INTERNATIONAL BUSINESS MANAGEMENT MCOM

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MCOS-14

தமிழ்நாடு திறந்தநிலைப் பல்கலைக்கழகம்

எல்லோருக்கும் எப்போதும் கல்வி

M.COM. – FIRST YEAR
(Semester – 01)

INTERNATIONAL BUSINESS MANAGEMENT

SCHOOL OF MANAGEMENT STUDIES

TAMIL NADU OPEN UNIVERSITY
577, ANNA SALAI, SAIDAPET, CHENNAI - 600 015

Master of Commerce

MCOS -14

INTERNATIONAL BUSINESS MANAGEMENT

School of Management Studies

Tamil Nadu Open University

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Best wishes for your joyful learning with us.

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SYLLABUS

Course Title : **INTERNATIONAL BUSINESS MANAGEMENT**

Course Code : **MCOS 14**

Course Credit : **3**

COURSE OBJECTIVES (CO)

CO1. Acquaint the learners to concept of international business and to emerging global trends in business environment.

CO2. Study various theories of international business, and list of agreements which disclose the procedure and impact on international trading activities.

CO3. Describe the foreign collaboration and joint venture for various purpose specifically transfer of technology based on industrial policy of nation.

CO4. Point out various tariff and non-tariff barrier for international trade and to make out foreign exchange markets

CO5. Comprehend international business conflict, negotiation & ethics

COURSE SYLLABUS

BLOCK 1: International Business

International Business: Definition, Importance, Nature and Scope -Concept of international business - Classification of international business - Factors influencing international business – Economic, Political, Cultural and policy environment - Regulation of international business- Liberalization of Global business environment.

BLOCK 2: Trade Theory & Trade Agreement

International Trade Theory Overview - Mercantilism- Absolute advantage –Comparative Advantage - Heckscher- ohlin theory-the new trade theory – National competitive advantage - Porters Diamond – WTO and role in world trade - Structure of various regional economic agreements such as ASEAN, SAARC / SAPTA, NAFTA, EC - their procedure and impact on the trading activities of the member states.

BLOCK 3: Foreign Collaborations and Joint Ventures

Foreign Collaborations and Joint Ventures - Industrial policy and foreign direct investment in the World Economy - Horizontal and Vertical Foreign Direct Investment and its advantages - Kinds of collaboration and joint ventures – Negotiating foreign collaboration / joint venture– Drafting of agreement – Restrictive clauses in the foreign collaboration / joint venture – UN Code of conduct of transfer of technology –Indian joint ventures abroad.

BLOCK 4: World Trade & Foreign Exchange

World Trade in Goods and services – Major trends and developments – World Trade and Protectionism – Tariff and Non-Tariff barriers - Movements in Foreign Exchange and Interest rates and their impact on Trade and Investment flow – Functions of Foreign Exchange Market.

BLOCK 5: Conflict, Negotiation & Ethics in International Business

Conflict in international business- Sources and types of conflict – Conflict resolutions – Negotiation - Drafting of arbitration agreements – Procedure for international commercial arbitration - International Business and Ethics, National Differences in Ethics, Ethical issues in international business – Ethical decision making.

REFERENCES

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
3. Education Asia, New Delhi, 13th editon.
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7. Oded Shenkar and Yaong Luo, International Business, John Wiley Inc, Noida, 2nd edition, 2007.
8. Gupta C.B, .International Business, S Chand & Company revised 2020

WEB SOURCES

1. International Business Lecture Notes | Download book (freebookcentre.net)
2. INTERNATIONAL BUSINESS MANAGEMENT (ascdegreecollege.ac.in)
3. (PDF) BA7401 International Business Management (1) pdf | ASRAF ALI S.R - Academia.edu

COURSE OUTCOMES (CLO)

On completion of this course, learners would be able to

CLO1. Recite the regulation of international business and its liberalization of global business, diagnose the international business environment

CLO2. Analyse international trade agreements and its procedure for involving international business.

CLO3. Compute the foreign collaboration and its code, restrictive method of joint venture.

CLO4. Identify the major developments in international trade in terms of tariff and non-tariff and calculate the foreign exchange rate under its market movements

CLO5. Detect the various current issues, negotiation and ethics in international business.

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BLOCK 1

INTERNATIONAL BUSINESS AND FOREIGN INVESTMENT POLICY

UNIT 1

INTRODUCTION TO INTERNATIONAL BUSINESS

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the concept of international business and how it involved to the trade of goods, services, technology, capital or knowledge across national borders and at a global or transnational scale. It covers about the nature of international business. It contains cross-border transactions of goods and services between two or more countries. In this unit there are various classification and factors influencing in international business to exhibit the services like finance, banking, construction etc., international business is also incorporating FDI (Foreign Direct Investment)

LEARNING OBJECTIVES

After studying this Unit, you will be able to:

- know the concept of international business evolved
- state the nature of international business.
- overview of factors influencing in international business
- determine the various classification of international business.
- Identify the problems of international business.

1.1 MEANING OF INTERNATIONAL BUSINESS

International business denotes all those business activities which take place beyond the geographical limits of the country. It involves not only the international movements of goods and services, but also of capital personnel, technology and intellectual property like patents, trademarks, know-how and copy rights.

Ranbaxy's mission to become a research based international pharmaceutical company' led it to enter foreign markets.

1.2 DEFINITION OF INTERNATIONAL BUSINESS

Roger Bennet defines, international business involves commercial activities that cross-national frontiers

According to John D. Daniels and Lee H. Radebaugh, International business is all business transactions-private and governmental- that involve two or more countries. Private companies undertake such transactions for profits, governments may or may not do the same in their transactions.

1.3 NATURE OF INTERNATIONAL BUSINESS

1. International Business is much broader term than that of International Trade.

International business includes:

(a) Export and import of goods.

(b) Export and import of services or intellectual property rights.

(c) Licencing and franchising.

(d) Foreign Investments including both direct investment and portfolio investments.

2. International Trade refers to only export and import of merchandise,

like machinery, gold, silver, electronic goods etc.

1.4 CHARACTERISTICS OF INTERNATIONAL BUSINESS

1.4.1 Large Scale Operations

In international business, all the operations are conducted on a very huge scale. Production and marketing activities are conducted at international level. It first sells its goods in the local market. Then the surplus goods are exported.

1.4.2 Integration of Economies

International business assimilates (combines) the economies of many countries. This is because it uses finance from one country, labour from another country, and infrastructure from another country. It designs the product in one country, produces its parts in many different countries and assembles the product in another country. It sells the product in many countries, i.e. In the international market.

1.4.3 Dominated by Developed Countries and MNCs

International business is dominated by developed countries and their multinational corporations (MNCs). At present, MNCs from USA, Europe, and Japan dominate (fully control) foreign trade. This is because they have large financial and other resources. They also have the best technology and research and development (R & D). They have highly skilled employees and managers because they give very high salaries and other benefits. Therefore, they produce good quality goods and services at Low prices. This helps them to capture middle dominate the world market.

1.4.4 Benefits to Participating Countries

International business gives benefits to all Participating countries. However, the rich countries get the maximum benefits. The poor countries also get benefits. They get rapid industrial development. They get rapid industrial development. They get more employment opportunities. All this results in the economic development of the developing countries. Therefore, developing countries open up their economies through liberal economic Policies.

1.4.5 Excessive Competition

International business has to face Extreme competition in the world market. The competition is between unequal partners i.e., developed and developing countries. In this intense competition, developed countries and their MNCs are in a favourable position because they produce superior quality goods and services, at very low prices. Developed countries also have many contacts in the world market. So, developing countries find it very difficult to face competition from developed countries.

1.4.6 Significant Role of Science and Technology

International business gives a lot of importance to science and technology. Science and Technology (S & T) help the business to have large-scale production. When MNCs and developed countries use high technologies in their international business activities, there is a high possibility of these technologies getting transmitted to developing countries as well.

1.4.7 Sensitive Nature

The international business is very sensitive in nature. Any changes in the economic policies, technology, political environment, etc. have a huge impact on it. Therefore, an international business must conduct marketing research to find out and study these changes. • They must adjust their business activities and adapt accordingly to survive changes.

1.4.8 Increased Investment Opportunities

Globalization companies can move the capital to whatever country offers the most attractive investment opportunity. This prevents capital from being trapped in domestic economies earning poor returns.

1.4.9 Earn Foreign Exchange

Countries export their goods and services all over the world. It helps to earn valuable foreign exchange. This foreign exchange is used to pay for imports. Foreign exchange helps to strengthen the economy of its country.

1.4.10 Optimum Utilization of Resources

International trade makes optimum utilization of resources. This is because it produces goods on a very large scale for the international market. International trade utilizes resources from all over the world.

1.4.11 Prone to Political Risk

International business is complex and always surrounded by risks of political nature. This is because in external markets, managers have to continuously adjust their strategies keeping in mind the chances in economy, regulations political stability. Also, alteration have to made in marketing initiatives that are greatly affected by cultural and national factors of that country.

1.5. OBJECTIVES OF INTERNATIONAL BUSINESS

a. Profit advantage an important objective for international business is the profit advantage. International business could be more profitable than the domestic. There are number of cases, where more than 100% of the total profit of the company is made in the foreign market.
b. Growth opportunities international business provide huge growth potential of many foreign markets, which is a very strong attraction for foreign companies. In a number of developing countries, both the population and income are growing fast.

1.6 FACTORS OF INTERNATIONAL BUSINESS

There are numerous types of business environments, however the political, the cultural, and the economic environments are the prime ones. These factors influence the decision-making process of an international business firm. It is important to note that the types of environments we discuss here are interlinked; meaning one's state affects the others in varying dimensions.

1.6.1 The Political Factors

The political environment of a nation moves the legal aspects and government rules which a foreign firm has to experience and follow while doing business in that nation. There are confident legal rules and governance terms in every country in the world. A foreign company that works within a particular country has to accept by the country's laws for the duration it operates there.

Political environment can affect other environmental factors −

- Political decisions concerning economy can disturb economic environment.
- Political decisions may affect the socio-cultural environment of a nation.
- Politicians may move the rate of occurrence of new technologies.
- Politicians can apply influence in the approval of emerging technologies.
- There are four major effects of political environment on business organizations
- **Impact on Economy** − the political conditions of a nation have a bearing on its economic status. For example, Democratic and Republican policies in the US are different and it influences various norms, such as taxes and government spending.

- **Changes in Regulation** − Governments often alter their decisions related to business control. For example, accounting scandals in the beginning of the 21st century prompted the US SEC turn more mindful on the issues of corporate compliance. Sarbanes-Oxley compliance regulations (2002) were social reactions. The social environment demanded the public companies to be more responsible.
- **Political Stability** − Political stability effects business operations of international companies. An aggressive takeover overthrowing the government could lead to a disordered environment, disrupting business operations. For example, Sri Lanka's civil war and Egypt and Syria disturbances were overwhelming for businesses operating there.
- **Mitigation of Risk** − There are political risk insurance policies that can mitigate risk. Companies with international operations leverage such insurances to reduce their risk exposure.

1.6.2 The Economic Factors

Economic factors apply a huge impact on international business firms. The economic environment includes the factors that influence a country's attractiveness for international business firms.

- Business firms pursue predictable, risk-free, and stable mechanisms. Monetary systems that acknowledge the relative dependence of countries and their economies are good for a firm. If an economy adopts growth, stability, and fairness for prosperity, it has a positive effect on the growth of companies.
- Inflation contributes extremely to a country's attractiveness. High rate of inflation increases the cost of borrowing and makes the revenue contract in domestic currency. It exposes the international firms to foreign-exchange risks.
- Absolute purchasing power parity is also an important consideration. The ratio of exchange rate between two particular countries is identical to the ratio of the price levels. The law of one price states that the real price of a product is same across all nations.
- Relative purchasing power parity (PPP) is valuable for foreign firms. It asks how much money is needed to buy the same goods and services in two particular countries. PPP rates prompt international comparisons of income.

1.6.3 The Cultural Factors

Cultural environments include educational, religious, family, and social systems within the marketing system. Knowledge of foreign culture is important for international firms. Marketers who ignore cultural differences risk failure.

- Language − There are nearly 3,000 languages in the world. Language differences are important in designing advertising campaigns and product labels. If a country has several languages, it may be problematic.
- Colours − It is important to know how people associate with colours. For example, purple is unacceptable in Hispanic nations because it is associated with death.
- Customs and Taboos − It is important for marketers to know the customs and taboos to learn what is acceptable and what is not for the marketing programs.
- Values − Values stem from moral or religious beliefs and are acquired through experiences. For example, in India, the Hindus don’t consume beef, and fast-food restaurants such as McDonald's and Burger King need to modify the offerings.
- Time − Punctuality and deadlines are routine business practices in the U.S. However, Middle East and Latin American people are far less bound by time constraints.
- Religious Beliefs − Religion can affect a product’s labelling, designs, and items purchased. It also affects the consumers' values.

1.7 INTERNATIONAL BUSINESS ENVIRONMENT INTER-RELATIONSHIP

Any meaningful organisations which have their own vision, mission, objectives and goals and a strategy to achieve them. To realise them it is very important for business firms to understand their environment and changes occurring in it. Hence, it is sometime even said that formulation of appropriate strategy is establishing a proper firm environment.

“The determination of Chandler describes strategic management as basic long-term goals and objectives of an enterprise and the adopt courses of action and allocation of resources necessary to carry out the goals." Strategic management or business policy is; thus, the mean achieve the organisational purpose. The process of strategic management involves determining the objectives, analysis of the environment opportunities and the kind evaluating the strength and weaknesses of the firm to tap opportunities or to combat the threat, formulating strategies to achieve the objectives of the organisation.

Thus, environment scanning leads. a formulation of sound and effective organisational and managerial strategies by coping with the probable demands of the environment and to a great extent, it helps to reduce uncertainty and threat.

1.8 SCOPE OF INTERNATIONAL BUSINESS

1.8.1 International Trade

International business involves export and import of goods.

1.8.2 Export and Import of Services

It is also called invisible trade. Items of invisible trade include tourism, transportation, communication, banking, warehousing, distribution and advertising.

1.8.3 Licensing and Franchising

Licensing is a contractual agreement in which one firm (the licensor) grants access to its patents, copyrights, trademarks or technology to another firm in a foreign country (the licensee) for a fee called royalty. It is under the licensing system that Pepsi and Coca Cola are produced and sold all over the world.

Franchising is also similar to licensing, but it is a term used in connection with the provision of services. For example, McDonald's operates fast food restaurants all over the world through its franchising system.

1.8.4 Foreign Investments

It involves investments of funds abroad in exchange for financial return.

1.9 TYPES OF FOREIGN INVESTMENTS

a) **Foreign Direct Investment (FDI)** – Investment in properties such as plant and machinery in foreign countries with a view to undertaking production and marketing of goods and services in those countries.

b) **Portfolio Investment** – Investments in shares or debentures of foreign companies with a view to earn income by way of dividends or interest.

1.10 FEATURES OF INTERNATIONAL BUSINESS

1. **Involves Two Countries** – International business is possible only when there are transactions across different countries.
2. **Use of Foreign Exchange** – Every country has its own different currency. This gives rise to the problem of exchange of currencies as foreign currency is used in making transactions.

3. **Legal Obligations** – Each country has its own laws regarding foreign trade, which have to be complied with. Further, there is more government intervention in case of international transactions.
4. **High Degree of Risk –** International business faces huge risk due to long distances, risk of fluctuations in two currencies, fear of obsolescence, etc.
5. **Heavy Documentation** – It is subject to number of formalities. Many documents have to be filled in and despatched to the other party.
6. **Time Consuming** – The time gap between sending and receiving of goods and payment is wider as compared to inland trade.
7. **Lack of Personal Contact** – It lacks direct and personal contact between importer and exporter.

1.11 NEED FOR INTERNATIONAL BUSINESS

- To achieve higher rate of profits
- Expanding the production capacity beyond the demand of the domestic country
- Severe competition in the home country
- Limited home market
- Political conditions
- Availability of technology and managerial competence
- Cost of manpower, transportation
- Nearness to raw material
- Liberalisation, Privatisation and Globalisation (LPG)
- To increase market share.

1.12 IMPORTANCE OF INTERNATIONAL BUSINESS

1.12.1 Market Expansion

Everyone wants to expand their market share and to sell more and more products. The importance of international business lies in the fact that you get a new market to enter and to expand in. No matter what your position in the old market was, the new market is a new playing field for any company.

1.12.2 Non-Availability of Product in New Market

A major advantage the company can have is that the product it produces is not available in the international market which the company is targeting. The firm, therefore, has a “production advantage” which it can use to maximum benefit. As a result, it is one of the benefits of the International business that the firm can establish a monopoly or a duopoly in the target market, thereby generating a lot of revenue.

1.12.3 Cost Advantage

Many times, there is a cost advantage of exporting products to a different country. This cost advantage is apparent in the way China is operating in today’s business environment. The benefits of international business are huge to Chinese companies because their cost of production is very low. One of the major contributors is their low-labour cost due to which Chinese equipment’s are able to match any rates in the international market.

1.12.4 Product Differentiation

If your products are differentiated and the differentiation is possible only in one’s own country, then a company should definitely expand to International markets.

Furthermore, if a company is capable of product design and implementation as well as establishing new products and services, then this company has various benefits of International business already available. Expanding to international market sounds logical if you can differentiate your products from existing market products.

1.13 CLASSIFICATION OF INTERNATIONAL BUSINESSES

All the major international business conducted in the world can come under seven main types. These can also be termed as modes of business. Let’s look at each in detail –

1.13.1 Imports and Exports

Simplest and most commonly used method, imports and exports can be seen as the foundation of international business. Imports are an inflow of goods into the markets of home country for consumption, in contrast, export means selling of goods to foreign countries. In short, imports mean inflow whereas export means outflow of goods in any form.

1.13.2 Licensing

Licencing is one of the easiest ways to expand a business internationally. When a company has a standardized product with ownership rights, it can use licensing to distribute and sell the products in the international market. Licenses come in many forms, some of which are patent, copyright, trademark, etc. Products such as books and movies are usually distributed internationally through licensing agreements.

1.13.3 Franchising

A very operative method to expand a business nationally as well as internationally, franchising is similar to licensing. In this, a parent company gives the right to another company to conduct business using the parent company's name/ brand and products. The parent company becomes the franchiser and the receiving company becomes the franchisee. Many of the biggest restaurant chains in the world have used the franchisee model to expand internationally. Some examples include – McDonald, Pizza Hut, Starbucks, Domino's Pizza and many more.

1.13.4 Outsourcing and Off shoring

Outsourcing means giving out contracts to international firms for certain business processes. For example, giving out accounting function to an international firm. This is usually effective when the cost of conducting these processes is comparatively much cheaper in some other country than in the home country. For example, many developed countries such as the USA, Australia, the UK, etc. outsource its functions to companies in India, China, etc. because it is cheaper.

Offshoring is similar to outsourcing in the sense that a function is moved away from the home country. However, it is different in the sense that the facility is physically moved to another country, but the management stays with the company itself. For example, Apple Inc. is conducting its manufacturing function in China, however, it is completely controlled by Apple Inc.

LET US SUM UP

International business differs from domestic business in terms of the environment it faces. The actors in international business confront different socio-economic, cultural and physical environment in different countries.

Therefore, they have to make necessary adjustments in their strategies and approaches of managing business to conform to the diverse environments in overseas markets. There are some difficulties that are unique to international business which arise because of long distance between trading nations, different languages, customs and laws, currency measurements, different controls, regulations and tax regimes in different countries, and greater risk and uncertainty.

Important benefits of international business include higher standard of living of people in different countries, stability in prices, advantages emanating from specialization, increased productivity, wider markets, overall growth of economies and promotion of international peace. International business has assumed greater importance as it enables in the diffusion of new technologies, stimulates competition, provides impetus to standardization, motivates firms to adapt to international environment, encourages globalization of business, and promotes economic cooperation and integration

CHECK YOUR PROGRESS

Choose the Correct Answer

1. ___ has grown to be one of the most important features of the world's economy.

    a. International Business

    b. Globalization

    c. Liberalization

    d. All of the above

2. Many US information technology companies are turning to international locations to remain-

    a. Leader

    b. Competitor

    c. Stable

    d. Master

3. Salaries and fringe costs for well-trained software engineers in Northern Ireland approximately ___ lower than costs for US engineers**.**

    a. 50%

    b. 80%

    c. 47%

    d. 69%

4. ___ is a process that is beneficial – a key to future world economic development- and also inevitable and irreversible.

    a. Privatization

b. Globalization

c. Liberalization

d. Economist

5. Economic globalization is a historical process, the result of ___.

a. Human innovation

b. Technological Progress

c. Both a and b

d. Knowledge

GLOSSARY

Franchising	:	A parent company grants another independent entity the privilege to do business in a pre-specified manner, including manufacturing, selling products, marketing technology and other business approach
Licensing	:	One firm gives another firm a permission, which allows the latter to engage in an activity otherwise legally forbidden to it. Such activities usually involve the transfer of intellectual and proprietary knowledge in return for royalty as revenue.
Import	:	Any resource, intermediate good, or final good or service that buyers in one country purchase from sellers in another country.
Import License	:	A document required and issued by some national government authorizing the importation of goods into their individual countries.
Portfolio Investment	:	It is ownership of a stock, bond, or other financial asset with the expectation that it will earn a return or grow in value over time, or both. It entails passive or hands-off ownership of assets as opposed to direct investment, which would involve an active management role.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
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4. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.
5. Oded Shenkar and Yaong Luo, International Business, John Wiley Inc, Noida, 2ndedition, 2007.

WEB RESOURCES

1. Lecture 01: Introduction to International Business - YouTube
2. Lecture 02: Importance, Nature and Scope - Bing video
3. Lecture 05: Challenges and Approaches, EPRG Framework - Bing video
4. International Finance - Lecture 01 - Bing video

ANSWERS TO CHECK YOUR PROGRESS

1. a 2. b 3.a 4.b 5.c

UNIT 2

FOREIGN INVESTMENT POLICY

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the Foreign Investment Policies are for investing directly into production or business in a country by a company or an individual of another country. And also, you are learning about the various features of foreign direct investment, the stimulation of economic development. The benefits of foreign investment may be buying a company in another country or by expanding operations of the existing business in that country. The terminologies of international business are the traditional aims of foreign direct investment (FDI) policy in terms of employment, exports and, to a lesser extent, import substitution still exist, but the overall emphasis in now much more on the contribution of foreign MNEs to the overall development and competitiveness of the local business sector.

LEARNING OBJECTIVES

After completing this unit, you will be able to:

- understand about the Foreign Investment Policy
- know objectives of Foreign Trade Policy and characteristics of international business
- integrate economies and large number of Middlemen
- discuss high risk of foreign investment
- identify Intense competition and the economic growth
- comprehend the international restriction of terminologies in International Business

2.1. FOREIGN INVESTMENT POLICY

Foreign funding includes capital flows from one to another, granting the overseas buyers large possession stakes in home agencies and assets. Foreign funding denotes that foreigner have an energetic function in control as part of their funding or an fairness stake massive sufficient to allow the overseas investor to persuade enterprise strategy. A present-day fashion leans closer to globalization, wherein multinational corporations have investments in loads of countries.

2.1.1 Objectives of Foreign Trade Policy

The policy related to the investment by the foreigners in a country is known as foreign investment policy. If the government has adopted liberal investment policy, then it will lead to more inflow of foreign capital in the country which ultimately results in more industrialisation and growth in the country. This will increase domestic competition and would put many domestic firms, which are shielded from foreign competition, in to problem. On the other hand, it will promote many domestic firms by permitting global sourcing of capital and technology, thus quantity and quality of such industry will be increasing.

1. The primary purpose is not the mere earning of foreign exchange, but the stimulation of greater economic activity. The foreign trade policy of India is based on two major objectives.
2. To double the percentage share of global merchandise trade within the next five years.
3. To act as an effective instrument of economic growth by giving a thrust to employment generation.

2.2 FEATURES OF FOREIGN DIRECT INVESTMENT POLICY

2.2.1 FDI in Areas of Special Sectors Activity

- Activities/items that require an Industrial Licence.
- Proposals in which the foreign collaborator has a previous/existing venture/tie up in India in the same or allied field.
- All proposals relating to acquisition of shares in an existing Indian company by a foreign/NRI investor.
- All proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted.

2.2.2 FDI in Areas of Special Economic Activity

- **Special Economic Zones:** 100 per cent FDI is permitted under automatic route for setting up of Special Economic Zone. Units in SEZ qualify for approval through automatic route subject to sectorial norms. Details about the type of activities permitted are available in the Foreign Trade Policy issued by the Department of Commerce. Proposals not covered under the automatic route require approval by FIPB.

- **Export Oriented Units (EOUs):** 100 per cent FDI is permitted under automatic route for setting up 100 per cent EOU, subject to sectorial norms. Proposals, which are not covered under the automatic route would be considered and approved by FIPB.
- **Industrial Park:** 100 per cent FDI is permitted under automatic route for setting up of the Industrial Park. Electronic Hardware Technology Park (EHTP) Units All proposals for FDI/NRI investment in EHTP Units are eligible for approval under the automatic route subject to the parameters listed. For proposals not covered under automatic route, the applicant should seek separate approval of the FIPB, as per the procedure outlined in the policy.
- **Software Technology Park Units**: All proposals for FDI/NRI investment in STP Units are eligible for approval under automatic route subject to parameters listed. For proposals not covered under automatic route, the applicant should seek separate approval of the FIPB, as per the procedure outlined in the policy.

2.3 ADVANTAGE OF FOREIGN DIRECT INVESTMENT

2.3.1 FDI Stimulates Economic Development

FDI in India stimulates large-scale economic growth. It is the primary sources of external capital as well as increased revenues for a country. It often results in the opening of factories in the country of investment, in which some local equipment – be it materials or labour force, is utilised. This process is repeated based on the skill levels of the employees. Large-scale employment results in people leading better lives and improves their standard of living. Such people also start paying taxes, which are further invested in the development of the nation.

2.3.2 FDI Results in Increased Employment Opportunities

FDI increases employment opportunities. As FDI increases in a nation, especially a developing one, its service and manufacturing sectors receive a boost, which in turn results in the creation of jobs. Employment, in turn, results in the creation of income sources for many. People then spend their income, thereby enhancing a nation’s purchasing power.

2.3.3 FDI Results in the Development of Human Resources

FDI aids with the development of human resources. The employees, also known as the human capital, are provided adequate training and skills, which help boost their knowledge on a broad scale. But if you consider the overall impact on the economy, human resource development increases a country’s human capital quotient. As more and more resources acquire skills, they can train others and create a ripple effect on the economy.

2.3.4 FDI Enhances a Country’s Finance and Technology Sectors

The process of FDI is robust. It provides the country in which the investment is occurring with several tools, which they can leverage to their advantage. For instance, when FDI occurs, the recipient businesses are provided with access to the latest tools in finance, technology and operational practices. As time goes by, this introduction of enhanced technologies and processes get assimilated in the local economy, which make the fin-tech industry more efficient and effective.

2.4 DISADVANTAGES OF FOREIGN DIRECT INVESTMENT

- It Hindrance to Domestic Investment. As it focuses its resources elsewhere other than the investor’s home country, foreign direct investment can sometimes hinder domestic investment.
- Risk from Political Changes because political issues in other countries can instantly change, foreign direct investment is very risky. Plus, most of the risk factors that you are going to experience are extremely high.
- Negative Influence on Exchange Rates where Foreign direct investments can occasionally affect exchange rates to the advantage of one country and the detriment of another.
- The Higher Costs will be invested in some foreign countries, it is more expensive than export goods. So, it is very imperative to prepare sufficient money to set up the process.
- Economic Non-Viability were considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.
- Expropriation will remember that political changes can also lead to expropriation, which is a scenario where the government will have control over your property and assets.

2.5 BENEFITS OF FOREIGN DIRECT INVESTMENT

2.5.1 Benefits of Host Country

The four main benefits of FDI to host country are: (i) Resource-transfer effects, (ii) Employment effects (iii) Balance of Payments effect, and (iv) Effect on competition and economic growth.

2.5.1.1 Resource-Transfer Effects

FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate. Many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company resources, or because of their reputation, large MNEs may find it easier to borrow money from capital markets that host-country firms would.

Technology can stimulate economic development and industrialization. It can take two forms, both are valuable. Technology can be incorporated in a production process, or it can be incorporated in a product.

Foreign managers trained in the latest management techniques can often help to improve the efficiency of operations in the host country, whether those operations are acquired or green-field developments. Beneficial spin-offs effects may also arise when local personnel who are trained to occupy managerial, financial, and technical posts in the subsidiary of a foreign MNE leave the firm and help to establish indigenous firms. Similar benefits may arise if the superior management skills of a foreign MNE stimulate local suppliers, distributors, and competitors to improve their own management skills.

2.5.1.2 Employment Effects

The effects of FDI on employment are both direct and indirect. Direct efforts arise when a foreign MNE employs a number of host-country citizens. Indirect effects arise when jobs are created in local suppliers as a result of investment and when jobs are created because of increased local spending by employees of the MNE. The indirect employment effects are often as large as, if not larger than, the direct effects.

2.5.1.3 Balance of Payments Effect

Given the concern about current account deficits, the balance-of-payments effects of FDI can be an important consideration for a host government. There are three potential balance-of-payments consequences of FDI. First, when an MNE establishes a foreign subsidiary, the capital account of the host country benefits from the initial capital inflow (A debit will be recorded in the capital account of the MNEs home country since capital is flowing out of the home country). Second, if the FDI is a substitute for imports of goods or services, it can improve the current account of the host country's balance of payments.

2.5.1.4 Effect on Competition and Economic Growth

When FDI takes the form of a green-field investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase competition in a national market and thus consumer choice. In turn, this can increase competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations and greater economic growth.

FDI's impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services where exporting is often not an option because the service has to be produced where it is delivered.

2.5.2 Benefits of Home Country

The benefits of FDI for the home country.

- The effect on the capital account of the home country's balance of payments from the inward flow of foreign earnings.
- The employment effects that arise from outward FDI
- The gains from learning valuable skills foreign markets that can subsequently be transferred back to the home country.

2.6 TERMINOLOGIES IN INTERNATIONAL BUSINESS

International Marketing: It focuses on the firm-level marketing practices across the border, including market identification and targeting, entry mode selection, and marketing mix and strategic decisions to compete in international markets.

International Investments: Cross-border transfer of resources to carry out business activities

International Management: Application of management concepts and techniques in a cross-country environment and adaptation to different social- cultural, economic, legal, political and technological environments.

International Business: All those business activities which involves cross border transactions of goods, services, and resources between two or more nations

Global Business: Conduct of business activities in several countries using a highly co-ordinated and single strategy across the world.

2.7 REASON FOR INTERNATIONAL BUSINESS NEEDED BY COUNTRIES

Three primary reasons include:

(1) Availability Natural advantage: the ability to produce due to readily available resources such as minerals and agricultural products

(2) Acquired advantage: based on research and development

- Most new products originate and find their largest markets in the wealthier countries such as the United States, Germany, Japan, France, the United Kingdom, and Italy
- The fastest growth area in world trade has been in services, which has grown from less than 4% to more than 20% of world trade between 1980 and 1999
- Manufacturing now accounts for less than 20% of the economies of the wealthier countries

(3) Cost

- The production of various goods and services requires different combinations of inputs
- The cost of these inputs varies from one country to another for a variety of complex reasons

(4) Comparative advantage

- When an individual, firm, or country uses its resources to specialize in the production of those goods and services that are most productive and profitable, it is producing according to comparative advantage
- Comparative advantage implies specialization.

2.8 COUNTRY ATTRACTIVENESS

It is a multidisciplinary concept at the crossroads of development economics, financial economics, comparative law and political science: it aims at tracking and contrasting the relative appeal of different territories and jurisdictions competing for “scarce” investment inflows, by scoring them quantitatively and qualitatively across ad hoc series of variables such as GDP growth, tax rates, and capital repatriation.

There are multiple factors determining host country attractiveness in the eyes of large foreign direct institutional investors, notably pension funds and sovereign wealth funds. Research conducted by the World Pensions Council (WPC) suggests that perceived legal/political stability over time and medium-term economic growth dynamics constitute the two main determinants. Some development economists believe that a sizeable part of Western Europe has now fallen behind the most dynamic amongst Asia's emerging nations, notably because the latter adopted policies more propitious to long-term investments:

"Successful countries such as Singapore, Indonesia and South Korea still remember the harsh adjustment mechanisms imposed abruptly upon them by the IMF and World Bank during the 1997-1998 'Asian Crisis'. What they have achieved in the past 10 years is all the more remarkable: they have quietly abandoned the "Washington consensus" [the dominant Neoclassical perspective] by investing massively in infrastructure projects. This pragmatic approach proved to be very successful."

1. Guide to analyse country's attractiveness.
2. Managerial Implications.
3. Two broad implications for IB are Political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. The political, economic, and legal environment of a country clearly influences the attractiveness of that country as a market and/or investment site
4. Attractiveness Return.
    - A country attractiveness assessment is based on two dimensions
    - Market and industry opportunities
    - Country risks (many organizations publish country assessment results based on various economic/political/social factors)

5. Country attractiveness analysis

Market opportunities

- Market opportunities assessment measures the potential demand in the country for a firm's products or services based on:
- Market size
- Growth

- Quality of demand.

Industry opportunities

- Industry opportunities assessment determines profitability potential of a company's presence in a country given the following factors:
- Quality of industry competitive structure (Porter's five-force Industry Analysis Framework)
- Resource availability (Porter's diamond framework)

6. Framework for country market and industry attractiveness assessment MARKET – How important is the demand in this country? + Growth? + Size? + Customer quality

- Resources
- Skilled personnel
- Raw materials
- Components
- Labour
- Technology
- Innovation
- Quality of infrastructure supporting services
- Location

2.8.1 Country Attractiveness Analysis

- **Political risks**
  Political risks are probable disruptions owing to internal or external events or regulations resulting from political action of governments or societal crisis and unrest.
- **Economic risks**
  Economic risks expose business performance to the extent that the economic business drivers can vary and therefore put profitability at stake.
- **Competitive risks**
  Competitive risks are related to non-economic distortion of the competitive context owing to cartels and networks as well as corrupt practices. The competitive battlefield is not even and investors who base their competitive advantage on product quality and economics are at disadvantage.
- **Operational risks**
  Operational risks are those that directly affect the bottom line, either because government regulations and bureaucracies add

costly taxation or constraints to foreign investors or because the infrastructure is not reliable.

2.8.2. Framework For Country Risk Analysis

Political risks operational risks competitive risks economic risks

- Shareholder's exposure
- Asset's destruction (war, riots)
- Asset's spoliation (expropriation)
- Asset's immobility (transfer, freeze)
- Operational Exposure
- Market disruption
- Labour unrest
- Racketing
- Supply shortages
- Employees Exposure
- Kidnapping
  - ✓ Gangsterism
  - ✓ Harassment
  - ✓ Variability
  - ✓ Inflation
  - ✓ Cost of inputs
  - ✓ Exchange rates
  - ✓ Business logics
  - ✓ Corruption
  - ✓ Cartels
  - ✓ Networks

Infrastructure- Power, Telecommunication, Transport - Supplier Country Risk Analysis

- Regulations
- Nationalistic preferences
- Constraints on local capital, local content, local employment.

2.9 INDIAN COMPANIES ON A GLOBAL STAGE

One must give credit to the reform process that began in the 1990s for the catalytic role it has played in India's globalisation drive.

The AV Birla group's takeover of the U.S. based aluminium products manufacturer, Novelis for a consideration of approximately $7 billion came within two weeks after the Tatas linked their deal with the U.K. based steel producer Corus. That two of India's most admired business groups should move decisively ahead with their global growth strategies at roughly the same time might be a coincidence. But there are important similarities.

The Tatas and the AV Birla group have consciously pursued global strategies, and this had been evident even before their deals involving Corus and Novelis. A third of the Tata group's revenues already comes from abroad and with the Corus acquisition the ratio will go up sharply. The AV Birla group's dependence on international operations is strikingly similar. From almost 30 per cent now, the proportion of revenues generated from abroad will go up to 50 per cent. Around a fifth of the group's total manpower will be based abroad. In the case of Tatas this proportion is likely to be even higher given that TCS has been a global player for a very long time.

The U.S. based Novelis is a world leader in aluminium flat-rolled products and by acquiring it, Hindalco, the flagship of the AV Birla group, gets to reap substantial synergies, but over time. By June this year, when the acquisition formalities are through, it will become the fifth largest aluminium company in the world and get access to important global markets. It will add nearly one million tonnes of downstream aluminium facilities. The AV Birla group is expected to enter the list of Fortune 500 companies after the acquisition. Novelis counts among its customers GM, Ford and Coca Cola.

Similar comments were made after the Tatas were declared winners in the battle for the control of Corus. Among the Anglo-Dutch company's strengths are its dominance in the speciality steels used in automotive, aeronautical and construction sectors and its investments in research and development. Tata Steel therefore gets access to these markets as well as to the R&D facilities. It bid for a company four times its size and after acquiring Corus became the world's fifth largest steel company. Tata Steel is among the lowest cost producers of steel in the world, a claim that Hindalco can make with justification for its core product, primary aluminium.

2.10 MANY SIMILARITIES

There are other similarities too, extending to issues such as the ways both the Tatas and the Birlas propose to run the acquired companies. There has been no hint of disturbing the present managements. The two companies Corus and Novelis will, in all probability, be run as subsidiaries of their Indian parents. Even the routes the two companies are taking to finance the takeovers are similar. In both cases, a significant part of the debt is being raised outside the country on the strength of future earnings of the companies being taken over. That of course is possible only because of the standing of the Tatas and the Birlas. Their sterling reputations, for long recognised in India, have begun to count everywhere.

Both acquisitions have not evoked any nationalist opposition from politicians of the host countries. Their trade unions too have not opposed the sales. All these are very different from the stormy reception Lakshmi Mittal faced initially while taking over the European steel major, Arcelor. Senior politicians from France and Luxembourg had initially rallied against the takeover.

The Tatas and the Birlas did not face opposition from the managements of the companies they were taking over. In fact, the two Indian companies were invited. Indeed, much has been made of the cultural fit between the acquirers and the acquired companies. While the Tatas faced competition from CSN and consequently had to pay more than what they had envisaged, the Hindalco management is confident of their deal sailing through.

Another similarity, though not in a complimentary sense, is that in the aftermath of both deals, many analysts felt that the price being paid was too high in relation to the likely benefits. But on balance most agree that the two acquisitions make for strong business sense, over the medium term. A noteworthy point is that all such cross-border deals are possible because of the even-handed treatment meted out to all the parties by the regulators in Europe and North America.

In the Corus acquisition, it was the regulator in the U.K. who forced the Tatas and CSN, the Brazilian bidder, into a head-to-head auction, in which the Tatas clinched the issue.

2.11 GLOBALISATION OF INDIAN COMPANIES

There is something inherently exciting about the news of Indian companies, admittedly only the best rated ones, taking over companies with strong traditions in Western Europe and North America. Hindalco's takeover of Novelis and the Tatas' acquisition of Corus are spectacular in every sense of the word but there has already been a steady acceleration in the pace of Indian companies going global.

Many of them have made a mark. Bharat Forge is the world's second largest forging company. Ranbaxy is one of the top ten generic pharmaceutical manufacturers in the world. Wipro and Infosys are great brand names globally. The list will expand in days to come. It is not just a question of Indian companies expanding abroad. Simultaneously there has been greater foreign interest in India than at any time before. As the Vodafone offer for Hutch-Essar shows, foreign interests are not shy to invest in India even if the valuations are steep.

One must give credit to the reform process that began in the 1990s for the catalytic role it has played in India’s globalisation drive. The Indian corporate sector learnt to withstand fierce competition from abroad and then took the battle to the most advanced countries.

This calendar year is likely to witness new records in the number of mergers and acquisitions (M&As) involving Indian companies. Already in the first one and a half months, Indian companies have been involved in M&A deals worth $32 billion.

Today’s globalisation drive by Indian companies may well be sound business strategy, a necessity rather than an opportunity to do business without the cumbersome restraints of the pre-reform days.

LET US SUM UP

In this unit you have learnt the objectives of foreign trade policy, characteristics of international business environment. You have also come to know about large scale operations and enumerated about restrictions of international business and integrated economies. Foreign investment involves capital flows from one country to another, granting the foreign investors extensive ownership stakes in domestic companies and assets. The government has now allowed Foreign Institutional Investors (FII) and Non-Resident Indians (NRIs) to invest in the Insurance sector through automatic route within the 26% cap on FDI (Foreign Direct Investment).

Foreign Direct Investment means “cross border investment made by a resident in one economy in an enterprise in another economy, with the objective of establishing a lasting interest in the investee economy. – FDI is also described as “investment into the business of a country by a company in another country”. – FDI is a major source of external finance which means that countries with limited amounts of capital can receive finance beyond national borders from wealthier countries. – The Department of Industrial Policy & Promotion is the nodal Department for formulation of the policy of the Government on Foreign Direct

Investment (FDI). – Foreign Direct Investment (FDI) in India is undertaken in accordance with the FDI Policy which is formulated and announced by the Government of India.

CHECK YOUR PROGRESS

Choose the correct answer

1. Which index did India rank 8th on, April 20, 2017?

   a. AT Kearney FDI Confidence Index

   b. Morgan Stanley Index

   c. Moody's Rating

   d. ICRA rating

2. Which companies will soon be allowed to attract 100 percent FDI investment?

   a. Cash management companies.

   b. ATM management companies.

   c. Both a and b.

   d. Neither a nor b

3. What is the percentage of FDI through automatic route at present according to the Budget?

   a. 60 percent

   b. 70 percent

   c. 80 percent

   d. 90 percent

4. India has retained its ranking as the 10th highest recipient of FDI in 2015, according to which UNCTAD report?

   a. World Investment Report 2016

   b. World Investment Report 2015.

   c. World Investing Report 2016.

   d. World Investing Report 2015.

5. Government has released updated compendium through policy changes and unnecessary explanations to make which type of investment policy simpler?

   a. FDI

b. FII

c. Foreign Investment

d. Domestic Investment

GLOSSARY

Foreign Trade Policy: The overseas exchange coverage is largely a fixed of recommendations for the import and export of products and services. These are mounted via way of means of the Directorate General of Foreign Trade (DGFT), the governing frame for the advertising and facilitation of exports and imports below the Ministry of Commerce and Industry

Large Scale business operations : Industries which call for large infrastructure and manpower with an inflow of capital belongings are Large Scale Industries. In India, large-scale industries are those with a hard and fast asset of multiple hundred million rupees or Rs. 10 crores

Integrated business economies : Economic integration is an association amongst countries that generally consists of the discount or removal of change obstacles and the coordination of economic and economic policies. Economic integration is on occasion known as local integration because it frequently happens amongst neighbouring countries.

Domestic Investor : Gross private domestic investment is the measure of physical investment used in computing GDP in the measurement of nations' economic activity.

Attractive Return : The bank has a new product that offers an attractive return, but, if the stock market falls, investors face large losses.

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1. Direct Foreign Investment (FDI): What It Is, Types, and Examples (investopedia.com)
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3. FII vs FPI vs FDI | Explained | Tamil - YouTube
4. FDI vs FII (Foreign Direct Investment vs Foreign Institutional Investment) - Indian Economy - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.a 2. c 3. d 4.a 5. a

UNIT 3

INTERNATIONAL BUSINESS OPERATIONS

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the factors of international business operations and the SWOT analysis of environment factors and the features of Indian economy and the regulation of international trade and the concept of liberalisation, forms of privatization and also regulations of economic legislations in international economic environment and the trade liberalization objectives of income tax act, company act and the problems of globalization.

LEARNING OBJECTIVES

After completing this unit, you will be able to:

- understand factors to consider before starting international business operations
- know the Features of Company Act, 1956
- learn the Objectives of Income Tax Act, 1961
- know the Regulation of International Trade
- overcome the Concept of Liberalisation
- known the Background of Liberalisation in India
- understanding International Trade Liberalization
- overcome about the Privatization, forms of Privatization, Objectives of Privatization.

3.1 GEOGRAPHICAL FACTORS

Simple challenges that come with the change in geography have to be studied when considering international business. There are differences in storage requirement, supply chain requirements, connectivity issues, etc. from country to country. Colgate-Palmolive will face a thousand challenges even before its soaps and shampoos can reach rural areas of India where there is a lack of basic necessities such as water, electricity, transportation, etc.

3.1.1. Economic Environment

The economic environment may be very different from one country to the next. The economy of countries may be industrialized (developed), emerging (newly industrializing), or less developed (third world). Further, within each of these economies are a vast array of variations, which have a major effect on everything from education and infrastructure to technology and healthcare.

A nation’s economic structure as a free market, centrally planned market, or mixed market also plays a distinct role in the ease at which international business efforts can take place. For example, free market economies allow international business activities to take place with little interference. On the opposite end of the spectrum, centrally planned economies are government controlled. Although most countries now function as free-market economies, China—the world's most populous country—remains a centrally planned economy.

3.2 TECHNIQUES OF ECONOMIC ENVIRONMENT

William F Glueck has mentioned the following techniques of Economic scanning environment

3.2.1 Verbal and Written Information

Environmental information can easily be obtained by industrial journals, business magazines. Technological Business Socio-cultural published and unpublished materials, talk shows, consultants' seminars and customers etc. The information available from such Political source provides an authentic information about the environment around the organisation.

3.2.2 Search and Scanning

If particular type of information is required dependent on each other. It is a never-ending process regarding the business environment, proper research is conduct to the process of interaction come up with any conclusion Environment Scanning

3.2.3 Spying

Spying is considered as unethical in business, even though organisation often use spying as a source to collect information.

3.2.4 Forecasting and Formal Studies

The information gathered by a business manager operates in an environment above three methods is used to predict the economical business environment. Such a study the variables to attain good result and forecast is basically done by corporate planners of consultants. These termed as economic environment scanning or analysis. At the same time, some of the popular techniques of environment analysis are described below scanning points towards interaction among.

3.3 SWOT ANALYSIS ENVIRONMENT FACTORS

It is a systematic identification or analysis of Strengths (S) Weaknesses (W) Opportunities (O) and Threats (T) in the environment that exist internal or external to the organisation and the strategy that reflects the best match between them. It bases on the assumption that an effective strategy maximises a business's strengths and opportunities but at the same time, minimises its weaknesses and threats. SWOT is the corner stone of business policy formulation, which determine the course of action to ensure the survival and growth of the firm.

3.4 ELEMENTS OF ECONOMIC ENVIRONMENT

Economic Conditions

Economic policies of a business unit are largely affected by the economic conditions of an economy. This keeps on changing over time in line with the economy and business cycle, as an economy goes through expansion and contraction. A country's economic conditions are influenced by nuncios macroeconomic and micro economic factors, including mantrap and sale quality underplaying levels of current account and budget supplies oddest, GDP growth rates, inflation rates exchange rates the state of the global ware and so on. in the economic Conditions such as standard of living, purchasing of public demand and supply, distribution, affects the Economic Environment, Policies and Planning.

3.5 TYPES OF ECONOMIC SYSTEM MARKET ECONOMY / CAPITALISM

The economic system, in which business units or factors of production are privately owned and governed is called capitalism. The profit earning is the sole aim of the business units. Government of that country does not interfere in the economic activities of the country. It is also known as free market economy.

According to GDH Cole, Capitalism is that profit-oriented system, which is characterised by private ownership of objects of labour, instruments of labour and means of labour. Production is mainly carried out with the help of labour services rendered by the working class in return for wages and the class of capitalists has the right to whatever output is produced within the system. Examples of capitalistic economy: US, Japan, Canada, Mexico etc.

3.6 ECONOMIC PLANNING

Economic planning may be defined as a continuous process, which involves decisions or choices pertaining to alternative way of listing the available resources for achieving particular goals work a specified time period in the future economic planning in a country is undertaken by a Central Authority (e.ge Planning Commission), which is entrusted commission), entrusted with the powers of formulating, implementing and reviewing the national plan.

3.7 OBJECTIVES OF PLANNING IN INDIA

a) To improve the standard of living of the people
b) To enhance national income and per capita income
c) To promote industrialisation
d) To achieve full employment.
e) To remove poverty.
f) To reduce disparities in income and wealth
g) To make self-sufficient in food and other basic raw material.

3.7.1 Objectives of the Industrial Policy

The major objectives of industrial policy are as under

a) Maintenance of a sustained grown in productivity and gainful employment
b) Rectification of the distortions or weakness that may have expects in the industrial structure as has developed over the period.
c) Consolidation of the strength build up during the period of economic planning and to build on the gains already made.
d) Attaining of international competitiveness.

3.8 SALIENT FEATURES OF INDIAN ECONOMY

There have been fundamental and irreversible changes in the economy. government policies, outlook of business and industry and in the mind-set of the Indians in general following are the salient features of Indian economy.

From a shortage economy of food and foreign exchange. India has now become a surplus economy and based economy; it has emerged as a service oriented one. From the low growth of the past the economy has become a high growth one in the long-term after having been an aid recipient. India has now joined the ad givers club the government is pursuing and liberalisation not out of computation. but out of conviction and consensus Indian companies are no longer afraid of multinational companies

They are becoming competitive and some of them are going global. Indian culture which looked down upon wealth as a sin and believed in simple living and high thinking has recognising prosperity and success as acceptable and necessary goals. Indian economy is the largest democracy with stable mature, vibrant and exemplary democratic and institutions.

