INTERNATIONAL TRADE

M-232

Self Learning Material

Directorate of Distance Education

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UNIT

1

INTRODUCTION TO INTERNATIONAL TRADE

STRUCTURE

1.0. LEARNING OBJECTIVES

After going through this unit, you will be able to :

- explain the gross domestic product
- discuss about the need of international trade
- describe the aim of international trade
- differentiate between domestic trade and risk in international trade.

1.1. INTRODUCTION

International trade is exchange of capital, goods and services across international borders or territories. In most countries, it represents a significant share of Gross Domestic Product (GDP). While international trade has been present

throughout much of history (see Silk Road, Amber Road), its economic, social, and political importance has been on the rise in recent centuries.

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1.2. MEANING OF INTERNATIONAL TRADE

Trade between two or more nations is called foreign trade or international trade. This involves the exchange of goods and services between the citizens of two nations. When the citizens of one nation exchange goods and services with the citizens of another nation, it is called foreign trade; for example, India's trade with USA, Japan, France and Pakistan.

International trade transactions are classified under three categories:

- Import Trade
- Export Trade
- Entrepot Trade.

Industrialization, advanced transportation, globalization, multinational corporations and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders.

1.3. NEED OF INTERNATIONAL TRADE

International trade is needed so that all countries can avail themselves of the things that they need (and want) and that are not available in their own country. The most common example is oil, which is needed throughout the world, but it is limited to particular areas, and so is traded internationally. There is always a need for international trade because the countries have different capabilities and they specialize in producing different things. To compensate for what they do not produce, they have to involve in trade with other countries. For example, not all the countries have oil resources, the rest of the countries import oil from the oil producers. Most of the oil producers on the other hand import finished goods because they do not produce enough.

International trade accounts for a huge part of a country's Gross Domestic Product (GDP) and is a vital source of revenue for all countries, particularly those that are developing, though it is the nations that have the strongest international trade and who have prospered by it, that have become the driving force behind world economy. It is usually accepted that the benefits of international trade, and therefore, the reasons why it is needed are: It enhances domestic competitiveness; it increases sales and profits; it takes advantage of international trade technology; it extends the sales potential of existing products; it maintains cost competitiveness in the domestic market; it increases the potential for business expansion; it achieves a global market share; it reduces the dependency on markets that already exist; and it stabilizes seasonal market fluctuations.

International trade is no new phenomena; the silk route is a very famous trading route that was used to transport silk and spices in the 14th and 15th centuries. The 18th century saw Clippers, which were ships designed for speed, being used to transport all manner of things from tea from China, and spices from the Dutch East Indies. Sugar, cotton and other goods were also traded internationally to the delight of both those producing them and those receiving them but the most sinister trading happened in a much darker period of history: Slaves also became a commodity to be traded internationally; the very negative repercussions of which can still be seen today.

1.4. AIM OF INTERNATIONAL TRADE

The aim of international trade is to increase production and to raise the standard of living of the people. Foreign trade helps citizens of one nation to consume and enjoy the possession of goods produced in some other nation. There is a need of foreign trade due to the following reasons:

1. Uneven Distribution of Natural Resources: Natural resources of the world are not evenly divided amongst the nations of the world. Different countries of the world have different amount of natural resources and they differ with each other in regard to climate, minerals and other factors. Some countries can produce more of sugar like Cuba, some can produce more of cotton like Egypt, while there are some others which can produce more of wheat like Argentina. But all these countries need sugar, cotton and wheat. So they have to depend upon one another for the exchange of their surpluses with the goods are in short in their country and hence the need for foreign trade is natural.

2. Division of Labour and Specialization: Due to uneven distribution of natural resources, some countries are more suitable placed to produce some goods more economically then other countries. But they are geographically at a disadvantageous position to produce other goods. They specialize in the production of such goods in which they have some natural advantage in the form of availability of raw material, labour, technical know-how, climatic conditions, etc., and get other goods in exchange for these goods from other countries.

3. Differences in Economic Growth Rate: There are many differences in the economic growth rates of different countries. Some countries are developed, some are developing, while there are some other countries which are under-developed; these under-developed and developing countries have to depend upon developed ones for financial help, which ultimately encourages foreign trade.

4. Theory of Comparative Cost: According to the theory of comparative cost each country should concentrate on the production of those goods for which it is best suited, taking into account its natural resources, climate, labour supply, technical know-how and the level of development. Each country specializes in the production of those goods which it can produce at the lowest cost as compared to other countries which leads to international specialization and division of labour. This reduces the cost of production all over the world and improves the standard of

living of the people in various countries. Hence the theory of comparative cost encourages foreign trade.

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1.5. SCOPE OF INTERNATIONAL TRADE

Scope of international trade is quite wide. It includes not only merchandise exports, but also trade in services, licensing and franchising as well as foreign investments. Domestic business pertains to a limited territory. Though the firm has many business establishments in different locations all the trading activities are inside a single boundary.

1. To the Nations: Through international trade nations gain by way of earning foreign exchange, more efficient use of domestic resources, greater prospects of growth and creation of employment opportunities. Domestic business as it is conducted locally there would be no much involvement of foreign currency. It can create employment opportunities too and the most important part is business since carried locally and always dealt with local resources the perfection in utilization of the same resources would obviously reap the benefits.

2. To the Firms: The advantages to the firms carrying business globally include prospects for higher profits, greater utilization of production capacities, way out to intense competition in domestic market and improved business vision. Profits in domestic trade are always lesser when compared to the profits of the firms dealing transactions globally.

3. Market Fluctuations: Firms conducting trade internationally can withstand these situations and huge losses as their operations are wide spread. Though they face losses in one area they may get profits in other areas, this provides for stabilizing during seasonal market fluctuations. Firms carrying business locally have to face this situation which results in low profits and in some cases losses too.

4. Modes of Entry: A firm desirous of entering into international business has several options available to it. These range from exporting/importing to contract manufacturing abroad, licensing and franchising, joint ventures and setting up wholly owned subsidiaries abroad. Each entry mode has its own advantages and disadvantages which the firm needs to take into account while deciding as to which mode of entry it should prefer. Firms going for domestic trade does have the options but not too many as the former one.

5. Purvey: Providing goods and services as a business within a territory is much easier than doing the same globally. Restrictions such as custom procedures do not bother domestic entities but whereas globally operating firms need to follow complicated customs procedures and trade barriers like tariff etc.

6. Sharing of Technology: International business provides for sharing of the latest technology that is innovated in various firms across the globe which in consequence will improve the mode and quality of their production.

7. Political Relations: International business obviously improve the political relations among the nations which gives rise to cross-national cooperation and agreements. Nations cooperate more on transactional issues.

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1.6. IMPORTANCE OF INTERNATIONAL TRADE IN MODERN TIME

No country has within its own boundaries resources for economical production of all its requirements. Through international trade it is possible for a country to obtain goods it cannot produce or cannot produce as cheaply as other countries. Hence a country's well-being is determined to a great extent by the nature of its foreign trade. New products are being developed almost every year and the existing ones are being improved upon and produced in greater numbers. As a result, standards of living throughout the world are improving.

Every citizen is interested in foreign trade whether he is interested as a consumer, producer, investor or taxpayer. The importance of foreign trade to consumers lies in the fact that they can purchase from the cheapest source. India depends upon foreign countries partially for capital equipment and maintenance imports. U.S. consumers depend upon imports for the supply of coffee and sugar while the U.K. consumers obtain the major portion of their foodstuffs and the entire supply of tea from foreign countries.

Foreign trade leads to an increase in overall employment. For example, 4 out of 5 new manufacturing jobs created during 1978–82 in the U.S.A. were in export-related industries. Development of exports and imports gives a fillip to auxiliary services such as transport, shipping, banking and insurance which further increases employment.

Countries rely on foreign trade not only to obtain domestically non-available goods but also for the disposal of their products, in some cases the degree of dependence being substantial. For example, the Indian producers of jute manufactures and tea are mainly dependent upon export markets. Japanese industry is mainly dependent upon exports for its prosperity. Similarly, in the U.S.A. though the overall dependence is not so great, yet more than 25 per cent of the U.S. production of a number of agricultural and industrial products is exported. In many cases, the existence of an export market enables the producers to increase their production and thus avail themselves of the economies of large-scale production.

If industries prosper, investors too get good returns. If foreign trade and investment are free, there is a good possibility of investing in other countries too if the return in the domestic market is not satisfactory. That explains why investments are flowing to countries like Hong Kong and Singapore where there are good prospects of higher return.

International trade has increased economic interdependence of nations. Modern industries are dependent upon a variety of raw materials all of which cannot be conveniently and economically produced in any one country. If the flow of imported raw materials is disturbed in anyway, production in industries dependent on them will be seriously dislocated. At present goods are not exported merely because there is a surplus for exports. Often goods are produced specifically to satisfy export demands. Sometimes exports are encouraged to obtain essential imports. During the period of acute dollar shortage, the U.K. exported Scotch Whisky to the U.S.A. not because there was a surplus but to obtain dollars. Even now a

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substantial portion of the production of Scotch Whisky is earmarked for export. Once the production pattern of a country has been adjusted to producing surplus for exports, any dislocation in its export markets will create serious problem for it and its people by seriously reducing their purchasing power. And if the prosperity of the particular industry is affected, other industries, would not remain unaffected. Not only that, international trade also transmits economic disturbances from one country to other countries.

The extent of dependence upon international trade differs from country to country. Among the leading nations, the U.K. is highly dependent upon foreign trade. She needs to import not only half of her supplies of food but also nearly all the raw materials needed by her industry. Therefore, she must export a major portion of her manufactures in order to pay for her heavy imports.

1.7. IMPORTANCE OF INTERNATIONAL TRADE IN INDIA'S ECONOMY

Importance of International trade in India's economy can be explained as under:

1. Helpful in the Expansion of Production Capacity: Imports help in the expansion of production capacity by making necessary raw materials and machinery available. It helps in diversifying and expanding production capacity also.

2. Proper Utilisation of Installed Capacity: Import of a number of raw materials and intermediate goods is essential to make proper use of installed capacity.

3. To Get the Advantage of Technical Advancement: Resources of every country are limited. No country can be self reliant in the present time. Imports make it possible for a country to get the benefit of technical advancement achieved by other countries of the world.

4. To Meet the Demand of Consumer Goods: No country of the world can produce all the goods and services required by its people. To meet the requirements of people, imports are inevitable.

1.8. ADVANTAGES OF INTERNATIONAL TRADE

International trade has the following advantages:

1. Profit: International business may help to improve the bottom line of a firm. Even when international business is less profitable than the domestic, it could increase the total profit. There are many companies which make major share of their profits from the foreign markets. There are also MNCs which earn more than 100 per cent of their profits from foreign markets. Further, in certain cases, international business can help to increase the profitability of the domestic business.

One of the important motivations for foreign investment is to reduce the cost of production (by taking advantage of the cheap labour, for example). While in some cases, the whole manufacturing of a product may be carried out in foreign locations, in some cases only certain stages of it are done abroad. Almost 20 per cent of the merchandise imported into the United States is manufactured by foreign branches of American companies. Several American companies ship parts and components to overseas locations where the labour intensive assembly operations are carried out and then the product is brought back home. The North American Free Trade Agreement comprising the U.S., Canada and Mexico is expected to encourage large relocation of production of Mexico where the labour is substantially cheap.

2. Growth Opportunities: An important reason for going international is to take advantage of the opportunities in other countries. MNCs are getting increasingly interest in a number of developing countries as the income and population are rapidly rising in these countries.

Foreign markets, both developed country and developing country, provide enormous growth opportunities for the developing country firms too. For example, in recent years, a number of Indian pharmaceutical firms have achieved a much faster growth of their foreign business than the domestic. The U.S., market alone is expected to contribute as much as half of the total sales of Ranbaxy shortly.

3. Domestic Market Constraints: Domestic demand constraints drive many companies to expand the market beyond the national border.

The market for the number of products tend to saturate or decline in the advanced countries. This often happens when the market potential has been almost fully tapped. In the United States, for example, the stock of several consumer durables like cars, TVsets etc. exceed the total number of households. Estimates are that in the first quarter of the 21st century, while the population in some of the advanced economies would saturate or would grow very negligibly, in some others there would be a decline. Such demographic trends have very adverse effects on certain lines of business. For example, the fall in the birth rate implies contraction of market for several baby products.

When the domestic market is declining, as is the case with several products in the developed countries, foreign markets may provide growth opportunities.

Another type of domestic market constraint arises from the scale economies. The technological advances have increased the size of the optimum scale of operation substantially in many industries making it necessary to have foreign market, in addition to the domestic market, to take advantage of the scale economies. It is the thrust given to exports that enabled certain countries like South Korea to set up economies size plants. In the absence of foreign markets, domestic market constraint comes in the way of benefitting from the economies of scale in some industries.

4. Competition: Competition may become a driving force behind internationalisation. A protected market does not normally motivate companies to seek business outside the home market Until the liberalisation which started in July 1991. The Indian economy was a highly protected market. Not only that the domestic producers were protected from foreign competition but also domestic competition was restricted by several policy induced entry barriers, operated by

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such measures as industrial licensing and the MRTP regulations. Being in a seller's market, the Indian companies, in general, did not take the foreign market seriously. The economic liberalisation, ushered in India since 1991, which has increased competition from foreign firms as well as from those within the country, have, however, significantly changed the scene. Many Indian companies are now systematically planning to go international in a big way.

Many companies also take an offensive international competitive strategy by way of counter-competition. The strategy of counter-competition is to penetrate the home market of the potential foreign competitor so as to diminish its competitive strength and to protect the domestic market share from foreign penetration.

5. Government Policies and Regulations: Government policies and regulations may also motivate internationalisation. There are both positive and negative factors which could cause internationalisation.

Many *governments* give a number of incentives and other positive support to domestic companies to export and to invest in foreign countries. Similarly, several countries give a lot of importance to import development and foreign investment.

Sometimes, as was the case in India, companies may be obliged to earn foreign exchange to finance their imports and to meet certain other foreign exchange requirements like payment of royalty, dividend, etc. Further, in India, permission to enter certain industries by the large companies and foreign companies was subject to specific export obligation.

Some companies also move to foreign countries because of certain regulations, like the environmental laws advanced countries.

6. Monopoly Power: In some cases, international business is a corollary of the monopoly power which a firm enjoys internationally. Monopoly power may arise from such factors as monopolisation of certain resources, patent rights, technological advantage, product differentiation etc. Such monopoly power need not necessarily be an absolute one but even a dominant position may facilitate internationalisation. Similarly, exclusive market information (which includes knowledge about foreign customers, market, places or market situations not widely shared by other firms) is another proactive stimulus.

7. Spin-off Benefits: International business has certain spin-off benefits too. International business may help the company to improve its domestic business; international business helps to improve the image of the company. When domestic consumers get to know that the company is selling a significant portion of the production abroad, they will be more inclined to buy from such a company. International trade, thus, becomes a means of gaining better market share domestically. Further, exports may have pay-offs for the internal market too by giving the domestic market better products.

Further, the foreign exchange earnings may enable a company to import capital goods, technology etc., which may not otherwise be possible in countries like India.

8. Strategic Vision: The systematic and growing internationalisation of many companies is essentially a part of their business policy or strategic management. The stimulus for internationalisation comes from the urge to grow, the need to become more competitive, the need to diversify and to gain strategic advantages of

internationalisation. Many companies in India, like several pharmaceutical firms, have realised that a major part of their future growth will be in the foreign markets. There are a number of corporation which are truly global. Planning of manufacturing facilities, logistical system, financial flows and marketing policies in such corporations are done considering the entire world as it is and a single market—a borderless world.

1.9. RISK IN INTERNATIONAL TRADE

Companies doing business across international borders face many of the same risks as would normally be evident in strictly domestic transactions. For example,

1. Potential and Legal Differences: The political and legal environment of foreign markets are different from that of the domestic. The complexity generally increases as the number of countries in which a company does business increases. It should be noted that the political and legal environment is not the same in all provinces/states of many home markets. For instance, the political and legal environment is not exactly the same in all the state of India.

2. Difference in the Language: An international marketer often encounters problems arising out of the differences in the languages. Even when the same language is used in different countries may vary widely. The multiplicity of languages in India is an example.

3. Cultural Difference: The cultural differences is one of the most difficult problems in international marketing. May domestic markets, however, are also not free from cultural diversity.

4. Differences in the Marketing Infrastructure: The availability and nature of the marketing facilities available in different countries may very widely. For example, an advertising medium very effective in one market may not be available or may be underdeveloped in another market.

5. Difference in the Currency Unit: The currency unit varies from nation to nation. This may sometimes cause problem of currency convertibility, besides the problems of exchange rate fluctuations. The monetary system and regulations may also vary.

6. Economic Differences: The economic environment may very from country to country.

7. Differences in Trade Practices: Trade practices and customs may differ between different countries.

8. Trade Restrictions: Trade restriction, particularly import controls, is very important problem which an international trader faces.

9. High Costs of Distance: When the markets are very removed by distance, the transport cost becomes high and the time required for effecting the delivery tends to becomes longer. Distance tends to increase certain other costs also.

10. Non-acceptance (buyer rejects goods as different from the agreed upon specifications);

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11. Credit risk (allowing the buyer to take possession of goods prior to payment).

12. Regulatory risk (*e.g.*, a change in rules that prevents the transaction).

13. Intervention (governmental action to prevent a transaction being completed).

14. War, piracy and civil unrest or turmoil.

15. Natural catastrophes, freak weather and other uncontrollable and unpredictable events.

16. This mode of system leads to rapid depletion of exhaustible natural resources.

17. Although profits are huge companies need to wait for long periods.

18. Deal with special licenses and regulations of the different nations really makes the companies to step back at times to carry on business.

19. Countries may interfere in the political matters of other countries, sometimes in here rich nations gain control over weaker nations.

In addition, international trade also faces the risk of unfavorable exchange rate movements (and, the potential benefit of favorable movements).

1.10. DOMESTIC TRADE

Domestic trade is the exchange of goods, services, or both within the confines of a national territory. They are always aimed at a single market. It always deal with only one set of competitive, economic, and market issues. The trading is always with a single set of customers all the time, though the company may have several segments in a market.

Internal trade or home trade or Domestic trade may be subdivided into Wholesale trade, and Retail trade. Wholesale trade is concerned with buying goods from manufacturers or dealers in large quantities and selling them in smaller quantities to others who may be sub-dealers, retailers or even consumers. Wholesale trade may be undertaken by wholesale merchants or wholesale commission agents. The wholesale merchant makes outright purchases from dealers or manufacturers or in wholesale commodity markets, and arrange their reselling to the best advantage on his own account. The wholesale commission agents act as selling agents of producers or dealers, arrange the sale of goods on best possible terms on behalf of the principal, and earn a commission for their services.

Retail trade is concerned with the sale of goods in small quantities to the actual users or consumers. It is generally carried on by a class of traders known as retailers. In actual practice, however, manufacturers and wholesalers may also undertake retail distribution of goods to bypass the intermediary retailer.

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1.11. DIFFERENCE BETWEEN FOREIGN TRADE AND DOMESTIC TRADE

S. No.	Basis of Difference	Foreign Trade	Domestic Trade
1.	Meaning	Foreign trade is the trade between two or more nations.	Domestic trade is the exchange of domestic output within the political boundaries of the nation.
2.	Political differences	Foreign trade occurs between the different political units, as it is a trade between two or more nations.	Domestic trade takes place within the same political unit, as it is a exchange of output within the political bundaries of nation.
3.	Heterogeneous groups	Foreign trade is the heterogeneous groups as it is a trade between countries and takes place between differently cohered groups. It is a trade between us and them.	Domestic trade is not between heterogeneous groups as it is a trade within the country among the same group of people (same nationality).
4.	Different rules	In International trade the rules differ markedly as the laws and policies relating to trade, commerce, industry, taxation etc., differ between countries.	The rules remain the same in domestic trade as in foreign trade.
5.	Different currencies	International trade involves the use of different types of currencies and each country follows different foreign exchange policies.	The currency used in the domestic trade does not vary.
6.	Heterogeneous world markets	In foreign trade, the world markets lack homogeneity on account of difference in climate, language, preferences, habits, customs, weights and measures etc.	Domestic trade has a homogeneous market.
7.	Factor immobility	Factors such as factors of production like labour and capital are greater between the countries than within the country.	Factors are less mobile in case of domestic trade.
8.	Greater degree of risk	There is greater degree of risk involved in foreign trade.	There is a lesser degree of risk involed in domestic trade.
9.	Difference in procedures and documentation	Difference in procedures and documentation are more in case of foreign trade because each country has its own procedures and documentary requirements.	Differences in procedure and documentation is lesser in case of domestic trade.
10.	Local taxes	Due to local taxes foreign trade are comparatively costlier than the domestic trade.	Domestic goods are comparatively cheaper than foreign goods.

1.12. REASONS FOR THE NEED OF A SEPARATE THEORY OF INTERNATIONAL TRADE

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1. Economic Reasons: The main reason why we have a separate theory of International trade is that the world is divided into political units and factors of production cannot move freely between these units. There are several economic reasons for concentrating our attention on nations as the classic economic units. As a general rule a vast difference exists in the degree of mobility of resources between countries as opposed within countries. These affect human beings through mobility and immigration laws, financial transactions through restrictions on capital flows.

2. Land: Land is severely restricted as far as its international mobility is concerned. The physical transfer of land between countries is possible only if nations change the size of their territory by war (uganda in the 1970's with Tanzania and Iraq in 1990 with Kuwait but these can be temporary), purchase of territories (for example, Alaska between U.S.A and former U.S.S.R) or land grants to and from other nations. The acquisition of tile of land ownership by foreigners are severally restricted in many nations by having laws that either exclude on severally limit foreigners from owning real estate.

3. Socio-Political Environment: Although the socio-political environment often differs greatly between nations. It tends to be more uniform within countries. Examples, include legal frameworks, social institutions and governments being the same habits and business customs being relatively unifrom and neighbourhood at borders vis a vis smuggling restrictions despite geographical proximity.

4. Specialization of Economists: Though seemingly much less important, for the considerable time there has been a specialization of economists in the International trade field (Baker, 1995). As a result we find that international trade theory has developed its own body of literature, often employing methods that differ from those used in other branches of economics. For instance, International trade theory relies greatly on general equilibrium analysis and does not restrict itself to the problems of partial equilibrium that characteristics much of traditional price theory. Much international trade theory deals with models incorporating several commodities, several factors of production and several countries simultaneously. The greater complexity of the analysis has led to the development of special technique for dealing with these problems. One unsequence of this specialization within economics is that International trade theory has tended to either antedate or lag behind the developments in general economic theory.

International trade specialists, for example held to the labour theory of value for much longer time than did economists in most other fields. On the other hand, much of modern welfare economics was first elaborated within the framework of international trade theory.

