If interest rate moves down, it prefers to let the call option expire and pays interest at the lower rate. But in both the cases it has to pay the premium. On the contrary, a lending firm buys a put option on the FRA. If the interest rate moves up, it lets the option expire and receives interest at a higher rate. But if the interest rate moves down, the option is exercised as a result of which the lending firm locks itself to the higher rate. In both the cases, the interest inflow gets reduced by the amount of premium.

15.4.10 Options on Swaps

Swaption is option on swap in medium term and long term borrowing.

An option on swap is also called a swaption. It is used in case of medium-term and long term borrowing. This instrument confers the right to enter into an interest rate swap either as the payer or as the recipient of the fixed side of the swap. When it is a payer swaption, it confers the right to pay the fixed rate in the swap. If the interest rate exceeds the swaption strike rate, the buyer exercises the option and locks itself to a lower interest rate. The seller gets the fixed rate equal to the strike price and pays the floating rate. If the interest rate does not exceed the strike rate, swaption is not exercised.

In case of receiver swaption, the buyer exercises the option and locks itself to a higher rate when the interest rate falls below the swaption strike rate. If it is not so, swaption is not exercised.

SUMMARY

- Exchange rate exposure is the loss or gain caused by changes beyond anticipation in exchange rate. Foreign exchange exposure is of different types. One is known as accounting exposure, leaving no impact on the cash flows. The other is transaction exposure, involving changes in the present cash flows. Yet another is real operating exposure, altering the future cash flows.
- Transaction exposure is often concerned with changes in trade receipt/payments, changes in external debt burden or changes in the amount of intra-firm flows. In case of MNCs, it is the consolidated net figure of cash flows that determines the size of transaction exposure.
- Real operating exposure is concerned with, both, changes in inflation rate and the exchange rate, causing changes in the future revenue and cost stream of the firm.
- Translation exposure emerges on account of consolidation of financial statements of foreign subsidiaries by the parent company. With changes in the exchange rate, and particularly on account of varying methods of translation, the picture of the consolidated statement changes. This change represents the size of the translation exposure.
- Transaction exposure is managed by both contractual hedges and natural hedges. There are different techniques of contractual hedges such as hedging in the forward, futures, and options market, and the money market hedge. In the natural hedge, the usually adopted techniques are leads and lags, price variation and currency of invoicing, matching of currency flows, currency swaps, currency diversification, risk sharing, cross hedging, parallel loans, and so on.
- While managing real operating exposure, some of the natural hedging techniques are applied, which are especially meant for hedging long term transaction exposure. But in this case, the firm applies a combination of financial, marketing, and production strategies so that the future net cash inflow improves significantly to offset the adverse effects of exchange rate changes.
- In case of translation exposure management, the balance-sheet hedge is the most common technique, followed by some financial hedging techniques.
- Again, borrowers and lenders have to face interest rate exposure on account of changes in the interest rate. Such a change influences the earning position of a non-financial firm, while it affects the very asset-liability position of a financial firm. Interest rate risk is grouped as credit risk, liquidity risk, and basis risk.
- There are different techniques for management of interest rate exposure. Most of them are found in the over-the-counter market. Only few of them are practised through the organised exchanges. They are grouped as yield-curve-based techniques, such as mismatched borrowing and forward rate agreement; derivative based techniques such

as interest rate swap and interest rate futures; and yet again, option-based techniques, such as interest rate caps, floors, collars, options on FRA and swaption.

Review Questions

1. Describe the different forms of exchange rate exposure. How do they differ among themselves?
2. Explain, with suitable examples, the different forms of contractual hedge.
3. Explain the techniques adopted for natural hedge.
4. What are the different types of interest-rate risk? Do they affect financial and non-financial firms in the same way?
5. Discuss some more common techniques of interest rate risk management.

Study topic

Interest Rate Futures Contracts and the Indian Banks

Interest rate futures (IRFs) contracts are the tools used by banks, primary dealers, corporate houses, financial institutions, foreign institutional investors and retailers in order to hedge interest rate risk. In fact, they are now an important instrument to manage interest rate volatility. That is why they have become popular at the global level as well as in India. At the global level, based on the database of the Bank of International Settlements (BIS), IRFs involved over 74 million outstanding contracts for the value of over $17.8 trillion at the end of March 2009.

Features

IRFs contracts are of a definite lot size which is Rs. 0.2 million. The underlying securities are normally a 10-year notional coupon bearing Government of India security. The notional coupon is normally 7.0 per cent with semi-annual compounding. The maximum maturity is one year and the maturity falls in the month of March, June, September and December.

The contract is settled through physical delivery of securities. The electronic book-keeping entry system of NSDL/CDSL/PDO of RBI is used for this purpose. The delivery of deliverable securities can take place from the very first to the last working day of the settlement month. The working day lies between Monday and Friday and the working hours lie between 9.00 a.m. and 5 p.m. It is the owner of the short position that initiates the delivery. The clearing house needs to be informed at least two working days in advance. The conversion factor for the security to be delivered is equal to the price of the security on the first day of the delivery month and is to yield 7.0 per cent, which is to be compounded semi-annually.

The settlement price is the closing price of 10-year notional coupon-bearing Government of India security futures contract on the trading day, whereas the closing price is the weighted average price of the futures for last 30 minutes on the working day. If there is no transaction in IRFs during the last half an hour on that day, it is the stock exchange that determines the settlement price.

Why do banks go for IRFs

Banks are one of the major participants in the IRFs market. The reason is that the IRFs help alleviate different kinds of risk, such as basis risk, re-pricing risk, risk arising on account of SLR/non-SLR securities, options risk, etc. It may be noted that basis risk arises when the cost of liabilities and the yield on assets are based on different benchmarks. Re-pricing risk arises on account of fluctuation of cash flow due to revaluation of assets and liabilities over a period of time. Risk arising on account of Statutory Liquid Ratio (SLR)/non-SLR securities is manifested when such assets get devalued. Similarly, option risk arises in case of optionality provisions in lending and borrowing.

Besides hedging of the risk, IRFs help to increase the yield on fund advances ratios that increases in turn the net interest income. Any such increase means improved financial performance. There is also improvement in the capital adequacy ratio. It is because that the clearing house performs the clearing and settlement functions which help to lower the capital allocation risk for the hedged assets.

Again, IRFs help to minimise the portfolio volatility. They also decrease the sensitivity of returns on banks' assets and liabilities on account of interest rate fluctuations.

Case Example

A bank in India has SLR investment for some amount, a part of which is classified as "available for sale" and also "held for trade". The bank is expecting an increase in interest rate which may increase the yield rates manifesting in decreased value of these assets. The bank prefers to go for an IRF contract.

The position on November 10, 2008 is as follows:

(a) The yield on a 10-year Government of India security (priced at Rs. 102.40) is 6.09 per cent and it is trading at 5.76 per cent.
(b) March 2009 futures contracts on 10-year, 7.0 per cent GOI security is trading at Rs. 108.34 indicating a yield rate of 5.85 per cent.
(c) The bank takes a short position based on March 2009 IRFs.

The position on January 1, 2009 is as follows:

(a) The yield rate of 6.09 per cent goes up to 7.56 per cent. As a result, the price of the security falls to Rs. 90.10.
(b) March 2009 futures contract on a 10-year, 7% GOI security is trading at Rs. 96.03 indicating a yield rate of 7.59 per cent.

(c) The bank unwinds a short position through buying the futures contract.
(d) This way the long position in the cash market is hedged through taking a short position in the IRF market.

QUESTIONS
1. What are the essential features of IRFs contracts?
2. Why do the banks go for such contracts?
3. Present a hypothetical example showing how such contracts are used for hedging interest rate risk.

REFERENCES

Books

Buckley, A. (1996), *Multinational Finance* (New Delhi: Prentice Hall of India).
Sharan, V. (2003), *International Financial Management*, Second Edition (New Delhi: Prentice-Hall of India).

SELECT FURTHER READINGS

Antl, B. (1988), *Management of Interest Rate Risk* (London: Euromoney Publication).
DeRosa, David F. (1991), *Managing Foreign Exchange Risk* (Chicago: Probus).
Moffett, Michael H. and Jan Karl Karlsen (1994), "Managing Foreign Exchange Rate Economic Exposure", *Journal of International Financial Management and Accounting*, V (2), 157–75.

*Hong Kong is one of the two special administrative regions of the People's Republic of China and the world's leading financial centres and a highly developed capitalist economy. The Hong Kong Stock Exchange is the sixth largest in the world, with a market capitalisation of US$2.97 trillion as at October 2007. Hong Kong is the world's largest re-export centre and its economy is dominated by the service sector, which accounts for over 90 per cent of its GDP.

Zurich, Switzerland*

16

Host Country Heterogeneity and International Business Strategy

CHAPTER OBJECTIVES

Host countries vary on account of varying economic, political and legal, socio-cultural, and other environmental characteristics. Naturally, MNCs have to adopt different entry and operating strategies for different sets of host countries. The present chapter discusses this issue. The objective is to:

- ✦ Analyse the economic indicators of developed market economies and the entry and operating strategy, of the MNCs, meant for these countries in general and the European Union in particular.
- ✦ Show the broad compartments of the less developed world and to indicate the environment in a less developed country.
- ✦ Discuss the entry and operating strategy of MNCs in the less developed world.
- ✦ Present the features of the emerging market economies, especially the Asian Tigers and the People's Republic of China.
- ✦ Discuss the entry and operating strategy of MNCs in case of emerging market economies.
- ✦ Explain the features of transition economies and the process of reforms that had started in the 1990s.
- ✦ Analyse the entry and operating strategy of MNCs, with respect to transition economies.

The earlier chapters discuss various strategies related to international business. These strategies need at least some modification when they are applied to different sets of the host country environment. Some of the strategies may be more important for a particular type of host country, whereas other strategies may be more relevant for other sets of countries. It is from this point of view that the present chapter discusses the basic features of the different sets of countries and the entry and operating strategies related to conducting business there. For purposes of the discussion, host countries are grouped broadly as developed market economies or industrialised countries; less developed countries, in general; and emerging market economies and transition economies of the developing world, in particular.

16.1 DEVELOPED MARKET ECONOMIES

16.1.1 Basic Economic Indicators

Table 16.1 shows that the per capita income level in 2006 in select industrialised countries was very high varying from $36,170 to $44,970. The growth rate in GDP during 2005–06 varied between 1.7 and 2.9 per cent. The share of industry in GDP stood at between 21.0 and 30.0 per cent. Their share in the world trade was high as their trade figure (export + import) varied in the range of $745 and $2,957 billion. Some of them experienced deficit on the current account. The size of FDI varied between $132.851 billion in Japan and $2,093.049 billion in the USA. The size of FDI stock as percentage of GDP too varied in a wide range. Despite variation, the industrialised countries accounted for a lion's share in the world trade and investment.

In four newly industrialised countries, as Table 16.2 shows, per capita income varied between $17,690 and $29,320. The growth rate varied between 4.7 and 6.9 per cent and so it was higher than in the industrialised world. The current account balance/GDP ratio varied widely. The FDI stock/GDP ratio was as high as 573.0 per cent in Hong Kong and 154.7 per cent in Singapore and as low as 12.3 per cent in Korea.

However, when one looks at them individually, some more differences appear among them, especially the way in which they regulate international business and also the basic environment pertaining to international business. For example, the cultural environment is different in Japan from that in the United States of America. The traditionally inward-looking business culture in Japan presents a sort of barrier for international business entrants (*The Economist*, 1990). Language is another problem in non-English speaking countries such as Japan, France, and Germany. Again, in the countries coming under the fold of European Union, international business entrants have to take into consideration not only the rules and regulations of the individual country but also those of the European Union. Yet again, in European Union countries, imports from outside the Union have to face a common external tariff. On the contrary, in case of the countries in the European Free Trade Area, goods normally make their entry through a country with lower tariff.

Table 16.1 Economic Indicators in Select Industrialised Countries

Country	*Per capita income ($) in 2006*	*Growth rate % in 2005–06*	*Share of industry in GDP %*	*Export in 2006 $ billion*	*Import in 2006 $ billion*	*Current Account balance in 2006 $ billion*	*FDI stock in 2007 $ billion*	*FDI stock as % of GDP in 2007*
Canada	36,170	2.0	n.a.	387.551	357.274	21.441	520.737	36.5
France	36,550	1.7	21	490.145	533.407	–27.667	1,026.081	40.1
Germany	36,620	2.9	30	1,112.320	910.160	146.874	629.711	19.0
Italy	32,070	2.0	27	409.572	436.083	–27.724	364.839	17.3
Japan	38,410	2.4	30	647.137	577.472	170.517	132.851	3.0
Netherlands	42,670	2.6	24	462.083	416.121	57.448	673.430	87.9
UK	40,180	2.6	26	443.358	600.833	–79.966	1,347.688	48.6
USA	44,970	2.4	22	1,037.320	1,919.574	–856.669	2,093.049	15.1

Source: *World Development Report, 2008*

Table 16.2 Economic indicators in four newly industrialised countries

Country	*Per capita income $ in 2006*	*Growth rate % in GDP in 2005–06*	*Current account balance/GDP ratio in 2006 %*	*FDI stock/GDP ratio % in 2007*
Hong Kong	28,460	5.9	12.0	573.0
Korea	17,690	4.7	1.0	12.3
Singapore	29,320	6.6	32.0	154.7
Taiwan*	n.a.	4.0	5.8	n.a.

* Relates to 2005.
Source: 1. *World Development Report, 2008*
2. *World Investment Report, 2008*

16.1.2 Entry and Operating Strategy for the MNCs

Sequential Entry refers to the strategy acquired to enter a new market. MNCs first adopt the contractual mode and only then make an investment.

As far as the entry strategy is concerned, it is the kind and the extent of competition that really matters. The government of these countries does not normally differentiate between a domestic firm and a foreign firm, with the result that the competition is very strong. In such a situation, an MNC operating there looks for the ways to maintain an edge over its competitors. It opts for transferring the latest technology that the competitors do not possess. If this is the case, technical collaboration would be an appropriate mode of entry. But if tariff and transportation cost are a greater hurdle in the way of competing with rivals, setting up its subsidiary would be a more feasible proposition for the MNC. Again, if the cultural barriers are more prominent in the host country, joint ventures with the host country producers may be suggested. It is a fact that cultural barriers are not very significant in industrialised countries, but in Japan, the problem of language persists even today and also consumers maintain preference for domestically produced goods. In such cases, joint ventures with host country firms are preferred. Mostly American MNCs have entered Japan in this way. The sequential entry strategy is yet another strategy often adopted by MNCs. In this they opt for licensing in the first stage and after making themselves well acquainted with the host country market, they proceed to set up a manufacturing unit.

An MNC can operate successfully if it launches a differentiated product.

Apart from the entry strategy, the operating strategy is also worth considering in face of severe competition from rival firms. The operating strategy is normally based on a combination of three factors, namely, cost, product differentiation, and market segmentation. Infact, it is the cost factor that has motivated MNCs to locate their assembly units in countries with cheap labour force and not in industrialised countries. Again, the strategy of product differentiation is very significant in conducting business with industrialised countries because consumers in these countries have large amounts of discretionary income to spend on both necessities and luxury items. An MNC can operate successfully in such countries to bag a large part of the consumers' disposable income if it launches a differentiated product. In the United States of America, McDonald's, Burger King, and so on were already operating, but Wimpy's and Kentucky's Chicken operated successfully with their differentiated products.

Furthermore, since the market in an industrialised country is quite large and the consumers choices vary, market segmentation strategy can prove more successful than in a less developed country. Even if an MNC caters to the need of a single segment or only a few segments of the market, it can easily survive.

16.1.3 International Business Strategy for EU

Since a large part of the industrialised world is represented by the European Union member countries, it is worthwhile to discuss international business strategy with respect to these counties. Chapter 8 discusses the various aspects of economic integration schemes along with the EU at some length. So at the present moment, only strategy is taken into account.

The strategy is no doubt similar to that of other industrialised countries. Nevertheless, the EU is distinguished by some special characteristics. Over the decades, this integration scheme has moved ahead from a mere customs union to a common market and an economic community, and also to some extent towards a political union. The result is that the integration is now quite strong; intra-union trade is greatly free; factors of production move freely; and the monetary union too is in a mature stage with the adoption of a common currency, the euro. From the viewpoint of an international business entrant, the size of the market has grown considerably large and so has the size of the demand.

The adoption of the euro has a definite impact on international business. Let us assume that an MNC sets up its plant in France, gets its supplies from Germany, raises funds from Belgium, and caters to the Dutch market. Had there been different currencies in these four countries and had these currencies been fluctuating greatly, the MNC's performance would have been jeopardised considerably. The euro has solved this problem. Moreover, the euro has, to a great extent, eased the accounting procedures, pricing policy, and the management of administration. Prices will now be more transparent, in the interest of the consumers.

The EU is moving towards a political union, as it is evident from the Common Foreign and Security policy. With this move, there will be greater consistency in the policy across the EU. The greater the consistency and stability in policy, the lower the political risk and more smooth the operation. However, in certain quarters, there is a fear that stronger political unification will lead to the emergence of a 'United States of Europe', in turn, weakening the bargaining power of MNCs.

There is also fear in some quarters that the EU has erected high trade barriers under the provisions of customs union and by devising a common agricultural policy. It is a fact that "trade diversion and trade creation" is the motive behind the economic integration scheme. But as far as the EU is concerned, it has gone along with the GATT/WTO provisions and its tariff is one of the lowest in the world. Its common agricultural policy does have the element of subsidies and import control measures, but over the years, the restrictive provisions have eased considerably. Moreover, it has pioneered the introduction of a Generalised System of Preferences that facilitates the import of manufactured goods from the developing world duty free into the EU. Under the Lome Convention, imports from erstwhile colonies are given preferential treatment. Imports from East European countries have become freer through various agreements with these countries and now with the enlargement of the EU. The EU has turned out to be a major export market for Mediterranean countries after it took a decision to maintain closer ties with these countries in 1994. There is a possibility that a free trade area will be created between the EU and these countries by 2010.

It is of course true that the labour cost is very high in Germany and MNCs would not like to set up their operations there. But considering it in totality, the EU definitely represents a fertile ground for international business.

16.2 BUSINESS WITH A LESS DEVELOPED COUNTRY

16.2.1 Income-based Classification of Developing Countries and their Broad Features

A less developed country, often termed as a developing country, is different from industrialised countries in the sense that it is posited on a lower ladder of economic development with lower per capita income and lower socio-economic indicators. The World Bank (2008) groups developing countries on the basis of per capita income valued at the rate of the US $ 2007. They are:

Country classification	*Per capita income based on 2007 Dollar*
Low-income country	$935 or less
Lower middle-income country	$936–3,705
Upper middle-income country	$3,706–11,455
High-income country	$11,456 or more

There is wide gap in the per capita income between the industrialised countries and the developing countries, in general, and also among different sets of developing countries. Similarly, their involvement in international business too varies widely. Table 16.3 presents a few important indicators regarding the different types of developing countries.

The growth rate of GDP during 2005–06 was higher in low-income countries than in the upper middle-income and high-income countries. The current account balance/GDP ratio in low-income countries during 2006 was negative compared to a positive ratio in the middle-income countries. As regards FDI stock/GDP ratio in 2006, the low-income countries lagged behind compared to the lower and upper middle-income countries but fared slightly better than the high-income developing countries.

Table 16.3 Some major economic indicators of the developing world

Group of countries	*Growth rate in GDP in 2005–06 %*	*Current account balance/GDP ratio % in 2006*	*FDI stock as % of GDP in 2006*
Low-income	6.5	–0.4	1.5
Lower middle-income	7.6	1.0	2.9
Upper middle-income	3.9	3.0	2.8
Middle-income as a whole	5.6	2.0	2.8
High-income	2.3	0	1.4

Source: 1. *World Development Report, 2008*
2. *World Investment Report, 2008*

Note:

Low-income countries: Burundi, Comoros, Congo, Ethiopia, Kenya, Madagascar, Malawi, Mozambique, Rwanda, Somalia, Sudan, Tanzania, Uganda, Zambia, Zimbabwe, Benin, Burkina Faso, Central African Republic, Chad, Cote d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Sao Tome & Principe, Senegal, Sierra Leone, Togo, Cambodia, Laos, Mongolia, Myanmar, Solomon Islands, Vietnam, Afghanistan, Bangladesh, India, Nepal, Pakistan, Kyrgyzistan, Moldova, Tajikistan, Uzbekistan, Yemen Rep., Haiti, Papua New Guinea, Timor-Leste, Eritrea.

Lower middle-income countries: Lesotho, Congo Rep., Cameroon, Angola, Bhutan, Egypt, Nicaragua, Namibia, Swaziland, Cape Verde, China, Fiji, Kiribati, Marshall Islands, Micronesia Fed. Sts., Philippines, Samoa, Thailand, Tonga, Vanuatu, Maldives, Sri Lanka, Albania, Belarus, Bosnia and Herzegovina, Latvia, Lithuania, Macedonia, Federation, Yugoslavia, Iran, Iraq, Jordan, Syria, West Bank and Gaza, Algeria, Djibouti, Morocco, Tunisia, Bolivia, Colombia, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Paraguay, Peru, Surinam, Georgia, Azerbaijan, Armenia, Indonesia, South Africa, Ukraine, Turkmenistan.

Upper middle-income countries: Botswana, Mauritius, Seychelles, Gabon, American Samoa, Malaysia, Croatia, Czech Republic, Hungary, Poland, Slovak Republic, Lebanon, Oman, Libya, Argentina, Barbados, Chile, Dominica, Grenada, Mexico, Panama, St. Kitts & Nevis, St. Lucia, Uruguay, Venezuela, Palau, Coasta Rica, Belize, Lithuania, Lativa, Mayotte, St. Vincent and Grenadines, Northern Mariana Islands, Bulgaria, Kazakhstan, Montenegro, Romania, Russia, Serbia, Turkey, Brazil, Equatorial Guinea.

High-income countries: Brunei, French Polynesia, Guam, Macao, New Caledonia, Slovenia, Channel Islands, Cyprus, Greenland, Liechtenstein, Monaco, Israel, Kuwait, Qatar, United Arab Emirates, Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Virgin Islands, Andorra, Aruka, Isle of Mau, Malta, Puerto Rico, San Marino, Antigua and Barbuda, Bahrain, Brunei Darussalam, Estonia, Faeroe Islands, Hong Kong, Saudi Arabia, Singapore, Taiwan, Trinidad & Tobago.
—Based on *World Development Report: 2008*

Source: The World Bank (2008), *Global Development Indicators: 2008*, Washington, D.C.

Apart from the economic indicators presented in Table 16.3, developing countries, in general, present a greater regulatory environment than the industrialised countries as a whole. It is a fact that some of the Asian and Latin American countries maintain substantial freedom of economic activities and it is also that many others have been limiting regulations under the aegis of structural adjustment and macroeconomic reforms, yet regulatory environment is prominent in these countries in the form of limitations on the activities of the private sector and still large participation of the government in their economic activities.

Again, the socio-cultural environment in developing countries is more rigid than in the industrialised countries. At the core of the problem lies a low literacy rate and low level of socio-economic development. The result is that consumers do not prefer using new varieties of goods; producers are often not innovative; superstitions reign the social customs and beliefs; and workers have only limited mobility.

Moreover, the existence of a dual economy is found in these countries. A large part of the economy is represented by the traditional sector, which experiences either little or no development. On the other hand, only a small part of the economy is developed, representing a greater amount of manufacturing activities and higher level of income and consumption. It is only this sector that attracts international business. In other words, the scope for foreign investors is limited to the developed part of the economy.

Developing countries present:

1. a greater regulatory environment
2. rigid socio-cultural environment
3. a dual economic structure
4. immature political system
5. lack of finance and improved technology.

The political system in developing economies is not matured with the result that they present far greater political risk from the viewpoint of international business. Naturally, the number of cases of expropriation, nationalisation, and ethnic crisis has been much larger in developing countries than in industrialised countries. Many of the developing countries enforce restrictions on the outgoing foreign exchange in view of their ailing balance of payments. Many of them impose restrictions on the participation of foreign investors in the equity of national enterprises. There are many other such cases found in developing countries.

Lack of finance and improved technology is a common feature of the developing countries. Since their income level is low, savings are low, and the necessary funds are not available for achieving the desired rate of investment. It is not only the question of domestic savings, but also the availability of foreign exchange on account of bleak export performance that poses a serious problem for desired investment. In order to conserve foreign exchange, the government imposes control on the outflow of funds. But it leads to the emergence of a black market, worsening the problem further. Similarly, the R&D activities in these countries are minimal, with the result that the level of technology used is low. They have to depend mostly on the import of technology.

The need for funds is met by the inflow of foreign investment. But the inflow of foreign investment is constrained by the poor level of infrastructure, such as absence of good roads, accessible power supply, improved communication network, technically skilled manpower, good public utility services, and so on. Since returns from investment in infrastructure are not quick, this sector hardly attracts any investment.

16.2.2 Entry and Operating Strategies

The mode of entry MNCs adopt for developing countries in general may not be the same as those adopted in case of industrialised countries. The

MNCs have to be very wary of the political and exchange rate risks that are high in the developing world. The host government may nationalise the assets of MNCs, and fair compensation may or may not be given. Moreover, because of constraints on the external balance position, the government can impose restrictions on the imports of MNCs and encourage local procurement. It may impose curbs on the repatriation of profits and other transfers. The host country currency may depreciate and may cause shrinkage of profits in terms of the home country currency. This does not mean that these risks are absent in industrialised countries, but they are more common in developing countries. So, any entry strategy with respect to a developing country must take into account all these facts. In fact, it is the bargaining power of the MNC vis-á-vis the host government that matters. Sometimes the conditions are favourable at the time of entry but after some time they turn restrictive putting the MNC in a tight spot. If this is the case, it is only the bargaining strength of the MNC that counts. It is because of such risks that MNCs first opt for technical collaborations and when they find the host country environment suitable for making any investment, they commit financial resources.

MNCs first opt for technical collaborations and when they find the host country environment suitable for making any investment, they commit financial resources.

Again, it is the bargaining power of the MNC that is crucial for the operating strategy. In order to maintain the bargaining power, MNCs prefer to provide proprietary technology to the affiliate and try to strengthen the intra-firm information, production, and distribution linkages. If the affiliate in a particular host country is largely dependent on its sister concerns in other host countries or on the parent company, the host government will deliberate at length before attempting nationalisation. This is perhaps the reason that the offshore assembly projects of American and other MNCs in some East Asian countries have been immune to the changing political scenario in these countries. The government cannot achieve any purpose by nationalising them as they obtain their supply from the parent unit or any of the other sister units located elsewhere, and their market lies mostly in other countries.

It is true that the operating strategy in a developing country is influenced by cost minimisation, product differentiation, and market segmentation similar to that of an industrialised country. But in developing countries, market segmentation plays a crucial role. This is because some sectors get government protection and they become sheltered markets. MNCs can gain from such protection through market segmentation.

Financial strategy is more important in the case of a developing country than in the case of a developed market economy. This is because the currency of developing countries is often weak and tends to depreciate frequently vis-á-vis convertible currencies. Moreover, the financial market is not developed with the result that the interest rate structure is rigid and procurement of funds within the host country is not so easy. The financial strategies discussed in Chapter 19 and 20 of the book should be used very carefully.

Last but not least, the government of a developing host country often sees an MNC as a "foreign" company and maintains a strict vigil in order to protect its own economic and political interests. It is very particular regarding the issues of repatriation of dividend and other remittances, employment of foreign personnel, tax evasion, use of appropriate technology, and so on. If an MNC operates with the motive of maximising its global profit it is bound to develop a relationship full of tensions with the host government. So, the appropriate operating strategy for MNC should be to maintain cordial relations with the host government and within this limit, it has to meet its objective of maximising global profit.

16.3 LESS DEVELOPED COUNTRIES: A FUNCTIONAL CLASSIFICATION

The less developed countries or the developing countries can be grouped not necessarily on the basis of per capita income but on the basis of a number of macro-economic and socio-economic indicators. From this point of view, the different groups may be as follows:

1. Tax havens
2. Least developed countries
3. Emerging market economies
4. Transition economies

The classification is not water-tight. A particular developing country can be placed under two groups. For example, Czech Republic and China can be grouped both as emerging market economies (EMEs) and as transition economies. The readers need to be acquainted with the broad features of the different groups and also with their significance for international business.

16.3.1 Tax Havens

The features of a tax haven or a low tax-rate country have already been discussed in the preceding chapter. It does not need repetition. However, from the viewpoint of international business, the tax havens are very significant in the sense that the MNCs are found directing their profits and other incomes to these countries in order to lessen their tax burden. And then, these funds are again directed to different host countries in the form of foreign direct investment. In other words, the tax havens act neither as a host country nor as a home country but as a financial entrepot encouraging in turn the operation of the MNCs. Quoting one of such cases, Mauritius stands as the biggest source of FDI to India. It is not because many of the MNCs are headquartered there, but this country is a tax haven where the US and European MNCs channel their profits and from there itself, they make FDI in India.