3.9 INTERNATIONAL ECONOMIC ENVIRONMENT

With the increase in the volume of foreign trade, investment and with the increasing scope of World Trade Organisation, IMF, World Bank the role of international economic environment has increased. If any business unit is indulged in international trade, then it is governed not only by economic environment of the country to which it belongs, but also by the economic environment of the country to which it is importing or exporting its goods.

3.10 ECONOMIC LEGISLATIONS

Besides these, Government has also framed certain legislations, which regulate and control the business. It includes

- Industrial Dispute Act, 1947
- Factories Act, 1948
- Companies Act, 1956
- Consumer Protection Act, 1986
- Depositories Act, 1996
- Foreign Exchange Management Act, 1999
- Competition Act, 2002
- Limited Liability Partnership Act, 2008

3.11 INTERNATIONAL ECONOMIC INSTITUTIONS

3.11.1 Command Economy/Socialism

Under socialism economic system, all the economic activities of the country are controlled and regulated by the government in the interest of the public. Under this economic system government appoints a central planning authority that takes all economic decisions and formulates an exhaustive plan to achieve the set objectives.

According to Paul M Sweezy, "Socialism is a complete social system, which differs from capitalism not only in the absence of private ownership of means of production, but also in its basic structure and mode of functioning. "The first country to adopt this concept was Soviet Russia. Countries like China, Vietnam. Cuba etc have economies based on socialism.

3.11.2 Forms of Socialism

1. **Democratic Socialism** All the economic activities are controlled and regulated by the government, but the people have the freedom of choice of occupation and consumption.

2. **Totalitarian Socialism** This form is also known as communism. Under this, people are obliged to work under the directions of government.

Some factors of production are privately owned and some are owned by government. There exists free of choice of occupation and consumption. Both private and public sectors play key roles in the development of the country. Considering the limitations of both maximum role of government under socialism and minimum role of government under capitalism, the world political-economic order has moved towards mixed economy with optimum role of government. India is perhaps the best example of such economy and legitimately called as a mixed economy.

3.11.3. Characteristics of Socialist Economic System

Government ownership in socialist countries, all important means of production are either owned by the government or their use is controlled by the government. Private ownership is nominal,

- **Central Authority**
  The socialist economies generally have a central authority like the central planning agency to formulate the national plan for development and to direct resource mobilisation, allocation and investment to achieve the plan.
- **Social Welfare**
  The socialist economic system works for the benefit of the whole society rather than merely for the private benefit of individuals. There is absence of profit motive, and the ultimate objective is to maximise social welfare.
- **Restriction on Occupation**
  The freedom of occupation is absent or restricted in socialist countries. Fixation of Wages and Prices. The wages and prices in a communist economy are fixed by the government and not by market forces. Non-communist socialist countries may also fix wages and prices by certain means. Absence of Competition: since the state owns all the major means of production, there is no competition between the different production units.

3.11.4. Political Environment

The political environment of international business refers to the relationship between government and business, as well as the political risk of a nation. Therefore, companies involved in international business must expect to deal with different types of governments, such as multi-party democracies, one-party states, dictatorships, and constitutional monarchies.

Some governments may view foreign businesses as positive, while other governments may view them as exploitative. Because international companies rely on the goodwill of the government, international business must take the political structure of the foreign government into consideration.

International firms must also consider the degree of political risk in a foreign location; in other words, the likelihood of major governmental changes taking place. Just a few of the issues of unstable governments that international companies must consider include riots, revolutions, war, and terrorism.

3.11.5. Cultural Environment

The cultural environment of a foreign nation remains a critical component of the international business environment, yet it is one of the most difficult to understand. The cultural environment of a foreign nation involves commonly shared beliefs and values, formed by factors such as language, religion, geographic location, government, history, and education.

It is common for many international firms to conduct a cultural analysis of a foreign nation as to better understand these factors and how they affect international business efforts.

3.11.6. Competitive Environment

The competitive environment is constantly changing according to the economic, political, and cultural environments. Competition may exist from a variety of sources, and the nature of competition may change from place to place. It may be encouraged or discouraged in favour of cooperation, and the relationship between buyers and sellers may be friendly or hostile. The level of technological innovation is also an important aspect of the competitive environment as firms compete for access to the newest technology.

To ensure success in a foreign market, international businesses must understand the many factors that affect the competitive environment and effectively assess their impact.

3.11.7. Legal Environment

Legal environment means the rules and regulations, which are framed to regulate the business. Laws are formulated to smoothen the working environment of the business. In every country, business can be started and operated within the framework of the legal system. Every nation has its own legal framework for the promotion and regulation of business and industry. According to Salmond, “Legal environment may be defined as principles recognised and applied by the state in the administration of justice”. In India, legal environment is studied after analysing the pre and post period of independence. If we are talking about the current scenario, India is marching fast to attain the economic development. To channelize the trade and commerce in India, following acts were enacted

Companies Act, 1956 The Companies Act, 1956 is an Act of Parliament, enacted in 1956, which enabled companies to be formed by registration and set-up the responsibilities of companies their directors and secretaries. The Registrar of Companies (RoC) handles incorporation of new companies and the administration of running companies. A company is an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The basic aim of the Companies Act, 1956 is to ensure healthy growth of corporate sector and safeguard the interest of investors and the general public.

3.12 FEATURES OF COMPANY ACT, 1956

The main features of the act are

1. Full and fair disclosure of various matters in prospectus.
2. Detailed information of the financial affairs of a company to be disclosed in the accounts.
3. Provision for democratic election of directors and separation of ownership from management.
4. Provisions for intervention and investigation by government into the affairs of a company
5. Restrictions on the powers of managing agents and other managerial personnel. Duties, powers and liabilities of directors and managerial personnel
6. Restrictions on power of company and its director with the limits set by Memorandum of Association and Articles of Association
7. Protection of minority shareholders.
8. Procedure for winding up of a company and settlement account.

3.13 OBJECTIVES OF INCOME TAX ACT, 1961

The main objectives of the income tax act are as follows

- To make certain the revenue technology to the government
- To prevent tax evasion and frauds.
- To offer felony framework and manner to the for submitting of returns and price of earnings tax.

- To punish the defaulters for his or her tax evasion and a consequences and prosecutions to them.
- To create a mechanism of tax payments, returns fil exams and refunds.
- To body an appellate tribunal to settle the litigations.

3.14 REGULATION OF INTERNATIONAL TRADE

Traditionally, trade was regulated through bilateral treaties between two nations. After World War II, as free trade emerged as the dominant doctrine, multilateral treaties like the GATT and World Trade Organization (WTO) became the principal regime for regulating global trade.

The WTO, created in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT), is an international organization charged with overseeing and adjudicating international trade. The WTO deals with the rules of trade between nations at a near-global level; is responsible for negotiating and implementing new trade agreements; and is in charge of policing member countries' adherence to all the WTO agreements, signed by the majority of the world's trading nations and ratified in their parliaments. Additionally, it is the WTO's duty to review the national trade policies and to ensure the coherence and transparency of trade policies through surveillance in global economic policy making.

Headquartered in Geneva, Switzerland, the WTO has more than 150 members, which represent more than 95% of total world trade. It is governed by a ministerial conference, which meets every 2 years; a general council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the ministerial conference.

Five basic principles guide the WTO's role in overseeing the global trading system:

1. **Non-discrimination:** This principle inspired two major policies—the most favoured nation (MFN) rule and the national treatment policy—embedded in the main WTO rules on goods, services, and intellectual property. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, that is, a WTO member has to grant the most favourable conditions under which it allows trade in a certain product type to all other WTO members. The national treatment policy, adopted to address non-Tariff barriers to trade (e.g., technical standards,

security standards) dictates that imported and locally produced goods should be treated equally (at least after the foreign goods have entered the market).

2. **Reciprocity:** This principle reflects both a desire to limit the scope of free riding that may arise because of the MFN rule and a desire to obtain better access to foreign markets.
3. **Binding and enforceable commitments:** The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a list of concessions. A country can change its commitments but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. **Transparency:** WTO members are required to publish their trade regulations, to maintain institutions charged with review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO.
5. **Safety valves:** Under specific circumstances, governments can (within limits) restrict trade to attain noneconomic objectives, to ensure "fair competition," and under special economic circumstances.

The WTO operates on a "one country, one vote" system, but actual votes have never been taken. Ostensibly, decisions are made by consensus, with relative market size as the primary source of bargaining power. In reality, most WTO decisions are made through a process of informal negotiations between small groups of countries, often referred to as the "green room" negotiations (after the colour of the WTO director-general's office in Geneva) or "mini ministerial" when they occur in other countries. These processes have been regularly criticized by many of the WTO's developing-country members who are often excluded from these negotiations.

The WTO oversees about 60 different agreements that have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. Some of the most important agreements concern agriculture, services, and intellectual-property rights.

Regional arrangements such as Mercosur in South America; the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico; ASEAN in Southeast Asia; and the European

Union (EU) between 27 independent states constitute a second dimension of the international trade regulatory framework.

The EU is an economic and political union of 27 member states. Committed to regional integration, the EU was established by the Treaty of Maastricht on November 1, 1993, upon the foundations of the pre-existing European Economic Community. With almost 500 million citizens, the EU combined generates an estimated 30% share of the nominal gross world-product.

The EU has developed a single market through a standardized system of laws that apply in all member states, ensuring the freedom of movement of people, goods, services, and capital. It maintains common policies on trade, agriculture, fisheries, and regional development. A common currency, the Euro, has been adopted by 16 member states known as the Eurozone. The EU has developed a limited role in foreign policy, having representation at the WTO, G8 summits, and at the UN. It enacts legislation in justice and home affairs, including the abolition of passport controls between many member states. Twenty-one EU countries are also members of NATO, those member states outside NATO being Austria, Cyprus, Finland, Ireland, Malta, and Sweden.

Mercosur is a regional trade agreement among Argentina, Brazil, Paraguay, and Uruguay, founded in 1991 by the Treaty of Asunción, which was later amended and updated by the 1994 Treaty of Ouro Preto. Its purpose is to promote free trade and the fluid movement of goods, people, and currency.

Bolivia, Chile, Colombia, Ecuador, and Peru currently have associate-member status. Venezuela signed a membership agreement on June 17, 2006, but before becoming a full member, its entry has to be ratified by the Paraguayan and the Brazilian parliaments.

The NAFTA is an agreement signed by the governments of the United States, Canada, and Mexico, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994. It superseded the Canada–United States Free Trade Agreement. In terms of combined purchasing power, parity GDP of its members, as of 2007 the trade block, is the largest in the world and second largest by nominal GDP comparison. NAFTA has two supplements: The North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC).

The Association of Southeast Asian Nations, commonly abbreviated ASEAN, is a geopolitical and economic organization of 10 countries located in Southeast Asia, which was formed on August 8, 1967, by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Since then, membership has expanded to include Brunei, Burma (Myanmar), Cambodia, Laos, and Vietnam. Its aims include the acceleration of economic growth, social progress, cultural development among its members, and the protection of the peace and stability of the region.

3.15 ECONOMIC CRISIS OF 1991 AND INDIAN ECONOMY REFORMS

Crisis in India is figured out because of the inefficient management of Indian Economy in 1980s. The revenues generated by the government were not adequate to meet the growing expenses. So, the government resorted to borrowing to pay for its debts and was caught is a debt-trap. Deficit it refers to the excess of government expenditure over its revenue.

3.15.1 Causes of Economic Crisis

Different causes of economic crisis are given below

- The continued spending on development programmes of the government did not generate additional revenue.
- The government was not able to generate sufficient funds from internal sources such as taxation.
- Expenditure on areas like social sector and defence do not provide immediate returns, so there was a need to utilise the rest of its revenue in a highly effective manner, which the government failed to do.
- The income from public sector undertakings was also not very high to meet the growing expenditures.
- Foreign exchange borrowed from other countries and international financial institutions was spent on meeting consumption needs and to make repayments on other loans.
- No effort was made to reduce such increased spending and sufficient attention was not given to boost exports to pay for die growing needs.

Due to above stated reasons, in the late 1980s, government expenditure began to exceed its revenue by such large margins that meeting the expenditure through borrowings became unsustainable.

3.15.2 Need for Economic Reforms

The economic policy followed by the government up to 1990 failed in many aspects and landed the country in an unprecedented economic crisis. The situation was so alarming that India's reserves of foreign exchange were barely enough to pay for two weeks of imports. New loans were not available and NRIs were withdrawing large amounts. There was an erosion of confidence of international investors in the Indian economy. The following points highlight the need for economic reforms in the country

- Increasing fiscal deficit
- Adverse Balance of Payments
- Gulf crisis
- Rise in prices
- Poor performance of Public Sector Units (PSUs).
- High rate of deficit financing.
- Collapse of soviet bloc.

3.15.3 Emergence of New Economic Policy (NEP)

Finally, India approached International Bank for Reconstitution and Development, popularly known as World Bank and International Monetary Fund (IMF) and received $ 7 million as loan to manage the crisis. International agencies expected India to liberalise and open up economy by removing restrictions on private sector and remove trade restrictions between India and other countries.

India agreed to conditions of World Bank and IMF and had announced New Economic Polity (NEP) which consist of wide range of economic reforms. The measures adopted in the New Economic Policy can be broadly classified into two groups i.e.,

- **Stabilisation Measures:** They are short-term measures which were intended to correct some weakness that have developed in the Balance of Payments and to bring Inflation under control.
- **Structural Reforms:** They are long-term measures, aimed at improving the efficiency of the economy and increasing its international competitiveness by removing the rigidities in various segments of the Indian economy.

The various structural reforms are categorised as

- Liberalisation
- Privatisation
- Globalisation

- **Balance of Payment:** It is a system of recording country's economic transactions with the rest of the world over a period of one year.
- **Inflation:** It is a situation in which general price level of goods and services increases in an economy over a period of time.

3.16 LIBERALISATION

Liberalisation means the removal of controls or liberal the rules and law by the government to encourage economic development. It is a process by which the economy is opened up and stringent regulatory measures are relaxed to a large extent, most often, the term is used to refer to economic liberalisation, especially trade liberalisation or capital market liberalisation. Although economic liberalisation is often associated with privatisation, but it is altogether a separate process.

3.16.1. Background of Liberalisation In India

1. After independence in 1947, India adhered to socialist policies.
2. Attempts were made to liberalise economy in 1966 and 1985.
3. The first attempt was reversed in 1967. Thereafter, a stronger version of socialism was adopted.
4. Second major attempt was in 1985 by Prime Minister, Rajiv Gandhi. The process came to a halt in 1987
5. The economic liberalisation in India was started on 24th July, 1991
6. In 1991, after India faced a Balance of Payments crisis, it had to pledge 20 tons of gold to Union Bank of Switzerland and 47 tons to Bank of England as part of a bailout deal with the International Monetary Fund (IMF).

3.17 INTERNATIONAL TRADE LIBERALIZATION

International trade liberalization is the removal or reduction of restrictions or barriers on the free exchange of goods between nations. These barriers include tariffs, such as duties and surcharges, and nontariff barriers, such as licensing rules and quotas. Economists often view the easing or eradication of these restrictions as steps to promote free trade

3.17.1. Understanding International Trade Liberalization

International trade liberalization is a controversial topic. Critics of international trade liberalization claim that the policy can cost jobs because cheaper goods will flood the nation's domestic market. Critics also suggest that the goods can be of inferior quality and less safe than competing domestic products that may have undergone more rigorous safety and quality checks.

Proponents of international trade liberalization, however, claim that it ultimately lowers consumer costs, increases efficiency, and fosters economic growth. Protectionism, the opposite of international trade liberalization, is characterized by strict barriers and market regulation. The outcome of international trade liberalization and the resulting integration among countries is known as globalization.

3.17.2 International Trade Liberalization

The North American Free Trade Agreement (NAFTA) was signed on Dec. 17, 1992, by Canada, Mexico, and the United States. It entered into force on Jan. 1, 1994.The agreement eliminated the tariffs on products that were traded among the three countries. One of NAFTA's goals was to integrate Mexico with the highly developed economies of the United States and Canada, in part because Mexico was considered a lucrative new market for Canada and the United States. The three governments also hoped that the trade deal would improve Mexico's economy.

Over time, regional trade tripled, and cross-border investment increased among the countries. However, President Donald J. Trump considered the agreement detrimental to U.S. jobs and manufacturing. On Sept. 30, 2018, the Trump administration concluded negotiations on an updated pact, the U.S.-Mexico-Canada Agreement (USMCA), which entered into force on July 1, 2020.

Most economists agree that NAFTA was beneficial to the Canadian and U.S. economies. According to a Council on Foreign Relations report, regional trade increased from $290 billion in 1993 to over $1.1 trillion in 2016, and U.S. foreign direct investment (FDI) stock in Mexico increased from $15 billion to more than $100 billion. However, economists also say that other factors may also have contributed to these outcomes, such as technological change and extended trade with China.

Critics of NAFTA argue that the agreement caused job losses and wage stagnation in the United States because companies moved their production to Mexico to take advantage of lower labour costs. It remains to be seen how the USMCA will affect these factors.

Liberalisation of Financial Services in the Fast Lane

Reform of the International Financial System Stuck in Traffic At the international level, the current GATS negotiations on financial services are taking place at a time when the reform of the financial system announced after the Asian financial crisis has bogged down. At the spring meeting of the IMF in 2003, the discussion of an insolvency regulation for sovereign debtors (states), which had originally been proposed by the U.S. vice-director of the IMF, Ann Kruger, was removed from the agenda. Merely a so-called “collective action clause” was accepted. The German federal government had, as recently as the autumn of 2002 in its post-election coalition agreement, declared itself in favour of an insolvency procedure for sovereign debtors.

Proposals for reform involving improved supervision and stricter regulation of offshore centres and tax havens have largely fallen by the wayside. Some countries with tax havens have not yet reformed their systems. A considerable amount of money from drug-trafficking, the illegal arms trade and other criminal operations is laundered in this manner. International measures to control the risks stemming from the highly speculative hedge funds, which are increasingly active in times of low value of stocks are still very weak. Whether the new multilateral standards for risk management in lending ("Basel 2") will in fact fulfil their much-lauded promise, remains to be seen. Indeed, Basel 2 could actually increase the tendency of international banks to take more risks in their lending and investment activities. Only the next crisis will tell.

An important issue in the reform of the financial system is improved transparency by banks operating internationally. Publishing more information increases “market discipline” in the financial markets because investors and customers can assess the bank’s state of affairs and act; accordingly, in addition, it opens up more opportunities to supervisory authorities to play their role. A review of fifty-four international banks in 2001 showed that they disclosed only 63% of the items considered important by the Basel Committee of Banking Supervision (the association of all major supervisory authorities). While that was an improvement over the previous years, it was still far from sufficient. In particular, information about their techniques for mitigating credit risks (including more speculative credit derivatives) was lacking, which makes it difficult to monitor from the outside their practices and expertise for avoiding bad loans, a major source of instability. Ironically, while GATS make greater transparency of governments on service regulation a priority, it does not address the lack of transparency of service providers operating internationally, which poses many problems for host country authorities, particularly in the financial sector.

Liberalisation of financial services which is not embedded in a new financial architecture that serves the needs of the poor and of sustainable development is a dangerous strategy that increases the overall instability of a globalised economic system.

3.18 PRIVATIZATION

This is the second of the three policies of LPG. It is the increment of the dominating role of private sector companies and the reduced role of public sector companies. In other words, it is the reduction of ownership of the management of a government-owned enterprise. Government companies can be converted into private companies in two ways:

- By disinvestment
- By withdrawal of governmental ownership and management of public sector companies.

3.18.1 Forms of Privatization

- Denationalization or Strategic Sale: When 100% government ownership of productive assets is transferred to the private sector players, the act is called denationalization.
- Partial Privatization or Partial Sale: When private sector owns more than 50% but less than 100% ownership in a previously construed public sector company by transfer of shares, it is called partial privatization. Here the private sector owns the majority of shares. Consequently, the private sector possesses substantial control in the functioning and autonomy of the company.
- Deficit Privatization or Token Privatization: When the government disinvests its share capital to an extent of 5-10% to meet the deficit in the budget is termed as deficit privatization.

3.18.2 Objectives of Privatization

- Improve the financial situation of the government.
- Reduce the workload of public sector companies.
- Raise funds from disinvestment.
- Increase the efficiency of government organizations.
- Provide better and improved goods and services to the consumer.
- Create healthy competition in the society.
- Encouraging foreign direct investments (FDI) in India.

3.19 GLOBALIZATION

The term “globalization” was evolved in 1980s, but it is an older concept and is understood differently by different people all over the world. These varied conceptions gave an unclear view about ‘globalisation’. Different scholars, policy makers, and activists regarded it as a stimulus for the worldwide economic growth. While the same people simultaneously also assumed it as a crucial threat to the world economic system.

It means to integrate the economy of one country with the global economy. During Globalization the main focus is on foreign trade & private and institutional foreign investment. It is the last policy of LPG to be implemented.

Globalization as a term has a very complex phenomenon. The main aim is to transform the world towards independence and integration of the world as a whole by setting various strategic policies. Globalization is attempting to create a borderless world, wherein the need of one country can be driven from across the globe and turning into one large economy.

3.19.1 Outsourcing as an outcome of Globalization

The most important outcome of the globalization process is Outsourcing. During the outsourcing model, a company of a country hires a professional from some other country to get their work done, which was earlier conducted by their internal resource of their own country.

The best part of outsourcing is that the work can be done at a lower rate and from the superior source available anywhere in the world. Services like legal advice, marketing, technical support, etc. As Information Technology has grown in the past few years, the outsourcing of contractual work from one country to another has grown tremendously. As a mode of communication has widened their reach, all economic activities have expanded globally.

Various business process outsourcing companies or call centres, which have their model of a voice-based business process, have developed in India. Activities like accounting and book-keeping services, clinical advice, banking services or even education are being outsourced from developed countries to India.

3.19.2 Benefits of Globalization

The most important advantage of outsourcing is that big multi-national corporate or even small enterprises can avail good services at a cheaper rate as compared to their country’s standards. The skill set in India is considered most dynamic and effective across the world. Indian professionals are best at their work. The low wage rate and specialized personnel with high skills have made India the most favourable destination for global outsourcing in the later stage of reformation.

3.20 CHARACTERISTICS OF GLOBALISATION

Globalisation is a process of deeper integration between countries and regions of the world involving:

1. Greater trade across borders in goods and services
2. An increase in transfers of capital including the expansion of foreign direct investment (FDI) by transnational companies (TNCs) and the rising influence of sovereign wealth funds. Fifty-one of the largest economies in the world are corporations. The top 500 TNCs account for nearly 70% of world trade.
3. The development of global brands that serve markets in lower, middle and higher-income countries
4. Greater use of outsourcing and offshoring of production. The classic example is the iPhone which is part of a complex global supply chain. The product was conceived and designed in Silicon Valley in the USA and the software enhanced by engineers working in India. Most iPhones are assembled in China and Taiwan.
5. High levels of labour migration both within and between countries
6. New nations joining the trading system, for example Russia joined the World Trade Organisation (WTO) in 2012. The latest countries to join the WTO are Yemen (2014), Seychelles (2015) , Kazakhstan (2015) and Afghanistan (2016)
7. A shift in the balance of economic and financial power from developed to emerging economies and markets – i.e. a change in the centre of gravity in the world economy.
8. Increasing spending on capital investment, innovation and infrastructure across large parts of the world.
9. Globalisation is a process of making the world economy more connected and inter-dependent
10. Many industrialising (emerging) countries are winning a rising share of world trade and their economies are growing faster than developed nations.
11. Emerging and developing countries now account for more than 57% of global GDP adjusted for purchasing power according to 2015 data published by the IMF. The 28-nation European Union has a share of global GDP of less than 17%.

3.21 PROBLEMS IN GLOBALIZATION

- Global competition and imports keep a lid on prices, so inflation is less likely to derail economic growth.
- An open economy spurs innovation with fresh ideas from abroad. Export jobs often pay more than other jobs.
- Unrestrained capital flows give the US access to foreign investment and keep interest rates low.
- Millions of Americans have lost jobs due to imports or production shifts abroad. Most find new jobs that pay less
- Millions of others fear losing their jobs, especially at those companies operating under competitive pressure.
- Workers faces pay cut demands from employers, which often threaten to export jobs.
- Service and white-collar jobs are increasingly vulnerable to operations moving off shore.
- US employees can lose their comparative advantage when companies build advanced factories in low-wage countries, making them as productive as those at home.

LET US SUM UP

IBE is defined as a set of activities relating to industry and commerce, on an international level. IBE is unfamiliar and different from domestic environment. Every business enterprise consists of a set of internal factors and is confronted with a set of external factors. The external environment includes social, technological, economic, environmental, and political trends and developments. It consists of actors in the immediate environment that affects the performance of the firm, such as suppliers, competitors, marketing intermediaries, customers etc. Economic environment covers all those factors, which give shape and form to the development of economic activities and may include factors like nature of economic system, general economic conditions, various economic policies, and various production factors. An economic system refers to a particular set of social institutions which deals with production, distribution and consumption of goods and services in a particular society. It is basically composed of people and institutions, including their relationship to productive resources. An important factor influencing international trade is taxes. Of the different taxes that can be applied to imported goods, the most common is a tariff, which is generally defined as an excise tax imposed on imported goods. A country can have several reasons for imposing a tariff.

Technological environment refers to the sum total of knowledge providing ways to do things. It may include inventions and techniques, which affect the ways of doing things, i.e., designing, producing, and distributing products.

Political-legal environment consists of laws and regulatory framework and political set-up in which a business unit is operating. The Social-cultural environment is another important aspect of environmental scanning in strategic management. It basically refers to the set of values, ideals, attitudes, belief, desires, expectations which distinguish one group from those of another.

CHECK YOUR PROGRESS

Choose the correct answer

1. The first phase of globalization started around 1870 and ended with _______.

   a. World War I

   b. World War II

   c. The Establishment of GATT

   d. In 1913 when GDP was high

2. Which is the right sequence of stages of Internationalization?

   a. Domestic, Transnational, Global, International, Multinational

   b. Domestic, International, Multinational, Global, Transnational

   c. Domestic, Multinational, International, Transnational, Global

   d. Domestic, International, Transnational, Multinational, Global

3. According to ______ the holdings of a country's treasure primarily in the form of gold constituted its wealth.

   a. Gold Theory

   b. Ricardo Theory

   c. Mercantilism Theory

   d. Hecksher Theory

4. Globalization refers to ______.

   a. Lower incomes worldwide

b. Less foreign trade and investment

c. Global warming and their effects

d. A more integrated and interdependent world

5. This is only a legal agreement, and it is not an institution, but ______ is a permanent institution.

a. GATT, WTO

b. WTO, GATT

c. WTO, IMF

d. IMF, GATT

GLOSSARY

Geographical Factor: Geography and economy are closely tied together because transport makes trade with widespread areas possible. This is because geographical features include mountains, deserts, and water, which directly impact the movement of people and thus the movement of trade

Economic Factor : A country's stability of change is described through its internet exports (exports minus imports) and is as a consequence motivated through all of the elements that have an effect on global change. These consist of component endowments and productivity, change policy, alternate rates, overseas foreign money reserves, inflation, and demand

Forecasting : Trade in items and offerings forecast is described because the projected fee of alternate in possession of cloth assets and offerings among one financial system and another. The indicator incorporates internet trade, imports and exports and export market place growth.

Foreign Trade It is the mutual exchange of services or goods between international regions and borders. There are varieties such as import and export.

	They are important concepts for the national economy.
Capital Flows	It occurs at nearly every scale, from individuals to firms to national governments. Investors also look at the growth rate of certain capital flows, such as venture capital and capital spending, to find any trends that might indicate future investment opportunities or risks.

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WEB RESOURCES

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2. International Business - Social, Cultural and Technological Environment - YouTube
3. Socio-cultural Approach to Behaviour – Introduction - YouTube
4. Privatization, Liberalization and Globalization (LPG) - Explained | Tamil - YouTube
5. What is privatization, liberalization and globalization | 1st year - B.ed | explained in tamil | - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1. a 2.b 3.c 4.d 5.a

BLOCK 2

TRADE THEORY AND WORLD TRADE

UNIT 4

TRADE THEORY & TRADE AGREEMENT

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the international trade and their theories of absolute and comparative advantage theory and to learn about the factors influencing intensity of competition in industry. To discuss the various porter diamond model bases its assessment in six elements and the analysis of national competitiveness.

LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Demonstrate their understanding of the determinants of the trade pattern between countries and assess its effects on the distribution of income between and within these countries.
- Understand the political economy of trade policy and the economic effects of different trade policy instruments.

- Know at the level of formal analysis, the major models of international trade and be able to distinguish between them in terms of their assumptions and economic implications.
- Understand the principle of comparative advantage and its formal expression and interpretation within different theoretical models.

4.1 INTERNATIONAL TRADE THEORY OVERVIEW

It's easy to think that trade is just about business interests in each country. But global trade is much more. There's a convergence and, at times, a conflict of the interests of the different stakeholders—from businesses to governments to local citizens. In recent years, advancements in technology, a renewed enthusiasm for entrepreneurship, and a global sentiment that favours free trade have further connected people, businesses, and markets—all flatteners that are helping expand global trade and investment. An essential part of international business is understanding the history of international trade and what motivates countries to encourage or discourage trade within their borders. In this chapter we'll look at the evolution of international trade theory to our modern time. Companies react to these business incentives and regulations as they evaluate with which countries to do business and in which to invest. Governments often encourage foreign investment in their own country or in another country by providing loans and incentives to businesses in their home country as well as businesses in the recipient country in order to pave the way for investment and trade in the country.

4.2 MEANING OF INTERNATIONAL TRADE

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. International trade is then the concept of this exchange between people or entities in two different countries. People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this many sounds very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade.

In this section, you'll learn about the different trade theories that have evolved over the past century and which are most relevant today. Additionally, you'll explore the factors that impact international trade and how businesses and governments use these factors to their respective benefits to promote their interests.

4.3 THEORIES OF INTERNATIONAL TRADE

Balance of payments (BOP) is a systematic record of all economic transactions between the residents of the reporting country and the residents of the rest of the world for a given period of time. It is pertinent to note that international trade theories and policies represent microeconomic aspect of international economics, while balance of payments represents macroeconomics aspect of international economics. An insight into various theories of international trade provides a basis for the evolution of the concept of balance of payments. The theories of international trade can be broadly classified into:

- Mercantilist theories of international trade.
- Classical theories of international trade.
- Modern theories of international trade
- New theories of international trade.

4.4 MERCANTILISM THEORIES OF INTERNATIONAL TRADE

It was only after the publication of The Wealth of Nations by Adam Smith in 1776. It is oldest trade theory that formed the economic thought during about 1500 to 1800 centuries in Europe a group of men - like merchants, bankers, traders, government officials and philosophers wrote essays and pamphlets on international trade that advocated an economic philosophy known as mercantilism. Mercantilism is an economic theory that advocates government regulation of international trade to generate wealth and strengthen national power. Merchants and the government work together to reduce the trade deficit and create a surplus. Mercantilism—a form of economic nationalism—funds corporate, military, and national growth. It advocates trade policies that protect domestic industries. In mercantilism, the government strengthens the private owners of the factors of production. These four factors of production are:

1. Entrepreneurship
2. Capital goods
3. Natural resources
4. Labour

It establishes monopolies, grants tax-free status, and grants pensions to favoured industries. It imposes tariffs on imports. It also prohibits the emigration of skilled labour, capital, and tools. It doesn't allow anything that could help foreign companies. In return, businesses funnel the riches from foreign expansion back to their governments. Its taxes pay for increase national growth and political power.

4.4.1 Principles of Mercantilism

a. The belief that the amount of wealth in the world was relatively static.
b. The belief that a country's wealth could best be judged by the amount of precious metals or bullion it possessed.
c. The need to encourage exports over imports as a means for obtaining a favourable balance of foreign trade that would yield such metals.
d. The value of a large population as a key to self-sufficiency and state power.
e. The belief that the crown or state should exercise a dominant role in assisting and directing the national and international economies to these ends.

4.4.2 Mercantilism Involves

- Restrictions on imports – tariff barriers, quotas or non-tariff barriers.
- Accumulation of foreign currency reserves, plus gold and silver reserves. (Also known as bullionism) In the sixteenth/seventeenth century, it was believed that the accumulation of gold reserves (at the expense of other countries) was the best way to increase the prosperity of a country.
- Granting of state monopolies to particular firms especially those associated with trade and shipping.
- Subsidies of export industries to give a competitive advantage in global markets.
- Government investment in research and development to maximise the efficiency and capacity of the domestic industry.
- Allowing copyright/intellectual theft from foreign companies.
- Limiting wages and consumption of the working classes to enable greater profits to stay with the merchant class.
- Control of colonies, e.g., making colonies buy from Empire country and taking control of colonies wealth.

4.4.3 Examples of Mercantilism

- England Navigation Act of 1651 prohibited foreign vessels engaging in coastal trade.

- All colonial exports to Europe had to pass through England first and then be re-exported to Europe.
- Under the British Empire, India was restricted in buying from domestic industries and were forced to import salt from the UK. Protests against this salt tax led to the ‘Salt tax revolt’ led by Gandhi.
- In seventeenth-century France, the state promoted a controlled economy with strict regulations about the economy and labour markets
- Rise of protectionist policies following the great depression; countries sought to reduce imports and also reduce the value of the currency by leaving the gold standard.
- Some have accused China of mercantilism due to industrial policies which have led to an oversupply of industrial production – combined with a policy of undervaluing the currency.

4.4.4 Criticisms of Mercantilism

- Adam Smith’s “The Wealth of Nations” (1776) – argued for benefits of free trade and criticised the inefficiency of monopoly.
- Theory of comparative advantage (David Ricardo)
- Mercantilism is a philosophy of a zero-sum game – where people benefit at the expense of others. It is not a philosophy for increasing global growth and reducing global problems. Trying to impoverish other countries will harm our own growth and prosperity. By contrast, if we avoid zero-sum game of mercantilism increasing the wealth of other countries can lead to selfish benefits, e.g., growth of Japan and Germany led to increased export markets for UK and US.
- Mercantilism which stresses government regulation and monopoly often lead to inefficiency and corruption.
- Mercantilism justified Empire building and the poverty of colonies to enrich the Empire country.
- Mercantilism leads to tit for tat policies – high tariffs on imports leads to retaliation.
- The growth of globalisation and free trade during the post-war period showed possibilities from opening markets and respecting other countries as equal players.
- Economies of scale from specialisation possible under free trade.

4.4.5 Justification for Neo-Mercantilism

Despite many criticisms of mercantilism, there are arguments to support the restriction of free trade in certain circumstances.

- **Tariffs in response to domestic subsidies**. Supporters argue that since China's steel is effectively subsidised leading to a glut in supply, it is necessary and fair to impose tariffs on imports of Chinese steel to protect domestic producers from unfair competition. US tariffs on imports of steel from China 266%. In Europe, tariffs are 13%.
- **Protection against dumping**. If some countries have an excess supply of goods, they can sell at a very low price to get rid of the surplus. But this can make domestic firms unprofitable. Protectionism can be justified to protect against this dumping. Examples include EEC dumping excess agricultural production on world agricultural markets and China's dumping of steel.
- **Infant industry argument**. For countries seeking to diversify their economy, tariffs may be justified to try and develop new industries. When the industries have developed and benefited from economies of scale, then the tariffs and protectionism can be dropped.

4.4.6 Drawbacks of Mercantilism Theory or Neo-Mercantilism Theory

- Mercantilism weakens a country.
- Restrictions on free trade decreases country's wealth.
- Overlooks other factors such as natural resources, manpower and its skill level, capital etc.
- Restrictive policies promoting exports and restrict imports creating trade barriers.
- Colonial exploitation.

4.5 ABSOLUTE ADVANTAGE THEORY

The trade theory that first indicated importance of specialization in production and division of labour is based on the idea of theory of absolute advantage which is developed first by Adam Smith in his famous book The Wealth of Nations published in 1776. Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation's import and instead stated that all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage. Smith also stated that the wealth of nations depends upon the goods and services available to their citizens, rather than their gold reserves. While there are possible gains from trade with absolute advantage, the gains may not be mutually beneficial. Comparative advantage focuses on the range of possible mutually beneficial exchanges. Smith also used the concept of absolute advantage to explain gains from free trade in the international market. He theorized that countries' absolute advantages in different commodities would help them gain simultaneously through exports and imports, making the unrestricted into Adam Smith's Theory of Absolute Advantage Adam Smith. In simple terms absolute advantage theories are:

- Theory is based upon principle of division of labour.
- Free trade among countries can increase a country's wealth.
- Free trade enables a country to provide a variety of goods and services to its people by specializing in the production of some goods and services and importing others.
- Every country should specialize in producing those products at cost less than that of other countries and exchange these products with other products produced cheaply by others.
- When one country produces a product at a lower cost and another country produces another product at lower cost, both can exchange required quantity and can enjoy benefits of absolute cost advantage.

The mercantilist economic theory, which was widely followed between the 16th and the 18th century, came under a lot of criticism with the emergence of economists like John Locke and David Hume. Mercantilism advocated a national economic policy designed to maximize the nation's trade and its gold and money reserves. Mercantilism gained influence due to the emergence of colonial powers such as Britain and Portugal, before Adam Smith, and later Daniel Ricardo, both staunch critics of the concept, came up with their own theories to counter mercantilism.

Smith was the first economist to bring up the concept of absolute advantage, and his arguments regarding the same supported his theories for a laissez-faire state. In "The Wealth of Nations",

- Smith first points out that, through opportunity costs, regulations favouring one industry take away resources from another industry where they might have been more advantageously employed.

- Secondly, he applies the opportunity cost principle to individuals in a society, using the particular example of a shoemaker not using the shoes he made himself because that would be a waste of his productive resources. Each individual thus specializes in the production of goods and services in which he or she has some sort of an advantage.
- Thirdly, Smith applies the same principles of opportunity costs and specialization to international economic policy, and the principle of international trade. He explains that it is better to import goods from abroad where they can be manufactured more efficiently because this allows the importing country to put its resources into its own most productive and efficient industries. Smith thus emphasizes that a difference in technology between nations is the primary determinant of international trade flows around the globe.

4.5.1 Advantages Absolute Cost Advantage

- **Specialization**: Specialization of labour leads to higher productivity and allows to achieve less labour cost per unit of output.
- **Suitability**: Suitability of the skills of labour of the country in producing certain products
- **Economies of Scale**: Economies of Scale helps to reduce Scale the labour cost per unit of output.

4.5.2 Limitations of Absolute Advantage Theory

1. No absolute advantages for many countries.
2. Country size varies.
3. Country by country differences in specializations.
4. Deals with labour only and neglects other factors of production.
5. Neglected Transport cost.
6. Theory is based on an assumption that Exchange rates are stable and fixed.
7. It also assumes that labour can switch between products easily and they will work with same efficiency which in reality cannot happen.

4.5.3 Significance of Absolute Cost Advantage Theory

1. More quantity of both products.
2. Increased standard of living for both countries.
3. Increased production efficiency.
4. Increase in global efficiency and effectiveness.
5. Maximization of global productivity and other resources productivity.

4.5.4 Assumptions of The Absolute Advantage Theory

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

4.5.5 Achieving an Absolute Advantage

An absolute advantage is achieved through low-cost production. In other words, it refers to an individual, company, or country that can produce at a lower marginal cost. Such an advantage is established when (compared to competitors):

- Fewer materials are used to produce a product.
- Cheaper materials (thus a lower cost) are used to produce a product.
- Fewer hours are needed to produce a product.
- Cheaper workers are (in terms of hourly wage) used to produce a product.

4.5.6 Criticisms Against Absolute Advantage

The Absolute Advantage Theory assumed that only bilateral trade could take place between nations and only in two commodities that are to be exchanged. This assumption was significantly challenged when the trade, as well as the needs of nations, started increasing. Thus, this theory did not take into account the multilateral trade that could take place between countries. This theory also assumed that free trade exists between nations. It did not take into account the protectionist measures that are adopted by countries. These protectionist measures included quantitative restrictions, technical barriers to trade, and restrictions on trade on account of environmental protection or public policy.

Ricardo later came up with his own criticisms of Adam Smith’s theory. Ricardo’s 1817 work, “On the Principles of Political Economy and Taxation”, introduced a theory that later attained fame as the theory of comparative advantage, which places opportunity cost at the focus of agents' production decisions.

4.6 COMPARATIVE ADVANTAGE

It can be argued that world output would increase when the principle of **comparative advantage** is applied by countries to determine what goods and services they should specialise in producing. Comparative advantage is a term associated with 19th Century English economist **David Ricardo**.

Ricardo considered what goods and services countries should produce and suggested that they should specialise by allocating their scarce resources to produce goods and services for which they have a comparative cost advantage. There are two types of cost advantage – absolute, and comparative.

Absolute advantage means being more productive or cost-efficient than another country whereas comparative advantage relates to how much productive or cost efficient one country is than another.

Example:

In order to understand how the concept of comparative advantage might be applied to the real world, we can consider the simple example of two countries producing only two goods – motor cars and commercial trucks.

Maximum outputs	Country A	Country B
CARS	30 m	35 m
TRUCKS	6 m	21 m

Fig.4.1

Using all its resources, country A can produce 30m cars or 6m trucks, and country B can produce 35m cars or 21m trucks. This can be summarised in a table. In this case, country B has the absolute advantage in producing both products, but it has a comparative advantage in trucks because it is relatively better at producing them. Country B is 3.5 times better at trucks, and only 1.17 times better at cars.

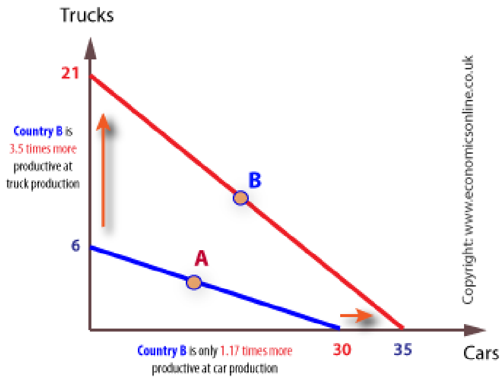

Fig.4.2

However, the greatest advantage – and the widest gap – lies with truck production, hence Country B should specialise in producing trucks, leaving Country A to produce cars.

Economic theory suggests that, if countries apply the principle of comparative advantage, combined output will be increased in comparison with the output that would be produced if the two countries tried to become self-sufficient and allocate resources towards production of both goods. Taking this example, if countries A and B allocate resources evenly to both goods combined output is: Cars = 15 + 15 = 30; Trucks = 12 + 3 = 15, therefore world output is 45 m units.

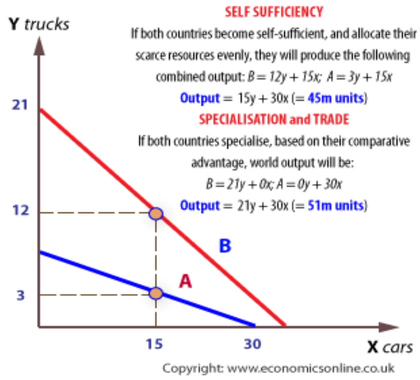

Fig.4.3

4.6.1 Opportunity Cost Ratios

It is being able to produce goods by using fewer resources, at a lower opportunity cost, that gives countries a comparative advantage. The gradient of a PPF reflects the opportunity cost of production. Increasing the production of one good means that less of another can be produced. The gradient reflects the lost output of Y as a result of increasing the output of X.

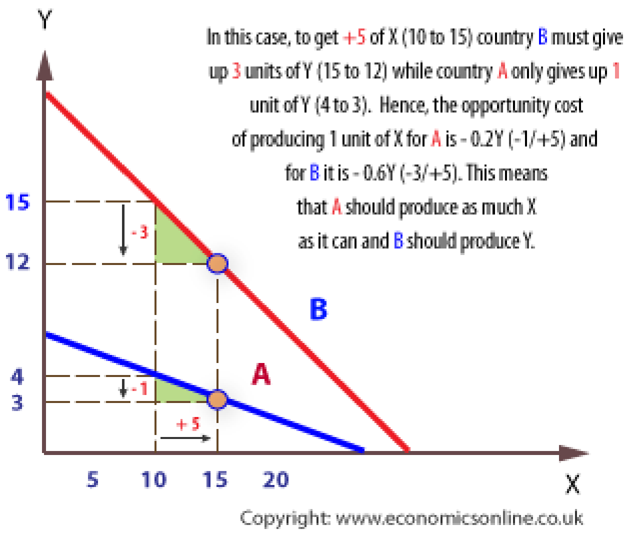

Fig.4.4

Having a comparative advantage in X, Country A sacrifices less of Y than Country B. In terms of two countries producing two goods, different PPF gradients mean different opportunity costs ratios, and hence specialisation and trade will increase world output.

4.6.2 Criticisms of Comparative Advantage

However, the principle of comparative advantage can be criticised in a several ways:

- It may overstate the benefits of specialisation by ignoring a number of costs. These costs include transport costs and any external costs associated with trade, such as air and sea pollution.
- The theory also assumes that markets are perfectly competitive – in particular, there is perfect mobility of factors without any diminishing returns and with no transport costs. The reality is likely to be very different, with output from factor inputs subject to diminishing returns, and with transport costs. This will make the PPF for each country non-linear and bowed outwards. If this is the case, complete specialisation might not generate the level of benefits that would be derived from linear PPFs. In other words, there is an increasing opportunity cost associated with increasing specialisation. For example, it may be that the maximum output of

cars produced by country A is only 20 million (compared with 30), and the maximum output of trucks produced by country B might only be 16 million instead of 21 million. Hence, the combined output from trade might only be 46 million units (instead of the 51 million units initially predicted).

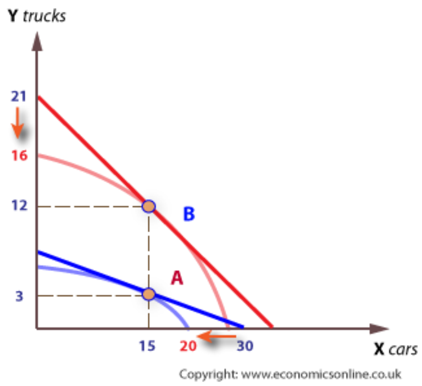

Fig.4.5

- Complete specialisation might create **structural unemployment** as some workers cannot transfer from one sector to another.
- Relative prices and **exchange rates** are not taken into account in the simple theory of comparative advantage. For example, if the price of X rises relative to Y, the benefit of increasing output of X increases.
- Comparative advantage is not a static concept – it may change over time. For example, non-renewable resources can slowly run out, increasing the costs of production, and reducing the gains from trade. Countries can develop new advantages, such as **Vietnam** and coffee production. Despite having a long history of coffee production, it is only in the last 30 years that it has become a global player. seeing its global market share increase from just 1% in 1985 to 20% in 2014, making it the world's second largest producer.
- Many countries strive for **food security**, meaning that even if they should specialise in non-food products, they still prefer to keep a minimum level of food production.
- The principle of comparative advantage is derived from a highly simplistic two good/two country model. The real world is far more complex, with countries exporting and importing many different goods and services.

According to influential US economist **Paul Krugman**, the continual application of economies of scale by global producers using new technology means that many countries, including China, can produce very cheaply, and export surpluses. This, along with an insatiable demand for choice and variety, means that countries typically produce a variety of products for the global market, rather than specialise in a narrow range of products, rendering the traditional theory of comparative advantage almost obsolete.

Modern approaches to explaining trade patterns and trade flows tend to use gravity theory – which explains trade in terms of the positive attractiveness between two national economies – based on economic size (in a similar fashion as planets attracting each other based on their mass) – and the 'economic distance' between two economies. *Economic size* attracts countries to trade, and *economic distance* makes trade harder. Economic distance is increased by barriers to trade, and cultural, political and linguistic differences. One advantage of gravity theory is that it can help economists predict the likely effect of changes in government policy on trade patterns, including decisions regarding joining (or leaving) trading blocs.

Despite these significant criticisms, the underlying principle of comparative advantage can still be said to give some 'shape' to the pattern of world trade, even if it is becoming less relevant in a globalised world and in the face of modern theories.

4.7 HECKSCHER- OHLIN THEORY-THE NEW TRADE THEORY

Heckscher and Ohlin developed a theory to explain the reasons for differences in relative commodity prices and competitive advantage between two nations. According to this theory, a nation will export the commodity whose production requires intensive use of the nation's relatively abundant and cheap factors and import those commodities, whose production requires intensive use of nation's scarce and expensive factors.

Thus, the theory explains the basis of international trade in three stages

- The basis of trade lies in the difference in the final price of a commodity.
- The difference in final price of a commodity is due to difference in the comparative cost of producing that commodity.
- Finally, it examines the root cause, which produces this difference in the comparative cost.

It is difference in factor intensities in the production function of goods along with actual difference in relative factor endowments that explains the international differences in comparative cost of production. A country can produce a commodity more cheaply by matching its abundant factor with the factor intensity of the commodity because, when a nation has relatively more of a particular factor, the cost of that factor will be comparatively lower.