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SUMMARY

- Trade between two or more nations is called foreign trade or international trade. This involves the exchange of goods and services between the citizens of two nations.
- International trade is needed so that all countries can avail themselves of the things that they need (and want) and that are not available in their own country. The most common example is oil,
- International trade accounts for a huge part of a country's Gross Domestic Product (GDP) and is a vital source of revenue for all countries, particularly those that are developing.
- The aim of international trade is to increase production and to raise the standard of living of the people. Foreign trade helps citizens of one nation to consume and enjoy the possession of goods produced in some other nation.
- Through international trade nations gain by way of earning foreign exchange, more efficient use of domestic resources, greater prospects of growth and creation of employment opportunities.
- The advantages to the firms carrying business globally include prospects for higher profits, greater utilization of production capacities, way out to intense competition in domestic market and improved business vision.
- International business provides for sharing of the latest technology that is innovated in various firms across the globe which in consequence will improve the mode and quality of their production.
- International business obviously improve the political relations among the nations which gives rise to cross-national cooperation and agreements.
- The importance of foreign trade to consumers lies in the fact that they can purchase from the cheapest source.
- Foreign trade leads to an increase in overall employment.
- Countries rely on foreign trade not only to obtain domestically non-available goods but also for the disposal of their products, in some cases the degree of dependence being substantial.
- International trade has increased economic interdependence of nations.
- Imports help in the expansion of production capacity by making necessary raw materials and machinery available.
- Import of a number of raw materials and intermediate goods is essential to make proper use of installed capacity.
- No country of the world can produce all the goods and services required by its people.
- International business may help to improve the bottom line of a firm.
- An important reason for going international is to take advantage of the opportunities in other countries.
- Competition may become a driving force behind internationalisation.

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- Government policies and regulations may also motivate internationalisation.
- The cultural differences is one of the most difficult problems in international marketing.
- Trade restriction, particularly import controls, is very important problem which an international trader faces.
- Domestic trade is the exchange of goods, services, or both within the confines of a national territory. They are always aimed at a single market. It always deal with only one set of competitive, economic, and market issues.
- Wholesale trade is concerned with buying goods from manufacturers or dealers in large quantities and selling them in smaller quantities to others who may be sub-dealers, retailers or even consumers.
- Retail trade is concerned with the sale of goods in small quantities to the actual users or consumers.

REVIEW QUESTIONS

1. Explain the meaning, nature, aim and scope of international trade.
2. Discuss importance of International Trade in modern time.
3. Write the importance and advantages of international trade in India's economy.
4. What do you mean by "Domestic Trade"? Differentiate between Foreign Trade and Domestic Trade.
5. What are the reasons for the need of a separate theory of International Trade?

FURTHER READINGS

- **A Short Course in International Documentation:** Edward G. Hinkelman, Laxmi Pub., 2010, Third edition.
- **Agricultural Expansion and Tropical Deforestation: Poverty, International Trade and Land Use:** Solon L. Barraclough and Krishna B Ghimire, Viva Books, 2006, pbk.
- **Behind The Scenes At The WTO: The Real world of International Trade Negotiations:** Fatoumata Jawara and Aileen Kwa, Books For Change, 2003, pbk.

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UNIT

2

THEORIES FOR INTERNATIONAL TRADE

STRUCTURE

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2.0. LEARNING OBJECTIVES

After going through this unit, you will be able to:

- describe the theories of international trade
- discuss the classical theory of international trade
- illustrate the difference between classical theory and modern theory of trade
- define the term balance of payment.

2.1. THEORIES FOR INTERNATIONAL TRADE

Several different theory have been proposed to predict patterns of trade and to analyze the effects of trade policies such as tariffs.

2.2. RICARDIAN THEORY

The Ricardian theory focuses on comparative advantage, perhaps the most important concept in international trade theory. In a Ricardian theory, countries specialize in producing what they produce best.

The Ricardian theory does not directly consider factor endowments, such as the relative amounts of labor and capital within a country. The main merit of Ricardian theory is that it assumes technology differences between countries. Technology gap is easily included in the Ricardian and Ricardo-Sraffa theory.

The Ricardian theory makes the following assumptions:

1. Labor is the only primary input to production (labor is considered to be the ultimate source of value).
2. Constant Marginal Product of Labor (MPL) (Labor productivity is constant, constant returns to scale, and simple technology).
3. Limited amount of labor in the economy.
4. Labor is perfectly mobile among sectors but not internationally.
5. Perfect competition (price-takers).

The Ricardian theory measures in the short-run, therefore technology differs internationally. This supports the fact that countries follow their comparative advantage and allows for specialization.

2.3. HECKSCHER-OHLIN THEORY

In the early 1900s an international trade theory called factor proportions theory emerged by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory is also called the Heckscher-Ohlin theory. The Heckscher-Ohlin theory stresses that countries should produce and export goods that require resources (factors)

that are abundant and import goods that require resources in short supply. This theory differs from the theories of comparative advantage and absolute advantage since those theories focus on the productivity of the production process for a particular good. On the contrary, the Heckscher-Ohlin theory states that a country should specialize production and export using the factors that are most abundant, and thus the cheapest. Not to produce, as earlier theories stated, the goods it produces most efficiently.

The Heckscher-Ohlin theory was produced as an alternative to the Ricardian theory of basic comparative advantage. Despite its greater complexity it did not prove much more accurate in its predictions. The theory argues that the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce. Empirical problems with the H-O theory, known as the Leontief paradox, were exposed in empirical tests by Wassily Leontief who found that the United States tended to export labor intensive goods despite having a capital abundance.

The H-O theory makes the following core assumptions:

1. Labor and capital flow freely between sectors
2. The production of shoes is labor intensive and the production of computers is capital intensive
3. The amount of labor and capital in two countries differ (difference in endowments)
4. Free trade
5. Technology is the same across countries (long-term)
6. Tastes are the same.

The problem with the H-O theory is that it excludes the trade of capital goods (including materials and fuels). In the H-O theory, labor and capital are fixed entities endowed to each country. In a modern economy, capital goods are traded internationally. Gains from trade of intermediate goods are considerable, as it was emphasized by Samuelson (2001).

2.4. CLASSICAL THEORY OF INTERNATIONAL TRADE

The Classical theory of international trade is given by Adam Smith and David Ricardo. The theory explains the condition of international trade specialization and benefits of trade.

According to the theory international trade is a case of geographical speculation. Different countries have different set of resources. In this process a country may have more of a resource. The abundance of a resource gives cost advantage in the production of a commodity. The cost advantage is the basic of specialization and international trade.

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Assumptions

1. The theory of international trade is based on the labour theory of value. With this, value of any product can be explained in term of labour units.
2. IT is a 2 × 2 theory, 2 countries and 2 commodities.
3. The theory assumes barter system of exchange.
4. It is a case of free trade without any restriction from either country.
5. No transport cost.
6. Perfect competition and full employment.
7. Factors of production are perfectly mobile within a country and immobile between countries.

The classical theory of international trade is explained in 2 parts:

(*i*) Absolute Cost Advantage.

(*ii*) Comparative Cost Advantage.

2.5. THEORY OF ABSOLUTE COST ADVANTAGE

Adam Smith was one of the fore runners of the classical school of thoughts.

He prounded a theory of international theory in 1776 that is known as the theory of absolute cost advantage.

He was of the opinion that the productive efficiency among different countries differs because of diversity in the natural and acquired resources possessed by them. A particular country should specialize in producing only those goods that is able to produce with greater efficiency, that is at lower cost and exchange those goods with other goods of their requirements from a country that produces those other goods with greater efficiency on at lower cost.

This will lead to optimal utilization of resources in both the countries.

Adam Smith explains the concept of absolute advantage in A2-commodity, 2-country frame-work

Suppose,

Bangladesh Produces

1 kg. of rice with 10 units of labour

Or

1 kg. of wheat with 20 units of labour

And

Pakistan Produces

1kg. of rice with 20 units of labour

Or

1 kg. of wheat with 10 units of labour

Each of the countries has 100 units of labour. Equal amount of labour is used for the production of two goods in the absence of trade in the two countries.

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In the absence of trade

Amount of Production:

	Rice	Wheat
Bangladesh	10kg.	Nil
Pakistan	Nil	10 kg.

Total output in two countries 20 kg. The total output in both the countries will rise because of trade.

Bangladesh will only produce rice and exchange a part of the rice output, wheat from Pakistan. Pakistan will produce only wheat and exchange a part of wheat output with rice from Bangladesh.

The theory of absolute cost advantage explains how trade helps to increase the total output in the two countries.

But it fails to explain whether trade will exist if any of the two countries produces both the goods at lower cost. In fact, this deficiency led **David Ricardo** to formulate the theory of comparative cost advantage.

2.6. THEORY OF COMPARATIVE COST ADVANTAGE

Ricardo focuses not on absolute efficiency but on the relative efficiency of the country for producing goods. That is why his theory is known as the theory of comparative cost advantage. In a Two-country, two-commodity model, he explains that a country will produce only that product which it is able to produce more efficiently.

Suppose Bangladesh and India, each of the two has 100 units of labour. One half of the labour force is used for the production of rice and the other half is used for the production of wheat in absence of trade.

In Bangladesh

1 kg. of rice with 10 units of labour is produced.

Or

1 kg. of wheat with 10 units of labour is produced.

In India

1 kg, of rice with 8 units of labour is produced.

And

1 kg. of wheat with 5 units of labour is produced.

In absence of trade

Amount of production:

	Rice	Wheat
Bangladesh	5 kg.	5 kg.
India	6.25 kg.	10 kg.

Total output in two countries, 26.25 kg.

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If one looks at this situation from the view point of comparative cost advantage, there will be no trade as India possesses absolute cost advantage in the production of both the commodities.

But Ricardo is of the view that from the viewpoint of comparative cost advantage, there will be trade because India possesses comparative cost advantage only in the production of wheat. This is because the ratio of cost between Bangladesh and India is 2 : 1 in case of wheat, while it is 1.25 : 1 in case of rice.

In presence of trade

Amount of production:

	Rice	Wheat
Bangladesh	10 kg.	Nil
India	Nil	20 kg.

Total output in two countries 30 kg.

Because of comparative cost advantage, India will produce only 20 kg. of wheat with 100 units of labour and export a part of wheat to Bangladesh on the other hand, Bangladesh will produce only 10 kg. of rice in India total output of food grains in the two countries, which was equal to 26.25 kg. prior to trade, rises to 30 kg. after trade.

International trade cannot always take place on grounds of absolute cost advantage. Even if a competitive cost advantage trade is possible and profitable. Further in a competitive world economy comparative cost advantage leads to trade. In the table it can be seen that trade is indicated because domestic exchange rates are different. International trade means that there are relative price differences in different countries.

The position of International exchange rate depends on several factors like bargaining power, level of development, nature of commodity export and import and demand elasticity of goods traded.

2.7. EVALUATION

Ricardian Theory of comparative cost advantage is a first ever theory of international trade explaining the possibilities of international trade and causes international trade identities inter country resource variations on a base of complete specialization and trade. However, there are several limitations of classical theory.

1. The theory assumed labour as the only production factor. So all factors are equally important and resources have opportunity cost .
2. 2 × 2 theory is rigid. It fails to explain multi-commodity and multi-lateral trade.
3. By considering barter system the theory neglected important international issues like currencies, conversion, international payments and liquidity.
4. Barter system and free trade did not exist in modern trade.

5. Transport cost is significant part of international trade which is not explained.
6. Trade between countries of unequal development tend to benefit advanced countries.

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2.8. MODERN THEORY OF INTERNATIONAL TRADE

Heckscher-Ohlin theory is known as modern theory of international trade. It was first formulated by Swedish economist Heckscher in 1919 and later on fully developed by his student Ohlin in 1935. Heckscher-Ohlin theory, also called the factor endowments theory of international trade, attempts to explain that international trade is simply a special case of inter-local or inter-regional trade and there is no need for a separate theory of international trade. It emphasises that differences in factor endowments and not differences in factor efficiency as maintained in the classical theory, are the true basis of international trade. The following are the general features of the modern theory of international trade:

1. A General Theory of Value: Heckscher-Ohlin theory is considered as a general equilibrium theory of value at the international level. According to the theory of value, at the equilibrium level, demand is equal to supply and commodity price is equal to average cost of production. Heckscher-Ohlin theory emphasises the mutual interdependence of the prices of commodities the prices of factors of production, the demand for commodities and the demand and supply of factors of production in international trade. Thus, while Marshall explains the time-dimension of general theory of value, Heckscher-Ohlin theory explains the space-dimension (*i.e.*, international trade) of the general theory of value.

2. No Need for a Separate Theory: According to the classical economists, international trade was basically different from trade. Therefore, there is a need for a separate theory of international trade. Ohlin, on the contrary, believes that there is no basic difference between local or inter-regional trade and international trade and no separate theory of international trade is needed. He remarked: International trade is a special case of inter-local or inter-regional trade.

3. Supplement to Ricardian Theory: Heckscher-Ohlin theory supplements and not supplants, the Ricardian comparative cost theory of international trade. According to the Ricardian theory, the differences in the comparative costs provide the foundation on which the international trade is possible. But, it does not tell why do the costs differ? Ohlin's theory not only accepts the comparative advantages as the basis of international trade, but also further develops the Ricardian theory by providing answer to the above question. According to him, the difference in comparative costs are due to (*a*) different prevailing endowments of factors of production, (*b*) the fact that the production of various commodities requires that the factors of production be used with different degrees of intensity. Thus, Ohlin's theory starts where the Recardian theory ends.

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4. Statement of the Theory: The Heckscher-Ohlin theory states that a country has a comparative advantage in the good that is relatively intensive in the country's relatively abundant factor. The theory emphasies that:

(*a*) It is not merely the differences in costs (as the classical theory believes), but differences in prices that become the basis of trade;

(*b*) The differences in costs are not due to differences in factor efficiency, but due to the differences in the quantities of factors of production;

(*c*) Comparative advantage arises when abundant factor is utilised intensively and scarce factor sparingly; and

(*d*) It is partial specialisation that will lead to the full utilisation of factors of production, while complete specialisation will leave some quantities of the factors of production unutilised.

5. Factor Endowments Theory: Heckscher-Ohlin theory is known as factor endowments theory or factor proportions theory because it emphasises the interplay between the proportions in which different factors of production are available in different countries and the proportions in which they are used in producing different goods. True basis of international trade is to be found in the comparative advantage that emerges due to the difference in the factor endowments.

6. Pattern of Trade: The Heckscher-Ohlin theory explains the pattern of world trade on the basis of differences in factor endowments. In the labour-abundant countries, wages are likely to be low relative to the cost of other factors of production. Cheap and abundant labour utilised in the production of labour-intensive goods provides sufficient justification for exporting these goods to other countries where labour is scarce and relative wages are higher. The same is true for other factors of production.

Explanation of Heckscher-Ohlin Theory

Heckscher-Ohlin theory is the factor endowment theory which explains the pattern of comparative advantage and hence the trade in terms of factor endowments. The theory states that a country has a comparative advantage in the production and export of the good that is relatively intensive in the country's relatively abundant factor. In other words, the theory predicts that goods requiring greater amounts of labour should be produced in countries where labour is abundant relative to other factors of production and where the labour costs are therefore low relative to cost of other factors. These countries then export labour-intensive goods to other countries where labour is relatively scarce and labour costs are relatively high.

Heckscher-Ohlin theory involves the following arguments:

(*i*) Two countries A and B involve in trade if relative prices of goods X and Y are different. According to Ohlin, "the immediate cause of inter-regional trade is always that goods can be bought cheaper from outside in terms of money than they can be produced at home".

(*ii*) Under competitive market conditions, prices are equal to average costs. Thus, relative price differences are due to cost difference.

(*iii*) Cost differences exist because of the factor-price differences in the two countries.

(*iv*) Factor prices are determined by factors' supply and demand. Assuming a given demand it follows that a capital-rich country has cheaper capital or lower capital price and a labour-abundant country has a relatively lower labour price,

(*v*) Each country has an advantage in the production and export of goods into which enter considerable amounts of factors, abundant and cheaper in that country.

Let us illustrate Heckscher-Ohlin theory with an example of two countries India and England. Suppose in India labour is in plenty and cheap, while capital is scarce and costly. On the other hand, England is capital-rich, but labour-poor. Further suppose wheat and cloth are two goods, former being labour-intensive and latter being capital-intensive. Thus, India will specialise in labour-intensive good wheat which can be relatively cheaply produced here. On the other hand, the production of capital-intensive cloth will be relatively cheaper in England. Hence the trade will occur between India and England. Indian will import cloth from England and export wheat; England will import wheat from India and export cloth. Putting the same thing in another way, India's import is indirectly an import of scarce factor capital and its export is indirectly an export of abundant factor labour, England indirectly imports her scarce factor labour and exports here abundant factor capital.

Thus, Heckscher-Ohlin theory concludes that:

(*a*) The basis of international trade is the difference in commodity prices in the two countries.

(*b*) Differences in commodity prices are due to cost differences which are a result of differences in factor endowments in the two countries.

(*c*) Labour-rich country specialises in labour-intensive goods and exports them. Capital abundant country specialises in capital-intensive goods and exports them.

2.9. DIFFERENCE BETWEEN CLASSICAL THEORY AND MODERN THEORY OF TRADE

Modern theory of international trade differs from the classical comparative cost theory in many ways and is also superior to the latter.

(*i*) According to the classical economists, there was need for a separate theory of international trade because international trade was fundamently different from internal trade. Heckscher and Ohlin, on the other hand, felt that there was no need for a separate theory of international trade because international trade was similar to internal trade. The difference between the, two was one of degree, and not of kind.

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(*ii*) The classical economists explained the phenomenon of international trade in terms of the old, discredited labour theory of value. The modern theory explained international trade in terms of the general equilibrium theory of value.

(*iii*) The classical theory attributes the differences in the comparative advantage of producing commodities in two countries to the differences in the productive efficiency of workers in the country. The modern theory attributes the differences in the comparative advantage to the differences in factor endowments.

(*iv*) The classical theory presents a one-factor (labour) theory, while the modern theory presents a more realistic multi-factor (labour and capital) theory.

(*v*) The classical theory never took into account the factor price differences, while the modern theory considers factor price differences as the main cause of commodity price differences, which, in turn, provides the basis of international trade.

(*vi*) The classical theory does not provide the cause of differences in comparative advantage. The modern theory explains the differences in comparative advantage in terms of differences in factor endowments.

(*vii*) The classical theory is a single market theory of value, while the modern theory emphasizes the importance of space element in international trade and involves a multi-market theory of value.

(*viii*) The classical theory is a normative or welfare-oriented theory, whereas the modern theory, is a positive theory. The classical theory tries to demonstrate the gains from international trade, while the; modern theory concentrates on the basis of trade.

2.10. LIMITATIONS OF MODERN THEORY OF INTERNATIONAL TRADE

Although the modern theory of international trade is superior to the classical theory in many respects, it has the following limitations:

1. Unrealistic Assumptions: Modern theory is unrealistic in nature because it is based on oversimplified and unrealistic assumptions of free trade, perfect competition, full employment absence of transport costs.

2. Static Theory: The modern theory is static in nature because it is based on the assumption that factor endowments in the two countries are fixed and unchanging in quantity. In the dynamic conditions, the quantity of factor supply may vary.

3. Trade with Similar Factor Endowments: According to the modern Theory, Trade between the two countries occurs only when they have differences in factor endowments. This Implies that there would be no trade between the countries having identical factor endowments. But in reality, international trade takes place even with identical factor endowments.

4. Mobility of Factors: The modern theory also assumes that factors of production are perfectly immobile between countries. This assumption has been criticised on the ground that in reality factors of production have never been immobile internationally.

5. Different Production Functions: Another unrealistic assumption of the modern theory is homogeneous production functions between the countries. In reality, however, production functions for the same product may vary in the two countries.

6. Productive Factors are not Homogeneous: The modern theory assumes that the factors of production are homogeneous in quality between the countries. Labour, for example, is qualitatively identical in two countries. This is quite unrealistic assumption.

7. Differentiated Products: The modern theory is based on the assumption that the two products in the two countries are identical. This is an unrealistic assumption. The products in different countries are usually differentiated.

8. Commodity Prices Determine Factor Prices: According to the modern theory, factor prices determine costs and there by the commodity prices. Wijanhold on the contrary, holds the opposite view. He argues that it is the commodity prices that determine factor prices. Prices of the commodities are determined by their utility (or demand), while the factor prices are dependent on the demand and prices of the commodities produced by them. After all, the demand for factor of production is a derived demand.

9. Demand Side Ignored: Modern theory pays greater attention to the supply side of international trade. It ignores the demand side. Critics fee; that if differences in consumer's demand for goods are recognised, the commodity price ratios will not reflect cost ratios.

2.11. NEO-CLASSICAL THEORY OF INTERNATIONAL TRADE

Haberer made a significant improvement in the Recardian theory of comparative cost advantage. Haberler has used the concept of opportunity cost of producing a commodity instead of absolute or comparative cost of production. Haberler's theory of trade is called opportunity cost theory or neo-classical theory of trade.

The opportunity costs theory says that if a country can produce either commodity X or Y. The opportunity cost of commodity X is the amount of the other commodity Y that must be given up in order to get on additional unit of commodity X. Thus, the exchange ratio between the two commodities is expressed in terms of their opportunity costs.

Assumptions

1. There are only two countries, say A and B.
2. Each country possesses two factors of production, labour and capital.

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3. Each country can produce two commodities say X and Y.
4. There is perfect competition in both the factor and commodity markets.
5. The price of each commodity equals its marginal money costs.
6. The price of each factor equals its marginal value productivity in each employment.
7. The supply of each factor is fixed.
8. There is full employment in each country.
9. There is no change in technology.
10. Factors are immobile between the two countries.
11. Factors are completely mobile within countries.
12. Trade between the two countries is completely free and unrestricted.

Explanation of the Theory

Given these assumptions, a PP curve shows the various alternative combinations of the two commodities that a country can produce most efficiently by fully utilising its factors of production with the available technology. The slope of the PP curve measures the amount of one commodity that a country must give up in order to get an additional unit of the second commodity. In other words, the slope of the PP curve is its Marginal Rate of Transformation (MRT).

It is the shape of the PP curve under different cost conditions that determines the basis and the gains from international trade under the theory of opportunity costs. If the amount of Y required to be given upto get additional quantity of X remain constant, the PP curve would be a straight line and it would indicate constant opportunity costs. If more quantity of Y is required to be given up in order to have an additional quantity of X, the PP curve would be concave to the origin and it would indicate increasing opportunity costs Lastly, if in order to get an additional quantity of X, less quantity of Y is required to be given up, the PP curve would be convex to the origin and it would indicate diminishing opportunity cost.

Trade Under Constant Opportunity Costs

Under constant opportunity costs, the PP curve is a straight line PA is the PP curve of country A and PB of country B. Country A can produce either OP of Y or OA of X and similarly country B can produce either OP of Y or OB of X, If they want to produce both commodities, then they must be on anyone point of their respective PP curves. For instances, at point E country B can produce OX_1 of X and OY_1 of Y. Since the slope of a PP curve determines the relative prices of the two commodities, they are the same at all points on a straight line curve. This is because the opportunity cost of leaving a unit of the other is constant. Thus, the cost ratio on the relative prices of the two commodities in country B is OP/OB and in country A, OP/OA.