16.3.2 Least Developed Countries

Among the less developed countries, there are presently 50 countries designated as the least developed country (LDCs). They share around 11 per cent of the world population but only 0.6 per cent of the world GDP. Many of them are land-locked countries meaning that they are far

> The various LDCs are: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, People's Democratic Republic of Lao, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, Sao Tome and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Timor-Leste, Togo, Tuvalu, Uganda, United Republic of Tanzania, Vanuatu, Yemen, and Zambia.
> —Based on the criteria developed by UNCTAD

away from any sea port. It is not convenient for them to make export or import. The transport cost is high as well the time consumed in trade is large. Consequently, their foreign trade does not expand smoothly. Again, many others are small-island countries where the size of domestic market is small and the foreign markets are quite remote. Moreover, some of them are highly prone to natural calamities that do entail upon the output. All of them are the LDCs because of the following reasons:

1. The level of income is very low. The "vicious circle of poverty" does exist meaning that low level of income limits domestic savings; low rate of savings means low rate of investment and thereby low level of income. Among African LDCs, over one-half of the population has less than 1 US dollar per capita income per day. The statistics reveal that in 18 out of 46 LDCs, the per capita income grew by 1 per cent between 2000 and 2004. Again, in 17 out of 41 countries, the growth rate in per capita income was negative during the same period (UNCTAD, 2006). The domestic-savings-investment gap is, to some extent, bridged up by foreign economic aid but that has created huge external debt burden.
2. The human asset is very weak. This is natural in view of the fact that the educational and health facilities are still very poor in these countries. The lack of healthy and skilled persons affects productivity adversely.
3. A very high degree of economic vulnerability exits in these countries. Their export list is highly concentrated among only a few agricultural and primary items. With high fluctuations in their demand, their export earnings fluctuate that creates vulnerability. According to a study, the economic vulnerability index in these countries is 34 per cent higher than in developing countries in general (UNCTAD, 2006). It is because of all these factors that

the share of LDCs in global trade fell from 0.4 per cent in 1980 to 0.2 per cent in 2003.

From the viewpoint of international business, the LDCs are not significant as the size of domestic market is small and the physical and financial infrastructure is inadequate. There are, of course, few evidences of FDI but it is primarily confined to extractive sectors. The statistics reveal that 10 of the LDCs absorbed 84 per cent of FDI flow meant for this group of countries during 2004 (UNCTAD, 2006).

16.3.3 Emerging Market Economies

The EMEs are those with high saving, investment and economic growth rate. To be precise, there are 38 EMEs spread over different continents and comprising of:

1. The newly industrialising countries, such as South Africa, Brazil, China, India, Malaysia, Mexico, Thailand, etc.
2. The countries having potential to become the newly industrialising country, such as Argentina, Chile, Indonesia, Philippines, Brunei, Czech Republic, Hungary, Poland, Russia, Slovakia, Turkey, Vietnam, etc.

As per a World Bank study, the 38 EMEs are: Argentina, Bolivia, Brazil, Bulgaria, Chile, China Mainland, Columbia, Costa Rica, Croatia, the Czech Republic, the Dominican Republic, Ecuador, Egypt, El Salvador, Hungary, India, Indonesia, Jordon, Malaysia, Mexico, Morocco, Panama, Pakistan, Paraguay, Peru, the Philippines, Poland, Romania, the Russian Federation, the Slovak Republic, South Africa, Thailand, Tunisia, Turkey, Ukraine, Uruguay, Venezuela, and Vietnam.

—Based on the criteria developed by the World Bank Working Group of the Capital Markets

One of the reasons behind high investment and growth rate is that they have adopted an outward-looking policy of foreign trade and investment. As a result, they are a very fertile ground for international business, especially FDI. The statistics show that the quantum of FDI inflow into these 38 EMEs went on increasing from US \$19.7 billion in 1990 to US \$149.5 billion in 2000 and to US \$217.5 billion in 2005 despite a fall in the world FDI inflow during 2000s. Consequently, their share in world FDI inflow moved up during this period from 9.4 to 10.7 per cent and to 23.7 per cent, respectively. The Asian EMEs accounted for the largest share in 2005 which stood at 10.6 per cent, followed by the Latin American ones sharing the other 7.1 per cent. The Eastern and Central European EMEs and those of the Middle East and Africa shared, respectively, 3.6 and 2.3 per cent of the world FDI inflow during 2005 (WIR, 2006). It is because of the significance of the EMEs in the area of international business that a few select cases will be discussed in the subsequent Section 16.4.

16.3.4 Transition Economies

There is another group of the developing world represented by the transition economies that were earlier under a communist regime but now they are on the transition from socialist ownership and centralised planning to a market-based economy with private ownership. They are spread mainly in the central and eastern Europe and Baltics, but they are also in Asia. In some of them, where the process of transition has been successful, the volume of trade and the FDI inflow has increased in recent years as the MNCs have shown interest in them. A detailed discussion in respect of them from the viewpoint of international business is presented in Section 16.5.

16.4 THE FIVE EMERGING MARKET ECONOMIES

Table 16.4 enlists five countries—two from Asia, two from Latin America and one from Eastern Europe. It shows that per capita income varies from $720 in India to $7,310 in Mexico. The growth rate is the highest at 9.1 per cent in China. It is slightly lower in India and Russia but far lower in Brazil and Mexico. The export/GDP ratio is about one-third in China and Russia but lower at 13–16 per cent in other countries of the list. In case of import as percentage of GDP, the figure stands at 30 in case of China but lower at 10–19 per cent in others. The figures show that except for India and Mexico, the other countries experience surplus balance of current account. The FDI stock/GDP ratio stands around a quarter in all except for India where it is barely 6.0 per cent. The apparent reason is that India adopted liberal policy late in 1991. The inflation rate is, of course, disturbing as it is as high as 9.7 per cent in Russia and 5.6 per cent in India. In all, the EMEs present heterogeneous macroeconomic indicators, despite the fact that they are very important from the viewpoint of international business.

Table 16.4 Select Macroeconomic indicators in select EMEs: 2005

Country	*Per capita income US $*	*Growth rate of GDP % during 1998–2006*	*Export/ GDP ratio %*	*Import/ GDP ratio %*	*FDI stock/ GDP ratio %*	*Inflation rate in 2006*
China	1,740	9.1	34	30	27	105
India	720	6.6	13	19	6	5.6
Russia	4,460	5.4	32	18	22	9.7
Brazil	3,460	2.4	15	10	25	4.5
Mexico	7,310	3.2	16	19	27	3.5

Source: 1. *World Development Report: 2008.*
2. *World Investment Report: 2008.*

16.4.1 FDI in China and India

As mentioned earlier, Asian EMEs have attracted the largest segment of the world FDI inflows. In Asia, China and India are the major host, although there is wide difference in the quantum of the FDI inflow between these two countries. During 1992–1995, the size of FDI inflow in China was US $109 billion compared to US $4 billion in India. During 1996–2000, it was US $209 billion in China vis-à-vis US $15 billion in India. Again, during 2001–2005, it was US $286 billion in China as against US $24 billion in India. The difference in the two sets of figures is natural in view of the fact that China adopted a liberal FDI policy as back as in 1979, whereas in India the liberal policy dates back to 1991. In India too, in the recent past, there has been a fast increase in the size of the FDI inflow. In FY 2006–07, it was US $17.7 billion compared to US $7.7 billion in FY 2004–05 and US $9.3 billion in FY 2005–06. It is expected that over the years, this difference will be narrow.

Rising FDI in Asian R&D and Real Estate

In 2005, 315 new FDI projects in R&D were recorded in South, East and South-East Asia, four-fifths of them being located in China and India. The number of foreign-owned R&D centres rose to 750 in China by the end of 2005. Similarly, the Asian real estate sector has attracted large FDI. Foreign investors have entered this sector through different ways including establishing new real estate developers, acquiring local ones, investing via financial institutions and buying properties directly. According to an estimate, foreign investment now accounts for 15 per cent of China's real estate market. Again, FDI in India's real estate sector was $120 million in 2005 despite the fact that this sector is not formally open to FDI. After the SEBI allowed foreign funds to invest in the local real estate sector in April 2004, there are over 30 foreign funds that have applied to conduct business in Indian real estate.
Source: *World Investment Report, 2006*

Again, the development of infrastructure supporting FDI inflow in China is quite large compared to that in India. The Indian Government is, of course, giving emphasis on infrastructure development. The policy towards the setting up of special economic zones (SEZs) is being fine-tuned. But all this will take at least some time. In China, the amount of electric power available to the SEZs is large being comparable to electricity generated in England and Thailand taken together. In India, the availability of electric power is still a problem area. Thus, it is also a question of time. Over the years, India may emerge as a big host for the MNCs.

Last but not least, it is observed in some quarters that the figures of FDI inflow in respect of China stand exaggerated in view of large-scale round-tripping. Intra-MNCs funds move from Mailand China to Hong Kong and again back from Hong Kong to Mainland China in the form of FDI. Xiao (2004) believes that the extent of round-tripping in the Chinese case is as high as 50 per cent. Thus, if it is true, the difference between India and China attracting FDI flow is not so big as it appears from the figures.

> *Round-tripping* is channelling of local funds by direct investors to special purpose entities (SPEs) abroad and the subsequent return of the funds to local economy in the form of direct investment. Round-tripping is represented by another nomenclature, 'trans-shipping', the amount of which was US $113.226 billion or 96.6 per cent of total FDI inflow into Luxembourg during 2002.
> — *World Investment Report, 2006*

16.4.2 Strategy of MNCs

It has already been narrated that despite being a part of the developing world, emerging market economies have many similarities with developed market economies. It is also a fact that they vary widely amongst themselves. But in a few of them the income level is high; the saving rate, investment rate and the resultant growth rate is high; and there are the least restrictions on the trade and the flow of capital. This means that MNCs do not face any significant entry hurdle. Nor do they face significant operating hurdles. The mode of entry may be through simple technical collaboration, a greenfield investment, or mergers and acquisitions. It is found that MNCs have moved into them through the export of technology in a sizeable way. The reason is that these countries have the capability of modifying the imported technology in order to suit the market requirements of the developing world. Sometimes the modified technology is exported back to the home country because it enjoys a competitive advantage (Sharan, 1985). Modification of technology is an important reason behind the entry of MNCs through the export of technology. But, at the same time, it is also that MNCs have started setting up R&D centres in these countries in collaboration with research institutes to benefit not only the host country but also the home country.

> MNCs export technology to emerging market economies and modify it through setting up R&D centres, although green field investment and M&As are also common. But in view of competition from rival firms, just as in case of developed economies, they adopt product differentiation and market segmentation strategy in a big way.

This does not mean that MNCs do not involve equity investment. Since the financial sector is strong as well as the return from the investment is handsome, the entry mode with equity investment is also significant. Moreover, in recent years, mergers and acquisitions have become a more common mode of entry.

As far as operating strategy is concerned, MNCs find ample freedom. There are a large number of offshore assembly units in at least some of the emerging market economies. It is because these countries enjoy the advantage of cheap labour and at the same time have the developed infrastructure required for industrial activities. But MNCs face tough competition from rival firms, just as they do in case of developed economies. This is why they adopt product differentiation and market segmentation strategy in a big way, as they have been adopting in case of a developed host country.

16.5 TRANSITION ECONOMIES

> **Transition economies** are countries shifting from a centrally planned economic system to a market based economic system.

Transition economies are mainly the economies of central and eastern Europe and the Baltic countries and the countries, carved out of the former Soviet Union, now known as the Commonwealth of Independent States (CIS). Some of them are also in Asia, the most important among them being China, Vietnam, and Cambodia. In some cases, the transition began earlier, in the 1970s and the 1980s, but in majority of them, the move towards transition began in the 1990s. While some of the countries have witnessed consistent growth, others had to face growth reversal. In many, the economy is too weak to have a successful transition and to involve itself greatly in international business.

16.5.1 Early Experiences

> **Glasnost** refers to reforms in the erstwhile Soviet Union for freedom of expression.

> **Perestroika** refers to economic reforms in the erstwhile Soviet Union.

The former Soviet Union and its allies continued to remain under the influence of communism for decades and remained practically isolated from the growing magnitude of international business. With excessive dependence on the public sector and with huge expenditure on defence, the rate of economic development and standard of living was low in many cases. The centralised planning mechanism failed to bear desired fruits. A couple of countries, namely. Poland and Hungary, began reforming the economic system as back as in the 1970s and the 1980s. In the former Soviet Union, it was President Gorbachev who initiated reforms in the mid and late 1980s. **Glasnost** encouraged open political discussion and freedom of expression, while **perestroika** implied major economic reforms. Beginning from 1988, individuals were allowed to set up enterprises, although in the service sector only. The economic reforms did not face much resistance as the communist party was not against it. The year 1989 was probably the last year representing the old system for the entire region. This was the year when the officially measured output had peaked in the former Soviet Union and in many other countries of this group.

16.5.2 Reforms during 1990s

The reform process in CIS and other east European countries was characterised by wide ranging political reforms. Western governments too participated in a big way. However, the success rate varied from one country to the other. In Poland, Hungary, and the Czech Republic, the success rate was comparatively high in view of the fact that they had allowed foreign investment during the final years of communist regime. The bureaucracy was honest and efficient and the general public supported the reforms. On the contrary, CIS member countries had to face serious economic problems. Most of them did not have supportive infrastructure for making the reform a success.

Whatever might be the rate of success, the process of reform mainly incorporated:

1. Price liberalisation measures
2. Monetary and fiscal stabilisation
3. Liberalisation of the external sector
4. Creation of the private sector

The price stabilisation schemes embraced, among other things, withdrawal of subsidies that could ensure competition. But it led to inflation, especially in Russia and other CIS countries, where shortages had prevailed.

The monetary and fiscal stabilisation programme included mainly tax reforms and reduction in the level of government expenditure so as to limit the fiscal deficit within a reasonable range. In Russia, budgetary deficit was met through central bank lending, but this caused inflation. In Hungary and Poland, it was met through the issue of government securities to the public. The government got the funds as well as excess money supply was mopped up.

The reforms in the external sector was brought about through import liberalisation, through exchange rate rationalisation and through conclusion of Bilateral Investment Treaties (BITs) and Double Taxation Treaties (DTTs). In the Czech Republic, currency convertibility was introduced in 1995, but in other countries overvalued currency and scanty foreign exchange reserves came in the way.

Last but not least, the private sector was encouraged and restrictions on FDI inflow were lifted. However, the approach to privatisation differed in different countries. In Hungary, the sale of an enterprise to foreign investors was common and at the same time, private sector investment was encouraged through the provision of incentives. In the Czech Republic, the pace of privatisation was faster than in Hungary. Joint ventures were more common and not the outright sale of the enterprise to foreign investors. In Poland, public sector units were converted into limited liability companies and then these companies represented the interest of domestic/foreign investors. In the beginning, the pace of privatisation was slow because private sector entrepreneurs did not have enough money to invest. But in 1995, with the creation of privately managed national investment funds, the pace turned rapid. In Russia, the process was not very successful in view of retention of control by the government. Moreover, as Harrison *et al* (1999) point out, privatisation process was overshadowed by corruption at the bureaucratic level.

The figures in Table 16.5 confirm wide variation in four transition economies. The per capita income varied from $5,780 in Russia to 21,470 in Czech Republic in 2006. The growth rate varied during 2005–06 from 4.2 per cent to 7.3 per cent. The trade figures during 2006 (export + import) was the lowest at $188 billion in Czech Republic compared to $468 billion in Russia. Similarly, FDI/GDP ratio in 2007 too varied from 25.1 per cent in Russia to as large as 70.6 per cent in Hungary. All this shows that the features and pace of transition has been different in different countries of this region.

Table 16.5 Economic Indicators in Select Transition Countries

Country	*Per capita income in 2006 $*	*Growth rate % in GDP in 2005–06*	*Export in 2006 $ billion*	*Import in 2006 $ billion*	*FDI stock/ GDP ratio %*
Czech Republic	21,470	6.2	95.106	93.198	57.7
Hungary	18,290	4.2	73.719	76.514	70.6
Poland	14,830	5.9	109.731	124.178	33.8
Russia	5,780	7.3	304.520	163.867	25.1

Source: *1. World Development Report, 2008*
2. World Investment Report, 2008

16.5.3 International Business Strategy in Transition Economies

The entry and operating strategy of MNCs in these countries depends on how far the process of transition has been successful. MNCs are not normally interested in countries where the supportive infrastructure is still not developed and where sufficient income has not been generated to give boost to the demand. MNCs are interested in others that have shown consistent growth. Statistics show that these countries have been capable of generating a large volume of trade and also that they have attracted a good amount of FDI. However, the early phases of transition carried high business risk. As a result, MNCs moved to these countries with the minimum possible equity capital (Rivoli and Salorio, 1996).

As far as entry strategy is concerned, MNCs have normally gone for joint ventures. The reason is that despite the move towards privatisation, the government is still in favour of maintaining control over private enterprises and free play of MNCs is still remote. In case of joint ventures, both technical and financial collaborations are common. The former is common because these countries only have an obsolete technological base and they are eager to have new and updated technology. Financial collaborations are common because they lack the required foreign exchange. They get it through financial collaboration, which involves transfer of capital.

MNCs have normally gone for joint ventures and free play of MNCs is still remote.

The entry of MNCs are largely found in the consumer goods segment as there is still shortage of consumer goods. The purpose is primarily to cater to the domestic consumers in the host country. Moreover, the domestic market is more profitable than exports.

However, there are still many challenges facing MNCs. The rules and regulations are still cumbersome. MNCs have to go through a number of procedural formalities for entry as well as for operation. Trade restrictions are common and it is still the governmental organisations that control a large part of foreign trade. Restrictions in respect of the convertibility of the domestic currency exist. Consumers enjoying subsidies for decades are not in favour of the market determined price, which is usually higher. The bureaucratic set up has not kept abreast of the changing scenario. The supply of managerial expertise has not picked up. These are some of the challenges that MNCs have to take into account while entering these countries and beginning their operation. However, there is a large area that can be explored for the purpose of international business, especially in case of transition economies that have joined the European Union recently.

> The entry of MNCs are largely found in the consumer goods segment as there is still shortage of consumer goods.

SUMMARY

- Since economic and socio-economic indicators differ widely between the developed market economies and the developing countries, and also among the different groups of developing countries, the same international business strategy cannot be applied to all host countries.
- Developed countries are characterised by a high income level, quality oriented consumption pattern, rich financial and technological resources, and the minimum of regulations and restrictions. MNCs rate them high as they find their environment congenial for entry and operation. But, at the same time, MNCs have to face strong competition from rivals. In order to maintain an edge over their rivals, they adopt, among other things, cost minimisation, product differentiation, and a market segmentation strategy. If the host country is a member of any regional grouping, such as the EU, MNCs have to consider additionally the rules and regulations of the regional grouping.
- The developing world has various sets of countries ranging from low-income to middle-income and high income countries. There are 48 least developed countries where economic and socio-economic indicators are very poor. MNCs do not prefer them for operation, unless these countries offer an abundance of natural resources for exploitation. Again, tax haven countries have attracted MNCs to pool their funds and to enjoy the benefit of a very low rate of taxes.
- There is also other group of countries that are known as emerging market economies. They are in many respects similar to developed market economies, providing unrestricted entry to MNCs. Transnational companies get an additional benefit of cheap labour and so they have gone for offshore assembly operations on a large scale in these countries.
- Last but not least, there are also transition economies making a shift from centralised planning to a market-based system. In cases where the transition process has been

successful, MNCs have moved in a big way. However, they do not commit too much financial resources in the earlier phase of operation in view of the large business risk there. The operating strategy is greatly focussed on meeting the demand of domestic consumers rather than on exporting goods.

Review Questions

1. Explain what distinguishes a developed market economy from a developing economy.
2. What are the challenges faced by MNCs in a developed market economy? What strategy do they follow while operating there?
3. How do MNCs operate in a tax haven country?
4. In what way are the emerging market economies similar to developed market economies? What type of strategy do MNCs follow in an emerging market economy?
5. What do you mean by transition economy? Discuss the entry and operating strategy of MNCs moving to these countries.

Study Topic

The 2008 International Financial Crisis and its Impact on International Business of Different Sets of Countries

The international financial crisis of 2008 was primarily the outgrowth of the sub-prime mortgage crisis in the USA. A continued escalation in the real estate prices for a decade or so and then a sudden and drastic drop in those prices during 2007 made the collateral of the home loans sub-prime. There were large defaults that in turn led to huge bank losses and put abnormal pressure on the functioning of the banks. The losses on this account were expected for over $400 billion, over one-half of which was to be borne by banks and other highly leveraged financial institutions. For each dollar of loss, these institutions had to shrink their balance sheet by $10 to $25 with the result that their lending was to be squeezed for over $2 trillion (*www.livemint.com*). All this had a spill-over effect in the form of dwindling currency, an economic recession and subdued activities in the financial market of the USA.

It is true that the immediate impact fell on the financial markets, but the impact spilled over gradually to the different sectors of the economy. In the beginning, the foreign institutional investors pulled back their funds from the financial market in order to salvage the banks in which they had a stake. The pull-back had a demonstration effect. The other investors turned hesitant to make any investment that led in turn to the emergence of the liquidity crisis. The economic activities remained starved of the required funds. As a result, the performance of different sectors fell far down. The growth rate in the economy plummeted. The fall in income and thereby in demand for spending was a natural corollary. In such a situation, it was not possible for the international business to remain aloof of these trends. Those economies that had maintained an open economic policy were hit hard. Thus, the crisis emerging in the USA spread over to different parts of the globe.

Shrinking World Trade

The shrunk income led to lower demand for imports. At the same time, lower availability of funds entailed on the capacity to export. Both the exports and imports slackened during 2008. The annual growth in the world trade (at constant prices) plummeted from 6.0 per cent in 2007 to 2.0 per cent in 2008. The respective figures for the US exports were 7.0 in 2007 and 5.5 in 2008. For its import, they were 1.0 in 2007 and (–)4.0 in 2008. The fall was recorded also in the growth rate of EU's export and import. For the export, the fall was recorded from 3.5 per cent to zero per cent. For the import, it was from 3.5 to (–)1.0 per cent. The downtrend was not limited to the industrialised countries. In EMEs also, the situation was not different. The growth rate in Chinese export and import dropped from 19.5 per cent to 8.5 per cent and from 13.5 per cent to 4.0 per cent, respectively. In case of India, the respective figures for export were 13.0 and 7.0 per cent and they were 16.0 and 12.5 per cent for imports. This is not all. Based on the trends, the growth rate in the world trade was to drop by 9.0 per cent in 2009.

Table 1 Annual change in merchandise trade at constant prices

Per cent

Country	*Export*		*Import*	
	2007	2008	2007	2008
World	6.0	2.0	6.0	2.0
USA	7.0	5.5	1.0	–4.0
EU	3.5	0.0	3.5	–1.0
China	19.5	8.5	13.5	4.0
India	13.0	7.0	16.0	12.5

Source: *WTO, Press Release*, 24.3.2009

The impact of the international financial turbulence was not limited to trade in merchandise. The trade in services too was the victim. The annual growth rate of world trade in services fell from 19.0 per cent in 2007 to 11.0 per cent in 2008. The growth rate of export of services in case of the USA fell from 16.0 per cent in 2007 to 10.0 per cent in 2008. In imports, the drop was recorded from 9.0 to 7.0

per cent. In case of the EU, the respective figures were 21.0 and 0.0 per cent, and 19.0 and 10.0 per cent.

Table 2 Annual change in services trade at constant prices

Per cent

	Export		*Import*	
	2007	2008	2007	2008
World	19.0	11.0	19.0	11.0
USA	16.0	10.0	9.0	7.0
EU	21.0	10.0	19.0	10.0

Source: *WTO, Press Release*, 24.3.2009

Squeezing FDI

Besides trade, FDI too suffered a blow from the international financial crisis. The global inflow of FDI shrank by 21.0 per cent—from $1,833.3 billion in 2007 to $1,449.1 billion in 2008. The developed countries experienced a greater squeeze of 32.7 per cent—from $1,247.6 billion to $840.1 billion during the above period. In case of the EU, it was a drop of 30.7 per cent—from $804.3 billion to $557.4 billion. In other developed countries, the percentage fall was lower.

The FDI flow into developing countries, on the other hand, increased by 3.6 per cent—from $499.7 billion to $517.7 billion. However, the rate of increase was lower than in 2007. The geographic pattern was heterogeneous. Except for West Asia where the inflow plummeted by 21.3 per cent, there was an increase in all other regions varying between 3.3 and 12.7 per cent. As far as India is concerned, there was an increase of 59.9 per cent—from $23.0 billion in 2007 to $36.7 billion in 2008.

Table 3 Changes in FDI inflow during 2008 over 2007

Billions of US Dollar

Region/ Country	*FDI Inflow*			*Cross-border M&As*		
	2007	2008	% change	2007	2008	% change
World	1,833.3	1,449.1	–21.0	1,637.1	1,183.7	–27.7
Developed countries	1,247.6	840.1	–32.7	1,454.1	981.8	–32.5
EU	804.3	557.4	–30.7	782.0	506.4	–35.2
US	232.8	220.0	–5.5	379.4	314.9	–17.0
Japan	22.5	17.4	–22.6	21.4	19.1	–10.8

Billions of US Dollar

Region/ Country	*FDI Inflow*			*Cross-border M&As*		
	2007	2008	% change	2007	2008	% change
Developing countries	499.7	517.7	3.6	152.9	177.0	15.7
Latin America & Caribbean	126.3	142.3	12.7	30.7	29.5	–3.8
West Asia	71.5	56.3	–21.3	30.3	31.5	4.0
South, East & South-east Asia	247.8	256.1	3.3	81.5	89.4	9.7
South-east Europe & CIS	85.9	91.3	6.2	30.1	25.0	–17.0
India	23.0	36.7	59.9	5.6	11.2	100.8

Source: *Compiled from UNCTAD Press Release*, 19.1.2009

When one analyses the cross-border M&As exclusively, it is evident that the international financial crisis affected them adversely. On the global level, there was a downturn of 27.7 per cent in 2008 over 2007. In this case too, the developed countries suffered a greater shock as the fall was recorded at 32.5 per cent. In case of EU, it was still greater at 35.2 per cent. On the contrary, the developing countries as a whole experienced a rise in cross-border deal in value terms of 15.7 per cent in 2008 over 2007. In India, this percentage was as big as 100.8. However, the Caribbean and Latin American countries and the South-east Europe and CIS witnessed a fall in such deals in value terms.

QUESTIONS

1. What led to the international financial crisis?
2. In what way was the international financial crisis related to the international business?
3. Comment on the extent of the influence of international financial crisis on the world trade and investment.

REFERENCES

Book

Harrison, A. L. *et al* (2001), *International Business: Global Competition from a European Perspective* (Oxford: Oxford University Press).

Journals and Report

Ramamurti, R. (2001), "The Obsolescing Bargaining Model? MNC-Host Developing Country Relations Revisited", *Journal of International Business Studies,* XXXII (1), 23–40.
Rivoli, P. and E. Salorio (1996), "Foreign Direct Investment and Investment under Uncertainty", *Journal of International Business Studies,* XXVI (2), 335–58.
Sharan, V. (1985), "Internationalisation of Third World Firms: An Indian Case Study", *International Marketing Review*, II (Summer), 63–72.
The Economist (1990), "America and Japan: The Unhappy Alliance", February 17, 21–24.
The World Bank (2006), *World Development Report: 2007* (New York: Oxford University Press).
UNCTAD (2006), *The Least Development Countries: 2006*, Geneva.
—— (2006), *World Investment Report: 2006*, Geneva.
Xiao, G. (2004), "Peoples Republic of Chine's Round tripping FDI: Scale, Causes and Implications", ADB Institute Discussion Paper No. 7, Manila.

SELECT FURTHER READINGS

Behrman, J. and R. Grosse (1990), *International Business and Governments* (Columbia SC: University of South Carolina Press).
Blanchard, O. (1997), *The Economics of Post-communist Transition* (Oxford: Clarendon Press).
Child, J. and D. K. Tse (2001), "China's Transition and Its Implications for International Business", *Journal of International Business Studies,* XXXII (1), 5–21.
Roy, H. and K. Calder (1984), *The Eastasia Edge* (New York: Basic Books).

* Zürich is the largest city in Switzerland and the capital of the canton of Zürich. It is a leading financial centre and global city. The high quality of life has been cited as a reason for economic growth and the most important sector in the economy of Zürich is the service industry, which employs nearly four fifths of workers. Other important industries include light industry, machine and textile industries and tourism.

MODEL QUESTION PAPERS

MODEL QUESTION PAPER I

M.B.A. DEGREE EXAMINATION

INTERNATIONAL BUSINESS MANAGEMENT

Time: Three hours *Maximum : 100 marks*

Note: 1. Answer any Four full questions from Q. No. 1 to 7
2. Q. No. 8 is compulsory.