The lower the price of the major input, the greater is the price advantage the producer will have in trade. The following are the example of Heckscher and Ohlin. Let us take two counties A and B. In country A, capital is abundant, and labour is scarce. In country B, labour is abundant, and capital is scarce. In country A, production of capital-intensive goods will be comparatively cheaper while in country B, production of labour-intensive goods will be cheaper. Country A possess a comparative advantage in the production of capital-intensive goods, country B has a comparative advantage in the production of labour-intensive goods. When a country like A exports capital intensive goods in return for labour intensive exporting her abundant and cheap factor embodied in the form goods. Thus, indirectly factors in abundant supply are exported in the form of goods produced by them and factors in scarce supply are imported by the country.

4.7.1 Assumptions of the Heckscher-Ohlin Theory

- This theory considers a two-country, two- commodity and two factor (labour and capital) case. It is possible, however, to extend the theory to a multi-factor and multi-commodity case. But such an extension can be done only if the number of factors and number of commodities are equal.
- The factors of production are perfectly mobile within their respective countries, but they are immobile between the countries.
- There is a state of perfect competition both in the product and factor markets.
- There is full employment of the factors of production in both the countries.
- Production functions pertaining to both the commodities are linearly homogenous. It implies that the production is governed by constant returns to scale.
- The techniques of production in both the countries remain unchanged. In such a situation, the input-output co-efficient in production functions will remain unchanged.
- The consumer’s taste pattern and therefore the demand functions for different goods are identical in both the countries.
- The factors endowments, in absolute terms, remain constant in both the countries but the relative endowments of the two factors are disproportionate in the two countries. Suppose country A has

an abundance of capital while B has an abundance of labour. In qualitative terms, however, the factors are homogenous in the two countries.

- The production functions are such that the two commodities show different factor intensities—one commodity is capital-intensive and the other is labour-intensive. Although production functions for different commodities are different, yet the production functions for each commodity are the same in both the countries.
- The factor intensities are not reversible.
- The trade between two countries is free and unrestricted.
- There is an absence of transport costs so that product prices are related exclusively to factor costs.
- There is incomplete specialisation in the trading countries.

The whole basis of differences in comparative costs, according to H-O theory, rests upon two crucial elements—factor endowments and factor intensities.

4.7.2 Factor Endowments

It is an incontrovertible fact that regions or countries differ from one another in respect of endowments or availability of factors. In country A, there may be an abundance of capital and labour may be scarce. On the opposite, there may be an abundance of labour in country B, while capital may be scarce.

The terms 'relative factor abundance,' in H-O model can be defined in terms of two criteria:

(i) The physical criterion of relative factor abundance, and

(ii) The price criterion of relative factor abundance.

(i) Physical Criterion

According to this criterion, a country is said to be relatively capital abundant, if and only if, it is endowed with a higher proportion of capital to labour than the other country.

The country A can be called as relatively capital abundant, if the following condition is satisfied:

$$\frac{\bar{K}_A}{\bar{L}_A} > \frac{\bar{K}_B}{\bar{L}_B}$$

where K and L refer to capital and labour respectively. Bars over K and L signify the fixed factor quantities in each country. The subscripts A and B refer to countries A and B. Similarly, the relative scarcity of labour, in physical terms, in country A can be expressed as:

$$\frac{\bar{L}_A}{\bar{K}_A} < \frac{\bar{L}_B}{\bar{K}_B}$$

For country B, relative labour-abundance can be indicated by:

$$\frac{\bar{L}_B}{\bar{K}_B} > \frac{\bar{L}_A}{\bar{K}_A}$$

And capital-scarcity in this country can be denoted by:

$$\frac{\bar{K}_B}{\bar{L}_B} < \frac{\bar{K}_A}{\bar{L}_A}$$

Given the above conditions, H-O theory lays down that country A will produce capital-intensive commodity (say machines) and country B will have a bias in producing labour-intensive commodity (say, cloth). If both the countries produce machines and cloth in the same proportion and production occurs along OR in Fig. 4.6, the country A would be producing at C and country B at D. The points C and D lie on the respective production possibility curves PQ and P1Q1 of these two countries.

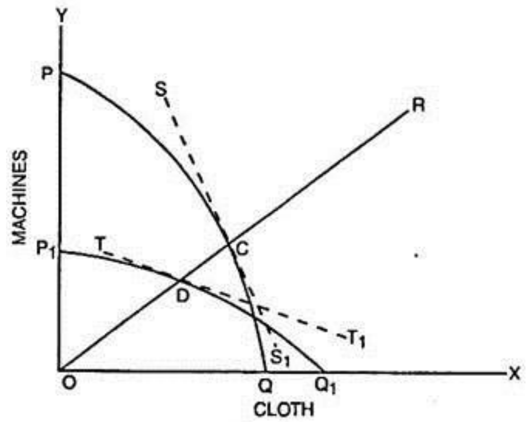

Fig.4.6

Since at point C, the slope of country A's production possibility curve is steeper than the slope of the production possibility curve of country B at D, this will imply that MC of producing cloth in country A is higher than the MC of producing cloth in country B. So, if the production takes place at points C and D, machines can be produced more cheaply in country A and cloth can be produced more cheaply in country B. Since country A is capital-abundant and the production of machines is capital-intensive, country A will tend to extend the production of machines. Country B, at the same time being labour-abundant, will tend to extend the production of cloth, which is relatively labour- intensive.

The Heckscher-Ohlin theorem can, however, be valid on the basis of this physical criterion and give the above conclusion only if the consumption pattern in both the countries is identical and the income elasticity of demand for each commodity equals unity. If the demand conditions are different in two countries, the conclusion that capital-abundant countries will export capital-intensive commodity and vice-versa cannot be sustained. This can be shown through Fig. 4.7

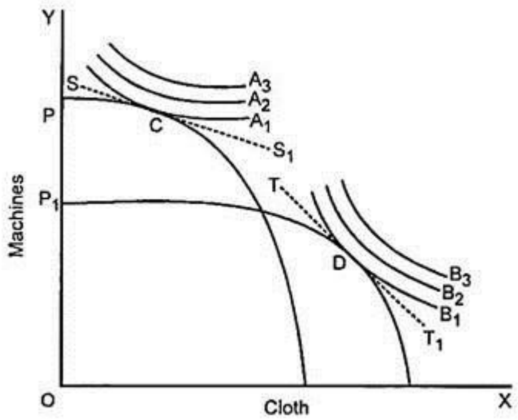

Fig.4.7

Even in Fig. 4.2, the opportunity cost curves PQ and P1Q1 indicate that country A is capital-abundant and country B is labour-abundant. The pattern of demand is different in the two countries. The community indifference curves A1, A2 and A3 indicate demand pattern in country A and the indifference curves B1, B2 and B3 indicate the demand pattern in country B. The iso-revenue curve SS1 related to country A is less steep than the iso- revenue curve TT1 for country B, therefore-

$$\frac{\text{Price of Cloth}}{\text{Price of Machine}} \text{ in A} < \frac{\text{Price of Cloth}}{\text{Price of Machine}} \text{ in B.}$$

Now demand conditions indicate that machines are costly in country A while cloth is costly in country B. Therefore, country A may decide to export cloth and country B may export machines. So the pattern of demand may off-set the Heckscher-Ohlin generalisation that capital-abundant country will export capital-intensive commodity and vice-versa.

(ii) Price Criterion

The alternative criterion for defining relative factor-abundance is the price criterion. The criterion lays down that a country having capital relatively cheap and labour relatively costly is capital-abundant and vice-versa, irrespective of the physical quantities of capital and labour that they have.

Country A can be called as relatively capital-abundant if (PKA/PLA) < (PKB/PLB). Here P denotes prices. K and L signify capital and labour respectively. A and B indicate countries A and B respectively. Similarly country A can be regarded as labour- abundant and capital-scarce, if (PLA/PKA) < (PLB/PKB).

Now suppose country A is capital-abundant and labour-scarce, the interest rates will be relatively low and wage rates will be relatively higher when compared with interest rates and wage rates in country B. Therefore, country A will decide to produce and export capital-intensive commodity (say, machine) and import labour-intensive commodity (say, cloth). Now this generalization can be proved through Fig. 4.8.

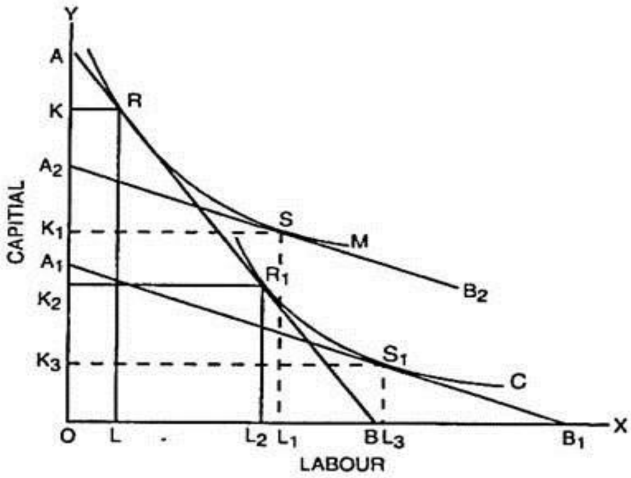

Fig.4.8

AB is the factor-price line for country A and A1B1 is the factor price line for country B. As the slope of AB is greater than that of A1B1, capital is relatively cheap in country A and labour is relatively cheap in country B. It signifies that (PKA/PLA) < (PKB/PLB).

Now the factor price line AB is tangent to the isoquant M of the capital-intensive commodity machine at R. It means country A can produce certain number of units of machine, say 100 machines, by employing OK units of capital and OL units of labour. OL amount of labour is equal to AK amount of capital. In other words, the cost of producing 100 machines in country A in terms of capital is OA.

The factor price line A2B2 of country B is parallel to A1B1. It is tangent to the isoquant M at S. It signifies that country B can produce 100 machines by employing OK1 units of capital and OL1 units of labour. It means A2K1 units of capital are equal to OL1 units of labour and the total cost of producing 100 machines in country B is OA2 in terms of capital. From this, the conclusion can be derived that the production of machine is more capital-intensive in country A than in country B.

Similarly in the production of one unit of cloth (say, 1000 metres) in country A, OL2 units of labour and OK2 units of capital are employed at R1, the point of tangency between country A's factor price line AB and the isoquant for cloth C representing 1000 meters of cloth. Given this factor combination, OK2 units of capital are equal to BL2 units of labour and the cost of producing 1000 metres of cloth in country A in terms of labour is OB.

In country B, given the factor price line A1B1, the point of tangency between A1B1 and isoquant C is S1. Country B employs OK3 units of capital and OL3 units of labour for producing 1000 metres of cloth. Now the quantity of capital OK3 equals B1L3 units of labour.

The cost of producing 1000 metres of cloth in labour terms is OB1 in country B. This shows that labour-abundant country B makes more use of labour in producing 1000 metres of cloth than country A. B will specialise in the production and export of cloth while country A will export more capital-intensive commodity machine.

4.7.3 Factor Intensities

The Heckscher-Ohlin theory attributed the comparative differences in costs also to the factor intensities which have been defined by Ellsworth as "relative use made of each one of the two (or more) factors when combined in production." Alternatively, factor intensity means the relative proportions in which two factors, say labour and capital, are combined at each point on a given isoquant. This is explained through Fig. 4.9.

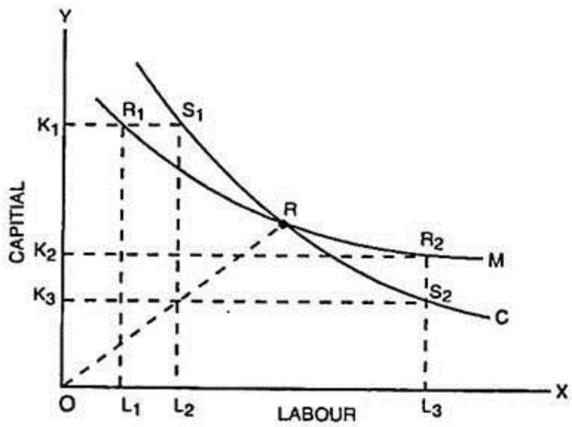

Fig.4.9

C and M in Fig. 4.9 represent the isoquants of cloth and machine respectively. They are not identical otherwise they would have coincided. They intersect each other at R. That indicates equal factor proportions in producing a given number of units of the two commodities. The portion to the left and above R is capital-intensive and the portion below and to the right of R is labour-intensive. Along isoquant M, the quantities of capital and labour used at R1 are OK1 and OL1 respectively. At R2, these inputs are OK2 and OL3 to have the same output of machines.

Thus, above and to the left of R, the factor combinations involve larger input of capital than labour. The opposite is true on the combinations below and to the right of R. The same applies even in the case of isoquant C. If OK1 quantity of capital is used, one unit of machine requires the labour input of OL1 but one unit of cloth requires OL2 units of labour along with OK1 units of capital at point S1.

Similarly, if OK2 units of capital are employed, one machine can be turned out when labour input is OL3. At S2, one unit of cloth needs OL3 labour input along with a smaller capital input OK3. It clearly shows that machine is a capital- intensive and cloth is a labour-intensive commodity, throughout the length of isoquants M and C except of course at the point of intersection R.

So, the relative factor abundance and factor intensity together determine the comparative differences in costs and accordingly the countries will decide about specialisation and export of specific commodities. On the basis of factor proportions, factor intensities and factor prices, Heckscher and Ohlin made the generalisation that capital-abundant countries will export capital-intensive commodities and labour-abundant countries will export labour- intensive commodities.

4.7.4 Superiority of Heckscher-Ohlin Theory Over the Classical Theory

Heckscher- Ohlin theory does not contradict the Ricardian theory. It rather supplements it as it attempts to investigate the basic forces determining the comparative advantage of one country over the other. However, H-O theory makes some departures from the traditional theory and in the process, effects significant improvements upon the latter in following respects:

(i) Based on General Theory of Value: While the classical theory is based upon the labour theory of value, Heckscher-Ohlin model, on the other hand, is necessarily based upon a more general theory of value. It takes into amount both demand and supply forces for determining specialisation and pattern of trade. In contrast, Ricardian theory was very deficient and one-sided. It had relied exclusively upon the supply factors and overlooked completely the demand factors.

(ii) No Need for Separate Theory: Ricardo had made a distinction between internal and international trade. On account of factor immobility among different countries, he felt the need for a separate theory of international trade. Even though Heckscher and Ohlin too believe that there are obstacles to international mobility of factors, yet the greater mobility of products tends to neutralise the factor immobility.

In their opinion, the immobility of factors remains only a matter of degree and not of kind and any distinction between international or inter-regional trade is only superficial. In the words of Ohlin, “International trade is but a special case of inter-local or inter-regional trade and there is not substantial difference between domestic trade and foreign trade. The basis of inter-regional specialisation also follows the principle of comparative cost.”

(iii) Ultimate Cause of Trade: The classical theory failed to explain the cause of comparative difference in costs. Heckscher and Ohlin provided a highly plausible cause of comparative differences in costs and consequent international specialisation in production.

(iv) Permanent Basis of Trade: The classical theory implicitly relates the comparative differences in costs to differences in skill and efficiency of labour. Over a long period, there can be international transmission of technical knowledge from one country to another and all differences in costs due to skill, efficiency and technology are likely to be eliminated. It implies that the trade between two countries may come to an end in the long run.

Kelvin Lancaster has, however, pointed out that the trade between countries is not likely to come to an end even if there is perfect transmission of knowledge and techniques because the differences in factor endowments will continue to persist even in the long run. Since the factor movements from one country to the other cannot take place on such a scale that the factor endowment gap can be completely bridged, the comparative cost differences will continue to exist and hence there can be permanent exchange of commodities. It shows that H-O model lays down a permanent basis for international trade.

(v) Two Factors of Production: In the classical comparative costs theory, it was supposed that production involves only one factor of production—labour. The H-O theory, on the opposite, maintains that in a two-country and two- commodity model, production involves two factors of production—labour and capital.

(vi) Stress on Relative Product or Factor Prices: A highly significant difference between the classical and H-O theories is that the former approach consists primarily of propositions related to the relative product prices. The latter, on the contrary, deals with propositions related to the relative factor prices.

(vii) Emphasis on Gains vs. Bases of Trade: The traditional theory emphasises upon the gains accruing to countries from foreign trade. Therefore, the classical theory has useful welfare implication. The Heckscher-Ohlin theory on the opposite, stresses on the analysis of bases of trade between two countries and makes contribution mainly to positive economics.

(viii) Qualitative vs. Quantitative Differences in Factors: The classical theory takes into account only the single factor, labour, and attributes the comparative differences in costs to qualitative differences in labour. The H-O theory, on the other hand, deals with two factors—labour and capital. It assumes an absence of qualitative differences in them. The international trade and specialisation results on account of quantitative differences in factor proportions and factor intensities.

(ix) Production Function: The classical trade theory is based on the differences in the production of specified commodities between the two trading countries. In contrast, the H-O theory gives prominence to differences in their production functions.

(x) Product Specialisation: The comparative costs theory maintains that the comparative advantages of trading countries may or may not lead to complete specialisation in the production and export of respective commodities. On the opposite, the H-O theorem explicitly states that the factor proportions and factor intensities lead to complete specialisation in the production of a specific commodity in the first country and another commodity in the second country. From this view-point, the latter theory is more specific and realistic.

(xi) Locational Theory: Haberler points out that the H-O theory gives prominence to the space factor in the international trade through factor endowments of trading countries. He prefers to call this theory as a locational theory. In contrast, the Ricardian-Mill theory treats different countries as a spaceless market. Even from this angle, the H-O theory is an improvement upon the classical theory.

(xii) Distributions of Income and Welfare: Since the classical theory takes into account a single factor of production, the distribution of income remains unchanged. It implies that the welfare of every individual unequivocally increases with trade or else no one is worse off than before. The Heckscher-Ohlin theorem does not make such an unqualified, and unrealistic statement about welfare.

(xiii) Integration between the Theory of Value and Theory of International Trade: The classical theory relies upon the forces of demand and supply in their value theory. But when they come to the trade theory there is a complete neglect of demand factors. So classical approach fails to integrate the theories of value and trade. The Heckscher-Ohlin theory brought about a successful integration between the theories of value and trade.

From the above facts, it becomes clear that the modern theory of international trade does not only make a highly significant break from the traditional analysis but also registers a considerable improvement upon it.

4.7.5 Criticism of Heckscher-Ohlin Theory

The Heckscher-Ohlin theory has been found to be more exact, precise, scientific and analytically superior to the earlier approaches to the theory of international trade, still it has certain deficiencies for which it has been criticized by many a writer.

(i) Partial Equilibrium Analysis: Haberler although recognized Ohlin's theory as less abstract, yet it has failed to develop a general equilibrium concept. It remains, by and large, a part of the partial equilibrium analysis. This theory seeks to explain the pattern of trade only on the basis of factor proportions and factor intensities, while ignoring several other influences such as transport costs, economies of scale, external economies etc., which too exert influence on the cost of production. In such a situation, Ellsworth states that "with several causes operating simultaneously upon costs, it becomes a matter of adding up the influence of all cost-reducing and increasing forces to arrive at a net result."

(ii) Oversimplifying Assumptions: This theory is based upon highly over-simplifying assumptions of perfect competition, full employment of resources, identical production function, constant returns to scale, absence of transport costs and absence of product differentiation. Given this set of assumptions, the whole model becomes quite unrealistic.

(**iii) Static Analysis:** The Heckscher-Ohlin model assumes fixed quantities of factors of production, given production functions, incomes and costs. It means the theory investigates the pattern of international trade in a static setting. The conclusions drawn from such an analysis are simply not relevant to a dynamic economic system.

(iv) Identical Factors: This theory maintains that there are no qualitative differences in factors and that these factors are capable of exact measurement so that factor endowment ratios can be calculated. In the real world, however, qualitative factor differences exist. Moreover, there are more than one variety of each factor. This creates serious complications in the measurement and comparison of costs and the determinations of trade pattern.

(v) Neglect of Product Differentiation: The theory overlooks the role played by product differentiation in international trade. Even when the production agents are identical in two countries, the international trade may still take place due to product differentiation. For instance, the Japanese machines are sold out in the U.S.A. and the American machines are sold in Japan. In this context, Wijan holds opines that factor prices do not determine cost. It is rather the commodity prices that determine factor prices.

(vi) Factor Proportions and Specialisation: The H-O theory suggests that the relative factor proportions (or factor endowments) determine the specialisation in exports of different countries. The capital-abundant countries export capital-intensive goods and labour-abundant countries export the labour-intensive goods. It implies that trade will not take place between such countries or regions as have similar relative factor proportions. But this is not true.

A large part of world trade is between the U.S.A. and the countries of Western Europe despite the fact that all of them have a relative greater capital- abundance and scarcity of labour. The H-O theory cannot provide a complete and satisfactory explanation of trade in such cases. In fact, the specialisation is governed not only by factor proportions but also by several other factors like cost and price differences, transport costs, economies of scale, external economies etc. The H-O theory was clearly wrong in overlooking these factors.

(vii) Neglect of Factor Demand: The H-O theory assumes that the factor prices are determined by the relative factor endowments of a country. It means the rate of interest should be relatively low and wage rates relatively high in a capital-abundant but a labour-scarce country. On this basis, the United States should have a lower structure of interest rate but it is in fact higher because even in that capital-surplus country, the demand for capital too is very strong. In fact, the relative factor prices are influenced not only by their supply but also by the demand for them. The H-O theory failed to take into account the influence of demand for factors on their prices.

(viii) Factor Mobility: This theory assumes that there is absence of international mobility of factors. This assumption is not valid. The writers like Williams and Levin have pointed out that the international mobility of factors is actually even more than the inter-regional mobility within the same countries. This is evident from international capital flows from advanced countries to such export sectors in the LDC's as petroleum, minerals, plantations etc.

(ix) Neglect of Technological Change: The H-O model assumes identical production function. It implies that the technological conditions in a given country remain unchanged. This assumption again is invalid. There has been continuous improvement in techniques of production both in the advanced and the less developed countries. The neglect of technological change in H-O theory makes this model quite inconsistent with actual reality.

(x) Factor-Intensity: This theory gives much prominence to the concept of factor intensity. It is assumed in this model that one good is capital-intensive and the other is labour-intensive. The capital-intensive good remains capital-intensive in both the counties and the labour-intensive good remains labour-intensive in both the countries. It means there can be no reversal of factor-intensity i.e., the same good is capital-intensive in one country while labour-intensive in the other. The empirical evidence on this issue is conflicting. However, if there is reversal of factor-intensity, the whole structure of H-O theory will collapse.

(xi) Neglect of By-Products: Sometimes by-products are even more important than the main final product. The Heckscher-Ohlin theorem, however, provides no explanation how the terms of trade are determined in the case of by-products.

(**xii) Possibility of Trade Even under Identical Proportions:** The factor proportions theory implies that there can be no possibility of international trade when factor proportions between two countries are identical. In fact, the identical factor proportions may not close the possibility of trade if consumer preferences are not identical due to differences in income distribution in two countries. This can be explained through Fig. 4.10.

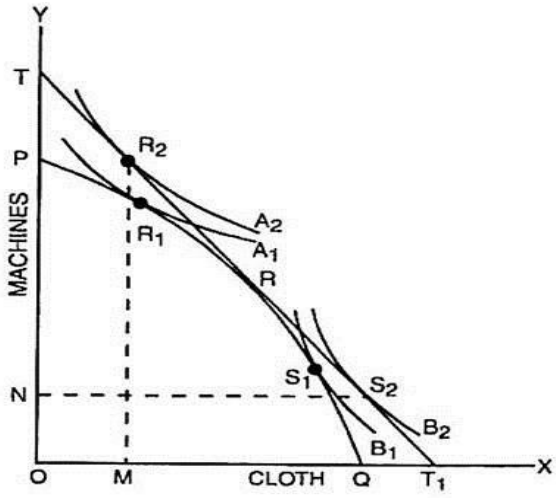

Fig.4.10

Given the identical factor proportions in two countries A and B, there is the same production possibility curve PQ for both the countries. A1 and A2 are the community indifference curves of A. B1 and B2 are the indifference curves of B. In the absence of international trade, consumption points of the two countries are respectively R1 and S1. It shows that country A has a stronger consumer preference for machines and country B has a greater preference for cloth.

As international trade takes place, TT1 is the international exchange ratio line. Now both the countries get superior alternatives at R2 and S2 respectively. At R2, country A consumes R2M of machines and OM of cloth. On the other hand, country B consumes S2N quantity of cloth and ON quantity of machines at S2. The consumption in excess of production is met through mutual imports. Thus even when the factor proportions are identical, the international trade may still occur and that vitiates the Heckscher-Ohlin theory.

(xiii) Vague Theory: No doubt H-O theorem attempted to explain the basis reason for comparative advantage of the trading countries, yet the theory is vague and conditional. It depends upon several restrictive and unrealistic assumptions. In the words of Haberler, "With many factors of production, some of which are qualitatively incommensurable as between different countries, and with dissimilar production functions in different countries, no sweeping a prior generalisation concerning the composition of trade are possible."

4.8 PORTER'S NATIONAL COMPETITIVE ADVANTAGE THEORY

The Porter Diamond, properly referred to as the Porter Diamond Theory of National Advantage, is a model that is designed to help understand the competitive advantage that nations or groups possess due to certain factors available to them, and to explain how governments can act as catalysts to improve a country's position in a globally competitive economic environment. The model was created by Michael Porter, a recognized authority on corporate strategy and economic competition, and founder of the Institute for Strategy and Competitiveness at the Harvard Business School. It is a proactive economic theory, rather than one that simply quantifies competitive advantages that a country or region may have. The Porter Diamond is also referred to as "Porter's Diamond" or the "Diamond Model."

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

The four determinants are

(1) local market resources and capabilities,

(2) local market demand conditions,

(3) local suppliers and complementary industries, and

(4) local firm characteristics.

Fig.4.11. Determinants of porter's theory

1. **Local market resources and capabilities (factor conditions**): Porter recognized the value of the factor proportions theory, which considers a nation's resources (e.g., natural resources and available labour) as key factors in determining what products a country will import or export. Porter added to these basic factors a new list of advanced factors, which he defined as skilled labour, investments in education, technology, and infrastructure. He perceived these advanced factors as providing a country with a sustainable competitive advantage.

2. **Local market demand conditions.** Porter believed that a sophisticated home market is critical to ensuring on going innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies. Many sources credit the demanding US consumer with forcing US software companies to continuously innovate, thus creating a sustainable competitive advantage in software products and services.

3. **Local suppliers and complementary industries.** To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry. Certain industries cluster geographically, which provides efficiencies and productivity.

4. **Local firm characteristics.** Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm's competitiveness. A healthy level of rivalry between local firms will spur innovation and competitiveness.

4.9 UNDERSTANDING THE PORTER DIAMOND

The Porter Diamond suggests that countries can create new factor advantages for themselves, such as a strong technology industry, skilled labour, and government support of a country's economy. Most traditional theories of global economics differ by mentioning elements, or factors, that a country or region inherently possesses, such as land, location, natural resources, labour, and population size as the primary determinants in a country's competitive economic advantage. Another application of the Porter Diamond is in corporate strategy, to use as a framework to analyse the relative merits of investing and operating in various national markets.

4.10 PORTER DIAMOND WORKS

The Porter Diamond is visually represented by a diagram that resembles the four points of a diamond. The four points represent four interrelated determinants that Porter theorizes as the deciding factors of national comparative economic advantage. These four factors are firm strategy, structure and rivalry; related supporting industries; demand conditions; and factor conditions. These can in some ways also be thought of as analogous to the eponymous forces of Porter's Five Forces model of business strategy.

Firm strategy, structure, and rivalry refer to the basic fact that competition leads to businesses finding ways to increase production and to the development of technological innovations. The concentration of market power, degree of competition, and ability of rival firms to enter a nation's market are influential here. This point is related to the forces of competitors and barriers to new market entrants in the Five Forces model.

Related supporting industries refer to upstream and downstream industries that facilitate innovation through exchanging ideas. These can spur innovation depending on the degree of transparency and knowledge transfer. Related supporting industries in the Diamond model correspond to the suppliers and customers who can represent either threats or opportunities in the Five Forces model.

Demand conditions refer to the size and nature of the customer base for products, which also drives innovation and product improvement. Larger, more dynamic consumer markets will demand and stimulate a need to differentiate and innovate, as well as simply greater market scale for businesses.

4.11 THE IMPORTANCE OF FACTOR CONDITIONS

The final determinant, and the most important one according to Porter's theory, is that of factor conditions. Factor conditions are those elements that Porter believes a country's economy can create for itself, such as a large pool of skilled labour, technological innovation, infrastructure, and capital.

For example, Japan has developed a competitive global economic presence beyond the country's inherent resources, in part by producing a very high number of engineers that have helped drive technological innovation by Japanese industries.

Porter argues that the elements of factor conditions are more important in determining a country's competitive advantage than naturally inherited factors such as land and natural resources. He further suggests that a primary role of government in driving a nation's economy is to encourage and challenge businesses within the country to focus on the creation and development of the elements of factor conditions. One way for the government to accomplish that goal is to stimulate competition between domestic companies by establishing and enforcing anti-trust laws.

4.12 THE PORTER DIAMOND MODEL – ANALYSIS OF NATIONAL COMPETITIVENESS

The Porter Diamond model offers an effective way for analysing the national competitiveness. Based on the characteristics of the home country, it is possible to assess the international success of the firm. According to the Porter Diamond model, the characteristics of the home country play a central role in explaining the international competitiveness of the firm. Thus, it asserts that the quality of the home country environment influences how successful the company can become in other markets.

4.12.1 The Porter Diamond Model Bases Its Assessment on Six Elements

- Factor conditions
- Demand conditions
- Related and supporting industries
- Firm strategy, structure and rivalry
- Chance
- Government

Indeed, the home base of the company is an important determinant of a firm’s strengths and weaknesses relative to foreign rivals. The reason is that the home nation yields the company advantages and disadvantages and also shapes its likely future strategies.

4.13 ELEMENTS OF THE PORTER DIAMOND MODEL

- **Factor conditions: Factor** conditions are the first element of the Porter Diamond model. They refer to different types of resources that may or may not be present in the home country: human resources, physical resources, knowledge resources, capital resources and infrastructure. One can make the distinction between basic and advanced factors. Basic factors include natural resources (climate, minerals, oil) where the mobility of the factors is low. Although these factors may create the ground for international competitiveness, they can never turn into real value creation without the advanced factors. Advanced factors are more sophisticated, such as human resources (skills) and research capabilities. They are normally specific to the industry.

- **Demand conditions:** Demand conditions, located in the right-hand box of the Porter Diamond model, involve such factors as early home demand, market size, market growth and sophistication. These characteristics can help companies create competitive advantage, for instance when sophisticated home market buyers pressure firms to innovate faster and to create more advanced products than those of foreign competitors. In fact, a product's fundamental or core design nearly always reflects home market needs. Often, the needs of the home market even shape the industry that later responds to global markets.
- **Related and supporting industries:** Related and supporting industries can produce inputs that are critical for innovation and internationalization. These industries provide cost-effective inputs, but do also participate in the upgrading process, thus stimulating other companies in the chain to innovate. The success of an industry is associated with the presence of suppliers and related industries within a certain region. For instance, the international competitiveness of the German automotive industry can be explained by the strong focus of the German industry on this sector.
- **Firm strategy, structure and rivalry: This** element in the Porter Diamond model includes how companies are organized and managed, their objectives and the nature of rivalry in the home market. The way in which companies are established, set goals and are managed is critical to success on international markets. However, also the presence of intense rivalry makes companies competitive: it creates pressure. This triggers companies to innovate in order to maintain and upgrade competitiveness. To give an example: BMW, Mercedes-Benz and Audi would not be such successful brands if they did not have to compete against each other. Constant pressure from competition makes them develop competitive products, offer them at competitive prices and stay competitive on the whole.
- **Government:** The government can have strong influence on the international competitiveness of a firm. In addition, it can influence each of the five other forces in the Porter Diamond model. The government of a country can either promote or hinder export. It

can influence the supply conditions of key production factors. It can shape the demand conditions in the home market, as well as the competition between firms. These interventions can occur at local, regional, national, or even supranational level.

- **Chance:** The final element in the Porter Diamond model is chance. Chance refers to random events that are beyond the control of the company. For the international competitiveness, they may be very important: the discontinuities created by chance may lead to advantages for some and disadvantages for other companies. Some firms may gain competitive positions, while others may lose. When you take a look at the history of most industries, you will see that chance almost always plays a role. It starts with the question of who comes up with a major new idea first, which may very much be the result of a random event. For reasons that usually have little to do with economics, people typically start new businesses in their home countries. Once the industry begins in a certain country, scale and clustering effects may cement its position in that country.

4.14 FACTORS INFLUENCING INTENSITY OF COMPETITION IN AN INDUSTRY

The intensity of rivalry between existing competitors in a market or industry depends on a number of factors. It is important to be aware of these factors influencing intensity of competition, as it may influence the decision of entering a market or staying away of it.

- **Relevance of the factors influencing intensity of Competition:** Assessing the intensity of competition in an industry is the most important step in the 5 forces of Porter Model Analysis. This model analyses the competitive structure in an industry. For that, it is of course highly relevant to reveal the intensity of rivalry. To do that, all factors influencing intensity of competition should be taken into consideration.
- **Concentration of the Industry: Clearly**, a high number of competitors of equal size will lead to more intense rivalry. There will be less rivalry when a clear leader exists (at least 50 % larger than the second). Therefore, the degree of concentration in the industry must be assessed as one of the primary factors influencing intensity of competition in the industry.
- **Rate of Market Growth: The** rate of market growth is another important factor. If market growth is high, competition will be less intense. Why? Because slow growth will usually tend to greater

rivalry: the market is close to saturation at this stage, and no new customers are there to be attracted by competitors. Contrarily, if the market is still strongly growing, there is enough new space and untapped opportunities for competitors.

- **Structure of Costs: Structure** of costs refers to the share of fixed costs, as opposed to variable costs in a given industry. This structure belongs to the important factors influencing intensity of competition because high fixed costs encourage price cutting to fill capacity. Consequently, competition will be fiercer.
- **Degree of Differentiation: Certainly**, degree of differentiation has a strong influence on the intensity of competition. Commodity products encourage rivalry, because there are little opportunities to differentiate the firm's offerings from those of competitors. Thus, competition is all about prices – fierce competition is the consequence. Highly differentiated products, on the other side, are hard to copy and associated with less intense rivalry.
- **Switching Costs: When** customers switch their supplier, switching costs arise, in whatever form. It may even be that these costs are not even tangible – customers simply do not like to change. When switching costs are high because the product is specialized, the customer has invested a lot of resources in learning how to use the product or has made tailor-made investments. These may be worthless with other products and suppliers. Thus, rivalry is reduced. On the contrary, if customers do not have any switching costs, which is often the case for commodity products, intensity of competition is higher.
- **Exit Barriers:** Among the factors influencing intensity of competition in an industry, also exit barriers play an important role. When competitors cannot easily exit the market, competition is intensified, of course. What barriers could exist making exiting difficult? For instance, the lack of opportunities elsewhere could be a decisive barrier to leaving the market. Also, high vertical integration (particularly referring to the dependence of suppliers, the firm, and distributors), emotional barriers or the high cost of closing down a plant can be factors influencing the intensity of competition, because exiting is more difficult.

LET US SUM UP

International trade and commerce are perhaps as old as civilization, the development of international economics as an independent branch of economic theory is a relatively recent phenomenon. International trade is the exchange of capital, goods, and services across international borders or territories. In most countries, such trade represents a significant share of gross domestic product (GDP).

The first reasonably systematic body of thought devoted to international trade is called “mercantilism” and emerged in seventeenth and eighteenth century in Europe. The mercantilist writers argued that a key objective of trade should be to promote a favourable balance of trade.

Adam Smith and the classical economists claimed international trade was an efficient mechanism for allocating resources and for increasing national welfare, regardless of the level of a country’s economic development. The theory of comparative advantage suggests that a country should export goods in the country in which its relative cost advantage, and not the absolute cost advantage, is greatest in comparison to other countries.

The comparative advantage proposition states that a less developed country that lacks an absolute advantage in any goods can still engage in mutually beneficial trade, and that an advanced country whose domestic industries are more efficient than those in any other country can still benefit from trade even as some of its industries face intense import competition. A trade bloc is a type of intergovernmental agreement, often part of a regional intergovernmental organization, where regional barriers to trade, (tariffs and non-tariff barriers) are reduced or eliminated among the participating states

CHECK YOUR PROGRESS

Choose the correct answer

1. The theory of comparative cost advantage is given by……….

   a. David Ricardo
   b. Adam Smith
   c. F W Taussig
   d. Ohlin and Heckscher

2. The first phase of globalization started around 1870 and ended with …..

   a. World War I
   b. World War II
   c. The Establishment of GATT
   d. In 1913 when GDP was High

3. What are the four factor endowments?

   a. National resources, labour, physical capital and human capital

b. Types of technology
c. Material inputs used up in the process of production
d. International differences in climate

4.The movement to free international trade is most likely to generate short-term unemployment in which industries………

a. Industries in which there are neither imports nor exports
b. Import-competing industries.
c. Industries that sell to domestic and foreign buyers
d. Industries that sell to only foreign buyers.

5……………....is the payment method most often used in International Trade which offers the exporter best assurance of being paid for the products sold internationally.

a. Bill of Lading
b. Letter of Credit
c. Open Account
d. Drafts

GLOSSARY

Mercantilism: Mercantilism turned into a financial machine of alternate that spanned from the sixteenth century to the 18th century. Mercantilism is primarily based totally at the precept that the world's wealth turned into static, and consequently, many European countries tried to build up the most important viable percentage of that wealth with the aid of using maximizing their exports and with the aid of using restricting their imports through tariffs.

Trade : Trade is the activity of buying, selling, or exchanging goods or services between people, firms, or countries. When people, firms, or countries trade, they buy, sell, or exchange goods or services between themselves.

Barriers : Trade obstacles are government-caused regulations on global trade. Barriers take the shape of tariffs (which impose a economic burden on imports) and non-tariff obstacles to trade (which makes use of different overt and covert way to limitation imports and every now and then exports).

Bill of Lading: A invoice of lading (BL or BOL) is a criminal record issued via way of means of a provider to a shipper that information the type, amount and vacation spot of the products being carried. A invoice of lading additionally serves as a cargo receipt while the provider offers the products at a pre-determined vacation spot.

Factor intensity It refers to the relative amounts of capital and labour used in producing a goods.

SUGGESTED READINGS

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WEB RESOURCES

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2. Regional Trade Agreements | PTA | FTA | Custom Union | General Studies In Tamil | TNPSC - YouTube
3. Evolution of Trade Theory - YouTube
4. International trade theory - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1. a 2.a 3.a 4.b 5.b

UNIT 5

WORLD TRADE AND ROLE OF WORLD TRADE

STRUCTURE

OVERVIEW

In this unit you are going to learn about the introduction of world trade organisation and the structure various functions and their agreements of responsibilities of world trade organisation to resolves the trade disputes of trade negotiations and the regulatory coherence were encouraging development and economic reform the promoting fair competition and discuss about the national treatment of world trade organisation.

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- understand the role of international trade bodies such as the world trade organisation.
- understand the effects of international trade on economic development, international politics/conflicts and the environment.
- Be familiar with the major recent developments in the world trading system, and be able to critically analyse key issues raised both by the current round of WTO negotiations and by the spread of regional trading arrangements
- Critically reflect on how trade agreements are negotiated in the WTO.

5.1 ORIGIN OF WORLD TRADE ORGANISATION (WTO)

The international trade (ITO) was proposed to be set up along with the world bank and IMF recommendation of the Bretton woods conference in 1944. ITO was not set up but in place GATT was established in 1947. GATT was favoured of the developed countries. After UN appoint committee as UNCTAD (united Nation's conference on trade and development) in 1963 developing countries get participant in GATT. Several rounds' negotiations of GATT during 1947 to 1960. Uruguay round of multilateral trade negotiations was initiated in September 1986. The world trade organisation (WTO) was established to implement the final act of Uruguay Round agreement of GATT. The world trade organisation was established on 1st January 1995. 31st May 1995 WTO general council approved the headquarter in Geneva, Switzerland. Further, GATT 1994 is not only legally binding agreement included via the final act at Marrakesh. There are total of 60 agreements, annexes, decisions and understandings. These agreements are divided into 6 main parts viz.

- The agreement establishing the WTO
- Multilateral agreements on trade in goods including the GATT 1994

- Trade related investment measures (TRIMS)
- General agreement on trade in services (GATS)
- Trade-related aspects of intellectual property rights (TRIPS)
- Dispute settlement (DSU)
- Reviews of governments trade policies (TPRM)

5.2 STRUCTURE OF WORLD TRADE ORGANISATION

The WTO has nearly 153 members accounting for over 97% of world trade. Around 30 others are negotiating membership. Decisions are made by the entire membership. This is typically by consensus.

A majority vote is also possible, but it has never been used in the WTO and was extremely rare under the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top level decision-making body is the Ministerial Conferences which meets at least once in every two years. Below this is the General Council (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Disputes Settlement Body.

At the next level, the Goods Council, Services Council and Intellectual Property (TRIPs) Council report to the General Council. Numerous specialized committees, working groups and working parties deal with the individual agreements and other areas such as, the environment, development, membership applications and regional trade agreements.

5.3 SECRETARIAT OF WORLD TRADE ORGANISATION

The WTO secretariat, based in Geneva, has around 600 staff and is headed by a Director-General. Its annual budget is roughly 160 million Swiss Francs. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the secretariat does not have the decision making the role those other international bureaucracies are given.

The secretariat s main duties to supply technical support for the various councils and committees and the ministerial conferences, to provide technical assistance for developing countries, to analyse world trade and to explain WTO affairs to the public and media. The secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

5.4 FUNCTIONS OF WORLD TRADE ORGANISATION

The former GATT was not really an organisation; it was merely a legal arrangement. On the other hand, the WTO is a new international organisation set up as a permanent body. It is designed to play the role of a watchdog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights, etc. Article III has set out the following five functions of WTO.

- The WTO shall facilitate the implementation, administration and operation and further the objectives of this Agreement and of the Multilateral Trade Agreements, and shall also provide the framework for the implementation, administration and operation of the plurilateral Trade Agreements.
- The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreement in the Annexes to this Agreement.
- The WTO shall administer the understanding on rules and Procedures Governing the Settlement of Disputes.
- The WTO shall administer Trade Policy Review Mechanism.
- With a view to achieving greater coherence in global economic policy making, the WTO shall cooperate, as appropriate, with the international Monetary Fund (IMF) and with the International Bank for Reconstruction and Development (IBRD) and its affiliated agencies.

5.5 OBJECTIVES OF WORLD TRADE ORGANISATION

- To implement the new world trade system as visualised in the agreement.
- To promote World trade in a manner that benefits of every country.
- To ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental of needs and wants.
- To demolish an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth.
- To enhance competitiveness among all trading partners so as to benefit consumers and help in global integration.
- To increase the level of production and productivity with a view to ensuring level of employment in the world.
- To utilize world resources to the best.

- To improve the level of living for the global population and speed up economic development of the member nations.

5.6 WORLD TRADE ORGANISATION MINISTERIAL CONFERENCE

Conference	Year	Place
I	9-13 Dec., 1996	Singapore
II	18-20 May 1998	Geneva (Switzerland)
III	30 Nov.-3 Dec., 1999	Seattle (USA)
IV	9-14 Nov., 2001	Doha (Qatar)
V	10-14 Sep., 2003	Cancun (Mexico)
VI	13-18 Dec.. 2005	Hong Kong
VII	30 Nov-2Dec., 2009	Geneva (Switzerland)

5.7 WORLD TRADE ORGANISATION AGREEMENTS

The WTO's rule and the agreements are the result of negotiations between the members. The current sets were the outcome to the 1986-93 Uruguay Round negotiations which included a major revision of the original General Agreement on Tariffs and Trade (GATI).

GATT is now the WTO's principal rulebook for trade in goods. The Uruguay Round also created new rules for dealing with trade in services, relevant aspects of intellectual property, dispute settlement and trade policy reviews.

The complete set runs to some 30,000 pages consisting of about 30 agreements and separate commitments (called schedules) made by individual members in specific areas such as, lower customs duty rates and services market-opening.

Through these agreements, WTO members operate a non-discriminatory trading system that spells out their rights and their obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other countries' markets. Each country promises to do the same for imports into its own market. The system also gives developing countries some flexibility in implementing their commitments.

(a) Goods: It all began with trade in goods. From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important, rules, particularly non-discriminations since 1995, the updated GATT has become the WTO s umbrella agreement for trade in goods. It has annexes dealing with specific sectors such as, agriculture and textiles and with specific issues such as, state trading, product standards, subsidies and action taken against dumping.

(b) Services: Banks, insurance firms, telecommunication companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of free and fair that originally only applied to trade in goods. These principles appear in the new General Agreement on Trade in Services (GATS). WTO members have also made individual commitments under GATS stating which of their services sectors, they are willing to open for foreign competition and how open those markets are.

(c) Intellectual Property: The WTO's intellectual property agreement amounts to rules for trade and investment in ideas and creativity. The rules state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout designs and undisclosed information such as trade secrets "intellectual property" should be protected when trade is involved.

(d) Dispute Settlement: The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore, for ensuring that trade flows smoothly. Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgments by specially appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

The system encourages countries to settle their differences through consultation. Failing that, they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of the ruling by a panel of experts and the chance to appeal the ruling on legal grounds. Confidence in the system is Bourne out by the number of cases brought to the WTO, around 300 cases in eight years compared to the 300 disputes dealt with during the entire life of GATT (1947-94).

(e) Policy Review: The Trade Policy Review Mechanism's purpose is to improve transparency, to create a greater understanding of the policies that countries are adopting and to assess their impact. Many members also see the reviews as constructive feedback on their policies. All WTO members must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO Secretariat.

5.8 WORLD TRADE ORGANISATION MEMBERSHIP BENEFITS

The WTO helps trade throughout the world flow smoothly through its trade agreements. Members of the WTO know what the rules are, and they understand the penalties for breaking the rules—which creates a safer trading arena for everyone. The WTO also provides its members with a fair method to resolve trade disputes; they don't have to resort to violence or war. It prevents trade protectionism, a practice that hinders economic growth.

The WTO grants each member Most Favoured Nation status, which means that WTO members must treat each other the same and not give preferential trade benefit to any one member without giving it to all. WTO members also have lower trade barriers with each other, including tariffs, import quotas, and regulations. Larger markets lead to greater sales, more jobs, and faster economic growth. Because roughly two-thirds of WTO members are developing countries, their membership gives them immediate access to developed markets at the lower tariff rate—which gives them time to catch up with sophisticated corporations and their mature industries. They don't have to remove reciprocal tariffs in their markets until later. As a result, developing countries don't immediately have to open their markets to overwhelming competitive pressure. 36 WTO members are categorized as least-developed countries (LDCs), which are low-income countries with severe blocks to sustainable economic growth, and the U.N. and other agencies provide them extra assistance in development and trade.

5.9 RESPONSIBILITIES OF WORLD TRADE ORGANISATION

A membership in the WTO comes with responsibilities. Members agree to avoid trade barriers and abide by the WTO's resolution of any dispute, which prevents retaliatory trade warfare. These escalating trade restrictions help individual countries in the short term but hurt world trade in the long term.

Trade protectionism of this kind worsened the Great Depression of 1929, and as global trade slowed, countries sought to protect domestic industries. They erected trade barriers and created a downward spiral. As a result, world trade shrank by 25%.

5.10 WORLD TRADE ORGANISATION MEMBERS BY CATEGORY

- The WTO has 76 founding members that started the organization on January 1, 1995.
- Asia has seven LDC members: Afghanistan, Bangladesh, Cambodia, Laos, Myanmar, Yemen, and Nepal. Its founding members are Bahrain, Bangladesh, Brunei, Hong Kong, India, Indonesia, Japan, Kuwait, Macao, Malaysia, Myanmar, Pakistan, Philippines, Singapore, South Korea, and Thailand.
- Its other members are Armenia, China, Georgia, Israel, Jordan, Kazakhstan, Kyrgyz Republic, Maldives, Mongolia, Oman, Papua New Guinea, Qatar, Russia, Samoa, Saudi Arabia, Sri Lanka, Chinese Taipei, Tajikistan, Turkey, United Arab Emirates, Viet Nam, and Yemen.
- Africa has 27 LDC members: Angola, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Congo Democratic Republic, Djibouti, Gambia, Guinea, Guinea-Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nigeria, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, and Uganda.
- Its founding members are Cote d'Ivoire, Kenya, Mauritius, Morocco, Namibia, Senegal, South Africa, Swaziland, Tanzania, and Uganda, and its other members are Botswana, Cameroon, Congo Republic, Egypt, Gabon, Ghana, Niger, Seychelles, Tunisia, Zambia, and Zimbabwe.
- Europe has the most founding WTO members: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Luxembourg, Malta, Netherlands, Norway, Portugal, Romania, Slovak Republic, Sweden, and the United Kingdom. In addition, the European Union is a founding member.
- Its other members are Albania, Bulgaria, Croatia, Cyprus, Estonia, Latvia, Lichtenstein, Lithuania, North Macedonia, Moldova, Montenegro, Poland, Slovenia, Spain, Switzerland, and Ukraine.
- Central and North America have just one LDC member: Haiti. Its founding members are Antigua and Barbuda, Barbados, Belize, Canada, Costa Rica, Dominica, Honduras, Mexico, Saint Lucia, Saint Vincent and the Grenadines, and the United States.
- Its other members are Cape Verde, Cuba, Dominican Republic, El Salvador, Grenada, Guatemala, Jamaica, Nicaragua, Panama, Saint Kitts and Nevis, and Trinidad and Tobago.