As the relative prices differ in the two countries, trade is possible between the two. Taking the two countries A and B, both can produce the same amount OP of Y, but A can produce a larger amount of X, it can produce OA of X as compared to

OB of country B. So commodity X will be cheaper in A than in 3 and Y will be relatively cheaper in B than in A. So A has a comparative advantage in the production of X and B has a comparative advantage in the production of Y under these circumstances, country A will specialise in the production of commodity X and export it to B, the country B will specialize in the production of commodity Y and export it to A.

The pre-trade and post-trade situation of country B is shown in Fig. 2.1, where PR is the new international price line. Before trade, it was consuming and producing both the commodities at point E. After trade it specialises exclusively in the production of Y at point E to C on the international price ratio PR,. It will now export TC of Y to country A in exchange for PT of X. In this situation, country B will not gain but country A will definitely share the gains from international trade.

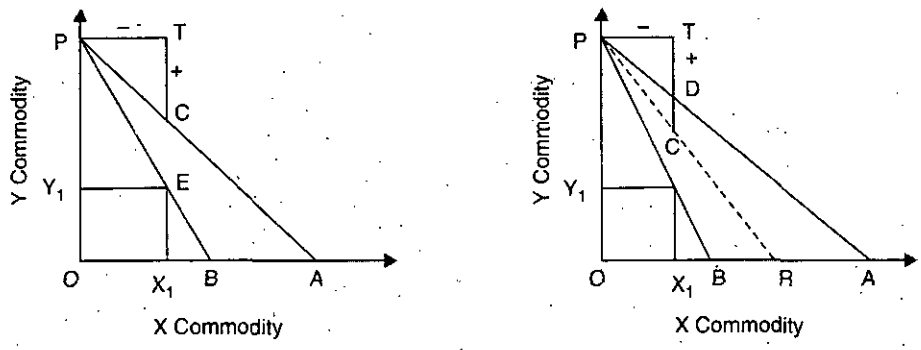

Fig. 2.1

Trade Under Increasing Opportunity Costs

The above analysis of constant opportunity cost is based on the assumptions that factors of production are used in the same fixed proportions due to perfect substitutability for the production of both commodities and that all units of each factor of production are homogeneous. But these assumptions are unrealistic. As a matter of fact, factors of production cannot be subtituted for each other in the production of the two commodities. Moreover some factors are more suited for the production of one commodity than for the other.

The PP curve under increasing opportunity cost is concave to the origin because when a country specialises the production of one commodity, in which it possesses, comparative advantage, its opportunity costs increase. AA_1 is the PP curve of country A which is concave to the origin. The slope of this curve shows that this country will specialise in the production of commodity X. As we move from point A towards point A_1 on this curve, country A will give up larger and larger units of commodity Y in order to have additional units of commodity X. Thus, the country faces increasing opportunity costs as it produces each additional unit of commodity X in which it specialises.

On the other hand, panel B shows BB_1 as the PP curve of country B. The slope of this curve reveals that it will specialise in the production of the commodity Y. As we move upwards from point B_1 to B along this curve, country B will give up larger and larger of X in order to produce additional units of commodity Y. Thus, country

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B faces increasing opportunity costs as it produces each additional unit of commodity Y in which it specialises.

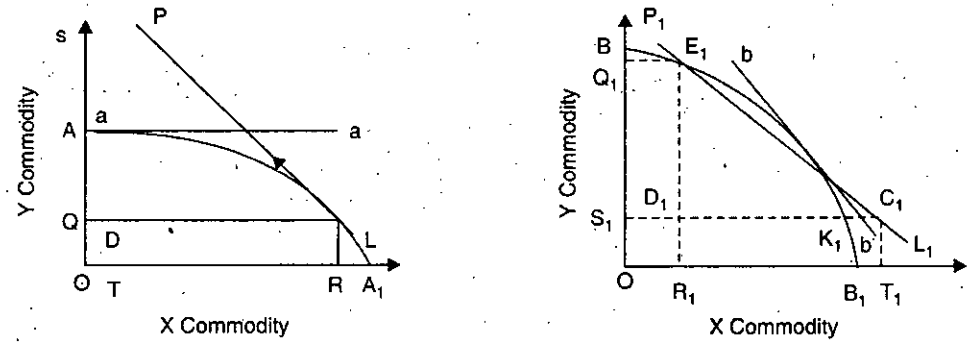

Fig. 2.2

Suppose that in the absence of international trade, country A produces and consumes some qualities of both X and Y at point K, where the line aa is tangent to the production possibility curve AA_1. The line aa indicates that the domestic relative commodity price of X and Y. Similarly, country B produces and consumes some quantities of the two commodities at point K_1 where its price-line bb is tangent to the PP curve BB_1.

Now suppose, both countries decides to trade with each other. This is only possible if the international price ratio of the two commodities differs from that prevailing in the domestic market of each country. Let us assume that the international price ratio is given by the line PL in the country A and P_1L_1 in country B. Since PL is parallel to $P_1 L_1$, the international terms of trade are the same for both the countries.

Trade Under Decreasing Opportunity Costs

When two countries experience decreasing opportunity costs, their PP curves are convex to the origin. Under decreasing opportunity costs, each country completely specialises in the production of only one commodity after trade. This is because there are increasing returns based on internal economies of production.

Trade under decreasing cost is shown, where AA_1 is the PP curve of country A arid BB_1 is that of country B. The pre-trade consumption and production point of country B is K_1 where its domestic price line bb is tangent to its PP curve BB_1. The slope of the domestic price line aa of country A shows that its comparative advantage is greater in the production of commodity X. Similarly, the slope of country B's domestic price ratio bb reveals its greater comparative advantage in the production of commodity Y. But the points K and K_1 are not of stable equilibrium because of the operation of increasing returns in the production of each commodity in the respective country. Any slight disturbance in the form of increasing the price of the specialised commodity in relation to the other will lead to its complete specialization in that country.

Suppose they enter into trade with each other and the international price ratio line in BA_1. This line BA_1 is steeper than the domestic price line aa of country A.

It means that commodity X has become more expensive in the international market. So A will completely specialise in the production of X and accordingly shifts all its resources to its production and move from point K to A_1. On the other hand, the international price line BA_1 is flatter than the domestic price line bb of country B. It means that commodity Y has become more expensive in the international market accordingly, B will shift all its resources to the production of Y and completely specialize in its production and move from point K_1 to B.

Criticism of Neo-Classical Theory

1. Inferior as a Tool of Welfare Analysis: Accordingly to **Viner,** the opportunity cost approach is inferior as a tool of welfare revaluation of the classical real cost approach. He asserts that the doctrine of opportunity costs fail to measure real costs in the form of 'sacrifices', 'disutilities' or 'irksomeness', involved in providing productive services.

2. Ignores Changes in Factor Supplies: Viner also criticises the opportunity costs theory on the ground that the PP curve does not take into account changes in factor supplies.

3. Neglects Preference for Leisure Against Income: Viner further criticises this theory for the failure of the PP curve to take into account the preference for leisure against income. This criticism of Viner has been refused by Walsh. Walsh argues that the possibility of trading at an internation price ratio normally allows a country to increase its real of more leisure, so that the output of both commodities may decrease.

4. Unrealistic Assumptions: Haberler's opportunity cost theory is based on such assumptions as two-countries, two-commodities, a two factors, perfect competition, full employment, no technical change etc. These are unrealistic assumptions which do not hold in the real world.

2.12. GAINS FROM INTERNATIONAL TRADE

Modern Economists argue that the principle governing the gain from domestic trade apply equally well to international trade.

International trade enables a country to import a commodity which it cannot produce at all or can produce only at high cost. Similarly, it provides market for the exports of a country. Thus, a country benefits both as an importer and exporter.

The gains from or causes of international trade are the following:

1. Advantages of International Specialisation: Trade and specialisation are intimately connected, without trade every one must be self-sufficient and with trade everyone can specialise. Thus, nations like regions or individuals can gain from specialisation or division. International trade enables a country to specialise in the production of those goods in which it enjoys special advantage. Every country is endowed with certain special resources in the form of national resources, capital and efficiency of labour. In the absence of trade, every country will be compelled to

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produce all goods which it requires but for which it may not have necessary resources. International trade will enable everyone to specialise in the commodity in which it has absolute or comparative advantage. This leads to international specialization or division of labour which confers benefits of all nations participating in trade. Thus, the biggest gain of international trade relate to the advantages occurring from territorial or international division of labour and specialisation. This specialisation will result in the more production of those goods that are traded between the nations. In other words, specialisation leads to the optimum utilization of resources in a country. Concentrating in the production of only those goods in which the country has absolute or comparative cost advantage.

2. Equal Distribution of Scarce Resources: There be exclusive monopoly of a country or a group of countries over some scarce resources. **For example**, there is monopoly of certain middle eastern countries over petroleum. International trade is the only means by which such scarce resources can be equally distributed among all the nations of the-world and efficiently utilised for the benefit of the world.

3. Equalisation of Prices: As a result of international trade there is movement or goods from countries with abundant commodities to countries with scarcity of commodities. Thus, international trade causes equality in prices of goods in different countries of the world. But perfect equality is not possible.

International trade brings equality in the process of factors of production in all the countries. Through equality of prices of goods, international trade helps to equalise the prices of the factors of production also. Abundant factors will get higher prices, because the commodity produced with their use get higher prices. This will be so in all countries. But complete equality of factors prices is not possible in practice because if all factor prices are equal then there will be no trade between countries.

4. International Trade and Industrialisation: There is close casual relation between international trade and industrialization. Modern Industrialisation is based on specialization and large scale production. Both are based on the existence of large size of markets. Larger the size of market for products, greater is the possibility of specialisation and large scale production.

2.13. BALANCE OF PAYMENT

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payment statements. The balance of international payments or simply the balance of payments, of a country is a systematic record of all international economic transactions of that country during a given period, usually a year. In other words, the balance of payments statements is a device for recording all the economic transactions within a given period between the residents of one country and the rest of the world (the residents of the other countries). Transactions entered on the balance of payments are, of course, international transaction—constituting the transfer of assets and liabilities, the

creation or the reduction of claims or the receipts and payments of funds, which take place between the residents of one country and those of other countries.

Balance of payments accounting of any country uses a double entry system of recording accounts with the rest of the world. Thus, the balance of payments account is divided into transactions giving rise to payments (or debit) and receipts (or credit). All international transactions that result in payments in India (receipts of India), for instance, increase India's stock of, or claims on, foreign currencies and may be recorded as credit (or plus) entries in India's balance of payments. Conversely, all payments by India (receipts to foreigners) deplete India's stock of or claims on, foreign currencies and may be recorded as debit (or minus) entries in the balance of payments account.

However, the balance of payments account should not be confused with the conventional accounting balance sheet or "Profit and Loss" statement of a firm. A balance sheet shows assets and liabilities at a particular time, whereas a balance of payments account groups transactions during a year. However, a country's real economic gain or loss from international trade or transactions cannot be expressed mathematically like an income statement; the real gain to a country from international transactions is social or utility gain.

The balance of payments thus forms part of the national or social accounts of a country, because in social accounting, the economy is classified into:

(*i*) Firms (Production sector),

(*ii*) Households (Consumption sector),

(*iii*) Government sector,

(*iv*) Capital sector, and

(*v*) Rest of the world sector. The transaction in the "rest of the world sector" are known from the balance of payments of the country. It shows what is sent to the foreign countries by the nation and what is received from them in return.

2.14. IMPORTANCE OF BALANCE OF PAYMENTS ACCOUNTS

Basically, a balance of payments account is compiled to measure gross deficits or surpluses with the rest of world. However, the balance of payments statement has became increasingly important in recent years, as it has been devised to describe in a concise fashion the state of international economic relationship of the country, as a guide to its monetary, fiscal, exchange and other policies. It offers a major control tool for both analysing and directing a country's international economic position. Thus, the fundamental aim of the balance of payments statement is to inform governmental authorities about the international economic position of the country, assist them in reaching decisions on monetary and fiscal policies and foreign trade and foreign exchange phenomenon.

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The balance of payments analysis shows whether a country is paying its way internationally, whether it is paying for its imports and other current payment transactions by exporting goods, drawing down its foreign assets, accumulating foreign liabilities or receiving donations. Thus, whether a country is borrowing or lending money, whether its currency and foreign exchange resources are becoming weaker or stronger and how effective are the monetary and exchange control policies it pursues, can be studied from the balance of payments statement of the country. Balance of payments accounting also permits an appraisal of the effects of currency devaluation *i.e.*, whether exports have increased to a considerable extent through devaluation or not can be easily seen from the current account section of the balance of payments statement.

2.15. DIFFERENCE BETWEEN BALANCE OF TRADE AND BALANCE OF PAYMENT

There is a marked distinction between the two concepts, balance of trade and balance of payments. Balance of payments is a wider concept than balance of trade. Infact, balance of payments includes in its structure the notion of balance of trade.

As we know, a country may export and import many items, some of which are visible and some are invisible. Balance of trade refers only to the value of imports and exports of goods, *i.e.*, visible items only. Import or export of goods is a visible item because it is an open trade between the countries and can be easily certified by the customs officials. On the other hand, balance of payments is more comprehensive in scope and covers the total debits and credits of all items, visible as well as invisible. Thus, balance of trade is only a segment of the balance of payments. It simply refers to the difference between the value of visible exports and visible imports.

This is what is represented in the trade or merchandise account section of the current account in the balance of payments statement. Thus, balance of trade is nothing but a major component of the balance of payments. However, balance of payments includes apart from balance of trade or merchandise account, the invisible account which again is composed of services sector and the gifts and charities account comprising varieties of invisible items, plus the record of capital account. It goes without saying, therefore, that since balance of trade is only a partial study of the total economic transactions in international trade, it has little analytical significance. It is the balance of payments which provides a complete record of international economic transactions and has great analytical and economic significance.

2.16. BALANCE OF TRADE IN NATION

A balance of payments statement summarises of nation's total economic transactions undertaken on international trade account. It is usually composed of two sections:

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1. The current account, and
2. The capital account.

The dichotomy is based on the classification of economic transactions into:

(*i*) Real transactions and

(*ii*) Financial transactions.

Real transactions are those which are taken in the real sense of actual transfer of goods and services to foreigners (*i.e.*, export), it creates income for them; similarly when they purchase goods and services from foreigners (*i.e.*, import), it creates income for the foreigners.

Thus, real transactions are income creating transactions. On the other hand, financial transactions are those transactions which involve only the transfer of money or currency (foreign exchange) or claims to money or titles to investment. Financial transactions are often regarded as capital transactions. These transactions do not directly influence the level of income of the countries concerned, as they are effected only through transfer of claims between the countries. They directly involved only changes in the capital or financial assets and liabilities of countries but not their output and income. Thus, real or income-creating transactions are entered into the current account section of the balance of payments, while financing or capital transactions are entered into the current account section of the balance of payments, while financial or capital transactions are entered into the capital account section of the balance of payments. It should be noted that in the balance of payments accounting, transactions which involve receipts of foreign exchange are treated as credits with the plus (+) sign, while transactions which involve payments of foreign exchange are treated as debits with minus (–).

Current Account

Current account mainly consists of two sub-groups:

(*i*) Merchandise or the trade account and

(*ii*) Invisible account.

In the trade or merchandise account, only the transactions relating to goods are entered, *i.e.*, all goods exported and imported are recorded in the trade account.

The invisible account usually consists of services account and the gifts or charities account (usually referred to as "transfer payments"). The services account records all the services exported and imported by residents of the nation. It consists of such items as banking and insurance charges, interest on loans, tourist expenditure, transport charges etc. Similarly, the gifts or charities account consists of all these items received for given away free by residents of the nation. It may be in kind or in cash. It goes without saying that these are all referred to as invisible transactions in the balance of payments theory and therefore, recorded in the invisible account. It is interesting to note here that the International Monetary Fund includes the following items as invisible transactions:

(*i*) International transportation of goods, including warehousing while in transit and other transit expenses.

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(*ii*) Travel for reasons of business, education, health, international conventions or pleasure.

(*iii*) Insurance premiums and payment of claims.

(*iv*) Investment income, including interest, rents, dividends, profits.

(*v*) Miscellaneous service items such as advertising, commissions, film rental, pensions, patent fees, royalties, subscriptions to periodicals and membership fees.

(*vi*) Donations, migrant remittances, legacies.

(*vii*) Contractual amortization and depreciation of direct investment.

Further, the current account also comprises items of "unilateral" or "unrequited transfers" in the transfer payment account.

On the credit side, we have thus, "unrequited receipts", *i.e.*, receipts which the residents of a country receive "for free", without having to make any present or future payments in return. Such items are gifts, indemnities etc. received from foreigners. Similarly, on the debit side, there are "unrequited payments" when gifts, indemnities etc. are made to foreigners. Such unrequited or unilateral transfers lack specific return as a quid pro quo.

Capital Account: Capital account deals with payments of debts and claims. It consists of all such items as may be employed in financing both imports and exports, namely, private balanced, assistance by the international institutional agencies and specific flow and balances held on government account. Accordingly, we shall have private capital account, international institutional capital account, specie account and government capital account. Balance in these accounts may rise or fall from year to year depending upon the account movements or fluctuations in other items on capital account.

Under private capital accounts, all the private balance held by corporate bodies or commercial banks are recorded. Private capital account usually consists of short and long period adjustments. Obviously, the short period capital movements are caused by changes in short-term liabilities. The long-term capital movement is affected by capital investment, direct or indirect. Direct investment is real investment in industries. Indirect or portfolio investment is financial investment in holding of existing assets.

International institutional capital accounts consists of assistance from the short and long-term capital supplying agencies like MF, BIS (Bank for International Settlements), World Bank, International Finance Corporation, International Development Association etc.

Specie account records the movements (inflow and outflow) of gold bullion.

The balance on government capital account consist of all governmental capital transactions in the form of grants or loans, short-term as well as long-term.

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2.17. TYPES OF DISEQUILIBRIUM IN BOP

In general terms, a deficit in the balance of payments is called disequilibrium. Such a deficit may be at the capital account, current account, occasional, chronic, cyclical, enlarging deficits. Each type is caused by different set of factors. But in general, disequilibrium is an unfavourable position in BoP caused by continuous deficits which are large.

Following are the different types of disequilibrium in BoP:

1. Cyclical disequilibrium: This is caused by the trade cycles. The economic activity changes in cyclical fashion with boom depression. In each state, the disequilibrium is caused depending on the spurt of incomes, intensity of demand for imports, domestic prices and nature of exports and imports.

The impact of cyclical disequilibrium is found in developed economies as compared with less developed economies.

2. Secular equilibrium: Secular disequilibrium depends on the level of growth in an economy.

An economy can be a primitive economy, or an economy under preparatory stage for development or an economy in the take-off stage or an economy with high mass consumption. These are the stages of growth as given by W.W. Rostow.

Secular disequilibriumis characterised by the level of population, capital accumulation, technology and resources.

3. Structural disequilibrium: This is caused mainly due to the nature and composition of exports and imports. The elasticities of exports and imports determine the efficiency of any methods of correcting the trade. For example, stagnant exports and elastic imports cause BoP problems. Correction of such disequilibrium will need structural changes in the composition of trade and foreign exchange position.

2.18. CAUSES OF DISEQUILIBRIUM

1. Temporary changes (or Disequilibrium): There may be a temporary disequilibrium caused by random variations in trade, seasonal fluctuations, the effects of weather on agricultural production etc. Deficit or surpluses arising from such temporary causes are expected to correct themselves within a short time.

2. Fundamental Disequilibrium: It refers to a persistent and long-run BoP disequilibrium of a country. It is a chronic BoP deficit, according to IMF. It is caused by such dynamic factors as:

(*a*) Changes in consumer tastes within the country or abroad which reduce the country's exports and increase it's imports.

(*b*) Continuous fall in country's foreign exchange reserves due to supply inelasticities of exports and excessive demand for foreign goods and services.

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(c) Excessive capital out flows due to massive imports of capital goods, raw materials, essential consumer goods, technology and external indebedness.

(d) Low competitive strength in world markets which adversely affects exports.

(e) Inflationary pressures within the economy which make exports dearer.

3. Structural Changes: Structural changes bring about disequilibrium in BoP over the long-run. They may result from the following factors:

(a) Technological changes in methods of production of products in domestic industries or in the industries of other countries. They lead to changes in costs, prices and quality of products.

(b) Import restrictions of all kind bring about disequilibrium in balance of payment.

(c) Deficit in balance of payment also arises when a country suffers from deficiency of resources which it is required to import from other countries.

(d) Disequilibrium in BoP may also be caused by changes in the supply or direction of long-term capital flows. More and regular flow of long-term capital may lead to BoP surplus, while an irregular and short supply of capital brings BoP deficit.

4. Changes in Exchange Rates: Changes in foreign exchange rate in the form of overvaluation or undervaluation of foreign currency lead to BoP disequilibrium. When the value of currency is higher in relation to other currencies. It is said to be over-valued. Opposite is the case of an under-valued currency. Over valuation of the domestic currency makes foreign goods cheaper and exports dearer in foreign countries.

As a result, the country- imports more and exports less of goods. There is also out flow of capital. This leads to unfavourable BoP. On the contrary, undervaluation of the currency makes BoP favourable for the country by encouraging exports and inflow of capital and reducing imports.

5. Cyclical Fluctuations: Cyclical fluctuations in business activity also lead to BoP disequilibrium. When there is depression in a country, volumes of both exports and imports fall drastically in relation to other countries. But the falls in export may be more than that of imports due to decline in domestic production. Therefore, there is an adverse BoP situation. On the other hand, when there is boom in a country in relation to other countries, both exports and imports may increase but there can be either a surplus or deficit in BoP situation depending upon whether the country exports more than imports or more than exports. In both the cases, there will be disequilibrium in BoP.

6. Changes in National Income: Another cause is the change in the country's national income. If the national income of a country increases, it will lead to an increase in imports thereby creating a deficit in its BoP, other things remaining the same. If the country is already at full employment level, an increase in income will lead to inflationary rise in prices which may increase and thus bring disequilibrium.

7. Price Changes: Inflation or deflation is another cause of disequilibrium in the BOP. If there is inflation in the country, prices of exports increase. As a

result, exports fall. At the same time, the demand for imports increase. Thus, increase in export prices leading to decline in exports and rise in imports results in adverse BoP.

8. Stage of Economic Development: A country's BoP also depends on its stage of economic developments. If a country is developing, it will have a deficit in its BoP because it imports raw materials machinery, capital, equipment and services associated with the development process and exports primary products. The country has to pay more for costly imports and gets less for its cheap exports. This lead to disequilibrium in its BoP.