1. (a) What do you mean by globalization of markets? (03 Marks)
   (b) Discuss various drivers of globalization. (07 Marks)
   (c) Explain various modes and entry strategies of international business. (10 Marks)

2. (a) What are values and norms? Explain. (03 Marks)
   (b) Discuss the different economic systems. Explain their implications on international business. (07 Marks)
   (c) Explain the various determinants of culture. (10 Marks)

3. (a) Explain the concept of mercantilism. (03 Marks)
   (b) Discuss the theory of absolute advantages, with an illustration. (07 Marks)
   (c) Explain the Porter's diamond model. (10 Marks)

4. (a) What is a free trade? (03 Marks)
   (b) Explain the different instruments of trade policy. (07 Marks)
   (c) Explain the various arguments for government intervention in international trade. (10 Marks)

5. (a) What do you mean by regional economic integration? (03 Marks)
   (b) Discuss the different levels of economic integration. (07 Marks)
   (c) Explain the political structure of the European union. (10 Marks)

6. (a) Explain the meaning of the term"Multinational corporation". (03 Marks)
   (b) Discuss the arguments for centralization and decentralization of a multinational corporation. (07 Marks)
   (c) Explain the formal integration mechanisms used for achieving coordination between headquarters and subsidiary units. (10 Marks)

7. (a) What do you mean by foreign exchange market? (03 Marks)
   (b) Explain the terms spot exchange rate, forward exchange rate and currency swap. (07 Marks)
   (c) What is WTO? Explain the role of WTO. (10 Marks)

8. CASE STUDY

MTV has emerged as a significant global medium, with more than 375 million households in 164 countries subscribing to its services. The reason for its success is simple – MTV offers consistent, high quality programming that reflects the tastes and life styles of young people. While admired to its global reach, MTV has drawn, the ire of critics, who accuse the teen-savvy network of being a cultural imperialist, trampling regional and local values and preferences.

MTV has shrewdly deflected such criticism and downplays its role as an exporter of American culture. To cater to the 80% of MTV viewers who reside outside the United States, the company has a policy of 70% local content. Early in MTV's international expansion in the 1980, using American imagery was trendy, but 1990's brought about a need to give the brand a local imagery.

Digital compression allows the number of services offered on satellite feed to be multiplied. MTV has used this capacity to complement pan regional programming and play lists, customizing them to local tastes in key areas. For example, MTV Asia launched MTV India and has five hours of India specific programming during the 24 hours satellite feed to the sub-continent.

For various reasons, MTV is now embarking on a strategy to develop shows for more than one overseas market at a time. MTV has a big infrastructure of 76 channels in 17 languages and feels that it is time to leverage resources and develop programming that can not only cross borders but even have global appeal.

Under the new plan, local managers will not give up the power to make local programming decisions. The goal is to encourage cooperation among country units to develop new ideas that can be used in multiple countries.

MTV's goal is to derive 40% of revenue from overseas markets in the medium-to-long term future. The trick will be to create programming that both individual and multiple markets can relate to. Expensive new cross-border shows can easily fail because of cultural differences and various traditions.

QUESTIONS

(a) Expensive new cross-border shows can easily fail because of cultural differences and various traditions. Do you agree with the statement? Explain. (05 Marks)
(b) Explain the strategies adopted by MTV to reduce cultural risk. (05 Marks)
(c) Explain why MTV has given local managers power to make local programming decisions. (05 Marks)

MODEL QUESTION PAPER II

M.B.A. DEGREE EXAMINATION

International Business Management

Time: Three hours *Maximum : 100 marks*

Note: 1. Answer any Four full questions from Q. No. 1 to 7
2. Q. No. 8 is compulsory.

1. (a) What is meant by 'Command economy'? (03 Marks)
(b) "The study of international business has no relevance for individuals, who are going to work for small firms". Do you agree with this statement? Justify your answer. (07 Marks)
(c) Briefly explain the theory of comparative advantage. How does this theory support the case for free trade? (10 Marks)

2. (a) What is 'Dumping' ? What are its forms? (03 Marks)
(b) Explain Michael Porter's Diamond theory of national competitive advantage. (07 Marks)
(c) Discuss tariff and non – tariff barriers as instruments of trade policy. (10 Marks)

3. (a) What is a turnkey project? (03 Marks)
(b) Write short notes on' Leontief Paradox'. (07 Marks)
(c) Explain briefly, the various modes of international business. (10 Marks)

4. (a) Describe the drivers of international business. (03 Marks)
(b) "Firms should not be investing abroad, when there is a need for investment, to create jobs at home". Discuss. (07 Marks)
(c) Explain briefly with examples, the different levels of economic integration, amongst the nations. (10 Marks)

5. (a) What is social mobility? How does it influence the international business? (03 Marks)
(b) Write a note on TRIPS and TRIMS. (07 Marks)
(c) Discuss details of NAFTA. (10 Marks)

6. (a) What are the elements of competitive strategy that affect the manufacturing strategy in international business? Explain. (03 Marks)
(b) Discuss what is meant by external debt of a country and the various ways to measure it. (07 Marks)
(c) Briefly describe various methods of payment, in international business. (10 Marks)

7. (a) What is meant by Balance Of Payments (BOP)? (03 Marks)
   (b) What kind of location(s) should a firm seek for its plant(s) internationally? (07 Marks)
   (c) Explain the basic manufacturing philosophies for MNEs. (10 Marks)

8. CASE STUDY

Dixon Ticonderoga—Victim of Globalization?

Dixon Ticonderoga is one of the oldest public companies in the United States. The company's flagship product is the No. 2 yellow pencil, introduced in 1913, known to almost everyone. With annual income of a little over $100 million, Dixon is the second largest pencil manufacturer in the country. For most of its history, Dixon has been a prosperous company, but the 1990s proved to be a very difficult decade. It's not that people are no longer buying pencils – in fact, demand for pencils in United States has soared. Americans bought an estimated 4.2 billion pencils in 1999, a 53% jump from 1991. But an increasing proportion of these have been from China.

The problem began in the early 1990s, when Chinese manufacturers entered the market, with low priced pencils. The pencil industry fought back, arguing that the Chinese were dumping pencils in the U.S. market, at below cost. In 1994, when foreign pencil imports accounted for 16% of the market, the United States enacted heavy anti-dumping duties on Chinese pencils, effectively raising their price. Imports fell dramatically, but the Chinese kept making better, cheaper pencils, and after a couple of years, imports returned to the levels attained before the imposition of duties. It did not stop there. In 1999, U.S. manufacturers shipped some 2.2 billion pencils domestically, down from 2.4 billion in 1991. During that time, imports jumped from 16% to over 50% of the market, with China leading the importers. The pencil industry continued to lobby for protection, and in mid – 2000, the United States renewed duties on pencil imports from China, imposing import tariffs as high as 53% on some brands.

In the meantime, to try to meet the foreign competition on price, Dixon experimented with cheaper ways to make pencils. The company tried to make pencils out of recycled paper cases, but quickly backed away after the product jammed pencil sharpeners. Then the company looked at the wood, used to make pencils – traditionally California incense cedar – and decided it was too expensive for all, but the company's premium brand. Now the company uses the lower priced Indonesian wood. As an additional cost reduction measure instituted in the late 1990s, Dixon started to buy the erasers for its pencils from a Korean supplier, rather than the traditional U.S. supplier.

Despite these steps, the company continued to lose share to imports, and by 1999 it was beginning to lose money, too. Realizing that it could bring in finished pencils cheaper, than it could manufacture them in the United States, Dixon established a manufacturing operation in Mexico. The original idea behind the Mexican operation was to supplement its U.S. manufacturing, but in late 2000 the company realized, it needed to be more aggressive and switched many of its processes from the United States to Mexico, cutting some 40 jobs at its U.S. facility. In another strategic move, in 2000 Dixon created a wholly – owned subsidiary at China. This subsidiary manufactures wooden slats for pencil manufacturing. The slats are then sent to Mexico, where they are turned into pencils. The lead for the pencils (carbon) is still made in the United States by Dixon, while the erasers are shipped from Korea. The Chinese subsidiary is also responsible for the production and distribution of certain products that are sold internationally.

QUESTIONS

(a)	Why do you think the Chinese apparently have a cost advantage in the production of pencils?	(05 Marks)
(b)	Why has Dixon become a multinational? What are the economic benefits to Dixon of becoming an international business?	(05 Marks)
(c)	Do you think, lobbying the U.S., government to impose anti-dumping duties on imports of pencils from China is a good way to protect the American jobs? Who benefits most form such duties, and who loses?	(05 Marks)
(d)	What alternative policy stance might the government take?	(05 Marks)

MODEL QUESTION PAPER III

M.B.A. DEGREE EXAMINATION

International Business Management

Time: Three hours *Maximum : 100 marks*

Note: 1. Answer any Four full questions from Q. No. 1 to 7
2. Q. No. 8 is compulsory.

1.	(a)	Why do firms become multinational enterprises?	(03 Marks)
	(b)	Explain the various entry strategies of international business.	(07 Marks)
	(c)	Describe the cost comparative advantage theory with a suitable example.	(10 Marks)
2.	(a)	What is the significance of international business environment?	(03 Marks)
	(b)	Explain briefly the levels of economic integration amongst nations with examples.	(07 Marks)
	(c)	Discuss the propositions and implications of Raymond Vernon's international product life cycle theory.	(10 Marks)
3.	(a)	Explain Leontiff Paradox.	(03 Marks)
	(b)	How do different political systems affect the international business?	(07 Marks)
	(c)	Describe the political and economic arguments for intervention in trade.	(10 Marks)
4.	(a)	Write a short note on GATT.	(03 Marks)
	(b)	Describe the determinants of culture and its influence on international business.	(07 Marks)
	(c)	What is NAFTA? Who are the parties to the agreement? What are the contents and the objectives of the agreement?	(10 Marks)
5.	(a)	What are the functions of WTO?	(03 Marks)
	(b)	What is a multinational corporation? How is it different from a global company, international company and transnational corporation?	(07 Marks)
	(c)	Discuss the importance of SAARC for the health of Indian economy.	(10 Marks)
6.	(a)	Distinguish between balance of trade and balance of payments.	(03 Marks)
	(b)	Explain the role of ethics in international business.	(07 Marks)
	(c)	Discuss the various instruments of international trade policy.	(10 Marks)

7. (a) What is currency convertibility? (03 Marks)
   (b) Explain the functions and finding strategies of word bank. (07 Marks)
   (c) Describe the various aspects of headquarters and subsidiary relations in MNC. (10 Marks)

8. CASE STUDY

It all started with the takeover of Tetly in 2000. Then became Daewoo commercial (2004); Tyco Global (2004); Natsteel (2005); Teleglobe (2005); Brunner Mond (2005); Millenium steel (2006); Eight O' clock (2006); Ritz carlton (2006); Corns (2007); PT Bumi Resources with 30 percent stake (2007); and General Chem Partners (2008). The latest in the acquisition spree is the takeover of Jaguar and Land Rover (March 2008). The stake involved in all these buyouts is a whopping Rs. 81,527 crore.

It is a moment of glory which any Indian should be proud of – particularly because of the timing of Jaguar and Land Rover deal. Compared to the Corns deal, which carried a price tag of Rs. 53,850 crore, the buyout of the two brands, with Rs. 9223 crore, is miniscule. But what makes it breathtaking? First, the deal has been struck when the world economy is dipping and companies everywhere are facing falling fortunes. Viewed against this background, Tata deal demonstrates how resilient and vibrant Indian companies are. Second, the brands acquired are no mean "also rans". Jaguar and Land Rover are world's top class brands with a long history. Land Rover was born in 1880s and Jaguar in 1930s. Third, the acquisition of the two brands marks a paradigm shift of the balance of power in financial and technological arenas. The power is shifting from west to east. Finally, from now onwards, Tata's name will be seen and heard in the premier markets of Europe and Americas.

Sentiments apart, challenges before Tatas are going to be hard nuts. Tata motors, the flagship company of Tatas which is deemed to have acquired Jaguar and Land Rover, has no experience in managing luxury brands. The Indian car maker is well known for offering rugged cheap cars, buses and trucks suiting to Indian buyers and Indian roads. Its costliest passenger vehicle, the Safari Dicor, is about Rs. 1 lakh cheaper than the least expensive Land Rover. Will Tata motors be able to sustain the quality of the two brands?

The Indian market for the luxury cars is growing but is still small. The cheapest luxury cars are available in India, such as Honda Siel cars India Ltd.'s Accord, cost around Rs.15.5 lakhs. It is believed that some 5000 luxury cars are sold in India every year. True, some Indians do own and use high-end foreign brands, such as BMW, Mercedes-Benz, Audi and Lxus, but their numbers are still in the thousands, a fraction of the 1.4 million cars sold each year in the country's exploding market of automobiles. Nor the markets in Europe and America are promising because of the recession in their economies.

Trade unions of 16000 – strong ford work force in UK, have in a way paved the way for Tata takeover. It is, these unions that, in principle, picked up Tatas as their first "preferential choice" as the bidder. The Tatas have now assured job security and better working conditions to British work force. This led the British worker feel reassured about his future, under the Indian management.

Ford has agreed to use finance arm to help its dealers and Tatas sell their cars for another 12 months. It will also supply engines and transfers some intellectual properties and offer engineering support. Inspite of this, Tata might be required to pump in more money to develop new and improved products. Also, refinancing dept is likely to pose a big challenge to Tata Motors. It might find difficult to raise long-term debt in current environment. While

Tatas managed to get a bridge loan of $3 billion for a period of 12 months, it may have trouble raising debt to repay, as lenders have grown jittery over extending credit.

Thus the road ahead is humpy and bumpy. But going by the clout enjoyed by Tata Motors, the challenges may not be insurmountable. Tata Motors is a $ 5.5 billion company, is the leader and second largest in passenger vehicles. The company is world's fifth largest medium and heavy commercial vehicle manufacturer.

The company's 22000 employees are guided by the vision to be"best in the manner in which we operate, best in the products we deliver and best in one value system and ethics".

Established in 1945, Tata Motors' presence cuts across the length and breadth of India. Close to four million Tata vehicles ply on Indian roads, since 1954. Its manufacturing base is spread across Jamshedpur, Pune and Lucknow, supported by a nation-wide dealership, sales, services and spare parts network of over 2000 touch points.

The foundation of the company's growth over the last 50 years is a deep understanding of economic stimuli and customer needs, and the ability to translate them into customer desired offerings through leading edge R and D with 1400 engineers and scientists. The company's research centre has enabled pioneering technologies and products. The company today has R and D centres in Pune, Jamshedpur, Lucknow, in India and in South Korea, Spain and UK.

With the announcement of the launch of 1 lakh rupee car Nano, Tata Motors has gained the attention of people around the world.

QUESTIONS

(a) Do you think the challenges listed above are genuine? If yes, how do you think Tatas will face them? (05 Marks)

(b) With the widest range of cars (from the cheapest to the costliest) under its belt, how do you think Tata Motors will manage and sustain? (05 Marks)

(c) Comment on the strategy of Tata group in acquiring companies for growth. (05 Marks)

MODEL QUESTION PAPER IV

M.B.A. DEGREE EXAMINATION

International Business Management

Time: Three hours *Maximum : 100 marks*

Note: 1. Answer any Four full questions from Q. No. 1 to 7
2. Q. No. 8 is compulsory.

1. (a) What is globalisatoin? (03 Marks)

(b) Describe the various entry modes to international business. (07 Marks)

(c) Explain the cost comparative theory, with a suitable example. (10 Marks)

2. (a) What is the market economy? (03 Marks)
   (b) Explain the various cultural aspects in international business environment. (07 Marks)
   (c) Describe in brief, the Michael Porter's diamond theory. (10 Marks)

3. (a) What are the anti-dumping policies? (03 Marks)
   (b) Describe briefly, the levels of economic integration, with an example. (07 Marks)
   (c) Explain the different political systems affecting the international business environment. (10 Marks)

4. (a) Explain the trading blocks. (03 Marks)
   (b) Explain the objectives and functions of WTO. (07 Marks)
   (c) What are the factors to be considered for a company to locate its manufacturing activity, so as to minimize the costs and improve the quality, so that company can be globally competitive? (10 Marks)

5. (a) What is global marketing? (03 Marks)
   (b) What is NAFTA? Explain the contents and objectives of the agreement. (07 Marks)
   (c) Explain GATT, with the origin and objectives. (10 Marks)

6. (a) What is IMF? (03 Marks)
   (b) Explain the various aspects of headquarters and subsidiary relations in multinational corporation. (07 Marks)
   (c) Discuss the importance of SAARC for the health of Indian economy. (10 Marks)

7. (a) What is the currency convertibility? (03 Marks)
   (b) Explain in detail, the functions of foreign exchange market. (07 Marks)
   (c) Describe the ethical dimensions in international business. (10 Marks)

8. CASE STUDY

   Analyse the following case and answer the questions given at the end :

"Impact of Chinese Industries on Indian Market"

"If you can't beat them, join them."If you don't want the Chinese to get you, get them. Even as the scare of low-cost, high quality Chinese imports flooding in has sent one section of India inc., scurring for cover and protectionism, organized players in the home appliances industry are taking advantage of it. Instead of lobbying to keep out the Chinese, companies like Bajaj electricals and Jaipan industries are switching over to Chinese manufacturers to source products for the Indian market. And they are not alone.

Chinese products are expected to have a significant impact on the consumer electronics segment like televisions and refrigerators, in addition to several other products, in the next few years. Industry experts say that, industry majors like LG, Samsung etc., would exit the television and other consumer durable business in the long run and focus on digital products, making way for the Chinese makes. Consumer electronics experts predict that, unless the Indian policies change, Indian players will increasingly switch over to marketing Chinese products in India.

Bajaj electricals is bringing in a range of products such as fans and toasters, into India, at cheaper prices and providing the brand support and after sales service here. Home appliances like toasters, irons, fans and microwave ovens, are being brought in from China at rates, which are cheaper by as much as 35–50 percent vis-à-vis other Indian makes.

Jaipan industries, a leading local player in non-stick utensils, toasters, rotimakers, mixer-grinder, is also working on the same lines. These companies, like many others, are sourcing form China, mainly because of the quality and cost advantages. With China becoming a part of WTO, this is only just a sign of things to come.

QUESTIONS

(a) How do you define the strategy "If you can't beat them, join them", in the contest of competition between India and China?

(b) What do you think are the limitations of Indian manufacturers in comparison with Chinese?

(c) Do you think it is unethical to join hands with Chinese?

(d) What do you think would be the impact of Chinese entry into WTO on Indian manufacturing sector? (20 Marks)

ANSWERS TO MODEL QUESTION PAPER I

Ans. 1(a): Globalisation is a process through which different economies get inter-woven by way of international trade and investment. They become an integral part of the world economy.

Globalisation is a move towards open economic policies lifting up the restriction imposed on the international economic flows that in turn leads to a sharp increase in the quantum of such flows.

Ans. 1(b):

Drivers of Globalization

Technological drivers: Technology shaped and set the foundation for modern globalization. Innovations in the transportation technology revolutionized the industry. The most important developments among these are the commercial jet aircraft and the concept of containerisation in the late 1970s and 1980s. Inventions in the area of microprocessors and telecommunications enabled highly effective computing and communication at a low-cost level. Finally the rapid growth of the Internet is the latest technological driver that created global ebusiness and e-commerce.

Political drivers: Liberalized trading rules and deregulated markets lead to lowered tariffs and allowed foreign direct investments in almost all over the world. The institution of GATT (General Agreement on Tariffs and Trade) 1947 and the WTO (World Trade Organization) 1995 as well as the ongoing opening and privatization in Eastern Europe are only some examples of latest developments.

Market drivers: As domestic markets become more and more saturated, the opportunities for growth are limited and global expanding is a way most organizations choose to overcome this situation. Common customer needs and the opportunity to use global marketing channels and transfer marketing to some extent are also incentives to choose internationalization.

Cost drivers: Sourcing efficiency and costs vary from country to country and global firms can take advantage of this fact. Other cost drivers to globalization are the opportunity to build global scale economies and the high product development costs nowadays.

Competitive drivers: With the global market, global inter-firm competition increases and organizations are forced to'"play" international. Strong interdependences among countries and high two way trades and FDI actions also support this driver.

Globalisation is a move towards open economic policies lifting up the restriction imposed on the international economic flows that in turn leads to a sharp increase in the quantum of such flows. The different economies, driven by international trade and investment and aided by information technology, turn this way closely inter-woven and become an indispensable part of the world economy. However, the literature on the subject interprets globalisation in three different ways. First of all, the hyper-globalist school feels that globalisation leads to a single global economy transcending and integrating the different economic regions. Supported by technological sophistications and market integration, globalisation leads to denationalisation of strategic economic activities. In the sequel, the flow of global finance exercises a decisive influence on the location and distribution of economic power and wealth. The economy turns borderless. A particular economy has no option rather than to accommodate global market forces.

Secondly, the sceptical view, on the contrary, does not interpret globalisation in terms of emerging and unified international economic activity. It believes in inter-nationalisation where the increasing flow of economic resources takes place among well-defined national economies. In this case, national economic policies remain effective to influence the flow of economic resources.

Thirdly, there are transformationalists who interpret globalisation in terms of a process or a set of processes rather than an end-state. The process embodies a shift in the spatial organisation of social relations from national to transcontinental pattern of human organisation. The economic activities stretch out across frontiers, regions and continents. There is growing interconnectedness among different regions through flow of trade and investment. The flow of trade and investment is so intensive and extensive that the impact of local developments spills over to remotest corners of the globe. In other words, the boundary between the domestic and global affairs turns blurred. The international organisations support and regulate such activities. The transformationalists go on arguing that the very scale of human social organisation extends the reach of power nations across the world's major regions.

Whatever might be the interpretation, the process of globalisation has many dimensions. It has multiple causes and multiple results. There are benefits of globalisation. But it is also true that this process leads sometimes to lack of homogenisation across countries because global economic transactions are influenced by disparity in the economic and political conditions in different countries. However, the divergence is corrected through the process of globalisation depending on the nature of this process.

Ans. 1(c):

Determinants of Entry Mode

A firm adopts various modes for its entry into business transaction across borders. Which particular mode a firm should adopt depends, at least, upon four factors. They are:

1. Subservience of the corporate objective
2. Corporate capability
3. Host country environment
4. Perceived risk

When the objective of a firm spreading internationally is simply to earn profits and not necessarily to maintain control over the entire operation, only trading activities will serve its purpose. But if control is the primary objective, the investment mode, and especially investment in a wholly owned foreign subsidiary, will be the best course of action. Thus, a particular mode is selected in tune with the very objective of the firm behind international business.

The corporate objective shaping the entry mode must be supported by the company's capability to select the particular entry mode. For example, if the company' financial position is not strong enough to make large investment abroad, it will be difficult for the company to make such investment even if it is desirable on the grounds of fulfilling corporate objectives. Thus, the choice of the entry mode depends, to a considerable extent, on the capability of the company going international.

The host country environment too influences the entry mode. It includes many aspects, such as the regulatory environment; cultural environment; political and legal environment; economic environment, especially the size of the market and the production; the shipping cost, and so on. When the managers of a firm are not well acquainted with the values, beliefs, customs, language, religion, and other aspects of the target market, the firm does not prefer to invest there. Rather, it limits its business only to trading activities in such cases. The company starts operation in the host country only when the managers are acquainted with the cultural environment in the host countries. Again, if the political conditions are not congenial in the target market or if the legal formalities are lengthy, large investment is often avoided. Sometimes, when the host government bans certain types of investment, foreign investors cannot make such investments even if they wish to make them. In India, in 1973, the government had fixed a ceiling on foreign equity participation. Foreign companies that did not favour the ceiling dismantled their operations in India. Yet again, it is the size of the market in the host country that influences the entry mode of foreign firms. When the market is large and ever expanding, foreign firms prefer to enlarge their involvement through investment. But if the size of the market remains small, trade is the only suitable option. Last but not least, if the cost of production in the host economy is lower than in the home country, the host country attracts foreign investment. In fact, this is one of the important reasons that companies from the developed world have moved to developing countries. If the shipping cost is also low, it is possible that the firm may shift the entire production process to the low cost host country and may ship the output back to the home country for meeting the domestic demand. If, on the other hand, the host country does not represent cost effectiveness, trading remains the only way out.

Besides these factors, it is risk involved in the different modes of entry that influences the decision of a firm in this respect. Different modes involve varying degrees of risk. The lesser the amount of control in a particular mode, the lower the risk. If trading activities are ranked on the lowest rung of the ladder from the viewpoint of control, it carries the least risk. On the contrary, if investment in a wholly owned subsidiary possesses the largest element of control, it is supposed to be highly risky. Thus, the choice of the entry mode depends, among other things, upon the control-risk consideration of the firm.

Trade Mode

Direct and Indirect Export

The trade mode presents the first step in international business. It includes export and import. Export may be either direct or indirect. In case of direct export, a company takes full responsibility for making its goods available in the target market by selling directly to the end users, normally through its own agents. Direct export is feasible when the exporter desires to involve itself greatly in international business; and at the same time possesses the capacity to do so. There are also some commodities where direct export is more convenient. They are, for example, air crafts and similar industrial products.

When the exporting company does not possess the necessary infrastructure to involve itself in direct exporting, indirect export takes place. It takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end-users in the target market.

It is a fact that the nature of intermediary differs in direct export or import from that in an indirect export and import. However, when one talks about intermediaries, export management companies (EMCs) and trading companies cannot be ignored. When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Sometimes it acts as an agent for one client and as a distributor for the other. Trading companies, on the other hand, provide services to exporters, in addition to exporting activities, such as storage facilities, financing services, and so on. These companies originated in Europe but are now common in Japan and South Korea.

Apart from the intermediaries, there are trade facilitators. They are independent entities supplying information and knowledge to the exporter but definitely not participating in the transactions. They exist both in the public and private sectors. Various commodity boards and export promotion councils can be grouped as trade facilitators. There are also government organisations working under the Ministry of Commerce, such as trade development authority, that act as trade facilitator.

Counter-trade

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods. In this type of external trade, a seller provides a buyer with deliveries and contractually agrees to purchase goods from the buyer equal to the agreed percentage of the original sale contract value. Counter-trade is classified broadly as:

1. Commercial counter-trade such as classical barter, counter-purchase and pre-compensation.
2. Industrial counter-trade such as buy-back agreements, develop for import arrangements, and framework agreements.

Commercial Counter-trade: Classical barter is one of the oldest modes of commercial counter-trade. It involves a once-only exchange of goods on the terms agreed upon between the buyer and the seller. The quantum, quality, and value of goods to be exchanged are well defined. Naturally, the trade flows in one direction are fully compensated by those in the reverse direction. There is no need for bridging finance. Negotiating parties are often governments. The exchange of Iranian oil for New Zealand's lamb or the exchange of Argentine wheat for Peruvian iron pillets are examples of classical barter.

In case of counter-purchase, which is also known as parallel barter, the contracts are often separate for import and export. The type and price of goods traded are generally not specified at the time of signing of the contract. The exporter of goods agrees to accept, in return, a wide range of goods from the importer. Balancing of the value of export and import is done every three to five years. If the two sides are not equal, the balance is paid in cash.

In case of pre-compensation, the value of exports is entered into an evidence account and imports are made on that basis. This means that payments for imports are not made immediately.

Industrial Counter-trade: Being a form of industrial counter-trade, buy-back agreements normally involve a larger amount corresponding to the sale of industrial equipment or turnkey plants in exchange for the products manufactured by these industrial plants. Naturally, the contract period is longer, varying from 10 to 20 years. The United Nations Economic Commission for Europe mentions the case of Austria selling pipeline equipment and related material to the then Soviet Union so that the latter could develop certain gas fields and could pipe a part of the output back to Austria. In case of developing countries, such agreements are common as they suffer from the technology gap on a large scale.

Develop-for-import arrangements are also a variant of the buy-back agreement where the exporter of the plant and machinery participates in the capital of the importing firm and, thereby, takes a share in the profits thereof. This means the involvement of the exporting firm is deeper than in a general buy-back arrangement. Japanese investment in an Australian firm developing gunpowder copper mine is an apposite example.

Framework agreements are the long term protocol or bilateral clearing agreement normally concluded between governments. Trade is balanced after a long period as mentioned in the agreement. If the trade is not equal in value, the debtor sells the agreed upon commodity in the international market and the creditor is paid off. For example, Mexico sold cocoa to the United States of America to pay for its excess import from Malaysia.

Growth of Counter-trade: Barter trade was the mode of international trade in the eighteenth century when there was no sufficient monetisation. During the twentieth century, especially during the inter-War years, the West german government had resorted to bartering for strategic raw material. In the post-War period, counter-trade was initiated on a large scale by East European countries while trading with western countries and developing countries because they did not relish multilateral trade. In the wake of the oil crisis of 1970s, oil was exchanged for Soviet arms. The share of counter-trade in the world trade rose from around two per cent in 1964 to 20–30 per cent by the late 1980s, although accurate estimates cannot be made on account of unavailability of figures. There is also region-wise difference as far as the volume of counter-trade is concerned.

Contractual Entry Modes

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm. But in this case, the secrecy of technology is not maintained and the firm's ownership advantage is always at stake. Thus, in order to maintain the ownership advantage, a firm passes on the technology only to its own subsidiary located abroad. But if the host government does not permit any foreign investment, the subsidiary of the firm in that host country cannot exist. Transfer of technology through contractual deals is the only way out. The contractual entry mode, often known as technical collaboration or technical joint-venture, is very common. It is preferred in many cases where:

1. The licensor does not possess enough capital for investment, nor does it possess the requisite knowledge of the foreign market for the purpose of export.
2. The licensor wishes to exploit its technology in the foreign market.
3. The licensor finds the host country market too small to make any investment for reaping economies of scale.
4. Nationalisation is feared in the host country.
5. Foreign investment in the host country is restricted.