- Oceania has two LDC countries: Solomon Islands and Vanuatu. Its founding members are Australia and New Zealand, and the other three members are Fiji and Tonga.
- South America has no LDC members. Its founding members are Argentina, Brazil, Chile, Paraguay, Peru, Uruguay, Suriname, Guyana, and Venezuela, and its other members are Bolivia, Colombia, and Ecuador.

5.11 PROSPECTIVE WORLD TRADE ORGANISATION MEMBERS

The WTO has a category called observer. These 23 countries have applied to become members. Except for the Vatican, they have five years to complete the process. How a country becomes a WTO member depends on its government’s ability to negotiate the six-step process.

The prospective members are Algeria, Andorra, Azerbaijan, Bahamas, Belarus, Bhutan, Bosnia and Herzegovina, Comoros, Equatorial Guinea, Ethiopia, Iran, Iraq, Lebanon, Libya, Sao Tome and Principe, Serbia, Somalia, South Sudan, Sudan, Syria, Timor-Leste and Uzbekistan.

5.12 COUNTRIES OUTSIDE THE WORLD TRADE ORGANISATION

16 countries aren't members and haven't applied to become members. They are Aruba, Curacao, Eritrea, Kiribati, Kosovo, Marshall Islands, Micronesia, Monaco, Nauru, North Korea, Palau, the Palestinian Territories, San Marino, Sint Maarten, Turkmenistan, and Tuvalu.

5.13 WORLD TRADE ORGANISATION RESOLVES TRADE DISPUTES

One of the World Trade Organization's functions is to resolve international trade problems. Fortunately, any member can file a complaint with the WTO against another member they believe is dumping, unfairly subsidizing or violating any other trade agreement. If the WTO decides the case is valid, it has the authority to levy sanctions on the offending country.

The staff will then investigate to see if a violation of any multilateral agreements has taken place. The WTO staff first try to settle disputes through consultations. Since 1995, members had filed more than 500 disputes. Only about a third needed to be reviewed by a panel before being resolved. Most of them were settled “out of court” or still in the consultation process. As a result, only 350 formal rulings needed to be issued. The WTO offers a chronological list of dispute cases.

Not surprisingly, the United States has been either a complainant or defendant in about half the WTO disputes. The Office of the United States Trade Representative represents the United States in these cases. As China's economy grows, it is involved in more trade disputes.

The benefit of the WTO process is it prevents the damaging consequences of trade protectionism. That's when countries retaliate against offending country's dumping, tariffs or subsidies by doing the same or worse. That creates a downward spiral which hurts both countries' economic growth. Trade protectionism helped extend the Great Depression, where global trade fell by 25 percent. Nations can apply to the WTO to resolve their dispute instead of raising tariffs.

Examples

In July 2016, the United States filed a dispute with China. It claimed China was taxing exports of high-demand raw materials. These include antimony, graphite, and magnesia. China mines more than two-thirds of the world's supply of each of these metals. The export tax increased the prices of these exports between 5 percent to 20 percent. That put U.S. high-tech companies, such as Qualcomm and DJO Global, at a disadvantage. They must pay more for these essential raw materials than Chinese-based companies. That makes their prices higher on the global market. Their only solution is to open Chinese-based manufacturing plants. That takes jobs away from American workers.

The European Union nearly the same case at the same time. The United States won similar cases against different raw materials in 2009 and rare earth metals in 2012. As a result, the chances of winning are good. That will keep these manufacturing jobs in the United States. But it may take years since the dispute process is thorough and lengthy. That's why almost 70% of cases settled by negotiation.

5.14 PRINCIPLES OF THE TRADING SYSTEM

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of "trade policy". Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. **Non-discrimination**: It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO

members, i.e., a WTO member has to grant the most favourable conditions under which it allows trade in a certain product type to all other WTO members.

2. **Reciprocity:** It reflects both a desire to limit the scope of free riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialise.

3. **Binding and enforceable commitments:** The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures

4. **Transparency:** The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.

5. **Safety values: In** specific circumstances, governments are able to restrict trade. The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health.

There are three types of provision in this direction:

1. Articles allowing for the use of trade measures to attain non-economic objectives.

2. Articles aimed at ensuring "fair competition"; members must not use environmental protection measures as a means of disguising protectionist policies.

3. Provisions permitting intervention in trade for economic reasons. Exceptions to the MFN principle also allow for preferential treatment of developing countries, regional free trade areas and customs unions.

5.15 TRADE NEGOTIATIONS

- The World Trade Organization came into being in 1995. One of the youngest of the international organizations, the WTO is the successor to the General Agreement on Tariffs and Trade (GATT) established in the wake of the Second World War. So while the WTO is relatively young, the multilateral trading system that was originally set up under the GATT is over 70 years old.
- The past 70 years have seen an exceptional growth in world trade. Merchandise exports have grown on average by 6% annually. This growth in trade has been a powerful engine for overall economic expansion and on average trade has grown by 1.5 times more than the global economy each year. Total exports in 2016 were 250 times the level of 1948. The GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.
- The system was developed through a series of trade negotiations, or rounds, held under the GATT. The first rounds dealt mainly with tariff reductions, but later negotiations included other areas such as anti-dumping and non-tariff measures. The 1986-94 round – the Uruguay Round – led to the WTO's creation.
- The negotiations did not end there. In 1997, an agreement was reached on telecommunications services, with 69 governments agreeing to wide-ranging liberalization measures that went beyond those agreed in the Uruguay Round.
- In the same year, 40 governments successfully concluded negotiations for tariff-free trade in information technology products, and 70 members concluded a financial services deal covering more than 95% of trade in banking, insurance, securities and financial information.
- In 2000, new talks started on agriculture and services. These were incorporated into a broader work programme, the Doha Development Agenda, launched at the fourth WTO Ministerial Conference in Doha, Qatar, in November 2001.
- The new work programme included negotiations and other work on non- agricultural tariffs, trade and the environment, WTO rules on anti-dumping and subsidies, trade facilitation, transparency in government procurement, intellectual property and a range of

issues raised by developing economies as difficulties they face in implementing WTO agreements.

- Negotiations on these and other topics have resulted in major updates to the WTO rulebook in recent years. A revised Government Procurement Agreement – adopted at the WTO's 8th Ministerial Conference in 2011 – expanded the coverage of the original agreement by an estimated US$ 100 billion a year.
- At the 9th Ministerial Conference in Bali in 2013, WTO members struck the agreement on Trade Facilitation, which aims to reduce border delays by slashing red tape.
- When fully implemented, this Agreement – the first multilateral accord reached at the WTO – will cut trade costs by more than 14% and will lift global exports by as much as US$ 1 trillion per year.
- The expansion of the Information Technology Agreement – concluded at the 10th Ministerial Conference in Nairobi in 2015 – eliminated tariffs on an additional 200 IT products valued at over US$ 1.3 trillion per year. Another outcome of the conference was a decision to abolish agricultural export subsidies, fulfilling one of the key targets of the UN Sustainable Development Goal on "Zero hunger".
- Most recently, an amendment to the WTO's Intellectual Property Agreement entered into force in 2017, easing poor economies' access to affordable medicines. The same year saw the Trade Facilitation Agreement enter into force.

5.15.1 Freer Trade: Gradually, through Negotiation

Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. From time-to-time other issues such as red tape and exchange rate policies have also been discussed.

Since GATT's creation in 1947–48 there have been eight rounds of trade negotiations. A ninth round, under the Doha Development Agenda, is now underway. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the mid-1990s industrial countries' tariff rates on industrial goods had fallen steadily to less than 4%. Opening markets can be beneficial, but it also requires adjustment. The WTO agreements allow countries to introduce changes gradually, through "progressive liberalization". developing countries are usually given longer to fulfill their obligations.

5.15.2 Predictability: Through Binding and Transparency

Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created, and consumers can fully enjoy the benefits of competition — choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable.

In the WTO, when countries agree to open their markets for goods or services, they "bind" their commitments. For goods, these bindings amount to ceilings on customs tariff rates. Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. In developed countries the rates actually charged, and the bound rates tend to be the same.

A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments (see table). In agriculture, 100% of products now have bound tariffs. The result of all this: a substantially higher degree of market security for traders and investors.

The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports — administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries' trade rules as clear and public ("transparent") as possible. Many WTO agreements require governments to dis- close their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

5.16 PROMOTING FAIR COMPETITION

The WTO is sometimes described as a "free trade" institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair and undistorted competition.

The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.

Many of the other WTO agreements aim to support fair competition: in agriculture, intellectual property, services, for example. The agreement on government procurement (a “plurilateral” agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries.

5.17 ENCOURAGING DEVELOPMENT AND ECONOMIC REFORM

The WTO system contributes to development. On the other hand, developing countries need flexibility in the time they take to implement the system’s agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries.

Over three quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programmes autonomously. At the same time, developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round, and they are even more so in the current Doha Development Agenda.

At the end of the Uruguay Round, developing countries were prepared to take on most of the obligations that are required of developed countries. But the agreements did give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions — particularly so for the poorest, “least-developed” countries. A ministerial decision adopted at the end of the round says better-off countries should accelerate implementing market access commitments on goods exported by the least-developed countries, and it seeks increased technical assistance for them. More recently, developed countries have started to allow duty-free and quota-free imports for almost all products from least-developed countries. On all of this, the WTO and its members are still going through a learning process. The current Doha Development Agenda includes developing countries’ concerns about the difficulties they face in implementing the Uruguay Round agreements.

5.18 THE ROLE OF THE WORLD TRADE ORGANIZATION

The World Trade Organization (WTO) is one of the three international organisations (the other two are the International Monetary Fund and the

World Bank Group) which by and large formulate and co-ordinate world economic policy.

It can be argued that the WTO plays a particularly significant role in the promotion of free international trade. The organisation acts as an umbrella institution, that is an organisation covering the agreements concluded at the Uruguay Round. The Uruguay Round was the preparatory stage for the launch of the WTO. The Round was based on the General Agreement on Tariffs and Trade (GATT).

The crucial role of the WTO is to provide a common institutional framework for the implementation of those agreements. The organisation is the result of the Uruguay Round of negotiations (1986-1994) and was formally created in 1995.

5.19 WORLD TRADE ORGANIZATION ON REGULATORY COHERENCE

The way the world trades has changed since the World Trade Organization (WTO) was established. Fewer goods and services originate from any one supplier or country. Components and intermediate services are increasingly sourced and assembled from specialist suppliers around the world. Regulation also plays a more significant role in this era of international trade. The adequacy of regulatory oversight has become more important as complex, unbundled global supply chains have become harder for businesses and customers to monitor. To date, the WTO has had a limited role in promoting regulatory coherence. Businesses and some governments are turning elsewhere for relief. Many multinational corporations rely on private standards, third-party certifications, and their own quality management systems to oversee their global supply chains. Since negotiating agreements that require approval of the full WTO membership is difficult, this paper focuses on the prospects of concluding commitments on regulatory coherence that involve only a subset of WTO Member countries. It summarises the key features of the types of agreements by which a subset of WTO Members may undertake additional commitments and trade liberalisation—critical mass agreements (CMAs) and plurilateral agreements (PAs). It assesses the potential utility of CMAs and PAs over preferential trade agreements (PTAs) for improving regulatory coherence. It also suggests the regulatory matters on which CMAs and PAs should focus, and the design elements these agreements should incorporate to be most successful.

5.20 WORLD TRADE ORGANISATION IN PROMOTING INTERNATIONAL TRADE AND INVESTMENT

The WTO is a multilateral organisation that regulates trade relations between states. It has a unique tripod purpose. First, it seeks to encourage the progressive trade liberalisation and remove restrictive barriers states place on importation and exportation of goods and services which distort trade flows and decrease general economic wellbeing and development.

Second, it is a negotiating forum referred to as “rounds,” wherein member states meet to negotiate terms of trade liberalisation treaties which become binding on all members. Lastly, the WTO seeks to provide clear rules of engagement to ensure a more transparent and predictable international trade. The WTO has underlining principles that defines and determines its policies and agreement. The most prominent of these principles are the MFN and the national treatment principle. The MFN clause is the foundational principle of WTO which provides for non-discrimination among states as it requires members to accord all other members of the Agreement similar treatment concerning any tariff or concession in respect of a particular product, as they would have done to any other country. Also under the national treatment principle, once goods pass through the borders of member states, members are obliged to give equal treatment to those goods as though it is of their national origin. This is a measure to prevent states’ use of internal regulations to discriminate against imported goods which will negatively affect tariffs reduction and other means of trade liberalisation.

The six key objectives of WTO include:

- Setting and enforcing rules for international trade.
- Providing forum for negotiation and monitoring of further trade liberalisation.
- Resolving trade disputes.
- Increasing transparency in the decision-making processes. Enabling cooperate with other major international economic institutions involved in global economic management.
- providing help to developing countries to take full benefit of the global trading system.
- WTO has succeeded in concluding several trade agreements liberalising trade between states.
- This success has resulted in the increase in the volume of world trade.

- This increase has been measured to amount up to 25% in the preceding 8 years.

5.21 NATIONAL TREATMENT

Treating foreigners and locals equally Imported and locally- produced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of "national treatment" (giving others the same treatment as one's own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these. National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally produced products are not charged an equivalent tax.

LET US SUM UP

The World Trade Organization (WTO) deals with the rules of trade between nations at a global or near global level. It's an organization for liberalizing trade. – It's a forum for governments to negotiate trade agreements. It's a place for them to settle trade disputes The WTO has 153 members, accounting for over 97% of world trade. All WTO members may participate in all councils, committees, etc, except Appellate Body, Dispute Settlement panels, Textiles Monitoring Body, and plurilateral committees. The WTO Secretariat, based in Geneva, has around 625 staff and is headed by a director general. It does not have branch offices outside Geneva. The WTO agreements cover goods, services and intellectual property. They spell out the principles of liberalization, and the permitted exceptions The main aim of world trade organisation is to promote the free trade by lowering tariffs and other barriers. It does this through agreements negotiated and signed by most of the world's trading nations and also the polices of these agreements are to make sure all nations are to follow the rules and regulations passed by world trade organisation.

CHECK YOUR PROGRESS

Choose the correct answer

1. Along with the World Bank and WTO is the third economic pillar of worldwide dimensions.

a. International Economic Association (IEA)
b. International Monetary Funds (IMF)
c. International Development Bank (IDB)
d. International Funding Organisation (IFO)

2. Which of the following statements is false?

a. India's vote share in the International Monetary Fund is 10%.
b. Both the IMF and the IBRD have headquarters in Washington.
c. The IBRD is also known as the World Bank.
d. Both the IMF and the World Bank are known as the Bretton Woods twins.

3. TRIPS (Trade-Related Aspects of Intellectual Property Rights) agreement is administered by the _______ .

a. World Bank (WB)
b. United Nations Organization (UNO)
c. World Trade Organization (WTO)
d. United Nations Conference on Trade and Development (UNCTAD)

4._____ primarily deals with the economic issues like tariffs and other trade barriers in many countries.

a. ILO b. WTO

c World Bank d.EU

5.General Agreement on Tariffs and Trade (GATT) agreement covers the following basic element(s):

a. protection shall be afforded to domestic industries through customs tariffs, not through such commercial measures as import quotas.
b. trade shall be conducted on a non-discriminatory basis
c. consultation shall be the primary method used to solve global trade problems.
d. all of the above

GLOSSARY

Transparency : Transparency is a World Trade Organization principle stipulating that a country's policies and regulations affecting foreign trade should be clearly communicated to its trading partners.

Disputes : A dispute arises when a member government believes another member government is violating an agreement or a commitment that it has made in the WTO

Discrimination : In international trade, inequality of treatment accorded to imports from different countries, such as preferential tariff rates for imports from particular countries or trade restrictions targeted against particular countries.

General Agreement on Tariffs and Trade : It is a multilateral agreement regulating international trade, the purpose of which is the "substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis".

Trade negotiations **:** The negotiations aim to reduce or, as appropriate, eliminate tariffs as well as non-tariff barriers, particularly on goods of export interest to developing countries.

SUGGESTED READING

1. Aswathappa, K., 2010. *International Business*, 4th ed. Tata McGraw Hill.
2. Rugman, Alan M., 1985. *International Business: Theory of the Multinational Enterprise*, McGraw Hill Book company.
3. Tayeb, Monir H., 1999. *International Business: Theories, Politics and Practices*, Financial Times Management.

WEB RESOURCES

1. Lecture 45: WTO, GATT, Origin and Functions, MFN Principles, Agreements - YouTube
2. WTO#Structure of WTO#principles of WTO in tamil - YouTube
3. GATT explained in Tamil (General Agreement on Trade and Tariff) - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1 b   2.a   3.c   4.b   5.c

UNIT 6

REGIONAL ECONOMIC AGREEMENTS

STRUCTURE

OVERVIEW

In this lesson, you are going to learn about the structure of various regional economic agreements such as ASEAN, SAARC / SAPTA, NAFTA, EC for their procedure and impact on the trading activities of the member states. To estimates of benefits from quantitative studies and the national schedules of concessions and the membership of ASEAN regional forum its used and helps to regional trade agreement

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- study about the various regional economic integration and impact on the trading activities of the member states.
- understand the various agreements such as ASEAN, SAARC / SAPTA, NAFTA, EC.

6.1 INTRODUCTION OF REGIONAL ECONOMIC INTEGRATION

Regional economic integration has enabled countries to focus on issues that are relevant to their stage of development as well as encourage trade between neighbours.

There are four main types of regional economic integration.

1. **Free trade area.** This is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves but are free to independently determine trade policies with non-member nations. An example is the North American Free Trade Agreement (NAFTA).

2. **Customs union.** This type provides for economic cooperation as in a free-trade zone. Barriers to trade are removed between member countries. The primary difference from the free trade area is that members agree to treat trade with non-member countries in a similar manner.

3. **Common market.** This type allows for the creation of economically integrated markets between member countries. Trade barriers are removed, as are any restrictions on the movement of labour and capital between member countries. Like customs unions, there is a common trade policy for trade with non-member nations. The primary advantage to workers is that they no longer need a visa or work permit to work in another member country of a common market. An example is the Common Market for Eastern and Southern Africa (COMESA).

4. **Economic union.** This type is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies. An example is the European Union (EU).

In the past decade, there has been an increase in these trading blocs with more than one hundred agreements in place and more in discussion. A trade bloc is basically a free-trade zone, or near-free-trade zone, formed by one or more tax, tariff, and trade agreements between two or more countries. Some trading blocs have resulted in agreements that have been more substantive than others in creating economic cooperation. Of course, there are pros and cons for creating regional agreements.

6.2 ADVANTAGE OF REGIONAL AGREEMENTS

The pros of creating regional agreements include the following:

- **Trade creation.** These agreements create more opportunities for countries to trade with one another by removing the barriers to trade and investment. Due to a reduction or removal of tariffs, cooperation results in cheaper prices for consumers in the bloc countries. Studies indicate that regional economic integration significantly contributes to the relatively high growth rates in the less-developed countries.
- **Employment opportunities.** By removing restrictions on labour movement, economic integration can help expand job opportunities.
- **Consensus and cooperation.** Member nations may find it easier to agree with smaller numbers of countries. Regional understanding and similarities may also facilitate closer political cooperation.

6.3 DISADVANTAGES OF REGIONAL AGREEMENTS

The cons involved in creating regional agreements include the following:

- **Trade diversion.** The flip side to trade creation is trade diversion. Member countries may trade more with each other than with non-member nations. This may mean increased trade with a less efficient or more expensive producer because it is in a member country. In this sense, weaker companies can be protected inadvertently with the bloc agreement acting as a trade barrier. In essence, regional agreements have formed new trade barriers with countries outside of the trading bloc.

- **Employment shifts and reductions.** Countries may move production to cheaper labour markets in member countries. Similarly, workers may move to gain access to better jobs and wages. Sudden shifts in employment can tax the resources of member countries.
- **Loss of national sovereignty.** With each new round of discussions and agreements within a regional bloc, nations may find that they have to give up more of their political and economic rights. In the opening case study, you learned how the economic crisis in Greece is threatening not only the EU in general but also the rights of Greece and other member nations to determine their own domestic economic policies.

6.4 MAJOR AREAS OF REGIONAL ECONOMIC INTEGRATION AND COOPERATION

There are more than one hundred regional trade agreements in place, a number that is continuously evolving as countries reconfigure their economic and political interests and priorities. Additionally, the expansion of the World Trade Organization (WTO) has caused smaller regional agreements to become obsolete. Some of the regional blocs also created side agreements with other regional groups leading to a web of trade agreements and understandings.

6.5 ASIA: ASEAN

The Association of Southeast Asian Nations (ASEAN) was created in 1967 by five founding-member countries: Malaysia, Thailand, Indonesia, Singapore, and the Philippines. Since inception, Myanmar (Burma), Vietnam, Cambodia, Laos, and Brunei have joined the association.

ASEAN’s primary focus is on economic, social, cultural, and technical cooperation as well as promoting regional peace and stability. Although less emphasized today, one of the primary early missions of ASEAN was to prevent the domination of Southeast Asia by external powers—specifically China, Japan, India, and the United States.

In 2002, ASEAN and China signed a free trade agreement that went into effect in 2010 as the ASEAN–China Free Trade Area (ACFTA). In 2009, ASEAN and India also signed the ASEAN–India Free Trade Agreement (FTA). In 2009, ASEAN signed a free trade agreement with New Zealand and Australia. It also hopes to create an ASEAN Economic Community by 2015. While the focus and function remain in discussion, the intent is to forge even closer ties among the ten member nations, enabling them to negotiate more effectively with global powers like the EU and the United States.

6.6 NORTH AMERICA: NAFTA

6.6.1 Brief History and Purpose

The North American Free Trade Agreement (NAFTA) came into being during a period when free trade and trading blocs were popular and positively perceived. In 1988, the United States and Canada signed the Canada–United States Free Trade Agreement. Shortly after it was approved and implemented, the United States started to negotiate a similar agreement with Mexico. When Canada asked to be party to any negotiations to preserve its rights under the most-favoured-nation clause (MFN), the negotiations began for NAFTA, which was finally signed in 1992 and implemented in 1994.

The goal of NAFTA has been to encourage trade between Canada, the United States, and Mexico. By reducing tariffs and trade barriers, the countries hope to create a free-trade zone where companies can benefit from the transfer of goods. In the 1980s, Mexico had tariffs as high as 100 % on select goods. Over the first decade of the agreement, almost all tariffs between Mexico, Canada, and the United States were phased out.

The rules governing origin of content are key to NAFTA. As a free trade agreement, the member countries can establish their own trading rules for non-member countries. NAFTA's rules ensure that a foreign exporter won't just ship to the NAFTA country with the lowest tariff for non-member countries. NAFTA rules require that at least 50 percent of the net cost of most products must come from or be incurred in the NAFTA region. There are higher requirements for footwear and cars. For example, this origin of content rule has ensured that cheap Asian manufacturers wouldn't negotiate lower tariffs with one NAFTA country, such as Mexico, and dump cheap products into Canada and the United States. Mexican *maquiladoras* have fared well in this arrangement by being the final production stop before entering the United States or Canada. *Maquiladoras* are production facilities located in border towns in Mexico that take imported materials and produce the finished good for export, primarily to Canada or the United States.

6.6.2 Current Challenges and Opportunities

Canadian and US consumers have benefited from the lower-cost Mexican agricultural products. Similarly, Canadian and US companies have sought to enter the expanding Mexican domestic market. Many

Canadian and US companies have chosen to locate their manufacturing or production facilities in Mexico rather than Asia, which was geographically far from their North American bases.

When it was introduced, NAFTA was highly controversial, particularly in the United States, where many felt it would send US jobs to Mexico. In the long run, NAFTA hasn't been as impactful as its supporters had hoped nor as detrimental to workers and companies as its critics had feared. As part of NAFTA, two side agreements addressing labour and environmental standards were put into place. The expectation was that these side agreements would ensure that Mexico had to move toward improving working conditions.

Mexico has fared the best from NAFTA as trade has increased dramatically. *Maquiladoras* in Mexico have seen a 15 percent annual increase in income. By and large, Canadians have been supportive of NAFTA and exports to the region have increased in the period since implementation. "Tri-lateral [merchandise] trade has nearly tripled since NAFTA came into force in 1994. It topped $1 trillion in 2008.

6.6.3 Effects Of NAFTA

Since NAFTA took away taxes for products traded between the US, Canada, and Mexico, Mexico has been buying more products from the US. It saved U.S. companies the cost of selling products to Mexico and saved Mexican companies the cost of buying items from US companies. A benefit of the bill is that labels on products exchanged between the three countries come in

French, English and Spanish. That way, Mexicans and Americans who speak Spanish can read the Spanish label, Americans and Canadians can read the English label, and Canadians who speak French can read the French label. NAFTA also encourages more immigration from Mexico to the US. Since small businesses can no longer be protected by tariffs, many small business owners in Mexico cannot compete with the prices of subsidized products from the US. As a result, many Mexicans have gone to the US looking for work. Some believe that NAFTA has been positive for Mexico, which has seen its poverty rates fall and real income rise.

6.6.4 Future Outlook

Given the 2008 global economic recession and challenging impact on the EU, it isn't likely that NAFTA will move beyond the free-trade zone status to anything more comprehensive (e.g., the EU's economic union). In the opening case study, you read about the pressures on the EU and the resistance by each of the governments in Europe to make policy adjustments to address the recession. The United States, as the largest country member in NAFTA, won't give up its rights to independently determine its economic and trade policies. Observers note that there may be the opportunity for NAFTA to expand to include other countries in Latin America.[5] Chile was originally supposed to be part of NAFTA in 1994, but President Clinton was hampered by Congress in his ability to formalize that decision. Since then, Canada, Mexico, and the United States have each negotiated bilateral trade agreements with Chile, but there is still occasional mention that Chile may one day join NAFTA.

6.7 EUROPE: EUROPEAN UNION (EU)

6.7.1 Brief History and Purpose

In 1957, the six nations signed the Treaty of Rome, which established the European Economic Community (EEC) and created a common market between the members. Over the next fifty years, the EEC added nine more members and changed its name twice—to European Community (EC) in the 1970s and the European Union (EU) in 1993.

The European Union (EU) is a political and economic union of 28 member states that are located primarily in Europe. Even after the BREXIT, for the time being, the United Kingdom remains a full member of the EU and rights and obligations continue to fully apply in and to the UK. The Maastricht Treaty established the European Union in 1993 and introduced European citizenship. The latest major amendment to the constitutional basis of the EU, the Treaty of Lisbon, came into force in 2009. The EU has developed an internal single market through a standardised system of laws at apply in all member states. The Union reached its current size of 28 member countries with the accession of Croatia on 1 July 2013. EU policies aim to ensure the free movement of people, goods, services, and capital within the internal market, enact legislation in justice and home affairs, and maintain common policies on trade, agriculture, fisheries, and regional development. Within the Schengen Area, passport controls have been abolished. A monetary union has been established within union but lacks common fiscal union. EU is composed of 28 member states but only 19 EU member states use the euro currency. The Lisbon treaty now contains a clause under Article 50, providing for a member to leave the EU. United Kingdom enacted the result of a membership referendum in June 2016 and is Currently negotiating its withdrawal The EU as a whole is the largest economy in the world. The six founding nations were France, West Germany, Italy, and the Benelux countries (Belgium, Luxembourg, and the Netherlands), all of which signed a treaty to run their coal and steel industries under a common management. The focus was on the development of the coal and steel industries for peaceful purposes.

- EU has a common foreign and security policy, thus developing a coordinated external relations and defence.
- The membership of EU entails a partial delegation of sovereignty to the institutions
- Return for representation within those institutions, a practice often referred to as pooling of sovereignty".
- To become a member, a country must meet the Copenhagen criteria, of the Europe
- Council which requires a stable democracy that respects human rights and the rule or law a functioning market economy; and the acceptance of the obligations of membership including EU law.
- The four countries that are not EU members have partly committed to EU's economy are regulations Iceland, Liechtenstein and Norway. The European Council gives political direction to the EU.
- Council of European Union acts together with European Parliament as a legislature.
- European Commission is the Executive arm.
- Court of Justice of European Union ensures uniform application and interpretation Or European Law.
- European Central Bank together with national central bank determines monetary policy

The European Economic Area (EEA) was established on January 1, 1994, following an agreement between the member states of the European Free Trade Association (EFTA) and the EC (later the EU). Specifically, it has allowed Iceland (now an EU candidate), Liechtenstein, and Norway to participate in the EU’s single market without a conventional EU membership. Switzerland has also chosen to not join the EU, although it is part of similar bilateral agreements.

Countries in the EU (as May 1, 2011)	
Austria	Italy
Belgium	Latvia
Bulgaria	Lithuania
Cyprus	Luxembourg
Czech Republic	Malta
Denmark	Netherlands
Estonia	Poland
Finland	Portugal
France	Romania
Germany	Slovakia
Greece	Slovenia
Hungary	Sweden
Ireland	United Kingdom

Candidate Countries
Croatia
The former Yugoslav Republic of Macedonia
Turkey
Iceland

Potential Candidate Countries
Albania
Bosnia and Herzegovina
Kosovo under UN Security Council Resolution 1244
Montenegro
Serbia

Fig.6.7.1

6.7.2 EU Governance

The EU is a unique organization in that it is not a single country but a group of countries that have agreed to closely cooperate and coordinate key aspects of their economic policy. Accordingly, the organization has its own governing and decision-making institutions.

- **European Council.** The European Council provides the political leadership for the EU. The European Council meets four times per year, and each member has a representative, usually the head of its government. Collectively it functions as the EU's "Head of State."
- **European Commission.** The European Commission provides the day-to-day leadership and initiates legislation. It's the EU's executive arm.
- **European Parliament.** The European Parliament forms one-half of the EU's legislative body. The parliament consists of 751 members, who are elected by popular vote in their respective countries. The term for each member is five years. The purpose of the parliament is to debate and amend legislation proposed by the European Commission.
- **Council of the European Union.** The Council of the European Union functions as the other half of the EU's legislative body. It's sometimes called the Council or the Council of Ministers and should not be confused with the European Council above. The Council of the European Union consists of a government minister

from each member country and its representatives may change depending on the topic being discussed.

- **Court of Justice.** The Court of Justice makes up the judicial branch of the EU. Consisting of three different courts, it reviews, interprets, and applies the treaties and laws of the EU.

6.7.3 Current Challenges and Opportunities

The biggest advantage of EU membership is the monetary union. Today, sixteen member countries use the Euro. Since its launch, the Euro has become the world's second-largest reserve currency behind the US dollar. It's important to remember several distinctions. First, the EU doesn't consist of the same countries as the continent of Europe. Second, there are more EU member countries than there are countries using the Euro. Euro markets, or euro countries, are the countries using the Euro.

The European single market is the foremost advantage of being a member of EU. According to Europa, which is the official website of the EU (http://europa.eu), the EU member states have formed a single market with more than five hundred million people, representing 7 percent of the world's population. This single market permits the free flow of goods, service, capital, and people within the EU. Although there is a single tariff on goods entering an EU country, once in the market, no additional tariffs or taxes can be levied on the goods.

Businesses conducting business with one country in the EU now find it easier and cheaper, in many cases, to transact business with the other EU countries. There's no longer a currency–exchange rate risk, and the elimination of the need to convert currencies within euro markets reduces transaction costs. Further, having a single currency makes pricing more transparent and consistent between countries and markets.

Despite the perceived benefits, economic policymakers in the EU admit that the Union's labour markets are suffering from rigidity, regulation, and tax structures that have contributed to high unemployment and low employment responsiveness to economic growth. This is the case, particularly, for relatively low-skilled labour.

6.7.4 Future Outlook

Europe's economy faces a deeper recession and a slower recovery than the United States or other parts of the world. Because the EU's $18.4 trillion economy makes up 30 percent of the world economy, its poor prospects are likely to rebound on the United States, Asia, and other regions. Fixing the EU's banking system is particularly tricky, because sixteen of the twenty-seven countries share the euro currency and a central bank, but banking regulation mostly remains under the control of the national governments.

The Europe 2020 strategy put forth by the European Commission sets out a vision of the EU's social market economy for the twenty-first century. It shows how the EU can come out stronger from this crisis and how it can be turned into a smart, sustainable, and inclusive economy delivering high levels of employment, productivity, and social cohesion. It calls for stronger economic governance in order to deliver rapid and lasting results.

6.8 EUROPEAN COMMITTEE OF SOCIAL RIGHTS

The European Committee of Social Rights (ECSR) was created by Article 25 of the European Social Charter to monitor States' compliance with the rights contained in the Charter. The European Social Charter spells out the social and economic rights that State Parties to the Charter must guarantee for people living within their jurisdiction.

The Charter, which was adopted in 1961, revised in 1996 and amended by three additional protocols, has been signed by all 47 members of the Council of Europe. It complements the European Convention on Human Rights which focuses on civil and political rights and is monitored by the European Court on Human Rights.

States must have accepted at least six 'hard core' provisions of the Charter; these are: Articles 1, 5, 6, 7, 12, 13, 16, 19 and 20. They must also agree to be bound by a number of other articles or numbered paragraphs which they may select. The total number of articles may not be less than 16; the total number of numbered paragraphs may not be less than 63. Both the European Committee of Social Rights and the European Court of Human Rights report to the Committee of Ministers of the Council of Europe.

The European Committee of Social Rights is made up of 15 independent experts who are elected by the Council of Europe's Committee of Ministers for a period of six years. Mandate holders may be re-elected once.

6.9 SAARC PREFERENTIAL TRADING ARRANGEMENT (SAPTA)

The Agreement on SAARC Preferential Trading Arrangement (SAPTA) which envisages the creation of a Preferential Trading Area among the seven member states of the SAARC, namely Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka was signed in Dhaka in April 1993. The idea of liberalizing trade among SAARC countries was first mooted by Sri Lanka at the sixth Summit of the South Asian Association for Regional Co-operation (SAARC) held in Colombo in December 1991. It was agreed that SAPTA is a stepping stone to higher levels of trade liberalization and economic co-operation among the SAARC member countries.

6.9.1 Objective Of SAPTA

The objective of the SAPTA is to promote and sustain mutual trade and the economic co-operation among the member states through exchange of trade concessions. SAPTA therefore is the first step towards higher levels of trade and economic co-operation in the region.

6.9.2 Main Components

- Tariff
- Para Tariff
- Non-Tariff
- Direct Trade Measures

SAPTA specified four negotiating approaches namely, product by product basis, across the board tariff reduction, sectoral basis and direct trade measures. However, it was agreed that tariff concessions would initially be negotiated on a product - by- product basis. The agreement also provides for negotiation of tariff concessions to be an ongoing process. The SAPTA envisages that concessions on tariff para-tariff and non-tariff measures will be negotiated step -buy step improved and extended in successive stages.

6.9.3 Estimates of Benefits from Quantitative Studies

A number of scholars have attempted to model the potential economic benefits of free trade in South Asia. While quantitative predictions offer varying degrees of accuracy, the popular gravity and computable general equilibrium (CGE) models seem to offer significant insight on how much economic synergy might be achieved. In its basic form, the gravity model postulates that the degree of trade between two countries is directly proportional to the product of their GDPs and inversely proportional to their distance. Popularized for modelling trade flows, the gravity model has received numerous adjustments. In particular, it has proven unable to account for the welfare effects of free trade agreements. Using 1997 statistical series, Kabir Hassan discovered that the seven SAARC economies not only reduced trade amongst themselves but with other regions as well. Given the traditionally weak trading performance of SAARC economies, particularly the large ones, his conclusion seems intuitive. Seekkuwa Hirantha also employed the gravity model, using both panel and cross-sectional data from 1996 to 2002 to estimate trade creation and trade diversion effects under the current SAFTA regime. Unlike Hassan, Hirantha found evidence of trade creation among the SAARC member countries, without any trade diversion with the rest of the world.

6.9.4 National Schedules of Concessions

The process of negotiation on the schedule of concession, which forms an integral part of the Agreement, commenced in 1993. For this purpose, the Inter-Governmental Group on Trade Liberalization (IGG) was set up. The IGG met on six occasions in various capitals. At the sixth meeting held in Kathmandu on 20th and 21st April 1995, the delegations held intensive rounds of bilateral and multilateral negotiations and agreed on the National Schedule of concessions to be granted by individual member states to other member states under the SAPTA Agreement.

Four rounds of trade negotiations were concluded under SAPTA covering over 5000 commodities. Each Round contributed to an incremental trend in the product coverage and the deepening of tariff concessions over previous Rounds.

During the first and the second rounds, trade negotiations were conducted on a product-by-product basis. In the third and the fourth rounds, negotiations were conducted on chapter wise.

Maintenance of SAPTA Concession the Agreement on the South Asian Free Trade Area (SAFTA)which was implemented with effect from 1st January 2006 will supersede the SAARC Preferential Trading Arrangement (SAPTA). On the issue of maintaining SAPTA concessions for LDCs, the Committee agreed that once the non-LDCs member states complete the Trade Liberalization Programme (TLP) for LDC member states, SAPTA concessions would cease for LDC member states. However, if any item on which SAPTA concessions are available to LDC, appear in the sensitive lists of non-LDC, they shall maintain the same level of concession through derogation.

6.9.5 The basic Principles underlying SAPTA

- Step by step negotiations and periodic reviews so as to improve and extend the preferential trade arrangement, in stages
- Inclusion of all products, manufactures and commodities in their raw semi- processes and processed forms

- Special and favourable treatment to Least Developed Contacting States
- Overall reciprocity and mutuality of advantages so as to benefit equitably all contracting States, taking into account their respective level of economic and industrial development, the pattern of their external trade, and trade and tariff policies and systems.
- Negotiation of tariff reform step by step, improved and extended in successive stages through periodic review.
- Recognition of the special needs of the Least Developed Contracting States and agreement on concrete preferential measures in their favour.
- Inclusion of all products manufactures and commodities in their raw, semi- processed and processed forms.
- Four rounds of trade negotiations have been concluded under SAPTA covering over 5000 commodities. Each round contributed to an incremental trend in the product coverage and the deepening of tariff concessions over previous Rounds.

6.10 COUNTRY AND REGIONAL POLICY RECOMMENDATIONS

- Reduction of tariffs and NTBs.
- Improvement of trade facilitation with the simplification and transparency of trade regulations and procedures.
- Curtailment of long negative lists and the removal of important trading items in those lists.
- Improvement and expansion of transportation and telecommunications; energy generation, transmission, and distribution; and other infrastructure to support industry and commerce.
- Removal of restraints and sector caps on investments among SAARC countries and simplification of investment regulations.

6.11 TRADE AGREEMENTS AND EFFORTS IN BUSINESS

Overall, global businesses have benefited from the regional trade agreements by having more consistent criteria for investment and trade as well as reduced barriers to entry. Companies that choose to manufacture in one country find it easier and cheaper to move goods between member countries in that trading bloc without incurring tariffs or additional regulations.

The challenges for businesses include finding themselves outside of a new trading bloc or having the “rules” for their industry change as a result of new trade agreements. Over the past few decades, there has been an increase in bilateral and multilateral trade agreements. It's often called a "spaghetti bowl" of global bilateral and multilateral trade agreements, because the agreements are not linear strands lining up neatly; instead, they are a messy mix of crisscrossing strands, like a bowl of spaghetti, that link countries and trading blocs in self-benefiting trading alliances. Businesses have to monitor and navigate these evolving trade agreements to make sure that one or more agreements don't negatively impact their businesses in key countries. This is one reason why global businesses have teams of in-house professionals monitoring the WTO as well as the regional trade alliances.

For example, American companies doing business in one of the ASEAN countries often choose to become members of the US–ASEAN Business Council, so that they can monitor and possibly influence new trade regulations as well as advance their business interests with government entities.

The US–ASEAN Business Council is the premiere advocacy organization for U.S. corporations operating within the dynamic Association of Southeast Asian Nations (ASEAN). ASEAN represents nearly 600 million people and a combined GDP of USD $1.5 trillion across Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. The Council's members include the largest U.S. companies working in ASEAN and range from newcomers to the region to companies that have been working in Southeast Asia for over 100 years.

The Council leads major business missions to key economies; convenes multiple meetings with ASEAN heads of state and ministers; and is the only U.S. organization to be given the privilege of raising member company concerns in consultations with the ASEAN Finance and Economic Ministers, as well as with the ASEAN Customs Directors-General at their annual meetings. Having long-established personal and professional relationships with key ASEAN decision makers, the Council is able to arrange genuine dialogues, solve problems and facilitate opportunities in all types of market conditions, and provide market entry and exclusive advisory services.

US–ASEAN member companies read like the *Fortune* Global 500 and include AT&T, Coca-Cola, Microsoft, Johnson & Johnson, Chevron, Ford Motor Company, and General Electric. While other countries and the EU have ongoing dialogues with ASEAN, the US–ASEAN Business Council is the most formal approach.

It's easy to see how complicated the relationships can be with just one trading bloc. A global firm with operations in North America, the EU, and Asia could easily find itself at the crosshairs of competing trade interests. Staffed with lawyers in an advocacy department, global firms work to maintain relationships with all of the interested parties. If you are curious about a business career in trade, then you may want to consider combining a business degree with a legal degree for the most impact.

6.12 REGIONAL TRADE AGREEMENTS

ASEAN	**Association of Southeast Asian Nations**	Brunei Darussalam Cambodia Indonesia Laos Malaysia Myanmar Philippines Singapore Thailand Vietnam
NAFTA	**North American Free Trade Agreement**	Canada Mexico United States
SAPTA	**South Asian Preferential Trade Arrangement**	Bangladesh Bhutan India Maldives Nepal Pakistan Sri Lanka

6.13 MEMBERSHIP

10 States — Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.1 Observer – Papua New Guinea.

6.13.1 ASEAN Regional Forum (ARF) Membership

27 States – Australia, Bangladesh, Brunei Darussalam, CaSmbodia, Canada, China, European Union, India, Indonesia, Japan, Democratic Peoples' Republic of Korea, Republic of Korea, Laos, Malaysia, Myanmar, Mongolia, New Zealand, Pakistan, Papua New Guinea, Philippines, Russian Federation, Singapore, Sri Lanka, Thailand, Timor Leste, United States, and Vietnam.

LET US SUM UP

In this unit you have learnt about the various Structure of regional economic agreements such as ASEAN, SAARC / SAPTA, NAFTA, EC and also you have learnt about their procedure and impact on the trading activities of the member states in economic agreementsThe objective of ASEAN is to accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South East Asian nations, and to promote regional peace and stability through abiding respect for Justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.

The European Union (EU) has four main institutions namely, the Council of Ministers, the European Commission, the European Parliament and the European Court of Justice. Other bodies such as the Economic and Social Committee and the Committee of the Regions have particular roles to play in the decision-making process.

The South Asian Association for Regional Cooperation (SAARC) comprises Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. The main goal of the Association is to accelerate the process of economic and social development in member states, through joint action in the agreed areas of cooperation.

CHECK YOUR PROGRESS

Choose the correct answer

1. A ____ is a regional trading bloc in which member countries eliminate internal trade barriers but maintain existing barriers against countries that are not member?
   a. free trade area
   b. customs union
   c. common market
   d. monetary union
2. Members of the EU find that trade creation is fostered when their economies are?
   a. highly competitive
   b. highly non-competitive
   c. small in economic importance
   d. geographically distant
3. The Common Agricultural Policy of the European Union has?
   a. increase American farm exports to the EU
   b. decrease American farm exports to the EU
   c. lowered the price of American farm exports to the EU
   d. not affected the price of American farm exports to the EU

4.What was the main objective of the foundation of ASEAN?

   a. To form an economic block against European countries
   b. To accelerate economic progress in Southeast Asia

c. To finalize step by step a programme to develop a free market zone.
d. Equalizing of import duties and changes and uniform control on investments in all member countries

5. AFTA is ___________.

a. ASEAN Free Trade Area
b. American Free Trade Area
c. Asian Free Trade Area Agreement for Free Trade Area
d. None of the above

GLOSSARY

Integration : Economic integration, or regional integration, is an agreement among nations to reduce or eliminate trade barriers and agree on fiscal policies. The European Union, for example, represents a complete economic integration. Strict nationalists may oppose economic integration due to concerns over a loss of sovereignty.

Negotiation : The negotiations aim to reduce or, as appropriate, eliminate tariffs as well as non-tariff barriers (NTBs), such as import licensing systems and technical barriers to trade, particularly on goods of export interest to developing countries.

Facilitation : In a globalised world where goods often cross borders many times as both intermediate and final products, trade facilitation helps lower overall trade costs and increase economic welfare, in particular for developing and emerging economies.

Regional trade: It refers to a treaty that is signed by two or more countries to encourage free movement of goods and services across the borders of its members. The agreement comes with internal rules that member countries follow among themselves. Tariffs are a common element in international trading.

Para-tariffs : It means border charges and fees, other than "tariffs", on foreign trade transactions of a tariff-like effect which are levied solely on imports, but not those indirect taxes and charges, which are levied in the same manner on like domestic products.

SUGGESTED READING

1. Aswathappa, K., 2010. *International Business*, 4th ed. Tata McGraw Hill.
2. Rugman, Alan M., 1985. *International Business: Theory of the Multinational Enterprise*, McGraw Hill Book company.
3. Tayeb, Monir H., 1999. *International Business: Theories, Politics and Practices*, Financial Times Management.

WEB RESOURCES

1. Lecture 49: Regional Economic Integration - YouTube
2. UGC NET SET TRB COMMERCE Regional Economic Integration ASEAN SAARC NAFTA EuropeanUnion - YouTube
3. Regional Economic Integration - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1 a 2.a 3.b. 4.a 5.a

BLOCK 3

FOREIGN COLLABORATIONS AND JOINT VENTURE

UNIT 7

INTRODUCTION OF FOREIGN COLLABORATIONS

STRUCTURE

OVERVIEW

In this unit you are going to learn about the foreign collaboration and the nature of foreign collaboration by industry sector and the government policy, industrial policy, and the advantage of foreign direct investment in global economy were follow and approval the foreign collaboration is more powerful business tool for companies of their size or industry. Foreign collaboration is an agreement between two or more companies in mutual benefit

LEARNING OBJECTIVES

After completing this unit, you will be able to:

- Know the meaning, definition of foreign collaboration
- Understand the nature and Objectives of foreign collaboration
- Discuss the types of foreign collaboration
- understand about marketing collaboration, financial collaboration, take over, Amalgamation.
- Know the impact of foreign collaboration.

7.1 INTRODUCTION OF FOREIGN COLLABORATION

Developing countries like India have been using import of technology through foreign collaboration as a strategy to bridge the technological gaps in the country, to expedite economic development

1. There have not been many studies, however, to understand its impact and implications for technological capacity building of the country, and the deficiencies to be overcome for deriving the maximum benefits from collaborations. Experience also shows that many a collaboration have failed to fetch results as expected, and many have run into rough weather in implementation
2. There is thus, a need for comprehensive, systematic studies on the subject to help the decision makers at various levels in the industry and government. This study makes an effort to address some of the above issues. It analyses the patterns of foreign collaborations in India, spanning a period of 50 years from 1951 to 2000, divided into two parts, the pre- and post-liberalization era. The study reveals significant patterns in terms of the level of foreign collaborations in India (both in terms of number and value), the nature of collaborations, the patterns by partner countries and trade blocks and by industry sectors. The study also reports significant, albeit preliminary findings on the patterns by individual Indian firms in the corporate sector.

The findings raise certain questions on the technological capacity building of India and the staleness of corporate strategies of Indian firms to meet the emerging challenges of global competition. It also reflects on the role being played by Indian corporate leaders in turning India into more of a global market than making it a global player. The paper also points out the need for close monitoring of the foreign collaborations and for developing relevant databases in public domain to facilitate systematic, comprehensive studies for practicing managers as well as policy makers.

7.1.1 Definition of Foreign Collaboration

In general, the definition of foreign collaboration can be stated as follows.

“Foreign collaboration is an alliance incorporated to carry on the agreed task collectively with the participation (role) of resident and non-resident entities.”

Alliance is a union or association formed for mutual benefit of parties.

Foreign collaboration is such an alliance of domestic (native) and abroad (non-native) entities like individuals, firms, companies, organizations, governments, etc., that come together with an intention to finalize a contract on some tasks or jobs or projects.

“Foreign collaboration includes ongoing business activities of sharing information related to financing, technology, engineering, management consultancy, logistics, marketing, etc., which are generally, offered by a non-resident (foreign) entity to a resident (domestic or native) entity in exchange of cheap skilled and semi-skilled labour, inexpensive high-quality raw-materials, low cost hi-tech infrastructure facilities, strategic (favourable) geographic location, and so on, with an approval (permission) from a governmental authority like the ministry of finance of a resident country.”

Foreign collaboration is thus an alliance (a union or an association) formed for mutual benefit of collaborating parties.