9. Capital Movements: Borrowings and lendings or movements of capital by countries also result in disequilibrium in BoP. A country which gives loans and grants on a large scale to other countries have a deficit in its BoP on capital account. If it is also importing more, as is the case with the U.S.A., it will have chronic deficit On the other hand a developing country borrowing large funds from other countries and international institutes may have a favourable BoP. But such a possibility is remote because these countries usually import huge quantities of food, raw materials, capital goods etc. and export primary products. Such borrowings simply help in reducing BoP deficit.

10. Political Conditions: Political condition of a country is another cause of disequilibrium in BoP. Political instability in a country creates uncertainity among foreign investors which leads to the outflow of capital and retards its inflow. This causes disequilibrium in BoP of the country. Disequilibrium in BoP also occurs in the event of war or fear of war with some other country.

2.19. METHODS OF CORRECTION OF DISEQUILIBRIUM/ CURES OF DISEQUILIBRIUM

If the balance of payment disequilibrium due to surplus balance the country enjoys the position as it would be more desirable but the country's worry when there balance of payment show deficit. In case of disequilibrium due to deficit the country's take measures to eliminate deficit if possible otherwise to reduce the deficit.

1. Automatic Correction: The deficit balance of payment indicates that the demand for foreign exchange is higher than that of the supply for the same. These demand for and supply factors result in devaluation of the domestic currency in terms of foreign currencies. This increase exchange rate, makes the import costlier and export cheaper. Therefore, the country reduces imports and increases exports which inturn increases foreign exchange reserves and restore equilibrium position.

2. Deliberate Measures: Govt. takes certain measures deliberately to control deficit balance of payment position. They include:

(*a*) Monitary measures.

(*b*) Trade measures.

(*c*) Miscelleneous measures.

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(a) Monitary Measures:

(i) Reduction in Money Supply: Monitary measures aim at reducing imports through reducing money supply. Reduction in the supply of money leads to declining income, purchasing power, aggregate demand and consumption. This process of decline in imports and increase in exports corrects the deficit in the balance of payment of a country.

(ii) De-valuation: The value of domestic currency is devalued against foreign currency automatically when the balance of payment position is deficit. Under this measure, the country deliberately devalued its currency in order to reduce imports and boost exports. India devalued its rupee a number of time for this purpose. The import become costly. Once the currency is devalued as importer has to pay more domestic currency for the same quantity of imports, through this measure the Govt. of the domestic currency reduces the import. Further the foreign businessman feels that importing from country which devalued its currency as cheap as they can get more number of products for the same amount of their currency. Thus, this measure increases export.

(iii) Exchange Control: The exporters after earning the foreign exchange have to the surrender to the Reserve Bank of India Imports get the permission for the Reserve Bank of India for import and the use of foreign exchange. Reserve Bank of India and Govt. control imports in this process and reduces the deficit of the balance of payment.

(b) Trade Measures: Trade measures are divided into export promotional measure and import control measures.

(i) Export Promotional Measures: Include abolishing export duties, export subsidies, encouragement to export oriented units, liberal loans for export oriented units, marketing incentive and facilities etc.

(ii) Import Control Measures: Import control measure include import duties, import quotas, import licences, prohibiting import of certain items, increase in custom duty of import etc.

(c) Miscellaneous Measures: Include loans in foreign currencies attracting foreign NRI deposit development of tourism etc.

2.20. CAUSES OF DISEQUILIBRIUM IN DEVELOPING COUNTRIES

BoP disequilibrium is common with most developing economies. Study of the factors and nature of disequilibrium will help in correction and design of methods of protection.

Following are the important causes of disequilibrium:

1. Large population, increasing growth rates of population.
2. Stagnant exports due to out dated products
3. Increasing demand for imports.

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4. Low productivity and poor growth rates.
5. Lack of bargaining power.
6. Large external debt due to which the burden of debt servicing increases.
7. Adverse terms of trade.
8. Cyclical fluctuations in economic activity.
9. Problems of international liquidity.
10. Absence of ant trading association or regional block.
11. Weak currency.

2.21. PHYSICAL BALANCE OF TRADE

Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials, known as Total Material Consumption). Developed countries usually import a lot of primary raw materials from developing countries at low prices. Often, these materials are then converted into finished products, and a significant amount of value is added. Although for instance the EU (as well as many other developed countries) has a balanced monetary balance of trade, its physical trade balance (especially with developing countries) is negative, meaning that a lot less material is exported than imported. For this reason, activists talk about the issue of ecological debt which implies a sort of predatory economic system. The nature of the trade balance statistics is such that it conceals distorted material flow.

SUMMARY

- Labor is the only primary input to production (labor is considered to be the ultimate source of value).
- Limited amount of labor in the economy.
- Labor is perfectly mobile among sectors but not internationally.
- The Heckscher-Ohlin theory stresses that countries should produce and export goods that require resources (factors) that are abundant and import goods that require resources in short supply.
- The Classical theory of international trade is given by Adam Smith and David Ricardo. The theory explains the condition of international trade specialization and benefits of trade.
- The position of International exchange rate depends on several factors like bargaining power, level of development, nature of commodity export and import and demand elasticity of goods traded.
- According to the theory of value, at the equilibrium level, demand is equal to supply and commodity price is equal to average cost of production. Heckscher-

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Ohlin theory emphasises the mutual interdependence of the prices of commodities the prices of factors of production, the demand for commodities and the demand and supply of factors of production in international trade.

- According to the classical economists, there was need for a separate theory of international trade because international trade was fundamently different from internal trade. Heckscher and Ohlin, on the other hand, felt that there was no need for a separate theory of international trade because international trade was similar to internal trade.
- Modern theory is unrealistic in nature because it is based on oversimplified and unrealistic assumptions of free trade, perfect competition, full employment absence of transport costs.
- The modern theory is static in nature.
- According to the modern Theory, Trade between the two countries occurs only when they have differences in factor endowments.
- Haberler has used the concept of opportunity cost of producing a commodity instead of absolute or comparative cost of production. Haberler's theory of trade is called opportunity cost theory or neo-classical theory of trade.
- The principal tool for the analysis of the monetary aspects of international trade is the balance of international payment statements. The balance of international payments or simply the balance of payments, of a country is a systematic record of all international economic transactions of that country during a given period.
- Balance of payments statement has became increasingly important in recent years, as it has been devised to describe in a concise fashion the state of international economic relationship of the country, as a guide to its monetary, fiscal, exchange and other policies.
- The fundamental aim of the balance of payments statement is to inform governmental authorities about the international economic position of the country, assist them in reaching decisions on monetary and fiscal policies and foreign trade and foreign exchange phenomenon.
- A balance of payments statement summarises of nation's total economic transactions undertaken on international trade account.
- Cyclical disequilibrium is caused by the trade cycles. The economic activity changes in cyclical fashion with boom depression.
- Secular disequilibrium depends on the level of growth in an economy.
- Structural disequilibrium caused mainly due to the nature and composition of exports and imports.
- Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials, known as Total Material Consumption).

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REVIEW QUESTIONS

1. Describe Ricardian theory, Heckscher-Ohlin, classical theory of International Trade.
2. What do you mean by absolute cost advantage? Discuss with suitable examples.
3. Write the limitations of classical theory. How Ricardian theory differs from classical theory of International Trade.
4. Differentiate between classical theory and modern theory of trade.
5. What do you mean by Balance of payment? Differentiate between Balance of trade and Balance of payment.

FURTHER READINGS

- **Dictionary of International Trade and Business:** New Century, 2008, xxxvi
- **Exchange Rates, Capital Flows and International Trade: The Case of Bangladesh:** Akhtar Hossain, University Press, 2000
- **Financial and Consultancy Services: Issues in International Trade:** Edited by V.L. Rao and Jan ter Wengel, Sage, 2000

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UNIT

3

FOREIGN EXCHANGE

STRUCTURE

3.0. LEARNING OBJECTIVES

After going through this unit, you will be able to :

- explain the meaning of foreign exchange
- describe the methods of foreign payments
- discuss the balance of payment theory
- define the term foreign exchange market.

3.1. INTRODUCTION

Foreign Exchange: Foreign exchange is the system or process of converting one national currency into another and transferring of money from one country to another.

Foreign exchange is the monetary mechanism by which transactions evolving two or more currencies take place.

An international marketer needs to transact financial transfers, across national lines in order to close deals. The financial transfers from one country to another are made through the medium of foreign exchanges.

3.2. MEANING OF FOREIGN EXCHANGE

The term 'Foreign Exchange' is used in two senses:

1. Wide Sense: According to some economists, the term 'Foreign Exchange' refers to that entire operation by which to countries clear off their indebtedness. Here the term 'Foreign Exchange' is used in wide sense. It includes:

(*i*) All those institutions which facilitate foreign payments,

(*ii*) All those methods and mechanisms which are made use of for making international payments and

(*iii*) The rate at which the currency of one country is converted into the currency of another country.

2. Narrow Sense: Some economists have used the term 'Foreign Exchange' in a narrow sense. According to them, foreign exchange refers to the sale and purchase of foreign currencies. According to other economist, the term 'Foreign Exchange' refers to the rate of exchange or the rate at which the currency of one country is converted into the currency of another country.

According to **S.E. Thomas,** "Foreign exchange is that branch of the science of economics in which we seek to determine the principles on which the peoples of the world settle their debts one to the other." In the words of Hartley Withers, "Foreign exchanges are a mechanism by which international indebtedness is settled between one country and another."

According to **S.J. Chapman,** "The machinery whereby payments are effected in international trade is known as foreign exchange."

In short, foreign exchange rate is the price of one unit of the foreign currency in terms of the domestic currency.

3.3. NEED FOR FOREIGN EXCHANGE

There was a time in human civilization that money, whether in coins or in paper, didn't exist. When we needed something, we would have to give up one of our possessions for another's. For example, if a farmer sees a travelling merchant visiting their community to sell some precious and delicate china porcelains, he would have to exchange a portion of his rice for the merchant's china. Such an agreement is called barter where one thing is exchanged for another that were believed to be of the same value.

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Of course, this hardly ever happens now as barter, except may be for e-bay, as it could become a very complicated process in the large-scale. Money has become an effective tool to make businesses and ultimately, our daily lives, easy and simple. When you need a commodity or service, all you need to do is to have the right amount of money in order to have that thing you desire.

Because of globalization and with more countries opening up to the world, it is inevitable that we become more involved with each other. The young Koreans have found it important to see and travel the world with a certain fondness for the beaches in the Southeast Asia. The Americans travel all the time to France and Italy to see the latest fashion and the great landmarks. The Africans are selling their nicely-crafted home designs to the Europeans. All of these are indicative as to how we are all connected, one way or another. However, when you travel, you cannot bring your nation's money alone and expect to live on a foreign land. This is where foreign exchange becomes important to us.

Multiple countries are also doing business with each other and this is another situation where foreign exchange becomes important. When a Filipino exporter exports his mangoes to the US, he does not get paid in pesos but in dollar equivalent. Foreign exchange is an exchange of two national currencies, in this case, the peso and the dollar.

The foreign exchange market is unique because of:

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, *i.e.* trading from 20:15 GMT on Sunday until 22:00 GMT Friday;
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins and with respect to account size.

3.4. METHODS OF FOREIGN PAYMENTS

A country can make payments to another country in three ways:

1. Export of Commodities: A country can make payments for its imports by exporting its own goods to that country. In other words, the payments are made not in terms of currency or gold, but in terms of commodities. This method, however, is highly defective, Firstly, it is possible that the second country may not like to import goods from the first country because the second country is perhaps producing those goods itself. Secondly, under this method, the country in question has to face all those difficulties which arise under the barter system.

2. Export of Gold: The payment for foreign goods can also be made in terms of gold. But this system is also defective because the cost of transporting gold from

one country to another is quite prohibitive these days. Moreover, it is inconvenient for one country to make the payment to another country in terms of gold, the reason being that there are innumerable international trade transactions taking place everyday.

3. Payment through Foreign Exchange Bills: The foreign payments these days are mostly made through foreign exchange bills. According to this method the trader of a country makes the payment for the imported goods through the medium of foreign exchange bills. The foreign exchange bills are generally of three types :

(*a*) Bill of Exchange: Most of the international payments these days are made through the medium of exchange bills.

(*b*) Banker's Draft: This is the second method of making international payments. It is similar to the internal bank draft. An importer can make the payment for the imported goods by sending the banker's draft to the exporter of the other country. By depositing the national currency, the importer can buy from the exchange bank the banker's draft which he can send to his creditor in the exporting country. The banker's draft is always drawn in terms of foreign currency.

(*c*) Telegraphic Transfer: This is the third method of making international payments. Generally, making payments through bank drafts is a time-consuming process. If the foreign exporter has to be paid immediately, the importer makes the payment through telegrahic transfer. Under this, the foreign exporter receives the payment for his goods telegraphically. Telegraphic transfers, like banker's drafts, are issued by the exchange bank.

Major Types of Exchange Rates: Major types of exchange rates are as follows:

1. Spot Rate: Spot rate of exchange is the rate at which foreign exchange is made available on the spot. It is also known as cable rate or telegraphic transfer rate because at this rate cable or telegraphic sale and purchase of foreign exchange can be arranged immediately. Spot rate is the day-to-day rate of exchange. The spot rate is quoted differently for buyers and sellers. For example, \$ 1 = ₹ 15.50 for buyers and \$ 1 = ₹ 15.30 for the seller. This difference is due to the transport charges, insurance charges, dealer's commission etc. These costs are to be born by the buyers.

2. Forward Rate : Forward rate of exchange is the rate at which the future contract for foreign currency is made. The forward exchange rate is settled now but the actual sale and purchase of foreign exchange occurs in future. The forward rate is quoted at a premium or discount over the spot rate.

3. Long Rate: Long rate of exchange is the rate at which a bank purchases or sells foreign currency bills which are payable at a fixed future date. The basis of the long rate of exchange is the interest on the delayed payment. The long rate of exchange is calculated by adding premium to the spot rate of exchange in the case of credit purchase of foreign exchange and deducting premium from the spot rate in the case of credit sale.

4. Fixed Rate: Fixed or pegged exchange rate refers to the system in which the rate of exchange of a currency is fixed or pegged in terms of gold or another currency.

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5. Flexible Rate: Flexible or floating exchange rate refers to the system in which the rate of exchange is determined by the forces of demand and supply in the foreign exchange market. It is free to fluctuate according to the changes in the demand and supply of foreign currency.

6. Multiple Rate : Multiple rates refer to a system in which a country adopts more than one rate of exchange for its currency. Different exchange rates are fixed for importers, exporters and for different countries.

7. Two-Tier Rate System: Two-tier exchange rate system is a form of multiple exchange rate system in which a country maintains two rates, a higher rate for commercial transactions and a lower rate for capital transactions.

3.5. ROLE OF EXCHANGE RATE IN THE ECONOMY OF A COUNTRY

The whole exchange rate system is determined by the debits and credits of the record of foreign" exchange transactions, since the latter involves demand for and supply of the foreign currency. Usually, there is no great difference between the balance of payments and the record of foreign exchange transactions. On the other hand, exchange rates exercise and influence on the autonomous payments and receipts included in the balance of payments. The exchange rates are normally fixed in such a way that they lead to an equilibrium.

If other things remain equal and if foreign demands are at all elastic to price, any reduction in the exchange rate of a country's currency will have the effect of increasing the volume of its exports and, thus, increasing the total value of its exports as measured in terms of its own money. Moreover, the low exchange rate will induce a greater demand for the currency of this country in exchange markets to buy its exports. The actual effect of a reduction of exchange rate will, however, depend on the elasticity of foreign demands for its exports Now Marshall-Learner condition states that depreciation of a country's currency will improve its balance of payments only when the sum of elasticities of demand for its exports is greater than unity.

On the other hand, if the price elasticity of a country's demand for imports is greater than unity, other things being equal, the higher the exchange rate of its currency, the less expensive will be its imports and therefore, greater the quantity of its imports. If the imports are much larger than exports, then total value of imports in domestic currency will be more than exports and there will be a deficit in the balance of payments.

A change in exchange rate, thus; brings about changes in the balance of trade. The country having a surplus in the balance of payments gets an increase in investment, output and employment. While there is a decline in the level of economic activity in the other country having a deficit in its balance of payments. A change in exchange rates gives rise to multiplier effects. Even without induced multiplier effect, the composition of output in each country is likely to change as a consequence of changing exchange rate. It follows then that even if the total level of activity

remains unchanged, a change in exchange rates leads to disturbances and adjustments; and secondly, as a result of the shift of the producers to export industries and industries competing imports in the depreciating country and the counter-shift in appreciating country, the producers of these industries are better off in the former and worse off in the latter. The redistribution of incomes thus effected may affect savings and investment plans and consequently the general level of activity may change.

The analysis of the effects of changes in exchange rates on the balance of payments based on elasticities of demand is subject to limitations, but this does not invalidate the basic contention that exchange depreciation is an interesting device that a nation can use to cheapen its exports to foreigners without reducing their prices in terms of domestic currency received by its exporters. The exchange rate variations not only affect the external balance, but also have a considerable influence on the level of prices and income in each trading country. The situation keeps changing under the influence of the changes in the volume of international trade and capital movements. This leads us to the conclusion that monetary policy, including money supply policy, cannot be viewed and treated in isolation. Instead, it must be seen in the context of foreign exchange rate developments.

3.6. FUNCTIONS OF FOREIGN EXCHANGE MARKET

1. Transfer of Purchasing Power: The main function of foreign exchange market is the transfer of purchasing power from one country to another and from one currency to another.

2. Provision of Credit: The growth of foreign trade depends upon the extend on credit facilities. Exporter get re-shipment of post-shipment credit.

3. Provision of Hedging Facilities: Hedging refers to covering of exports risk and guards the exporters and importers against losses arising from fluctuation from exchange rate.

Transaction Foreign Exchange Deals Presents Two Problems

1. Methods and Procedures: Each country has its own methods and procedures for effecting foreign exchange usually developed by its central bank. The transactions themselves, however, take place through the banking system. Both the methods and procedures of the central, bank and commercial banking constraints must be thoroughly understood and followed to complete a foreign exchange transaction.

2. The Fluctuation of the Rates of Exchange: Fluctuations in exchange rates are based on the supply and demand of different currencies.

Conducting Foreign Exchange Transactions: Foreign exchange transactions may be conducting by government via their central bank, brokers commercial banks or business corporations.

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The supply and demands of a currency are influenced by variety of following factors:

1. Imports and exports of commodities.
2. Imports and exports of gold and silver.
3. American tourist expenditure abroad and foreign tourist expenditure in United States.
4. Interests and dividends due on foreign securities held here.
5. New purchase and sale of foreign securities.
6. Re-purchase and redemption of foreign securities held here.

3.7. THEORIES FOR EXCHANGE RATE DETERMINATION

The reason behind the difference is that different theories, data and econometric methods are used. It is clear that not all the theories that are actually used are suitable for forecasting the movement of exchange rate. Some may be better than others. Thus, it is very important for researchers who study exchange rates to choose or create a better theory with micro foundations for an empirical study.

The exchange rate theories investigated in this part can be classified into three kinds: partial equilibrium theories, general equilibrium theories and disequilibrium or hybrid theories. Partial equilibrium theories include relative PPP and absolute PPP, which only consider the goods market; and covered interest rate parity (CIRP) and uncovered interest rate parity (UCIRP), which only consider the assets market, and the external equilibrium theory, which states that the exchange rate is determined by the balance of payments.

DETERMINATION OF EXCHANGE RATES

3.8. PURCHASING POWER PARITY THEORY

Purchasing power parity theory was developed by "Gustav Caesel" in the years following the first world war when the exchange rates are free to fluctuate the rate of exchange between two currencies in the long-run will be determined by their respective purchasing power.

"The rate of exchange between two currencies must stand essentially on the quotient of the international purchasing of these currencies". —***Gustav Caesel***

"While the value of the unit of one currency in terms of the another currency is determined at any particular time by the market conditions of demand and supply in the long-run that value is determined by the relative value of the two currencies as indicated by their relative purchasing power over goods and services."

—***Prof. S.E. Thomas***

In other words the rate of exchange tends to rest at that point which express quality between the respective purchasing power of the two currencies. This point is called the purchasing power parity.

Thus, according to the purchasing power parity theory the exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at that rate of exchange are equivalent.

For example: Assume that a particular bundle of goods in India cost ₹ 48 and the same in U.S.A. cost $1 then the exchange rate will be in equilibrium if the exchange rate is

$1 = ₹ 48

Once the equilibrium is established the market forces will operate to restore the equilibrium if there are some deviations.

For example: If the exchange rate changes to $1 = ₹ 50.

When the purchasing power of these currencies remain stable. A Dollar holder will convert Dollar into rupees because by doing so they can save ₹ 2 when they purchase a commodity worth Dollar 1. This will increase the demand for the Indian currency and the supply of Dollars will increase in foreign exchange market and ultimately the equilibrium rate of exchange will be re-established.

A change in the purchasing power of currencies will be reflected in their exchange rates. The index number of prices may be made used to determine the purchasing power parity.

Evaluation of the Theory

The purchasing power parity theory is subject to following criticism:

(*a*) The theory makes use of the price index number to measure the changes in the equilibrium rate of exchange. Hence, the theory suffers from various limitations of the price index number.

(*b*) The quality of goods and services may vary from country to country comparison of prices without regard to the quality is unrealistic.

(*c*) The theory rendered further unrealistic approaches by ignoring the cost of transport in international trade.

(*d*) Another very unrealistic assumption made by the theory is that international trade is free from all barrier.

(*e*) The theory does not explain the demand and supply of foreign exchange, when the exchange rate is determined largely by demand and supply condition, any theory that does not pay adequate attention to these aspects proves to be unsatisfactory.

(*f*) No satisfactory explanation of short term changes in exchange rate is provided by the theory.

(*g*) The purchasing power parity theory goes country to general experience. Critics points of that there has hardly been any case when the rate of exchange between two currencies have been equivalent to the ratio of their purchasing powers.

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Despite its many defects and deficiencies the purchasing power parity theory exposes some very important aspects of exchange rate determination:

(*i*) It indicate the relationship between the international price level and exchange rates.

(*ii*) It explain the state of the trade of a country as well as the nature of its balance of payment at a particular time.

(*iii*) Further the theory is applicable to some extent to all sorts of monetary standards.

3.9. BALANCE OF PAYMENT THEORY

The balance of payment theory also known as demand and supply theory and general equilibrium theory of exchange rate holds that the foreign exchange rate under the free market conditions is determined by the conditions of demand and supply in the foreign exchange market.

Thus, according to this theory the price of the currency that is the exchange rate is determined just like the price of any commodity is determined by the free play of the forces of demand and supply.

The value of a currency appreciate when the demand for it increases and depreciates when the demand falls in relation to its supply in the foreign exchange market.

The extent of the demand for and supply of a country's currency in the foreign exchange market depends on its balance of payment position. When the balance of payment is in equilibrium the supply of and demand for the currency are equal. But when there is a deficit in the balance of payment supply of the currency exceeds its demand and causes a fall in the external value of the currency when there is a surplus demand exceeds supply and causes a rise in the external value of currency.