Technical collaboration normally takes four forms. They are:

1. Licensing
2. Franchising
3. Management Contracts
4. Turnkey Projects

These different forms of the contractual mode are explained here (Figure 1).

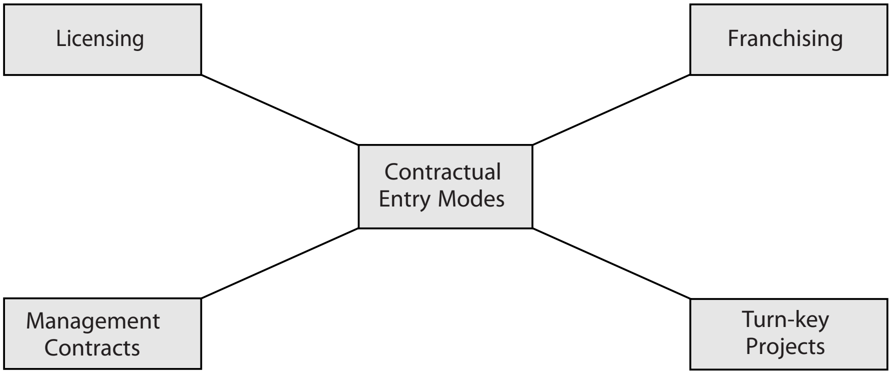


Figure 1: Different Forms of Contractual Entry Mode

Licensing

Nature and Forms: Licensing is an arrangement by which a firm transfers its intangible property such as expertise, know-how, blueprints, technology, and manufacturing design to its own unit, or to a firm, located abroad. It is also known as technical collaboration. The firm transferring technology, and so on is known as the licensor. The firm receiving technology, at the other end, and so on is known as the licensee. The arrangement is meant for a specific period. The licensor gets technical service fee from the licensee. The licensee, on the other end, does not have to make a huge investment on research and development. Thus both the parties reap the benefits of licensing.

A licence can be exclusive, non-exclusive, or cross. In an exclusive licence, the arrangement provides exclusive rights to produce and market an intangible property in a specific geographic region. On the contrary, a non-exclusive licence does not grant a firm sole access to the market. The licensor can grant even more companies the right to use the property in the same region. Cross licensing is reciprocal where intangible property is transferred between two firms, both of them being the licensor and the licensee at the same time. In the early 1990s there was cross licensing between Fujitsu of Japan and Texas Instruments of the USA. Both the companies used each other's technology for a given period.

Franchising

In this form of technical collaboration, the franchiser is the entrant and the franchisee is the host country entity. The franchisee makes use of intellectual property rights, like trademarks, copyrights, business know-how, managerial assistance, geographic exclusivity, or of specific set of procedures of the franchiser for creating the product in question. In the literature available on this subject, a few experts have established similarities between licensing and franchising. Oman suggests that "franchising may be regarded as a particular type of licensing". Root too feels that franchising is a form of licensing in which the franchiser licenses a business system and other property rights to a franchisee. On the contrary, there are views to suggest that these two are different. Perkins is of the view that while franchising encompasses transfer of the total business function, licensing concerns just one part of business, including transfer of right to manufacture or distribute a single product or process. Again, franchising differs from licensing in that the former gives a company greater control over the sale of the product in the target market. When the franchisee fails to abide by the set of procedures, the franchiser takes back the franchise. Yet again, licensing is common in manufacturing industries, whereas franchising is more common in service industries where the brand name is more important.

Franchising may take different forms. In direct franchising, the franchiser frames policy and monitors and directs the activities in each host country from its home-country base. But in case of indirect franchising, there are sub-franchisers between the original franchiser and the host country units. The sub-franchiser possesses the exclusive right to exploit the original franchiser's business package within a defined geographic area.

Management Contracts

In a management contract, one company supplies the other with managerial expertise. Such agreements are normally signed in case of turnkey projects where the host country firm is not able to manage day to day affairs of the project, or in other cases where the desired managerial capabilities are not available in the host country. The transfer includes both technical expertise and managerial expertise.

Turnkey Projects

In a turnkey project agreement, a firm agrees to construct an entire plant in a foreign country and make it fully operational. It is known as turnkey because the licensor starts the operation and hands over the key of the operating plant to the licensee. Agreements for turnkey projects normally take place where the initial construction part of the plant is more complex than the operational part. Such projects are either self-engineered or made to specifications. In case of the former, it is the licensor who decides the design of the project. In the latter, it is the licensee who takes such decision. In both cases, the contract involves either a fixed price or a cost-plus price. In a fixed-price contract, the risk of cost over-runs lies with the licensor.

Foreign Investment

Foreign Portfolio Investment and Foreign Direct Investment

Foreign investment takes two forms. One is foreign portfolio investment, which does not involve the production and distribution of goods and services. It is not concerned with the control of the host country enterprise. It simply gives the investor, a non-controlling interest in the company. Investment in securities on the stock exchanges of a foreign country or under the global depository receipt mechanism is an example of foreign portfolio investment. On the other hand, foreign direct investment (FDI) is very much concerned with the operation and ownership of the host country firm. It is often said that even in case of FDI, if a company acquires around 10 per cent of the equity in a foreign firm, it should be treated as foreign portfolio investment as the investing or the acquiring firm does not have a say in the affairs of the target company.

FDI is found in form of either green-field investment (GI) or mergers and acquisitions or brown-field investment. Green-field investment takes place either through opening of branches in a foreign country or through foreign financial collaborations—meaning investment in the equity capital of a foreign company, in the majority of cases a newly established one. If the firm buys the entire equity shares in a foreign company, the latter is known as the wholly-owned subsidiary of the buying firm. In case of purchase of more than 50 per cent shares, the latter is known as a subsidiary of the buying firm. In case of less than 50 per cent purchase, it is known simply as an equity alliance. Sometimes an equity alliance is reciprocal, meaning that both companies invest in the equity capital of each other.

M&As are either outright purchase of a running company abroad or an amalgamation with a running foreign company. The term "brown-field" investment is used to denote a combination of green-field investment and M&As. It is found in cases when a firm acquires another firm; and after the acquisition, it completely replaces the plant and equipment, labour, and product line.

Again, FDI is either horizontal or vertical. Horizontal FDI is said to exist when a firm invests abroad in the same operation/industry. Suzuki's investment in India to manufacture cars is an example of horizontal FDI. On the contrary, vertical FDI is found when a firm invests abroad in other operations either with a view to have control over the supply of inputs or to have control over marketing of its product. British Petroleum and Royal Dutch Shell have invested abroad in the production of oil.

Ans. 2(a): Values are the belief and norms prevalent in a particular society. They determine largely the attitude and behaviour of individuals towards work, status, change, and so on. In some societies, where income and wealth are emphasised upon, people work for more hours in order to earn more. On the contrary, in societies where leisure is preferred, people work only for limited hours, just to meet their essential wants necessary for survival. However, the preference for leisure can change if people are influenced by the demonstration effects of higher living standards.

Ans. 2(b):

Forms of Economic System

There are primarily two forms of economic systems, that is, the centrally planned economy (CPE) and the market-based economy. The two forms lie on the two extremes and so the third form, known as the mixed economy, is a compromise between the two. In other words, the system of mixed economy possesses the features of the first two systems. It is a more common form of the economic system insofar as neither of the first two systems is found in the purest form.

A CPE is defined as an economy where decisions regarding production and distribution of goods is taken by a central authority, depending upon the fulfilment of a particular economic, social, and political objective. The government designs the investment and coordinates the activities of the different economic sectors. Ownership of the means of production and the whole process of production lies in the hands of the government. The former USSR and East European countries were apposite examples of this type of economic system.

At the other extreme, in the market based economic system, the decision to produce and distribute goods is taken by individual firms based on the forces of demand and supply. The means and factors of production are owned by individuals and firms and they behave according to the market forces. The firms are quite free to take economic decisions. They take such decisions for the purpose of maximising their profit or wealth. Consumers are sovereign, they are free to decide what they want to buy. This is nothing but economic freedom, which manifests normally in freedom from governmental restrictions on, or interference with, economic activities. The United States of America and West European countries are examples of the market based economic system.

Between the two extremes, there is the mixed economic system. As mentioned just above, there is no country that represents any of the two systems in its purest form. In China, which is a CPE, the government has demarcated an area, known as special economic zone where private initiatives are allowed. On the other hand, in the United States of America, which has been a staunch advocate of the free-market economy, some economic activities are owned and regulated by the government. Thus, mixed economy, which represents a mixture of state control on one hand and the economic freedom of entrepreneurs and consumers on the other is the natural outcome. In other words, one can say that it is a system that involves greater governmental intervention than found in a market based economy or that relies more on market forces than experienced in a centrally planned economy. To cite an example, the Indian economy represents a mixed economic system. Economic activities that are fraught with social considerations are owned and regulated by the government. The others are owned and performed in the private sector.

Preliminary Economic Indicators

Whenever a firm moves abroad for international business, it takes into account some preliminary economic indicators of the host country at a particular point of time, as well as over a particular period. These economic indicators help the firm know, among other things,

1. The size of demand for its product,
2. The expected cost of production and the net earning, so as to ascertain its competitive edge, and
3. Whether it will be able to smoothly repatriate its earnings back to its home country.

The size of demand depends inter alia upon the level of income and its distribution, the propensity to consume, and rate of inflation. The cost of production depends upon the availability of human and physical resources; development of infrastructure; and on the fiscal, monetary, and industrial policies. Similarly, smooth repatriation of income and profit depends upon the strength of the external sector.

Level of Income and Its Distribution

The size of demand for a product is dependent upon the size of income of its buyer. This is why a firm doing business with a foreign country evaluates the income level existing in that foreign country. The level of income is normally represented by the gross national product (GNP) or gross domestic product (GDP). GDP is the aggregate of the total output of goods and services provided during a year. If one adds to it the income from abroad, the sum is known as GNP. However, strictly speaking, GNP or GDP in absolute terms does not carry much meaning insofar as per capita income may be smaller and the per capita purchasing power may be lower if population in that country is very large, despite its large GDP. Thus the income level in a particular country should better be evaluated in terms of per capita income. It is on this basis that the World Bank has classified different countries as:

1. low income country
2. middle income country
3. high income country

The per capita income levels in these different groups of countries is as follows:

Country classification	*Per capita income based on 2007 dollar*
Low-income country	$ 935 or less
Lower middle-income country	$ 936 3705
Upper middle-income country	$ 3706–11455
High-income country	$ 11456 or more

Based on the level of income and some other economic and socio-economic indicators, one can group the countries into: (1) developed and (2) developing. The industrialised countries of North America, Western Europe, Asia, and the Australian continent are designated as developed countries. In the developing world, some of the countries have made fast strides towards industrialisation and have witnessed a high growth rate. They are known as newly industrialising countries (NICs) or emerging market economies. The others are the less developed countries in general. However, at the wrong end of the less developed countries are the least developed countries, presently numbering 50, that have very poor economic and socio-economic indicators.

Low income level means low purchasing power. Thus, multinational firms market or manufacture low price goods in such countries. The scope for a costly product in such countries is very limited. This is why a luxury car manufacturer will move to a country that is either a middle income country or a high income country.

However, on the basis of experience, it can be said that multinational firms also often move to low income countries for manufacturing high price goods. There are two reasons for this. First, when the population is quite large and the wage level in general is very low in view of the large supply of labour. In other words, MNCs move to such countries to take advantage of their cheap labour force, which has a positive impact on the cost of production. Secondly, high price items can have a market if the national income is not equally distributed. Suppose a country has a population of 500 million and 10 per cent of the population share 60 per cent of the national income. This means that there are 50 million persons that can buy even costlier goods. If this is the case, it is easy for multinational firms to market or to manufacture high-price goods in such countries. On the contrary, if the income is equally distributed, they will have the scope for marketing only low price goods. In brief, it is not simply the per capita income level that influences the international business decision, but more importantly, it is the distribution of the national income that is relevant in this context.

The distribution of income in the host country is important for multinational firms for attempting market segmentation. They can market a simple version of a particular product at low prices among low-income consumers. At the same time, they can market a sophisticated version of the same product at very high price among the wealthy people in the same country. This is possible if national income is highly unequally distributed.

Inflation

It is a fact that the size of demand for a product depends not only on the level of income and its distribution, but it is also subject to the level of inflation in the country. It is because the purchasing power of the consumers depends on their real income. The higher the level of inflation, the lower is the real income and the purchasing power of the consumers. Thus, when a multinational firm decides to set up a manufacturing unit in a foreign country, it has to take into account the rate of inflation in the host country.

The rate of inflation is also important from the viewpoint of cost of production. If it is high in the host country, the production cost of the host country plant will be higher. The price may be competitive for the host country market because the other manufacturers in that country too face the same problem. But exports from the host country to markets with a lower rate of inflation will definitely be affected on account of higher cost. However, if the multinational firm exports its products to the high-inflation country instead of setting up of a manufacturing unit there, the exports may have a competitive edge in view of the lower rate of inflation at home. When one examines the impact of inflation on the foreign trade of the country, it should not be done in isolation of the changes in the exchange rate. It is because the changes in the exchange rate may nullify the effects of inflation rate changes.

Again, inflation has varying impact on different sections of the society. Fixed-wage earners are the worst hit. Inflation causes diminution in their purchasing power. But, on the other hand, the business community is well off. Profit is higher, which means nothing but rise in purchasing power. If the multinational firm pinpoints this particular consumer group and manufactures goods to meet its specific demand, it would be a profitable venture.

Besides the level of inflation, the way in which the monetary authorities tackle the growing inflation is also important. If they raise interest rates to bring down the rate of inflation, the rate of industrial growth would be adversely affected on account of availability of costly funds. Industrial stagnation may also be a factor inhibiting inflow of foreign investment.

Consumption Behaviour

Consumption behaviour or the pattern of consumption influences the demand for a particular product to a sizeable extent. In a low income country, where the consumers care more for price rather than for the quality of the goods, multinational firms find it very difficult to sell their improved quality, high price products, even if they are for the daily use of common people.

Again, in rural areas of less developed countries, people attach importance to saving or to real estate investment. As a result, their marginal propensity to consume is very low. This has a bearing on the demand for general consumption goods. Yet again, in less developed countries, it is found that a large segment of income is spent on food and housing, with the result that the demand for other goods languishes considerably.

In fact, the decision to save more or to consume more depends on the quality of population or on the social security schemes provided by the government. If the population is literate, it will have a different approach towards consumption. People will demand good quality products even if they are available at higher prices. On the contrary, uneducated people are price conscious and not quality conscious. Again, in absence of social security schemes, people prefer saving in order to meet exigencies, the propensity to consume is naturally very low. But where such schemes are ample, the propensity to consume is high. Thus, whenever a multinational firm selects a particular host country, it certainly takes into account the consumption pattern and the quality of the population.

Availability of Human and Physical Resources

Easy availability of human and physical resources makes the manufacturing process easier and at the same time lowers the cost of production so as to confer upon the firm a competitive edge. This is because if such resources are in abundance, they are available with no difficulty and at a lower cost.

It is not feasible for a multinational firm to transport the entire labour force from the home country. It normally employs its own men at the very senior positions and employs the rest of persons from the local manpower market. But this is possible only if skilled manpower is available locally. This is why a multinational firm looks at the availability of technical and managerial personnel whenever it analyses the economic environment in the host country.

Besides the issue of human resources, it is also necessary for multinational firm to assess the availability of physical resources. By physical resources, we mean various inputs necessary for manufacture. Moreover this fact lies at the core of the locational theory of foreign direct investment. Indian firms have moved to Sri Lanka for the manufacture of rubber products and to Nepal for the manufacture of herbal products. This is primarily because the required raw material is available in abundance in the host country.

Network of Infrastructure

Building up of supportive infrastructure is a prerequisite for the development of industry. For successful operation, a firm needs uninterrupted power supply, good road/rail link, efficient communication system, and so on. This is why multinational firms must take into account the availability of infrastructure while analysing the economic environment in a host country. When US economic aid began flowing to developing countries for financing infrastructure projects as back as in the early 1950s, the primary objective was to pave the way for US investment in those countries. Presently, in India, an important reason for the gap between the approval of foreign direct investment and its actual inflow is the lack of supportive infrastructure.

Fiscal, Monetary, and Industrial Policies

Various forms of economic policies pursued in the host country make the economic environment either congenial or act as a deterrent to the operation of a multinational firm. A firm never relishes a high rate of corporate income tax, as it lowers the net profit. Sometimes firms employ various techniques, for example transfer pricing devices, to lower the incidence of tax, but the management is not very easy. However, there are often tax treaties between the home government and the host government, which help reduce the burden of tax and so they act as a motivating factor for foreign direct investment. Similarly, in some countries, in order to attract foreign direct investment, tax holiday schemes are provided to the foreign investor for a specific period. This too lowers the burden of taxes.

The case of excise duties too is similar as such duties cause cost appreciation. In some countries, they are levied on the amount of output. In others, they are levied on the amount of value addition. So firms have to see which type of duties are less harmful to their interests.

Besides the corporate income tax and excise duties, there is tariff or import duty, such duties are either ad valorem, based on the value of the import, or specific, based on the quantity of the specific import, or mixed, combining both of them. Whatever may be the form of import duty, it raises the price of the imported item in the hands of the consumers. Thus, whenever a firm exports goods to a foreign country, it has to assess the size of such duty. In case of foreign manufacturing too, this duty prevailing in the host country affects the cost of production if various inputs are imported either from the home country or from any other country. However, in case of a free trade area or a customs union, when tariff is abolished from the intra-region trade, the abolition encourages intra-region international business.

The fiscal policy does not deal simply with various taxes and duties, but it is more concerned with the budgetary deficit or fiscal deficit. If the fiscal policy in a host country is not effective in curbing high fiscal deficit, it will have a dampening impact on the monetary sector, external sector, and many other sectors and thereby will adversely influence the interest of the multinational firm.

With regard to the monetary policy, it is found that it has a definite influence on the money supply and the rate of inflation, rate of interest and the cost of credit, and on the general health of the financial sector. If the monetary policy is such that it keeps inflation within manageable limits, keeps the interest rate low, and strengthens the health of financial institutions and banks, credit availability for a firm will be easier and cheaper. All this will have a positive impact on the operational cost of the firm, which means greater competitive strength. A multinational firm may not be in a better position compared to other local firms as they too get easier and cheaper credit, but it will certainly be on a better footing compared to firms in other countries with not so effective monetary policies.

Again, one of the aspects of the industrial policy is related to the area where foreign investors can invest. If the policy is restrictive on this count, it permits foreign investors only into a very limited area of the industrial economy. On the contrary, a liberal policy environment helps attract foreign investment. India's industrial policy was made more liberal in 1991, with the result that large number of foreign investors came to invest in this country during the period of liberalisation.

Strength of External Sector

Multinational firms are greatly interested in repatriating profits to their parent unit. Repatriation is easier when the monetary authorities in the host country pursue a liberal policy in this respect. The policy is liberal only when the balance of payments position is strong enough and the size of foreign exchange reserves is comfortably large.

It is a fact that the majority of the developing countries face deficit on current account balance in view of the fact that their import needs are large and they face both demand constraints and supply constraints on their exports. Their invisible trade is not big enough to cover the trade deficit. However, in some cases, the current account deficit is met by capital account flows. Such flows are so large that they not only make up the current account deficit but also, after meeting such deficit, add to the foreign exchange reserves. This is found in cases where ample incentives are given to foreign investors and the foreign investors find a safe place to invest on account of congenial economic and political environment. Thus, when a multinational firm has to select a host country, it analyses the health of the external sector of the host country. It relies on various ratios, such as export-import ratio, current account balance/GDP ratio, or current receipt/GDP ratio, import cover of foreign exchange reserves in terms of the number of months, external debt/GDP ratio, debt service ratio, and so forth. The stronger the health, the better the economic environment and the greater the foreign investment.

Ans. 2(c):

Culture represents the entire set of social norms and responses that dominate the behaviour of persons living in a particular geographic or political boundary. It is a fact that cultural boundaries may differ from national/political boundaries because individuals with varying cultural backgrounds may reside in a particular nation. For example, Canada has at least three cultures—an Anglo culture, a French-speaking "Quebecois" culture and a Native American culture. Alternatively, individuals with similar cultural background may represent different countries. For example, Islamic culture is shared by the citizens of many countries in the Middle East, Asia, and Africa. Yet cultural boundaries and national boundaries are often equated.

Culture, represents the whole set of social norms and responses that shape the knowledge, belief, morals, attitude, behaviour, and the very way of life of a person or a group of persons. Culture is not in-born. It is acquired and inculcated. The inculcation of culture begins at the very birth of a person and lies below the level of conscious thought. This means that an individual is unaware of the learning process because he or she learns through seeing how others behave. The learning persists throughout his or her life and does not escape him/her entirely. It may be mentioned that culture is not specific to a single individual, rather it is shared by a group of persons. In fact, it is culture that enables persons to communicate with others and to distinguish between what should be done and what should not be done.

Elements of Culture

Based on the definition of culture, there are a few basic elements of culture. These elements are universal; meaning that they form the cultural environment of all societies. But, what is important is that they perform differently in different societies, leading ultimately to cultural diversity across different societies. Czinkota et al. list these elements as follows:

1. Language
2. Religion
3. Education
4. Attitudes and values
5. Customs
6. Aesthetics
7. Social institutions
8. Material elements

Language: Language is the medium through which message is conveyed. It may be verbal or non-verbal. The former includes the use of particular words or how the words are pronounced. The latter embraces the gestures through which feelings are expressed. When an international manager gives the instructions to his subordinates, who normally come from the host country, the instructions must be understood properly by the latter; or when the firm's salesmen tries to convince the consumers, the latter should follow the language of the former well. There is no problem if the language spoken in the home country and the host country is similar. But, normally, it is not.

Again, even if the language is the same in the two countries, it is possible that the same word or the same phrase carries different meanings in different countries. For example, the word, *homely* means friendly and comfortable in England but plain or even ugly in the United States. American brand names sometimes carry strange meanings when translated into other languages. American Motors' Matador became 'killer' in Spanish. DeVries feels that when legal contracts are formalised across national boundaries, they sometimes alter in character as well as language. It was the problem of language that compelled Close-up to change the name of its tooth paste as Klai-chid in Thailand so as to make the consumers aware of the product.

As far as the non-verbal language is concerned, it is also different in different countries. For example, Latin Americans prefer standing close to a person with whom they are talking, but this is not liked by the Americans or by Britons.

Religion: Religion is another element of culture. Irrespective of forms, religion believes in a higher power. It sets the ideals of life and thereby the values and attitude of individuals living in a society. These values manifest in individuals' behaviour and performance. Since different forms of religion differ in details, the attitude towards entrepreneurship or consumption, and so on varies among different societies practising different forms of religion or among different schools of the same religion. For example, protestants and catholics, both represent Christianity, but the former give weightage to accumulation of wealth, while the latter oppose it. Similarly, in Islam, prayers five times a day and fasting during *Ramzan* are emphasised upon, which in turn, effects productivity. Moreover, the *purdah* system discourages women moving out for work. Income in form of interest is also prohibited in Islam, which restricts spread of banking.

In Hinduism, the caste system comes in the way of the mobility of the work force as certain types of works are to be performed only by a certain caste. It was very rigid a few decades ago, but this factor has softened considerably in recent years. Similarly, Buddhism believes in spiritual achievement and not in material achievement and this has a dampening effect on entrepreneurship and profit making.

Education: The level of education in a particular culture depends primarily on the literacy rate and on enrolment in schools and colleges. This element has a close relationship with the availability of skilled manpower, availability of workers and managers who can be sent to the home country for training, production of sophisticated products, and with the adaptation of imported technology. If the level of education is high in a particular society, it is easy for multinational firms to operate there. It is because skilled manpower will be easily available, its training will be easy and the firm will be able to produce sophisticated goods. However, it is not only the level of education but also the pattern of education that is important. If the majority of persons in the host country are educated in the area of humanities or languages, they cannot be of as much use as those educated in the area of business studies or engineering.

Attitude and Values: Values are the belief and norms prevalent in a particular society. They determine largely the attitude and behaviour of individuals towards work, status, change, and so on. In some societies, where income and wealth are emphasised upon, people work for more hours in order to earn more. On the contrary, in societies where leisure is preferred, people work only for limited hours, just to meet their essential wants necessary for survival. However, the preference for leisure can change if people are influenced by the demonstration effects of higher living standards.

Again, the attitude towards social status is an important factor. Those who believe in higher social status spend even more; and to this end, they work more and earn more. For example, in Japan, youth pay a higher price for Levi's jeans because such jeans give them higher social status. It is the status that motivates individuals to opt for a particular branch of study. In less developed countries, bureaucracy is believed to the best profession. But in the United States of America and many other societies, business professionals have a higher social status.

Yet again, in some societies, the attitude of the individuals does not favour change. To this end, they like to protect their own culture with elaborate sets of sanctions and laws. This means that individuals who deviate from their own culture are punished under the law.

Customs: Customs and manners vary from one society to another. In the United States of America, silence is taken as negation, while it is not so in Japan. Similarly, Britons prefer instant coffee, while in the USA, ground coffee and instant coffee both are popular. Campbell's sells large cans of soup in Mexico in order to cater to the needs of large families, while in Britain, it is not so.

Aesthetics: Aesthetics is concerned with the sense of beauty, good taste, and with the particular symbolism of colours. Colour symbolism, for example, is very important. Black is the symbol of mourning in the United States of America and the United Kingdom, while it is white in Japan and some other Far Eastern countries. Green is popular in Islamic countries. Thus, while designing the advertisement programme or while packaging products, we must take into account these facts so that the aesthetic sensibilities of the people are not marginalised and product marketing is smooth.

Social Institutions: Social institutions form an integral part of culture. They are concerned mainly with the size of the family and social stratification. In the United States of America and the United Kingdom and most other developed countries, the size of the family is small, comprising of a husband, wife, and children. But in many other countries, especially in developing ones, grand parents too are a part of the family. In yet another group of countries, the family is larger, comprising of cousins, aunts, and uncles. In India, the joint family system is still prevalent.

Similarly, in some societies, social stratification is very much apparent. Persons of different strata, may be in a single factory or in a single office, enjoy different facilities. For example, the more senior an officer, the more spacious his cabin is. On the other hand, there are countries where no such discrimination is practised. All the employees in a factory, irrespective of rank, eat lunch in the same dining hall.

Social stratification is also apparent in people's buying habits. Low income persons use low price products, while the same need of the affluent class is catered with a sophisticated variety of goods.

Material Elements: Last but not least, this aspect of material culture cannot be ignored. Material culture is related to the economic, financial, and social infrastructure and to objects and things enjoyed by people. For example, Germans like beer, while the French like wine. So marketing of wine in Germany will be a bad proposal. In Japan, due to lack of space and the prevalence of small homes and apartments, marketing of lawn mowers will be a futile attempt. Similarly, in less developed countries, where power shortage is common, power generating machines can easily be marketed. But in developed countries, where the economic infrastructure is developed, marketing of time saving home appliances will turn out to be a good proposal. Social infrastructure manifests in form of housing, health and other facilities, and the level of education. If the consumers are uneducated, their consumption pattern will be different. In such cases, computer marketing will not be successful. Again, in cases where financial infrastructure is lacking, foreign companies will have to arrange funds, not from the host country financial market, but, from elsewhere. Thus, these varying elements of culture lead to cultural diversity among different societies.

Ans. 3(a): Mercantilism stretched over about three centuries ending in the last quarter of the eighteenth century. It was the period when the nation-states were consolidating in Europe. For the purpose of consolidation, they required gold that could best be accumulated through trade surplus. In order to achieve trade surplus, the governments monopolised the trade activities, provided subsidies and other incentives for export. On the other hand, it restricted imports. Since the European governments were mainly the empire, they imported low-cost raw material from the colonies and exported high-cost manufactures to the colonies. They also prevented colonies from producing manufactures. All this was done in order to generate export surplus. Thus, in short, increasing gold holding through export augmentation and import restriction lay at the root of the Mercantilist theory.

Ans. 3(b): Adam Smith was one of the forerunners of the classical school of thought. He propounded a theory of international trade in 1776 that is known as the theory of absolute cost advantage. He is of the opinion that the productive efficiency among different countries differs because of diversity in the natural and acquired resources possessed by them. The difference in natural advantage manifests in varying climate, quality of land, availability of minerals, of water and other natural resources; while the difference in acquired resources manifests in different levels of technology and skills available. A particular country should specialise in producing only those goods that it is able to produce with greater efficiency, that is at lower cost; and exchange those goods with other goods of their requirements from a country that produces those other goods with greater efficiency or at lower cost. This will lead to optimal utilisation of resources in both the countries. Both the countries will gain from trade in so far as both of them will get the two sets of goods at the least cost.