7.2 MEANING OF FOREIGN COLLABORATION

Following important points convey the meaning of foreign collaboration:

Foreign collaboration is a mutual co-operation between one or more resident and non-resident entities. In other words, for example, an alliance (a union or an association) between an abroad based company and a domestic company forms a foreign collaboration.

It is a strategic alliance between one or more resident and non-resident entities.

Only two or more resident (native) entities cannot make a foreign collaboration possible. For its formation and as per above definitions, it is mandatory that one or more non-resident (foreign) entities must always collaborate with one or more resident (domestic) entities.

Before starting a foreign collaboration, both entities, for example, a resident and non-resident company must always seek approval (permission) from the governmental authority of the domestic country.

During an ongoing process of seeking permission, the collaborating entities prepare a preliminary agreement.

According to this preliminary agreement, for example, the non-resident company agrees to provide finance, technology, machinery, know-how, management consultancy, technical experts, and so on. On the other hand, resident company promises to supply cheap labour, low-cost and quality raw-materials, ample land for setting factories, etc.

After obtaining the necessary permission, individual representative of a resident and non-resident entity sign this preliminary agreement. Signature acts as a written acceptance to each other's expectations, terms and conditions. After signatures are exchanged, a contract is executed, and foreign collaboration gets established. Contract is a legally enforceable agreement. All contracts are agreements, but all agreements need not necessarily be a contract.

After establishing foreign collaboration, resident and non-resident entity start business together in the domestic country.

Collaborating entities share their profits as per the profit-sharing ratio mentioned in their executed contract.

The tenure (term) of the foreign collaboration is specified in the written contract.

7.3 EXAMPLES OF FOREIGN COLLABORATION

Some prominent examples of foreign collaboration are depicted below.

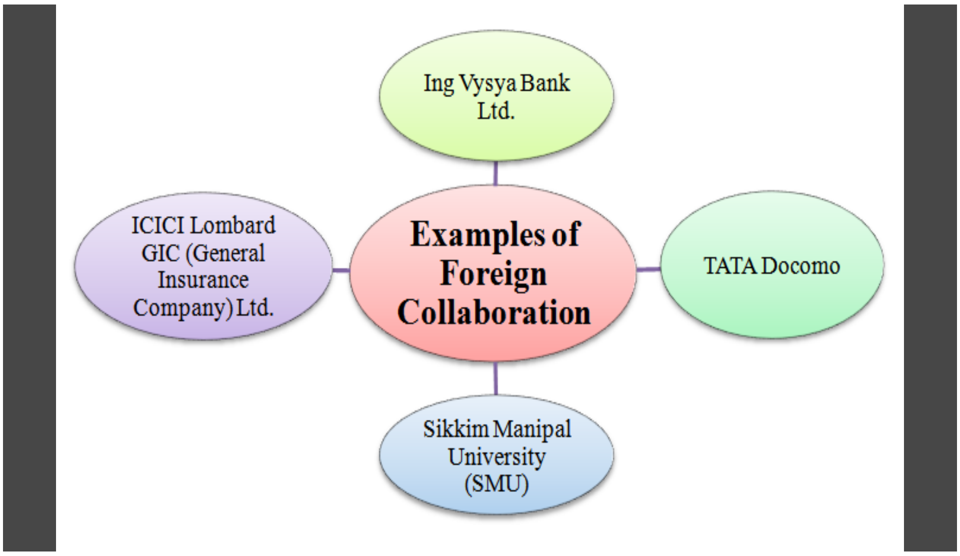

Fig.7.1

The examples of foreign collaboration between an Indian and abroad entity:

- **ICICI Lombard GIC (General Insurance Company) Limited** is a financial foreign collaboration between ICICI Bank Ltd., India and Fairfax Financial Holdings Ltd., Canada.
- **ING Vysya Bank Ltd.** is a financial foreign collaboration formed between ING Group from Netherlands and Vysya Bank from India.

- **TATA Docomo** is a technical foreign collaboration between Tata Teleservices from India and NTT Docomo, Inc. from Japan.

Sikkim Manipal University (SMU) from India runs some academic programs through an educational foreign collaboration with abroad universities like Liverpool School of Tropical Medicine from UK, Loma Linda and Louisiana State Universities from USA, Kuopio University from Finland, and University of Adelaide from Australia.

Number Foreign Collaborations in the Pre- and Post-liberalization Era

The number of foreign collaborations has been increasing on a cyclical manner in the first forty years, from 1951-91, starting with a meagre 44 collaboration in the year 1951, it increased to 592 in the year 1961 and then suddenly to 402 in 1962, the year in which India faced war with China. The number of collaborations hovered around the same figure until 1965, when India faced war with Pakistan, when number dropped further to 343.

This was followed with further decline due to political turmoil and rapid changes in government policies, marked with stricter regulatory requirements. The trend continued more or unchanged during 1970s, when the country underwent dramatic changes is political arena, with the imposition of emergency followed by short lived Janata Party government at the Centre. Eighties, however, saw the return to the rising trend, which became steeper and steeper in the 1990s, Total number of collaborations in the eighties equalled the total number of collaborations in the three decades of 1950s, 1960s and

1970s. The period 1991-2000 saw total number of collaborations in the decade surpassing the total number of all the collaborations in the 4 decades preceding it. Indeed, the total number collaborations in the 9 years of post- liberalization (1992-2000) period is observed to be 17810, while in the 41 years of pre- liberalization (1951-91), there were only 15105 foreign collaborations. India is thus banking on expert technological support for goods and services at an accelerated pace than in the pre-liberation era. The rise in number is substantial in the post liberalization era, 10- fold compared to the decade of 1950s, 5- fold compared to the decades of 1960s and 1970s and 2-fold compared to the decade of 1980s.

Table 7.1

Year-wise no. of Foreign Collaboration in India

Year	No.of	Year	No.of	Year	No.of	Year	No.of	year	No.of
	Collaborations		Collaborations		Collaborations		Collaborations		Collaborations
			ons						ons
1951	44	1961	592	1971	232	1981	388	1991	891
1952	40	1962	452	1972	263	1982	579	1992	1407
1953	53	1963	443	1973	264	1983	653	1993	1476
1954	61	1964	521	1974	374	1984	955	1994	1864
1955	81	1965	343	1975	274	1985	798	1995	2337
1956	92	1966	203	1976	273	1986	906	1996	2303
1957	119	1967	179	1977	268	1987	590	1997	2325
1958	169	1968	131	1978	307	1988	648	1998	1786
1959	368	1969	138	1979	268	1989	979	1999	2224
1960	478	1970	185	1980	527	1990	1481	2000	2098
Total	**1505**		**3187**		**3055**		**7976**		**18709**

7.4 COLLABORATING COUNTRIES

An interesting development is observed in terms of number of countries with whom India has foreign collaborations. In the 41 years of pre-liberalization era, the foreign collaborations were limited to 25 countries only. In the post liberalization era, the number of countries, with whom India has entered into foreign collaboration, swelled to 112 (see exhibit 1 for details), a dramatic over 4-fold rise indeed. It would be noticed from the table 7.2 that the number of

Table 7.2

Number of Collaborating Countries in the Pre- and Post-liberalisation Era

No. of collaborations	Pre-liberalisation (1951-91)		Post-liberalisation (1992-2000)	
	No.of Countries	Cumulative	No.of Countries	Cumulative
> 3000	2	2	1	1
> 1000 but <3000	2	4	4*	5*
> 500 but <1000	3	7	6	11
> 100 but <500	6	13	13	24
> 50 but <100	6	19	8	31
> 10 but <50	4	23	27	59
> 1 but <10	2	25	55	113

including NR's which was nil in pre-liberalization era. countries with whom India have very large number of collaborations (more than 1000 each) during the 41 years of pre liberalisation era (1951-91) and the 9 years of post- liberalization era (1992-2000) has not changed substantially, except that NRIs have engaged in a big way in the post liberalization era. But there has been a substantial rise in the number of countries with whom India did not have collaboration in the pre-liberalisation period and has entered into collaboration only in the post liberalization era.

This is true both for the 100-500 and below 100 collaborations categories. A look at exhibit I will reveal that foreign collaborations have been entered into even with very small countries, who are generally not considered to possess sound technological prowess to help bridge the technology gaps of India. The data thus, indicates that in the post-liberalisation era, the country is entering into foreign collaborations for a variety of reasons rather than for importing technology to build industrial base or to bridge the technology gaps, most important among them being to increase variety for meeting the customers' choice of products and services, which is a major shift in pattern of collaborations in the post- liberalization period.

In term of level of collaborations in the post liberalization era (1992-2000) by number, USA tops the list followed by Germany, the Great Britain and Japan. This is followed by Netherlands, Mauritius, Italy, France and Switzerland. The next few places have been occupied by the south- east Asian countries, nearly. Singapore, Korea(s), Australia and Hong Kong, which did not have any collaborations in the pre-liberalization era, They have pushed other leading European countries namely Denmark, Austria, Sweden & Belgium to the next lower position East European technology providers of pre-liberalization era, the giant like USSR, Hungry, Poland, Romania etc., are pushed down to positions lower than even the countries like Luxembourg, indicating a major shift in both, the geo-political considerations as well as the main purpose of foreign collaboration (bridging the technology gaps).

Two more striking observations may be worth noting. Firstly, unlike the popular perception in the west, the foreign collaborations with east-European countries (U.S.S.R, Poland, Hungary, Romania, etc) have been far lower (10%total) than the western developed countries, which constituted the balance 90%. Secondly, the giants of Europe, namely Germany and the Great Britain have badly lost out to USA in terms of number of collaborations with India in the post liberalization era. Indeed, the entire west European block has now lost its business closeness with

India to the USA and to some extent even to the south- east Asian countries as discussed later.

7.5 FOREIGN COLLABORATIONS BY VALUE

The foreign calibrations have also been analyses by value in terms of foreign equity. It will be seen from the table 4 that there has been a steep rise in the value of foreign collaboration in the post liberalisation era. From table exhibit 4, it will also be seen that out of a total of 112 countries with whom India has collaboration (see table 7.4), 21 countries have collaborations with 1% of total or more by value (i.e.; foreign equity), including U.S.A. & Canada, seven EU countries (U.K, Germany, France Netherlands, Italy, Belgium and Sweden), 4 south-east Asian countries (Malaysia, Singapore, Thailand and Hong Kong) and 8 others.

Table 7.3 Level of Foreign Collaboration in India by Value Rs. in Million

Year	Value
1992	26895
1993	88571
1994	141872
1995	324324
1996	361498
1997	548902
1998	307388
1999	283665
2000	340282
Total 1992-99	**2423397**

U.S.A. ranks number one (see table 7.4) with 25% share in foreign equity followed by Mauritius (!), U K (8%) and Japan (5%). South Korea (5%) Germany (4%). France, Netherlands, Italy and Belgium come close to ASEAN partners like Malaysia,

7.6 NATURE OF FOREIGN COLLABORATIONS

The approvals of foreign collaborations have been classified in two classes: namely technological (without foreign equity participation) and financial (having foreign equity participation). It will be seen from the data given in table 7.4 that out of a total of 17810

Table 7.4 Foreign Collaboration s in the Post-liberalisation Era by Type

YEAR	TYPE		TOTAL	FIN %
	FIN	TECH		
1992	639	768	1407	45%
1993	785	691	1476	53%
1994	1062	792	1854	57%
1995	1353	984	2337	58%
1996	1557	746	2303	68%
1997	1664	661	2325	72%
1998	1185	601	1786	66%
1999	1726	498	2224	78%
2000	1684	414	2098	80%
TOTAL	**11642**	**6155**	**17810**	**65%**

7.7 FOREIGN COLLABORATION BY INDUSTRY SECTOR

For analysing the patterns by industry sectors, CAPEX database from CMIE was used, which had the information on industry sub-sector for each collaboration. The database, however, had information on foreign collaboration only from June 1992 onwards. The information for the year 1992 was observed to be incomplete and hence has been ignored for this study

A look at foreign collaboration (see table 8) would show that there has been a spurt in foreign collaborations in almost all the industry sectors. No sector of industry has remained untouched with it. In as many as 45 (25%) industry sectors there have been more than 100 collaborations in 9 years (1993-2001). Another 32 industry sectors had 51- 100 collaborations in 9 years. There were only 29 sectors in which there were less than 10 collaborations during the decade.

Although a more detailed study is required to make a conclusive statement, the data indicates that there is still a steady trend in most of the sectors which are increasingly banking on foreign assistance rather than developing products and technology on their own (see exhibit iv for details). It is no indication of domestic capacity building for developing global competitiveness of India, although it has enhanced domestic competition with all the global giants competing for market share here, pushing out domestic players, leading to overcapacity creation. Running to global competitors for collaborations by industry at such a pace neither generates confidence that liberalisation is helping enhancement of India's global competitiveness though it provides an opportunity to be outsourcing point.

7.8 OBJECTIVES OF FOREIGN COLLABORATION

The main intention or prime goal or objective of foreign collaboration is to:

- Improve the financial growth of the collaborating entities.
- Occupy a major market share for the collaborating entities.
- Reduce the higher operating cost of a non-resident entity.
- Make an optimum and effective use of resources available in the resident entity's country.
- Generate employment in the resident entity's country.

7.9 MAJOR FEATURES OF FOREIGN COLLABORATION FOR THE GROWTH OF BUSINESS ARE AS FOLLOWS

7.9.1 Agreement

Foreign collaboration is an agreement or contract between two or more companies from different countries for mutual benefit. The collaborating agreement can be between:

a. Domestic and foreign private firm.

b. Domestic and foreign public firm.

c. Domestic Public and foreign private firm.

d. Domestic government and foreign government.

7.9.2 Government Consent

Foreign collaboration is now recognized as an important driver of growth in the country. Foreign collaboration requires Government approval, as the collaboration involves partnership between two countries. Some legal formalities are to be fulfilled to enter into a contract. That requires government permission.

7.9.3 World Integration

Globalisation means integration of world economy, where the world becomes a single market. Foreign collaboration allows different countries to enter into partnership and reap the benefit. It helps both the developed and developing countries to come together to achieve the common objectives and maintains international peace.

7.9.4 Growth of Industrial Sector

Foreign collaboration leads to growth of industries of the countries coming into contract. Foreign collaboration develops industries and increases employment opportunities, thereby improving the working conditions of the masses. Foreign collaboration encourages domestic and international entrepreneurs to invest in business activities and accelerates industrial growth.

7.9.5 Gives Legal Identity

Foreign collaboration is a legal entity between two or more parties for a particular purpose or venture.

7.9.6 Helps to Meet Out Requirements

As no country in the world is self-sufficient in itself. All countries need to be dependent on each other to meet out the requirements. Interdependence among countries is a common phenomenon these days. Foreign collaboration is very useful in meeting out the deficiencies of the resources and in getting advanced technology with competitive price.

7.10 TYPES OF COLLABORATION

It is available for the growth of Indian Companies is as follow:

Foreign collaboration in Indian market is increasing at a great speed due to the effect’s liberalization, privatisation and globalisation. Indian companies are interested in foreign counterpart because of gaining technical and market skills from the foreign market.

The following are the types of collaboration:

7.10.1 Technical Collaboration

Technical collaboration is a contract whereby the developed country agrees to provide technical know-how, sophisticated machinery and any kind of technical assistance to the developing country. Technical collaboration enables to undertake research and development activities and innovation.

7.10.2 Marketing Collaboration

Marketing collaboration is the agreement where the foreign collaborator agrees to market the products of the domestic company in the international market. Marketing collaboration creates value for customers and builds strong customer relationship. Marketing collaboration promotes export.

7.10.3 Financial Collaboration

When the foreign contribution is in the form capital participation, that contract is known as foreign collaboration. When the foreign company agrees to provide capital or financial assistance to the domestic company that collaboration is known" as financial collaboration.

7.10.4 Consultancy Collaboration

A Consultant is a professional who provides advice in a particular area of expertise such as management, accountancy, human resource, marketing, finance etc. Consultancy collaboration is the agreement between the foreign and the domestic company where the company agrees to provide managerial skills and expertise to the domestic company. This type of collaboration bridges the information gap.

a. Joint Venture: Joint venture is a legal entity formed between two or more parties to undertake an economic activity together. In joint venture companies agree to share capital, technology, human resources, risks and rewards in a formation of a new entity under shared control. A joint venture takes place when two parties come together to undertake one project. It is a temporary partnership between the two organisations for achieving common goals. Once the goal is achieved, joint venture comes to an end.

b. Amalgamation: Amalgamation means bringing of two or more business into single entity. In other words, amalgamation means blending together two or more undertakings into one undertaking. In this type of growth strategy two or more companies come together to form a new company. In amalgamation companies lose their individual identity. For example: one company called ABC. Another company called BCD.

Now, ABC is running loss and BCD also running loss, so these two companies agreed to Amalgamate and a new company ABCD is formed.

c. Merger: Merger is a combination of two companies into one company where one company loses its identity. It is an arrangement whereby the assets of two companies become vested under the control of one company. Merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. The process of mergers and acquisitions has gained substantial importance in today's corporate world. For example: Tata Steel acquired Corus Group.

d. Take Over/Acquisition: Acquisition is a growth strategy in which a strong company acquires all the assets and liabilities of another company. When one company takes over another company and clearly established itself as the new owner, the purchase is called an acquisition. Takeover is a form of acquisition.

There are two types of acquisitions: Friendly acquisitions and Hostile acquisitions. In a friendly acquisition the target company is formally informed about the acquisition and there is an agreement on corporate management and finance control.

In a hostile acquisition, the owner loses their ownership and control of the company against their wishes.

7.11 THERE ARE TWO APPROVING AUTHORITIES FOR FOREIGN COLLABORATION

a. Reserve Bank of India (RBI), and
b. Department of Industrial Development in the Ministry of Industry, Government of India.

Under the changing globalized scenario, attainment of international competitiveness is become very important. Such competitiveness can be attained through foreign collaboration especially through technical collaboration in country like India.

7.12 GOVERNMENT POLICY OF FOREIGN COLLABORATION

The policy followed by the Government of India on Foreign Collaboration and foreign private investment is based mainly in the approach adopted in 1949. The basic policy followed is to welcome foreign private investment on a selective basis in those areas which are advantageous to the Indian economy. The conditions under which foreign capital or foreign collaboration is welcome include.

(i) All undertakings (Indian or Foreign) have to conform to the general requirements of the Industrial polity of the Government.

(ii) Foreign enterprises are to be treated at par with their Indian counterparts.

(iii) Foreign enterprises were given freedom to remit profits and repatriate capital, subject to foreign exchange considerations.

7.13 INDUSTRIAL POLICY

The Industrial Policy 1991 prepared a specified list of high technology and high investment 34 priority industries (Annexure III) in which automatic permission will be available for foreign direct investment up to 51 per cent foreign equity. Thus, this new policy faced Indian industries from official controls for fully exploiting opportunities for promotion of foreign investment.

Thus, it is felt that foreign investment and foreign collaboration would bring advantages of technology transfer, marketing expertise, product diversification, introduction of modern managerial techniques and new possibilities for export promotion for Indian Industries.

7.14 AREAS OF FOREIGN COLLABORATION

Time of time, the Government of India issues a list of industries indicating clearly where foreign investments may be permitted.

Foreign Investment Promotion Board (FIPB) of Government of India also considers import of technology in industries listed in Annexure A and Annexure B of Schedule 1 of Foreign Exchange Management Regulations, 2000 subject to compliance with the provisions of the Industrial Policy and Procedures as notified by secretarial for Industrial Assistance (SIA) in the Ministry of Commerce and Industry of Government of India, from time to time.

7.15 PROCEDURE FOR SETTING UP FOREIGN COLLABORATION

As per the Government Policy and Foreign Exchange Laws prevailing in India, proposals for foreign investment and technical collaborations would require Government approval. Later on, with adoption on New Industrial Policy, 1991 and subsequent amendments of laws regulating foreign collaborations and industry, this procedure has been simplified further. With the enactment of FEMA, foreign collaborations and investments have become much easier.

7.15.1 Investment and Policy of Foreign Collaboration

In recent years, lot of changes have been brought in the foreign investment and foreign collaboration policy for creating a more favourable fiscal environment for foreign collaborations and investment virtually in every sector of the economy excepting those selective industries reserved for the public sector.

The obstacles that once stood in the path of foreign collaborations are becoming thing of the past. The procedures for approval from the Government are now being simplified continuously in order to make foreign investments more attractive and beneficial.

7.15.2 Foreign Collaboration and MNCS

In India, collaboration with Indian industrialists is a common form of participation of MNCs in Indian industry. In India, foreign collaboration agreements are being made between Indian and foreign companies through its sale of technology, spare parts and use of foreign brand names for its final products.

In India, almost all the new industries in the large and medium scale category, set up in the post-independence period, had some foreign collaboration agreement.

During 1980s, liberalisation process resulted a considerable spurt in foreign collaborations. Accordingly, out of the total 12,760 foreign collaboration agreements approved during the period between 1948 and 1988, 6,165 agreements (i.e., 48.3 per cent) were approved during the period between 1981 and 1988.

Again, with the liberalisation of foreign investment policy announced during the post-1991 period, the number of foreign collaborations in India increased considerably.

During the period from August 1991 to November 1993, total number of foreign collaboration proposals approved by the Government was 3,467, including 1,565 proposals of foreign equity valued as Rs 122.9 billion. Again, during the period 1991 to 2005, total actual inflows of Foreign Direct Investments was to the extent of $32.29 billion (Rs 1,31,385 crore) and till 2013-14, total inflow of FDI stood at $ 173.28 billion.

7.16 FAVOURABLE IMPACT OF FOREIGN COLLABORATION

Foreign Collaborations have some favourable impacts on Indian economy. Initially, Indian industries were concentrated on consumer goods sector only. Foreign collaborations in Indian industry have helped the sector to diversify its production spectrum which includes steel, light and heavy engineering, petroleum refinery, man-made fibre manufacture, automobile, chemical, pharmaceuticals and several other types of industrial products.

Without the support of technical knowhow and skills made available from foreign companies through such foreign collaborations approvals, the development of such basic industries would have been difficult. Thus, the gain from foreign collaboration in Indian industries is realised both in terms of increase in physical output, training of technicians, technology transfer and development of skills of modern management.

7.17 FOREIGN DIRECT INVESTMENT IN THE GLOBAL ECONOMY

Many countries rely on inflows of foreign direct investment (FDI) as a key source of aggregate demand and also as a driver of real economic growth. In 2017, total foreign direct investment was $1.43 trillion globally.

7.17.1 Developed Economies

- FDI Inflows: $712.4 billion
- FDI Outflows: $1,009.2 billion

7.17.2 Developing Economies

- FDI Inflows: $670.7 billion
- FDI Outflows: $380.8 billion

7.18 STRATEGIES TO ATTRACT INWARD INVESTMENT

- Attractive rates of corporation tax.
- Soft loans and tax reliefs / other subsidies
- Trade and Investment Agreements
- Flexible labour markets + up-skilling of workers
- Creation of Special Economic Zones (SEZ)Investment in high quality critical infrastructure such as ports and telecoms
- Open capital markets to allow remitted profits from the FDI of multinational businesses
- Attraction of relatively low unit labour costs e.g., for labour intensive manufacturing

While many countries have tried to make their economy more favourable and open to inward investment, it is also important to realise that others have tightened up the regulations required for inflows of FDI to happen. Some national governments are worried about national security and foreign ownership of land and natural resources. Others are fearful of the consequences of allowing takeovers of technology firms.

7.19 SOME ADVANTAGES OF FOREIGN DIRECT INVESTMENT

Foreign direct investment can help overcome a domestic savings gap and therefore increase the rate of capital investment for developing / emerging countries.

- Infrastructure improvement
- Capital deepening - i.e. there is more capital per worker to use in production
- Better training for local workers leading to improved human capital
- FDI can help grows a country's export capacity (e.g. via special economic zones) and develop new areas of comparative advantage
- Technology & know-how transfer can help to diversify an economy and reduce primary product dependency
- More competition in markets which might then lead to lower prices and higher real incomes for consumers
- Creates new jobs leading to higher per capita incomes and household savings
- Lift in level of factor productivity which also increases GNI per capita
- Risks / Downsides from Foreign Direct Investment (FDI)

7.20 POTENTIAL DOWNSIDES FROM ATTRACTING FOREIGN DIRECT INVESTMENT INTO A COUNTRY

- Inequality – the gains of FDI are often captured by powerful elites and the benefits may not flow equitably to people and families at the bottom end of the income and wealth scale
- Land grabs / extractive FDI which generates little extra tax revenues for the government
- Ethical standards from TNCs may be poor – especially in industries such as mining and textiles
- Volatile / footloose FDI flows – e.g., FDI is more volatile than remittances
- Limited job creation effects / perhaps with a small spill over for local content suppliers. TNCs may bring in their own managers and specialists favouring them over employing local people
- Monopsony power of TNCs who are able to negotiate highly favourable terms of trade with domestic suppliers and bid for tax relief from host governments.

LET US SUM UP

Foreign collaboration is such an alliance of domestic (native) and foreign (non-native) entities like individuals, firms, companies, organizations, governments, etc., that come together with an intention to finalize a contract on some tasks or jobs or projects In case of financial collaboration, the inflow of foreign investment takes place in the domestic (host) country. In case of technical collaboration, the inflow of foreign technology takes place in the domestic (host) country. – In case of marketing collaboration, the inflow of foreign goods and services take place in the domestic (host) country. In case of management consultancy collaboration, the inflow of foreign management consultancy takes place in the domestic (host) country. In India there are basically two forms of foreign collaboration. The collaboration may be either financial collaboration or it may be technical.

CHECK YOUR PROGRESS

Choose the correct answer

1. The foreign direct investment includes _______.

   a. Intellectual properties
   b. Human resources
   c. Tangible goods
   d. Intangible goods.

2. What is it called when a country is specialised in a particular good and then it trades the good with other countries?

   a. Agreement
   b. Interdependence
   c. Correlation
   d. Dependence

3. Which industry will have a free entry?

   a. Mineral mining
   b. Cable television
   c. T-shirt silk screening
   d. Satellite radio.

4.For spreading information, the foreign policy decision-makers rely on _______.

a. Bureaucrats
b. Politicians
c. Media
d. Public

5.The three disputes of FDI are over __________

a. Concern
b. Interest
c. Regard
d. Hobby

GLOSSARY

Foreign Collaboration :		Foreign collaboration is an agreement or contract between two or more companies from different countries for mutual benefit.
Financial Collaboration:		collaboration agreement is a legally binding agreement between different parties that want to co-operate together or work collaboratively on a commercial project that sets out how the parties will work together, divides the benefits, responsibilities and obligations created by or for the project between the parties
Consultancy Collaboration	:	The consultancy agreement is made between the company and consultant. ... It outlines the scope of work to be performed by them and other terms and conditions related to their appointment in the company. It is a kind of service agreement only.
Amalgamation	**:**	Amalgamation is process by which two or more companies join with each other and create a new large one.
Industrial policy	:	Its official strategic effort to encourage the development and growth of all or part of the economy, often focused on all or part of the

manufacturing sector. ... Industrial policies are interventionist measures typical of mixed economy countries.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
3. John D. Daniels and Lee H. Radebaugh (2010), International Business, Pearson Education Asia, New Delhi, 13th edition.
4. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.
5. Oded Shenkar and Yaong Luo, International Business, John Wiley Inc, Noida, 2nd edition, 2007.

WEB RESOURCES

1. International Collaborations - YouTube
2. Foreign Direct Investment | International Business | From A Business Professor - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1 .c 2. b 3.c 4 c 5.b

UNIT 8

FOREIGN DIRECT INVESTMENTS

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the foreign direct investment and the incentives on investment decisions in various foreign portfolio investment and the economic liberalization and the export restrictions and policy of technology, strategies of foreign direct investment were made by a company or entity based in one country, into a company or entity based in another country. National foreign direct investment policy framework was differing substantially from indirect investments such as portfolio flows, wherein overseas institutions invest in equities listed on a nation's stock exchange.

LEARNING OBJECTIVES

After completing this unit, you will be able to:

- learn the Meaning, Definition of Foreign Direct Investment
- understand the Nature and Objectives of Foreign Direct Investment
- know the various Types of Foreign Direct Investment
- understand about Export restrictions
- understand about Foreign Portfolio Investment
- understand the Effects of Incentives on Investment Decisions

8.1 FOREIGN DIRECT INVESTMENT

Direct investment abroad is a complex venture. As distinct from trade, licensing or investment, EDT involves a long-term commitment to a business endeavour in a foreign country. It often involves the engagement of considerable assets and resources I that need to be coordinated and managed across countries and to satisfy the principal of successful investment, such as sustainable profitability and acceptable risk/profitability ratios. Typically, there are many host country factors involved in deciding where an FDI project should be located, and it is often difficult to pinpoint the most decisive factor. However, it is widely agreed that FDI takes place when three sets of determining factors exist simultaneously: the presence of ownership-specific competitive ages in a transnational corporation (MNC), the presence of locational advantages in a host country, and the presence of superior commercial benefits in an intra-firm as against an arm's-length relationship between investor and recipient

The Ownership-Specific advantages (e.g., proprietary technology) of a firm if exploited optimally can compensate for the additional costs of establishing production facilities in a foreign environment and can overcome the firm 's disadvantages vis-a-vis local firms.

The ownership-specific advantages of the firm should be combined with the locational advantages of host countries (e.g., large markets or lower costs of resources or superior infrastructure). Finally, the firm finds greater benefits in exploiting both ownership specific and locational advantages by internalisation, i.e., through FDI rather than arm 's length transactions. This may be the case for several reasons. For one, markets for assets or production inputs (technology, knowledge or management) may be imperfect, if they exist at all, and may involve significant transaction costs or time-lags. For another, it may be in a firm 's interest to retain exclusive rights to assets (e.g., knowledge) which confer upon it a significant competitive advantage (e.g., monopoly rents).

While the first and third conditions are firm-specific determinants of FIJI, the second is location-specific and has a crucial influence on a host country 's inflows of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market. If the third condition is added to the first, FDI becomes preferred mode of servicing foreign markets, but only in the presence of boa specific advantages. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly.

8.2 THE NATIONAL FDI POLICY FRAMEWORK

As a general principle, host countries that offer what MNCs are seeking, and/or host countries whose policies are most conducive to MNC activities, stand a good chance attracting FDI.

But firms also see locational determinants in their interaction ownership-specific and internalisation advantages in the broader context of their corpora strategies. These strategies aim, for example, at spreading or reducing risks, pursuing, oligopolistic, competition, and matching competitors 'actions or looking for distinct sources of competitive advantage. In the context of different strategies, the same motive and the corresponding host country determinants can acquire different meanings. For example, the market-seeking motive can translate, in the case of one MNC, into the need to enter new markets to increase the benefits arising from multi plant operations; in the case of another MNC, it can translate into the desire to acquire market power; and for another MNC, it can aim at diversifying markets as part of a risk strategy.

Core FDT policies consist of rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them, and the functioning of the markets within which they operate. These policies can range from outright prohibition of FDI entry to non-discrimination in the treatment of foreign and domestic firms and even preferential treatment of foreign firms. They typically satisfy various objectives reducing or increasing FDI, influencing its sectorial composition or geographical origin, encouraging specific contributions to the economy and affecting ways in which these contributions are made. To achieve these objectives, PD policies are usually accompanied by other policies that also influence investors 'decisions.

8.3 INCENTIVES TO ATTRACT FDI

Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprises by (or at the direction of) a government, in order to encourage them to behave in a certain manner. They include measures either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks. They do not include broader non-discriminatory policies, relating to the availability of physical and business infrastructures, the general legal regime for FDI, the general regulatory and fiscal regime for business operations, free repatriation of profits or the granting of national treatment. While these policies certainly bear on the location decisions of TNCs, they are not FDI incentives perse. The main types of incentives used are fiscal incentives (e.g., reduction of the standard corporate income-tax rate, investment and reinvestment allowances, tax holidays, accelerated depreciation, exemptions from import duties), financial incentives (e.g. government grants, subsidised credits, government equity participation, government insurance at preferential rates) and market preferences (e.g. granting of monopoly rights, protection from import competition, closing the market for further entry, preferential government contracts). Other types of incentives frequently used include preferential treatment on foreign exchange and subsidised dedicated infrastructure and services.

8.4 ECONOMIC RATIONALE FOR INCENTIVES

The economic rationale behind incentives is to correct the failure of markets to reflect the wider benefits arising from externalities in production — for example, those resulting from economies of scale, the creation of widely diffused knowledge and the upgrading of skills of mobile workers. Incentives can thus be justified to cover the wedge between the private and the social returns on an investment. In a more dynamic context of growth and development, incentives can be justified to correct the failure of markets to reflect the gains that can accrue over time from declining unit costs and learning by doing the classic infant-industry argument used in a very different context. Incentives can also be justified to compensate investors for lost return due to other government interventions (for example, duty remissions on imports or performance requirements) or for carrying certain public costs where a government lacks the institutional capacity to bear them itself. In sum, incentives can serve a number of development purposes. However, they also have the potential to introduce economic distortions (especially when they are more than marginal) that are analogous to subsidies on trade, and they involve financial and administrative costs. It is not in the public interest that the cost of incentives granted exceed the value of the benefits to the public.

8.5 COMPETITION FOR FDI WITH INCENTIVES

Governments use incentives to attract FDI, to steer investment into favoured industries, activities or regions, or to influence the character of an investment, as, for example, when technology- intensive investment is being sought. Today, most investment incentives are directed to domestic and foreign investors alike, although sometimes only foreign investors can access certain incentives (as when special incentive packages are geared towards large projects or specific foreign investors, or where advanced technologies are involved that can only be provided by foreign investors). The range of incentives available to foreign investors and the number of countries that offer incentives have both increased considerably since the mid-1980s, as barriers to PDJ and trade have declined. In addition, many countries are experiencing increasing incentives competition among regional or even local authorities to attract FDI. Also, incentives are becoming increasingly focused and targeted and are sometimes contingent upon certain conditions being met by the investor, in fact, countries often offer a broad array of options linked to different objectives. Thus, further multiplying the number of incentive programmes available to foreign investors. However, it is difficult to discern clear patterns across countries and regions on the type of industries or activities favoured by incentive programmes. An increasing number of countries target investment activity in industries involving technology and high value-added (such as electronics, robotics, computer software) and in infrastructure projects. While manufacturing industries are still the main focus of incentive programmes, some governments continue to offer incentives in agriculture, fisheries, mining and oil exploration. Some co untried are also offering incentives to encourage companies to locate specific corporate functions within their territories (say, to set up regional headquarters). As a general rule, developed countries make more use of financial incentives than of fiscal ones, partly because fiscal incentives are less flexible, and their adoption involves more difficult parliamentary procedures. However, this pattern is reversed in developing countries, presumably because these countries lack the resources needed to provide financial incentives. Market incentives have played an important role until recently, although market reforms and the introduction of competition policy in an increasing number of countries are narrowing the scope for these incentives.

Whatever the rationale for FDI incentives, they are ultimately successful only to the extent that they succeed in attracting investment to a country away from another; if it were otherwise, and the investment were to take place anyway, the incentive would be superfluous. In an open world economy, in which barriers to FDI are falling, many countries have increased their incentives with the intention of diverting investment away from competing host countries. Competition for FDI with incentives is pervasive not only among nation al governments but also among sub-national authorities. When governments compete to attract FDI, there will be a tendency to overbid, if bidders may offer more than the wedge between public and private returns. The effects can be both distorting and inequitable since the costs are ultimately borne by the public and hence represent transfers from the local community to the ultimate owners of the foreign investment. In such competition for FDI, the poorer countries are relatively disadvantaged.

8.6 THE EFFECT OF INCENTIVES ON INVESTMENT DECISIONS

In spite of this competition, there is considerable evidence to suggest that incentives are a relatively minor factor in the locational decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, adequate infrastructure, economic stability and the quality of the general regulatory framework. For example, in many companies' incentives are frequently not considered and simply made an already attractive country more attractive. Investment decisions are made mainly on the basis of economic and long-term strategic considerations concerning inputs, production costs and markets. However, as regards individual investment projects, there is increasing evidence that when the location is broadly determined, e.g., a member country of the European Union or a country with a large national market, then incentives can play a decisive role in choosing, e.g. between Scotland and Wales; Ireland and Scotland; or North of England and North of France.

Foreign investors may respond differently to different types of incentives depending on their-strategies. Generally, the export-oriented investors seeking inexpensive labour valued fiscal incentives more highly than market protection or other incentives. Market seeking investors, on the other hand, value market protection more than fiscal incentives. In the case of regional incentives, financial incentives, particularly grants seem to have a greater impact on investors 'decisions than fiscal incentives. In recent years, a wide variety of incentives are being offered for foreign investors to transfer advanced technologies and attract R&D facilities (including tax reductions, subsidised infrastructure and land and industrial parks); governments have also intervened through the creation of markets (with defence expenditures and government purchasing) and research funding. However, a fiscal incentives and financial aid did not influence location, while the establishment of enterprise zones and research parks did.

In brief, while incentives do not rank high among the main FDI determinants, their impact on locational choices can be perceptible at the margin, especially for projects that are cost-oriented and mobile.

8.7 FOREIGN PORTFOLIO INVESTMENT (FPI)

While FPI has traditionally been concentrated in developed markets, new interest has been sparked by the so-called emerging capital markets. The emerging markets have at least three attractive qualities, two of which are their high average returns and their low correlations with developed markets. Diversification into these markets is expected to give higher expected returns and lower overall volatility.

Many individual investors, as well as portfolio and pension fund managers, are re-examining their basic investment strategies. The 1990s, fund managers realised that significant performance gains could be obtained by diversifying into high-quality global equity markets. These gains are limited, however, by the fairly high cross-correlations returns in these markets. The resulting investment strategy reflects current information.

In terms of portfolio theory, adding low-correlation portfolios to an optimisation enhances the reward-to-risk profile by shifting the mean-variance frontier to the left.

The portfolio optimisation problem requires important inputs—the expected returns and the variance-covariance matrix. In principle, all these measures should be forward-looking. That is, the returns, volatilities, and correlations should be forecasted.

An upsurge portfolio investment in developing countries has marked the end of the debt crisis, or perhaps even helped to end it. Using the World Bank ‘s definition of portfolio flows as consisting of bonds, equity (comprising direct stock market purchases, American Depository Receipts (ADRs), and country funds), and money market instruments (such as certificates of deposits (CDs) and commercial paper. Broadly speaking, there are six groups of investors in the emerging markets, each having a tolerance for different degrees of risks and returns:

I) Domestic residents of developing countries with overseas holdings and other private foreign investors, who constitute the dominant category of portfolio investors who are currently active in the major emerging markets. These investors keep abreast of developments in their country on a regular basis and monitor change in government policy. Their investments in emerging markets are motivated by expected short-term high yields. Preference is given to instruments that are in bearer form and provide returns in hard currency. These external fund as –Hot Money which are kept in the –Latin American Bank‖ which may or may not be beneficial to the long-term growth prospects of developing country depending on the manner in which they are invested.

ii) Managed funds (closed-end country funds and mutual funds), whose portfolio managed buy and sell shares and high-yield bonds in one or more of the emerging markets for performance-based trading purposes.

iii) Foreign banks and brokerage firms, who allocate their portfolio for inventory and trading purposes.

iv) Retail clients of Eurobonds houses who are involved in emerging securities markets due to portfolio diversification motives. They are generally interested in high-yield, high portfolio investments in the emerging markets.

v) Institutional investors (such as pension funds, life insurance companies), who have a longer time horizon for expected gains from their portfolio and look for stability and long-term growth prospects in the market in which they invest.

vi) Non-resident nationals of developing countries, who could be a potential source of portfolio investment from abroad (as opposed to flight capital).

The first three groups are active in the emerging securities markets primarily because of expectations of short-term returns and have been observed to move funds among different branches frequently. Purely speculative traders also continuously move funds between the emerging markets and the developed markets (primarily the United States).

The lower degree of integration of the emerging markets in the global capital markets, often makes them better avenues for achieving higher yields relative to the more globally integrated developed securities markets. Since all listed companies in the ESMs are not very well researched by foreign investors and their market information may be limited, there exists the potential for finding undervalued stocks which may yield high returns to potential investors. In general, P/E ratios in several ESMs may be lower than those in developed markets. Therefore, one expects to see larger inflows of portfolio investments into the emerging markets from institutional investors worldwide

8.8 THERE ARE TWO MAIN TYPES OF FOREIGN DIRECT INVESTMENT- HORIZONTAL AND VERTICAL.

8.8.1 Horizontal foreign direct investment refers to the overseas manufacturing of products and services similar to those the company produces and manufactures in its home market. Wondering why this type of overseas investment is called “horizontal”. It is called horizontal because the company duplicates its business activities of its home country in different countries. This type of FDI arises because it is expensive to serve the overseas market by exports because of transportation costs or trade limitations and barriers.

8.8.2 Vertical foreign direct investment occurs when firms establish manufacturing facilities in multiple countries, each producing a different input to, or stage of, the company’s production process.

Foreign investment in an Indian company can be done in the following ways, permitted by the Foreign Exchange Management Regulations:

- As an integrated entity by incorporating a company under the Companies Act, 1956 through
- Joint ventures; or
- Wholly owned subsidiaries
- As an office of a foreign entity through
- Liaison Office / Representative Office
- Project Office
- Branch Office.

8.9 AFTER THE INITIATION OF ECONOMIC LIBERALIZATION IN 1991

The Government of India amended FDI policies in order to encourage an increased FDI inflow. India is one of the largest economies in the world with a tremendous growth potential. With its special investment privileges such as tax exemption and relative lower wages, India has become an attractive investment destination for foreign companies and individuals. As of February 2019, the Government of India aims to achieve its goal of US $100 Billion worth of foreign direct investment inflows. To invest in India, an investor must follow two routes:

8.9.1 Automatic route: Under this route, no prior approval of authority is required by the foreign investor. 100% FDI is allowed. This slows the investor to invest in any company they wish to.

8.9.2 Government route: A prior approval is needed in order to proceed with FDI under this route.

8.10 EXPORT RESTRICTIONS

Export restrictions and policy of technology import based on the number of foreign collaboration approvals, in the literature, three phases in Government's policy have been identified:

(i) Period of liberalization until the mid-sixties, i.e., 1960-61 to 1963-64.

(ii) Period of tight regulations since then until mid/late seventies, i.e., from 1964-65 to 1969-70, and up to 1972-73. (The period of 1973-74 to 1977- 78, unfortunately is uncovered by any of the survey reports of RBI).

(iii) Period of relaxation of regulations from then until the end of seventies, i.e., from 1977-78 to 1980-81. The Indian experience shows that the tendency to impose ERs over the period, irrespective of the different phases of regulations, has increased but most severe types of them have been replaced with mild ERs.

The empirical evidence indicates that though the number of ERs have increased during the period of relaxations in regulations but the tendency of ERs of acquiring comparatively higher intensities during the phases of liberalizations (as is generally expected) can be checked if a strict watch is kept on no permissible ERs and they are discouraged to the extent possible.

8.11 STRATEGY

With the ongoing economic reforms and liberalization, MNCs are lined-up to enter into our large and lucrative domestic market. We also need latest, sophisticated foreign technology and investments and that is why more and more Indian units are coming forward to join their hands. But the question still remains? Why our rights to exports, as well as, of all those developing countries where such practices have been adopted by MNCs, be restricted. The issue of restricting exports and declaring ERs as illegal the worldwide therefore, becomes extremely relevant in context of new trading system and rules pertaining to investment flows that would emerge under the World Trade Organisation (WTO) and the related multilateral agreements. Would such ERs be pronounced as inconsistent with the Agreement on Trade Related Investment Measure

(TRIMs) on the same lines as the conditions for domestic content and import-export links have stipulated for multinational been pronounced as anti-GATT?

Till such time this is done, our industries need a great caution while signing an FCA. At no cost, non-permissible ERs be accepted, formally or informally. Reasonable, permissible ERs, however, in the unavoidable circumstances may be considered if they are absolutely necessary for the FCA. The experience reveals that number of ERs increase with liberalization. We should not allow them to go further. Foreign technology and investments are welcomed but we need them with an outward looking perspective, where ERs have no place.

LET US SUM UP

MNC is a corporation that has its facilities and other assets in at least one country other than its home country. Such companies have offices and/or factories in different countries and usually have a centralized head office where they co-ordinate global management. The Operations of a Multinational Corporation (MNC) extend beyond the country in which it is incorporated. Its headquarters are located in one country (home country) and in addition it carries on business in other countries (host country). Foreign Direct Investment means “cross border investment made by a resident in one economy in an enterprise in another economy, with the objective of establishing a lasting interest in the investee economy. FDI is a major source of external finance which means that countries with limited amounts of capital can receive finance beyond national borders from wealthier countries.

CHECK YOUR PROGRESS

Choose the correct answer

1. The investment in productive assets and participation in management as stake holders in business enterprises is-----

   a. FII
   b. Balance of payment
   c. SDR
   d. FDI

2.Which of the following are improved when capital and labour are moved internationally?

a. Economic growth gains
b. Capital gains
c. Gains from income
d. Gains from trade

3.What is it called when a country is specialised in a particular good and then it trades the good with other countries?

a. Agreement
b. Interdependence
c. Correlation
d. Dependence

4.Which of the following is not an example of foreign direct investment?

a. the construction of a new auto assembly plant overseas
b. the acquisition of an existing steel mill overseas
c. the purchase of bonds or stock issued by a textile company overseas
d. the creation of a wholly owned business firm overseas

5.Firms undertake multinational operations in order to?

a. hire low-income workers
b. manufacture in nations they have difficult exporting to
c. obtain necessary factor inputs
d. All of the above

GLOSSARY

Foreign Direct Investment (FDI) : A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. It takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company.

Foreign Portfolio Investment (FPI) : Consists of securities and other financial assets held by investors in another country. It does not provide the investor with direct ownership of a company's assets and is relatively liquid depending on the volatility of the market.

Horizontal Investment : It refers to the investor establishing the same type of business operation in a foreign country as it operates in its home country,

Incentives : It includes fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants and preferential loans to MNCs, as well as measures such as market preferences, infrastructure and sometimes even monopoly rights.

Foreign Institutional investors: FII is an investor or investment fund investing in a country outside of the one in which it is registered or headquartered

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
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5. Oded Shenkar and Yaong Luo,(2007), International Business, John Wiley Inc, Noida, 2nd edition.

WEB RESOURCES

1. Foreign Direct Investment|Green Field vs Brown Field|Business Strategies|Startup Analysis|Tamil - YouTube
2. Foreign Direct Investment (FDI) | Meaning, Types, Benefits, FDI in India, Routes of Entering India - YouTube
3. FII,FDI,FPI IN TAMIL - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1. d 2.c 3.b 4.c 5.d

UNIT 9

JOINT VENTURE AND INDUSTRIAL POLICY

STRUCTURE

OVERVIEW

In this unit, you are going to learn about the joint venture and the industrial policy and the formation of joint venture. The international joint venture was based on two or more countries to form a partnership. Taxes on joint venture were unable to share technology and complementary of intellectual property in constraints of industrial growth. It helps to understand various industrial policy and the policy statements in resolutions to complicate their business environment.

LEARNING OBJECTIVES

After completing this unit, you will be able to:

- know the meaning, definition of Joint Ventures
- discuss the Nature and Objectives of Joint Ventures
- trace out the Characteristics of Joint Ventures
- understand about Industrial Policy.
- help to Constraints the Industrial Growth

9.1 JOINT VENTURES IN INDIA

Introduction Foreign investment for development has become a matter of necessity for most growing economies in the world. India is no different. An emerging market implies a market which is deregulated and has conditions favourable to foreign investment. Although India falls within this category, the term, “emerging market” has not been legally defined. In several industrial sectors, the Government of India has felt that the best way forward is to permit foreign investment. In 1991, the Indian Government amended the New Industrial Policy, whereby many industrial sectors, hitherto foreclosed, were opened up for investment.

Since then, the Government has not looked back, and presently in many areas foreign corporations are allowed to incorporate wholly (100%) owned subsidiaries (“WOS”) in India. Furthermore, the Indian capital markets have also been liberalised. Today, foreign institutional investors (“FIIs”) operate in the Indian stock markets, providing a variety of services.

A joint venture is generally understood as technical and financial collaboration either in the form of greenfield projects, take-overs or alliances with existing companies’ In India, no legal definition as such has been given to joint ventures. However, the Government of India and its agencies prescribe certain guidelines, which distinguish joint ventures from other entities. Indian joint ventures usually comprise two or more individuals/companies, one of whom may be non-resident, who come together to form an Indian private/public limited company, holding agreed portions of its share capital.

A joint venture agreement primarily provides for the manner in which the shareholders of the joint venture company may transfer or dispose of their shares. It is also commonly referred to as a shareholder’s agreement

9.2 FORMATION OF A JOINT VENTURE

India has inherited the English common law system. Under this system, unlike the civil law system, contracts are detailed. Shareholders' agreements and the articles of association (bylaws) of the joint venture company form the basis of the joint venture.

The shareholders agreement prescribes share transfer restrictions, if any, which are then incorporated into the articles of association of the joint venture company. In India, joint ventures can exist in the form of companies, partnerships or joint working agreements.