Evaluation of the Theory

The balance of payment theory provides a fairly satisfactory explanation of the determination of the rate of exchange. This theory has the following merits :

(*a*) Unlike the purchasing power parity theory the balance of payment theory recognises the important of all the items in the balance of payment in determining the exchange rate.

(*b*) This theory is in confirming with a general theory of value like the price of any commodity in a free market. The rate of exchange is determined by the forces of demand and supply.

(*c*) This theory brings the determination of the rate of exchange within the preview of the general equilibrium theory that's why this theory is called the general equilibrium theory of exchange rate determination.

(*d*) It also indicates that balance of payment disequilibrium can be corrected by adjustments in the exchange rate by devaluation or revaluation rather than by internal deflation or inflation.

The main defect of this theory is that it does not recognise the fact that the rate of exchange may influence the balance of payment.

Criticism of the Balance of Payment Theory

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This theory suffers from certain serious drawbacks :

(*a*) **Based on the unrealistic assumption of perfect competition:** The assumption that there exist perfect competition in international trade is far from truth.

(*b*) **The rate of exchange also affect the balance of payment:** This theory determines the rate of foreign exchange on the basis of the balance of payment while as a matter of fact. Rate of exchange also affect the balance of payment. The balance of payment against the country with the rise in the rate of exchange.

(*c*) **This theory ignores the internal price level:** The fluctuation in the internal price level affects the quantum of the imports and exports of the country. This changes in the quantity of foreign trade affect ultimately the balance of payment which in turn affect the rate of exchange.

(*d*) **The demand for imported goods is not perfectly inelastic:** The theory assumes that demand for imported goods as perfectly inelastic. While it's assumptions is far from the truth.

3.10. MINT PARITY THEORY

This theory explains the determinations of rate of exchange between two countries. Which are on metallic standard. To illustrate the theory lets take the example of two countries which are only gold standard and see how the rate of exchange between them is determined in actual practices.

"The mint parity is on expression of the ratio between the statutory bullion equivalent of the standard monetary units of the two countries on the same metallic standards" —**S.E. Thomas**

Thus the mint parity theory implies the mint par rate at which the currencies of two countries can be exchanged with each other. Under this theory the gold contents of the standard coins of the two countries is evaluated and rate of exchange between them is established.

For example: Before the first world war the mint par of exchange between U.K. and U.S.A. was one Pound Sterling = 4.866 $ but which does not mean that the actual rate of exchange between the U.K. and U.S.A. was one pound sterling = 4.866 $. The actual rate of exchange could either be more or less than the mint par of exchange.

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3.11. GOLD OR SPECIE POINTS OF THE THEORY

The actual rate of exchange between the two countries is determined by the balance of payment within the two well defined limits. These limits are known as gold or specie points. The upper gold or specie points or the lower gold or specie points. These gold coins fix two limits and the rate of exchange between two countries will keep fluctuating between them. The upper gold limit is arrived at by adding two cost of transporting gold to the existing mint power of exchange.

Let us suppose that the cost of transporting gold worth 1 pound from the U.K. to the U.S.A. is 0.020 cents. Now, if this expenditure on transport is added to the mint parity we shall get the upper gold limit.

1 Pound Sterling = 4.866 + 0.020
= 4.886 Dollars

Likewise when we deduct the cost of transporting gold from the mint of exchange. We arrive at the lower gold point.

1 Pound Sterling = 4.866 – 0.020
= 4.846 Dollars

In this way the rate of exchange between the U.K. and U.S.A. will keep on fluctuating between those two gold or specie points.

Conclusion

We thus reach to the conclusion that the rate of exchange will neither rise above 1 Pound = 4.886 Dollars nor shall, it fall below 1 Pound = 4.846 Dollars. The rate of exchange will keep on fluctuating between the two gold points. According to the favourableness or the unfavourableness of the balance of payment.

If the two countries happen to be on silver standard then the rate of exchange between them shall be determined in the same manner as between the two countries on the gold standard.

The mint parity theory of exchange rate has lost whatever validity it had in the past. Because no country, today is either on the gold or on the silver standard.

SUMMARY

- According to some economists, the term 'Foreign Exchange' refers to that entire operation by which to countries clear off their indebtedness.
- Spot rate of exchange is the rate at which foreign exchange is made available on the spot. It is also known as cable rate or telegraphic transfer rate because at this rate cable or telegraphic sale and purchase of foreign exchange can be arranged immediately.
- Forward rate of exchange is the rate at which the future contract for foreign currency is made.
- Long rate of exchange is the rate at which a bank purchases or sells foreign currency bills which are payable at a fixed future date.

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- Fixed or pegged exchange rate refers to the system in which the rate of exchange of a currency is fixed or pegged in terms of gold or another currency.
- The main function of foreign exchange market is the transfer of purchasing power from one country to another and from one currency to another.
- Purchasing power parity theory was developed by "Gustav Caesel" in the years following the first world war when the exchange rates are free to fluctuate the rate of exchange between two currencies in the long-run will be determined by their respective purchasing power.
- "The rate of exchange between two currencies must stand essentially on the quotient of the international purchasing of these currencies".
- Thus, according to this theory the price of the currency that is the exchange rate is determined just like the price of any commodity is determined by the free play of the forces of demand and supply.
- "The mint parity is on expression of the ratio between the statutory bullion equivalent of the standard monetary units of the two countries on the same metallic standards"

REVIEW QUESTIONS

1. What do you mean by foreign exchange? Discuss about the need of foreign exchange.
2. Discuss different ways of Foreign payments.
3. Describe the role of exchange rate in the economy of a country.
4. Explain functions of foreign exchange market.
5. Describe different theories for exchange rate determination.

FURTHER READINGS

- **Glossary of International Trade:** Edward G. Hinkelman, Laxmi Publications, 2010
- **History of International Trade and Monetary Economy:** M A Chaudhary, Global Vision Pub, 2008, viii,
- **Import/Export: How to Get Started in International Trade, 3/e:** NELSON, Tata McGraw-Hill, 2004, Third.

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UNIT

4

FOREIGN TRADE OF INDIA

STRUCTURE

4.0. LEARNING OBJECTIVES

After going through this unit, you will be able to :

- describe the direction of India's foreign trade
- explain the meaning of export promotion
- discuss the term international liquidity
- illustrate the various measures to solve the problem of international liquidity.

4.1. THE DIRECTION OF INDIA'S FOREIGN TRADE

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When India started as an independent country, she had to her credit ₹ 1,736 crores worth of steeling balances and in the few years after independence, the Govt. of India's anxiety was to utilize these sterline balances as soon as possible. There was no emphasis on exports at all. The sterling balance were reduced to ₹ 911 crores in 1950-51 on the eve of our first five year plan. The first five year plan was a modest one and therefore the balance of payments deficit was much less than anticipated. This encouraged the Govt. of India to have a bigger second plan with a higher foreign exchange component. As a result, imports were much higher in the second plan exports did not show any significant increase nor there was any attempt to increase them. In fact, rising prices towards the end of the first plan coupled with a liberal import policy led a substantial increase in imports with the result that by the middle of the second plan foreign exchange reserves were reduced to a very low figure of ₹ 186 crores only.

The third plan was a much bigger plan and average annual imports increased to ₹ 1,241 crores inspite to the tight import policy, during third plan.

Reasons for an Enormous Increase in Imports

1. Large volume of food imports.
2. Large import of capital equipment due to increase in the developmental efforts.
3. Increasing requirements of maintenance imports.
4. Heavy increase in defence imports.
5. Increase in import prices.

Reasons for Slower Growth In Exports

1. Stagnant agricultural production.
2. Reduction in exportable surplus due to :

(*a*) Increase utilization of exportable to raw material at home.

(*b*) Increase in domestic incomes.

(*c*) Increase in population.

3. Intensification of inflationary pressures.
4. Static demand for some of the staple export items.
5. Reduction in export prices.

In 1966, India had to launch its fourth plan which was fairly ambitious with a heavy foreign exchange component. The world bank and IMF also impressed upon India to do something to improve her balance of payments position and Govt. of India decide to devalue the rupee on June 6,1966 by 36.5 per cent.

Average annual imports increased to ₹ 1991 crores while annual average exports increased to ₹ 1,238 crores and trade deficit was still greater.

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In the fourth plan, imports remained stagnant as a whole due to:

(*i*) General sluggishness of the economy as also.

(*ii*) India's capacity to manufacture herself most of what she needs.

In the fifth plan (1974-78) the average annual imports jumped by 165 per cent from ₹ 1973 crores to ₹ 5,221 crores. The primary cause of this sharp jump was the oil price hike which led to substantial increase in the import bill for petroleum products and fertilizers. The relaxation in restriction on imports of capital goods and equipment and increased purchases thereof seen to have made up for the suspension of Govt. gain purchases.

There was an increase in the annual average exports as well but the increase was less from ₹ 1,810 crores to ₹ 4,481 crores, *i.e.*, by 148 per cent.

The main reasons for the high growth rate in India's exports between 1972-73 and 1976-77 were :

(*i*) The availability of new markets in oil rich countries due to the oil price boom.

(*ii*) Commodity price boom which continued at least upto 1974 and the resultant higher unit value realization.

(*iii*) Opportunities created by oil crises due to increase in prices of petroleum based products.

(*iv*) Recession in domestic industries leading to search by Indian manufacturers for markets abroad.

(*v*) Increase in project and turnkey exports.

Sixth and Seven Plan Period

Export performance in terms of volume growth of less than three per cent per annum during the sixth plan considerably fell short of the target annual growth of nine per cent volume growth in exports accelerated during the seventh plan and averaged 6.3 percent per annum during the first four years as against the targeted annual growth of 0.7 percent. The strong volume growth in exports is reflected in average additional exports of ₹ 8,420 crores per annum over the average level of exports during the sixth plan. The share of manufacturers which was around 53 percent in terms of value during the sixth plan rose to about 70 per cent on average during the seventh plan period.

Eighth Plan

During the eighth plan a number of conscious policy reform undertaken by the government of India, exports have increased substantially. The various reasons have increased substantially.

The various reasons for the increase in exports are:

(*a*) Exemption of export profits from income tax.

(*b*) Devaluation of rupees.

(*c*) Greater availability of export credit and lower interest rates.

(*d*) Partial convertibility and later full convertibility of rupee of trade account.

(e) Easier imports of an export culture which has resulted in greater production for exports.

(f) Greater competition in domestic market.

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4.2. RECENT TRENDS IN INDIA'S FOREIGN TRADE

The ninth plan will stress the crucial importance of sound foreign trade and investment policies in order to promote rapid and sustained export growth. It will seek to enhance the technological strength and economic efficiency of domestic production and to ensure a smooth and effective transition to more open economy. The objective of the ninth plan is to achieve growth with equity this objective has to be seen against the need for self-reliance.

India has imparked on a process of gradual and phased opening up of its economy to take advantage of new opportunities in trade and investment. While this process needs to be continued and taken forward. It should form a position of strength. The ninth plan will address the issue of external vulnerability and develop suitable strategies for making India a strong and confident player in the international economy.

The first and perhaps most important, component of self-reliance is to ensure balance of payments sustainability and avoidance of excessive external debt. This required a commitment sound and prudent macro-economic policies.

4.3. FOREIGN TRADE IN 1996-97

India's export was on a growth path since 1992-93 and 1995-96, India's exports increased by about 29 per cent in rupee terms and 20 per cent in US dollar terms. Export growth rate started declining in 1996-97 and fell down to 11.71 per cent. The major sectors witnessing a declaration include leather good, gems and jewellery ore and minerals, tea and garments.

So far as concerned non-oil imports during 1996-97 stood $ 29.1 billion which is a little lower than the level in the previous period. Oil imports however, rose by 33.3 per cent during the same period. Total imports stood at $ 39.1 billion as against $ 36.7 billion during 1995-96 a rise of 10 per cent. The ninth plan will be based on a framework of prudent macro management and greater reliance on non-debt creating external flows for financing balance of payments needs such as foreign direct revetment.

Self-sufficiency in food is a basic element in any strategy of self-reliance. In view of the fluctuations is agricultural production arising out of weather related factors, India will have to target a secular growth rate of agriculture which is high enough to prevent period large-scale imports.

Natural resources are considered as the patrimony of the nation. It is not desirable to excessively deplete the natural resource. Endowments of the country

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which may expose future generations. The ninth plan play more stress on conservation and optional utilization of natural resources.

During the ninth plan, exports are assumed to grow at an average annual rate of 12 per cent in dollar terms. This rate of growth of exports is based on the assumption that the share of exports is incremental output of the manufacturing section will rise from the per cent level of 22 per cent to above 25 per cent.

4.4. MEANING OF EXPORT PROMOTION

Export promotion refers to the policy of the Govermnet designed to encourage the exporters to export more goods from the country than before. In order to render foreign trade of India favourable it is necessary to increase exports. In the words of **Sh. L.N. Mishra,** former Union Minister of Foreign Trade, "Exports are life line and motive power for economic growth and development." Export promotion refers to those policies and measures which can result into maximum increase in the exports of a country. It calls for a policy that may extend the market for export goods. To promote exports, several incentives are given to the exporters as mentioned above.

4.5. NEED OF EXPORT PROMOTION IN INDIA

Need of export promotion in India is mainly because of the following reasons :

1. To Reduce Foreign Loans: Country has to borrow large foreign funds to import essential machinery for country's economic and industrial development as also for strengthening its defence. Till March 1998, India had contracted foreign loans amounting to ₹ 3,73,511 crores. These loans are to be repaid one day. Out of these loans ₹ 70,970 crore was paid in 1998. In order to pay interest and repay the principal amount of these loans it is necessary that a policy of export promotion be adopted. Foreign exchange earned as a result of larger exports will be utilized for the repayment of foreign loans.

2. Export of New Products: During the period of planning, new industries have been set up in India. In order to increase the sale of the products of these industries their export is to be promoted. It becomes easy to increase exports under export promotion programme.

3. To-Correct Unfavourable Balance of Trade: During the period of planning excepting two years, all other years have witnessed unfavourable balance of trade. It not only reduced the foreign exchange reserves of India but also made it difficult to achieve plan targets. Successful completion of plans, therefore, calls for turning of unfavourable balance of trade into favourable one.

4. For the Defence: Essential war equipments, weapons, aeroplanes etc., are imported from advanced countries for our defence. To defray their cost, it is necessary to increase exports.

5. To Achieve the Objective of Self-reliance: One of the main objectives of Indian plans is to make the country independent of foreign assistance. To achieve this objective, it is necessary to promote exports. By accelerating exports large amount of foreign currency can be earned.

6. Success of the Planning: Successful execution of the plans, necessitates import of machines and other capital goods from abroad. To earn necessary foreign exchange to meet their import bills, it becomes incumbent to increase exports.

4.6. OBJECTIVES OF EXPORT PROMOTION

Objectives of export promotion is to achieve the goal of self-reliance. It is possible only if exports exceed imports. As a consequence, resources for economic development like machines, raw materials, petrol and essential commodities like foodgrains etc., will be obtained from abroad according to our need. When a country earns foreign currency through its exports, it no longer stands in need of foreign loans to pay for its imports. India's foreign trade has been adverse since independence. To meet the deficit of its foreign trade, it has to borrow foreign currency. Thus, a substantial part of country's export earnings are utilized in debt servicing. Foreign debts can easily be repaid if export earnings increase. Essential goods can be imported from abroad. It will accelerate the rate of economic growth and improve the standard of living of the people.

4.7. EXPORT PROMOTION BENEFITS

Export development is important to the firm and to the economy as a whole government measures aim. Normally, at the general improvement of the export performance of the nation for the general benefit of the economy. Such measures help exporting firms in several ways.

The benefits of exports to the economy are :

1. When the domestic market is small, foreign market provides opportunities to achieve economies of scale and growth.
2. The supply of many commodities, as on the case of a number of agriculture products in India, is more than the domestic demand.
3. Exports enable certain countries to achieve exported growth.
4. Export markets may help mitigate the effects of domestic recession.
5. A country may need to boost its exports to earn enough foreign exchange to finance its imports and service its foreign debt.
6. Even in the case of countries with trade surplus, export promotion may be required to maintain its position against the international competition and the level of domestic economic activity.

The principal objective of export promotion measures in India are to:

1. Compensate the exporters for the high domestic cost production.
2. Provide necessary assistance to the new and infant exporters to develop the export business.

3. Increase the relative profitability of the export business *vis-a-vis* the domestic business.

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4.8. ORGANIZATIONAL SET-UP

Government has established or sponsored a number of organisations to provide different types of assistance to the exporters. Apart from the organisation established exclusively for export promotion, there are also a number of other institutions which assist the export sector.

1. Ministry of Commerce: The ministry of commerce Govt. of India, is the most important organ concerned with the promotion and regulation of the foreign trade of the country. The ministry has elaborated organisational arrangement to look after various aspects of trade regulation and promotion. The department of commerce is assigned a very important role in different matters concerned with foreign trade of the country including:

(*a*) Commercial relation with other countries.

(*b*) Promotion and regulation of foreign trade.

(*c*) State trading.

Matters related to foreign trade are dealt with by eight divisions of the department of commerce.

(*i*) Administrative and general division

(*ii*) Finance division.

(*iii*) Economic division.

(*iv*) Trade policy division.

(*v*) Foreign trade territorial division.

(*vi*) Exports products division.

(*vii*) Service division.

2. Autonomous Bodies

(*a*) Commodity Boards: There are five statutory commodity boards responsible for production, development and exports of tea, coffee, rubber, species and tobacco.

(*b*) Export Inspection Council: The export inspection council, a statutory body is responsible for the enforcement of quality control and compulsory pre-shipment inspection of various exportable commodities.

(*c*) Indian Institute of Foreign Trade (IIFT): The IIFT, registered under the Societies Registration Act, is engaged in the following activities :

(*i*) Training of personnel in modern techniques of international trade.

(*ii*) Organization of research in problems of foreign trade.

(*iii*) Organization of marketing research area surveys, commodity surveys and market surveys.

(*iv*) Dissemination of information arising from its activities relating to research and market studies.

(*d*) Indian Institute of Packaging: There are a number of export promotion councils under the administrative control of ministry of commerce. These councils are registered as non-profit organisation under the Companies Act.

(*e*) Export Promotion Councils: These councils are registered under non-profit organisations of Companies Act. The councils perform both advisory and execute functions these councils are also the registering authorities under the import policy for registered exporters.

(*f*) Federation of Indian Export Organisation: It is an apex body of various export promotion organisation and institutions. It also functions as a primary servicing agency to provide integrated assistance to Govt. recognised export houses and as a central co-ordinating agency.

(*g*) Indian Council of Arbitration: This is set up under the Societies Registration Act, promotes arbitration a means of setting commercial disputes.

(*h*) Agricultural and Processed Food Products Export Development Authority (APEDA): The APEDA, set up in 1986 serves as the focal point for agricultural exports, particularly, the marketing of processed foods in value added forms.

(*i*) Indian Trade Promotion Organisation (ITPO): The ITPO was bought into being in 1992 by merging together the Erst while Trade Fair Authority of India (TFAI) and Trade Development Authority of India (TDA). The functions of the ITPO are :

(*i*) Develop and promote exports, imports and upgrade technology through fairs in India and abroad.

(*ii*) Compile and disseminate trade related information.

(*iii*) Undertake publicity through the rapt and electronic media.

(*iv*) Organise visit of foreign buyers and trade.

(*v*) Delegation to industry and trade establishments in India with a view to promoting trade contracts.

(*vi*) Asst. Indian Companies in trade development; organise export development programmers, buyer-seller meets and conduct promotion programmes and integrated marketing promotion programmes for the trade and industry in India.

3. Public Sector Undertakings: The following trading/service corporations are functioning under the administrative control of the ministry of commerce.

(*a*) The state trading corporation of India and it subsidiaries.

(*b*) The minerals and metals trading corporation of India and its subsidiary *viz.*, mica, trading corporation.

(*c*) The species trading corporation.

(*d*) The export credit guarantee corporation.

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4. Advisory Body

Central Advisory Council of Trade: The CACT, consisting of representative form of different organisations and individual with business standing and expertise in the field of trade and commerce, advice government on matters relating to:

(*a*) Export and import policy programme.

(*b*) Operation of import and export trade controls.

(*c*) Organisation and development of commercial services.

(*d*) Export credit guarantee corporation.

(*e*) The commerce minister is the chairman of this council.

5. Attached and Sub-ordinate Offices

(*a*) Office of the Director General of Foreign Trade (DGFT): The DGFT is responsible for the execution of the export and import policies of the government.

(*b*) Directorate General of Commercial Intelligence and Statistics: The directorate is the primary govt. agency for the collection, compilation and publication of the foreign, in land and ancillary trade statistics and dissemination of various types of commercial information.

(*c*) Office of development commissioner : For each of the free trade zone/ export processing zone there is an office of DC responsible for administration of the zone.

4.9. STEPS TAKEN BY GOVERNMENT FOR EXPORT PROMOTION

Government of India has taken the following measures to promote exports:

1. Committees: Several committees have been appointed to invite their suggestions for the promotion of exports, viz. Gorewala Committee 1950, De Souza Committee 1957, Import and Export Policy Committee 1962, Alexander Committee 1979, Tandon Committee 1980, and Abid Hussain Committee 1984, Rangarajan Committee 1991. These committees have given several suggestions for the promotion of exports from the country. For instance, special climate be created in the country for promoting exports, subsidies be granted to the exporters, concessions be given to them in respect of taxes and freight charges.

2. Institutions for Export Promotion: Government has set up several institutions to encourage exports. For instance,

(*i*) **Export Promotion Council:** With a view to promote the export of different products, 19 export committees have been formed,

(*ii*) **Trade Development Authority was set up in 1970:** It aimed as organizing small and medium-level enterprises and increasing their export capacity. It is being re-organised,

(*iii*) **Central Advisory Council on Trade:** This council was set up on 15 February, 1978. Its main function is to advise the government on matters

relating to exports and imports and to extend the production of export goods,

(*iv*) **Federation of Indian Export Organisations:** The federation is to coordinate the functioning of different export organisations in the country. The consultancy firms functioning with the organisation are provided financial assistance by the government,

(*v*) Export Inspection Advisory Council has been formed to examine the quality of export goods,

(*vi*) Export Credit and Guarantee Corporation has been set up in place of Export Risk Insurance Corporation. Its function is to arrange credit for export trade,

(*vii*) **Indian Institute of Packing:** The institute offers suggestions regarding packing of export goods,

(*viii*) **Commodity Boards:** Government has constituted these boards for promoting the production and export of five products, namely, tea, cardamon, rubber, coir and silk,

(*ix*) **Export-Import Bank:** The bank has been established to meet the financial requirements of foreign trade and to take prompt decision regarding exports,

(*x*) Board of Trade has been set up to advise on promotion of exports.