Adam Smith explains the concept of absolute advantage in a two-commodity, two-country framework. Suppose Bangladesh produces 1 kg of rice with 10 units of labour or it produces 1 kg of wheat with 20 units of labour. On the other hand, Pakistan produces the same amount of rice with 20 units of labour and produces the same amount of wheat with 10 units of labour. Each of the countries has 100 units of labour. Equal amount of labour is used for the production of two goods in absence of trade in the two countries.

In absence of trade, Bangladesh will be able to produce 5 kg of rice and 2.5 kg of wheat. At the same time, Pakistan will produce 5 kg of wheat and 2.5 kg of rice. But when trade is possible between the two countries, Bangladesh will produce only rice and exchange a part of the rice output with wheat from Pakistan. Pakistan will produce only wheat and exchange a part of the wheat output with rice from Bangladesh. The total output in both the countries will rise because of trade. Bangladesh, which was producing 7.5 kg of food-grains in absence of trade, will now produce 10 kg of food-grains. Similar will be the case with Pakistan where 10 kg of food-grains will be produced instead of 7.5 kg (Table 1).

Table 1: Theory of Absolute Cost Advantage

Amount of Production in Absence of Trade			*Amount of Production after Trade*		
	Rice	*Wheat*		*Rice*	*Wheat*
Bangladesh	5 kg	2.5 kg	Bangladesh	10 kg	Nil
Pakistan	2.5 kg	5 kg	Pakistan	Nil	10 kg
Total output in two countries: 15 kg			Total output in two countries: 20 kg		

The theory of absolute cost advantage explains how trade helps increase the total output in the two countries. But it fails to explain whether trade will exist if any of the two countries produces both the goods at lower cost. In fact, this was the deficiency of this theory that led David Ricardo to formulate the theory of comparative cost advantage.

Ans. 3(c): It is a fact that Porter never focussed primarily on the factors determining the pattern of trade, yet his theory of national competitive advantage does explain why a particular country is more competitive in a particular industry. If, for example, Italy maintains competitive advantage in the production of ceramic tiles and Switzerland possesses the competitive advantage in watches, it can be interpreted that the former will export ceramic tiles and the latter will export watches and both of them will import those goods in which their own industry is not competitive.

Why is this difference? Porter explains that there are four factors responsible for such diversity. He calls those factors as the "diamond of national advantage". The diamond includes the following (Figure 2):

1. Factor conditions
2. Demand conditions
3. Related and supporting industries
4. Firm strategy, structure and rivalry

These factors have been more or less taken into account by the earlier economists. What is crucial in Porter's thesis is that it is the interaction among these factors that shapes the competitive advantage.

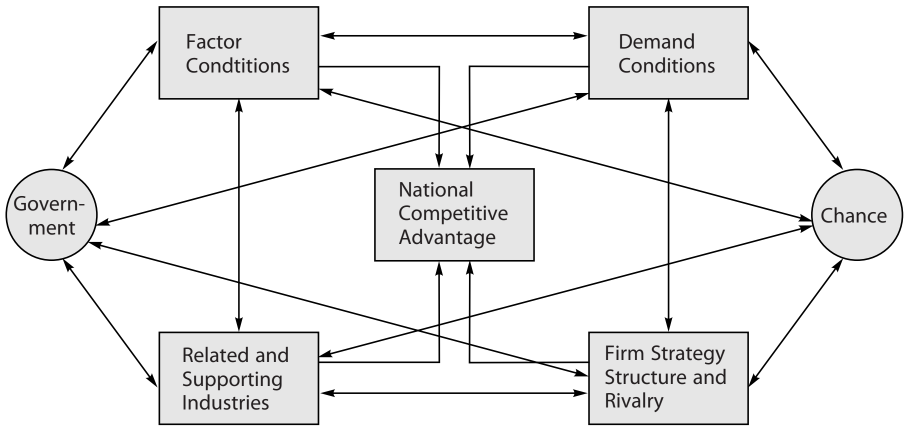


Figure 2: Porter's Diamond of National Advantage

Factor conditions show how far the factors of production in a country can be utilised successfully in a particular industry. This concept goes beyond the factor proportions theory and explains that availability of the factors of production per se is not important, rather their contribution to the creation and upgradation of product is crucial for the competitive advantage. This is possible if labour force is well-skilled and better-trained. Skill and training in Porter's view is an advanced factor which is essential for maintaining competitive advantage. If one says that Japan possesses competitive advantage in the production of automobiles, it is not simply because Japan has easy access to iron ore but this country has skilled labour force for making this industry competitive.

Secondly, the demand for the product must be present in the domestic market from the very beginning of production. Porter is of the view that it is not merely the size of the market that is important, but it is the intensity and sophistication of the demand that is significant for the competitive advantage. If consumers are sophisticated, they will make demand for sophisticated products and that in turn will help the production of sophisticated products. Gradually, the country will achieve competitive advantage in such production.

Thirdly, the firm operating along with its competitors as well as its complementary firms gathers benefit through close working relationship in form of competition or backward and forward linkages. If competition is acute, every firm will like to produce better-quality goods at lower cost in order to survive in the market. Again, if there is agglomeration of complementary units in a particular region, there may be strong backward and forward linkages. All this will help attain national competitive advantage.

Fourthly, the firm's own strategy helps in augmenting export. There is no fixed rule regarding the adoption of a particular form of strategy. It depends upon a number of factors present in the home country or the importing country and it differs from one point of time to the other. Nevertheless, the strategic decisions of the firm have lasting effects on their future competitiveness. Again, equally important is the industry structure and rivalry among the different companies. The greater the rivalry, the greater will be the competitive strength of the industry.

Besides the four factors, Porter gives weightage to a couple of factors such as, governmental policy and the role of chance of events. The governmental policy influences all the four factors through various regulatory/deregulatory measures. It can control the availability of various resources or change the pattern of demand through taxes, etc. It can encourage/discourage the supportive industries through various incentives/disincentives. Similarly, chance of events such as, war or some unforeseen events like inventions/innovations, discontinuities in the supply of inputs, etc. can eliminate the advantages possessed by the competitors.

However, there are various criticisms put forth against Porter's theory. First, there are cases when the absence of any of the factors does not influence much the competitive advantage. For example, when a firm is exporting its entire output, the intensity of demand does not matter. Secondly, if the domestic suppliers of inputs are not available, the backward linkage will be meaningless. Thirdly, Porter's theory is based on empirical findings covering 10 countries and four industries. Majority of the countries in the world have different economic background and do not necessarily support the finding. Fourthly, availability of natural resources, according to Porter, is not the only condition for attaining competitive advantage and there must be other factors too for it. But the study of Rugman and McIlveen shows that some of the Canadian industries emerged on the global map only on the basis of natural resource availability. Fifthly, Porter feels that sizeable domestic demand must be present for attaining competitive advantage. But there are industries that have flourished because of demand from foreign consumers. For example, a lion's share of Nestle's earnings comes from foreign sales. Nevertheless, these limitations do not undermine the significance of Porter's theory.

Ans. 4(a): Free trade refers to absence of restrictions on export and import. If regulation aims at *liberalisation of trade*, it is definitely a move towards *free trade*.

Free trade primarily leads to specialisation, which helps increase output and the gains from the increased output is shared by the trading partners. It may be noted that output can also be increased through acquiring greater resources or through improving the quality of the factors of production.

Free trade generates competition, which in turn promotes efficiency in production. Increased productive efficiency leads to improvement in quality and in lowering of prices. All this benefits both the producers and the consumers.

Free trade leads to the generation of economies of scale. There are some industries that can achieve minimum average cost only through a bigger amount of sale, which is possible only when goods are exported to a global market.

Free trade helps check inflation through the application of the one-price principle. It maximises the welfare of trading countries, and consequently, global welfare.

Ans. 4(b):

Instruments of Trade Policy

There are a number of tools that are applied by a government for regulating trade. More importantly, they are tariff. There are non-tariff barriers, such as quota, customs valuation, embargo and the technical barriers, such as classification, labelling requirements, testing standards, voluntary export restraints and buy-local legislation. Subsidy is another tool to augment export.

Tariff

Tariff means duty levied by the government on imports. When assessed on a per unit basis, tariff is known as specific duty. But when assessed as a percentage of the value of the imported commodity, tariff is called *ad valorem* duty. When both types of tariff are charged on the same product, it is known as compound duty. Sometimes tariff is imposed to counter unfair trade practices, such as subsidy of the trading partner. In such cases, tariff is known as countervailing duty. Whatever may be the form of tariff, it reduces the quantum of import as the imported product turns costlier after the imposition of tariff. How much deeper the effect of tariff will be on the import restriction depends not only on the nominal rate of tariff but, more importantly, on the effective rate of protection.

Effective rate of protection may be much lower/much higher than the nominal rate of tariff. This is because many goods are produced with imported raw material or intermediate products.

Quota

Quota is an instrument to put quantitative restrictions on import. It may take different forms. One is the outright limitation on the quantity of import. Limitation may be either a global one or specific to a country. For example, if the government permits the import of only 2,000 bicycles without mentioning a particular country, it will be global quota. But if the government limits the import of 500 bicycles from the USA, it will be country-specific quota or selective quota. Since the global quota is based on first-come-first-served, the importing country has to accept those supplies that are made earlier irrespective of their quality and source.

Sometimes, the government fixes quota for the import and at the same time imposes tariff. Up to the quota limit, the rate of tariff is lower, but if the imports are made beyond the quota, a higher rate of tariff is applicable for the additional import. The tariff-rate quota is a subtler form of quota that permits the import beyond the quota limit, although at a higher rate of tariff.

The other form of quota is import licensing requirement. If obtaining licence from the government to import a particular commodity is mandatory, the commodity can be imported only to the extent it is specified in the licence. The government issues licence for import based on the required size of import. It is true that the import licensing requirement is a less transparent form of quota than the outright limitation on the size of import, but it is a common instrument. By 1980s, it was used as a major tool for protecting industries in Mexico. In India too, it was used more frequently till 1980s.

Still the other form of quota is known as voluntary export restraint (VER). In this case, the exporting country is asked by the importing country to limit the supply of a particular commodity. The restriction is imposed by the exporting country and not by the importing country. There are many examples of VER negotiated by the USA to restrict the import of textiles, automobiles and other products from Japan, Korea and other countries.

Subsidies

Subsidies are other form of non-tariff barriers. Subsidies take many forms, such as cash assistance given by the government, tax concessions, loans at lower than market rate of interest arranged by the government and such others. In this way, they allow the domestic producers to produce at prices lower than warranted by the actual cost or profit considerations.

Domestic Subsidy: With domestic subsidy, inefficient producers begin production at a price compatible with the international price. As a result, domestic production rises and import falls with a given demand for the product.

Domestic subsidies are better than tariff and quota. It is because the subsidies do not force consumers to lessen their demand and there is no dead-weight loss in the form of consumption effect. But, at the same time, subsidies fall on the state exchequer and enlarge the fiscal deficit.

Export Subsidy: Export subsidy is confined to those producers that produce for export. In this case, the domestic price of the commodity is higher than the foreign price. It is true that the volume of export rises thereby increasing the total export earnings, but the net barter terms of trade worsens as a result of the fall in price.

Dumping

Dumping is a form of price discrimination in favour of foreign consumers. The same product is sold to foreign buyers at a lower price than what the domestic buyers have to pay. Dumping also occurs when goods are sold in the overseas market at a price below the average cost of production.

Dumping may take different forms depending upon the purpose for which it is done. The first is distress dumping or the sporadic dumping. In this case, a firm clears its unsold stock at a lower price in overseas market. It is true that it hurts the competing exporters in other countries or the producers in the importing countries, but it is only a short-term problem.

The second is the predatory dumping. The purpose is not the clearance of the unsold stock but to throw the competing exporter out of the market. It is expected that when the competitors are out of the market and when the dumping firm enjoys the monopoly position, it raises the price in order to recover the losses incurred during dumping. However, this form of dumping is normally not found in the real world.

The third one is known as persistent dumping. It is a long-term phenomenon. A firm charges higher price from the domestic market where competition is lacking and a lower price from a highly competitive international market. Thus, it is synonymous with international price discrimination

Some Other Forms of Non-tariff Barriers

Among other non-tariff barriers, we here discuss some of their important forms, such as buy-local legislation, social regulations, health and sanitary regulations, etc.

Buy-local legislation is enacted to force the domestic producers to buy the inputs first in the domestic market. It also forces the consumers to buy locally-made goods. Such legislation is treated as a trade barrier because it discriminates against low-cost foreign suppliers in favour of domestic suppliers. Costly inputs raises the cost of production and thereby the price of the product and lowers the consumers' surplus. It causes dead-weight welfare losses in the form of consumption effect and protective effect.

During the international financial crisis of 2008 and 2009, the US Government emphasised on the local purchase of iron and steel for the infrastructural projects. It entailed upon the export performance of the Indian economy during FY 2009–2010.

Social regulations apply to specific social problems, environmental issues and other related issues. The US Government has put restrictions on the import of carpet from India because the Indian carpet industry employs child labour. Similarly, restrictions are there in case of environment-polluting exports. India put restrictions on the import of Chinese toys which had harmful effects on the health of the Indian children.

Other technical barriers to trade are related to a country's national standards of health and safety. They are also related to product designing and product packaging. When the US automobile firms sell cars in the UK and Japan, the steering system is changed from left to right.

Ans. 4(c):
If regulation aims at *liberalisation of trade*, it is definitely a move towards *free trade*. If, on the contrary, it is meant for restriction of trade, it is nothing but protection. It is better to mention the arguments sometimes given in favour of free trade before any discussion of regulation of trade.

First of all, the argument for free trade rests primarily on the belief that it leads to specialisation, which helps increase output and the gains from the increased output is shared by the trading partners. It may be noted that output can also be increased through acquiring greater resources or through improving the quality of the factors of production. But, international trade is the least painful of the three measures for increasing output. Moreover, trade facilitates the other two types of the measures.

Secondly, free trade generates competition, which in turn promotes efficiency in production. Increased productive efficiency leads to improvement in quality and in lowering of prices. All this benefits both the producers and the consumers.

Thirdly, free trade leads to the generation of economies of scale. There are some industries that can achieve minimum average cost only through a bigger amount of sale, which is possible only when goods are exported to a global market. For example, the aeroplane-manufacturing industry cannot achieve economies of scale when its has only domestic customers.

Fourthly, free trade helps check inflation through the application of the one-price principle. It maximises the welfare of trading countries, and consequently, global welfare.

Arguments for Protection

It is a fact that free trade has a sound theoretical base, but it has only limited empirical support. Moreover, in real life, free trade is a utopian ideal. There are economic as well as non-economic arguments for regulating trade (Table 2). The economic arguments are normally concerned with strengthening industrialisation in the country or with protecting balance of payments from any deterioration. The non-economic arguments are mainly political in nature. Whenever any government regulates foreign trade, there is normally a combination of factors behind it. Here it is relevant to discuss some of the major arguments behind protection of international trade.

Table 2: Arguments for Trade Protection

Economic Factors	*Non-economic Factors*
1. Protection of infant industry	1. Maintenance of essential industries
2. Promotion of industrialisation	2. Relations with unfriendly countries
3. Retaliatory action	3. Preservation of culture and national identity
4. Balance of payments adjustment	4. Preservation of community health
5. Price control and terms of trade	5. Preservation of national security
6. Employment generation	

Economic Factors:

1. The **infant industry** argument presents the most important justification behind the regulation of international trade. Newly born firms are generally not strong enough to compete with well established firms. Global firms enjoy economies of scale and are able to sell goods at a lower price. On the other hand, newly born domestic firms

have high costs and cannot sell their products at low prices, at least in the short run. If the import of such products is not restricted, consumers will demand the imported product and not the domestically produced high cost goods. The result will be that in absence of demand, domestic firms producing such goods will have to close down their operations. Thus, if such firms have to be developed at home, import restriction becomes a necessity.

This concept is not new. As far back as in 1930s, several industries in India were given protection against imports from the UK and other countries. It is often said that the sugar industry in India is a child of protection. However, there are a few problems that arise in such cases. First, it is very difficult to decide which industry has to be protected. Second, protection, once given, cannot easily be lifted because the producers, workers, and consumers tend to oppose it. Third, there is every possibility that the infant industry becomes dependent on the protection. If this is the case, it can never stand on its own feet and become competitive. Fourth, protection often causes greater economic harm than good insofar as the consumers have to pay higher prices for the product. Thus, whenever imports are restricted to help develop the infant industry, it should be a short-run phenomenon.

2. The **industrialisation promotion** argument is also important. In many countries, import substituting industries are developed to achieve self-reliance and to give a boost to other industries. This means that import restrictions lie at the very root of industrialisation. Sometimes, it is also said that when the government restricts imports, foreign investors boost up their investment in that country. This is because they get a sheltered market where they can make huge profits. Daniels and Radebaugh (2000) cite an example where Japanese automobile manufacturers began investing in the United States of America following restrictions on automobile import by the US Government. If this is the case, it means that import restrictions lead to foreign investment inflow and, thereby, strengthens the process of industrialisation.

   Again, sometimes the government restricts imports in order to help revive an already existing industry that is not in its infancy but is quite old. This is because such industries get a breathing space for revival in the absence of competition from imported products. This argument holds good in Canada where footwear imports are restricted because this is a traditional industry in Canada.

3. Sometimes, **retaliatory actions** need import restrictions. Such measures are taken when exporters adopt unfair trade practices. In order to capture the market, exporters sell goods in foreign countries, even at a lower price than their cost structure justifies. Such practices disrupt the very industrial structure in the importing countries. In order to counteract this move of exporters, the government in the importing country imposes restrictions on imports. However, it is very difficult to prove unfair trade practices in some cases. Moreover, retaliatory measures often turn to be unending and they prove harmful for trading countries.

4. **Balance of payments adjustment** is another justification, either for imposing restrictions on import or for export encouragement or both. In developing countries, axing the trade deficit lies at the root of import restrictions. In India, when the balance of trade was in a very bad shape during the early 1990s, import restriction measures were adopted quite intensively. Again, the import restriction measures are often accompanied by export encouragement measures. But sometimes it is found that import restrictions considerably hamper the export potential since the exporting industries do

not get the desired amount of raw material or they get it only at a higher cost. So, import restrictions are only a short-term measure. They cannot be long- term, especially when they affect the exporting industries.

5. **Price control** is another objective behind the regulation of international trade. It is often found in cases where the exporting country is in a monopolistic or oligopolistic position with respect to a particular commodity. The exporting government shapes the price of the export in such a way that it provides for maximum profit. When the demand for the product is price inelastic, the exporting government raises the price of the product far beyond the cost of production. But if, on the contrary, the demand for export is price-elastic and the importing government imposes duty on the import, the price of the product will be unusually high in the hands of the consumers. As a result, the supplier will be forced to cut the price in order to maintain demand for the product. With a cut in the price, the ratio between the import price and the export price will be lower for the importing countries, improving in turn the terms of trade. An improvement in the terms of trade means accruing of gains from trade.
6. Protection of trade helps **generate employment** in the importing country. In macroeconomic terms, protection helps generate balance of payments surplus, which in turn increases income and employment. But if the additional income is used for imports, surplus in the balance of payments is eroded. On the contrary, the microeconomic employment case for protection starts with the fact that imposition of tariff may raise the demand for labour in a particular industry where import substituting goods are produced. But if labour is not mobile among industries, this effect may not be felt.

Non-economic Factors:

1. Among the non-economic factors, **maintenance of essential industries** is a guiding factor behind the regulation of trade. Each and every country tries to develop some essential industries so that in case of an extra-ordinary situation, the supply of essential products is not completely hampered. In order to protect these industries, the government regulates the export and import of these products. Again, in some other cases where the producers need the assurance of an uninterrupted supply of raw material, the government regulates the export and import of raw material. For example, the US Government subsidises the domestic production of silicon, which is made easily available to the computer industry.
2. **Trade with unfriendly countries** needs to be regulated. If the political relations are not friendly between two governments, trade is not encouraged between them. In cases where minimum trade is conducted, there is often the possibility of non-payment. So in such cases, trade is highly regulated in terms of commodities and price.
3. **Preservation of national culture and identity** is one of the factors behind regulating trade. For example, France imposes partial curb on the import of foreign films. This is out of fear that those films may affect badly the French culture and identity. In Canada too, there are restrictions on the import of entertainment products from the United States.
4. **Preservation of community health** is of utmost importance. The essence of health and sanitary regulations is to import only those products that do not adversely affect consumers' health. This is why food products are checked by health authorities the moment they enter ports

5. Trade regulation is necessary in order to preserve **national security.** Industries considered important for national security are often subjected to export or import regulations. The export and import of defence related products are cases in point.

Ans. 5(a): Economic integration or regional economic grouping represents some kind of preferential economic arrangement among member countries, where they cooperate with one another in many ways and eliminate restrictions on the intra-region flow of goods, services, capital, and labour. The member countries normally belong to a particular geographic region, with the result that they have common history and similar awareness to the regional problem. However, belonging to a specific geographic region is not an essential qualification for regional grouping. Cuba was a member of the Council for the Mutual Economic Assistance (COMECON) before the break-up of the former USSR, despite the fact that it was quite distantly located.

Ans. 5(b): Economic integration or regional economic grouping represents some kind of preferential economic arrangement among member countries, where they cooperate with one another in many ways and eliminate restrictions on the intra-region flow of goods, services, capital, and labour. The member countries normally belong to a particular geographic region, with the result that they have common history and similar awareness to the regional problem. However, belonging to a specific geographic region is not an essential qualification for regional grouping. Cuba was a member of the Council for the Mutual Economic Assistance (COMECON) before the break-up of the former USSR, despite the fact that it was quite distantly located.

The different forms of regional economic integration schemes differ from each other. One of the reasons is that they represent different levels of economic integration. Based on the varying levels, the integration schemes are known as:

1. Free Trade Area
2. Customs Union
3. Common Market
4. Economic Union
5. Political Union

Free Trade Area: In a free trade area, which involves the least integration, member countries abolish tariff and non-tariff barriers on intra-region trade but they are free to impose tariff on their import from a third country at different rates. Thus tariff abolition is a preferential economic arrangement that aims at encouraging intra-region trade. European Free Trade Association (EFTA) and North American Free Trade Agreement (NAFTA) are apposite examples of this type of economic integration.

Customs Union: The second form of economic integration is known as customs union where the member countries abolish tariff and non-tariff barriers on intra-region trade just as in case of a free trade area. But, the member countries maintain a common tariff wall on imports from a third country. Thus, it is different from the free trade area, which does not involve a common external tariff. The European Union in its initial stage was a customs union.

Common Market: The third form is known as common market where the degree of integration is further one step ahead. The common market involves common external tariff that is found in a customs union. Over and above, it also involves free movement of factors of production such as labour, capital, enterprise, and technology among the member states. As a result, there are chances for best allocation of resources in a common market leading to maximisation of benefits from resource utilisation among the member states.

Economic Union: The fourth form is known as an economic union where all the features of a common market exist. But additionally, the member states try to harmonise monetary, fiscal, and other economic policies. Thus, the content of integration is the maximum in this case. This may mean that the member states surrender, at least to some extent, their national sovereignty for the harmonisation of economic policies. The European Union, after the Maastricht Treaty, has come to be an economic union.

Political Union: Political union represents the highest level of integration. Although it is not a pure form of economic integration, it does indicate the logical outcome of increased economic integration among a group of nations. In this case, the member countries lose their national identity and come under a single state. East Germany joined West Germany to form a political union.

These are the five stages through which the process of economic integration moves further. The time span for the movement from one stage to the other may vary widely depending upon the subservience of the economic goal among the member states. In Europe, it took around four decades to enter a complete economic union. In South Asia, the first stage is not complete even after one and a-half decades of the formation of the South Asian Association of Regional Co-operation (SAARC).

Ans. 5(c): **Early Attempts:** The first exercise towards economic integration was made in 1948 when the Organisation for European Economic Cooperation (OEEC) was established for the purpose of administering the Marshall Plan aid meant for the reconstruction of the war devastated economies. In 1952, six European countries, that is, West Germany, France, Italy, Belgium, the Netherlands, and Luxembourg formed the European Coal and Steel Community (ECSC). The purpose was to establish a common market for coal and steel among the member countries.

European Union: A major step towards regional grouping was manifest in the creation of the European Economic Community (EEC) among the ECSC countries in 1957 under the Treaty of Rome. It was basically a common market that had a customs union along with a provision for free internal movement of goods, services, labour, and capital. The process of abolition of internal tariff began in 1959 and was completed by 1968. The Common Agricultural Policy (CAP) established in 1962 incorporated various measures of tariff and price support and helped restrict the import of agricultural products in the interest of domestic agriculture and the farmers engaged in it. In 1967, the ECSC, EEC, and the European Atomic Energy Community (EAEC) were merged under a new banner of the European Community (EC). Denmark, Ireland, and the United Kingdom joined the EC in 1973. Greece joined it in 1981; Portugal and Spain in 1986; and Austria, Finland, and Sweden in 1995. The size of the European Union increased in 2004 when ten new countries joined it. The new members were: Cyprus, the Czech Republic, Estonia, Hungary, Lativa, Lithuania, Malta, Poland, Slovakia, and Slovenia. Two more countries, viz. Bulgaria and Romania joined the EU subsequently. The number of member countries rose to 27.

In 1987, the Single European Act was implemented in order to add more vigour to the EC as it provided for harmonising product standards throughout the region and removing barriers to internal trade and the flow of financial services.

The members of the EC met in 1991 at Maastricht, the Netherlands, to plan for more advanced stages of economic integration. The Maastricht Treaty, which was signed in February 1992 and came into force from November 1993, renaming the EC as the European Union (EU), called for a close link between the European economic union and the European monetary union. It set up monetary and fiscal targets for the countries participating in the monetary union. Of the then 15 EU members, there were only 11 members of the EMU as Greece and Sweden were not able to meet the convergence criteria and Denmark and the United Kingdom are still opposed to the single currency, Euro replacing their currency by 2002. However, Greece joined the Euro club in January 2001, raising the number of Euro club members to 12. Again, it called for political union among the members, that is, to include a common defence and foreign policy and a common citizenship.

The organisational structure of the EU primarily embraces five institutions. The European Commission initiates proposals for legislation and executes the policies. The European Parliament has legislative powers and it supervises the executive decisions. It is rather a consultative body that debates and amends legislation proposed by the European Commission. The Council of Ministers composed of the ministers from the member countries votes on the passage of the law. The Court of Justice, composed of one justice from each member country, hears the case when a country does not abide by the rules framed by the Union or when the Commission or the Council does not perform its duties well. The Court of Auditors looks after the management of the EU budget.

These five institutions are flanked by five other important bodies. They are:

- the European Economic and Social Committee looking after economic and social issues;
- the Committee of the Regions, expressing the views of the regional authorities;
- the European Central Bank, responsible for the management of monetary issues;
- the European Ombudsman, dealing with citizens' complaints; and
- European Investment Bank, responsible for financing investment projects.

European Economic and Monetary Union: The European Economic and Monetary Union was born in the mid-1970s with the creation of the "snake in the tunnel", which took a more concrete shape in the form of the European Monetary System (EMS) in 1979. The European Currency Unit (ECU) was then the monetary unit of the EMS. ECUs were created and allocated among the EMS member countries. It was a composite monetary unit made up of a basket of a specified amount of the currencies of the 12 EU member countries. The specified amount was determined on the basis of the country's GDP and foreign trade. One unit of the ECU was equal to the sum of the fixed amount of such currencies.

ECUs were created by revolving three-month swaps of gold and US dollars between the members' central banks and the European Monetary Co-operation Fund (EMCF). The EMCF was renamed as the European Monetary Institute (EMI) in 1994 and again, with greater functions and powers, as the European Central Bank, in 1998. The central bank of a member country, if it had held ECUs more than the allocated amount, got interest on the additional amount. If its holdings of ECUs were lower than the allocated amount, it had to pay interest.

ECU helped determine the parity grid or the grid of bilateral rates of exchange. This meant that the exchange rate between the two currencies was fixed through their share in the ECU valuation. Any fluctuation in the bilateral parity grid was not unexpected in view of the widely differing macroeconomic variables in the different member countries. So, a fluctuation band was prescribed that was initially +/– 2.25 per cent, except for the Italian lira, where it was 6.00 per cent. Any fluctuation beyond the prescribed limit was restricted through intervention by the central banks. In practice, intervention was made much before the prescribed limit had reached. This type of optional intervention prevented any compulsory intervention that had to be made when the prescribed limit had been reached.

Again, there was a provision for monetary support. It originated from the EMCF or the EMI, now the European Central Bank, and had varying maturity limit. The very short term credit was to assist central banks in intervention. Short term credit met the balance of payments deficit.

The medium term credit was meant for a medium term balance of payments support. Besides all these, there was also a provision for medium term financial support for fostering convergence between economically weak and the economically strong member countries. Such credits flowed from the European Investment Bank.

Exchange rate stability, which could not be achieved completely over the years, was to be achieved by reducing disparity in the macroeconomic performance of the member countries. This was possible through the convergence of economic policies among the members. In order to bring about a greater degree of convergence, the Committee for the Study of Economic and Monetary Union, 1989, put forth a three-stage plan. This was commonly known as the Delors Plan approved at Maastricht in February 1992.