The various companies that may be incorporated in India are as follows:

- Companies limited by shares
- Companies limited by guarantee
- Companies having unlimited liability Companies

limited by shares are of two types - public and private. As regards companies limited by shares, members are liable only to the extent of the unpaid amount on their shares, if any. In a company limited by guarantee, the liability is limited to the amount pledged, being the contribution to be paid in case of winding-up of the company.

In companies with unlimited liability, the liability of each member is unlimited. The most common form of joint ventures are Indian public or private companies, wherein share capital is issued to the joint venture partners. In this way, the risk of members is limited to the extent of the unpaid amount on their shares.

The next step is to decide whether to have a public or a private company. Unless money is sought to be raised from the public, joint venture partners do not incorporate public companies.

In India, partnerships are defined under section 4 of the Indian Partnership Act, as agreements to enter into a partnership business so as to share profits and to conduct such business for one or on behalf of all. Partnerships do not have any limitations on liability of the respective partners. Thus, the risk associated with this form of business is very high and is not advocated for any type of joint venture.

Joint working agreements are either customer or market oriented depending upon the needs of the partners. In joint working agreements, the domestic partner manufactures those components which are cost effective while the joint venture partner imports into India those components which are not cost effective to manufacture.

The final product is a result of the melange. In case of joint working agreements, there may not be a complete transfer of technology. Technology transfer may proceed gradually in steps. There is no payment of lump sum fee or royalty to the foreign company.

There is a gradual sharing of revenue between the parties. Due to the limited liability advantages, most parties to a joint venture in India go in for legal entity, i.e., a public or private company

9.3 CHARACTERISTICS OF A JOINT VENTURE

9.3.1 Creates Synergy

A joint venture is entered between two or more parties to extract the qualities of each other. One company may possess a special characteristic which another company might lack with. Similarly, the other company has some advantage which another company cannot achieve. These two companies can enter into a joint venture to generate synergies between them for a greater good. These companies can work on economies of large scale to give cost advantage.

9.3.2 Risk and Rewards Can Be Shared

In a typical joint venture agreement between two or more organization, may be of the same country or different countries, there are many diversifications in culture, technology, geographical advantage and disadvantage, target audience and many more factors to overcome. So, the risks and rewards pertaining to the activity for which the joint venture is agreed upon can be shared between the parties as decided and entered into the legal agreement.

9.3.3 No Separate Laws

As for joint venture, there is no separate governing body which regulates the activities of the joint venture. Once they are into a corporate structure, then the Ministry of Corporate Affairs in association with Registrar of Companies keep a check on companies. Apart from that, there is no separate law for governing joint ventures.

9.4 ADVANTAGES OF JOINT VENTURE

9.4.1 Economies of Scale

Joint Venture helps the organizations to scale up with their limited capacity. The strength of one organization can be utilized by the other. This gives the competitive advantage to both the organizations to generate economies of scalability.

9.4.2 Access to New Markets and Distribution Networks

When one organization enters into joint venture with another organization, it opens a vast market which has a potential to grow and develop. For example, when an organization of United States of America enters into a joint venture with another organization based at India, then the company of United States has an advantage of accessing vast Indian markets with various variants of paying capacity and diversification of choice.

At the same time, the Indian company has the advantage to access the markets of the United States which is geographically scattered and has good paying capacity where the quality of the product is not compromised. Unique Indian products have big markets across the globe.

9.4.3 Innovation

Joint ventures give an added advantage to upgrading the products and services with respect to technology. Marketing can be done with various innovative platforms and technological up gradation helps in making good products at efficient cost. International companies can come up with new ideas and technology to reduce cost and provide better quality products.

9.4.4 Low Cost of Production

When two or more companies join hands together, the main motive is to provide the products at a most efficient price. And this can be done when the cost of production can be reduced, or cost of services can be managed. A genuine joint venture aims at this only to provide best products and services to its consumers.

9.4.5 Brand Name

A separate brand name can be created for the Joint Venture. This helps in giving a distinctive look and recognition to the brand. When two parties enter into a joint venture, then goodwill of one company which is already established in the market can be utilized by another organization for gaining a competitive advantage over other players in the market.

For example, a big brand of Europe enters into a joint venture with an Indian company will give a synergic advantage as the brand is already established across the globe.

9.4.6 Access to Technology

Technology is an attractive reason for organizations to enter into a joint venture. Advanced technology with one organization to produce superior quality of products saves a lot of time, energy, and resources. Without the further investment of huge amount again to create a technology which is already in existence, the access to same technology can be done only when companies enter into joint venture and give a competitive advantage.

9.5 UNDERSTANDING JOINT VENTURES (JVS)

Joint ventures, although they are a partnership in the colloquial sense of the word, can take on any legal structure. Corporations partnerships, limited liability companies (LLCs), and other business entities can all be used to form a JV. Despite the fact that the purpose of JVs is typically for production or for research, they can also be formed for a continuing purpose. Joint ventures can combine large and smaller companies to take on one or several big, or little, projects and deals.

There are three main reasons why companies form joint ventures:

9.5.1 Leverage Resources

A joint venture can take advantage of the combined resources of both companies to achieve the goal of the venture. One company might have a well-established manufacturing process, while the other company might have superior distribution channels.

9.5.2 Cost Savings

By using economies of scale, both companies in the JV can leverage their production at a lower per-unit cost than they would separately. This is particularly appropriate with technology advances that are costly to implement. Other cost savings as a result of a JV can include sharing advertising or labour costs.

9.5.3 Combined Expertise

Two companies or parties forming a joint venture might each have unique backgrounds, skillsets, and expertise. When combined through a JV, each company can benefit from the other's expertise and talent within their company.

Regardless of the legal structure used for the JV, the most important document will be the JV agreement that sets out all of the partners' rights and obligations. The objectives of the JV, the initial contributions of the partners, the day-to-day operations, and the right to the profits, and the responsibility for losses of the JV are all set out in this document. It is important to draft it with care, to avoid litigation down the road.

9.6 PAYING TAXES ON A JOINT VENTURE (JV)

When forming a JV, the most common thing the two parties can do is to set up a new entity. But because the JV itself isn't recognized by the

Internal Revenue Service (IRS), the business form between the two parties helps determine how taxes are paid. If the JV is a separate entity, it will pay taxes like any other business or corporation does. So, if it operates as an LLC, then the profits and losses would pass through to the owners' personal tax returns just like any other LLC.

The JV agreement will spell out how profits or losses are taxed. But if the agreement is merely a contractual relationship between the two parties, then their agreement will determine how the tax is divided up between them.

9.7 USING A JOINT VENTURE (JV) TO ENTER FOREIGN MARKETS

A common use of JVs is to partner up with a local business to enter a foreign market. A company that wants to expand its distribution network to new countries can usefully enter into a JV agreement to supply products to a local business, thus benefiting from an already existing distribution network.

Some countries also have restrictions on foreigners entering their market, making a JV with a local entity almost the only way to do business in the country.

Joint Venture (JV) vs. Partnerships and Consortium

A joint venture (JV) is not a partnership. That term is reserved for a single business entity that is formed by two or more people. Joint ventures join two or more different entities into a new one, which may or may not be a partnership.

The term "consortium" may be used to describe a joint venture. However, a consortium is a more informal agreement between a bunch of different businesses, rather than creating a new one. A consortium of travel agencies can negotiate and give members special rates on hotels and airfares, but it does not create a whole new entity.

9.7.1 Requirements for Joint Ventures

The key elements to a joint venture may include (but are not limited to):

- The number of parties involved
- The scope in which the JV will operate (geography, product, technology)
- What and how much each party will contribute to the JV
- The structure of the JV itself
- Initial contributions and ownership split of each party
- The kind of arrangements to be made once the deal is complete
- How the JV is controlled and managed

- How the JV will be staffed

Examples Of Joint Ventures

Once the joint venture (JV) has reached its goal, it can be liquidated like any other business or sold. For example, in 2016, Microsoft Corporation (NASDAQ: MSFT) sold its 50% stake in Paradigm, a JV it had created in 2011 with General Electric Company (NYSE: GE). The JV was established to integrate Microsoft's Amalga enterprise healthcare data and intelligence system, along with a variety of technologies from GE Healthcare. Microsoft has now sold its stake to GE, effectively ending the JV. GE is now the sole owner of the company and is free to carry on the business as it pleases.

Industrial Policy is the set of standards and measures set by the Government to evaluate the progress of the manufacturing sector that ultimately enhances economic growth and development of the country.

The government takes measures to encourage and improve the competitiveness and capabilities of various firms.

9.8 OBJECTIVES OF INDUSTRIAL POLICY

- To maintain steady growth in productivity.
- To create more employment opportunities.
- Utilize the available human resources better
- To accelerate the progress of the country through different means
- To match the level of international standards and competitiveness

9.9 INDUSTRIAL POLICY IN INDIA

The various industrial policy introduced by the Indian government are as follows:

9.9.1Industrial Policy Resolution, 1948

- It declared the Indian economy as Mixed Economy
- Small scale and cottage industries were given the importance
- The government restricted foreign investments

9.9.2 Industrial Policy Resolution, 1956 (IPR 1956)

- This policy laid down the basic framework of Industrial Policy
- This policy is also known as the Economic Constitution of India
- It is classified into three sectors
- Schedule A – which covers Public Sector (17 Industries)

- Schedule B – covering Mixed Sector (i.e. Public & Private) (12 Industries)
- Schedule C – only Private Industries

This has provisions for Public-Sector, Small-Scale Industry, Foreign Investment. To meet new challenges, from time to time, it was modified through statements in 1973, 1977, and 1980.

9.10 INDUSTRIAL POLICY STATEMENT, 1977

- This policy majorly focused on Decentralisation
- It gave priority to small scale Industries
- It created a new unit called "Tiny Unit"

  These policy-imposed restrictions on Multinational Companies (MNC).

9.11 INDUSTRIAL POLICY STATEMENT, 1980

- The Industrial Policy Statement of 1980 addressed the need for promoting competition in the domestic market, modernization, selective Liberalization, and technological up-gradation.
- Due to this policy, the MRTP Act (Monopolies Restrictive Trade Practices) and FERA Act (Foreign Exchange Regulation Act, 1973) were introduced.
- The objective was to liberalize the industrial sector to increase industrial productivity and competitiveness of the industrial sector.
- The policy laid the foundation for an increasingly competitive export-based and for encouraging foreign investment in high-technology areas.

9.12 NEW INDUSTRIAL POLICY, 1991

The New Industrial Policy, 1991 had the main objective of providing facilities to market forces and to increase efficiency. Larger roles were provided by

- L – Liberalization (Reduction of government control)
- P – Privatization (Increasing the role & scope of the private sector)
- G – Globalisation (Integration of the Indian economy with the world economy)

Because of LPG, old domestic firms have to compete with New Domestic firms, MNC's and imported items. The government allowed Domestic firms to import better technology to improve efficiency and to have access to better technology. The Foreign Direct Investment ceiling was increased from 40% to 51% in selected sectors.

The maximum FDI limit is 100% in selected sectors like infrastructure sectors. Foreign Investment promotion board was established. It is a single-window FDI clearance agency. The technology transfer agreement was allowed under the automatic route.

Phased Manufacturing Programme was a condition on foreign firms to reduce imported inputs and use domestic inputs, it was abolished in 1991.

Under the Mandatory convertibility clause, while giving loans to firms, part of the loan will/can be converted to equity of the company if the banks want the loan in a specified time. This was also abolished.

Industrial licensing was abolished except for 18 industries.

Monopolies and Restrictive Trade Practices Act – Under his MRTP commission was established. MRTP Act was introduced to check monopolies. The MRTP Act was relaxed in 1991.

On the recommendation of the SVS Raghavan committee, Competition Act 2000 was passed. Its objectives were to promote competition by creating an enabling environment.

To know more about the Competition Commission of India, check the linked article.

Review of the Public sector under this New Industrial Policy, 1991 are:

- Public sector investments (Disinvestment of Public sector)
- De-reservations –Industries reserved exclusively for the public sector were reduced
- Professionalization of Management of PSUs
- Sick PSUs to be referred to the Board for Industrial and financial restructuring (BIFR).
- The scope of MOUS was strengthened (MOU Is an agreement between a PSU and concerned ministry).

9.13 CONSTRAINTS TO INDUSTRIAL GROWTH

The major challenges that have restricted industrial growth inter-alia include the following:

9.13.1 Inadequate Infrastructure

Physical infrastructure in India suffers from substantial deficit in terms of capacities as well as efficiencies. Rapid growth of the economy has put further stress on infrastructure. Lack of quality industrial infrastructure has resulted in high logistics cost and has in turn affected cost competitiveness of Indian goods in global markets.

9.13.2 Restrictive Labour Laws

The tenor of labour laws has been overly protective of labour force in the formal sector. Though labour protection and security are required, the flipside is that it discourages employers from hiring workers on a regular basis. It has probably also led to entrepreneurs choosing to stay away from labour intensive sectors and opt for highly capital or skilled-labour intensive technologies sectors.

9.13.3 Complicated Business Environment

Complex and time taking business processes and clearances have been a disincentive for businesses. India also suffered from a complex multi-layered tax system, which with its high compliance costs and its cascading effects adversely affects competitiveness of manufacturing.

9.13.4 Slow Technology Adoption

Indian industry has been a slow adopter of new and advanced technologies. Inefficient technologies led to low productivity and higher costs adding to the disadvantage of Indian products in international markets.

9.13.5 Low Productivity

Productivity as measured by value added per worker and average wages in manufacturing in India are only one-third of that in China. Differences in productivities across sectors and across firms within the same sector make matters worse. Workers in India are overwhelmingly employed in low productivity and low wage activities.

9.13.6 Challenges for Trade

Manufacturing sector especially exporters are facing challenges of stagnant/shrinking global demand and rising protectionist tendencies around the world. Indian MSME sector is particularly facing tough competition from cheap imports from China and FTA countries.

9.13.7 Inadequate Expenditure On R&D And Innovation

An investment in these areas is essential to ensure growth in industry. Public investments have been constrained by the demands from other public service demands and private investment is not forthcoming as these involve long gestation periods and uncertain returns.

It is also to be understood that these factors work in tandem to increase costs of goods and services. They are strongly entwined; one feeds into another thereby exacerbating the disadvantages. The nexus needs to be broken at more than one link to ensure that the spin-off is in the positive direction.

9.14 A FUTURE READY INDUSTRIAL POLICY

Clear vision, strategic objectives and intent the policy aims to set a clear vision for the role of industry and industrial growth in the growth and development of the economy. A shared vision to develop a globally competitive Indian industry with skill and scale, which leverages technology, will be developed through engagement with stakeholders. Strategic objectives have to be delineated with measurable outcomes. The policy has to also ensure that it embeds into itself sectoral objectives and provides an overarching umbrella policy framework. The timeframe for implementation of the policy needs to be decided taking into consideration the changing economic and business cycles of the world and the Indian economy, geo-political trends and broad policy directions in the country. To begin with, the following strategic objectives are set forth for the policy, to enable commencement of work. They have been developed to provide a picture of the policy intent. Illustrative outcomes and questions that trigger the search for solutions have also been spelt out.

9.15 ESTABLISHING GLOBAL LINKAGES

9.15.1 India Needs to Strengthen Global Strategic Linkage

By creating global brands out of India, strengthening linkages between Indian and global SMEs and intensifying FDI. Concerns have been raised about the brand value of Indian products, significantly low value addition done in India and the minimal positive externalities from FDI.

9.15.2 Brand Building

It should gain importance alongside achieving quality and scale. The quantum of value addition has to be increased at all levels. Larger the value addition, greater the positive externalities from economic activity. Creating complete value chains domestically and globally or integrating into existing chains is vital to ensure that the world market is accessed at the right time.

9.15.3 FDI Policy Has Largely Aimed At Attracting Investment.

Benefits of retaining investments and accessing technology have not been harnessed to the extent possible. FDI policy requires a review to ensure that it facilitates greater technology transfer, leverages strategic linkages and innovation.

9.15.4 Illustrative Outcomes and Trigger Questions Long-Term

- Increasing the number of global-Indian firms to those in the Fortune500 category
- Establish complete value chains, within India or across countries, in select sunrise sectors like renewable energy, food processing, electronics etc.
- An FDI regime that balances the short term and long-term benefits of inward and outward investments. Industrial Policy 2017

LET US SUM UP

A joint venture is an association of two or more individuals or business entities who combine and pool their respective expertise, financial resources, skills, experience, and knowledge in the furtherance of a particular project or undertaking. Joint Ventures are generally created for a single activity or project and may have a limited time span. Joint Venture agreements, commonly referred to as a “JV”, are typically formed either by individuals, business entities, corporations or partnerships. The contributions to the joint ventures are either in the form of money [capital], services, or physical asset(s), i.e., equipment or intellectual property [software, patents], etc., or a combination of all. The investments in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) abroad have been recognized as important avenues for promoting global business by Indian entrepreneurs in terms of foreign exchange earnings like dividend, royalty, technical know-how fee and other entitlements on such investments.

There are two fundamental types of joint venture, i.e., Equity Joint Venture and Contractual Joint Venture – The equity joint venture is an arrangement whereby a separate legal entity is created in accordance with the agreement of two or more parties. The contractual joint venture might be used where the establishment of a separate legal entity is not needed or the creation of such a separate legal entity is not feasible in view of one or the other reasons.

CHECK YOUR PROGRESS

Choose the correct answer

1. Which of the following enterprises may benefit the most by an established brand name at the time of incorporation?

   a. Departmental Undertaking
   b. Government Company
   c. Statutory corporations
   d. Joint Venture

2. A government company is any company in which the paid-up capital held by the government is not less than
   a. 49 percent
   b. 51 percent
   c. 50 percent
   d. 25 percent

3. Which of the following statements regarding recent Government policy measures towards the public sector is/are true?
   a. Restructuring and reviving potentially viable PSU's.
   b. Closing down of those PSU's that cannot be revived.
   c. Bringing down government equity in all non-strategic PSUs to 50 percent or lower.
   d. Fully protecting the interest of workers.
      (a) Only a, b and c
      (b) Only a, c and d
      (c) Only a, b and d
      (d) Only b, c and d

4. The funding of which of the following enterprise comes directly from the government treasury, is under an annual appropriation from the budget of the government and the revenue earned by it is also paid into the treasury?
   a. Departmental undertaking
   b. Statutory corporation
   c. Government company
   d. Cooperatives

5. All public sector units were referred to _______________, to decide whether a sick unit was to be restructured or closed down.
   a. PSU
   b. MOFA
   c. MOU
   d. BIFR

GLOSSARY

Joint Venture : It is a combination of two or more parties that seek the development of a single enterprise or project for profit, sharing the risks associated with its development. An agreement (written or oral) between the parties manifesting their intent to associate as joint ventures.

Leverage : Leverage is the ability to influence situations or people so that you can control what happens. ... Leverage is the force that is applied to an object when something such as a lever is used.

Industrial Policy : It defined as the strategic effort by the state to encourage economic transformation, i.e., the shift from lower to higher productivity activities, between or within sectors

Foreign Trade : It is the mutual exchange of services or goods between international regions and borders. There are varieties such as import and export. They are important concepts for the national economy.

Internal revenue service : The revenue of a government from any domestic source, usually considered to be any source other than customs.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
3. John D. Daniels and Lee H. Radebaugh (2010), International Business, Pearson Education Asia, New Delhi, 13th edition.
4. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.
5. Oded Shenkar and Yaong Luo, (2007), International Business, John Wiley Inc, Noida, 2nd edition.

WEB RESOURCES

1. International Joint Ventures – What you need to know - YouTube
2. What Is A Joint Venture & Strategic Alliance? - YouTube
3. Roadmap to Joint Venture Agreements: Legal and Accounting Considerations - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.d 2. b 3.c 4.a 5.d

BLOCK 4

WORLD TRADE AND FOREIGN EXCHANGE MARKET

UNIT 10

WORLD TRADE AND PROTECTIONISM

STRUCTURE

OVERVIEW

In this lesson you are going to learn about the concept of world trade and its trend and strategies of trading and its major trends and development. To know about the protectionism and its advantage and disadvantage of protectionism of the defence measures to ensure fair competition and the transparency of dispute resolution against protectionism.

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- know how distance and borders reduce the trade
- understand about trend trading
- discuss about the transparency and dispute resolution against protectionism
- understand about the major trends and developments of world trade
- know about the trade defence measures to ensure of fair competition
- learn about the protectionism and its types, advantage and disadvantage of protectionism.

10.1 TRADE IN GOODS AND SERVICES

Trade in goods and services is defined as the transactions in goods and services between residents and non-residents. It is measured in million USD, as percentage of GDP for net trade, and also in annual growth for exports and imports. All OECD countries compile their data according to the 2008 System of National Accounts (SNA).

10.2 TRADE IN GOODS AND SERVICES FORECAST

Trade in goods and services forecast is defined as the projected value of change in ownership of material resources and services between one economy and another. Projections are based on an assessment of the economic climate in individual countries and the world economy, using a combination of model-based analyses and expert judgement. The indicator comprises net trade, imports and exports and export market growth. Net trade is the value of exports minus the value of imports; imports and exports are the value of goods and services imported or exported from other economies; export market growth measures the demand for a country’s exports constructed as a weighted average of import growth in all export destinations using export shares as weights.

This indicator is measured in USD for net trade, annual growth rate for exports and imports and USD, 2015 prices for exports, imports and export market growth.

10.3 TREND TRADING

Trend trading is a trading style that attempts to capture gains through the analysis of an asset's momentum in a particular direction. When the price is moving in one overall direction, such as up or down, that is called a trend. Trend traders enter into a long position when a security is trending upward. An uptrend is characterized by higher swing lows and higher swing highs. Trend traders may opt to enter a short position when an asset is trending lower. A downtrend is characterized by lower swing lows and lower swing highs.

10.4 UNDERSTANDING TREND TRADING

Trend trading strategies assume that a security will continue to move in the same direction as it is currently trending. Such strategies often contain a take-profit or stop-loss provision in order to lock in a profit or avoid big losses if a trend reversal occurs. Trend trading is used by short-, intermediate-, and long-term traders. Traders use both price action and other technical tools to determine the trend direction and when it may be shifting.

Price action traders look at the price movements on a chart. For an uptrend, they want to see the price move above recent highs, and when the price drops it should stay above prior swing lows. This shows that even though the price is oscillating up and down, the overall trajectory is up.

The same concept is applied to downtrends, with traders watching to see if the price makes overall lower lows and lower highs. When that is no longer happening, the downtrend is in question or over, and therefore the trend trader will no longer be interested in holding a short position.

10.5 TREND TRADING STRATEGIES

There are many different trend trading strategies, each using a variety of indicators and price action methods. For all strategies, a stop loss should be used to manage risk. For an uptrend, a stop loss is placed below a swing low that occurred prior to entry, or below another support level. For a downtrend and a short position, a stop loss is often placed just above a prior swing high or above another resistance level.

10.5.1 Moving Averages

These strategies involve entering a long position when a short-term moving average crosses above a longer-term moving average or entering a short position when a short-term moving average crosses below a longer-term moving average. Alternatively, some traders may watch for when the price crosses above a moving average to signal a long position, or when the price crosses below the average to signal a short position.

Typically moving average strategies are combined with some other form of technical analysis to filter out the signals. This may include looking at price action to determine the trend, since moving averages provide very poor signals when no trend is present; the price just whipsaws back and forth across the moving average.

Moving averages are also used for analysis. When the price is above a moving average it helps to indicate that an uptrend may be present. When the price is below the moving average it helps to indicate that a downtrend may present.

10.5.2 Momentum Indicators

There are many momentum indicators and strategies. In regard to trend trading, an example might include looking for an uptrend, and then using the relative strength index (RSI) to signal entries and exits. For example, a trader may wait for the RSI to drop below 30 and then rise above it. This could signal a long position, assuming the overall uptrend remains intact. The indicator is showing that the price pulled back but is now starting to rise again in alignment with the overall uptrend. The trader could potentially exit when RSI rises above 70 or 80 and then falls back below the selected level.

10.5.3 Trend Lines & Chart Patterns

A trend line is a line drawn along swing lows in an uptrend, or along swing highs in a downtrend. It shows a possible area where the price may pull back to in the future. Some traders opt to buy during an uptrend when the price pulls back to, and then bounces higher off of, a rising trend line. Similarly, some traders opt to short during a downtrend when the price rises to, and then falls away from, a declining trend line.

Trend traders will also watch for chart patterns, such as flags or triangles, which indicate the potential continuation of a trend. For example, if the price is rising aggressively and then forms a flag or triangle, a trend trader will watch for the price to break out of the pattern to signal a continuation of the uptrend.

Often times, traders use a combination of these strategies when looking for trend trading opportunities. A trader might look for a breakout through a resistance level to indicate a move higher may be starting, but only enter into a trade if the price is trading above a specific moving average.

10.6 MAJOR TRENDS AND DEVELOPMENTS

Current trends are towards the increasing foreign trade and interdependence of firms, markets and countries. Intense competition among countries, industries, and firms on a global level is a recent development owed to the confluence of several major trends. Among these trends are:

10.6.1 Forced Dynamism

International trade is forced to succumb to trends that shape the global political, cultural, and economic environment. International trade is a complex topic, because the environment it operates in is constantly changing. First, businesses are constantly pushing the frontiers of economic growth, technology, culture, and politics which also change the surrounding global society and global economic context. Secondly, factors external to international trade (e.g., developments in science and information technology) are constantly forcing international trade to change how they operate.

10.6.2 Cooperation Among Countries

Countries cooperate with each other in thousands of ways through international organisations, treaties, and consultations. Such cooperation generally encourages the globalization of business by eliminating restrictions on it and by outlining frameworks that reduce uncertainties about what companies will and will not be allowed to do. Countries cooperate:

i. To gain reciprocal advantages,
ii. To attack problems, they cannot solve alone.
iii. To deal with concerns that lie outside anyone's territory.

Agreements on a variety of commercially related activities, such as transportation and trade, allow nations to gain reciprocal advantages. For example, groups of countries have agreed to allow foreign airlines to land in and fly over their territories, such as Canada's and Russia's agreements commencing in 2001 to allow polar over flights that will save five hours between New York and Hong Kong.

Groups of countries have also agreed to protect the property of foreign-owned companies and to permit foreign-made goods and services to enter their territories with fewer restrictions. In addition, countries cooperate on problems they cannot solve alone, such as by coordinating national economic programs (including interest rates) so that global economic conditions are minimally disrupted, and by restricting imports of certain products to protect endangered species.

10.6.3 Liberalization of Cross-Border Movements

Every country restricts the movement across its borders of goods and services as well as of the resources, such as workers and capital, to produce them. Such restrictions make international trade cumbersome; further, because the restrictions may change at any time, the ability to sustain international trade is always uncertain. However, governments today impose fewer restrictions on cross-border movements than they did a decade or two ago, allowing companies to better take advantage of international opportunities. Governments have decreased restrictions because they believe that:

i. So-called open economies (having very few international restrictions) will give consumers better access to a greater variety of goods and services at lower prices,
ii. Producers will become more efficient by competing against foreign companies, and
iii. If they reduce their own restrictions, other countries will do the same.

10.6.4 Transfer of Technology

Technology transfer is the process by which commercial technology is disseminated. This will take the form of a technology transfer transaction, which may or may not be a legally binding contract, but which will involve the communication, by the transferor, of the relevant knowledge to the recipient. It also includes non-commercial technology transfers, such as those found in international cooperation agreements between developed and developing states. Such agreements may relate to infrastructure or agricultural development, or to international, cooperation in the fields of research, education, employment or transport.

10.6.5 Growth in Emerging Markets

The growth of emerging markets (e.g., India, China, Brazil, and other parts of Asia and South America especially) has impacted international trade in every way. The emerging markets have simultaneously increased the potential size and worth of current major international trade while also facilitating the emergence of a whole new generation of innovative companies. According to “A special report on innovation in emerging markets” by The Economist magazine, “The emerging world, long a source of cheap la, now rivals the rich countries for business innovation”.

10.7 PROTECTIONISM

Definition

Protectionism is where nations aim to prevent or restrict the supply of goods coming into the country. Governments use various policies to prevent imports from international competition to prevent them competing with local businesses. Examples include subsidies, tariffs, quotas, foreign direct investment restrictions, and exchange rate controls.

Proponents of protectionist policies argue that domestic jobs will be lost to foreign competition without such policies being imposed. Over the years, this argument has gained traction as more and more jobs have been moved to the likes of China and Mexico. At the same time, advocates look to impose restrictions on imports in order to ‘protect consumers’ from poor quality overseas products. These policies have the intended effect, but also reduce competition and increase prices to the final consumer.

10.8 PROTECTIONISM AND NATIONALISM ON THE RISE

Protectionism is on the rise. In addition to import and export tariffs, market access barriers include quantitative import restrictions, unnecessarily complicated technical standards, and subsidies. This endangers economic growth and jobs worldwide. The German economy, in particular, is suffering from the global trend towards isolation.

Protectionism can take various forms – including, for example, tariffs, licensing procedures for imports and exports, complex authorisation procedures, and mandatory requirements for local value-added in public procurement or market access approval.

Governments use such instruments to improve the position of local companies, to promote production and processing at home, and to create jobs. For local companies and consumers, however, protectionism often leads to a decline in international competitiveness, a reduced diversity of supply, and unnecessarily high prices.

10.9 TYPES OF PROTECTIONISM

When a nation takes a protectionist approach, it can use a number of tools. These range from tariffs and quotas, to exchange rate controls and regulatory requirements. Whilst most developed nations have come a long way from 19th Century Protectionism, most still have some level of protectionist policies. Back in the 19th century, protectionist countries relied on simple tools such as tariffs, quotas, or purely restricting all goods entering. These have now developed, with many nations using tools such as exchange rate controls, currency manipulation, or restrictions on Foreign Direct Investment (FDI).

- **Tariffs:** Tariffs are one of the oldest tools that protectionist nations use. They are a tax on imports, with the leveraged rate stored in the 'tariff schedule' – a list of millions of products that have specific rates applied. The use of tariffs is effective because it makes imports more expensive when compared to domestic suppliers. Consumers can then choose more expensive imports, or cheaper domestic alternatives. Ultimately, consumers choose cheaper domestic suppliers, thereby boosting employment. At the same time, the imported goods that get brought mean consumers are paying an additional tax (the tariff), which provides government with revenue.

- **Import Quotas:** A quota is a restriction on the quantity of a good that is allowed into the country. For instance, Mexico set a quota on imported sugar in 2010, with a limit of 250,000 tonnes. Import quotas are applied over a set period – usually a year, with the same aims is as other restrictions prevent international competition from destroying domestic business and jobs. Import quotas are slightly more effective than tariffs because they completely restrict goods entering the country. By contrast, tariffs still allow goods to enter, just at a higher price. Yet at the same time, quotas allow goods to come in at a cheaper price than under a tariff – although in limited quantities. As a result, most protectionist nations will employ both a quota and tariff to offset the drawbacks of the other.

- **Subsidies:** A subsidy is a payment by government to domestic producers. With relation to protectionism, governments employ two kinds of subsidies. The first is a domestic subsidy that provides domestic suppliers with funds to help reduce prices. By providing money to local businesses to help keep prices down, it makes them more competitive against imports. This tool can be seen as slightly less aggressive and restrictive as it freely allows imports to come in. Yet at the same time it increases the competitive power of domestic businesses. The route is different, but the goal and results are the same. This is where government funds domestic suppliers to export their goods. In other words, government is paying so that its domestic firms export to other nations. Export subsidies contrast to domestic subsidies in the fact that it looks to shift consumption abroad.

- **Restriction on FDI:** Some nations use strict FDI restrictions in order to prevent foreign nations entering the market. For instance, China requires some industries to link up with local suppliers before they are allowed to sell their goods. Elsewhere, India places investment caps on specific industries. For instance, media industries are only allowed to invest up to 24 percent, whilst FDI is completely banned in industries such as real estate and most agriculture markets.
- **Exchange Rate Controls:** By controlling the exchange rate, a nation is able to dictate how much imports can cost. For instance, if the currency strengthens in relation to other currencies; imports will become cheaper as a result. So, a protectionist nation would seek to weaken and/or control the exchange rate to prevent this. There are several ways by which nations do this. One example includes printing and dumping currency onto the foreign exchange market. In turn this increases the supply in the market, thereby reducing its value. Alternatively, a nation may buy up the supply of other currencies. As this reduces the supply, it contrastingly increases its value. In turn, this decreases the value of the domestic currency, thereby increasing the price of imported goods.
- **Regulations:** Nations can prevent goods from coming in simply by imposing strict regulatory requirements. For instance, a banana has to be a certain size and shape, or a motor vehicle must have certain components attached. On occasion, regulations can be so strict that importers would have to specifically manufacture goods for that nation. A new production process would need to be created to fulfil the requirements. And because of such, it is not worth the importer's time, money, and effort. Consequently, it has the intended effect.

10.10 ADVANTAGES OF PROTECTIONISM

Protectionism is defined as the restriction of international trade in order to benefit the domestic industry. Now, whilst protectionism has slowly faded away, particularly after the creation of the World Trade Organisation (WTO), it has started to gain some traction again in recent times. Let us look at some of the arguments made for protectionism below:

- **Protect Industry and Jobs:** One of the original aims of protectionism was to protect industry and jobs. The argument rests of the fact that if international competitors are allowed to compete, then domestic firms will be destroyed. This argument is particularly pronounced in developing nations. For instance, a country like Vietnam would face fierce competition from brands such as Nike, Apple, and the like. If such developing nations let these big companies in, then a small business will not stand a chance.
- **Protect the Consumer:** One of the more recent phenomenon's surrounding protectionism has been the development of 'protecting the consumer'. As developed nations have advanced, they have left a large economic gap between them and developing nations. For instance, the quality of life is significantly different in Germany as opposed to Sudan. This has occurred over many years as economic growth has continued in such developed nations but is almost not existent in countries such as Sudan. However, these protectionist policies to protect the consumer are not just against the first world and developing nations. They are also against other developed nations. For instance, the EU completely bans products with pesticides or herbicides.
- **Retaliation and Unfair Competition:** As we have seen with the US-China trade war, protectionist policies have been used in retaliation to other nations. The argument from the US' point of view was that the Chinese already had very strict and protectionist policies, whilst the US' freely allowed most Chinese goods in. Simply put, the trading arrangement was deemed unfair by the US. The US had few tariffs, whilst China still had many that prevented US competition. In turn, the US retaliated to unfair competition. At the same time, this resulted in further escalations.
- **National Security:** Another historical argument for protectionism is national security. We now live in an age where the last serious war was nearly 80 years ago. Yet regional wars, particularly in Europe, were common place. This gave the 'national security' argument more weight. It is argued that should a nation become reliant on international imports,

it also becomes defensively weak. For example, a nation may import 75 percent of its food. However, should a war start, those resources may no longer be available. Even if the imports are from a neutral nation, it is highly likely that a hostile enemy would take out any supplies.

10.11 DISADVANTAGES OF PROTECTIONISM

- **Higher Prices:** Whether tariffs, quotas, exchange rate controls, or regulations are used, they can all affect the final price of a product. Tariffs are the most obvious because a tax is imposed on imported goods. These are paid for largely by the consumer as importers pass on the majority of this cost. Other tools such as quotas and regulations restrict the quantity that is made available. Regulations can completely limit the supply and competition, so consumers will have to buy from more expensive domestic suppliers. Similarly, quotas can restrict supply. At the same time, because the supply is limited, the level of demand will drive up prices. For instance, if Product A is being imported into Country A at $10, there may be 1,000 people who wish to buy it. In turn, 1,000 are produced. However, Product A now has a quota limit of 500. The demand has not changed, but the quantity supplied has.
- **Less Choice**: By restricting international competition, there are fewer goods coming into the country. This means less choice for the average consumer. For instance, the 2012 Skoda Fabia Green line II is banned from the US. The reason being that it does not meet US regulations. However, it has been tested and is widely used on European roads.
- **Economic Loss: Protectionist** policies impose an additional cost and loss on all parties. First of all, domestic consumers must pay a higher price for goods. At the same time, importers face a decline in demand, so international jobs are lost. For instance, the US-China trade war meant that US consumers paid a higher price while demand for Chinese workers is reduced.

10.12 TARIFFS: STUMBLING BLOCKS IN WORLD TRADE

Tariffs are taxes levied on the import (import tariff) or export (export tariff) of goods. For decades, a clear downward trend in average global tariff rates could be observed. This trend may now be coming to an end. Moreover, many sectors still have high tariff peaks. In the European Union (EU), for example, data from the World Trade Organisation (WTO) indicate that tariffs of up to 258 percent are levied on dairy products. In the United States, tariff peaks for beverages and tobacco reach up to 350 percent. Classic industrial sectors are also affected by such high tariffs. In India, for example, tariffs peaks of up to 88 percent are imposed on certain textile products. Particularly in emerging and developing countries, high average tariffs make international and regional trade more difficult. China, for example, applies an average WTO bound tariff of 9.8 percent; India applies 17.1 percent, and Nigeria 12.1 percent.

10.13 TRADE DEFENCE MEASURES TO ENSURE FAIR COMPETITION

In recent reports, the WTO has made a more precise distinction between trade-restrictive measures and trade defence instruments. In principle, the WTO allows the use of trade defence instruments. They are intended to compensate for unfair competition (anti-dumping and anti-subsidy measures) or to provide breathing room for an industry to carry out structural reforms in the event of an import surge (safeguards measures). Tariffs can also be levied in the event of threat to national security, the environment, or human health. However, measures must comply with WTO regulations, and they should not be misused for backdoor protectionism. This is, unfortunately, not always the case, demonstrated by the large number of dispute settlement cases at the WTO, which peaked at 39 in 2018. In 2019, the WTO recorded 19 new disputes.

10.14 TRANSPARENCY AND DISPUTE RESOLUTION AGAINST PROTECTIONISM

The WTO features several mechanisms to curtail protectionism and to settle disputes. These include the Trade Policy Review Mechanism (TPRM), the reports of the WTO Director General, and the WTO Integrated Trade Intelligence Portal (I-TIP). These monitoring instruments have already led to greater transparency, as they show where states have taken protectionist measures; however, there are no real consequences for the states apart from “naming and shaming”.

The WTO’s Dispute Settlement Mechanism (DS) is more effective in this regard. In the DS, WTO members can take action against other members if they violate WTO rules. The first step comprises consultations to allow the disputing partners to find an amicable solution. If this fails, a dispute settlement panel can be established. After the panel’s report has been published, members may appeal a panel decision. To enforce panel reports and Appellate Body decisions, the WTO can allow a member to implement retaliatory measures if the defendant does not correct its measures within the prescribed period.

The United States accuses the Appellate Body of regularly overstepping its mandate by creating new law to which the WTO members have not consensually agreed. As such, the U.S. government is currently blocking the nomination of new members to this important body. If no new members are appointed by December 2019, the DS will be essentially shut down. Ultimately, every trade conflict has the potential to escalate if it cannot be resolved in a rules-based process and without effective enforcement of WTO law. This would undermine the dispute settlement function of the WTO as a whole and severely damage the credibility of the entire multilateral trading system.

10.15 THE BDI IS ACTIVELY COMMITTED TO A STRENGTHENED AND FULLY FUNCTIONING WTO

- **Improvement of WTO monitoring instruments:** The WTO Secretariat should clearly identify any undesirable developments within the framework of the transparency mechanism.
- **Maintenance and strengthening of the dispute settlement mechanism**: Above all, the bureaucracy and duration of the DS procedure should be reduced, and the WTO's dispute settlement capacities expanded. It is also important to fill vacancies in the Appellate Body as quickly as possible. In order to accomplish this, the criticisms of the United States should be addressed. If no solution is reached, a Plan B must be developed and implemented; for example, an appeal procedure based on Article 25 of the DS Agreement.
- **Reduction of protectionist measures**: The G20 countries must commit to publicly justifying any new trade restriction and any recurring barriers. Fighting protectionism must become a top priority of the G20 once again.
- **Return to multilateral negotiations:** As a multilateral platform, the WTO should once again be given greater prominence in negotiations. Plurilateral agreements can be an intermediate step in this direction.

LET US SUM UP

In this unit you have learnt about the World Trade goods and services and various types of protectionism and also measures the trade defence of fair competition and transparency of resolution against protectionism. The Protectionist policies are place a specific restriction on international trade for the benefit of a domestic economy. Tariffs, import quotas, product standards, and subsidies are some of the primary policy tools a government can use in enacting protectionist policies.

CHECK YOUR PROGRESS

Choose the correct answer

1. A tariff differs from a quota in that a tariff is:
   a. levied on imports, whereas a quota is imposed on exports.
   b. levied on exports, whereas a quota is imposed on imports.
   c. a tax levied on exports, whereas a quota is a limit on the number of units of a good that can be exported.
   d. a tax imposed on imports, whereas a quota is an absolute limit to the number of units of a good that can be imported.

2. Which of these global economic organisations was created at the 1944 Bretton Woods Conference?
   a. The International Monetary Fund (IMF)
   b. The World Trade Organization (WTO)
   c. The International Trade Organization (ITO)
   d. The Organization for Economic Cooperation and Development (OECD)

3. Tariffs result in a decrease in consumer surplus because: the price and the quantity consumed of the protected good increases.
   a. the price and the quantity consumed of the protected good decreases.
   b. the price of the protected good increases and quantity consumed decreases.
   c. the price of the protected good decreases and quantity consumed increases.
   d. None of the above

4. Politicians often argue for tariff increases in order to reduce the nation's dependence on imports. If tariffs are increased, the long-run effect is most likely to be:
   a. an increase in American imports, and a decrease in American exports.
   b. an decrease in American imports, and an increase in American exports.
   c. an increase in both American imports and exports.
   d. a decrease in both American imports and exports.

5. _________is theoretically possible, even sensible: give an industry a short-term indirect subsidy through protection, and then reap the long-term economic benefits of having a vibrant healthy industry.

   a. Protectionism
   b. The infant industry argument
   c. Dumping
   d. Import quotas

GLOSSARY

Protectionism : It refers to government policies that restrict international trade to help domestic industries.

Dynamism : Market dynamics are forces that will impact prices and the behaviours of producers and consumers.

Subsidies : Subsidies make those goods cheaper to produce than in foreign markets. This results in a lower domestic price. Both tariffs and subsidies raise the price of foreign goods relative to domestic goods, which reduces imports.

Multilateral Agreement : Multilateral agreement is a commerce treaty between three or more nations. It allows for all of the countries that sign, called signatories, to be on an equal playing field. This agreement means that no signatories can give better or worse trade deals to one country than it does another.

Trend trading: When the price is moving in one overall direction, such as up or down, that is called a trend. Trend traders enter into a long position when a security is trending upward.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata McGraw Hill, 2nd edition.
2. John D. Daniels and Lee H. Radebaugh (2010), International Business, Pearson Education Asia, New Delhi, 13th edition.

3. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.

WEB RESOURCES

1. Protectionism (International Business) - YouTube
2. What is Free Trade and Protectionism? | IB International Economics | The Global Economy - YouTube
3. What is FREE TRADE? - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1. d   2. a   3.c   4.d   5.b

UNIT 11

TARIFF AND NON-TARIFF BARRIERS TO TRADE

STRUCTURE

OVERVIEW

In this unit you are going to learn about the Tariff and Non-tariff Barriers to Trade. It includes a customs fare or tariff on goods entering a country and are imposed by a government. To know about the non-tariff barriers and its impacts of trade barriers on business and the voluntary export restraint and the technical barriers to trade.

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- understand about the introduction of trade barriers.
- learn about the Non-Tariff Barriers to Trade.
- know about Difference between Tariff and Non-Tariff Barriers
- discuss about the Impacts of trade barriers on business.

11.1 INTRODUCTION OF TRADE BARRIERS

This unit examines tariff and non-tariff policies that restrict trade between countries in agricultural commodities. Many of these policies are now subject to important disciplines under the 1994 GATT agreement that is administered by the World Trade Organization (WTO).

First, tariffs, import quotas, and tariff rate quotas are discussed. Then, a series of non-tariff barriers to trade are examined, including voluntary export restraints, technical barriers to trade, domestic content regulations, import licensing, the operations of import State Trading Enterprises (STEs), and exchange rate management policies. Finally, the precautionary principle, an environment-related rationale for trade restrictions, and sanitary and phytosanitary barriers to trade are discussed.

11.2 TRADE BARRIERS

Definition

Trade barriers are government policies which place restrictions on international trade. Trade barriers can either make trade more difficult and expensive (tariff barriers) or prevent trade completely (e.g. trade embargo) Examples of Trade Barriers

- **Tariff Barriers.** These are taxes on certain imports. They raise the price of imported goods making imports less competitive.
- **Non-Tariff Barriers.** These involve rules and regulations which make trade more difficult. For example, if foreign companies have to adhere to complex manufacturing laws it can be difficult to trade.
- **Quotas**. A limit placed on the number of imports
- **Voluntary Export Restraint (VER).** Similar to quotas, this is where countries agree to limit the number of imports. This was used by the US for imports of Japanese cars.

- **Subsidies.** A domestic subsidy from government can give the local firm a competitive advantage.
- **Embargo**. A complete ban on imports from a certain country. E.g., US embargo with Cuba.

11.3 TARIFF BARRIERS

Tariffs, which are taxes on imports of commodities into a country or region, are among the oldest forms of government intervention in economic activity. They are implemented for two clear economic purposes. First, they provide revenue for the government. Second, they improve economic returns to firms and suppliers of resources to domestic industry that face competition from foreign imports.

Tariffs are widely used to protect domestic producers' incomes from foreign competition. This protection comes at an economic cost to domestic consumers who pay higher prices for import-competing goods, and to the economy as a whole through the inefficient allocation of resources to the import competing domestic industry. Therefore, since 1948, when average tariffs on manufactured goods exceeded 30 percent in most developed economies, those economies have sought to reduce tariffs on manufactured goods through several rounds of negotiations under the General Agreement on Tariffs Trade (GATT). Only in the most recent Uruguay Round of negotiations were trade and tariff restrictions in agriculture addressed. In the past, and even under GATT, tariffs levied on some agricultural commodities by some countries have been very large. When coupled with other barriers to trade they have often constituted formidable barriers to market access from foreign producers. In fact, tariffs that are set high enough can block all trade and act just like import bans.

11.4 NON-TARIFF BARRIERS TO TRADE

Non-Tariff Barriers (NTBs) refer to restrictions that result from prohibitions, conditions, or specific market requirements that make importation or exportation of products difficult and/or costly. NTBs also include unjustified and/or improper application of Non-Tariff Measures (NTMs) such as sanitary and Phyto-sanitary (SPS) measures and other technical barriers to Trade (TBT). NTBs arise from different measures taken by governments and authorities in the form of government laws, regulations, policies, conditions, restrictions or specific requirements, and private sector business practices, or prohibitions that protect the domestic industries from foreign competition.

11.5 NON-TARIFF BARRIERS TO TRADE – NEW AND OLD BARRIERS TO WORLD TRADE

Non-tariff barriers (NTBs) are policies that restrict trade but do not constitute tariffs. There are three types of NTBs:

1. **NTBs on imports**: These include import quotas, import restrictions, import licences, customs procedures, and administrative fees.
2. **NTBs on exports:** These include export taxes, export quotas, export bans, and other export restrictions.
3. **NTBs in the domestic economy:** These are measures imposed behind the border. They include, but are not limited to, disclosure requirements for sensitive company data, joint venture obligations, technical standards, taxes or other levies, and domestic subsidisation.

11.6 DIFFERENCE BETWEEN TARIFF AND NON-TARIFF BARRIERS

- With tariffs the Government receives the revenue whereas no revenue is received by the Government by applying non-tariff measures. However, it is favoured as an appropriate measure to meet the demand of the country and to protect the industry.
- Non-tariff measures protect the procedures and make them feel more secure than under a tariff. But incentives are not there under tariffs.
- In tariff customer's classification and valuation procedures pose a problem before the customs authorities. Where-as under non-tariff measures no such problem arises.
- Non-tariff barriers to trade induce the domestic producers to form monopolistic organisations with a view to keeping output low and prices high. This is not possible under import duty. Non-tariff barriers remain ineffective if monopolistic tendencies prevail in the country.
- Non-tariff measures are flexible than tariff. Imposition of tariff and amendments are subject to legislative enactment.
- In non-tariff the price differences will be greater in two countries because there is no free flow of imports; but in tariff—price differentiation will be equal to the cost of tariff and transportation between exporting and importing countries.
- Tariffs are simple to operate. Tariff rates once fixed through legislation require no individual allocation of licensing quotas or exchange. For non-tariff measures numbers of authorities are

there to administer. It may result in political interference or corruption.

- Tariff favours particularly to efficient firms in the country but non-tariff measures benefit established firm because they get quotas or import licenses.

11.7 IMPACTS OF TRADE BARRIERS ON BUSINESS

- Trade barriers are often criticized for the effect they have on the developing world. Because rich-country players call most of the shots and set trade policies, goods such as crops those developing countries are best at producing still face high barriers. Trade barriers such as taxes on food imports or subsidies for farmers in developed economies lead to overproduction and dumping on world markets, thus lowering prices and hurting poor-country farmers. Tariffs also tend to be anti-poor, with low rates for raw commodities and high rates for labour- intensive processed goods. The Commitment to Development Index measures the effect that rich country trade policies actually have on the developing world.
- Trade barriers are mostly a combination of conformity and per-shipment requirements requested abroad, and weak inspection or certification procedures at home. The impact of trade barriers on companies and countries is highly uneven. One particular study showed that small firms are most affected (over 50%).
- Another negative aspect of trade barriers is that they result in a limited choice of products and would therefore force customers to pay higher prices and accept inferior quality.
- Trade barriers obstruct free trade. Before exporting or importing to other countries, firstly, they must be aware of restrictions that the government imposes on the trade. Subsequently, they need to make sure that they are not violating the restrictions by checking related regulations on tax or duty, and finally they probably need a license in order to ensure a smooth export or import business and reduce the risk of penalty or violation. Sometimes the situation becomes even more complicated with the changing of policy and restrictions of a country.