3. Increase in Production: In order to increase exports, it is necessary to increase the output of agriculture, industry and minerals. Jute manufacturers, tea and cotton textiles play a significant role in the exports from India Efforts have been made to increase the production of these traditional exports in the five-year plans. Several new products are being exported, viz. machinery, gems and jewellery, electric fans, cycles, hosiery goods, iron, handicrafts and ready-made garments. Raw materials are provided to export industries at international prices. Production capacity of cement, fertilizer, iron and steel, sugar industries etc. is being fully utilized.

4. Publicity of Export Goods: With a view to giving wide publicity to Indian exports abroad, Trade Fair Authority of India was constituted, in 1977. It organizes International Trade Fairs wherein different countries participate. Indian Council of Trade Exhibition has been set up at Mumbai. In important cities and centres abroad, show-rooms displaying Indian products have been opened.

5. Export Houses: The firms and companies engaged in export have been classified in different types of houses on the following basis:

(*i*) **Export Houses:** Those firms and companies which export goods worth at least ₹ 15 crore per annum are called Export Houses.

(*ii*) **Trade Houses:** Those companies which export goods worth ₹ 75 crore per annum are regarded as Trade Houses.

(*iii*) **Super Trading Houses:** Export House having average exports worth ₹ 300 crore per annum are recognised as Super Trading Houses.

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(*iv*) Super Star Trading Houses: Export Houses having average exports worth ₹ 1,000 crore per annum are recognised as Super Star trading houses. All these Houses are entitled to more facilities concerning exports.

6. Export Finance: Reserve Bank of India, Commercial Banks, Export Credit and Guarantee Corporation (ECGC) and Industrial less Development Bank of India (IDBI) provide several facilities to the exporters, vs. The exporters get 90 per cent of the total value of exports as loan immediately after the shipment of the goods. In November 1992, it was made obligatory for the commercial banks to give 10 per cent of their net loans for exports by the end of June 1993. With a view to providing credit facilities to export trade, in January 1982, Export Import Bank was established. A Technical Development Fund has been established to finance foreign exchange requirements of export oriented units for their modernisation. A Productivity Fund was established for industries such as engineering and export oriented electronic industries to increase their productivity.

7. Tax Exemptions and Rewards: Export firms have been granted many tax exemptions. About 850 commodities have been exempted from custom duty. They have been allowed imports on a liberal scale. Government also gives awards to exporters for their performance. In 1996, as many as 730 firms were honoured with awards for the maximum export of different goods. Export firms are allowed to get their export earnings converted into domestic currency, in full, at market rate of exchange.

8. Encouragement to Tourist Trade: Several kinds of facilities are provided to foreign tourists with a view to encouraging tourist trade in India. Tourism Ministry has been set up for this purpose.

9. Inducement of Investment in Export Industries: In 1972, government of India in its export policy decided to encourage export industrial and for this purpose it established Trade Development Authority. Such foreign firms will be allowed to set up their units in India as undertake to export hundred per cent of their production.

10. GATT Agreements: In 1994, India signed General Agreement on Tariffs and Trade (GATT) and thereby entered into trade agreements with all the 125 member countries of GATT. In 1995 it was re-named as World Trade Organization and has been in operation since 1st January 1995. WTO is a permanent international trade body that has replaced GATT.

11. Devaluation of Indian Currency: Devaluation means lowering the value of domestic currency in terms of a foreign currency by government. Devaluation becomes necessary when the imports of a country are greater than its exports. In order to correct disequilibrium of the balance of payments and to promote exports, devaluation is resorted to. As a result of devaluation, imports become expensive and exports cheap. In India, in 1949 devaluation for the first time was resorted. On 6 June 1966, Indian rupee was devalued for the second time to the extent of 35.5 per cent. Value of the rupee came down to 0.11849 grains of gold or 13.3 cents. In July 1991, rupee was devalued to the extent of 20 per cent for the third time.

12. Reduction in cost of Production: Several measures have been taken to bring down the cost of production of the goods produced in country. Export industries are being modernized and rationalized.

13. Marketing Development Fund: In 1963 government of India established Marketing Development Fund. It provides financial assistance to such entrepreneurs as make special efforts to promote exports.

14. Import of Second Hand Capital Goods: According to new Export Import Policy, most of the second hand capital goods could be imported without licence. These machines should not be older than 7 years.

15. Relaxation in Controls: The government has relaxed the controls on exports. The industrial licensing policy had been made more liberal for setting up export oriented factories. The export of a large number of items is altogether decontrolled. Export procedures and formalities are simplified.

16. Fiscal Measures: The government has adopted the following fiscal measures for export promotion:

(*i*) The excise duties and other indirect taxes on export goods are fully remitted. The duty drawback rates have been finalised,

(*ii*) Under the Cash Compensatory Scheme (CCS) cash assistance is given to compensate for the indirect taxes levied on the imported inputs required for export production,

(*iii*) Export profits are totally exempted from income tax.

(*iv*) Certain raw materials like steel, aluminium, cement and rubber and fuels are supplied at concessional prices for export production.

(*v*) Under import replenishment scheme, foreign exchange was allocated to exporters for import of raw materials used up in the production of export goods.

17. Setting up of Export Zones: The government has established several export processing zones in Mumbai, Kandla, Chennai, Noida, Falta and Cochin. The export units located in these zones were allowed free trade with the rest of the world. They were not to pay taxes for five years. The government also promoted hundred per cent export oriented units. They were allowed several concessions to enable them to compete in the world market.

18. Export Oriented Units: In different parts of the country, 130 industrial units have been set up which export hundred percent of their production. These industries produce engineering goods, equipments, paper products etc.

19. Export Oriented Units for Agricultural Output: In order to the export of agricultural products, Export Oriented Units (EOU) have established. If these units export 50 per cent of their total output, then they will not required to pay any duty on imports. Besides, these units will import capital goods at concessional import duty.

20. Trade Representative: Government of India has appointed trade representatives in its embassies abroad. Their function is to conduct survey in foreign countries to explore the potential markets for Indian goods. In 1982, to encourage exports to european countries, Economic Mission of India was founded.

21. Full Convertibility of Rupee: During 1994-95 budget, the system of full convertibility of export earnings from abroad has been allowed. It means freedom to buy or sell foreign currency on current account of the balance of payments.

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Exporters will be free to sell foreign exchange earned by them at the market rate. Current account transactions refer to transactions in goods and services. It will increase the profitability of the exporters and they will be encouraged to increase exports. In 1997, Tarapore Committee was appointed to recommend full convertibility of the rupee. The committee had submitted its report in May 1997.

22. Training in Foreign Trade: In order to impart education concerning foreign trade, **Indian Institute of Foreign Trade** was set up. For imparting training regarding packing of goods exported from India in 1967 **Indian Institute of Packing** was founded.

4.10. SUGGESTION FOR EXPORT PROMOTION STRATEGY

Following suggestions are given to promote Indian exports:

1. Proper Management of Information: Prospective exporters must be fully informed regarding the market position in abroad. Survey should be conducted in different countries to explore the possibilities of export. Exporters must be fully informed of the facilities being given to them by the government. Export information and procedure must be widely disseminated. Big export houses must be fully apprised of relevant export information.

2. Export Sector Should be Declared Priority Sector: Export sector should be given wide publicity, so that handicrafts and art goods be exported to other countries. Engineers, doctors and technicians, etc. should be encouraged to serve abroad on contract basis. Likewise, musicians, dancers etc., be allowed to go abroad to demonstrate their art and skill. Foreign tourists be afforded all facilities, on priority basis. Similarly exporter should also be given several facilities like:

(*i*) Regular supply of electricity.

(*ii*) Concession in taxes.

(*iii*) Facilities of rapid shipment of cargo.

(*iv*) Availability of raw material in proper measure.

(*v*) Extension of production capacity.

3. Control Room for Exports: Under the ministry of commerce there should be set up a control room for exports. Its function will be to increase facilities for the promotion of exports and remove all difficulties faced by the exporters. The government should make efforts to make it more efficient in the interest of export promotion.

4. Product Planning for Exports: A proper plan need be framed in respect of the products to be exported. New products be produced on a large-scale to answer foreign demand. Supply of export goods must be uninterrupted. Goods having large domestic demand be exported only if their supply is in excess of internal demand. Quality of export goods should be high and their prices competitive.

5. Training for Export Marketing: Training facilities for export trade be expanded in the country. Special measures should be taken by the Indian Institute of Foreign Trade in this matter. The Institute should make provisions for imparting training for export marketing in different universities.

6. State Trading: In promoting exports, State Trading has a significant role to play. However, state trading in our country has not proved efficacious and beneficial. Like private sector, state trading should also adopt commercial attitude towards exports.

7. Cost Benefit Analysis: Government of India has been spending millions of rupees on the promotion of exports every year. Verghese Committee and Bhagwati and Desai are of the view that the expenditure incurred by the government on export development councils and others for promoting exports has not yielded any positive results. These councils have been spending more than half of their total expenditure or non-developmental activities. The amount actually spent on export incentives and export promotion should be properly utilized so that a proper ratio between cost of export promotion and the subsequent benefit there from is established.

8. Joint Ventures Abroad: Indian entrepreneurs and government should set up joint ventures in abroad. It will have a very healthy effect on our exports.

4.11. INTERNATIONAL LIQUIDITY

International liquidity is defined as the aggregate stock of internally acceptable assets held by the control bank to settle a deficit in country's BoP.

International liquidity provides a measure of a country's ability to finance its deficit in BoP without resorting to adjustment measures. Shortage of liquidity hampers the expansion of global trade and its surplus leads to global inflationary pressures.

International liquidity is generally used as a synonym for international reserves. Such reserves include a country's official gold stock holdings, its convertible foreign currencies. SDRs and its net reserve position in the IMF. International liquidity includes private as well as official holdings of international liquidity assets.

4.12. PROBLEMS OF INTERNATIONAL LIQUIDITY

The need or problem of international liquidity arises because the demand for international liquidity is rising more than its supply, thereby implying shortage of international liquidity. The principal causes for the shortage of international liquidity are the following:

1. BoP Deficits: There have been increasing BoP deficits of the majority of countries in the world. In particular, after the opening of LDCs to world markets, these countries have been facing persistent BoP deficit. Too much dependence on exports has exposed these economies to international fluctuations in the demand for and prices of their products. They have become unstable due to international cyclical instability. On the other hand, their import requirements have been on the increase in order to develop. As a result, they are faced with foreign exchange constraints. This has necessitated larger inflow of laid foreign investment. Consequently, debt serving and interest on debt have risen and payments of dividends, profits and royalties on private direct foreign investment have grown,

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thereby leading to decline in the net inflow of foreign capital. All these have led to further shortage of foreign exchange reserves.

2. High Tariff Barriers: The export of LDCs to developed countries have not been increasing, thereby adversely affecting their export earnings. One of the reasons for the non-expansion of their exports has been high tariff barriers imposed by the developed countries on their exports, specially by their exports, especially by their regional groups like the EEC. At the same time, LDCs are trying to cut down their essential imports from the developed countries by means of exchange controls, high tariffs, import quotas and similar protectionist devices in order to conserve foreign exchange. This has adversely affected their development process.

3. Attitude of Developed Countries: The majority of developed countries have surplus in their BoP. They are creditors of LDCs and do not take any interest in getting rid of their surplus so as to increase international liquidity.

4. Unequal Distribution of International Reserves: The distribution of International reserves is biased and favours the developed countries. It is primarily based on their quotas in the IMF. Whenever the IMF quotas are revised, the larger share goes to the developed countries. It is the developing countries whose need for international liquidity is far greater which suffer from its storage.

4.13. MEASURES TO SOLVE THE PROBLEM OF INTERNATIONAL LIQUIDITY

1. Promoting Export Expansion: Developing countries should reduce BoP deficit by promoting export expansion. The choice lies in concentrating the expansion of primary or secondary products requires import substitution for export expansion. These policies will earn them foreign exchange.

2. Limiting Exports: They should ban non-essential consumer goods and limit imports of specific goods by selective tariffs, physical quotas etc. This policy will enable them to conserve foreign exchange.

3. Changing Official Exchange Rate: A developing country can change its official exchange rate by developing its currency so that its export prices are lowered and import prices are increased. This will help in earning foreign exchange.

4. Restrictive Monetary Fiscal Policies: By following restrictive monetary and fiscal policies, a developing country can reduce domestic demand for products which will lower import prices, reduce inflationary pressures and BoP deficits.

5. Reduction in BoP Surplus: The majority of developed countries surplus which they should reduce by:

(*a*) Accepting the national currencies of developing countries for payments.

(*b*) Remove of trade barriers to the products of developing countries.

(*c*) Accepting products of developing countries in exchange for their products.

6. Expanding International Reserves: The IMF should expand international reserves by fresh allocation of larger quotas to member countries. In particular, all new issues of SDRs should be distributed to developing countries so that they may pay them to develop countries to solve their foreign exchange problem.

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4.14. POSITION OF INTERNATIONAL RESERVES

The main features of international reserves or international liquidity have been:

1. Gold reserves of the countries of the world increased from $ 33.9 billion in 1951 to SDR 224.1 billion in 1997.

2. Marked increase in the share of foreign exchange reserves from $ 13.7 billion in 1951 to SDR 1078.2 billion in 1997.

3. Increase in reserve position in the IMF from $ 1.7 billion in 1951 to SDR 36.2 billion in 1997.

4. Emergence of SDRs since 1972 which increased from SDR 8.7 billion to SDR 18.7 billion in 1997.

Thus, the total international reserves comprising the above four items increased from $ 49.3 billions to SDR 1357.2 billion in 1997.

An efficient trade information system is essential for success in the dynamic global market— our marketing infrastructure as well as marketing techniques.

4.15. QUANTITATIVE ASPECT OF THE PROBLEM

International liquidity problem is the problem of inadequacy of international reserves. Reserves are said to be inadequate when their availability is insufficient to ensure the smooth functioning of the international monetary system and to meet the expanding world trade. During 1950s, there was no liquidity problem in general because the availability of reserves was on the whole sufficient to meet its demand. But, the liquidity problem became serious since 1960. Shortage of reserves has been increasingly felt every where. The following are the reasons for the inadequacy of international reserves.

1. Inadequate Growth of Reserves: Although the total volume of reserves has been increasing since World War II, the rate of growth has been slower than the expansion of world trade. During 1960s, the world economy faced a situation when international liquidity was inadequate to maintain the total volume of trade. World's reserves declined as a percentage of imports for all groups of countries from 67% in 1951 to 55% in 1960 and further to 32% in 1970.

2. Uneven Expansion of Reserves: The growth of international reserves has been uneven among the countries. Some developed countries have registered a growth rate of 15% or more per annum, while many developing countries have a growth rate of less than 1%.

3. No Conscious policy: There has been no conscious policy of relating reserve growth to the expansion of the international trade. The growth of liquidity has been of a somewhat haphazard nature. It has tended to depend upon uncertain factors, such as gold mining developments, the sale of gold from U.S.S.R. and the willingness of people in various countries to hold their international reserves in dollars.

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4. Slow Growth of Gold: Gold reserves increased at a very low rate. In fact, gold reserves were limited by the physical amount of the metal in existence. There was some possibility of increasing gold reserves by new mining or by bringing some stock of gold out of private hoards, but this too was a limited possibility, especially when the price of gold was held fixed at a very low level in an inflationary world. Again the value of gold could have been increased by general devaluation (*i.e.,* by an increase in the price of gold). But, this was opposed by most of the officials.

5. No Solution by Rising IMF Quotas: The international liquidity can be improved by increasing reserve trench positions. The trench positions can be increased by raising IMF quotas and this was done a number of times. But, this measure cannot by itself increase the world's total reserves. Whenever a quota increase boosts a nation's trench position, its subscription payment reduces its stock of other reserve assets by an equal amount.

6. Liquidity Problem of Developing Countries: The liquidity problem is much more serious for the developing countries because of the following reasons :

(*a*) While the developed countries need international reserves mainly to tide over a short-term balance of payments deficit, the developing countries requires foreign resources both to cover the temporary fluctuations in their annual exhange earnings as well as to meet long-term needs of economic development.

(*b*) The developing countries are chronically capital deficient and technological backward countries and need huge amounts of funds for importing goods and technology.

(*c*) These countries mostly export cheaper primary goods and import costly capital goods. The foreign demand for primary goods has been declining and their terms of trade have been deteriorating.

(*d*) Recent recession in the developed countries has led these countries to adopt protectionist policies, which have further affected adversely the export earnings of the developing countries.

(*e*) All these factors have resulted in heavy balance of payment deficits in the developing countries and these deficits are growing continuously.

(*f*) The developing countries face serious debt-repayment problem and the rich countries as well the international financial institutions, like the IMF, the world Bank, the I.D.A., etc. do not provide sufficient assistance to help these countries come out of their present difficulties relating to debt-repayment crisis and adverse balance of payments.

4.16. QUALITATIVE ASPECT OF THE PROBLEM (OR THE CONFIDENCE PROBLEM)

The qualitative aspect of the liquidity problem is concerned with the use of reserve currencies. The U.S. dollar and the pound sterling are the principal or key currencies. However, since World War II, dollar has been widely accepted as the major international currency for carrying out international trade and investment transactions. In the composition of international liquidity, gold and reserve currencies play a dominant role. But, since gold reserves cannot be increased much,

the growing requirements of international liquidity are to he met by increasing the reserve currency holdings. Now the process of increasing the reserve currency (dollar) holdings means creating balance of payment deficits in the reserve currency centre country (America), if the other countries tend to accumulate the reserve currency. This leads to the confidence problem.

The confidence problem is primarily concerned with the inherent defect in the reserve currency system and is related to the value of a reserve currency as an asset. This problem arises from the need for increased reserves of the reserve currency and can be understood with the help of the following propositions:

(*a*) Dollar is as good as gold because the U.S. is ready to exchange dollar for gold at a fixed price on demand,

(*b*) Other countries need increasing stocks of reserves which can be supplied only by creating the U.S. payments deficits,

(*c*) If this process continues for a long-time, the other countries would have more dollars than the gold reserves owned by the U.S.

(*d*) All the dollars then could not possibly be exchanged for gold and the U.S. would be viewed as a chronic deficit country,

(*e*) The dollar would eventually cease to be attractive.

Thus, under the present monetary system, we are faced with an international liquidity dilemma. An increase in the liquidity reserves the U.S.'s willingness to incure deficits in its balance of payments. But, continued U.S. deficits will disincline the other countries to keep their international reserves in the form of dollars. They will start converting their dollars into gold. There will be dollar crises and it will lose its popularity. If, in order to avoid this crises, America attempts to reduce its balance of payments deficits, the world's liquidity reserves will fall. Thus the problem of international liquidity is closely linked with America's balance of payments problem.

SUMMARY

- The ninth plan will stress the crucial importance of sound foreign trade and investment policies in order to promote rapid and sustained export growth. It will seek to enhance the technological strength and economic efficiency of domestic production and to ensure a smooth and effective transition to more open economy. The objective of the ninth plan is to achieve growth with equity this objective has to be seen against the need for self-reliance.
- India's export was on a growth path since 1992-93 and 1995-96, India's exports increased by about 29 per cent in rupee terms and 20 per cent in US dollar terms.
- Export promotion refers to the policy of the Govermnet designed to encourage the exporters to export more goods from the country than before.
- Country has to borrow large foreign funds to import essential machinery for country's economic and industrial development as also for strengthening its defence.
- Objectives of export promotion is to achieve the goal of self-reliance. It is possible only if exports exceed imports.

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- When the domestic market is small, foreign market provides opportunities to achieve economies of scale and growth.
- The ministry of commerce Govt. of India, is the most important organ concerned with the promotion and regulation of the foreign trade of the country.
- Central Advisory Council on Trade was set up on 15 February, 1978. Its main function is to advise the government on matters relating to exports and imports and to extend the production of export goods.
- The federation is to coordinate the functioning of different export organisations in the country.
- Indian Institute of Packing offers suggestions regarding packing of export goods.
- Survey should be conducted in different countries to explore the possibilities of export. Exporters must be fully informed of the facilities being given to them by the government.
- International liquidity is defined as the aggregate stock of internally acceptable assets held by the control bank to settle a deficit in country's BoP.
- Developing countries should reduce BoP deficit by promoting export expansion.
- The growth of international reserves has been uneven among the countries.
- Gold reserves increased at a very low rate. In fact, gold reserves were limited by the physical amount of the metal in existence.

REVIEW QUESTIONS

1. What do you mean by export promotion? Explain the need of export promotion in India.
2. Discuss the objectives of export promotion and its benefits.
3. What are the steps taken by the government for export promotion? Explain with examples.
4. What is the meaning of International Liquidity? Write the problem arises due to international liquidity.
5. Explain in details the measures taken to solve the problem of international liquidity.

FURTHER READINGS

- **India's International Trade and Economic Reforms:** Narendra Prasad, Kanishka, 2004
- **International Trade:** P K Vasudeva, Excel Books
- **International Trade:** Raj Agrawal, Excel Books, pbk

UNIT

5

I.M.F AND W.T.O

STRUCTURE

5.0. LEARNING OBJECTIVES

After going through this unit, you will be able to :

- explain international monetary fund
- discuss the objectives of W.T.O
- explain the meaning of export documentation
- discuss the term bill of landing.

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5.1. INTERNATIONAL MONETARY FUND (IMF)

The TMF, also called the fund, is an international monetary institution established by 44 nations under the Bretton woods agreement of July, 1944. The Principal aim was to avoid the economic mistakes of the 1920s and 1930s.

Thus, the IMF was established to promote economic and financial co-operation among its members in order to facilitate the expansion and balanced growth of world trade. It started functioning from March 1, 1947. In 1996, the fund has 181 members.

Functions of the Fund

1. The IMF operates in such a way as to fulfill its objectives as laid down in the Bretton wood's Articles of Agreements. It is the fund's duty to see that these provisions are observed by member countries.
2. The fund gives short-term loans to its members so that they may correct their temporary balance of payments disequilibrium.
3. It aims at reducing tariffs and other trade restrictions by member countries.
4. The fund also renders, technical advice to its member on monetary and fiscal policies.
5. It conduct research studies and publishes them in IMF staff paper, finance and development etc.
6. It provide technical experts to member countries having BoP difficulties and other problems.
7. It also conducts short training courses on fiscal, monetary and BoP for personnel from member nations through its control banking service development, the fiscal affairs department, the Bureau of statics and the IMF institute.

Working of the Fund

1. Financial Resources The capital of the fund includes quotas of member countries, amount received from the sale of gold, GAB (General Agreement to Borrow) and loans from member nations.

The fund has general account based on quotas allocated to its members when a country joins the fund, it is assigned a quota that governs the size of its fund, it is assigned a quota that governs the size of its subscription, it's voting power and its drawing rights.

At the time of the information of the IMF, each member was required to pay 25% of its quota in gold on 10% of its net official holdings of gold and U.S. dollars whichever was less. Under the second amendment effective from 1 April, 1978, 25% of a member's quota payable in gold was substituted by SDRs or usable currencies.

2. Fund Borrowings: Besides performing regulatory and consultative functions the fund is an important financial institution. The bulk of its financial resources comes from quota subscriptions of member countries. Besides, it increases its fund by selling gold to members. Further it borrows from government, central banks or private institutions of industrialized countries, the banks for international settlements and even from OPEC countries like Saudi Arabia.