The first stage, which was formally to begin from July 1990, emphasised on currency convertibility through removal of exchange control and through encouraging free capital movement. The second stage, beginning from January 1994, focused on institutional development. The European System of Central Banks (ESCB) was to be set up for the purpose of envisaging a common monetary policy. Exchange Rate Mechanism (ERM) was to be hardened through narrowing the exchange rate fluctuation band. The time-table for the third stage was to begin from January 1999. In the first year, budgetary coordination was to be brought about. The EMI, now the European Central Bank (ECB), was responsible for fostering monetary coordination in the then proposed framework of the new European currency, the euro, that was created in January 1999. In the following three years, the exchange rate of member currencies was to be irrevocably pegged to one another. From 2002, the national currencies of the member countries were to retire in favour of the euro.

The Delors Plan suggested a full convergence of economic and monetary policies, focussing specifically on the size of inflation, interest rates, fiscal deficit, and government debt. However, it is difficult to say how far the convergence criteria will be met.

In January 1999, the Euro was created as the currency of the EMU. It replaced the ECU on a one-for-one basis, with the result that the ECU ceased to exist. One unit of euro comprised of 100 euro cents. The exchange rate between euro and the members' currency came to be fixed. This was done with a view to avoid fluctuation in the bilateral parity grid. Table 3 shows the Euro-member currency rates.

Table 3 Intra-EMU Exchange Rate

As on 1 January, 1999

Member's Currency	*Value per unit of Euro*
DM	1.95583
French franc	6.55957
Italian lira	1936.27
Spanish peseta	166.386
Dutch guilder	2.20371
Belgian franc	40.3399
Austrian shilling	13.7603
Portuguese escudo	200.482
Finnish markka	5.94573
Irish pound	0.787564
Luxembourg franc	40.3399

Note: Cyprus and Malta joined on 1 January, 2008 and on 1 January, 2009, Slovakia joined the EMU

On this count, the post-euro regime is different from the pre-euro regime. The bilateral parity grid is not expected to be constrained because the European System of Central Banks (ESCB), composed of the central banks of the participating countries, and the ECB will frame and implement a common monetary policy in all the member countries. However, the exchange rate between the euro and the non-member currency is subject to market forces. When the euro came into being, its value in relation to the US dollar was US $1.1665/euro.

On January 1, 2002, Euro notes and coins were introduced in the 12 member countries. By the end of February 2002, the euro completely replaced members' currencies. Euro bank notes are issued by both the European Central Bank and the national central banks with full understanding between them. Out of the total size of the issue, 8 per cent are allocated to the ECB. The coins are minted by the national authorities.

The euro has some benefits, but at the same time, there may be costs too. First of all, the benefits manifest in eliminating transaction costs that occur on account of exchanging one member currency for another. Secondly, goods produced in different member countries are priced in a single currency, which leads to price transparency and encourages market integration. Thirdly, there is no exchange rate changes and, thereby, no foreign exchange exposure in intra-union trade. With no exchange rate exposure, intra-union trade will expand, leading to increase in capital productivity and national income. Fourthly, the existence of a single currency is expected to minimise market imperfections that will be apparent more in financial services. In a nearly perfect financial market, the number of participants will increase. All this will help develop the financial market within the Union. Fifthly, there will be no problem in the consolidation of accounts by multinational corporations operating within the Union as translation of currency will not be required. But, on the other hand, in the absence of a multiple currency system, the number of transactions exchanging one currency for another will significantly reduce bankers' income.

Again, as far as the use of the euro for invoicing of trade with a third country is concerned, its success depends upon the stability of its value in the foreign exchange market and on the demand for it in international transactions. In fact, this is the reason that the US dollar is invariably the currency of invoice even where the United States of America is not involved in the trade. If one looks at the figures, it is found that 37 per cent of world trade is invoiced in the EU member countries' currency as against 48 per cent of the world trade invoiced in the US dollar. On this basis, one can be confident about the successful use of the euro in international transactions. Moreover, there is an indication that the Bank of Japan is holding euros in its reserves. If it is followed by the central bank of other countries, euro has a good prospect. Presently, the bonds denominated in EMU member currencies account for around one-half of dollar-denominated bonds. If these currencies retire in favour of the euro, euro-denominated bonds will be commonly used.

Ans. 6(a): An MNC is an enterprise with a substantial part of its operations in a number of foreign countries.

An MNC is sometimes known as transnational corporation or as supranational corporation. There is no single definition that is widely acceptable. Nevertheless, an MNC is an enterprise that owns or controls production or service facilities outside the country in which it is based.

Ans. 6(b): It is a fact that there are millions of exporting and importing firms that are engaged in international trade. Again, there are numerous firms that make foreign direct investment. But it is the multinational corporations (MNCs) that are responsible for a very large segment of international trade—intra-firm as well as inter-firm—and the largest part of foreign direct investment. Foreign direct investment and MNCs have become synonymous. In view of the significant contribution of the MNCs in international business, it is essential to acquaint the readers with some of their important features.

An MNC is sometimes known as transnational corporation or as supranational corporation. There is no single definition that is widely acceptable. Nevertheless, an MNC is an enterprise that owns or controls production or service facilities outside the country in which it is based. Since there are several small firms that possess these features, it is often said that for qualifying as an MNC, the number of countries where the firm operates must be at least six. At the same time, the firm must generate a sizeable proportion of its revenue from the foreign operation, although no exact percentage is agreed upon. All this means that the firm should be big enough to have its stronghold in many countries through branches and subsidiaries.

According to Vernon and Wells Jr., MNCs represent a cluster of affiliated firms located in different countries that:

1. are linked through common ownership
2. draw upon a common pool of resources
3. respond to a common strategy.

All this shows a high degree of integration among different units of the firm.

Based on the strategic features, MNCs are grouped as ethnocentric, polycentric, and geocentric. Ethnocentric firms are those that adopt home market oriented policy and seldom distinguish between domestic operation and global operation policies. On the other extreme, polycentric firms operate in foreign countries just to cater to the demand in those countries. This means that they follow a host market oriented policy. Between the two extremes, geocentric firms maintain a balance between the home market and host market oriented policies. They are in fact closer to real situations. It is this behavioural distinction that influences the differentiation between a multi-domestic company and a global company. The former is concerned more with the market of the host country where it operates. The latter is concerned with the global market. It finds the world as a single market and plans to cater it through integrated operations.

Again, basing on the behavioural features of MNCs, Bartlett and Ghoshal differentiate between a multinational company and a transnational company. In the former, decision making is normally decentralised and the activities of the firm in foreign countries are not tightly co-ordinated. In the latter, on the contrary, global business activities of the firm are perfectly configured, coordinated and controlled to achieve global competitiveness. However, in the present text, these different terms are used interchangeably.

When decisions related to the process of planning are taken at the parent office it is known as centralised planning. On the contrary, when the planning process evolves at the subsidiary level, it is called decentralised planning. In real life, neither of the two exists in its purest form. There is usually a combination of the two.

When a product involves intricate technology developed at home, it is often globally standardised. And, in this case, the planning is carried on at the parent unit, the subsidiaries have virtually no say in the decision. Again, when different units of a firm are closely interlinked and when host governments do not impose control over the cross-border mobility of funds and other factors of production, it is often due to centralised planning. Yet again, when pricing and product decisions in one country are expected to influence the demand in other countries, centralised planning is often evident. This is because executives at the parent unit have a better idea of pricing and demand in all the host countries.

On the contrary, when products need adaptation on account of widely differing economic and socio-cultural environments, planning needs more local inputs and it is decentralised. Executives at the subsidiary level have a better idea of the local issues and so decentralised planning in this case is closer to reality. However, in most of the cases, it is the hybrid of centralised and decentralised planning that is often called transnational planning.

Centralised and Decentralised Control: Control may be centralised, meaning that the parent unit maintains control over the operations of the entire firm and the subsidiaries get the least freedom. In a decentralised system, the subsidiaries get greater freedom to control their operation. Both systems have their merits. Decentralisation is preferred because the management of the subsidiary is normally better acquainted with the market behaviour and it can react quickly to changes in the market. Drake and Caudill are of the view that decentralisation should be the design of control when the subsidiary has only marginal involvement in overall international business, when product is a consumer product and when the human resource of the subsidiary is capable of taking important decisions. On the contrary, centralisation of control is favoured when the firm is faced with a global competitive threat, when a large amount of research and development (R&D) is involved in the manufacturing of product, or when cultural similarity is found between the home country and the host country. However, centralisation of control is normally not feasible when the subsidiary is marked with host country dominance.

In real life, the two extremes are rarely found. It is usually a mix of the two—often termed as coordinated decentralisation—where subsidiaries are given independence to take control measures, but essentially within the framework designed by the parent unit. Proper coordination between the parent unit and the subsidiaries or among the different subsidiaries is maintained through frequent meetings of personnel representing different units or through intranet or internet services that are quite popular today.

Ans. 6(c): According to Vernon and Wells Jr., MNCs represent a cluster of affiliated firms located in different countries that:

1. are linked through common ownership
2. draw upon a common pool of resources
3. respond to a common strategy.

All this shows a high degree of integration among different units of the firm.

Based on the strategic features, MNCs are grouped as ethnocentric, polycentric, and geocentric. Ethnocentric firms are those that adopt home market oriented policy and seldom distinguish between domestic operation and global operation policies. On the other extreme, polycentric firms operate in foreign countries just to cater to the demand in those countries. This means that they follow a host market oriented policy. Between the two extremes, geocentric firms maintain a balance between the home market and host market oriented policies. They are in fact closer to real situations. It is this behavioural distinction that influences Punnett and Ricks to differentiate between a multi-domestic company and a global company. The former is concerned more with the market of the host country where it operates. The latter is concerned with the global market. It finds the world as a single market and plans to cater it through integrated operations.

Again, basing on the behavioural features of MNCs, Bartlett and Ghoshal differentiate between a multinational company and a transnational company. In the former, decision making is normally decentralised and the activities of the firm in foreign countries are not tightly co-ordinated. In the latter, on the contrary, global business activities of the firm are perfectly configured, coordinated and controlled to achieve global competitiveness. However, in the present text, these different terms are used interchangeably.

Ans. 7(a): In the foreign exchange market different currencies are bought and sold. The market does not denote a particular place where currencies are transacted. Rather it is an over-the-counter market. It consists of trading desks at major agencies dealing in foreign exchange throughout the world, which are connected by telephones, telex, and so on, it is a round-the-clock market, meaning that the transactions can take place any time within 24 hours of the day. This is because different countries are located at different longitudes.

The foreign exchange market is classified either as a spot market or as a forward market. It is the timing of the actual delivery of foreign exchange that differentiates between spot market and forward market transactions. In the spot market, currencies are traded for immediate delivery at the rate existing on the day of transaction.

In the forward market, on the contrary, contracts are made to buy and sell currencies for a future delivery, say, after a fortnight, one month, two months, and so on.

Ans. 7(b): The foreign exchange market is classified either as a spot market or as a forward market. It is the timing of the actual delivery of foreign exchange that differentiates between spot market and forward market transactions. In the spot market, currencies are traded for immediate delivery at the rate existing on the day of transaction. For making book-keeping entries, delivery takes two working days after the transaction is complete. If a particular market is closed on Saturday and Sunday and if transaction takes place on Thursday, delivery of currency shall take place on Monday. Monday, in this case, is known as the value date or settlement date. Sometimes there are short-date contracts where time zones permit the delivery of the currency even earlier. If the currency is delivered the same day, it is known as the value-same-day contract. If it is done the next day, the contract is known as the value-next-day contract.

Forward exchange rate is normally not equal to the spot rate. The size of forward premium or discount depends mainly on the current expectation of the future events. Such expectations determine the trend of the future spot rate towards appreciation or depreciation and, thereby, determine the forward rate that is equal to, or close to, the future spot rate. Suppose, the dollar is expected to depreciate, those holding the dollar will start selling it forward. These actions will help depress the forward rate of the dollar. On the contrary, when the dollar is expected to appreciate, the holders will buy it forward and the forward rate will improve.

In the forward market, on the contrary, contracts are made to buy and sell currencies for a future delivery, say, after a fortnight, one month, two months, and so on. The rate of exchange for the transaction is agreed upon on the very day the deal is finalised. Forward rates with varying maturity are quoted in the newspaper and these rates form the basis of the contract. Both parties have to abide by the contract at the exchange rate mentioned therein, irrespective of the fact whether the spot rate on the maturity date resembles the forward rate. In other words, no party can back out of the deal even if changes in the future spot rate are not in his/her favour.

The value date in case of a forward contract lies definitely beyond the value date applicable to a spot contract. If it is a one month forward contract, the value date will be the date in the next month corresponding to the spot value date. Suppose a currency is purchased on the 1st of August; if it is a spot transaction, the currency will be delivered on the 3rd of August, but if it is a one-month forward contract, the value date will fall on the 3rd of September. If the value date falls on a holiday, the subsequent date will be the value date. If the value date does not exist in the calendar, such as the 29th February (if it is not a leap year), the value date will fall on the 28th of February.

A currency swap is different from the interest-rate swap insofar as it (currency swap) involves two different currencies. This is the reason that the two currencies are exchanged in the beginning; and again at maturity they are re-exchanged. The exchange of currencies is necessitated by the fact that one counter-party is able to borrow a particular currency at a lower interest rate than the other counter-party. Suppose firm *A* can borrow the euro at a fixed rate of 8.0 per cent or the US dollar at a floating rate of one-year LIBOR. Firm *B* can borrow euro the at a fixed rate of 9.2 per cent and can borrow the US dollar at one-year LIBOR. If firm *B* needs the fixed rate euro, it will approach the swap dealer, provided that firm *A* needs the floating rate US dollar.

Ans. 7(c): The greatest success of the Uruguay Round discussions was evident in the creation of the World Trade Organisation (WTO). The WTO, which was officially launched on January 1, 1995, replaced the GATT. Naturally, the GATT members became the members of WTO. It administers the agreements contained in the Final Act of the Uruguay Round.

Basic Difference between GATT and WTO

It is a fact that the WTO replaced the GATT and so the purpose of these two institutions is the same. Nevertheless, there is some dissimilarity between the two. First of all, GATT allowed the continuance of some side agreements concluded between specific members during different GATT rounds. But WTO administers a unified package of agreements to which all members are committed.

Secondly, the coverage of the WTO is bigger as it includes TRIPS, GATS, etc. under its purview. Moreover, the environment has come up as a major issue on the agenda for the first time.

Thirdly, WTO contains an improved version of the original GATT rules in relation to the trade in goods. And so it is more effective than the GATT.

Fourthly, the grey area measures such as textiles and clothing and agriculture remained to exist outside the GATT purview. But they are now under WTO.

Fifthly, the membership of the GATT was not as large as that of WTO. WTO members had 153 members during July 2008 and so its jurisdiction is far wider.

Finally, the settlement of the disputes between the member countries was not easy during the GATT regime as the members used to block decisions arrived at under the dispute settlement mechanism. But it is not possible under WTO. Moreover, there is a fixed time framework during which the dispute has to be settled.

Organisational Structure

The Ministerial Conference is the apex body in the WTO's organisational structure meeting every two years. It is composed of the representatives of the member governments—one representative from each member. It is the chief policy-making body. Any major policy change requires its approval.

Below the Ministerial Conference lies the General Council. Its composition is similar to that of the Ministerial Conference. Its principal functions are: to act as a dispute settlement body; to administer the TPRM; and to supervise the functioning of trade in goods, GATS, TRIPS, as well as all the trade committees. There is no fixed timing for its meeting, but normally it meets every two months. For day-to-day functioning, it delegates its responsibility to three subordinate

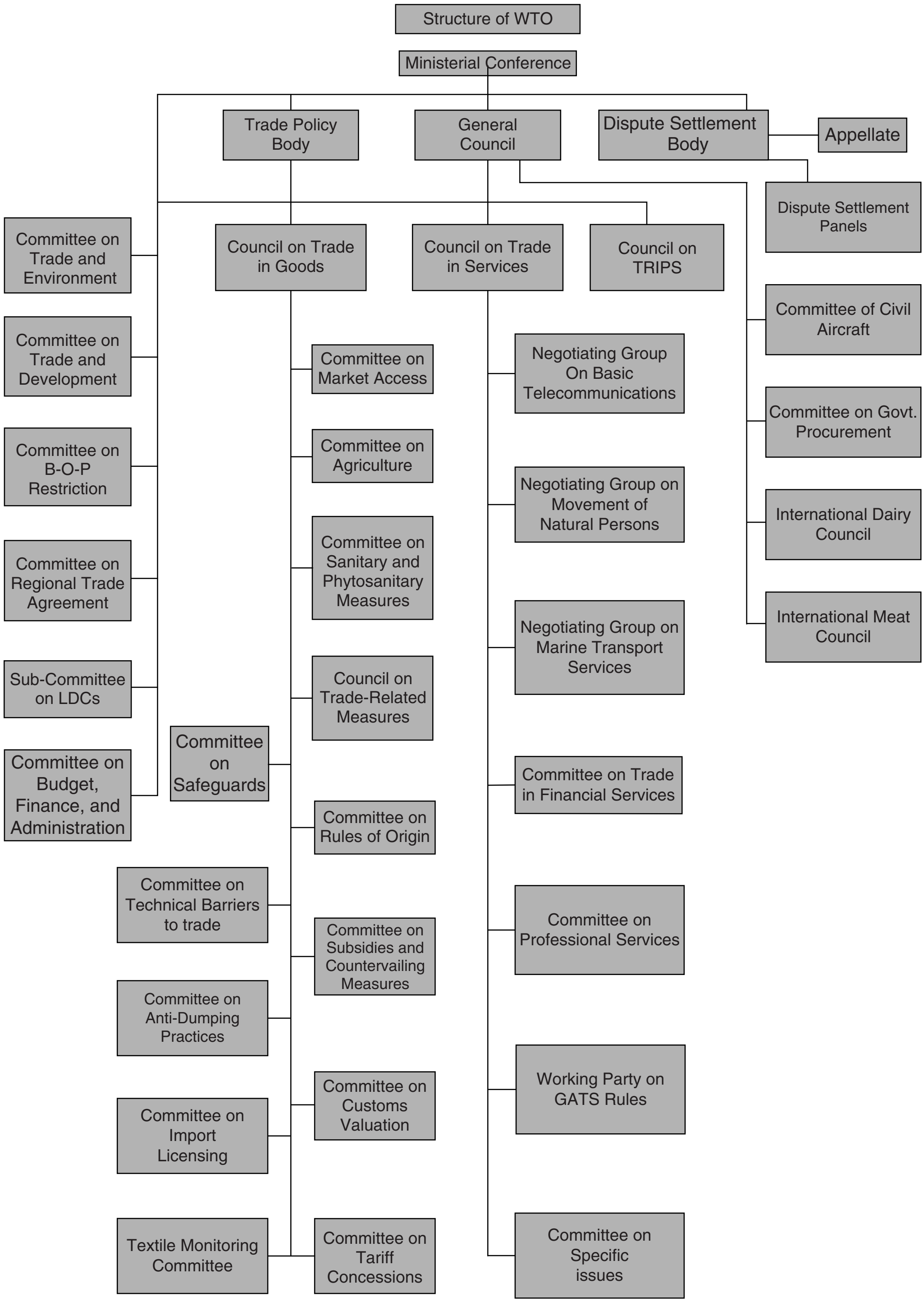


Figure 3: Structure of the World Trade Organisation

councils meant for trade in goods, trade in services, and intellectual property rights. The General Council can appoint a working group to deal with specific issues. The report of the working group is placed before the Heads of Delegation meeting. The findings and the suggestions are approved by the General Council.

The three councils just below the General Council have to look after the functioning of different committees constituted for specific areas. For example, the Council for Trade in Goods looks after the functioning of committees on market access, agriculture, specific non-tariff barriers, TRIMS, and the Textile Monitoring Body. The Council for Trade in Services looks after the committees established in the area of services. The Council for TRIPS manages the operation of the TRIPS agreement.

The Trade Committees looking after specific areas of the multilateral trade agreements are the lowest wing in the WTO structure. The committees are established in two ways. Those established under the terms of the Multilateral Trade Agreements and by the Trade Councils report to their supervising Trade Council. Those appointed by the Ministerial Conference or under the terms of the plurilateral agreements report directly to the General Council. The Director-General is the Head of the Secretariat who looks after the collective interest of the member countries.

The decisions at WTO are normally taken by consensus. However, in some not-so-important cases, either three-fourths or two-thirds majority votes serve the purpose. It may be noted that there is no weighted voting, rather there is one-member, one-vote.

Functions of the WTO

Broadly speaking, the function of the WTO is to implement, administer, direct, and further the objectives of the multilateral and plurilateral trade agreements concluded during the Uruguay Round. To be specific, it:

1. Provides a forum for further negotiations for trade liberalisation in the framework of the various agreements concluded;
2. Administers the new dispute settlement procedure;
3. Establishes and directs a trade policy review mechanism so as to examine trade policies and practices of the member countries and to suggest measures of reform;
4. Cooperates on an equal footing with the World Bank and the International Monetary Fund for the purpose of economic policy making; and
5. Undertakes research and publishes information and studies for the international community.

Ans. 8(a): Expensive new cross border shows can easily fail because of cultural differences and various traditions. Do you agree with the statement? Explain.

Yes. Expensive new cross border shows can easily fail because of cultural differences and various traditions. It is important to recognize that people from different cultures have are different in a variety of ways, including

- different ways of looking at things
- different ways of dressing
- different ways of expressing personality/goodness

For Example, lets see the difference between Americans and Russians characteristics

Cultural	America	Russia
Authority	Diffused from people, flows up	Centralized, flows down
Change	From below, individual	Imposed from above, society
Rights	Celebrated, protected	Subordinated forms communal good
Diverse	Tolerance, pluralism	Consensus, single truth
Economy	Private free market	Government-centered
Cultural	Western Europe	Europe, Asia
Warfare	Wars fought mostly abroad, little/no devastation	Constant cruelties, wars, devastation, hardships

The language differences is one of the issue to be addressed for failure:

Language issues: Language is an important element of culture. It should be realized that regional differences may be subtle. For example, one word may mean one thing in one Latin American country, but something off-color in another. It should also be kept in mind that much information is carried in non-verbal communication. In some cultures, we nod to signify "yes" and shake our heads to signify "no;" in other cultures, the practice is reversed. Within the context of language:

- There are often large variations in regional dialects of a given language. The differences between U.S., Australian, and British English are actually modest compared to differences between dialects of Spanish and German.
- *Idioms* involve "figures of speech" that may not be used, literally translated, in other languages. For example, baseball is a predominantly North and South American sport, so the notion of "in the ball park" makes sense here, but the term does not carry the same meaning in cultures where the sport is less popular.
- *Neologisms* involve terms that have come into language relatively recently as technology or society involved. With the proliferation of computer technology, for example, the idea of an "add-on" became widely known. It may take longer for such terms to "diffuse" into other regions of the world. In parts of the World where English is heavily studied in schools, the emphasis is often on grammar and traditional language rather than on current terminology, so neologisms have a wide potential not to be understood.
- *Slang* exists within most languages. Again, regional variations are common and not all people in a region where slang is used will necessarily understand this. There are often significant generation gaps in the use of slang.

Ans. 8(b): Strategies adopted by MTV to reduce cultural risk

- Develop shows for more than one overseas market at a time.
- Leveraging the resources
- Develop program that can not only cross borders but even have global appeal
- Local managers will not be given power to make local programming decisions. By this they thought that cooperation among country units to develop new ideas that can be used in multiple countries.
- Create programs that both individual and multiple markets can relate to.

Ans. 8(c): **Ethnocentrism** is the tendency to believe that one's ethnic or cultural group is centrally important, and that all other groups are measured in relation to one's own. The ethnocentric individual will judge other groups relative to his or her own particular ethnic group or culture, especially with concern to language, behavior, customs, and religion. These ethnic distinctions and sub-divisions serve to define each ethnicity's unique cultural identity.

The local managers are given power to make decision because,

- **Language issues:** Language is an important element of culture. It should be realized that regional differences may be subtle. For example, one word may mean one thing in one Latin American country, but something off-color in another. It should also be kept in mind that much information is carried in non-verbal communication. In some cultures, we nod to signify "yes" and shake our heads to signify "no;" in other cultures, the practice is reversed.
- **Cultural barriers:** Subtle cultural differences may make an ad that tested well in one country unsuitable in another—e.g., an ad that featured a man walking in to join his wife in the bathroom was considered an inappropriate invasion in Japan. Symbolism often differs between cultures, and humor, which is based on the contrast to people's experiences, tends not to travel well. Values also tend to differ between cultures—in the U.S. and Australia, excelling above the group is often desirable, while in Japan, "The nail that sticks out gets hammered down." In the U.S., "The early bird gets the worm" while in China "The first bird in the flock gets shot down."
- **Local attitudes toward advertising:** People in some countries are more receptive to advertising than others. While advertising is accepted as a fact of life in the U.S., some Europeans find it too crass and commercial.
- **Media infrastructure:** Cable TV is not well developed in some countries and regions, and not all media in all countries accept advertising. Consumer media habits also differ dramatically: newspapers appear to have a higher reach than television and radio in parts of Latin America.
- **Advertising regulations:** Countries often have arbitrary rules on what can be advertised and what can be claimed. Comparative advertising is banned almost everywhere outside the U.S. Holland requires that a toothbrush be displayed in advertisements for sweets, and some countries require that advertising to be shown there be produced in the country.

ANSWERS TO MODEL QUESTION PAPER II

Ans. 1(a): Command Economy: An economy where supply and price are regulated by the government rather than market forces. Government planners decide which goods and services are produced and how they are distributed. The former Soviet Union was an example of a command economy. Also called a centrally planned economy.

Ans. 1(b): "The study of international business has no relevance for individuals, who are going to work for small firms".

Not true at all. In today's world of computers and technology, at the click of a mouse any one can be globally connected. If small firms are going to compete & survive in a strained economy then staying on top of globalization is very relevant. Thus this statement cannot be evaluated because of its inaccuracy.

Globalization is changing the world economy. Firms, even small ones, can no longer ignore events going on outside their borders because what occurs in one country has implications for the rest of the world. Individuals who believe they can act in isolation by working for a small firm are not being realistic, but rather myopic and insular. Today, thanks to advances in technology, many small firms sell and source internationally very early in their evolution, those that fail to take advantage of international opportunities may not achieve their full potential, and ultimately may fail as competitors that do recognize the importance of international business dominate. In the United States, for example, almost 90 percent of firms that export employ fewer than 100 people. They also account for more than 20 percent of U.S. exports.

Ans. 1(c): Ricardo focuses not on absolute efficiency but on the relative efficiency of the countries for producing goods. This is why his theory is known as the theory of comparative cost advantage. In a two-country, two-commodity model, he explains that a country will produce only that product which it is able to produce more efficiently. Suppose Bangladesh and India, each of the two has 100 units of labour. One half of the labour force is used for the production of rice and the other half is used for the production of wheat in absence of trade. In Bangladesh, 10 units of labour are required to produce either 1 kg of rice or 1 kg of wheat. On the contrary, in India, 5 units of labour are required to produce 1 kg of wheat and 8 units of labour are required for producing 1 kg of rice. If one looks at this situation from the viewpoint of absolute cost advantage, there will be no trade as India possesses absolute advantage in the production of both the commodities. But Ricardo is of the view that from the viewpoint of comparative advantage, there will be trade because India possesses comparative advantage in the production of wheat. This is because the ratio of cost between Bangladesh and India is 2:1 in case of wheat, while it is 1.25:1 in case of rice. Because of this comparative cost advantage, India will produce only 20 kg of wheat with 100 units of labour and export a part of wheat to Bangladesh. On the other hand, Bangladesh will produce only 10 kg of rice with 100 units of labour and export a part of rice to India. The total output of foodgrains in the two countries, which was equal to 26.25 kg prior to trade, rises to 30 kg after trade. Thus it is the comparative cost advantage that leads to trade and specialise in production and thereby to increase in the total output in the two countries (Table 1).

Table 1: Theory of Comparative Cost Advantage

Amount of Output in Absence of Trade			*Amount of Output after Trade*		
	Rice	*Wheat*		*Rice*	*Wheat*
Bangladesh	5 kg	5 kg	Bangladesh	10 kg	Nil
India	6.25 kg	10 kg	India	Nil	20 kg
Total output in two countries: 26.25 kg			Total output in two countries: 30 kg		

Despite being simple, the classical theory of international trade suffers from a few limitations. Firstly, it takes into consideration only one factor of production, that is labour. But in the real world, there are other factors of production too that play a decisive role in production. Similarly, the theory does not take into account the transportation cost involved in trade.

Secondly, the theory assumes the existence of full employment, but in practice, full employment is a utopian. Normally, the entire resources in a country are not fully employed. In such cases, the country puts restrictions on the import in order to employ its idle resources, even if these resources are not to be employed efficiently.

Thirdly, the theory stresses too much on specialisation that is expected to improve efficiency. But it is not always the case in real life. The countries may pursue some other objectives too that may not be necessarily the productive efficiency. It is because when the country specialises in the production of a particular good, changes in the technology make the economy highly vulnerable.