11.8 TYPES OF NON-TARIFF BARRIERS

- **Licenses:** Countries may use licenses to limit imported goods to specific businesses. If a business is granted a trade license, it is permitted to import goods that would otherwise be restricted for trade in the country.

- **Quotas:** Countries often issue quotas for importing and exporting both goods and services. With quotas, countries agree on specified limits for products and services allowed for importation to a country. In most cases, there are no restrictions on importing these goods and services until a country reaches its quota, which it can set for a specific time frame. Additionally, quotas are often used in international trade licensing agreements.
- **Embargoes: Embargoes** are when a country–or several countries–officially ban the trade of specified goods and services with another country. Governments may take this measure to support their specific political or economic goals.
- **Sanctions:** Countries impose sanctions on other countries to limit their trade activity. Sanctions can include increased administrative actions–or additional customs and trade procedures–that slow or limit a country's ability to trade.
- **Voluntary Export Restraints:** Exporting countries sometimes use voluntary export restraints. Voluntary export restraints set limits on the number of goods and services a country can export to specified countries. These restraints are typically based on availability and political alliances.

11.9 TARIFF RATE QUOTAS

A tariff-rate quota (TRQ) combines the idea of a tariff with that of a quota. The typical TRQ will set a low tariff for imports of a fixed quantity and a higher tariff for any imports that exceed that initial quantity. In a legal sense and at the WTO, countries are allowed to combine the use of two tariffs in the form of a TRQ, even when they have agreed not to use strict import quotas. In the United States, important TRQ schedules are set for beef, sugar, peanuts, and many dairy products. In each case, the initial tariff rate is quite low, but the over-quota tariff is prohibitive or close to prohibitive for most normal trade.

11.10 VOLUNTARY EXPORT RESTRAINT (VER)

Explicit import quotas used to be quite common in agricultural trade. They allowed governments to strictly limit the number of imports of a commodity and thus to plan on a particular import quantity in setting domestic commodity programs. Another common non-tariff barrier (NTB) was the so-called "voluntary export restraint" (VER) under which exporting countries would agree to limit shipments of a commodity to the importing country, although often only under threat of some even more restrictive or onerous activity. In some cases, exporters were willing to comply with a VER because they were able to capture economic benefits through higher prices for their exports in the importing country's market.

11.11 ISSUES

In the Uruguay round of the GATT/WTO negotiations, members agreed to drop the use of import quotas and other non-tariff barriers in favor of tariff-rate quotas. Countries also agreed to gradually lower each tariff rate and raise the quantity to which the low tariff applied. Thus, over time, trade would be taxed at a lower rate and trade flows would increase.

Given current U.S. commitments under the WTO on market access, options are limited for U.S. policy innovations in the 2002 Farm Bill is a vis tariffs on agricultural imports from other countries. Providing higher prices to domestic producers by increasing tariffs on agricultural imports is not permitted. In addition, particularly because the U.S. is a net exporter of many agricultural commodities, successive U.S. governments have generally taken a strong position within the WTO that tariff and TRQ barriers need to be reduced.

11.12 NON-TARIFF TRADE BARRIERS

Countries use many mechanisms to restrict imports. A critical objective of the Uruguay Round of GATT negotiations, shared by the U.S., was the elimination of non-tariff barriers to trade in agricultural commodities (including quotas) and, where necessary, to replace them with tariffs -- a process called Tariffication. Tariffication of agricultural commodities was largely achieved and viewed as a major success of the 1994 GATT agreement. Thus, if the U.S. honours its GATT commitments, the utilization of new non-tariff barriers to trade is not really an option for the 2002 Farm Bill.

11.13 DOMESTIC CONTENT REQUIREMENTS

Governments have used domestic content regulations to restrict imports. The intent is usually to stimulate the development of domestic industries. Domestic content regulations typically specify the percentage of a product's total value that must be produced domestically in order for the product to be sold in the domestic market (Carbaugh). Several developing countries have imposed domestic content requirements to foster agricultural, automobile, and textile production. They are normally used in conjunction with a policy of import substitution in which domestic production replaces imports.

Domestic content requirements have not been as prevalent in agriculture as in some other industries, such as automobiles, but some agricultural examples illustrate their effects. Australia used domestic content requirements to support leaf tobacco production. In order to pay a relatively low import duty on imported tobacco, Australian cigarette manufacturers were required to use 57 percent domestic leaf tobacco. Member countries of trade agreements also use domestic content rules to ensure that non-members do not manipulate the agreements to circumvent tariffs. For example, North American Free Trade Agreement (NAFTA) rules of origin provisions stipulate that all single-strength citrus juice must be made from 100 percent NAFTA origin fresh citrus fruit.

11.14 IMPORT LICENSES

Import licenses have proved to be effective mechanisms for restricting imports. Under an import-licensing scheme, importers of a commodity are required to obtain a license for each shipment they bring into the country. Without explicitly utilizing a quota mechanism, a country can simply restrict imports on any basis it chooses through its allocation of import licenses. Prior to the implementation of NAFTA, for example, Mexico required that wheat and other agricultural commodity imports be permitted only under license. Elimination of import licenses for agricultural commodities was a critical objective of the Uruguay Round of GATT negotiations and thus the use of this mechanism to protect U.S. agricultural producers is unlikely an option for the 2002 Farm Bill.

11.15 IMPORT STATE TRADING ENTERPRISES

Import State Trading Enterprises (STEs) are government owned or sanctioned agencies that act as partial or pure single buyer importers of a commodity or set of commodities in world markets. They also often enjoy a partial or pure domestic monopoly over the sale of those commodities. Current important examples of import STEs in world agricultural commodity markets include the Japanese Food Agency (barley, rice, and wheat), South Korea’s Livestock Products Marketing Organization, and China’s National Cereals, Oil and Foodstuffs Import and Export Commission (COFCO).

STEs can restrict imports in several ways. First, they can impose a set of implicit import tariffs by purchasing imports at world prices and offering them for sale at much higher domestic prices. The difference between the purchase price and the domestic sales price simply represents a hidden tariff. Import STEs may also implement implicit general and targeted import quotas or utilize complex and costly implicit import rules that make importing into the market unprofitable.

Recently, in a submission to the current WTO negotiations, the United States targeted the trade restricting operations of import and export STEs as a primary concern. A major problem with import STEs is that it is quite difficult to estimate the impacts of their operations on trade, because those operations lack transparency. STEs often refuse to provide the information needed to make such assessments, claiming that such disclosure is not required because they are quasi-private companies. In spite of these difficulties, the challenges provided by STEs will almost certainly continue to be addressed through bilateral and multilateral trade negotiations rather than in the context of domestic legislation through the 2002 Farm Bill.

11.16 TECHNICAL BARRIERS TO TRADE

All countries impose technical rules about packaging, product definitions, labelling, etc. In the context of international trade, such rules may also be used as non-tariff trade barriers. For example, imagine if Korea were to require that oranges sold in the country be less than two inches in diameter. Oranges grown in Korea happen to be much smaller than Navel oranges grown in California, so this type of "technical" rule would effectively ban the sales of California oranges and protect the market for Korean oranges. Such rules violate WTO provisions that require countries to treat imports and domestic products equivalently and not to advantage products from one source over another, even in indirect ways. Again, however, these issues will likely be dealt with through bilateral and multilateral trade negotiations rather than through domestic Farm Bill policy initiatives.

11.17 EXCHANGE RATE MANAGEMENT POLICIES

Some countries may restrict agricultural imports through managing their exchange rates. To some degree, countries can and have used exchange rate policies to discourage imports and encourage exports of all commodities. The exchange rate between two countries' currencies is simply the price at which one currency trades for the other. For example, if one U.S. dollar can be used to purchase 100 Japanese yen (and vice versa), the exchange rate between the U.S. dollar and the Japanese yen is 100 yen per dollar. If the yen depreciates in value relative to the U.S. dollar, then a dollar is able to purchase more yen. A 10 percent depreciation or devaluation of the yen, for example, would mean that the price of one U.S. dollar increased to 110 yen.

One effect of currency depreciation is to make all imports more expensive in the country itself. If, for example, the yen depreciates by 10 percent from an initial value of 100 yen per dollar, and the price of a ton of U.S. beef on world markets is $2,000, then the price of that ton of beef in Japan would increase from 200,000 yen to 220,000 yen. A policy that deliberately lowers the exchange rate of a country's currency will, therefore, inhibit imports of agricultural commodities, as well as imports of all other commodities. Thus, countries that pursue deliberate policies of undervaluing their currency in international financial markets are not usually targeting agricultural imports.

Some countries have targeted specific types of imports through implementing multiple exchange rate policy under which importers were required to pay different exchange rates for foreign currency depending on the commodities they were importing. The objectives of such programs have been to reduce balance of payments problems and to raise revenues for the government. Multiple exchange rate programs were rare in the 1990s, and generally have not been utilized by developed economies.

Finally, exchange rate policies are usually not sector specific. In the United States, they are clearly under the purview of the Federal Reserve Board and, as such, will not likely be a major issue for the 2002 Farm Bill. There have been many calls in recent congressional testimony, however, to offset the negative impacts caused by a strengthening US dollar with counter-cyclical payments to export dependent agricultural products.

11.18 THE PRECAUTIONARY PRINCIPLE AND SANITARY AND PHYTOSANITARY BARRIERS TO TRADE

The precautionary principle, or foresight planning, has recently been frequently proposed as a justification for government restrictions on trade in the context of environmental and health concerns, often regardless of cost or scientific evidence. It was first proposed as a household management technique in the 1930s in Germany, and included elements of prevention, cost effectiveness, and ethical responsibility to maintain natural systems (O'Riordan and Cameron). In the context of managing environmental uncertainty, the principle enjoyed a resurgence of popularity during a meeting of the U.N. World Charter for Nature (of which the U.S. is only an observer) in 1982. Its use was re-endorsed by the U.N. Convention on Biodiversity in 1992, and again in Montreal, Canada in January 2000.

The precautionary principle has been interpreted by some to mean that new chemicals and technologies should be considered dangerous until proven otherwise. It therefore requires those responsible for an activity or process to establish its harmlessness and to be liable if damage occurs. Most recent attempts to invoke the principle have cited the use of toxic substances, exploitation of natural resources, and environmental degradation. Concerns about species extinction, high rates of birth defects, learning deficiencies, cancer, climate change, ozone depletion, and contamination with toxic chemicals and nuclear materials have also been used to justify trade and other government restrictions on the basis of the precautionary principle. Thus, countries seeking more open trading regimes have been concerned that the precautionary principle will simply be used to justify nontariff trade barriers. For example, rigid adherence to the precautionary principle could lead to trade embargoes on products such as genetically modified oil seeds with little or no reliance on scientific analysis to justify market closure.

Sometimes, restrictions on imports from certain places are fully consistent with protecting consumers, the environment, or agriculture from harmful diseases or pests that may accompany the imported product. The WTO Sanitary and Phytosanitary (SPS) provisions on technical trade rules specifically recognize that all countries feel a responsibility to secure their borders against the importation of unsafe products. Prior to 1994, however, such barriers were often simply used as excuses to keep out a product for which there was no real evidence of any problem. These phony technical barriers were just an excuse to keep out competitive products.

The current WTO agreement requires that whenever a technical barrier is challenged, a member country must show that the barrier has solid scientific justification and restricts trade as little as possible to achieve its scientific objectives. This requirement has resulted in a number of barriers being relaxed around the world. It should be emphasized that WTO rules do not require member countries to harmonize rules or adopt international standards -- only that there must be some scientific basis for the rules that are adopted. Thus, any options for sanitary and Phyto-sanitary initiatives considered in the 2002 Farm Bill must be based on sound science and they do not have to be harmonized with the initiatives of other countries.

LET US SUM UP

In this unit, you have learnt about the Tariffs are widely used to protect domestic producers' incomes from foreign competition. This protection comes at an economic cost to domestic consumers who pay higher prices for import-competing goods, and to the economy as a whole through the inefficient allocation of resources to the import competing domestic In International Business Tariff Barriers are related taxes imposed by Governments to control Import Export of one or more products with a particular country. Non-tariff barriers are government policies and actions other than tariff barriers.

CHECK YOUR PROGRESS

Choose the correct answer

1. Which of the following is not an example of sanitary and phytosanitary barrier to trade?

a) Level of pesticide residue in agricultural produce
b) Possibility of imported food causing disease in local population.
c) Addictive nature of a beverage.
d) None of the above

2.Price discrimination may be possible when

a) The nature of the commodity or service is such that there is no possibility of transference from one market to other.
b) The markets are separated by large distance or traffic barriers.
c) Several groups of buyers require the same service from clearly differentiated commodities.
d) Buyers are well informed and rational

3.Which of the statements given above are correct?

a. 1 and 2 only
b. 1,3, and 4
c. 2 and 3 only
d. 1, 2, and 3

4 .Which of the following is not a non-tariff barrier?

a) A quota on apparel.
b) A tax equal to 12% of value on imported oil.
c) A voluntary export restraint on cars.
d) A regulation requiring government agencies to favour domestically producers.

5.With reference to import tariffs, consider the following statements:

1. Domestic consumers benefit from the imposition of import tariffs.
2. Imposition of tariffs on imported products increase the level of competition in the economy.

Which of the statements given above is/are correct?

a. 1 only
b. 2 only

c. Both 1 and 2
d. Neither 1 nor 2

6.. Consider the following statements:

1. Infant industry argument is advocated in support of protectionism in international trade.
2. Infant industries require time to undergo the process of learning-by-doing to become competitive in the long run.

Which of the statements given above is/are correct?

a. 1 only
b. 2 only
c. Both 1 and 2
d. Neither 1 nor 2

GLOSSARY

Precautionary	:	Any measure, other than a customs tariff, that acts as a barrier to international trade.
Non-tariff Barrier	:	Is a trade restriction–such as a quota, embargo or sanction–those countries use to further their political and economic goals
Tariff rate quotas	:	It permits the import of a certain quantity of a commodity duty-free or at a lower duty rate, while quantities exceeding the quota are subject to a higher duty rate.
Technical barriers	**:**	The Technical Barriers to Trade (TBT) Agreement aims to ensure that technical regulations, standards, and conformity assessment procedures are non-discriminatory and do not create unnecessary obstacles to trade.
Voluntary Export Restraint	**:**	**T**he arrangements between exporting and importing countries in which the exporting country agrees to limit the quantity of specific exports below a certain level in order to avoid imposition of mandatory restrictions by the importing country.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. John D. Daniels and Lee H. Radebaugh (2010), International Business, Pearson Education Asia, New Delhi, 13th edition.
3. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.

WEB RESOURCES

1. Tariff And Non Tariff Barriers - YouTube
2. Trade Barriers - YouTube
3. What are non-tariff trade barriers? - YouTube
4. Pros and Cons of Free Trade - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1. d 2. d 3.b 4.d 5.c

UNIT 12

FOREIGN EXCHANGE MARKET

STRUCTURE

OVERVIEW

In this unit you have learnt about the movements in foreign exchange and interest rates and their impact on trade and investment flow and functions of foreign exchange market and its types, objectives and importance of foreign exchange market and the factors affect the foreign exchange rate.

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- determine the foreign exchange rate fluctuations.
- evaluate the optimal time for international money transfer.
- evaluate the factors that affect foreign exchange rate.
- discuss about the functions of foreign exchange market.

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12.1 INTRODUCTION OF FOREIGN EXCHANGE

As Kindle-Berger put, "the foreign exchange market is a place where foreign currencies are bought and sold." Foreign exchange market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies. Importers buy them. The foreign exchange market is merely a part of the money market in the financial centres. It is a place where foreign moneys are bought and sold. The buyers and sellers of claim on foreign currencies and the intermediaries together constitute a foreign exchange market. It is not restricted to any given country or a geographical area. Thus, the foreign exchange market is the market for a national currency (foreign money) anywhere in the world, as the financial centres of the world are united in a single market.

There is a wide variety of dealers in the foreign exchange market. The most important among them are the banks. Banks dealing in foreign exchange have branches with substantial balances in different countries. Through their branches and correspondents, the services of such banks, usually called "Exchange Banks," are available all over the world.

These banks discount and sell foreign bills of exchange, issue bank drafts, effect telegraphic transfers and other credit instruments, and discount and collect amounts on the basis of such documents. Other dealers in foreign exchange are bill brokers who help sellers and buyers in foreign bills to come together. They are intermediaries and unlike banks are not direct dealers.

Acceptance houses are another class of dealers in foreign exchange. They help effect foreign remittances by accepting bills on behalf of customers. The central bank and treasury of a country are also dealers in foreign exchange. Both may intervene in the market occasionally. Today, however, these authorities manage exchange rates and implement exchange controls in various ways. In India, however, where there is a strict exchange control system, there is no foreign exchange market as such.

12.2 DEFINITION OF FOREIGN EXCHANGE

"Foreign Exchange Control" is a method of state intervention in the imports and exports of the country, so that the adverse balance of payments may be corrected". Here the government restricts the free play of inflow and outflow of capital and the exchange rate of currencies.

According to Crowther: "When the Government of a country intervenes directly or indirectly in international payments and undertakes the authority of purchase and sale of foreign currencies it is called Foreign Exchange Control".

According to Haberle: "Foreign Exchange Control in the state regulation excluding the free play of economic forces for the Foreign Exchange Market". The Government regulates the Foreign Exchange dealings by Consideration of national needs.

"Foreign Exchange Control means the monopoly of the government in the purchase and sale of foreign currencies in order to restore the balance of payments equilibrium and disregard the market forces in the decision of monetary authority". When tariffs and quotas do not help in correcting the adverse balance of trade and balance of payments the system of Foreign Exchange Control is restored to by Governments.

12.3 FACTORS THAT AFFECT FOREIGN EXCHANGE RATES

Foreign Exchange rate (Forex rate) is one of the most important means through which a country's relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analysed. If you are thinking of sending or receiving money from overseas, you need to keep a keen eye on the currency exchange rates.

The exchange rate is defined as "the rate at which one country's currency may be converted into another." It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. For these reasons, when sending or receiving money internationally, it is important to understand what determines exchange rates.

- **Inflation Rates:** Changes in market inflation cause changes in currency exchange rates. A country with a lower inflation rate than another will see an appreciation in the value of its currency. The prices of goods and services increase at a slower rate where the inflation is low. A country with a consistently lower inflation rate exhibits a rising currency value while a country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates.

- **Interest Rates:** Changes in interest rate affect currency value and dollar exchange rate. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates provide higher rates to lenders, thereby attracting more foreign capital, which causes a rise in exchange rates.
- **Country's Current Account / Balance of Payments:** A country's current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt, etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.
- **Government Debt:** Government debt is public debt or national debt owned by the central government. A country with government debt is less likely to acquire foreign capital, leading to inflation. Foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate will follow.
- **Terms of Trade:** Related to current accounts and balance of payments, the term of trade is the ratio of export prices to import prices. A country's terms of trade improves if its exports prices rise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.
- **Political Stability &Performance:** A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency. A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see a depreciation in exchange rates.

- **Recession: When** a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.
- **Speculation:** If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well.

12.4 IMPORTANT FUNCTIONS OF A FOREIGN EXCHANGE MARKET

- To transfer finance, purchasing power from one nation to another. Such transfer is affected through foreign bills or remittances made through telegraphic transfer. (Transfer Function).
- To provide credit for international trade. (Credit Function).
- To make provision for hedging facilities, i.e., to facilitate buying and selling spot or forward foreign exchange. (Hedging Function).

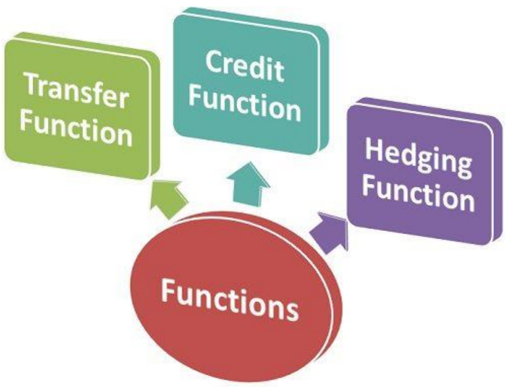

Fig.12.1

12.4.1Transfer Function

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is affected through a variety of credit instruments, such as telegraphic transfers, bank draft and foreign bills. In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

For example, If the exporter of India import goods from the USA and the payment is to be made in dollars, then the conversion of the rupee to the dollar will be facilitated by FOREX. The transfer function is performed through a use of credit instruments, such as bank drafts, bills of foreign exchange, and telephone transfers.

12.4.2 Credit Function

Another function of the foreign exchange market is to provide credit, both national and international, to promote foreign trade. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required. FOREX provides a short-term credit to the importers so as to facilitate the smooth flow of goods and services from country to country. An importer can use credit to finance the foreign purchases. Such as an Indian company wants to purchase the machinery from the USA, can pay for the purchase by issuing a bill of exchange in the foreign exchange market, essentially with a three-month maturity.

12.4.3 Hedging Function

A third function of the foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk. In a free exchange market when exchange rate, i. e., the price of one currency in terms of another currency, change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money.

Exchange risk as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future at a price agreed upon now. No money passes at the time of the contract. But the contract makes it possible to ignore any likely changes in exchange rate. The existence of a forward market thus makes it possible to hedge an exchange position.

Foreign bills of exchange, telegraphic transfer, bank draft, letter of credit, etc., are the important foreign exchange instruments used in the foreign exchange market to carry out its functions.

12.5 OBJECTIVES OF FOREIGN EXCHANGE CONTROL

Important objectives of Exchange Control are as follows:

- **Correcting Balance of Payments:** The main purpose of exchange control is to restore the balance of payments equilibrium, by allowing the imports only when they are necessary in the interest of the country and thus limiting the demands for foreign exchange up to the available resources. Sometimes the country devalues its currency so that it may export more to get more foreign currency.
- **To Protect Domestic Industries:** The Government in order to protect the domestic trade and industries from foreign competitions, resort to exchange control. It induces the domestic industries to produce and export more with a view to restrict imports of goods.
- **To Maintain an Overvalued Rate of Exchange:** This is the principal object of exchange control. When the Government feels that the rate of exchange is not at a particular level, it intervenes in maintaining the rate of exchange at that level. For this purpose, the Government maintains a fund, may be called Exchange Equalization Fund to peg the rate of exchange when the rate of particular currency goes up, the Government start selling that particular currency in the open market and thus the rate of that currency falls because of increased supply. On the other hand, the Government may overvalue or undervalue its currency on the basis of economic forces. In over valuing, the Government increases the rate of its currency in the value of other currencies and in under-valuing; the rate of its over-currency is fixed at a lower level.
- **To Prevent Flight of Capital:** When the domestic capital starts flying out of the country, the Government may check its exports through exchange control.
- **Policy of Differentiation:** The Government may adopt the policy of differentiation by exercising exchange control. If the Government may allow international trade with some countries by releasing the required foreign currency the Government may restrict the trade import and exports with some other countries by not releasing the foreign currency.
- **Other Objectives:** Apart from the above there may be certain other objectives of exchange control. They are:

- ✓ To earn revenue in the form of difference between selling and purchasing rates of foreign exchange.
- ✓ To stabilise the exchange rates.
- ✓ To make imports of preferable goods possible by making the necessary foreign exchange available.
- ✓ To pay off foreign liabilities with the help of available foreign exchange resources.

12.6 TYPES OF FOREIGN EXCHANGE MARKET

There are two foreign exchange markets: (a) the retail market and (b) the interbank market.

12.6.1 Retail Market

In the retail foreign exchange market, the individual and firms who require foreign currency can buy it and those who have acquired foreign currency can sell it. The commercial banks dealing in foreign exchange serve their customers by purchasing foreign exchange from some and selling foreign exchange to other. Thus, each bank acts as a clearing house where purchases of exchange can be offset by sales of foreign exchange.

12.6.2 Interbank Market

Interbank foreign exchange market serves to smoothen the excessive purchases or sales made by individual banks. At times, the quantity of foreign exchange supplied exceeds the quantity demanded, or vice versa. When such an imbalance occurs, the exchange rate changes. If the foreign exchange is in excess supply, the exchange rate falls; if the foreign exchange is in excess demand, the exchange rate rises, the movement in the exchange rate helps to correct the situation by encouraging or discouraging additional buyers and sellers into or from the market.

12.7 FOREIGN EXCHANGE RATE: CONCEPT AND TYPES

There are two foreign exchange rates: 1. Concept of Foreign Exchange Rate 2. Types of Foreign Exchange Rate.

12.7.1 Concept of Foreign Exchange Rate

Foreign exchange rate is the price at which one currency can be converted into another. It represents the rate at which a firm may exchange one currency for another. Thus, the exchange rate is simply the amount of a nation’s currency that can be bought at a given time for a specified amount of the currency of another country. The actual amount received in conversion or the effective exchange rate, usually differs from the stated rate because it takes into account all taxes, commissions and other costs that the public must pay to complete the transaction and actually receive the foreign funds.

12.7.2 Types of Foreign Exchange Rate

a. Fixed and Floating Rates: When Government of a country fixes the rate of exchange for its own currency, it is termed as 'Fixed Exchange Rate'. This is also known as official rate of exchange. Fixed exchange rates are fixed by the respective Governments from time to time for the betterment of their economy. In contrast exchange rates move, as in any other market place, depending on the demand and supply pressure and are further influenced by the market forces and economic conditions of the respective countries. Floating exchange rate may be free floating or a managed floating. A currency is freely floating if there does not exist a system of fixed exchange rates and if the Central Bank of the country in question does not attempt to influence the value of the currency. In most of the countries Governments attempt to influence movements of exchange rate either through direct intervention in the exchange market or through a mix of fiscal and monetary policies. Under such circumstances, floating is called as 'managed' or 'dirty float'.

A number of countries use a pegged float as a system of exchange rates. The value of one currency is pegged to the value of another currency that itself floats. In a joint float, currencies in a particular group have a fixed exchange value in terms of each other, but the group of currencies floats in relation to other currencies outside the group.

The fixed exchange rate system has inbuilt advantage of simplifying exchange transactions. It imbibes self-discipline for economic policies by participating countries. In India the exchange rate regime of rupee has evolved over a period of time moving in the direction of less exchange controls and current account accountability. The RBI manages the exchange rate of the rupee.

In recent few years the RBI has been very actively intervening in the market to hold the rupee-dollar rates within tight bounds while rupee rates in relation to other currencies fluctuate in correspondence with the fluctuation of this US dollar against them. In addition, the RBI took several measures to relax exchange control and liberalize foreign trade.

b. Spot and Forward Rates: Spot rates refer to those rates which are applicable on the day of transaction in which physical delivery is made within two working days after the date of transaction the spot exchange between two currencies should be the same across the various banks engaged in rendering foreign exchange services.

In case of large discrepancy customers or other banks would buy large amounts of a currency from whatever banks quoting relatively low price and sell the same immediately to a bank quoting a relatively high price. This will cause adjustments in the exchange rate quotations that would offset the existing discrepancy.

In Forward rates, exchange rates are fixed in advance for a transaction which matures at some specified future date. The exchange at the date in future will be at the price agreed upon now. Foreign exchange rates are function of forward demand and forward supply of various currencies.

A foreign currency is said to be at a forward premium if its future value exceeds its present value in terms of domestic currency and it is said to be at discount if the reverse is true. For example, spot rate between rupees and dollar is S (Rs/$) = Rs. 45.50- and three-months forward is F3 (Rs. /$) = Rs. 46.70/$; these rates signify that dollar is at a premium and rupee is at discount in the forward. Forward exchange rates are quoted on most major currencies for different maturities. Standard maturities quoted by banks are of 1, 3, 6, 9 and 12 months. Maturities beyond one year are now becoming more common. Maturity extending to 5 and beyond 5 years is also possible for good bank customers.

12.8 TYPES OF FOREIGN EXCHANGE CONTROL

There may be five types of Exchange Control:

12.8.1 Mild System of Exchange Control

Under mild system of exchange control, also known as exchange pegging, the Government intervenes in maintaining the rate of exchange at a particular level. Under this system, the Government maintains on 'Exchange Equalization Fund' in foreign currencies. The British Exchange Equalization Account and U.S. Exchange Stabilisation Fund were two examples of mild control. In case the demand for dollar goes up and as a result the value of pound falls, the U.K. Government would sell dollars for pounds and thus restrict the fall in the value of pound by increasing the supply of dollars.

12.8.2 Full Fledged System of Exchange Control

Under this system, the Government does not only Peg the Rate of Exchange but have complete control over the entire foreign exchange transactions. All receipts from exports and other transactions are surrendered to the control authority i.e., Reserve Bank of India. The available supply of foreign exchange is then allocated to different buyers of foreign exchanges on the basis of certain pre-determined criteria. In this way the Government is the sole dealer in foreign exchange.

12.8.3 Compensating Arrangement

Compensating arrangement per-takes of the character of the old-fashioned barter deal. An example would be the sale by India of cotton goods of a particular value to Pakistan, the latter agreeing to supply raw cotton of the same value to India at a mutually agreed exchange rate. Imports thus compensate for exports, leaving no balance requiring settlement in foreign exchange.

12.8.4 Clearing Agreement

A clearing agreement consists of an understanding by two or more countries to buy and sell goods and services to each other, at mutually agreed exchange rates against payments made by buyers entirely in their own currency. The balance of outstanding claims are settled as between the central banks at the end of stipulated periods either by transfers of gold or of an acceptable third currency, or the balance might be allowed to accumulate for another period, pending an arrangement whereby the creditor country works of the balance by extra purchases from the other country.

12.8.5 Payments Arrangements

In a payments arrangement the usual procedure of making foreign payments through the exchange market is left intact. But each country agrees to establish a method of control whereby its citizens are forced to purchase goods and services from the other country in amounts equal to the latter's purchase from the first country. Another type of payments agreement is one designed to collect past debts.

12.9 CONDITIONS NECESSITATING FOREIGN EXCHANGE CONTROL

The exchange control device is not effective in all cases. Only in selective cases, this measure of curbing imports is effective. The following are conditions where exchange control can be resorted:

- The exchange control is necessary and should be adopted to check the flight of capital. This is especially important when a country's currency is under speculative pressure. In such cases tariffs and quotas would not be effective. Exchange control being direct method would successfully present the flight of capital of hot money.
- Exchange control is effective only when the balance of payment is disturbed due to some temporary reasons such as fear of war, failure of crops or some other reasons. But if there are some other underlying reasons, exchange control device would not be fruitful.
- Exchange Control is necessary when the country wants to discriminate between various sources of supply. Country may allow foreign exchange liberally for imports from soft currency area and imports from hard currency areas will be subject to light import control. This practice was adopted after Second World War due to acute dollar shortage.
- Even in India, many import licenses were given for use in rupee currency areas only, i.e., countries with which India had rupee-trade arrangements. Thus, in above cases, the exchange control is adopted. In such cases quotas and tariffs do not help in restoring balance of payment equilibrium.

12.10 EXCHANGE RATE MOVEMENT AND FOREIGN DIRECT INVESTMENT IN ASEAN ECONOMIES

Foreign direct investment (FDI) is an international flow of capital that provides a parent company or multinational enterprises (MNEs) with control over foreign affiliates. Since the early 1980s, FDI is increasingly recognised as an important instrument for resource to flow across national borders to improve economic performance, industrial and international competitiveness, and exports. In a perfectly competitive economy, there would be no FDI but researchers now tend to use imperfect and asymmetric information of the market characteristics to explain FDI flows. Given these significant roles of FDI, several studies have tried to determine the factors that influence FDI inflows into countries regardless of what the markets are One of the factors that recently has been a source of debate is the exchange rate.

FDI theory based on exchange rate analyses the relationship of FDI flows and exchange rate changes. The existing literature has conflicting issues, with some studies supporting the significant relationship whilst others reject it. The direction of the relationship between FDI and exchange rate also varies with some findings showing a positive effect of exchange rate on FDI and other findings suggesting a negative effect. The objective of the FDI, cost reduction, and FDI as a tool for exchange rate risk are some of the explanations behind the issue.

FDI has played a larger role in the ASEAN region, and this role has become more significant since the mid-1980s. Each of ASEAN countries has also provided investment incentives, which have indirectly increased competition among the ASEAN countries to attract FDI.

Even though most of the Southeast Asian countries adopt the managed floating exchange rate regime, MNEs may still have to face the exchange rate risk in these countries which may affect the MNEs investment value in the future due to the level of competitiveness among the countries through their level of foreign exchange rate. Therefore, it is to investigate the relationship between the foreign exchange rate movements and the foreign investment inflows among the selected ASEAN countries (Malaysia, the Philippines, Singapore, and Thailand).

Contrary to the existing empirical studies in ASEAN countries that examine the relationship between FDI and exchange rate, our study takes the issue of the real value of the exchange rate and FDI in our testing analysis seriously. Analysing the exchange rate at the real value is important in these countries because the managed floating exchange rate represents significant government intervention in managing the exchange rate at certain ranges. Therefore, the real value of the exchange rate may show the true level of competitiveness of the country in the world market.

LET US SUM UP

In this unit you have learnt about the Movements in Foreign Exchange and Interest rates and their impact on Trade and Investment flow and also learnt about the various functions of the Foreign Exchange Market. This market determines foreign exchange rates for every currency. It includes all aspects of buying, selling and exchanging currencies at current or determined prices. The main functions of the market are to (1) facilitate currency conversion, (2) provide instruments to manage foreign exchange risk (such as forward exchange), and (3) allow investors to speculate in the market for profit.

CHECK YOUR PROGRESS

Choose the correct answer

1.The objective of trading in foreign exchange by a dealer of a bank is to-

a. make profit out of exchange rate fluctuations

b. insulate the bank from exchange rate changes
c. comply with exchange control regulations
d. none of the above

2.The system under which maintenance of external value of the currency at a predetermined level is

a. fixed exchange rate
b. floating exchange rate
c. gold standard
d. par value system

3.The purchase or sale of foreign exchange by the central bank of the country to influence the exchange rate is known as ----

a. Appreciation
b. Official intervention
c. Depreciation
d. Inflation

4.IMF classifies Indian currency system as

a. Currency Board Arrangements
b. Independently floating
c. Managed floating with no predetermined path for the exchange rate
d. Exchange rates within crawling banks

5.The price of one currency in terms of another is known as __________

a. Foreign exchange rate
b. Trade rate
c. Interest rate
d. Balance of Payment

GLOSSARY

Inflation : IT measures the rate of change in prices of goods and services over a given period. ... An increase in inflation indicates prices are quickly rising and if the rate of inflation decreases, the prices of goods and services are increasing at a slower rate.

Speculation : "Speculation" in Foreign Exchange is an act of buying and selling the foreign currency under the conditions of uncertainty with a view to earning huge gains. Often, the speculators buy the currency when it is weak and sells when it is strong.

Recession : A recession also increases volatility in the currency markets, leading to even more trading opportunities.

Floating : A floating exchange rate is a regime where the currency price of a nation is set by the forex market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate, in which the government entirely or predominantly determines the rate.

Foreign exchange Control : These controls allow countries to better stabilize their economies by limiting in-flows and out-flows of currency, which can create exchange rate volatility.

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3. Currency Exchange Rates Explained | Foreign Exchange| INR vs USD | Tamil - YouTube
4. What is Inflation in Tamil | Inflation | Types of Inflation - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.a 2. a 3.b 4.c 5.a

BLOCK 5

CONFLICT AND ARBITRAL TRIBUNAL IN INTERNATIONAL BUSINESS

UNIT 13

CONFLICT IN INTERNATIONAL BUSINESS

STRUCTURE

Check your Progress

Glossary

Suggested Readings

Answers to Check Your Progress

OVERVIEW

In this unit, you are going to learn about the conflict in international business will crash between in individuals arising out of a difference in process and attitudes. To influence of emotions in the conflicts and the uses of range in conflict strategies to develop a greater awareness of the role of power in conflicts for the values and ethics to conflict the resolution and also learnt about the methods of dispute resolutions.

LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Identify the types of conflict management styles.
- analyse, and understand the key practical and theoretical concepts of managing and resolving conflicts.
- understand the role of goals in conflict.
- develop a greater awareness of the role of power in conflicts.
- identify the influence of emotions in the conflicts.
- understand and use of a range of conflict strategies.

13.1 CONFLICT IN INTERNATIONAL BUSINESS

Conflict is actual or perceived opposition of needs, values and interests. A conflict can be internal (within oneself) (individuals). Conflict as a concept can help explain many aspects of social life such as social disagreement, conflicts of interests, and fights between individuals, groups, or organizations. In political terms, "conflict" can refer to wars, revolutions or other struggles, which may involve the use of force as in the term armed conflict.

13.2 CONFLICT MANAGEMENT

Conflict management refers to the long-term management of intractable conflicts. It is the label for the variety of ways by which people handle grievances—standing up for what they consider to be right and against what they consider to be wrong. Those ways include such diverse phenomena as gossip, ridicule, lynching, terrorism, warfare, feuding, genocide, law, mediation, and avoidance. Which forms of conflict management will be used in any given situation can be somewhat predicted and explained by the social structure—or social geometry— of the case.

Organizations face a great deal of conflict within and externally while doing business. Experts agree that managing conflicts can be actually quite challenging. International businesses use five distinct forms of solutions to solve conflicts. These are − avoidance, accommodation, competition, compromise, and collaboration.

13.2.1 The Avoidance Strategy

The avoidance strategy tends to ignore the conflict. Therefore, it provides no resolution to the disagreement. The real source of the conflict is never addressed which leaves the situation unresolved. This ultimately drives the organization away from the work at hand and makes the conflict worse than its initial state.

13.2.2 The Accommodation Strategy

The accommodation strategy believes in handling a problem as quickly as possible. in such a strategy, one party accepts the other's demands. Since one party usually gets ignored, it causes an ineffective attempt at conflict management. It only shows that the dominant party continues to rule over the compliant party. This strategy leaves the analysis to conclude the reasons and necessity of a mutual resolution.

13.2.3 Competition

It occurs as both parties attempt to maximize their own agenda. Competition can quickly escalate into greed. It does not offer the parties an opportunity to benefit the organization. This strategy often becomes ineffective since the two parties are more concerned about winning than arriving at the best possible solution.

13.2.4 Compromise

This is preferably a good strategy, as both parties involved in the process are willing to give and take. They are concerned about their own ambitions, yet at the same time, they pay heed to the objectives of the organization. Each party involved in a compromise fully understands and works for the best interest of the organization.

13.2.5. The Collaboration Strategy

The collaboration Strategy starts with the manager taking a preliminary initiative step in handling the issue already set. Each party wants to solve the problem by cultivating a pleasing solution leading to a win-win situation. The international managers however must understand the “internal environment in which the organization members function” to make use of this strategy. The collaboration strategy is both assertive and cooperation; yet it smoothly takes the different points of view into consideration. Collaboration is the most effective and efficient form of conflict management.

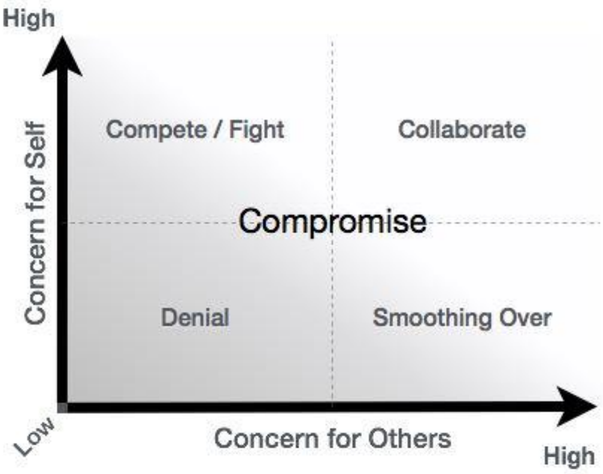

Fig.13.1

13.3 FIVE A’S TECHNIQUE

Boris off and Victor identify five steps in the conflict management process that they called the "five A's" of conflict management − Assessment, Acknowledgement, Attitude, Action, and Analysis.

13.3.1 Assessment

In the assessment step, the parties involved collect real information about the problem. The parties involved also choose the appropriate conflict-handling modes and decide the central factors of the problem. They also indicate compromise-able areas, and the wants of each party.

13.3.2 Acknowledgement

The acknowledgement step allows each party to hear out the other and both parties to build the empathy needed for the solution. Acknowledgement is more than just responding; it involves actively encouraging the other party to communicate.

13.3.3 Attitude

In the attitude step, parties try to remove pseudo-conflict issues. Stereotypes of different, culturally based behaviours are unearthed. Similarly, differences in communication of men and women are accepted. Generally, we can analyse problems from the styles of writing, speaking, and other nonverbal cues.

13.3.4 Action

This step includes implementation of the chosen conflict-handling mode. Each individual evaluates the opposite party's behaviour to ascertain potential trouble spots. Also, each individual stays aware of his own communication style and general behaviour. Finally, all parties become alert to new issues and look for productive solutions.

13.3.5 Analysis

In this last step, participants decide on actions, and find the gist of what they have agreed upon. The analysis step initiates the impetus for approaching conflict management as an on-going process.

13.4 TYPES OF CONFLICT

- Community conflict.
- Diplomatic conflict.
- Environmental resources conflict.
- External conflict.
- Interpersonal conflict.
- Organizational conflict.
- Intra-societal conflict.
- Military conflict.
- Religious-based conflict.
- Workplace conflict.
- Relationship conflict

Conflict also defines as natural disagreement resulting from individuals or groups that differ in beliefs, attitudes, values or needs. It can also originate from past rivalries and personality differences. Other causes of conflict include trying to negotiate before the timing is right or before needed information is available. Conflicts in an organization can arise due to multiple reasons, based on which they can be categorized into different types.

- **On the basis of involvement:** Conflicts may be personal (intrapersonal and interpersonal) and organizational. Organizational conflicts can be intra-organizational and inter-organizational. Inter-organizational conflicts occur between two or more organizations. Intra-organizational conflicts can be further divided into intergroup and intragroup conflict.
- **On the basis of scope:** Conflicts may be substantive and affective. An affective conflict deals with interpersonal aspects.

Substantive conflict is also called performance, task, issue, or active conflict. Procedural conflicts can include disagreements about the process of doing a job.

- **On the basis of results:** Conflicts can be constructive or destructive, creative or restricting, and positive or negative. Constructive conflicts are also known as functional conflicts, because they support the group goals and help in improving performance. Destructive conflicts are also known as dysfunctional conflicts, they prevent people from reaching their goals. Destructive conflicts take the attention away from other important activities, and involve negative behaviour and results, such as name-calling.
- **On the basis of sharing by groups:** Conflicts may be distributive and integrative. Distributive conflict is approached as a distribution of a fixed number of positive outcomes or resources. In an Integrative conflict, groups see the conflict as a chance to integrate the needs and concerns of both groups. It has a greater emphasis on compromise.
- **On the basis of Strategy:** Conflicts may be competitive and cooperative. Competitive conflict is accumulative. The original issue that began the conflict becomes irrelevant. Costs do not matter in competitive conflict. A cooperative conflict is of interest-based or integrative bargaining mode; it leads the parties involved to find a win-win solution.

13.5 FACTORS CAUSING CONFLICT

In an international business, there can be various factors behind a conflict –

- There can be conflicts over control of resource or area.
- Conflicts can arise over the right to participate in decision-making.
- No clear-cut goals of the organization can lead to conflicts.
- No clear-cut agreements and contracts may lead to a legal mess, causing conflict.
- Misleading communication may confuse and create conflicts.
- Corruption may also create conflicts.

13.6 SOURCES OF CONFLICT

- Communication failure.
- Personality conflict.
- Value differences.
- Goal differences.
- Methodological differences.
- Substandard performance.
- Lack of cooperation.
- Differences regarding authority.
- Differences regarding responsibility.
- Competition over resources.
- Non-compliance with rules.

13.7 CONFLICT RESOLUTION

Conflict resolution is a range of methods for alleviating or eliminating sources of conflict. The term "conflict resolution" is sometimes used interchangeably with the term dispute resolution or alternative dispute resolution. Processes of conflict resolution generally include negotiation, mediation, and diplomacy. The processes of arbitration, litigation, and formal complaint processes such as ombudsman processes, are usually described with the term dispute resolution, although some refer to them as "conflict resolution." Processes of mediation and arbitration are often referred to as alternative dispute resolution.

13.8 METHODS OF DISPUTE RESOLUTION INCLUDE

- Lawsuits (litigation)
- Arbitration
- Collaborative law
- Mediation
- Conciliation
- Many types of negotiation
- Facilitation

One could theoretically include violence or even war as part of this spectrum, but dispute resolution practitioners do not usually do so; violence rarely ends disputes effectively, and indeed, often only escalates them. Some individuals, notably Joseph Stalin, have stated that all problems emanate from man, and absent man, no problems ensue. Hence, violence could theoretically end disputes, but alongside it, life.

13.9 CONFLICT RESOLUTION PROCESSES

Adjudicative processes, such as litigation or arbitration, in which a judge, jury or arbitrator determines the outcome. Consensual processes, such as collaborative law, mediation, conciliation, or negotiation, in which the parties attempt to reach agreement.

- **A Lawsuit** is a civil action brought before a court of law in which a plaintiff, a party who claims to have received damages from a defendant's actions, seeks a legal or equitable remedy. The defendant is required to respond to the plaintiff's complaint. If the plaintiff is successful, judgment will be given in the plaintiff's favour, and a range of court orders may be issued to enforce a right, award damages, or impose an injunction to prevent an act or compel an act.
- **Arbitration**, a form of alternative dispute resolution (ADR), is a legal technique for the resolution of disputes outside the courts, wherein the parties to a dispute refer it to one or more persons (the "arbitrators", "arbiters" or "arbitral tribunal"), by whose decision (the "award") they agree to be bound. It is a settlement technique in which a third party reviews the case and imposes a decision that is legally binding for both sides. Other forms of ADR include mediation (a form of settlement negotiation facilitated by a neutral third party) and non-binding resolution by experts.
- **Collaborative Law** (also called Collaborative Practice, Collaborative Divorce, and Collaborative Family Law) was originally a family law procedure in which the two parties agreed that they would not go to court, or threaten to do so.
- **Mediation,** a form of alternative dispute resolution (ADR) or "appropriate dispute resolution", aims to assist two (or more) disputants in reaching an agreement. The parties themselves determine the conditions of any settlements reached— rather than accepting something imposed by a third party. The disputes may involve (as parties) states, organizations, communities, individuals or other representatives with a vested interest in the outcome.
- **Conciliation** is an alternative dispute resolution (ADR) process whereby the parties to a dispute (including future interest disputes) agree to utilize the services of a conciliator, who then meets with the parties separately in an attempt to resolve their differences. He does this by lowering tensions, improving communications, interpreting issues, providing technical assistance, exploring potential solutions and bringing about a negotiated settlement.

13.10 CAUSES OF ORGANISATIONAL CONFLICT

Structural factors cause organisational conflict. Structural factors normally impose rigidity while businesses need dynamic adjustment. Personnel who could not tend or mend the organisation but required to show targeted results see conflict between responsibility and authority. This is an organisational conflict. Specialisation of functions in organisations leads to conflict because generally the experts in fields fail to agree.

13.11 VALUES AND ETHICS CAN CAUSE CONFLICT

Differing commitment levels to, or interpretation of values and ethics of people may lead to conflict. Eventually 'means-ends' tussle erupt. Communication barriers result in no communication, missile-like communication or misleading communication. Eventually somewhat long-term conflicts form.

13.12 CULTURAL DIFFERENCES

Culture tells people what emotions ought to be expressed in particular situations and what emotions are to be felt. Cultures differ. These differences like lack of tolerance for diversity result in conflict of cultures. One suggests rituals simply not acceptable to others. Conflicts creep.

- **Behavioural:** The way emotional experience gets expressed which can be verbal or non-verbal and intentional or un-intentional.
- Physiological: The bodily experience of emotion. The way emotions make us feel in comparison to our identity.
- **Cognitive:** The mental process of "assessing or appraising" an event to reveal its relevancy to oneself. These three components collectively constitute 'emotional experience' determined by cultural values, beliefs, and practices. The emotion-conflict relationship is not acceptable to the Economists.

- **Scarcity leads to conflict, according to Economists:** This is not acceptable to Psychologists. It can be said, scarcity of emotional balance is the cause of conflict! Deprivation, economic or emotional, leads the conflict. In the circumstance of economic deprivation emotional disturbances are rational as well. Thus, subject of conflict is purely rational and related to deprivation.
- **Moral stance leads to conflict:** When an event occurs, it can be interpreted as moral or immoral. Judging something as immoral may lead to conflict.
- **Identity or individuality issues may lead to conflict:** Emotions and Identity are a part of conflict. When a person knows their

values, beliefs, and morals they are able to determine whether the conflict is personal, relevant and moral. Identity related conflicts are potentially more destructive.