3. Fund Lending: The fund has a variety of facilities for lending its resources to member countries. Lending by the fund is linked to temporary assistance to members in financing disequilibrium in their BoP on current account. It is not charged any interest on such drawings, but is required to repay within a period of 3 to 5 years.

4. Exchange Rates: The original fund agreement provides that the par value of each member country was to be expressed in terms of gold of certain weight and finances or U.S. dollars. The underlying idea was to create a system of stable exchange rates with orderly cross rates under the new system, the member countries are not expected to maintain and establish par values with gold or dollars. The fund has no control over the exchange rate adjustment policies, of the member countries.

5.2. NATURE OF IMF

A landmark in the history of world economic cooperation is the creation of the International Monetary Fund, briefly called IMF.

The genesis of the fund lies in the breakdown of Gold Standard, which created a vacuum in the field of international trade. With the abandonment of gold standard in the 'thirties all countries realised the need for international cooperation in economic affairs, as veritable chaos had resulted in the system of foreign exchange rates and international trade after the end of the gold standard system. As a result, each country tried to secure its own interest at the cost of others. Each deliberately undervalued its currency to secure an advantage for its exports. In short, international trade and investments passed through the worst period in the 'thirties'.

It was then recognised that the monetary disorder of the world could be corrected only by mutual agreement between nations having international economic relations. International monetary cooperation became the direct need of the day. Since it was not possible to revive the gold standard, a new system had to be deviced, a system which would provide sufficient flexibility through international assistance without affecting the internal economic order of the country, as also an efficient payments mechanism which would permit and foster high and stable levels of world trade. Different nations put forward different plans in this respect. In 1943, the United States Treasury published a proposal for the establishment of an International Stabilisation Fund of the United and Associated Nations.

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5.3. OBJECTIVES OF IMF

The fundamental objective of the IMF was the avoidance of competitive devaluation and exchange controls that had characterised the era of 1930. It was set up to administer a "code of fair practice" in the field of foreign exchange and to make short-term loans to member nations experiencing temporary deficits in their balances of payments, to enable them to meet these payments without resorting to devaluation or exchange control, while at the same time following internal policies to maintain domestic income and employment at high levels. Thus, basically there are three general objectives of the IMF :

1. The elimination or reduction of existing exchange controls.
2. The establishment and maintenance of currency convertibility with stable exchange rates.
3. The wide extension of multilateral trade and payments.

More precisely, the objectives of the Fund are stated as follows:

1. To promote international monetary cooperation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion of balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as the primary objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
4. To assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5. To lend confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct mal adjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
6. In accordance with the above, to shorten the duration and lesser the degree of disequilibrium in the international balances of payments of members.

Evidently, the cornerstone of the Fund Agreement because all decisions are to be guided by the purposes stated in this Article.

5.4. OTHER CREDIT FACILITIES

(a) Buffer Stock Financing Facility (BSFF): It was credited in 1969 for financing commodity buffer stock by member countries. The facility is equivalent

to 30% of the borrowing members quota. Repurchases are made in $3\frac{1}{4}$ to 5 years. But the member is expected to co-operate with the fund in establishing commodity prices within the country.

(*b*) Extended Fund Facility (EFF): It is another specialized facility which was created in 1974. Under EFF, the fund' provides credit to member countries to meet their BoP deficits for longer periods and in amount larger than their quotas under normal credit facilities EFF provides credit upto a period of 10 years and loans upto 300% of a member's quota are allowed.

(*c*) Supplementary Financing Facility (SFF): It was established in 1977 to provide supplementary financing under extended or stand by arrangements to member countries to meet serious BoP deficits that are large in relation to their economies and their quotas. The facility has been extended to low-income developing member countries of the fund.

(*d*) Structural Adjustment Facility (SAF): The fund set up SAF in March, 1986 to provide concessional adjustment to the poorer developing countries. Under it, loans are granted to them to solve BoP problems and to carry out medium term macro-economic and structural adjustment programmes.

(*e*) Enhanced Structural Adjustment Facility (ESAF): The facility is for medium term financing needs of low income countries. The objectives, eligibility and basic programme feature of this facility are similar to the SAF. Disbursements under the ESAF are semi-annual instead of annual.

(*f*) Compensatory and Contingency Financing Facility (CCFF): The CCFF was created in August, 1988 to provide timely compensation for temporary short falls or excess in cereal import costs due to factors beyond the control of the member and contingency financing to help a member to maintain the momentum of fund supported adjustment programmes in the face of external stocks on account of factors beyond its control.

(*g*) Systematic Transformation Facility (STF): In April 1993, the IMF established STF with $ 6 billion to help Russia and other Central Asian Republics to face BoP arises.

(*h*) Emergency Structural Adjustment Loans (ESAL): The fund established ESAL facility in early 1999 to help the Asian and Latin American countries inflicted with the financial crises. Under it, such countries are given short term loans 3% to 5% above the funds normal interest rate which are to be repaid in a short period.

(*i*) Contingency Credit Line (CCL): The CCL was created in April, 1999 to protect' fundamentally sound countries from the contingen of financial crises occurring in other countries, rather than from domestic policy weakness only countries that over the medium term can finance BoP comfortably and enjoy healthy financial sectors strong debt-creditor relations are considered for CCL. So for no country has drawn from it.

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5.5. W.T.O. (WORLD TRADE ORGANIZATION)

The Uruguay round of GATT negotiations concluded on 15 April, 1994 at Marrakesh, Morocco. India, along with 123 ministers beside the EC countries signed the final act incorporating the eight round of multilateral trade negotiation. The final act consists of:

1. The W.T.O. agreement which covers the formation of the organization and the rules governing its working.
2. The ministerial decisions and declarations which contain the important agreements covering trade in goods, services, intellectual property and plurilateral trade. They also contain the dispute settlement rules and trade policy review system. The W.T.O. agreement is infect the Uruguay Round Agreements whereby the original GATT is now a part of the W.T.O. agreement which came into force from 1 January, 1995.

The W.T.O. is the successor to the GATT. The GATT was a forum where the members countries met from time to time to discuss and solve world trade problems. But the W.T.O. is a properly established permanent W.T.O. It has legal status and enjoys privilages and immunities on the same footing as the IMF and the World Bank it includes:

1. The GATT, as modifies by the Uruguay Round.
2. All agreements and arrangements concluded under the GATT.
3. The complete results of the Uruguay Round.

There were 77 members countries of the W.T.O. on 1 Jan, 1995, which has increased to 127 by December 1996, India is the younger member.

It's Structure: The ministerial conference is the apex body in the W.T.O.'s organizational structure meeting every two years. It is composed of the representative of the members governments: One representative from each member. It is the chief policy making body. Any major policy change requires its approval.

Below the ministerial conference, lies the general council. Its composition is similar as that of the ministerial conference. There is no fixed timing for its meeting, but normally it meet every two months. For day-to-day functioning it.delegates its responsibility to three subordinate councils meant for trade in goods, trade in services and intellectual property rights.

The three councils lying just below the general council have to look after the functioning to different committees constituted for specific areas. The trade committees looking after a specific areas of the multilateral trade agreements are the lowest ladder of the W.T.O.

General Council: There is the general council composed of representatives of all the members to over see the operation of the W.T.O. Agreement and ministerial decisions on a regular basis. It also acts as a Dispute Settlement Body (DSB) and a Trade Policy Review Body (TPRB), each having it's own chairman. The general council sits in Geneva on an average of once in a month.

Council for Trade in Goods: There is the council for trade in goods, the council for trade in services and the council for Trade-Related aspects of Intellectual Property Rights (TRIPs) which operate under the general council. These councils, in turn have their subsidiary bodies. The councils and subsidiary bodies meet as necessary to carry out their respective functions.

Committee on Trade and Development: There is the committee on trade and development, the committee on BoP restrictions and the committee on budget, finance and administration which carry out the functions assigned to them by the W.T.O. agreement, the multilateral trade agreements and additional functions assigned to them by the general council.

Secretariat: The Secretariat of the W.T.O. is headed by the Director General, Renato Ruggiero at present. The minister conference appoints the Director General and sets out his powers, duties, conditions of service and terms of office. The Director General is appointed to a four-year term. He has four deputies from different member states.

Director General: The Director General appoints the members of the staff of the secretariat and determines their duties and conditions of service in accordance with the regulations adopted by the ministerial conference.

Budget: The Director General presents to the committee on budget, finance and administration, the annual budget estimates and financial statement and makes recommendations to the general council for final approval. The general council adopts the annual budget estimates and financial statements by a two-thirds majority comprising more than half the members of the W.T.O. The financial regulations relating to the scale of contributions and the budget are based on the rules and practices of the GATT.

Decision by Consensus: The W.T.O. continues the practice of decision making by consensus, as followed under the GATT 1947. Where a decision cannot be arrived at by consensus, the matter at issue is decided by 2/3rd majority voting on the basis of one country, one vote. But in the case of interpretation of the provisions of the agreements and waiver of a member's obligations, the majority required is 3/4th of the members. However, amendments relating to general principles, such as MFN treatment must be approved by all members.

5.6. OBJECTIVES OF W.T.O.

1. It's relations in the field of trade and economic endeavour shall be conducted with a view to raising standards of living, ensuring full employment and large and steadily growing volume of real income and effective demand and expanding the production and trade in goods and services.
2. To allow for the optimal use of the world's resources in accordance with the objectives of sustainable development, seeking both.

(*a*) To protect and pressure the environment.

(*b*) To enhance the means for doing so in a manner consistent with respective needs and concerns at different levels of economic development.

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3. To make positive efforts designed to ensure that developing countries, especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development.
4. To achieve these objectives by entering into reciprocal and mutually advantageous arrangements directed towards substantial reduction of tariffs and other barriers to trade and elimination of discriminatory treatment in international trade relations.
5. To develop an integrated, more viable and durable multilateral trading system encompassing the GATT, the results of past liberalization efforts and all the results of the Uruguay round of multilateral trade negotiations.
6. To ensure linkages between trade policies, environmental policies and sustainable development.

5.7. FUNCTIONS OF W.T.O.

1. It facilitates the implementation, administration and operation of the objectives of the agreement and of the multilateral trade agreements.
2. It provides the framework for the implementation, administration and operation of the plurilateral trade agreements relating to the trade in civil aircrafts, government procurement, trade in diary products and bovine meat.
3. It provides the forum for negotiations among its members concerning their multilateral trade relations in matters relating to the agreements and framework for the implementation of the results of such negotiations, as decided by the ministerial conference.
4. It administer the understanding of rules and procedures governing the settlement of disputes of the agreement.
5. It co-operates with the IMF and the World Bank and its afficiated agencies with a view to achieving greater coherence in global economic policy-making.

W.T.O. Agreements: The agreement establishing the W.T.O. consists of the following which embody the results of the Uruguay Round of the Multilateral Trade Negotiations.

1. Multilateral Agreements on trade in goods GATT rules 1994.
2. General Agreements on trade in services.
3. Agreements on Trade Related Aspects of Intellectual Property Rights (TRIPs).
4. Understanding the rules and procedures governing the settlement of disputes.
5. Plurilateral trade agreements.
6. Trade policy review mechanism.

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5.8. EXPORT DOCUMENTATION

Export documentation plays a very important role in international trade because it facilitates the smooth flow of goods and payments across national frontiers. These documents must be correctly and properly filled. There are large number of documents which are supposed to filled by concerned authorities and also submitted to the concerned authorities. These documents are not same for every country because different procedures is been adopted by different country. Every exporter should have the proper knowledge of export documentation and procedure. Therefore, it is advisable to take the help of shipping and forwarding agents who will obtain and pull out the documents correctly as well as arrange for transportation.

The various documents used in international trade are:

1. Commercial invoice
2. GR form
3. Letter of credit
4. Bill of exchange
5. Shipping bill
6. Marine insurance policy
7. Bill of lading.

1. **Commercial Invoice:** This is one of the main documents in an export transaction. It contains all the information which is required for the preparation of all others documents. It is a document of contents. It gives:

(*a*) The description of the good.

(*b*) Price charged.

(*c*) Terms of shipment.

(*d*) Marks and numbers on the packages containing the merchandise.

(*e*) Data, name and address of both buyer and seller.

(*f*) Name of shipping vessel.

(*g*) Part of debarkation.

The exporter has to design his own form. There is no standard form of commercial invoice. The exporter has necessarily to use the form prescribed by the importing country.

Several copies of the invoice will be required, some for the use by buyer and some for the information of various authorities in India.

Some of the invoice prescribed by the importing countries are:

(*i*) Combined certificate of origin and value.

(*ii*) Consular invoice.

(*iii*) Legalized invoice.

(*iv*) Customs invoice.

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The exporter is required to pay a prescribed fee for obtaining this invoice. The exporter has to submit four copies of the commercial invoice to the mission of the importing country with the requisite amount of fee. The mission returns three copies of the legalized invoice to the exporter. The exporter has to submit the invoice in the form prescribed by the importing country.

2. GR Form: This form has been prescribed by the Reserve Bank of India under FERA to ensure that the foreign exchange receipts in respect of exports are given to India. This has to be prepared in duplicate, both of the copies have to be submitted to the customs authorities at the port of shipment. Custom authorities will certify the value declared by the exporter on both the copies of GR form and will also record the assessed values.

When the exporter wants to retain the proceeds of his exports with agents or branches abroad or to make other approved types of payments abroad, he has to seek the permission of the RBI. For this purpose, he has to submit the 3 copies of GR-3 form. The original is submitted to the customs authorities who send it to the RBI directly. The duplicate and triplicate copies are to be dealt within accordance with procedure laid down by the "RBI".

3. Letter of Credit: Through the instrument of letter of credit, the promise to pay usually made by the overseas importer is submitted by the promise to pay by his bank. It is this characteristics of the letter of credit which gives the exporter the great security. The exporter should carefully examine the terms and conditions of the letter of credit to ensure:

(*a*) That he can meet them.

(*b*) That they confirm to the basic contract he has entered into with the importer.

4. Bills of Exchange: Bill of exchange means, "when a draft is drawn on a foreign bank" *i.e.*, collecting payment from the foreign buyer through the banking channel. It is also a method of extending credit. It has two main functions:

(*a*) If the bill of exchange is payable at sight, it becomes a demand for payment and a receipt for payment made.

(*b*) If the bill of exchange is payable at some future data after sign, it is a demand for payment by the exporter, a promise of payment by the importer and a receipt for payment after such payment has been made.

5. Shipping Bill: This is a customs documents. There are three types of forms of shipping namely:

(*a*) Shipping bill for free goods.

(*b*) Dutiable shipping bills.

(*c*) Duty Drawback Shipping Bill: The shipping bill must be prepared according to the category of the export goods.

6. Marine Insurance Policy: It is the basis instrument in marine insurance. A policy is a contract and a legal document. Its principal function is to serve as

evidence of the agreement between the insurer and the assured. The policy must be product to press and claim in a court of law. The exporter should ensure that:

(*a*) The currency and the total value of the policy are as per the terms of the letter of credit.

(*b*) Details of the transport documents are specified.

(*c*) Risks of transhipment or deck shipment are covered.

7. Bill of Lading: Bill of lading is a document which is issued by the shipping company acknowledging that the goods mentioned therein have been placed on board of the ship and our undertaking that the goods in like order and condition as received will be delivered to the consignee, provided that the freight specified therein has been duly paid. The bill of lading has the following main functions :

(*a*) It is a document of title to the goods shipped.

(*b*) It is a receipt for goods.

(*c*) It is an evidence of the contract of affreightment.

5.9. ROLE OF SOUND DOCUMENTATION SYSTEM IN INTERNATIONAL TRADE

1. To provide commercially useful information and assistance to their members developing and increasing their exports.
2. To offer professional advice to their members in areas such as technology upgradation quality and design improvement, standards and specifications, product development innovation etc.
3. To organize participation in trade fairs, exhibitions and buyer-seller meet in India an abroad.
4. To organize visits of delegations of its members abroad to explore overseas marke opportunities.
5. To promote interaction between the exporting community and the government both a the central and state-levels.
6. To build a statistical base and provide data on the exports and imports of the country exports and imports of their members as well as other relevant international trade data.

5.10. FOREIGN BILL OF EXCHANGE

This is an important method of payment. The bills of exchange are prepared by the exporter and sent to the importer through a commercial bank along with the documents on accoumptin of these bills or Documents against Acceptance (DA) the commercial bank delivers the documents importers.

According to the date specified in the bill of exchange the importer makes payment on the commercial bank in that foreign country and subsequently the payment are received in India.

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Three copies of the foreign bills of exchange are prepared and sent in separate post covers. Foreign bill of exchange may be of two types:

1. Ordinary or Clean Foreign Bill: This is an ordinary bill of exchange and written in case the exporter has sufficient confidence in the credit worthiness of the importer. Thus, a simple bill is written and documents are sent. This is called clean foreign bill of exchange.

2. Documentary Bill: When necessary document of, the title of the goods are also sent along with the foreign bill of exchange. It is called documentary bill. These may be of two types:

(*a*) Documents against Payment: In this case, the documents are delivered to the importer provided he make the full payments. The exporter given clear institution to the bank that the documents should only be given provided the importer has made the full payment.

(*b*) Documents against Acceptance: The exporter instructs the bank to deliver the documents to importer provided the importer accepts the enclosed bill of exchange.

Foreign bill of exchange bear the stamps of both the countries. The exporters should affix sufficient stamp while sending the bills and the acceptor of the bill also should affix the stamps according to the rules of his country following special features are to be noted in the foreign bills of exchange.

(*i*) Exchange Rates Regulations: Often the exchange rates fluctuates in the foreign-trade, therefore, they can determine the rate of exchange of the maturity date of the bill.

(*ii*) Expenses of Bank: They can clarify in the contract itself that who will bear the bank charges. As a matter of practices all such bank expenses are often borne by the exporters. However, if they wish they can clarify on this point also.

(*iii*) Rules of Interest: The amount of Interest is also referred in the bill of exchange. The interest is charged from the date of delivery of the documents till the date of the payment. In the meanwhile, the importer gets the delivery of the goods from the shipping company.

5.11. LETTER OF CREDIT

A letter of credit offers advantages both to the exporter and the importer. The advantages accruing to either of the parties differ depending upon the nature of credit opened. However, there are certain common benefits accruing from the use of credit of whatever type which are discussed below.

Advantages to the Exporter

1. The letter of credit provides the sort of assurance that an exporter likes before he embarks on manufacturing the goods for export. In an international deal, the exporter and the importer rarely meet and it is clinched only through exchange of correspondence. The exporter, therefore, requires to

ensure himself that on shipping the goods he will receive the payment promptly. There is always the risk of the importer failing to pay. The risk is greater if the antecedents of the importer are not known. The letter of credit protects the exporter against failure of the importer to pay. A superior undertaking of a bank under the letter of credit assures the exporter that when the documents are tendered as per the terms of the credit, payment would be made to him. Thus, it also helps the seller to expand the business by enabling him to conclude deals which in the absence of credit he would be hesitant to do.

2. The exporter is absolved of the botheration of knowing in detail the exchange control regulations of the importer' country and is also insured to some extent against changes in such regulations. The bank which issues the credit would take care to see that the goods covered by the letter of credit would be permitted to be imported under the exchange control regulations. Even in case there is a subsequent change in government policies, the government would think twice before restraining the bank from executing its commitment under the letter of credit.
3. The letter of credit helps easing the financial position of the exporter. The exporter can easily discount the bills under a letter of credit with his bank. As such bills carry an undertaking to pay by a bank, bills drawn under letter of credit are readily discounted by banks. Thus, the exporter gets payment immediately on shipping the goods. Moreover, on the strength of the letter of credit, the exporter may raise loans from his bank for procurement and processing of raw materials and their export (preshipment finance).

All the advantages mentioned above are in addition to those available under a bill transaction. For instance, the exporter does not lose his right over the goods till the issuing bank pays against the documents.

Advantages to the Importer

1. The letter of credit enables the importer to purchase materials (especially in seller's market) without making full advance payment. Further, on the strength of the superior credit of the bank, he is able to finalise contracts which the seller may not agree had he to rely only on the importer.
2. If he takes certain safeguards, like calling for packing certificates, etc., the quality and quantity of the goods consigned is assured.
3. Provided the buyer has a big credit with his bank he may get goods released by the bank under trust (without payment) and pay for them on sale.

Disadvantages/Limitations of letter of credit: A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the exporter, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit. It is only the bank that would decide, if the documents are as per the terms of the credit; any slight variation or non-fulfilment or excess detail in the documents tendered give scope for the

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bank to claim that the documents are not as per the terms of the credit. Moreover the credit does not protect the exporter from the governmental action that may deter payment.

To the importer, the major disadvantage is that is does not ensure that he would be receiving the goods of the specific condition and order. In letter of credit transactions, all parties deal with documents and not in goods. He stands committed to reimburse the issuing bank when documents as required are tendered to him. But this does not ensure the receipt of proper goods. Though the risk is safeguarded by calling for special documents like packing list, etc., the risk of falsification of documents still remains.

***(ii)* Kinds of Letters of Credit:** A letter of credit may be a clean credit or a documentary credit. A documentary credit requires the documents of title to goods and other documents to accompany the bill drawn under the credit. No such documents are necessary for a clean letter of credit.

Under a clean letter of credit, the documents of title to goods (bill of lading, for example) are sent by the exporter to the importer direct. Only the bill of exchange drawn on the importer is offered to the bank for purchase. Neither the exporter nor the bank retains control over the goods covered by the transaction. For the bank it remains an unsecured advance. For this reason, clean letter of credit is normally not found in commercial transaction. They are used for transfer of funds between banks. In exceptional cases they may be accepted from first class customers.

Almost all commercial letters of credit (issued for financing foreign trade) are documentary credits. Therefore, the UCP deals only with documentary credits. A documentary credit may be classified under the following types depending upon the particular provisions it contains:

1. Payment, Acceptance and Negotiation Credits.
2. Revocable and Irrevocable Credits
3. Confirmed and Unconfirmed Credits
4. With Recourse and Without Recourse Credits
5. Fixed and Revolving Credits
6. Transferable Creadits
7. Back-to-back Credits
8. Red Clause and Green Clause Credits
9. Stand by Credits.

5.12. BILL OF LADING (BL)

A bill of lading is a document issued by the shipping company upon shipment of the goods. It is a contract between the shipper (exporter) and the shipping company for the carriage goods to the port of destination. It is a document title to goods and as such required by the importer to clear the goods at the port of destination. A bill of lading normally contains the following details:

1. The name of the shipping company.
2. The name and address of the shipper/exporter.

3. The name and address of the importer/agent.
4. The name of the ship.
5. Voyage number and date.
6. The name of the ports of shipment and discharge.
7. Quality, quantity, marks and other description.
8. The number of packages.
9. Whether freight paid or payable.
10. The number of originals issued.
11. The date of loading of goods on the ship.
12. The signature of the issuing authority.