Fourthly, the classical economists feel that the resources are mobile domestically and immobile internationally. But neither of the two assumptions is correct. Within the country, it is difficult for the labour to move from one occupation to another, especially when the job is highly technical. On the contrary, labour and capital move easily across nations.

Nevertheless, the empirical tests carried on by MacDougall, Stern and Balassa supported the Ricardian hypothesis. It would not be wrong to say that the classical theory holds good even today insofar as it suggests how a nation could achieve the consumption level beyond what it could do in absence of trade. This is in fact the reason why the countries stress upon expansion in the world trade.

Comparative Advantage based on Opportunity Cost

Later writings did not remain confined to a single factor of production, labour. They explained comparative advantage based on opportunity cost. Opportunity cost is the amount of a commodity foregone to get the other commodity. Recalling the earlier example, if 6.25 kg of rice are foregone to get 10 kg of wheat in India, the marginal rate of transformation (MRT) in India will be -0.625 kg of rice for 1 kg of wheat. Similarly, in Bangladesh, 5 kg of rice are foregone to get 5 kg of wheat, the MRT in Bangladesh will be -1 kg of rice for 1 kg of wheat. In terms of equation,

$$\text{MRT} = \Delta \text{ Product A}/\Delta \text{ Product B}$$

Comparing the MRT in both the countries, it is found that India has lower opportunity cost of wheat for rice and so India has comparative advantage in the production of wheat.

Now trade is possible only when demand exists in each country for the commodity produced in other country. If demand is intense, the country may pay a higher price for imports. Suppose that there is demand for wheat in Bangladesh as a result of which it likes to import wheat from India. But now the question is at what price India will be ready to export wheat. If MRT in India is −0.625 kg rice/1 kg wheat, it will not accept less than 0.625 kg of rice for 1 kg of wheat. Rather it will like to get a better price. On the other hand, Bangladesh will not be ready to forego more than 1 kg of rice for 1 kg of wheat. Rather it will prefer to forego less rice for 1 kg of wheat. Thus the price will lie between the MRT existing in the two countries. If Bangladesh is ready to forego more rice than MRT in India, the terms of trade will move in favour of India because the same amount of export will fetch more imports for India. Suppose, Bangladesh is ready to forego 0.80 kg of rice for 1 kg of wheat in view of strong demand for it. In that case, India will get 0.80 kg − 0.625 kg or 0.175 kg more rice that what it could get in case of no trade. Bangladesh has still to forego less rice for wheat that it could have foregone in absence of trade.

Production Possibilities Schedule

The gains from trade can be explained through production possibilities frontier (PPF). PPF represents various combinations of two goods produced in a country with fully employed factors of production. We assume for the moment constant opportunity cost with the result that PPF is a straight line. The PPF existing in the two countries is given here in Figure 1(a) and Figure 1(b).

Figure 1(a) shows the MRT existing in India in absence of trade and also how, after trade with Bangladesh, 10 kg of wheat are traded for 8 kg of rice conferring gains on India. The difference between the MRT after trade and MRT in absence of trade represents the gain from trade. Similarly, Figure 1(b) shows the MRT existing before trade and after trade in Bangladesh and also how this country gains through trade.

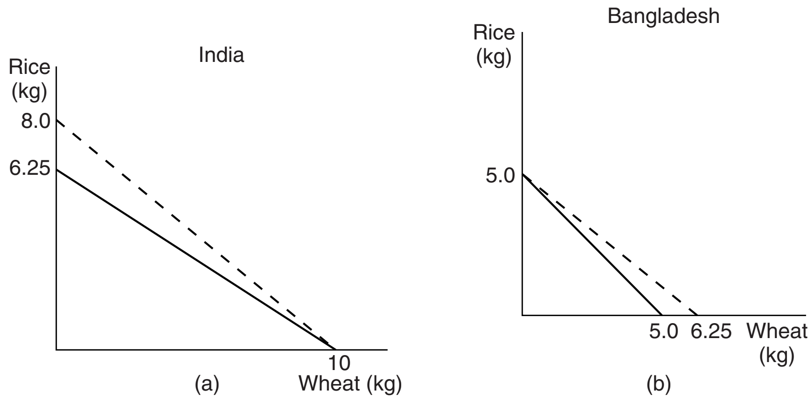


Figure 1a & 1b: PPF and Gains from Trade (Constant opportunity cost)

Static and Dynamic Gains from Trade Re-examined

The above analysis has shown gains from trade. They are in fact production gains and consumption gains both of static nature. Trade leads to specialisation and thereby growth in output in both the countries. Similarly, with larger production and trade, there will be ample opportunity for increased consumption. How much one of the two countries will share the gains depends on the terms of trade which was not explained systematically by Ricardo. Ricardo set a limit within which the terms of trade lay. He did not explain the role of demand that influences the terms of trade. The larger the demand, the greater the price a country will be willing to pay. And this will influence the terms of trade. The country is able to share more gains in whose favour the terms of trade will move.

However, there are dynamic gains too in form of contribution of trade to economic growth. The productivity theory of international trade explained by Hla Myint relates economic growth to the country's foreign trade. It is because trade encourages innovations, overcomes technical indivisibilities and raises labour productivity. These are nothing but dynamic gains. Leibenstein is of the view that free trade may lead to promote X-efficiency which means better use of inputs so as to reduce the real costs per unit of output. The cost reduction is definitely the dynamic gains from trade.

First of all, when resources are employed more efficiently based on comparative advantage, GDP is bound to rise. Income grows; saving grows and then investment grows.

Secondly, increasing production of specific commodities helps the producers to achieve economies of scale and thereby to reduce the cost per unit. The process makes the producers more competitive in the international market. Greater competition enhances efficiency.

Thirdly, import of lower cost goods compels the domestic producers to improve efficiency. All round efficiency will certainly be beneficial for the process of economic growth.

Ans. 2(a): Dumping is a form of price discrimination in favour of foreign consumers. The same product is sold to foreign buyers at a lower price than what the domestic buyers have to pay. Dumping also occurs when goods are sold in the overseas market at a price below the average cost of production.

There are normally three types of dumping. They are: (1) Sporadic dumping, (2) Predatory dumping, (3) Persistent dumping.

In sporadic dumping, the manufacturer, in order to eliminate the distressed stock of goods, sells the product at a throwaway price in the international market. The purpose is to reduce the loss as far as possible.

In predatory dumping, the objective is to penetrate a new market and throw the competitors out of the market so as to establish a monopolistic position in that market and charge high prices when monopoly is established.

Persistent dumping is a permanent type of dumping. When the product is highly price-elastic abroad, the firm adopts full-cost pricing covering the fixed cost for the domestic market and adopts marginal cost pricing abroad.

Ans. 2(b): It is a fact that Porter never focussed primarily on the factors determining the pattern of trade, yet his theory of national competitive advantage does explain why a particular country is more competitive in a particular industry. If, for example, Italy maintains competitive advantage in the production of ceramic tiles and Switzerland possesses the competitive advantage in watches, it can be interpreted that the former will export ceramic tiles and the latter will export watches and both of them will import those goods in which their own industry is not competitive.

Why is this difference? Porter explains that there are four factors responsible for such diversity. He calls those factors as the "diamond of national advantage". The diamond includes the following (Figure 2):

1. Factor conditions
2. Demand conditions
3. Related and supporting industries
4. Firm strategy, structure and rivalry

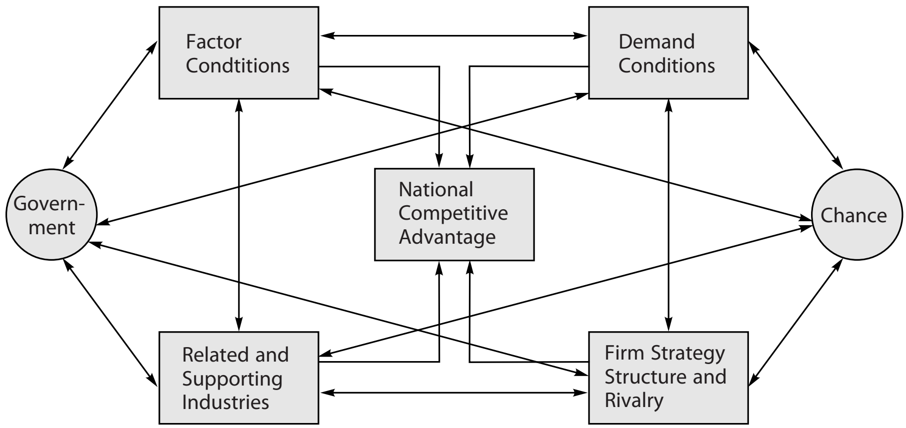


Figure 2: Porter's Diamond of National Advantage

These factors have been more or less taken into account by the earlier economists. What is crucial in Porter's thesis is that it is the interaction among these factors that shapes the competitive advantage.

Factor conditions show how far the factors of production in a country can be utilised successfully in a particular industry. This concept goes beyond the factor proportions theory and explains that availability of the factors of production per se is not important, rather their contribution to the creation and upgradation of product is crucial for the competitive advantage. This is possible if labour force is well-skilled and better-trained. Skill and training in Porter's view is an advanced factor which is essential for maintaining competitive advantage. If one says that Japan possesses competitive advantage in the production of automobiles, it is not simply because Japan has easy access to iron ore but this country has skilled labour force for making this industry competitive.

Secondly, the demand for the product must be present in the domestic market from the very beginning of production. Porter is of the view that it is not merely the size of the market that is important, but it is the intensity and sophistication of the demand that is significant for the competitive advantage. If consumers are sophisticated, they will make demand for sophisticated products and that in turn will help the production of sophisticated products. Gradually, the country will achieve competitive advantage in such production.

Thirdly, the firm operating along with its competitors as well as its complementary firms gathers benefit through close working relationship in form of competition or backward and forward linkages. If competition is acute, every firm will like to produce better-quality goods at lower cost in order to survive in the market. Again, if there is agglomeration of complementary units in a particular region, there may be strong backward and forward linkages. All this will help attain national competitive advantage.

Fourthly, the firm's own strategy helps in augmenting export. There is no fixed rule regarding the adoption of a particular form of strategy. It depends upon a number of factors present in the home country or the importing country and it differs from one point of time to the other. Nevertheless, the strategic decisions of the firm have lasting effects on their future competitiveness. Again, equally important is the industry structure and rivalry among the different companies. The greater the rivalry, the greater will be the competitive strength of the industry.

Besides the four factors, Porter gives weightage to a couple of factors such as, governmental policy and the role of chance of events. The governmental policy influences all the four factors through various regulatory/deregulatory measures. It can control the availability of various resources or change the pattern of demand through taxes, etc. It can encourage/discourage the supportive industries through various incentives/disincentives. Similarly, chance of events such as, war or some unforeseen events like inventions/innovations, discontinuities in the supply of inputs, etc. can eliminate the advantages possessed by the competitors.

However, there are various criticisms put forth against Porter's theory. First, there are cases when the absence of any of the factors does not influence much the competitive advantage. For example, when a firm is exporting its entire output, the intensity of demand does not matter. Secondly, if the domestic suppliers of inputs are not available, the backward linkage will be meaningless. Thirdly, Porter's theory is based on empirical findings covering 10 countries and four industries. Majority of the countries in the world have different economic background and do not necessarily support the finding. Fourthly, availability of natural resources, according to Porter, is not the only condition for attaining competitive advantage and there must be other factors too for it. But the study of Rugman and McIlveen shows that some of the Canadian industries emerged on the global map only on the basis of natural resource availability. Fifthly, Porter feels that sizeable domestic demand must be present for attaining competitive advantage. But there are industries that have flourished because of demand from foreign consumers. For example, a lion's share of Nestle's earnings comes from foreign sales. Nevertheless, these limitations do not undermine the significance of Porter's theory.

Ans. 2(c): There are a number of tools that are applied by a government for regulating trade. More importantly, they are tariff. They are non-tariff barriers, such as quota, customs valuation, embargo and the technical barriers, such as classification, labelling requirements, testing standards, voluntary export restraints and buy-local legislation. Subsidy is another tool to augment export. In this section, they need discussion at some length.

Tariff

Tariff means duty levied by the government on imports. When assessed on a per unit basis, tariff is known as specific duty. But when assessed as a percentage of the value of the imported commodity, tariff is called *ad valorem* duty. When both types of tariff are charged on the same product, it is known as compound duty. Sometimes tariff is imposed to counter unfair trade practices, such as subsidy of the trading partner. In such cases, tariff is known as countervailing duty. Whatever may be the form of tariff, it reduces the quantum of import as the imported product turns costlier after the imposition of tariff. How much deeper the effect of tariff will be on the import restriction depends not only on the nominal rate of tariff but, more importantly, on the effective rate of protection.

Effective rate of protection may be much lower/much higher than the nominal rate of tariff. This is because many goods are produced with imported raw material or intermediate products. Suppose a ball-point pen produced in India costs Rs. 25, of which Rs. 10 represents imported ink and the rest, Rs. 15, represents the value addition in the country. If tariff on an imported ball-point pen is 30 per cent and the tariff on the import of ink is 5 per cent, the effective rate of protection comes to 46.6 per cent compared to a nominal tariff rate of $30-5$ or 25 per cent. This difference is because the entire production process is not protected, but only the value addition is protected. So, the effective rate of protection can be unusually high if any, or all, of the following conditions prevails.

The conditions are:

1. tariff on imported input is very low or zero
2. tariff on the final product to be imported is very high
3. value addition to the imported input is only insignificant

Quota

Quota is an instrument to put quantitative restrictions on import. It may take different forms. One is the outright limitation on the quantity of import. Limitation may be either a global one or specific to a country. For example, if the government permits the import of only 2,000 bicycles without mentioning a particular country, it will be global quota. But if the government limits the import of 500 bicycles from the USA, it will be country-specific quota or selective quota. Since the global quota is based on first-come-first-served, the importing country has to accept those supplies that are made earlier irrespective of their quality and source.

Sometimes, the government fixes quota for the import and at the same time imposes tariff. Up to the quota limit, the rate of tariff is lower, but if the imports are made beyond the quota, a higher rate of tariff is applicable for the additional import. The tariff-rate quota is a subtler form of quota that permits the import beyond the quota limit, although at a higher rate of tariff.

The other form of quota is import licensing requirement. If obtaining licence from the government to import a particular commodity is mandatory, the commodity can be imported only to the extent it is specified in the licence. The government issues licence for import based on the required size of import. It is true that the import licensing requirement is a less transparent form of quota than the outright limitation on the size of import, but it is a common instrument. By 1980s, it was used as a major tool for protecting industries in Mexico. In India too, it was used more frequently till 1980s.

Still the other form of quota is known as voluntary export restraint (VER). In this case, the exporting country is asked by the importing country to limit the supply of a particular commodity. The restriction is imposed by the exporting country and not by the importing country. There are many examples of VER negotiated by the USA to restrict the import of textiles, automobiles and other products from Japan, Korea and other countries.

Subsidies

Subsidies are other form of non-tariff barriers. Subsidies take many forms, such as cash assistance given by the government, tax concessions, loans at lower than market rate of interest arranged by the government and such others. In this way, they allow the domestic producers to produce at prices lower than warranted by the actual cost or profit considerations.

Domestic Subsidy: With domestic subsidy, inefficient producers begin production at a price compatible with the international price. As a result, domestic production rises and import falls with a given demand for the product.

Domestic subsidies are better than tariff and quota. It is because the subsidies do not force consumers to lessen their demand and there is no dead-weight loss in the form of consumption effect. But, at the same time, subsidies fall on the state exchequer and enlarge the fiscal deficit.

Export Subsidy: Export subsidy is confined to those producers that produce for export. In this case, the domestic price of the commodity is higher than the foreign price. It is true that the volume of export rises thereby increasing the total export earnings, but the net barter terms of trade worsens as a result of the fall in price.

Dumping

Dumping is a form of price discrimination in favour of foreign consumers. The same product is sold to foreign buyers at a lower price than what the domestic buyers have to pay. Dumping also occurs when goods are sold in the overseas market at a price below the average cost of production.

Dumping may take different forms depending upon the purpose for which it is done. The first is distress dumping or the sporadic dumping. In this case, a firm clears its unsold stock at a lower price in overseas market. It is true that it hurts the competing exporters in other countries or the producers in the importing countries, but it is only a short-term problem.

The second is the predatory dumping. The purpose is not the clearance of the unsold stock but to throw the competing exporter out of the market. It is expected that when the competitors are out of the market and when the dumping firm enjoys the monopoly position, it raises the price in order to recover the losses incurred during dumping. However, this form of dumping is normally not found in the real world.

The third one is known as persistent dumping. It is a long-term phenomenon. A firm charges higher price from the domestic market where competition is lacking and a lower price from a highly competitive international market. Thus, it is synonymous with international price discrimination.

Some Other Forms of Non-tariff Barriers

Among other non-tariff barriers, we here discuss some of their important forms, such as buy-local legislation, social regulations, health and sanitary regulations, etc.

Buy-local legislation is enacted to force the domestic producers to buy the inputs first in the domestic market. It also forces the consumers to buy locally-made goods. Such legislation is treated as a trade barrier because it discriminates against low-cost foreign suppliers in favour of domestic suppliers. Costly inputs raises the cost of production and thereby the price of the product and lowers the consumers' surplus. It causes dead-weight welfare losses in the form of consumption effect and protective effect.

During the international financial crisis of 2008 and 2009, the US Government emphasised on the local purchase of iron and steel for the infrastructural projects. It entailed upon the export performance of the Indian economy during FY 2009–2010.

Social regulations apply to specific social problems, environmental issues and other related issues. The US Government has put restrictions on the import of carpet from India because the Indian carpet industry employs child labour. Similarly, restrictions are there in case of environment-polluting exports. India put restrictions on the import of Chinese toys which had harmful effects on the health of the Indian children. More recently, the European Union has put restrictions on the import of chemicals on the ground of protecting environment. The exporters were to get registered with the Registration, Evaluation and Authorisation of Chemical Substances (REACH) by November 2008. The REACH would permit the import only after proper scrutiny.

Other technical barriers to trade are related to a country's national standards of health and safety. They are also related to product designing and product packaging. When the US automobile firms sell cars in the UK and Japan, the steering system is changed from left to right. At the US ports, edible products are checked thoroughly. If any harmful live bacterium is found in any packet of the product, the ship is returned on the ground of preserving health in the country. Similarly, packaging is very important to protect the product from getting rancid. So goods with improper packaging are not accepted at the port of many countries.

Ans. 3(a): In a turnkey project agreement, a firm agrees to construct an entire plant in a foreign country and make it fully operational. It is known as turnkey because the licensor starts the operation and hands over the key of the operating plant to the licensee. Agreements for turnkey projects normally take place where the initial construction part of the plant is more complex than the operational part. Such projects are either self-engineered or made to specifications. In case of the former, it is the licensor who decides the design of the project. In the latter, it is the licensee who takes such decision. In both cases, the contract involves either a fixed price or a cost-plus price. In a fixed-price contract, the risk of cost over-runs lies with the licensor.

Ans. 3(b): Leontief put this theory to empirical testing and found in case of the US trade during 1947 that this country was exporting less capital-intensive goods even when it had abundance of capital compared to labour. Had the factor proportions theory been true, the USA would have exported more of capital-intensive goods. This is really a paradox and so it is known as *Leontief Paradox*. However, Leontief himself re-examined this issue and found that the paradox disappeared if the natural resource industries were excluded. Moreover, he found that the USA exported more of labour-intensive goods because the productivity of labour in this country was higher than in many labour-abundant countries. Even in case of labour-abundant economies, he viewed, different countries differ in the sense that some countries possess skilled labour pool, whereas in other countries, the labour resource may be unskilled. The country with skilled labour force will be able to manufacture the same labour-intensive product in a more capital-intensive fashion and will be able to export that product to those labour-abundant countries where improved skill is not employed in the manufacture of the same product. Thus it is not only that the factor endowments are not homogeneous, but also they differ along parameters other than the relative abundance. Leontiefs later views find support from a couple of studies. The studies of Hufbauer and of Gruber, Mehta and Vernon reveal that improved technology was involved in the US export of labour-intensive goods that characterised US exports as technology-intensive rather than labour-intensive.

Soon after Leontiefs study, Tatemoto and Ichimura found that in case of US-Japan trade, Japan exported labour-intensive goods to the USA and imported capital-intensive goods therefrom. Similarly, Bharadwaj found in case of Indo-US trade that India imported mainly capital-intensive goods from the USA and exported labour-intensive goods to this country in 1951. These two empirical tests support the Heckscher-Ohlin theory of international trade.

Ans. 3(c):

Trade Mode

Direct and Indirect Export

The trade mode presents the first step in international business. It includes export and import. Export may be either direct or indirect. In case of direct export, a company takes full responsibility for making its goods available in the target market by selling directly to the end users, normally through its own agents. Direct export is feasible when the exporter desires to involve itself greatly in international business; and at the same time possesses the capacity to do so. There are also some commodities where direct export is more convenient. They are, for example, air crafts and similar industrial products.

When the exporting company does not possess the necessary infrastructure to involve itself in direct exporting, indirect export takes place. It takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end-users in the target market.

It is a fact that the nature of intermediary differs in direct export or import from that in an indirect export and import. However, when one talks about intermediaries, export management companies (EMCs) and trading companies cannot be ignored. When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Sometimes it acts as an agent for one client and as a distributor for the other. Trading companies, on the other hand, provide services to exporters, in addition to exporting activities, such as storage facilities, financing services, and so on. These companies originated in Europe but are now common in Japan and South Korea.

Apart from the intermediaries, there are trade facilitators. They are independent entities supplying information and knowledge to the exporter but definitely not participating in the transactions. They exist both in the public and private sectors. Various commodity boards and export promotion councils can be grouped as trade facilitators. There are also government organisations working under the Ministry of Commerce, such as trade development authority, that act as trade facilitator.

Counter-trade

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods. In this type of external trade, a seller provides a buyer with deliveries and contractually agrees to purchase goods from the buyer equal to the agreed percentage of the original sale contract value. Counter-trade is classified broadly as:

1. Commercial counter-trade such as classical barter, counter-purchase and pre-compensation.
2. Industrial counter-trade such as buy-back agreements, develop for import arrangements, and framework agreements.

Commercial Counter-trade: Classical barter is one of the oldest modes of commercial counter-trade. It involves a once-only exchange of goods on the terms agreed upon between the buyer and the seller. The quantum, quality, and value of goods to be exchanged are well defined. Naturally, the trade flows in one direction are fully compensated by those in the reverse direction. There is no need for bridging finance. Negotiating parties are often governments. The exchange of Iranian oil for New Zealand's lamb or the exchange of Argentine wheat for Peruvian iron pillets are examples of classical barter.

In case of counter-purchase, which is also known as parallel barter, the contracts are often separate for import and export. The type and price of goods traded are generally not specified at the time of signing of the contract. The exporter of goods agrees to accept, in return, a wide range of goods from the importer. Balancing of the value of export and import is done every three to five years. If the two sides are not equal, the balance is paid in cash.

In case of pre-compensation, the value of exports is entered into an evidence account and imports are made on that basis. This means that payments for imports are not made immediately.

Industrial Counter-trade: Being a form of industrial counter-trade, buy-back agreements normally involve a larger amount corresponding to the sale of industrial equipment or turnkey plants in exchange for the products manufactured by these industrial plants. Naturally, the contract period is longer, varying from 10 to 20 years. The United Nations Economic Commission for Europe mentions the case of Austria selling pipeline equipment and related material to the then Soviet Union so that the latter could develop certain gas fields and could pipe a part of the output back to Austria. In case of developing countries, such agreements are common as they suffer from the technology gap on a large scale.

Develop-for-import arrangements are also a variant of the buy-back agreement where the exporter of the plant and machinery participates in the capital of the importing firm and, thereby, takes a share in the profits thereof. This means the involvement of the exporting firm is deeper than in a general buy-back arrangement. Japanese investment in an Australian firm developing gunpowder copper mine is an apposite example.

Framework agreements are the long term protocol or bilateral clearing agreement normally concluded between governments. Trade is balanced after a long period as mentioned in the agreement. If the trade is not equal in value, the debtor sells the agreed upon commodity in the international market and the creditor is paid off. For example, Mexico sold cocoa to the United States of America to pay for its excess import from Malaysia.

Contractual Entry Modes

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm. But in this case, the secrecy of technology is not maintained and the firm's ownership advantage is always at stake. Thus, in order to maintain the ownership advantage, a firm passes on the technology only to its own subsidiary located abroad. But if the host government does not permit any foreign investment, the subsidiary of the firm in that host country cannot exist. Transfer of technology through contractual deals is the only way out. The contractual entry mode, often known as technical collaboration or technical joint-venture, is very common. It is preferred in many cases where:

1. The licensor does not possess enough capital for investment, nor does it possess the requisite knowledge of the foreign market for the purpose of export.
2. The licensor wishes to exploit its technology in the foreign market.
3. The licensor finds the host country market too small to make any investment for reaping economies of scale.
4. Nationalisation is feared in the host country.
5. Foreign investment in the host country is restricted.

Technical collaboration normally takes four forms. They are:

1. Licensing
2. Franchising
3. Management Contracts
4. Turnkey Projects

These different forms of the contractual mode are explained here (Figure 1).

Licensing

Nature and Forms: Licensing is an arrangement by which a firm transfers its intangible property such as expertise, know-how, blueprints, technology, and manufacturing design to its own unit, or to a firm, located abroad. It is also known as technical collaboration. The firm transferring

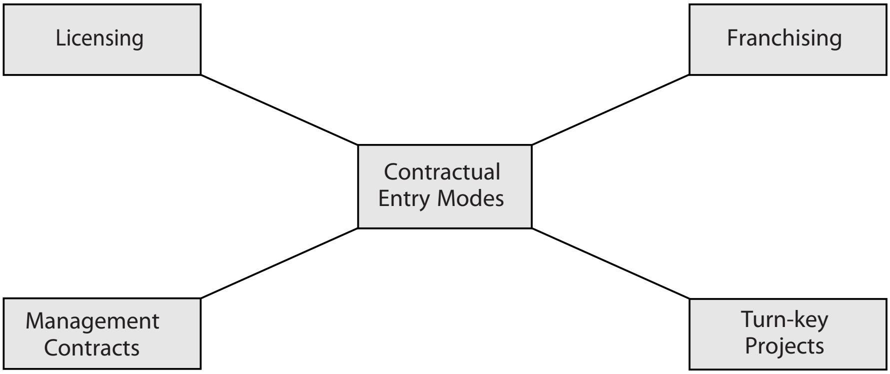


Figure 1: Different Forms of Contractual Entry Mode

technology, and so on is known as the licensor. The firm receiving technology, at the other end, and so on is known as the licensee. The arrangement is meant for a specific period. The licensor gets technical service fee from the licensee. The licensee, on the other end, does not have to make a huge investment on research and development. Thus both the parties reap the benefits of licensing.

A licence can be exclusive, non-exclusive, or cross. In an exclusive licence, the arrangement provides exclusive rights to produce and market an intangible property in a specific geographic region. On the contrary, a non-exclusive licence does not grant a firm sole access to the market. The licensor can grant even more companies the right to use the property in the same region. Cross licensing is reciprocal where intangible property is transferred between two firms, both of them being the licensor and the licensee at the same time. In the early 1990s there was cross licensing between Fujitsu of Japan and Texas Instruments of the USA. Both the companies used each other's technology for a given period.

Franchising

Meaning and Forms: In this form of technical collaboration, the franchiser is the entrant and the franchisee is the host country entity. The franchisee makes use of intellectual property rights, like trademarks, copyrights, business know-how, managerial assistance, geographic exclusivity, or of specific set of procedures of the franchiser for creating the product in question. In the literature available on this subject, a few experts have established similarities between licensing and franchising. Oman suggests that "franchising may be regarded as a particular type of licensing". Root too feels that franchising is a form of licensing in which the franchiser licenses a business system and other property rights to a franchisee. On the contrary, there are views to suggest that these two are different. Perkins is of the view that while franchising encompasses transfer of the total business function, licensing concerns just one part of business, including transfer of right to manufacture or distribute a single product or process. Again, franchising differs from licensing in that the former gives a company greater control over the sale of the product in the target market. When the franchisee fails to abide by the set of procedures, the franchiser takes back the franchise. Yet again, licensing is common in manufacturing industries, whereas franchising is more common in service industries where the brand name is more important.

Franchising may take different forms. In direct franchising, the franchiser frames policy and monitors and directs the activities in each host country from its home-country base. But in case of indirect franchising, there are sub-franchisers between the original franchiser and the host country units. The sub-franchiser possesses the exclusive right to exploit the original franchiser's business package within a defined geographic area.

Management Contracts

Nature of Management Contracts: In a management contract, one company supplies the other with managerial expertise. Such agreements are normally signed in case of turnkey projects where the host country firm is not able to manage day to day affairs of the project, or in other cases where the desired managerial capabilities are not available in the host country. The transfer includes both technical expertise and managerial expertise.