- **Conflict is relational:** Conflict is relational in the sense that emotional communication conveys relational definitions that impact conflict. Key relational elements are power and social status.
- **Societies with weak institutions witness more conflicts:** Violent conflict is more common in societies with weak institutions and chronic poverty.

LET US SUM UP

In this unit you have learnt about the conflict in international business and their sources and types of conflict and about the conflict resolutions process. Conflict management helps to find a middle way, an alternative to any problem and successful implementation of the idea. Problems must be addressed at the right time to prevent conflict and its adverse effects at a later stage.

CHECK YOUR PROGRESS

Choose the correct answer

1. Constructive and destructive conflict are distinguished from each other in which of the following ways?

a) constructive conflict is We-oriented; destructive conflict is Me-oriented
b) constructive conflict is characterized by de-escalation of the conflict; destructive conflict is characterized by escalation of the conflict
c) constructive conflict is characterized by cross-complaining; destructive conflict is characterized by flexibility
d) both a and b.

2.Which of the following is not a characteristic of conflict?

a) expressed struggle.
b) independent parties
c) perceived incompatible goals
d) perceived interference for outside parties

3.Conflict is

a) an unavoidable fact of life
b) sometimes constructive
c) a destructive force in relationships if continually avoided

d) all of the above

4.General Agreement on Tariffs and Trade (GATT) agreement covers the following basic elements…….

a) protection shall be afforded to domestic industries through customs tariffs, not through such commercial measures as import quotas
b) trade shall be conducted on a non-discriminatory basis
c) consultation shall be the primary method used to solve global trade problems
d) all of the above

5.GATT was a forum for member countries to…….

a) negotiate a reduction of tariffs
b) remove barriers to trade
c) both (A) and (B)
d) none of the above

GLOSSARY

Conflict : Organizational conflict, or workplace conflict, is a state of discord caused by the actual or perceived opposition of needs, values and interests between people working together. There is also conflict within individuals – between competing needs and demands – to which individuals respond in different ways.

Arbitration : International commercial arbitration is a means of resolving disputes arising under international commercial contracts. It is used as an alternative to litigation and is controlled primarily by the terms previously agreed upon by the contracting parties, rather than by national legislation or procedural rules

Corruption : Global social costs from corruption include the reluctance of investors to commit to projects in developing economies, inhibited growth of businesses due to syphoning off of revenues for bribes, and diversion of funds from food, medical, and educational aid programs.

Collaboration : Collaboration in the context of business allows people to work together in achieving a defined, common business purpose. Collaboration can occur in real-time through tools like online meetings and instant messaging or it can occur over a drawn-out period of time through shared workspaces in the cloud

Integration conflict management : Integrated Conflict Management Systems (ICMS) are defined as "a systematic approach to preventing, managing and resolving conflict within the organization"

SUGGESTED READINGS

1. Anant K Sundaram and J Stewart Black, The International Business Environment, PHI New Delhi, Eastern Economy Edition, 2012
2. Charles W L Hill, University of Washington and Arun Kumar Jain, Heilbronn Business School (Germany), International Business – Competing in the Global Market place, The Tata McGraw Hill publishing Company Ltd, 6th edition
3. P Subba Rao, International Business Text and Cases, Himalaya Publishing house, Geetanjali Press Nagpur, 2nd Revised edition
4. V K Bhalla and S Shiva Ramu International Business – Environment and management, Anmol Publications Private Ltd. New Delhi (India),12th revised edition (2009)

WEB RESOURCES

1. International Business: Ethical Conflicts - YouTube
2. Ethic Issues in International Business | International Business | From A Business Professor - YouTube
3. CONFLICT MANAGEMENT - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.d 2. b 3.d 4.d 5.c

UNIT 14

NEGOTIATION - DRAFTING OF ARBITRATION AGREEMENTS

STRUCTURE

Suggested Readings

Answers to Check Your Progress

OVERVIEW

In this unit, you are going to learn about the introduction of negotiation and the alternative dispute resolution. To discuss about the role of international agencies in negotiations and the drafting of arbitration agreement to exclusion of the right of appeal and the characteristics of negotiation and the special situations of consolidation of proceedings and optional clauses.

LEARNING OBJECTIVE

After studying this unit, you will be able to:

- understand the role of international agencies in negotiations.
- discuss about the characteristics, positive effect and the negative effect in negotiation.
- identify the drafting of arbitration agreements.

14.1 INTRODUCTION OF NEGOTIATION

Negotiation is a dialogue intended to resolve disputes, to produce an agreement upon courses of action, to bargain for individual or collective advantage, or to craft outcomes to satisfy various interests. It is the primary method of alternative dispute resolution.

Negotiation occurs in business, non-profit organizations and government branches, legal proceedings, among nations and in personal situations such as marriage, divorce, parenting, and everyday life.

14.2 ROLE OF INTERNATIONAL AGENCIES IN NEGOTIATIONS

The role of international agencies in the negotiation process is indispensable. The agencies play a key role in finding an amicable and mutually beneficial negotiation. Organizations like the WTO have a big role in making the MNCs find a good solution to their international disputes. The requirement of such agencies become critical mainly in three areas.

- **When the business is unfamiliar with the issues and rules at hand:** In many cases, business negotiations occur in a situation and place that is unfamiliar to the organization. These negotiations lead the managers out of their comfort zone and into unfamiliar territory. Often, the managers may not be quite knowledgeable in legal and cultural matters. In such situations, the international agencies can play a big role. If the organizations' managers are unsure of the issues under discussion or do not know the perfect rules of the game, an agency may be quite helpful in offering a helping hand.

- **When issues of time or distance present in the process:** If the negotiation process takes place in an unfamiliar territory, the customs and rules are generally unknown to the key managerial decision makers. In this case, an international agency may be handy. This also applies when the managers of an organization are under a tight deadline. When these managers don't have the time and resources to meet with the other parties in a distant location or cannot participate in all steps in the process, they are quite unlikely to represent themselves well. In this situation also, an international agency may fill the gap.
- **When there is a poor relationship with the negotiating partner:** If the organization is dreading to have negotiations with a party they had clashed earlier, then an international agency may play a key role. The agency may calm both the parties and ensure that the business negotiation remains a matter of business. This is a good strategy in case of contentious diplomatic contexts, such as the negotiation of a cease-fire between warring armies. In the business world, if the rancour between a company and another over a business contract is deep-seated and on-going, both sides may get benefits by employing experienced agents to move the negotiation process forward.

14.2.1 Another View of Negotiation Comprises 4 Elements

Strategy, process and tools, and tactics. Strategy comprises the top-level goals - typically including relationship and the final outcome. Processes and tools include the steps that will be followed, and the roles taken in both preparing for and negotiating with the other parties. Tactics include more detailed statements and actions and responses to others' statements and actions.

14.3 POSITIVE EFFECT IN NEGOTIATION

Even before the negotiation process starts, people in a positive mood have more confidence, and higher tendencies to plan to use a cooperative strategy. During the negotiation, negotiators who are in a positive mood tend to enjoy the interaction more, show less contentious behaviour, use less aggressive tactics and more cooperative strategies. This in turn increases the likelihood that parties will reach their instrumental goals and enhance the ability to find integrative gains.

14.4 NEGATIVE EFFECT IN NEGOTIATION

Negative effect has detrimental effects on various stages in the negotiation process. Although various negative emotions affect negotiation outcomes, by far the most researched is anger. Angry negotiators plan to use more competitive strategies and to cooperate less, even before the negotiation starts. These competitive strategies are related to reduce joint outcomes. During negotiations, anger disrupts the process by reducing the level of trust, clouding parties' judgment, narrowing parties' focus of attention and changing their central goal from reaching agreement to retaliating against the other side. Angry negotiators pay less attention to opponent 's interests and are less accurate in judging their interests, thus achieve lower joint gains.

14.5 CHARACTERISTICS OF NEGOTIATION

- Every negotiation involves two or more parties.
- The objective of a negotiation must be definite.
- Negotiation must be conducted on an equal basis.
- A consensus must be built on the basis of mutual concession.
- Negotiation involves exchange of ideas, communication, persuasion, compromise and such like (process).

14.6 DRAFTING OF ARBITRATION AGREEMENTS

Below is a checklist of provisions to be included in an international commercial agreement followed by a brief commentary with reference to the relevant rules of some of the main international arbitral institutions:

- All and any disputes or differences arising out of or in connection with this agreement, or the breach, termination or invalidity thereof shall be finally settled by arbitration.
- In accordance with the [UNCITRAL] Arbitration Rules.
- The number of arbitrators shall be [one/three].
- The appointing authority for the purpose of the UNCITRAL rules shall be the London Court of International Arbitration.
- The seat of the arbitration shall be [London].
- The language of the arbitral proceedings shall be English.
- All and any awards of the Arbitrators shall be final and binding.
- The parties expressly exclude all and any rights of appeal from all and any awards.

The final award shall be made within six months from the appointment of the third arbitrator, but in so far as it is impractical to do so, it shall be made as soon as possible thereafter.

14.6.1 Scope of the Clause

This section of the clause is critical; it sets the boundaries for which disputes the tribunal is authorised to determine. Clarity is essential since an award made on issues that fall outside the scope of the clause will be unenforceable. It is usually desirable to cast the net widely to ensure that the clause encompasses the broadest possible range of disputes.

It is possible to draft the clause so that certain categories of dispute are hived-off for resolution by, for example, expert determination. This can be useful where the contract contains terms of a highly technical nature. Such arrangements can be effective, although when a dispute first arises, they may lead to a time-consuming wrangle over the appropriate method of resolution for that particular dispute. One solution is to make express provision for how any such preliminary issue itself should be resolved.

14.6.2 Choice of Rules

Under English law, there is no need to subject the arbitration to any particular rules; the Arbitration Act 1996 sets out "default rules", which regulate the powers of the tribunal and other procedural matters in the absence of the agreement by the parties. Generally, however, it is preferable expressly to incorporate an established set of rules. This is particularly true if the chosen venue is in a jurisdiction which has no established law of arbitration. By Section 4(3) of the 1996 Act, the provisions of any rules that the parties have agreed to apply may be effective to exclude the operation of the default provisions in the 1996 Act.

There are a number of arbitral institutions that offer an arbitration service and a set of rules. These include the London Court of International Arbitration (LCIA) and the Court of Arbitration of the International Chamber of Commerce (ICC). Both have a secretariat which has an administrative role in the conduct of the proceedings, including the appointment of the tribunal and, in the case of the ICC, scrutiny of the award. The leading non-institutional rules are the UNCITRAL Arbitration Rules. UNCITRAL itself plays no part in the proceedings, the conduct of which is left to the tribunal.

There is no simple answer to which rules should be used, although with non-institutional rules, the parties do not have to meet the expenses of a secretariat and, arguably, the arbitrators have a greater flexibility to conduct the proceedings in the most efficient manner.

The UNCITRAL rules have been in use since 1976 and are tried and tested. The ICC and the LCIA Rules have a longer history and have introduced extensive revisions that apply to all arbitrations that start after 1st January 1998.

14.6.3 Number of Arbitrators

The larger the sum in dispute, the more likely it is that a tribunal of three will be appropriate. For obvious reasons, there should always be an uneven number.

The advantages of a sole arbitrator are speed of appointment and of decision-making, greater flexibility in fixing hearing dates and lower fees. On the other hand, the parties are likely to have a greater say in appointing a tribunal of three and this may be valuable where the parties come from differing legal and cultural backgrounds. In principle, at least, the fact that three different arbitrators will contribute to making the award reduces the risk of mistakes and misunderstandings, even if it does not guarantee a higher quality of decision making.

14.6.4 Appointing Authority

The role of the appointing authority is to appoint and/or replace members of the tribunal where one party defaults in appointment or in the event of death, incapacity, removal, etc of an arbitrator. No separate appointing authority is needed under the LCIA or ICC Rules. Under the UNCITRAL Rules, the Secretary-General of the Permanent Court of Arbitration at The Hague is empowered to designate an appointing authority if the parties have failed to agree, but this procedure takes time and could result in an unexpected institution being nominated. Where an appointing authority is named in the arbitration agreement, it is prudent to check that the organisation is willing and able to undertake the role and ensure that its correct title is used.

14.6.5 Choice of Venue

This is possibly the most important provision of all. It dictates not only where the proceedings will be held geographically, but also the law of the proceedings. Although the seat of the arbitration is usually where the proceedings are held, most institutional rules enable the tribunal to hold hearings at any other location without prejudice to the selection of the legal seat. However, since the award itself will usually be published in the state which the parties have chosen as the seat (wherever the arbitration may be heard) it is important to select a venue in a country that has ratified the New York Convention to facilitate the enforcement of any award. For this reason, at least, care must be taken by parties if invited by the arbitrators to change their chosen seat after the arbitration has commenced.

The unsatisfactory decision in Hiscox v Outhwaite, in which it was held that an award was made in the country where it was signed, was overturned by Section 53 of the 1996 Act. This clarifies that where the seat of the proceedings is in England and Wales the award shall be treated as made there regardless of where it was signed. A similar provision may be found in the ICC Rules (Article 25(3)). The UNCITRAL Rules (Article 32(4)) and those of the LCIA (Article 26.1) require the award to state the place in which it was made. The seat of the arbitration is also relevant to the enforceability of an award under the New York Convention, under which enforcement may be refused if:

- The arbitration agreement is not valid under the law of the country where the award was made, or;
- The composition of the arbitral tribunal or the arbitral procedure was not in accordance with the law of the country where the arbitration took place, or;
- The award has been set aside and suspended under the law of the country in which it was made.

14.6.6 Language of the Proceedings

Most rules enable the tribunal to determine the language of the proceedings, but, in the interests of certainty, it is advisable to make an express choice taking into account the language(s) of the parties, their advisers, the contract, the contractual correspondence and other documents and the venue of the proceedings.

14.6.7 Finality

To include a provision stipulating that the award shall be final. This does not preclude the possibility of an appeal, but it does clarify that the parties intend that the award should be satisfied, or enforceable through the courts, forthwith.

14.6.8 Exclusion of the Right of Appeal

The arbitration laws of most jurisdictions now exclude the possibility of appeal, but there are some, notably England, where it still exists. Some parties may like the comfort of having a possible recourse to the courts but excluding the right of appeal has the distinct advantage of putting a cap on the length of time, and therefore the costs, of bringing a dispute to final conclusion.

The UNCITRAL rules do not exclude the right of the appeal. Whether such a right exists depends on the law of the seat of the arbitration and if the parties wish to exclude the right they must say so expressly in their clause. Article 26.9 of the LCIA Rules and Article 28(6) of the ICC Rules do exclude any form of appeal or recourse to the courts.

14.6.9 Time Limit for Making the Award

A useful provision in an arbitration clause is one which requires the arbitrators to produce their award within, say, six months of being appointed. However, if such a provision is included, care must be taken to ensure that the time can be extended since, if the proceedings run into unavoidable delay, the tribunal may find itself functus officio if it does not deliver its award within the specified time limit.

Section 50 of the 1996 Act requires an application for an extension of any agreed time limit to be made to the court unless otherwise agreed. Article 24 of the ICC Rules requires an award to be made within 6 months of the Terms of Reference but gives the ICC Court power to extend. The LCIA and the UNCITRAL Rules do not require the award to be made within any specific time.

14.7 OTHER PROVISIONS

- **Multi-tier dispute resolution:** Some parties like to include a provision in the arbitration agreement requiring the parties to attempt to resolve a dispute by amicable negotiations before any proceedings are commenced; they may also build in a requirement to refer disputes initially to ADR. Such provisions are perfectly acceptable, although they can be a nuisance when the claimant wishes to start proceedings promptly.
- **Qualifications of the arbitrators:** In contracts relating to particular industries, or of a technical nature, consideration may be given to stipulating that the arbitrators should have specified academic, professional or commercial experience and/or qualifications. It is, however, important not to introduce too many requirements since this will limit the choice of whom can be appointed.
- **Governing law:** It is important to be clear what the governing law of the arbitration agreement is since this will determine its validity and effect. The main contract should have a governing law clause

in any event, and this will usually apply also to the arbitration agreement. But where the proceedings are to be conducted in a country other than the country whose laws govern the contract as a whole, it is advisable to specify expressly that the governing law of the contract applies equally to the arbitration agreement (or to make some other express provision). If this is not done, it may be argued, under some national laws, e.g., France, that the proper law of the arbitration agreement is not that of the main contract, but that of the chosen venue.

14.8 SPECIAL SITUATIONS

14.8.1 Multi-Party Contracts

The first question that the drafter of an arbitration agreement should ask is how many parties there are to the contract. If the answer is more than two, he will need to consider very carefully how the tribunal is to be appointed, bearing in mind the fundamental requirement that each party to the proceedings be treated equally. It is not acceptable, for example, for one party to be allowed to nominate its own arbitrator, with the remaining parties being forced to accept a joint appointment by the appointing authority even if that is what they agreed in the arbitration clause.

The arbitration agreement may make provision for groups of parties to make joint appointments, but the Dutco decision says such an agreement is not binding. The safer solution is to provide for the appointing authority to nominate and appoint either the sole or all three arbitrators. This involves abandoning the principle of party-appointment, but ensures, at least, that all parties are treated equally. This is the solution adopted by the ICC in Article 10 of its new rules.

The LCIA rules approach the problem less directly. Article 5.5 provides that the LCIA alone is empowered to appoint arbitrators and states that it shall have regard to, inter alia, the number of parties, if more than two.

The UNCITRAL rules do not deal with the issue at all, which is left to the appointing authority to grapple with. None of these solutions is entirely satisfactory and the inexperienced contract drafter would be well-advised to seek specialist advice.

14.8.2 Consolidation of Proceedings

An even more complex situation arises where there are a number of contracts relating to a single project. In such a situation, a dispute may arise which bears on several of the different project contracts and on any number of parties. If each contract contains a separate arbitration agreement between the parties to it, separate proceedings will have to be commenced in respect of each contract. This is likely to be seriously unsatisfactory causing delays, unnecessary expense and may result in inconsistent decisions between different sets of parties in different arbitrations based on the same set of facts.

Under the 1950 Arbitration Act, the court had a discretion, in relation to domestic arbitration agreements, to refuse to stay its proceedings precisely on these grounds. But, under the 1996 Act, which abolished the distinction between domestic and non-domestic arbitration agreements, the court no longer has such a discretion.

The apparently obvious solution to this problem would be to consolidate the various proceedings and bring all parties before one tribunal as with court proceedings. With arbitration proceedings, however, agreement of all parties is required if there is to be consolidation. This is now spelled out in section 35 of the 1996 Act, which specifically states that the tribunal has no power to consolidate in the absence of agreement.

In practice such agreement will almost never be reached after a dispute has arisen since any party whose role is peripheral is likely to want to avoid being dragged into a large multi-party dispute which may last for years and involve him in wasted time and expense. Such agreement to consolidate can be set out in the arbitration agreement itself, but the practical difficulties are considerable. Points that need to be covered include:

- To appoint the tribunal while maintaining equality of treatment of the parties.
- Enforceability of an award against a party who did not take part in the proceedings.
- An award - as to the interpretation of a clause in the contract - binding on a party who has not taken part in the proceedings.
- A waiver of confidentiality required.

While these issues can be catered for, the arbitration agreement is likely to become over complex and lengthy and, when it comes to be put into practice, may prove to be unworkable. The ICC and the LCIA fought shy of introducing any form of compulsory consolidation into their rules because of these very problems. The construction industry, which is perhaps most directly affected by this issue, has been bolder and has produced a draft set of rules, the Construction Industry Model Arbitration Rules (CIMAR). It will be interesting to see how these fare in practice.

For those responsible for drafting arbitration agreements involving a series of contracts, perhaps the best they can hope for is to create an environment which forces the parties to give consideration to the possibility of consolidation and creates a framework for it without actually seeking to make it compulsory. The alternative, of course, is to recognise and in some instances, it may be better not to agree to arbitration at all, but to accept that the courts may be the more effective forum.

14.8.3 Optional Clauses

In their loan agreements, banks have traditionally included jurisdiction clauses that give them the right to begin proceedings against the borrower in the widest range of jurisdictions while forcing the borrower, should he wish to sue, to bring proceedings only in the courts of one state, often that of the bank's domicile.

These provisions are generally effective, and banks are able to persuade borrowers to agree to them because of their dominant bargaining position. Recent years have seen a number of international banks extending this concept to give them (but not the borrower) the option to bring proceedings either in the courts or by way of arbitration. This enables the bank to take advantage of the New York Convention if it so wishes.

LET US SUM UP

In this unit you have learnt about the negotiation and drafting of arbitration agreements and the Procedure for international commercial arbitration agreements. The object of arbitration is to obtain a fair resolution of disputes by an impartial third party without unnecessary expense or delay. Parties should be free to agree how their disputes are resolved, subject only to such safeguards as are necessary in the public interest. Courts should not interfere.

CHECK YOUR PROGRESS

Choose the correct answer

1. Which of the following is not a characteristic of integrative negotiations?

a**.** Use subjective criteria for standards of performance

b. Exchange information and ideas

c. Invent options for mutual gain

d. Commit to meeting the needs of all involved parties

2. Is there any hierarchy or priority among the various methods of peaceful settlement of disputes?

a. Yes, all the political methods (e.g., negotiation, mediation, inquiry, conciliation) should be exhausted prior to resorting to legal methods
b. Legal methods prevail over the political methods, since they are binding upon the parties
c. There is no hierarchy among these methods and the choice belongs to the disputing States
d. It is a matter of an impartial third party to decide which method will have priority over the other

3.Are States under any obligation when they conduct negotiations?

a. States are under no obligation as to how they conduct their negotiation
b. States are under an obligation so to conduct themselves that the negotiations are meaningful
c. States are under an obligation to find a solution of the dispute whenever they conduct negotiations
d. States are under an obligation to inform the UN Secretary-General about the progress of their negotiations.

4. What is the obligation of the peaceful settlement of disputes?

a. It is an obligation of result, that is, States are under a strict obligation to resolve their disputes as soon as possible
b. It is an obligation of conduct, i.e., States have an obligation to try to resolve their disputes through peaceful means. This does not entail an obligation to resolve their disputes
c. It is a peremptory norm of international law and all States have a legal interest to safeguard its application in any given dispute
d. It is an obligation which concerns solely international courts and tribunals

5. What is the difference between political and legal means of dispute settlement?

a. The outcome arising from legal methods, i.e. arbitration or adjudication by the ICJ, is final and binding upon the parties, whereas this is not the case with diplomatic methods

b. The political methods are pursued upon the consent of then parties to the dispute, whereas the legal methods not
c. The political means lead to a final settlement of the dispute, whereas this is not the case with the legal methods
d. The legal methods of dispute settlement are pursued only in respect of significant disputes, whereas the political means are employed in all disputes

GLOSSARY

Arbitration	:	Arbitration is a procedure in which a dispute is submitted, by agreement of the parties, to one or more arbitrators who make a binding decision on the dispute
Agencies In Negotiations	:	A person who acts for or in place of another individual or entity as their representative in a negotiation with a third party.
Negotiation	:	A negotiation is a strategic discussion that resolves an issue in a way that both parties find acceptable.
Optional arbitration agreement	:	In the event that the Partners who are parties to a dispute are unable to agree on any matter arising under this agreement, such Partners may, but shall not be obligated, to have such dispute resolved pursuant to binding arbitration.
Multi-tiered dispute resolution	:	A boilerplate multi-tiered dispute resolution procedure clause to be inserted in a commercial agreement to give the parties the opportunity to resolve any disputes through less formal dispute resolution procedures, including negotiation and mediation, either before or in parallel to court or arbitration proceedings.

SUGGESTED READINGS

1. Anant K Sundaram and J Stewart Black, The International Business Environment, PHI New Delhi, Eastern Economy Edition, 2012

2. Charles W L Hill, University of Washington and Arun Kumar Jain, Heilbronn Business School (Germany), International Business – Competing in the Global Market place, The Tata McGraw Hill publishing Company Ltd, 6th edition
3. P Subba Rao, International Business Text and Cases, Himalaya Publishing house, Geetanjali Press Nagpur, 2nd Revised edition
4. V K Bhalla and S Shiva Ramu International Business – Environment and management, Anmol Publications Private Ltd. New Delhi (India),12th revised edition (2009)

WEB RESOURCES

1. ADR- Lecture 5-International Arbitration - YouTube
2. Arbitration Agreement | Section 7 | Dr. Shamiulla - YouTube
3. Trends in Arbitration Law - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.a 2. c 3.b 4.b 5.a

UNIT 15

COMPOSITION OF ARBITRAL TRIBUNAL

STRUCTURE

OVERVIEW

In this lesson you are going to understand about the composition of arbitral tribunal. It should be impartial and independent of the parties and shall be qualified for the office and it shall be possible to appoint the arbitrators. It comprises three arbitrators and the parties were failed to agree on its composition, each party shall appoint one arbitrator. To learn about the termination of mandate and substitution of arbitrator.

LEARNING OBJECTIVES

After studying this unit, you will be able to:

- learn about the various composition of arbitral tribunal
- understand the various challenges and failure of arbitrator.

15.1 NUMBER OF ARBITRATORS

1. The parties are free to determine the number of arbitrators, provided that such number shall not be an even number.
2. Failing the determination referred to in sub-section (1), the arbitral tribunal shall consist of a sole arbitrator.

15.2 APPOINTMENT OF ARBITRATORS

1. A person of any nationality may be an arbitrator, unless otherwise agreed by the parties.
2. Subject to sub-section (6), the parties are free to agree on a procedure for appointing the arbitrator or arbitrators.
3. Failing any agreement referred to in sub-section (2), in an arbitration with three arbitrators, each party shall appoint one arbitrator, and the two appointed arbitrators shall appoint the third arbitrator who shall act as the presiding arbitrator.
4. If the appointment procedure in sub-section (3) applies and—
   a) a party fails to appoint an arbitrator within thirty days from the receipt of a request to do so from the other party; or
   b) the two appointed arbitrators fail to agree on their arbitrator within thirty days from the date of their appointment, the appointment shall be made, upon request of a party, by the Chief Justice or any person or institution designated by him.
5. Failing any agreement referred to in sub-section (2), in an arbitration with a sole arbitrator, if the parties fail to agree on the arbitrator within thirty days from receipt of a request by one party from the other party to so agree the appointment shall be made, upon request of a party, by the Chief Justice or any person or institution designated by him.

6. Where, under an appointment procedure agreed upon by the parties, —
    a) a party fails to act as required under that procedure; or
    b) the parties, or the two appointed arbitrators, fail to reach an agreement expected of them under that procedure: or
    c) a person, including an institution, fails to perform any function entrusted to him or it under that procedure, a party may request the Chief Justice, or any person or institution designated by him to take the necessary measure, unless the agreement on the appointment procedure provides other means for securing the appointment.
7. A decision on a matter entrusted by sub-section (4) or sub-section (5) or sub-section (6) to the Chief Justice or the person or institution designated by him is final.
8. The Chief Justice or the person or institution designated by him, in appointing an arbitrator, shall have due regard to—
    a) any qualifications required of the arbitrator by the agreement of the parties; and
    b) other considerations as are likely to secure the appointment of an independent and impartial arbitrator.
9. In the case of appointment of sole or third arbitrator in an international commercial arbitration, the Chief Justice of India or the person or institution designated by him may appoint an arbitrator of a nationality other than the nationalities of the parties where the parties belong to different nationalities.
10. The Chief Justice may make such scheme as he may deem appropriate for dealing with matters entrusted by sub-section (4) or sub-section (5) or sub-section (6) to him.
11. Where more than one request has been made under sub-section (4) or sub-section (5) or sub-section (6) to the Chief Justices of different High Courts or their designates, the Chief Justice or his designate to whom the request has been first made under the relevant sub-section shall alone be competent to decide on the request.
12. a) Where the matters referred to in sub-sections (4), (5), (6), (7), (8) and (10) arise in an international commercial arbitration, the reference to "Chief Justice" in those sub-sections shall be construed as a reference to the "Chief Justice of India".

b) Where the matters referred to in sub-sections (4), (5), (6), (7), (8) and (10) arise in any other arbitration, the reference to "Chief Justice" in those sub-sections shall be construed as a reference to the Chief Justice of the High Court within whose local limits the principal Civil Court referred to in clause (e) of sub-section (1) of section 2 is situate and, where the High Court itself is the Court referred to in that clause, to the Chief Justice of that High Court.

15.3 GROUNDS FOR CHALLENGE

1. When a person is approached in connection with his possible appointment as an arbitrator, he shall disclose in writing any circumstances likely to give rise to justifiable doubts as to his independence or impartiality.
2. An arbitrator, from the time of his appointment and throughout the arbitral proceedings, shall, without delay, disclose to the parties in writing any circumstances referred to in sub-section (1) unless they have already been informed of them by him.
3. An arbitrator may be challenged only if—

a) circumstances exist that give rise to justifiable doubts as to his independence or impartiality, or

b) he does not possess the qualifications agreed to by the parties.

4. A party may challenge an arbitrator appointed by him, or in whose appointment he has participated, only for reasons of which he becomes aware after the appointment has been made.

15.4 CHALLENGE PROCEDURE

1. Subject to sub-section (4), the parties are free to agree on a procedure for challenging an arbitrator.
2. Failing any agreement referred to in sub-section (1), a party who intends to challenge an arbitrator shall, within fifteen days after becoming aware of the constitution of the arbitral tribunal or after becoming aware of any circumstances referred to in sub-section (3) of section 12, send a written statement of the reasons for the challenge to the arbitral tribunal.
3. Unless the arbitrator challenged under sub-section (2) withdraws from his office or the other party agrees to the challenge, the arbitral tribunal shall decide on the challenge.
4. If a challenge under any procedure agreed upon by the parties or under the procedure under sub-section (2) is not successful,

the arbitral tribunal shall continue the arbitral proceedings and make an arbitral award.

5. Where an arbitral award is made under sub-section (4), the party challenging the arbitrator may make an application for setting aside such an arbitral award in accordance with section 34.
6. Where an arbitral award is set aside on an application made under sub-section (5), the court may decide as to whether the arbitrator who is challenged is entitled to any fees.

15.5 FAILURE OR IMPOSSIBILITY TO ACT

1. The mandate of an arbitrator shall terminate if—
   a) he becomes dejure or defacto unable to perform his functions or for other reasons fails to act without undue delay; and
   b) he withdraws from his office, or the parties agree to the termination of his mandate.
2. If a controversy remains concerning any of the grounds referred to in clause (a) of sub-section (1), a party may, unless otherwise agreed by the parties, apply to the court to decide on the termination of the mandate.
3. If, under this section or sub-section (3) of section 13, an arbitrator withdraws from his office or a party agrees to the termination of the mandate of an arbitrator, it shall not imply acceptance of the validity of any ground referred to in this section or sub-section (3) of section 12.

15.6 TERMINATION OF MANDATE AND SUBSTITUTION OF ARBITRATOR

1. In addition to the circumstances referred to in section 13 or section 14, the mandate of an arbitrator shall terminate—
   a) where he withdraws from office for any reason; or
   b) by or pursuant to agreement of the parties.
2. Where the mandate of an arbitrator terminates, a substitute arbitrator shall be appointed according to the rules that were applicable to the appointment of the arbitrator being replaced.
3. Unless otherwise agreed by the parties, where an arbitrator is replaced under sub-section (2), any hearings previously held may be repeated at the discretion of the arbitral tribunal.
4. Unless otherwise agreed by the parties, an order or ruling of the arbitral tribunal made prior to the replacement of an arbitrator under this section shall not be invalid solely because there has been a change in the composition of the arbitral tribunal.

15.7 COMPOSITION OF ARBITRAL TRIBUNAL

The Arbitration and Conciliation Act, 1996 (herein referred to as the 'Act') lays down the provisions for the Composition of an Arbitral Tribunal. Also, Rule 22 of the Rules of Arbitration laid down by the Indian Council of Arbitration states that when an application for arbitration procedure is received, the Council takes necessary steps for the constitution of an arbitral tribunal to adjudicate the disputes or differences between parties. Several provisions concerning the composition of an arbitral tribunal are as follows:

15.7.1 Article 5-Number of Arbitrators

1) The parties may agree on the number of arbitrators before or within 30 days after commencement of the arbitral proceedings.
2) If the parties have not so agreed, the number of arbitrators shall be three unless the centre, in its discretion, determines that a sole arbitrator shall constitute the tribunal.
3) In determining whether a sole arbitrator should be constituted as the tribunal, the Centre shall have regard to the amount in dispute, the nature and complexity of the dispute and any other factor it considers relevant.

15.7.2 Article 6 - Appointment of A Sole Arbitrator

1) Where a sole arbitrator is to be appointed, either party may propose to the other the name of one or more persons acceptable to that party as the sole arbitrator.
2) Where the parties fail to reach an agreement on a sole arbitrator within 30 days after a party receives the proposal under (1), a party may request the centre to appoint the arbitrator in accordance with Article 8.

15.7.3 Article 7-Appointment of Three Arbitrators

1) Where three arbitrators are to be appointed, each party shall appoint one arbitrator, and the two appointed arbitrators shall appoint the third arbitrator who will act as presiding arbitrator.
2) Where a party fails to appoint an arbitrator within 30 days after receipt of a request to do so from the other party, the other party may request the Centre to appoint that arbitrator in accordance with Article 8.
3) Where the two appointed arbitrators fail to appoint a third arbitrator within 30 days after the date of the appointment of the last

arbitrator, a party may request the Centre to appoint the third arbitrator in accordance with article 8.

4) If the notice of request for arbitration names two or more claimants or two or more respondents and the parties do not agree on the appointment process within 30 days of delivery of the notice, the Centre shall appoint all three arbitrators under Article 8(2)(d).

15.7.4 Article 8 - Method of Appointment

1) The Centre shall appoint an arbitrator as promptly as possible after the request of a party under Article 6 or 7.

2) Unless the Centre determines that it is not appropriate in a particular case, the Centre shall use the following list procedure:

    a) the Centre shall communicate to both parties an identical list of at least three names.

    b) within a period of 15 days following receipt of the list referred to in (a), each party shall return the list to the Centre after having

        i. deleted any name to which it objects, and

        ii. Numbered the remaining names on the list in the order of its preference.

    c) after the 15-day period referred to in (b), the Centre shall appoint the arbitrator from the remaining names on the lists returned to it, taking into account the order of preference indicated by the parties; and

    d) if, for any reason the appointment cannot be made according to this procedure, the Centre may, in its sole discretion, appoint the arbitrator.

3) In appointing an arbitrator, the Centre will have due regard to

    a) any qualifications required of the arbitrator by the agreement of the parties.

    b) other considerations likely to secure the appointment of an independent and impartial arbitrator; and

    c) the advisability of appointing an arbitrator of a nationality other than those of the parties.

15.7.5 Article 9 - Proposing and Requesting Appointment

1) Where a person is proposed for appointment as an arbitrator, the following information shall be given to all parties by the proposer: the person's full name, address and nationality and a description of the person's qualifications.

2) Where a request for appointment is made to the Centre, the party making the request shall send to the Centre

    a) a copy of the notice of request for arbitration.

    b) a copy of the contract out of or in relation to which the dispute has arisen; and

    c) a copy of the arbitration agreement if an arbitration clause is not contained in the contract.

3) The parties shall supply the Centre with any additional information it considers necessary to fulfil its function.

15.7.6 Article 10 - Independence and Impartiality

1) An arbitrator shall be and remain at all times wholly independent and impartial.

2) To accept an appointment, an arbitrator must sign and provide the Centre with a written declaration that the arbitrator knows of no circumstance likely to give rise to justifiable doubts as to the arbitrator's independence and impartiality. The arbitrator shall disclose any such circumstance to the parties without delay should it arise before the arbitration is concluded.

3) Subject to (4) and (5), no party shall engage in any communication about the case with any arbitrator or any candidate for appointment as an arbitrator unless the other party or parties to the case is/are present.

4) A party or someone on behalf of a party may communicate with a candidate for appointment as a party-appointed arbitrator for the following purposes:

    a) to advise the candidate of the general nature of the dispute and the arbitration proceedings; or

    b) to discuss the candidate’s qualifications, availability, independence from the parties and impartiality in relation to the dispute.

5) A party or someone on behalf of a party may communicate with a party-appointed arbitrator to discuss the qualifications and suitability of candidates for the presiding arbour.

15.7.7 Article 11- Grounds for Challenge

1) An arbitrator may be challenged only if

   a) circumstances exist that give rise to justifiable doubts as to the arbitrator's independence or impartiality; or

   b) the arbitrator does not possess the qualifications agreed to by the parties.

2) A party may challenge an arbitrator in whose appointment it has participated, only for reasons of which it becomes aware after the appointment has been made.

3) Where an arbitration agreement provides

   a) for the appointment of a conciliator or mediator; and

   b) that the conciliator or mediator shall also act as arbitrator in the event of the conciliation or mediation failing to produce a settlement, a party shall not object to the appointment of a conciliator or mediator as arbitrator solely on the ground that the person acted as conciliator or mediator in connection with some or all of the matters referred to in the arbitration.

4) Where a person is appointed as conciliator or mediator under an arbitration agreement and then declines to act as an arbitrator, another person appointed as arbitrator shall not be required first to act as conciliator or mediator.

15.7.8 Article 12 - Challenge Procedure

1. A party who intends to challenge an arbitrator shall, within 15 days after becoming aware of the constitution of the arbitral tribunal or becoming aware of any circumstances referred to in Article 11(1), send a written statement of the reasons for the challenge to the arbitral tribunal.

2. If the arbitrator challenged under (1) withdraws from office or the other party agrees to the challenge, the mandate of the arbitrator terminates.

3. If the arbitrator challenged under (1) does not withdraw from office or the other party does not agree to the challenge, the arbitral tribunal shall decide on the challenge.

4. If a challenge to the arbitrator under (1) is not successful, the challenging party may request the Centre, within 30 days after having received notice of the decision of the challenge, to decide on the challenge.

5. The decision of the Centre under (4) is final.

6. While a request under (4) is pending, the arbitral tribunal, including the challenged arbitrator, may continue the arbitral proceedings and make an arbitral award.

15.7.9 Article 13 -- Termination of Mandate

1) The mandate of an arbitrator terminates if

   a) the arbitrator

      i. becomes de jure or de facto unable to perform the functions of arbitrator or for any reason fails to act without undue delay; and

      ii. withdraws from office or the parties agree to the termination.

   b) a challenge to the office is successful under article 12;

   c) the arbitrator withdraws from office for any reason; or

   d) the parties agree in writing that it is terminated.

2) If under (1)(a) or Article 12, an arbitrator withdraws from office or a party agrees to the termination of the mandate of an arbitrator, this does not imply acceptance of the validity of the grounds referred to in (1)(a) or Article 12.

   a) Where the mandate of an arbitrator who is one member of a three-arbitrator tribunal is not terminated but the arbitrator declines to participate in the arbitration, the other two arbitrators have the authority to continue the arbitration. Should the two arbitrators decide in their sole discretion to continue, any decision, ruling or award made by them shall be valid.

   b) In deciding whether to continue the arbitration, the two arbitrators shall have regard to the stage of the proceeding, the reason(s) given by the arbitrator declining to participate, and such other considerations which they consider relevant.

   c) Should the two arbitrators decide in their sole discretion not to continue the arbitration without the participation of a third arbitrator, the Centre may then terminate the mandate of the non-participating arbitrator and appoint a replacement arbitrator.

15.7.10 Article 14 -- Substitution Of An Arbitrator

1) Where the mandate of an arbitrator terminates under 13(1), a substitute arbitrator shall be appointed according to the provisions of the rules that were applicable to the appointment of the arbitrator being replaced.
2) Subject to the agreement of the parties, where an arbitrator is replaced, any hearings previously held may be repeated at the discretion of the arbitral tribunal.
3) An order or ruling of the arbitral tribunal made prior to the replacement of an arbitrator is not invalid solely because there has been a change in the composition of the tribunal.

LET US SUM UP

In this unit, you have learnt about the various composition of arbitral tribunal and their article. Arbitration is a procedure in which a dispute is submitted, by agreement of the parties, to one or more arbitrators who make a binding decision on the dispute. In choosing arbitration, the parties opt for a private dispute resolution procedure instead of going to court.

CHECK YOUR PROGRESS

Choose the correct answer

1. Which of the following is an accurate statement of the courts powers in relation to Alternative Dispute Resolution (ADR)?
    a. The court can force parties to engage in ADR
    b. The court cannot force parties to engage in ADR and has no power to sanction them for failing to do so
    c. The court cannot force parties to engage in ADR but does have the power to sanction them for failing to do so
    d. None of the options given is correct.

2. Which of the following is the most accurate description of arbitration?
    a. An informal meeting between the parties involving a discussion as to how the issue may be resolved
    b. An adjudicative process where the parties submit their dispute, for a binding decision, to an impartial tribunal.
    c. A meeting between the parties where an impartial third party facilitates discussions
    d. None of the options given is correct

3. Which of the following accurately reflects the situation where the county Court and High Court shares concurrent jurisdiction in a case?

a. The claimant has the choice as to where proceedings are commenced
b. The County Court will be allocated to the claimant's case
c. The High Court will be allocated to the claimant's case
d. The defendant has the choice as to where proceedings are commenced.

4. Which of the following is not a condition for a Part 36 offer to be valid?

a. The offer must be pre-approved by the trial judge
b. The offer must be in writing
c. The offer must state on its face that it is intended to be a Part 36 offer
d. The offer must state whether it takes into account any counter claim

5. The Ombudsman is responsible for investigating what kind of conduct?

a. Maladministration
b. Poor administration
c. Deficient administration
d. None of the options given is correct

GLOSSARY

Arbitrator : An arbitrator reviews testimony and evidence presented by the disputed parties at a hearing and resolves the dispute by issuing a decision that may include an award of money

Termination : Termination of employment refers to the end of an employee's work with a company. Termination may be voluntary, as when a worker leaves of their own accord, or involuntary, in the case of a company downsize or layoff, or if an employee is fired.

Sole Arbitrator : Sole Arbitrator means a sole Arbitrator appointed in accordance with these Rules and Procedures to pass an award in respect of a certain dispute submitted for settlement through BAPMI's

Arbitration.

Arbitral : Arbitral is used to describe things related to or involving arbitration—the process in which two parties in a dispute use an independent, impartial third party to settle the dispute, often by making a decision that they both agree to act as this arbitrator is to arbitrate.

Impartiality : To be impartial, an arbitrator should not be biased towards any of the parties or their counsel. As it may be difficult from the facts to conclude whether an arbitrator is impartial, it is often considered a demonstration of impartiality to be independent.

SUGGESTED READINGS

1. Aravind V. Phatak, Rabi S. Bhagat and Roger J. Kashlak (2008), International Management, Tata Mc Graw Hill, 2nd edition.
2. Crane, A. and Matten, D., 2007. Business Ethics. 2nd edition.
3. John D. Daniels and Lee H. Radebaugh (2010), International Business, Pearson Education Asia, New Delhi, 13th edition.
4. K. Aswathappa (2008), International Business, Tata Mc Graw Hill.
5. Oded Shenkar and Yaong Luo, International Business, John Wiley Inc, Noida, 2nd edition, 2007.
6. V K Bhalla and S Shiva Ramu “International Business – Environment and management” Anmol Publications Private Ltd. New Delhi (India)12th revised edition (2009)

WEB RESOURCES

1. What is the procedure of arbitration - YouTube
2. Steps in arbitration proceedings - YouTube
3. Arbitration, Tribunal Adjudication and ADR (English explanation) - YouTube
4. International Arbitration Practice - Online short course - Bing video

ANSWERS TO CHECK YOUR PROGRESS

1.c	2. b	3.a	4.a	5.a

Unit 16

ETHICAL ISSUES IN INTERNATIONAL BUSINESS

STRUCTURE

OVERVIEW

In this unit you are going to learn about the international business and ethics it includes outsourcing, working standards and conditions, workplace diversity and equal opportunities to establishing a code of ethics can build a positive international image that the results in better business practices and profits. To discuss about the ethical decision making in international business.

LEARNING OBJECTIVE

After studying this unit, you will be able to:

- identify ethical issues in real-life scenarios.
- articulate the ethical bases for a particular course of action.
- compare and contrast the ideas of major ethical thinkers.
- demonstrate the ability to think critically, solve problems, and make decisions

16.1 ETHICAL ISSUES

As political, legal, economic, and cultural norms vary from nation to nation, various ethical issues rise with them. A normal practice may be ethical in one country but unethical in another. Multinational managers need to be sensitive to these varying differences and able to choose an ethical action accordingly.

In an international business, the most important ethical issues involve employment practices, human rights, environmental norms, corruption, and the moral obligation of international corporations.

16.2 EMPLOYMENT PRACTICES AND ETHICS

Ethical issues may be related to employment practices in many nations. The conditions in a host country may be much inferior to those in a multinational's home nation. Many may suggest that pay and work conditions need to be similar across nations, but no one actually cares about the quantum of this divergence. 12-hour workdays, minimal pay, and indifference in protecting workers from toxic chemicals are common in some developing nations. Is it fine for a multinational to fall prey to the same practice when they chose such developing nations as their host countries? The answers to these questions may seem to be easy, but in practice, they really create huge dilemmas.

16.3 ETHICS IN INTERNATIONAL BUSINESS

Business Ethics: Business ethics are principles of right or wrong governing the conduct of business people. The text says, "The accepted principles of right and wrong" But there are many differences of opinion among highly ethical business people.

16.4 ETHICAL ISSUES IN INTERNATIONAL BUSINESS

Many ethical issues and dilemmas are rooted in differences in political systems, law, economic development, and culture. Some key ethical issues in international business employment practices When work conditions in a host nation are clearly those in a multinational's home nation.

16.5 DETERMINANTS OF ETHICAL BEHAVIOUR

- Organization culture.
- Personal ethics.
- Decision making processes Leadership.
- Unrealistic / realistic performance goals.

16.6 ETHICAL DECISION MAKING

Five things that an international business and its managers can do to make sure ethical issues are considered

- Favour hiring and promoting people with a well-grounded sense of personal ethics.
- Build an organizational culture that places a high value on ethical behaviour.
- Make sure that leaders within the business not only articulate the rhetoric of ethical behaviour, but also act in a manner that is consistent with that rhetoric.
- Implement decision-making processes that require people to consider the ethical dimension of business decisions.
- Develop moral courage.

16 .7 THE ROLE OF ETHICS IN INTERNATIONAL BUSINESS

International business ethics has a number of open questions and dilemmas. Today it is characterized by the following elements: Every culture and nation has its own values, history, customs and traditions, thus it has developed own ethical values and understanding of ethical principles; There is no international ethical code of conduct, accepted and followed by all the countries; There is a lack of governments' initiative to create ethical cooperation framework and thus to enhance ethical behaviour in international business; It is hard to outline those ethical values which would be understandable, acceptable and important for representatives of all the continents simultaneously within different types of international cooperation projects.

LET US SUM UP

In this unit you have learnt about the International Business and Ethics and National Differences in Ethics and the Ethical issues in international business and about the Ethical decision making. In an international business, the most important ethical issues involve employment practices, human rights, environmental norms, corruption, and the moral obligation of international corporations. In making ethical decisions, it is necessary to perceive and eliminate unethical options and select the best ethical alternative

CHECK YOUR PROGRESS

Choose the correct answer

1. A ________ is a problem, situation, or opportunity requiring an individual, group, or organization to choose among several actions that must be evaluated as right or wrong.

   a. Crisis
   b. ethical issue
   c. indictment
   d. fraud

2. Most companies begin the process of establishing organizational ethics programs by developing

   a. ethics training programs.
   b. codes of conduct.
   c. ethics enforcement mechanisms.
   d. hidden agendas.

3.Successful global initiatives addressing standards for business must begin and end with

   a. the role of corporate governance and shareholder power in corporate decision making.
   b. social activism
   c. the implementation of standardized ethic programs.
   d. the consolidation of economic and environmental efforts.

4. Which statement best describes ethics in business?

   a. Business is outside the realm of ethical enquiry and morally neutral or a moral

   b. Ethics in business do exist but differ from ethics in other spheres and may appear amoral in other spheres

   c. Business, politics and private life share the same ethics as part of a moral community

   d. None of the above.

5. What do we mean by ethics?

   a. Moral judgements

   b. Determinants of what is right or wrong

   c. Rules or standards governing a profession

   d. Elements of all of the above

GLOSSARY

Ethical Issue	:	International business ethics constitute a global code of conduct – a set of principles that establishes ethical standards for employees and businesses.
Ethical Decision Making	:	It refers to the accepted principles of right or wrong directing the behaviour of people in business.
Personal ethics	.:	It refers to the ethics that a person identifies with in respect to people and situations that they deal with in everyday life.
Professional ethics	:	It refers to the ethics that a person must adhere to in respect of their interactions and business dealings in their professional life.
Competency	:	The ability to collect and evaluate information, develop alternatives, and foresee potential consequences and risks

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3. V K Bhalla and S Shiva Ramu "International Business – Environment and management" Anmol Publications Private Ltd. New Delhi (India)12th revised edition (2009)

WEB RESOURCES

1. Ethical Issues in International Business - Bing video
2. Ethics in International Business - YouTube

ANSWERS TO CHECK YOUR PROGRESS

1.b 2. b 3.a 4.c 5.d

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