BL is usually made out in signed set of originals, any one of which can give to goods. The shipping company also issues non-negotiable copies which are not documents title to goods but are normally used for record purposes.

The reverse side of BL bears the terms and condition of the contrast of carriage. The clauses on most Blers are more or less similar. A BL should be clean *i.e.* it should not contain any adverse remarks by the shipping company as to the quality and condition of goods.

The goods can be consigned to order which, means the importer can authorise someone else to collect the goods on his behalf. In this case the BL will be endorsed, normally on the reverse side, by the exporter. If the importer/consignee is named, the goods will only be released to him, unless he transfers his right by endorsement.

5.13. TYPES OF BILL OF LADING

1. Clean BL: This type of BL do not contain any adverse remarks as to the condition and quality of goods. A clean BL is always insisted by the importer.

2. Claused BL: Such BL contains an adverse entry by the shipping company such as "Two cases damaged".

3. State BL: If the BL is presented to the bank for negotiations after many days from its issue it is called as state BL.

4. Freight paid BL: When freight is paid by the shipper, then this type of BL is issued with the words "freight paid".

5. Freight collect BL: When the shipper does not pay freight, such bill will indicate that 'freight is to be collected from the importer'.

6. To order BL: In this type, the BL is issued to the order of a certain person.

7. Straight BL: In this importer/consignee/agent is named in the BL, it is called straight BL.

8. On board and received BL : The bill can be either the shipped/board or received for shipment depending upon whether the goods are loaded on board the ship or received by the shipping company for storing.

9. Container BL: This bill is issued by the container shipping liens when the cargo is transported from an inland place of shipper to the final place of its arrival.

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5.14. THE ROLE OF GATT IN INTERNATIONAL TRADE IN THE PRE 1995 ERA

The General Agreement on Tariffs and Trade (GATT), the predecessor of WTO was born in 1948 as a result of the international desire to liberalise trade.

The establishment of an International Trade Organisation (ITO) had also been recommended by the Bretton Woods Conference of 1944 which had recommended the IMF and World Bank. Although the IMF and World Bank were established in 1946, because of objections that its enforcement provisions would interfere with the autonomy of domestic policy making, the ITO charter was never ratified. Instead the GATT, which had been drawn up only as an interim agreement to fill the gap until the ITO charter was ratified, became the framework for international trading system since 1948. The international trading system since 1948 was, at least in principle, guided by the rules and procedures agreed by the signatories to the GATT which was an agreement signed by the contracting nations which were admitted on the basis of their willingness to accept the GATT disciplines.

The GATT was transformed into a World Trade Organisation (WTO) with effect from January, 1995. Thus, after about five decades, the original proposal of an International Trade Organisation has taken shape as the WTO. The WTO which is a more powerful body than the GATT has an enlarged role than the GATT.

5.15. OBJECTIVES AND PRINCIPLES OF GATT IN INTERNATIONAL TRADE

The primary objective to GATT was to expand international trade by liberalising trade so to bring about all-round economic prosperity. The preamble to the GATT mentioned the following as its important objectives :

1. Raising standard of living.
2. Ensuring full employment and a large and steadily growing volume of real income and effective demand.
3. Developing full use of the resources of the world.
4. Expansion of production and international trade.

GATT embodied certain conventions and general principles governing international trade among countries that adhere to the agreement. The rule or conventions of GATT required that:

1. Any proposed change in the tariff, or other type of commercial policy of a member country should not be undertaken without consultation of other parties to the agreement.
2. The countries that adhere to GATT should work towards the reduction of tariffs and other barriers to international trade, which should be negotiated within the framework of GATT.

For the realisation of its objectives, GATT adopted the following principles:

1. Non-discrimination: The principle of non-discrimination requires that no member country shall discriminate between the members of GATT in the conduct of international trade. To ensure non-discrimination the members of GATT agree to apply the principle of Most Favoured Nation (MFN) to all import and export duties. This means that "each nation shall be treated as the most favoured nation." As far as quantitative restrictions are permitted, they too, are to be administered without favour.

However, certain exceptions to this principle are allowed. For instance, GATT does not, prohibit economic intergration such as free trade areas or customs union, *provided the purpose of such integration is "to facilitate trade between the* constitutent territories and not to raise barriers to the trade of other parties." The GATT also permits the members to adopt measures to counter dumping and export subsidies. However, the application of such measures shall be limited to the offending countries.

2. Prohibition of quantitative restrictions: GATT rules seek to prohibit quantitative restrictions as far as possible and limit restrictions on trade to the less rigid tariffs'. However, certain exceptions to this prohibition are granted to countries confronted with balance of payments difficulties and to developing countries. Further, import restrictions were allowed to apply to agricultural and fishery products if domestic production of these articles was subject to equally restrictive production or marketing controls.

3. Consultation: By providing a forum for continuing consultation, it sought to resolve disagreements through consultation. So far eight Rounds of trade negotiations were held under the auspices of the GATT. Each Round took several years. The Uruguay Round, the latest one, took more than seven years to conclude, as against the originally contemplated more than four years. This shows the complexity of the issues involved in the trade negotiations.

An Evaluation of GATT

The growing acceptance of GATT/WTO, despite their shortcomings, is evinced by the increase in the number of the signatories. When the GATT was signed in 1947 only 23 nations were party to it. It increased to 99 by the time of the Seventh Round and 117 countries participated in the next, *i.e.*, the Uruguay Round. In July 1995, there were 128 signatories.

The 50 years preceding the dawn of the present century have seen an exceptional growth in world trade. Merchandise exports grew on an average of 6 per cent annually. GATT helped to create a more liberal trading system contributing to unprecedented growth. The system was developed through a series of trade negotiations, or rounds, held under GATT. The first round dealt mainly with tariff reductions but later negotiations included other areas such as anti-dumping and non-tariff measures. The last round—the 1986-1994 Uruguay Round—led to the creation of WTO and provided for global economic and business liberalisations of very wide scope and ramifications.

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One of the principal achievements of GATT was the establishment of a forum for continuing consultations. Disputes that might other wise have caused continuing hard feeling, reprisals and even diplomatic rupture have been brought to the conference table and compromised.

GATT could achieve considerable trade liberalisation. There were, of course, several exceptions.

Agricultural trade was clearly an exception to the liberalisation. Far from becoming freer, trade in agriculture became progressively more distorted by the support given to farmers (which took the form of severe barriers to imports and subsidies to exports) in the industrial nations.

Besides agriculture and textiles, two exceptions to the general trend of trade liberalisation have been trade of developing countries and economic integration. Developing countries with balance of payments problems have been generally exempted form the liberalisation. Even the Uruguay Round has granted such exemptions to developing countries.

Although the picture of trade liberalisation has to be qualified with such exceptions, the GATT achieved very commendable trade liberalisation. The average level of tariffs on manufactured products in industrial countries was brought down from about 40 per cent in 1947 to nearly three per cent after the Uruguay Round.

Indeed the period of 1950-1973 is conspicuous by the splendid results of progressive trade liberalisation. In 275 years since 1720, this period witnessed the highest average annual growth rates in output and international trade. These rates were substantially higher than for any other period. Indeed, the 1950s and 1960s are described as the golden decades of capitalism. The output levels of companies using newer and newer technologies in many cases were much larger than the domestic markets could absorb. Expansion of markets to other countries enabled even companies in other industries to increase their output. There was also a surge in international investments.

The progressive liberalisation of trade, however, suffered a setback since 1974. Although the elimination of Tariff Barriers continued, even the developed countries have substantially increased Non-Tariff Barriers since then.

Further, the exports of developing countries gained significantly less from the GATT Rounds than did exports of the industrial nations. The trade liberalisation has been confined mostly to goods of interest to the developed countries. In case of agricultural commodities not only was that there was no liberalisation, but also there was an increase in protection. Manufactured products of interest to developing countries like textiles and clothing, footwear etc., have been subject to increasing non-tariff barriers. While the developed countries enjoy a more liberalised trading environment, the growing NTBs have been severely affecting the exports of developing countries. Ironically, the developed countries are increasing the protectionism when the developing countries are liberalising. This is indeed a sad commentary on the GATT and other multilateral organisations.

5.16. THE ROLE OF ECGC IN INSURING RISKS

In the context of growing competition in international markets no exporter can manage without selling goods on credit. Giving credit posses two problems to an exporter:

(*i*) He should find enough money to offer credit to his overseas buyers and

(*ii*) He should be prepared to take the credit risks.

Exporting on credit is not without risk. The overseas buyer may default; he may go bankrupt; there may be an earthquake or typhoon, a war or coup in his country which may wreck his fortunes. There may be sudden import or exchange restrictions, there may be moratorium. The Export Credit Guarantee Corporation (ECGC) covers the exporter against these risks. The ECGC also provides guarantees to the financing banks to enable them to provide adequate finance to the exporters.

Issues Covered by ECGC

The covers issued by ECGC could be divided broadly into four groups:

1. Standard policies issued to exporters to protect them against the risk of not receiving payments while trading with overseas buyers on short-term credit;
2. Specific policies designed to protect Indian firms against the risk of not receiving payments in respect of
   (*a*) exports on deferred payment terms,
   (*b*) services rendered to foreign parties, and
   (*c*) construction works undertaken abroad;
3. Financial guarantees issued to banks against the risks involved in providing credit to exporters; and
4. Special Schemes, *viz.*, Transfer Guarantee, Insurance Cover for Buyer's Credit, Line of Credit, Joint Ventures and Overseas Investment.

1. Standard Policies: Under its policies intended to protect the exporters against overseas credit risks, ECGC bears the main brunt of the risk and pays the exporter 90 per cent of his loss on account of 'commercial' and 'political' risks.

Commercial Risks:

(*a*) The insolvency of the buyer;

(*b*) The buyer's protracted default to pay (within 4 months of due date for goods accepted by him); and

(*c*) In some special circumstances specified in the policy, buyer's failure to accept the goods, when such non-acceptance is not due to the exporter's actions.

Political Risks:

(*a*) Restriction on remittances in the buyer's country or any government action which may block or delay payment to the exporter.

(*b*) War, revolution or civil disturbances in the buyer's country;

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(*c*) New import licensing restrictions or cancellation of a valid import licence in the buyer's country;

(*d*) Cancellation of export licence or imposition of new export licensing restrictions in India (under contracts policy);

(*e*) Additional handling, transport or insurance charges due to interruption or diversion of voyage which cannot be recovered from the buyer, and

(*f*) Any other cause of loss occurring outside India, not normally insured by commercial insurers and beyond the control of both the exporter and the buyer.

Risks not Covered: ECGC, however, does not cover risks of loss due to:

(*i*) commercial disputes including quality disputes raised by the buyer unless the exporter obtains a decree from a competent court of law in the buyer's country in his favour,

(*ii*) causes inherent in the nature of goods,

(*iii*) a buyer's failure to obtain import or exchange authorisation from the appropriate authority,

(*iv*) insolvency or default of any agent of the exporter or of the collecting bank,

(*v*) loss or damage to goods which can be covered by general insurers,

(*vi*) fluctuation in exchange rates and

(*vii*) failure of the exporter to fulfil the terms of the export contract or negligence on his part.

Contracts/Shipments Policies: An exporter may either take a comprehensive risks policy covering both political and commercial risks or secure himself against political risks alone, if he so chooses.

Though normally the cover starts from the date of shipment, in the case of goods manufactured according to the buyer's specifications and which cannot easily be sold to alternate buyers, cover could be provided from the date of contract under the Contracts Policy.

Basic Principles: There are two basic principles on which the ECGC operates:

(*i*) Spend of Risks: An exporter is normally expected to insure the whole of his turnover for a minimum period of 24 months other than those transactions which are covered by irrevocable letters of credit which carry the confirmation of the Indian banks. Where an exporter deals in different types of goods, he may insure the allied items, excluding those which are not allied. The; exporter cannot pick and choose bad risks only for insurance. This is also necessary to reduce premia in general.

(*ii*) An Exporter is a Co-insurer: The ECGC covers only 90 per cent of the loss. The insurer will have to bear the rest of the risks. This is necessary .to ensure that:

(*i*) the exporter also takes necessary precaution in selecting the parties to which he may decide to export,

(*ii*) he may not overextend credit and

(*iii*) he may take all possible care to minimize the risk.

The premium rats are closely related to the risks involved and depend upon:

(*i*) length of the credit,

(*ii*) terms of payment,

(*iii*) credit worthiness of the buyer and his country and

(*iv*) the past record of the exporter.

Depending on the combination of the payment terms and the country group, the premium may range from 0.07 per cent to 3.5 per cent ECGC's premium rates are one of the lowest among credit insurers of the world.

2. Specific Policies: Contracts for export of capital goods or projects for construction works and for rendering services abroad are insured by ECGC on case-to-case basis under specific policies. Special mention may be made of the services policy to protect Indian firms against payment for their services and the construction works policy to cover all payments that fall due to a contractor under a composite contract for execution of civil engineering works which may involve provision of services as well as supply of material.

3. Financial Guarantees: Exporters require adequate financial support from banks to carry out their export contracts effectively. ECGC's guarantees to the banks protect the latter from losses on their lendings to exporters.

The beneficiaries under the guarantees given by ECGC are not the banks alone but the exporters as well. These guarantees have been designed to encourage banks to give liberal credit and other facilities connected with exports, both at pre-shipment and post-shipment stages.

Six guarantees have been evolved for this purpose :

(*a*) Packing Credit Guarantee;

(*b*) Post-shipment Export Credit Guarantee

(*c*) Export Finance Guarantee,

(*d*) Export Performance Guarantee,

(*e*) Export Production Finance Guarantee, and

(*f*) Export-Finance (Overseas Lending) Guarantee.

These guarantees give protection to the bank against losses due to non-payment by an exporter arising from his insolvency or default. EGGC pays the bank three-fourths of the loss in the case of Export Finance Guarantee, Post-shipment Export Credit Guarantee and Export Performance Guarantee and two-thirds of the loss in the case of the rest.

The Corporation agrees to pay 75 per cent of the loss to banks which offer no cover all their pre-shipment accounts under a Whole Turnover Packing Credit Guarantee.

Again, ECGC agrees to pay, in special cases, 80 per cent of the loss in respect advances made under the Post-shipment Export credit Guarantee against shipment of engineering and metallurgical items of the value of ₹ 2 crores or more under a single contract. In the case of Export Performance Guarantee, higher cover of 90 per cent of loss is available on payment of proportionately higher premium.

NOTES

4. Special Schemes

(*a*) Transfer guarantee.

(*b*) Insurance cover for buyer's credit and line of credit.

(*c*). Overseas investment insurance.

Special Schemes for Small Scale Exporters: For small scale industries, the ECGC provides a higher percentage of cover and makes procedural relaxations in matters like. Settlement of claims, sanction of credit limit etc. The scheme applies to exporters whose annual export turnover is not more than ₹ 50 lakhs. This policy is issued for 12 months. Small exporters are allowed to submit declarations of shipments made on quarterly basis instead of on monthly basis. Against the normal 30 days for reporting overdue bills, 60 days are given under small exporters policy. The waiting period for the settlement of claims has been reduced from 4 months to two months. The percentage of cover for small exporters has been increased to 95 for commercial risks and 100 for political, risks from the normal level of 90 per cent.

Conclusion: With the opening up of the insurance sector to private players, the ECGC's monopoly has now ended. The various steps taken by the ECGC to face competition effectively are : Improvement in services offered to customers by designing and offering new products, simplifying and rationalizing the procedures particularly for settlement of claims, increased delegation of powers to field officers promoting screen based decision making and bringing about real time on line data transfer. ECGC intends to ensure that its rates are competitive with those of new entrants. ECGC's tie up with coface, the leading export credit insurer of France with clients across 73 countries, is aimed at providing better service and better information.

5.17. FOREIGN TRADE POLICY (2004–09)

Questions

1. To double India's percentage share of global merchandise trade by 2009. 1.5% share of global trade by 2009..
2. To act as an effective instrument of economic growth by giving a thrust to employment generation, especially in semi-urban and rural areas.

Policy Highlights

1. Special focus on five traditional exports—agriculture, handicrafts, handlooms, leather and footwear and gems and jewellery so as to make exports employment oriented.
2. A new handicraft Special Economic Zone would be established.
3. Absolute export sector to be exempted from service tax for cutting down export cost.
4. New service Export Promotion Council constituted for services.

5. Free Trade and Warehousing Zones under a new scheme has been established to make India a global trading hum. FDI would be permitted upto 100% in the development and establishment of the zones and their infrastructure facilities.
6. Domestic Tariff Area have been exempt from service tax and all exporters with minimum turnover of ₹ 5 crore and good track record have been exempted from furnishing Bank guarantee in any of the schemes so as to reduce their transaction costs.
7. Liberalisation of EPCG scheme.
8. Duty free import conditions for seeds.
9. Ban on old machinery imports lifted.
10. Biotechnology parks would be established in the country which would get all facilities of 100% Export Oriented Units.
11. Three new export promotion schemes had been introduced :

(*a*) **Vishesh Krishi Upaj Yojna:** It is introduced for boosting exports of agricultural products, export of flowers, fruits, vegetables, minor forest produce and their value added products. In the annual supplement of FTP (2004-09) to meet the objective of employment generation in rural and semi-urban area, export of village and cottage industry products were included in Vishesh Krishi Upaj Jyona, renamed as **Vishesh Krishi Gram Udyog Yojna.**

(*b*) Served from India scheme will boost export of services. Now it allows transfer of both the scrip and imported input to the group service company while, earlier, transfer of imported material only was allowed.

(*c*) Target Plus scheme, under which exporters, who achieve quantum growth in exports would be entitled to duty free credit based on incremental exports substantially higher than the general annual export target.

12. Government would promote establishment of Common Facility Centre for use by home based service provided.
13. The exports from India are likely to generate incremental employment of 21 millions between 2004-05 and 2009-10. Thus in order to give a thrust to the manufacture of industrial products and generate employment, in the annual revision of FTP the 'Focus Product Scheme' was formulated. The scheme allows duty-credit facility at 2.5% of FOB value of exports on 50% of export turnover of notified products like added fish and leather products, sports goods, handloom and handicraft items, free works etc.
14. A number of measures announced in FTP, mid Term Review of annual policy 2006-07 to achieve the objective of making India a gems and Jewellery hub, allowing all categories of foreign exchange earnings in exchange earners foreign currency accounts.
15. A number of procedural changes have been effected to streamline the existing provisions like enabling Information Technology enabled services to avail refund of Central Sales Tax and Interest payments on delayed refunds.

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16. Percentage share of India in world trade—1% India's share in world merchandise exports grew at more than double the rate of growth of world exports since 2005. For the first time in 2005 and first eight months of 2006, India's export growth surpassed that of China.

Annual Foreign Trade Policy 2007-08

(*i*) Export target for 2007-08 at $ 160 billion.

(*ii*) Introduction of two export promotion schemes incentivising high tech exports and agro processing,

(*iii*) All services rendered abroad or export oriented services delivered in India made exempted from 12.24% service tax.

(*iv*) Focus market scheme have been extended to 16 more countries.

(*v*) Duty entitlement pass book scheme extended upto March 31, 2008.

(*vi*) Vishesh Krishi-Upaj Yojna extended to include items like coconut oil, potato flakes, soaps etc.

(*vii*) Duty free import of tools, machinery and equipments for handicrafts and gems and jewellery sectors,

(*viii*) Norms for availing the benefits under EPCG scheme for handlooms and handicrafts sector has been simplified by increasing the export obligations period to 12 years from the current 8 years,

(*ix*) Status holder scheme revamped.

SUMMARY

- IMF was established to promote economic and financial co-operation among its members in order to facilitate the expansion and balanced growth of world trade.
- The fundamental objective of the IMF was the avoidance of competitive devaluation and exchange controls that had characterised the era of 1930.
- The elimination or reduction of existing exchange controls.
- The GATT was a forum where the members countries met from time to time to discuss and solve world trade problems. But the W.T.O. is a properly established permanent W.T.O. It has legal status and enjoys privilages and immunities on the same footing as the IMF and the World
- The ministerial conference is the apex body in the W.T.O.'s organizational structure meeting every two years.
- It's relations in the field of trade and economic endeavour shall be conducted with a view to raising standards of living, ensuring full employment and large and steadily growing volume of real income and effective demand and expanding the production and trade in goods and services.
- It facilitates the implementation, administration and operation of the objectives of the agreement and of the multilateral trade agreements.

- Export documentation plays a very important role in international trade because it facilitates the smooth flow of goods and payments across national frontiers.
- Commercial Invoice is one of the main documents in an export transaction. It contains all the information which is required for the preparation of all others documents. It is a document of contents.
- GR form has been prescribed by the Reserve Bank of India under FERA to ensure that the foreign exchange receipts in respect of exports are given to India.
- Through the instrument of letter of credit, the promise to pay usually made by the overseas importer is submitted by the promise to pay by his bank.
- Bill of exchange means, "when a draft is drawn on a foreign bank" *i.e.*, collecting payment from the foreign buyer through the banking channel.
- Clean Foreign Bill is an ordinary bill of exchange and written in case the exporter has sufficient confidence in the credit worthiness of the importer.
- A letter of credit offers advantages both to the exporter and the importer. The advantages accruing to either of the parties differ depending upon the nature of credit opened.
- The letter of credit provides the sort of assurance that an exporter likes before he embarks on manufacturing the goods for export. In an international deal, the exporter and the importer rarely meet and it is clinched only through exchange of correspondence.
- The letter of credit enables the importer to purchase materials (especially in seller's market) without making full advance payment.
- A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the exporter, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit.
- A bill of lading is a document issued by the shipping company upon shipment of the goods. It is a contract between the shipper (exporter) and the shipping company for the carriage goods to the port of destination.
- The primary objective to GATT was to expand international trade by liberalising trade so to bring about all-round economic prosperity. The preamble to the GATT mentioned the following as its important objectives:
- Special focus on five traditional exports—agriculture, handicrafts, handlooms, leather and footwear and gems and jewellery so as to make exports employment oriented.

REVIEW QUESTIONS

1. Explain the meaning and nature of monetary fund.
2. What are the credit facilities involved in financing?
3. What is W.T.O? Explain the objectives and functions of W.T.O.

NOTES

4. What do you mean by letter of credit? Explain in details the type of letter of credit.
5. Write the advantages of letter of credit to the importer.
6. Explain the term bill of lading and it's types.
7. Discuss the role of GATT in international trade in the pre 1995 ERA.
8. Write a notes on the Foreign Trade Policy (2004-2009).

FURTHER READINGS

- **A Short Course in International Documentation:** Edward G. Hinkelman, Laxmi Pub., 2010, Third edition.
- **Agricultural Expansion and Tropical Deforestation: Poverty, International Trade and Land Use:** Solon L. Barraclough and Krishna B Ghimire, Viva Books, 2006, pbk.
- **Behind The Scenes At The WTO: The Real world of International Trade Negotiations:** Fatoumata Jawara and Aileen Kwa, Books For Change, 2003, pbk.