Turnkey Projects

Meaning: In a turnkey project agreement, a firm agrees to construct an entire plant in a foreign country and make it fully operational. It is known as turnkey because the licensor starts the operation and hands over the key of the operating plant to the licensee. Agreements for turnkey projects normally take place where the initial construction part of the plant is more complex than the operational part. Such projects are either self-engineered or made to specifications. In case of the former, it is the licensor who decides the design of the project. In the latter, it is the licensee who takes such decision. In both cases, the contract involves either a fixed price or a cost-plus price. In a fixed-price contract, the risk of cost over-runs lies with the licensor.

Ans. 4(a): Globalisation is a process through which different economies get inter-woven by way of international trade and investment. They become an integral part of the world economy.

Drivers of International Business

Technological drivers: Technology shaped and set the foundation for modern globalization. Innovations in the transportation technology revolutionized the industry. The most important developments among these are the commercial jet aircraft and the concept of containerisation in the late 1970s and 1980s. Inventions in the area of microprocessors and telecommunications enabled highly effective computing and communication at a low-cost level. Finally the rapid growth of the Internet is the latest technological driver that created global ebusiness and e-commerce.

Political drivers: Liberalized trading rules and deregulated markets lead to lowered tariffs and allowed foreign direct investments in almost all over the world. The institution of GATT (General Agreement on Tariffs and Trade) 1947 and the WTO (World Trade Organization) 1995 as well as the ongoing opening and privatization in Eastern Europe are only some examples of latest developments.

Market drivers: As domestic markets become more and more saturated, the opportunities for growth are limited and global expanding is a way most organizations choose to overcome this situation. Common customer needs and the opportunity to use global marketing channels and transfer marketing to some extent are also incentives to choose internationalization.

Cost drivers: Sourcing efficiency and costs vary from country to country and global firms can take advantage of this fact. Other cost drivers to globalization are the opportunity to build global scale economies and the high product development costs nowadays.

Competitive drivers: With the global market, global inter-firm competition increases and organizations are forced to "play" international. Strong interdependences among countries and high two way trades and FDI actions also support this driver.

Ans. 4(b): If regulation aims at *liberalisation of trade*, it is definitely a move towards *free trade*. If, on the contrary, it is meant for restriction of trade, it is nothing but protection. It is better to mention the arguments sometimes given in favour of free trade before any discussion of regulation of trade.

First of all, the argument for free trade rests primarily on the belief that it leads to specialisation, which helps increase output and the gains from the increased output is shared by the trading partners. It may be noted that output can also be increased through acquiring greater resources or through improving the quality of the factors of production. But, international trade is the least painful of the three measures for increasing output. Moreover, trade facilitates the other two types of the measures.

Secondly, free trade generates competition, which in turn promotes efficiency in production. Increased productive efficiency leads to improvement in quality and in lowering of prices. All this benefits both the producers and the consumers.

Thirdly, free trade leads to the generation of economies of scale. There are some industries that can achieve minimum average cost only through a bigger amount of sale, which is possible only when goods are exported to a global market. For example, the aeroplane-manufacturing industry cannot achieve economies of scale when its has only domestic customers.

Fourthly, free trade helps check inflation through the application of the one-price principle. It maximises the welfare of trading countries, and consequently, global welfare.

Arguments for Protection

It is a fact that free trade has a sound theoretical base, but it has only limited empirical support. Moreover, in real life, free trade is a utopian ideal. There are economic as well as non-economic arguments for regulating trade (Table 1). The economic arguments are normally concerned with strengthening industrialisation in the country or with protecting balance of payments from any deterioration. The non-economic arguments are mainly political in nature. Whenever any government regulates foreign trade, there is normally a combination of factors behind it. Here it is relevant to discuss some of the major arguments behind protection of international trade.

Table 1: Arguments for Trade Protection

Economic Factors	*Non-economic Factors*
1. Protection of infant industry	1. Maintenance of essential industries
2. Promotion of industrialisation	2. Relations with unfriendly countries
3. Retaliatory action	3. Preservation of culture and national identity
4. Balance of payments adjustment	4. Preservation of community health
5. Price control and terms of trade	5. Preservation of national security
6. Employment generation	

Economic Factors

1. The **infant industry** argument presents the most important justification behind the regulation of international trade. Newly born firms are generally not strong enough to

compete with well established firms. Global firms enjoy economies of scale and are able to sell goods at a lower price. On the other hand, newly born domestic firms have high costs and cannot sell their products at low prices, at least in the short run. If the import of such products is not restricted, consumers will demand the imported product and not the domestically produced high cost goods. The result will be that in absence of demand, domestic firms producing such goods will have to close down their operations. Thus, if such firms have to be developed at home, import restriction becomes a necessity.

This concept is not new. As far back as in 1930s, several industries in India were given protection against imports from the UK and other countries. It is often said that the sugar industry in India is a child of protection. However, there are a few problems that arise in such cases. First, it is very difficult to decide which industry has to be protected. Second, protection, once given, cannot easily be lifted because the producers, workers, and consumers tend to oppose it. Third, there is every possibility that the infant industry becomes dependent on the protection. If this is the case, it can never stand on its own feet and become competitive. Fourth, protection often causes greater economic harm than good insofar as the consumers have to pay higher prices for the product. Thus, whenever imports are restricted to help develop the infant industry, it should be a short-run phenomenon.

2. The **industrialisation promotion** argument is also important. In many countries, import substituting industries are developed to achieve self-reliance and to give a boost to other industries. This means that import restrictions lie at the very root of industrialisation. Sometimes, it is also said that when the government restricts imports, foreign investors boost up their investment in that country. This is because they get a sheltered market where they can make huge profits. Daniels and Radebaugh cite an example where Japanese automobile manufacturers began investing in the United States of America following restrictions on automobile import by the US Government. If this is the case, it means that import restrictions lead to foreign investment inflow and, thereby, strengthens the process of industrialisation.

   Again, sometimes the government restricts imports in order to help revive an already existing industry that is not in its infancy but is quite old. This is because such industries get a breathing space for revival in the absence of competition from imported products. This argument holds good in Canada where footwear imports are restricted because this is a traditional industry in Canada.

3. Sometimes, **retaliatory actions** need import restrictions. Such measures are taken when exporters adopt unfair trade practices. In order to capture the market, exporters sell goods in foreign countries, even at a lower price than their cost structure justifies. Such practices disrupt the very industrial structure in the importing countries. In order to counteract this move of exporters, the government in the importing country imposes restrictions on imports. However, it is very difficult to prove unfair trade practices in some cases. Moreover, retaliatory measures often turn to be unending and they prove harmful for trading countries.

4. **Balance of payments adjustment** is another justification, either for imposing restrictions on import or for export encouragement or both. In developing countries, axing the trade deficit lies at the root of import restrictions. In India, when the balance of trade was in a very bad shape during the early 1990s, import restriction measures were adopted quite intensively. Again, the import restriction measures are often accompanied by export encouragement measures. But sometimes it is found that import restrictions considerably hamper the export potential since the exporting industries do not get the desired amount

of raw material or they get it only at a higher cost. So, import restrictions are only a short-term measure. They cannot be long-term, especially when they affect the exporting industries.

5. **Price control** is another objective behind the regulation of international trade. It is often found in cases where the exporting country is in a monopolistic or oligopolistic position with respect to a particular commodity. The exporting government shapes the price of the export in such a way that it provides for maximum profit. When the demand for the product is price inelastic, the exporting government raises the price of the product far beyond the cost of production. But if, on the contrary, the demand for export is price-elastic and the importing government imposes duty on the import, the price of the product will be unusually high in the hands of the consumers. As a result, the supplier will be forced to cut the price in order to maintain demand for the product. With a cut in the price, the ratio between the import price and the export price will be lower for the importing countries, improving in turn the terms of trade. An improvement in the terms of trade means accruing of gains from trade.
6. Protection of trade helps **generate employment** in the importing country. In macro-economic terms, protection helps generate balance of payments surplus, which in turn increases income and employment. But if the additional income is used for imports, surplus in the balance of payments is eroded. On the contrary, the microeconomic employment case for protection starts with the fact that imposition of tariff may raise the demand for labour in a particular industry where import substituting goods are produced. But if labour is not mobile among industries, this effect may not be felt.

Non-economic Factors

1. Among the non-economic factors, **maintenance of essential industries** is a guiding factor behind the regulation of trade. Each and every country tries to develop some essential industries so that in case of an extra-ordinary situation, the supply of essential products is not completely hampered. In order to protect these industries, the government regulates the export and import of these products. Again, in some other cases where the producers need the assurance of an uninterrupted supply of raw material, the government regulates the export and import of raw material. For example, the US Government subsidises the domestic production of silicon, which is made easily available to the computer industry.
2. **Trade with unfriendly countries** needs to be regulated. If the political relations are not friendly between two governments, trade is not encouraged between them. In cases where minimum trade is conducted, there is often the possibility of non-payment. So in such cases, trade is highly regulated in terms of commodities and price.
3. **Preservation of national culture and identity** is one of the factors behind regulating trade. For example, France imposes partial curb on the import of foreign films. This is out of fear that those films may affect badly the French culture and identity. In Canada too, there are restrictions on the import of entertainment products from the United States.
4. **Preservation of community health** is of utmost importance. The essence of health and sanitary regulations is to import only those products that do not adversely affect consumers' health. This is why food products are checked by health authorities the moment they enter ports
5. Trade regulation is necessary in order to preserve **national security**. Industries considered important for national security are often subjected to export or import regulations. The export and import of defence related products are cases in point.

Ans. 4(c): Economic integration or regional economic grouping represents some kind of preferential economic arrangement among member countries, where they cooperate with one another in many ways and eliminate restrictions on the intra-region flow of goods, services, capital, and labour. The member countries normally belong to a particular geographic region, with the result that they have common history and similar awareness to the regional problem. However, belonging to a specific geographic region is not an essential qualification for regional grouping. Cuba was a member of the Council for the Mutual Economic Assistance (COMECON) before the break-up of the former USSR, despite the fact that it was quite distantly located.

The different forms of regional economic integration schemes differ from each other. One of the reasons is that they represent different levels of economic integration. Based on the varying levels, the integration schemes are known as:

1. Free Trade Area
2. Customs Union
3. Common Market
4. Economic Union
5. Political Union

Free Trade Area: In a free trade area, which involves the least integration, member countries abolish tariff and non-tariff barriers on intra-region trade but they are free to impose tariff on their import from a third country at different rates. Thus tariff abolition is a preferential economic arrangement that aims at encouraging intra-region trade. European Free Trade Association (EFTA) and North American Free Trade Agreement (NAFTA) are apposite examples of this type of economic integration.

Customs Union: The second form of economic integration is known as customs union where the member countries abolish tariff and non-tariff barriers on intra-region trade just as in case of a free trade area. But, the member countries maintain a common tariff wall on imports from a third country. Thus, it is different from the free trade area, which does not involve a common external tariff. The European Union in its initial stage was a customs union.

Common Market: The third form is known as common market where the degree of integration is further one step ahead. The common market involves common external tariff that is found in a customs union. Over and above, it also involves free movement of factors of production such as labour, capital, enterprise, and technology among the member states. As a result, there are chances for best allocation of resources in a common market leading to maximisation of benefits from resource utilisation among the member states.

Economic Union: The fourth form is known as an economic union where all the features of a common market exist. But additionally, the member states try to harmonise monetary, fiscal, and other economic policies. Thus, the content of integration is the maximum in this case. This may mean that the member states surrender, at least to some extent, their national sovereignty for the harmonisation of economic policies. The European Union, after the Maastricht Treaty, has come to be an economic union.

Political Union: Political union represents the highest level of integration. Although it is not a pure form of economic integration, it does indicate the logical outcome of increased economic integration among a group of nations. In this case, the member countries lose their national identity and come under a single state. East Germany joined West Germany to form a political union.

These are the five stages through which the process of economic integration moves further. The time span for the movement from one stage to the other may vary widely depending upon the subservience of the economic goal among the member states. In Europe, it took around four decades to enter a complete economic union. In South Asia, the first stage is not complete even after one and a-half decades of the formation of the South Asian Association of Regional Co-operation (SAARC).

Ans. 5(a): In a society that defines itself by some type of status hierarchy, people naturally move up and down in the system throughout their lives. Social mobility refers to how far and how easily a person can move in the social system. People looking to gain power and influence, or simply an easier or more luxurious lifestyle, are often said to be "upwardly mobile." Yet scrambling for power can also carry its own risks, and in societies where social mobility is extremely important, it is often much easier to lose social status than to gain it.

Social Mobility

(a) Social Mobility is the ease with which individuals can move up or down a culture's "social ladder." For much of the world's population today, one of two systems regulates social mobility: a caste system or a class system.
(b) A caste system is a system of social stratification in which people are born into a social ranking, with no opportunity for social mobility. The caste system forces Western companies to decide whether to adapt to local human resource policies or import their own.
(c) A class system is a system of social stratification in which personal ability and actions decide social status and mobility. Highly class-conscious cultures offer less mobility and can experience more class conflict. Lower levels of class consciousness encourage mobility and lessen conflict.

Ans. 5(b): TRIPS: The Uruguay Round agreement covered TRIPS in view of the fact that practices like counterfeiting, copying, and piracy on a large scale had come in the way of fair trade. It was estimated that the loss incurred by EU on account of copyright piracy was around 10 per cent of the value of its export. The agreement aimed at regulating and standardising international intellectual property rights in order to prevent these abuses.

TRIMS: Regarding TRIMS, it was stated that no member country should attach conditions to foreign direct investment, which could in turn restrict or distort the trade. The conditions were related to purchases from the domestic country, a specific import-export ratio in the enterprise, and restrictions on export. The developed countries, developing countries, and the least developed countries were to adhere to these norms within two years, five years, and seven years, respectively. The agreement sought to set up a committee for monitoring TRIMS.

Ans. 5(c): North American Free Trade Agreement (NAFTA): The NAFTA, embracing three member countries, namely, the United States of America, Canada, and Mexico, came into force from January 1994. In the wake of peso devaluation during 1995, there were some problems, but since 1996 it has regained strength. The grouping aims at dismantling trade barriers and liberalisation of government procurement rules and the rules concerning trade in services, intellectual property rights, and environment. The US and Canadian firms have reaped advantage from the cheap surplus labour of Mexico. This is one of the reasons that there has been large flow of investment from the US and Canada to Mexico. Moreover, intra-union trade has multiplied. Mexico became the largest user of US goods, only next to Canada. Mexican export to these countries rose primarily on account of intra-firm trade. However, there were strict local content requirements in case of trade availing of duty free provisions.

Ans. 6(a): Five Elements for Comparing Competitive Position

1. **Philosophy:** A competitor with a strong philosophy is a strong competitor. A clear philosophy makes decision-making easier. Understanding your competitor's philosophy allows you to predict them.
2. **Heaven:** Trends over time that are beyond your control. You must foresee these changes to adjust to them.
3. **Ground:** It is both where you fight and what you fight for. The Ground is the basis of all competition because it is what people are fighting about. Competitors are distinguished by the position they hold on the ground. You can and must chose the ground over which you battle. Your choice of ground is a key aspect of your success.
4. **Leader:** The success of the competitive unit depends on five qualities in its leader i.e., bravery, intelligence, strictness, trust in and care about people.
5. **Methods:** Methods have five qualities that make them effective: systems, organization, learning, support, and standards.

The Four Primary Elements of a Competitive Strategy are:

- Market Analysis
- Self Assessment
- Goals & Objectives
- Strategic Plan

Ans. 6(b): The portion of a country's debt that was borrowed from foreign lenders including commer-cial banks, governments or international financial institutions. These loans, including interest, must usually be paid in the currency in which the loan was made. In order to earn the needed currency, the borrowing country may sell and export goods to the lender's country.

A debt crisis can occur if a country with a weak economy is not able to repay external debt due to the inability to produce and sell goods and make a profitable return. The International Monetary Fund (IMF) is one of the agencies that keep track of the country's external debt.

External debt (or **foreign debt)** is that part of the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the IMF and World Bank.

IMF defines the key elements as follows:

Outstanding and Actual Current Liabilities: For this purpose, the decisive consideration is whether a creditor owns a claim on the debtor. Here debt liabilities include arrears of both principal and interest.

Principal and Interest: When this cost is paid periodically, as commonly occurs, it is known as an interest payment. All other payments of economic value by the debtor to the creditor that reduce the principal amount outstanding are known as principal payments. However, the definition of external debt does not distinguish between whether the payments that are required are principal or interest, or both. Also, the definition does not specify that the timing of the future payments of principal and/or interest need be known for a liability to be classified as debt.

Residence: To qualify as external debt, the debt liabilities must be owed by a resident to a nonresident. Residence is determined by where the debtor and creditor have their centers of economic interest typically, where they are ordinarily located—and not by their nationality.

Current and Not Contingent: Contingent liabilities are not included in the definition of external debt. These are defined as arrangements under which one or more conditions must be fulfilled before a financial transaction takes place. However, from the viewpoint of understanding vulnerability, there is analytical interest in the potential impact of contingent liabilities on an economy and on particular institutional sectors, such as government.

Generally external debt is classified into four heads: (1) public and publicly guaranteed debt; (2) private non-guaranteed credits; (3) central bank deposits; and (4) loans due to the IMF. However the exact treatment varies from country to country. For example, while Egypt maintains this four head classification, in India it is classified in seven heads: (a) multilateral, (b) bilateral, (c) IMF loans, (d) Trade Credit, (e) Commercial Borrowings, (f) NRI Deposits, and (g) Rupee Debt, and (h) NPR Debt.

Ans. 6(c): Various Methods of Payment, in International Business

Cash in Advance: The importer pays for the merchandise before it's even shipped. You can use this method if you completely trust the exporter/manufacturer. In this case risk is on the importer.

- Sometimes manufacturer might ask for partial cash in advance, for example 25% to cover the costs.
- Sometimes when the demand for a particular product is high, you'll have to pay in advance in order to get the product.

Open Account: The buyer/importer has an account with the exporter. When the buyer/importer receives merchandise, he transfers money to the seller/exporter. In this case the seller should implicitly trust the buyer. This risk is on exporter/manufacturer.

On Consignment: The seller ships the merchandise without any sort of payment and doesn't get paid until the importer sells the product. This method would be great for new importers. However, the risk is again on exporter's shoulders. If the buyer won't sell all merchandise, he might return it back without any payment.

Collection Draft: This method is similar to the letter of credit, because the bank acts as a third party between buyer and seller. First the exporter ships the merchandise. Then, exporter's bank send the bill of landing and other specified documents, that are necessary for collecting the goods at a pay of entry to the importer's bank. The importer's bank won't release documents until the importer makes a full payment. Once the payment is made, the importer is allowed to take the documents and bank transfers the funds to the exporter. The bank's charges for collection draft might be between $250 and $500 less than for letter of credit ($1000 – $1500).

Collection draft is divided into three types:

1. **Sight Draft** requires payment before the importer is able to receive the goods. The importer keeps the title of the merchandise until it arrives to the destination (pending

entry). It is called sight draft because the merchandise is theoretically "in sight of the dock".

2. **Time Draft** is an extended credit to importer. The exporter allows importer to pickup the goods without payment and pay in a certain amount of time. For example importer gives 30 or 90 days to exporter to close the deal, from the month of picking up merchandise and accepting the draft.
3. **Clean Draft:** The exporter sends all the documents to importer at the same time as backup merchandise. This is pretty much the same as **open account** and could not used just when exporter is very confident in his customer.

Ans. 7(a): Balance of payments is a macro level statement showing inflow and outflow of foreign exchange. Balance of payments is a statement listing receipts and payments in the international transactions of a country. In other words, it records the inflow and the outflow of foreign exchange. The system of recording is based on the concept of double entry book keeping, where the credit side shows the receipts of foreign exchange from abroad and the debit side shows payments in foreign exchange to foreign residents. Disequilibrium does occur, but not from accounting point of view because debit and credit balances equal each other if the various entries are properly made.

Ans. 7(b): The operations strategy in a manufacturing firm involves many decisions. The most important among them are concerned with location for production; management of inventory; sourcing of inputs; and international logistics, including transport, packaging, and storage. The purpose of these decisions is to minimise the cost of production and to ensure production flexibility and market responsiveness. However, if a firm provides services, the strategy would be slightly different.

Options for Location

The traditional theory of location suggests that if the inputs account for a large share in the value of the final product or if the raw material carries heavy weight but loses its weight during the manufacturing process, the manufacturing unit should be located near the source of inputs. On the other hand, if input does not matter very much, from the viewpoint of cost or transportation, the manufacturing unit should be located near the market. However, the decision regarding the location of an international firm is complex insofar as, firstly, these firms are spread over a far wider geographic area; secondly, they source the inputs globally; and thirdly, their market is spread over different countries.

An international firm may have various alternatives regarding the location of manufacturing activities. Dicken describes these options as:

1. Centralisation of the manufacturing operations at the parent unit or any one of the subsidiaries. It will help reap either the economies of scale or the location specific advantage in the form of climatic, cultural, governmental, and other factors.
2. Decentralisation of manufacturing operations at different subsidiaries and distribution of the product in the respective areas.
3. Location of the different parts of the manufacturing process at different subsidiaries under a vertically integrated framework. Vertical integration may be of two types.

They are:

(i) The different units are linked in a chain-like sequence.
(ii) Different units manufacturing spares and components export the output to a particular unit engaged in assembling them. It is common that the spare parts of a product are produced in a country with abundance of capital and the assembly part is located in a labour surplus country.

Factors behind Selection of Location

Dunning mentions five factors behind the selection of a location. They are:

1. Size and growth of market and the degree of competition in the market
2. Availability of raw material and labour force of required skill
3. State of logistics and the degree of currency fluctuation
4. Political and legal environment
5. Cultural and linguistic environment

Not a single factor determines the location decision. It is rather a combination of all factors that really works. For example, if a market is large and promising, the plant may be located close to the market. But if raw material or labour is cheap in a particular country, the plant may be located there without considering proximity to the market. Again, if both of the above factors are favourable, but the logistics are not well developed, the firm may not be attracted by the availability of raw material or manpower. Scully and Fawcett have found in their empirical study that despite finding cost advantageous locations, US companies did not locate their plant there. This is because the state of logistics there was not supportive. Similarly the plant is located only in countries that are marked with political stability and where socio-cultural and language problems do not exist as a major barrier.

In fact, the purpose of considering these factors is to:

1. Minimise cost
2. Maintain quality
3. Have flexibility in designing the product and in the volume of production

The centralisation of plant at a particular unit leads to economies of scale, which tends to reduce the cost of production. But the benefit on this account needs to be weighed against the cost of transportation that is involved in carrying the product from the plant to different markets. However, cost can be reduced by locating a part of the manufacturing activities at a low-cost site. A number of US companies ship components necessary for the assembly of a product to Mexican maquiladora (a synonym for the export processing zones). The components are assembled there and the final product is shipped back to United States of America and other markets. The offshore assembly of many products of US companies is done in East Asian countries such as Taiwan, South Korea, and so on. All this is done to reap the benefits of low wage cost in Mexico or in the East Asian countries. This is especially so in cases where the assembly cost accounts for a very large share in the total production cost.

Again, quality control is a significant aspect. An international company locates its manufacturing activities only at a place where it feels trained manpower is available to make the best use of the technology and where the quality of the product is maintained. Maintenance of quality in international business means either zero-level defect or an acceptable level of defect. The former is in use among Japanese multinationals, whereas the latter is used by Western companies. It is because of this view that international companies stress on ISO 9000. Products maintaining ISO 9000 standards are widely accepted among the consumers, irrespective of geographical differences.

As regards flexibility in designing and volume of production, it is suggested to locate the manufacturing plant at different subsidiaries. This is because the subsidiaries can easily make relevant changes in the design of the product to suit the local consumption pattern or in the volume of production in the wake of fluctuating demand.

Selecting a Location

It is evident from the preceding section that some factors are favourable attracting a firm to locate its manufacturing activities in a particular place/country. At the same time, there are unfavourable factors, especially various types of risks that detract firms from locating their manufacturing unit. From this viewpoint, managers should first assign weightage to different factors depending upon the firm's requirements and then use a matrix showing favourable factors/locations on the Y-axis and unfavourable factors/locations on the X-axis. Finally, they should plot the locations depending upon the favourable and unfavourable factors. The most suitable location would be the one that has the highest ratio of favourable points/unfavourable points. This is the easiest way to select a location.

Ans. 7(c): It is a fact that the size of demand for a product depends not only on the level of income and its distribution, but it is also subject to the level of inflation in the country. It is because the purchasing power of the consumers depends on their real income. The higher the level of inflation, the lower is the real income and the purchasing power of the consumers. Thus, when a multinational firm decides to set up a manufacturing unit in a foreign country, it has to take into account the rate of inflation in the host country.

The rate of inflation is also important from the viewpoint of cost of production. If it is high in the host country, the production cost of the host country plant will be higher. The price may be competitive for the host country market because the other manufacturers in that country too face the same problem. But exports from the host country to markets with a lower rate of inflation will definitely be affected on account of higher cost. However, if the multinational firm exports its products to the high-inflation country instead of setting up of a manufacturing unit there, the exports may have a competitive edge in view of the lower rate of inflation at home. When one examines the impact of inflation on the foreign trade of the country, it should not be done in isolation of the changes in the exchange rate. It is because the changes in the exchange rate may nullify the effects of inflation rate changes.

Again, inflation has varying impact on different sections of the society. Fixed-wage earners are the worst hit. Inflation causes diminution in their purchasing power. But, on the other hand, the business community is well off. Profit is higher, which means nothing but rise in purchasing power. If the multinational firm pinpoints this particular consumer group and manufactures goods to meet its specific demand, it would be a profitable venture.

Besides the level of inflation, the way in which the monetary authorities tackle the growing inflation is also important. If they raise interest rates to bring down the rate of inflation, the rate of industrial growth would be adversely affected on account of availability of costly funds. Industrial stagnation may also be a factor inhibiting inflow of foreign investment.

Ans. 8(a):

- China can afford to price so competitively because it does not take on certain costs, such as the cost of customer insight and product innovation, and of making mistakes until you get it right
- low cost labor
- do not have Childhood Labor Laws
- deliver goods by ship

Ans. 8(b):

- Competitor retaliation: To counter attack the competitors in their own territories or home countries
- To compete with Chinese manufacturer and to receive economies of scale
- To increase the market size
- Foreign business selling in the market, much of the market is taken by cheaper, bigger brands and so businesses must find market elsewhere to replace the lost bits!
- Cost reduction measure and produce the product at cheap rate

Economic benefits to Dixon of becoming an international business

- Faster growth: economies that have in the past been open to foreign direct investments have developed a much quicker pace than those economies closed to such investment
- Cheaper imports this is down to the simple fact that if we reduce the barriers imposed on imports (e.g., tariff, quota, etc.) then the imports will fall in price
- New technologies by having an open economy we can bring in new technology as it happens rather than trying to develop it internally
- Spur of foreign competition: foreign competition will encourage domestic producers to increase efficient
- Increase consumer come: multination will bring up average wage levels because if the multinationals were there the domestic companies would pay less
- Increased investment opportunities: with globalization companies can move capital to whatever country offers the most attractive investment opportunity. This prevents capital being trapped in domestic economies earning poor returns

Ans. 8(c): Anti-dumping has a long history, especially in the English-speaking world, but it has spread across much of the world in recent years. The world's first anti-dumping law came into effect in Canada in 1904, followed shortly by New Zealand (1905) and Australia (1906). The United States implemented its first anti-dumping law in 1916. The countries that would eventually make up the European Union were also early users of anti-dumping provisions. This group of countries constitutes the traditional users of anti-dumping; up until 1986, worldwide use of anti-dumping was almost exclusively restricted to this group.

Lobbying the U.S government to impose anti-dumping duties on import of pencils from china is not a right way to protect the American jobs and U.S will be the loser and the Chinese company would be bene lilted by this duty.

- Leaving aside this unlikely case, if foreign firms wish to sell a product to us below cost, we should gladly take it. From the national welfare standpoint, we should want to pay less for foreign goods, not more. And it should not matter whether the low price is the result of sales below cost or the discovery of a cheaper method of production. Nor should it matter that the price is lower than what the firms charge in their own domestic market.
- While consumers and the country as a whole benefit from cheaper supply of foreign goods, inefficient domestic firms that produce similar goods lose. If these firms are politically powerful, they successfully lobby the government to take anti-dumping actions against the more efficient foreign suppliers.

Ans. 8(d): The alternate policy stance the government can take is to ask the company to go for merger or acquisition for the benefit of the country.

Mergers and Acquisitions may generate tax gains, can increase revenue and can reduce the cost of capital. The main benefits of Mergers and Acquisitions are the following:

- Greater Value Generation: Mergers and acquisitions often lead to an increased value generation lor the company. It is expected that the shareholder value of a firm after mergers or acquisitions would be greater than the sum of the shareholder values of the parent companies
- Mergers and acquisitions generally succeed in generating cost efficiency through the implementation of economies of scale
- Merger & Acquisition also leads to tax gains and can even lead to a revenue enhancement through market share gain. Companies go for Mergers and Acquisition from the idea that, the joint company will be able to generate more value than the separate firms. When a company buys out another, it expects that the newly generated shareholder value will be higher than the value of the sum of the shares of the two separate companies
- To lower cost of operation and/or production
- To gain higher competitiveness
- For industry know how and positioning
- For Financial leveraging